Taxpayer Beware: The Pitfalls of Section 965 Installment Payments

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For the taxable years ending on December 31, 2017, and 2018, Section 965[1] of the Internal Revenue Code required U.S. shareholders (as defined in Section 951(b)) to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations, treating those earnings as if they had been repatriated to the United States. Taxpayers could elect to pay the transition tax in installments over an eight-year period pursuant to Section 965(h).

Taxpayers who elected to pay the transition tax in installments are still struggling with the procedural elements of getting their transition tax paid.

Any individual or entity with a net tax liability under Section 965(h)[2] has the option to elect to pay the Section 965 net tax liability in eight equal installments under Section 965(h).[3]

Unless specific exceptions apply, the payment schedule for the installments is as follows:

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- 8% of the total liability for each of the first five installments;
- 15% of the total liability for the sixth installment;
- 20% of the total liability for the seventh installment; and
- 25% of the total liability for the eighth installment.[4]

The first installment is generally due on the original due date (excluding any extensions) of the tax return for the relevant taxable year. Each subsequent installment is due on the due date (excluding any extensions) for the tax return of the following taxable year after the one in which the prior installment was paid.[5] The relevant taxable year refers to either the Section 958(a) U.S. shareholder inclusion year or the taxable year in which the domestic pass-through entity owner has the Section 965(a) inclusion, depending on the situation—and that nuance is where the main issue generally begins for taxpayers.[6]

Taxpayers frequently worked with their accountants to get their Section 965(h) installment agreement in place and make their yearly payments with vouchers. However, since these installment payments are due annually, at the same time that taxpayers are making their income tax payments for the relevant year, taxpayers will frequently send a single check for both amounts. This is not the correct procedure and can lead to having the tax paid applied to their income tax liability for that year and erroneously refunded to the taxpayer, with no amount going to their Section 965(h) installment agreement. Similarly, if the taxpayer sends two checks, (1) one check for their income tax liability and (2) one check for their Section 965 liability and improperly designates their Section 965(h) installment payment check, the IRS has been known to also misapply the Section 965(h) installment payment. This happens because the Section 965 transition tax does not affect a majority of taxpayers. When the checks are sent to an IRS service center for processing, the people that open the mail and put the checks in piles for processing are not sophisticated tax professionals who can understand the effect of their actions when the IRS misapplies payments. They put checks in a pile, make sure that they get cashed, and move on with their day. Unfortunately for taxpayers, the outcome of the misapplication of payments can be disastrous.

If payments are misapplied or erroneously refunded to the taxpayer, the IRS will (falsely) determine that no amount was paid to the Section 965(h) installment agreement and the IRS will withdraw the taxpayer from that agreement making the entire Section 965 liability immediately due. If the IRS has removed a taxpayer from their Section 965(h) installment payment, and the entire Section 965 liability becomes due, the IRS will further assess interest and late payment penalties to that amount. When it happens in year 6 or 7 of the installment agreement on an already substantial tax bill, those amounts can be astronomical, even doubling the liability for the Section 965 inclusion year.

We have significant experience dealing with these issues in our practice and have helped a significant number of taxpayers reinstate their installment agreements, reapply payments to the correct tax years and periods, and get penalties and interest abated. If you are a taxpayer with a Section 965 liability or an accountant assisting with making transition tax payments, please feel free to reach out to our group with questions about properly designating checks for current payments, getting taxpayers properly reinstated in their Section 965(h) installment agreement, abating incorrectly assessed interest and penalties, or trying to resolve other errors from improperly applied checks in the past.

[1] Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., and all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.)

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[2] E.g., A Section 958(a) U.S. shareholder or a domestic pass-through entity owner of a Section 958(a) U.S. shareholder, provided the domestic pass-through entity itself is not a Section 958(a) U.S. shareholder.

[3] Treas. Reg. §1.965-7(b)(1).

[4] Section 965(h)(1); Treas. Reg. §1.965-7(b)(1)(i);

[5] Section 965(h)(2); Treas. Reg. §1.965-7(b)(1)(iii)(A);

[6] Treas. Reg. §1.965-7(b)(1)(iii)(A).

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