International Law Office

CORPORATE TAX - USA

IRS launches issue-based corporate compliance campaigns

February 24 2017 | Contributed by Caplin & Drysdale, Chartered

Introduction
Energy credit
Micro-captive insurance
Domestic production activities deduction
Related-party transactions
Deferred variable annuity reserves and life insurance reserves
Basket transactions
Completed contract method
TEFRA linkage plan strategy
S corporation losses claimed in excess of basis
Form 1120-F non-filer
Inbound distributor

Introduction

On January 31 2017 the Internal Revenue Service (IRS) launched its first wave of compliance campaigns. A 'campaign' is an issue-based compliance process centring on focused examinations, staffed with IRS experts on the targeted subject matter. The campaigns cover a broad range of topics, including Tax Equity and Fiscal Responsibility Act partnerships, micro-captive insurance transactions, transfer pricing and repatriation of foreign earnings. Working through the Large Business and International Division (LB&I), the IRS will deploy resources to investigate and remediate these issues through one or more 'treatment streams'.

This new issue-focused approach means that businesses dealing with any of the identified issues face increased IRS audit risk and should work with their legal advisers to prepare for IRS challenges to their positions. For the key campaigns that affect corporate taxpayers, this update identifies the targeted issues, explains the IRS strategy and provides insights on the implications of the campaign.

Energy credit

Section 48C of the Internal Revenue Code provides a tax credit to businesses that establish, expand or re-equip a manufacturing facility for the production of certain advanced energy property, such as solar panels, wind turbines, fuel cells or other property designed to reduce greenhouse gas emissions. The credit amount is equal to 30% of the qualified investment in selected manufacturing facilities.

In order to be eligible for the credit, taxpayers must apply in advance and have their facilities selected by the IRS. Notices 2009-72 and 2013-12 provide details on the rather extensive application process. The process requires, in part, that taxpayers submit concept papers to, and receive a recommendation from, the Department of Energy.

The IRS is concerned that taxpayers may be claiming Section 48C credits for projects that have not been approved by the Department of Energy or the IRS. LB&I has indicated that it will be issuing soft letters to taxpayers and commencing issue-focused examinations.

AUTHORS

Mark D Allison

Rachel L Partain

J Clark Armitage

James E Salles

Domestic production activities deduction

Section 199 of the code provides a tax deduction for certain domestic production activities. The deduction is calculated as a percentage of 'qualified production activities income', which includes, in part, certain gross receipts from 'qualified film' and computer software produced by the taxpayer.

The IRS is concerned that multi-channel video programming distributors (MVPDs) and television broadcasters may be improperly claiming this deduction. In particular, the IRS is concerned that certain of these taxpayers are taking the position that the subscription packages of channels or programmes that they distribute are, as a whole, 'qualified film' eligible for the Section 199 deduction, regardless of whether they or a third party produced the individual items of content provided in such packages. The IRS has released several private rulings over the past few years challenging this position. LB&I also states its concern that MVPDs may be improperly taking the position that they are entitled to the Section 199 deduction based on the fact that they are ultimately providers of computer software.

LB&I has indicated that it will be developing an externally published practice unit, potentially publishing additional guidance and, where warranted, commencing issue-based exams.

Micro-captive insurance

On the heels of identifying certain Section 831(b) captives as a reportable transaction with a reporting deadline of May 1 2017, the IRS campaign will be targeting LB&I 'micro-captive' insurance companies and entities taking a Section 162 deduction for the premium payments for examination. The Small Business/Self-Employed Division has been actively examining and litigating whether Section 831(b) captives are formed and operated as valid insurance companies, and has been conducting promoter examinations and summons enforcement actions. The Tax Court is expected to issue its first decision addressing Section 831(b) captives this summer.

Related-party transactions

LB&I will be examining related-party transactions for mid-market taxpayers. The IRS is concerned that taxpayers may use these transactions to shift or defer income, to avoid second-level taxation, to accelerate deductions or, in the worst cases, to commit fraud. This is one of the more open-ended campaigns. The targeted transactions are wide ranging and may involve Section 482 transfer pricing, reasonable compensation, disguised sales in the partnership context, like-kind exchange structures and so on. The IRS may also be focusing on debt-equity characterisation, which is an area of particular IRS emphasis following the issuance of Section 385 regulations.

Deferred variable annuity reserves and life insurance reserves

This is an industry issue resolution initiative, not an enforcement initiative, to provide guidance on life insurance companies' reserve computations that will be accepted for federal income tax purposes. This project is driven in part by the emergence for state regulatory purposes of stochastic methods of computing risk-based capital, as contrasted with the traditional state law methods of computing life insurance reserves that are reflected in Part I of Sub-chapter L of the Internal Revenue Code.

Basket transactions

Examinations of basket transactions is another focus of LB&I and several examinations have already commenced. The IRS has raised concerns that taxpayers are using basket transactions to defer the recognition of income and convert ordinary income and short-term capital gains into long-term capital gains.

Basket transactions are structured financial transactions entered into between an investor and a counterparty (typically, a bank), where the investor receives a return based on the performance of a notional 'basket' of actively traded securities, interests in hedge funds and/or other specified assets.

In Autumn 2015 the IRS issued two notices (2015-73 and 2015-74) designating certain basket

transactions as a listed transaction or a transaction of interest. Also in 2015, the IRS released CCA 201547004, explaining the substantive arguments that the IRS may raise in challenging these transactions.

LB&I also indicated that it will be issuing 'soft letters' to material advisers who arranged basket transactions for investors.

Completed contract method

The 'completed contract' method was widely used in the construction industry and among government contractors before the tax reforms of the 1980s. Taxpayers using this accounting method capitalise costs associated with the contract, but report no income until completion of the contract. It has been largely displaced by the 'percentage of completion' method, under which income is reported rateably as performance under the contract occurs. However, the Internal Revenue Code excuses taxpayers from the requirement to use the percentage completion method if their annual gross receipts are consistently under $10 million or if they are 'home construction contracts', which must relate to the construction of dwelling units in buildings of four units or less. (residential construction contracts that do not qualify as home construction contracts are subject to another, less favourable, special rule.)

The IRS is concerned that large home developers are using the method in circumstances when they are ineligible and plans to develop a 'practice unit' (guidance for auditing revenue agents), reach out to taxpayers that it suspects may be prone to these issues and, where warranted, follow up with audits. Cost allocation issues often arise when some of a taxpayer's contracts qualify for special treatment and others do not, when not all of the activity under a given contract may qualify or when land is developed in stages. Different rules may apply under the alternative minimum tax for taxpayers that are subject to it. Finally, numerous technical issues can arise when applying the percentage of completion method, especially for taxpayers that are transitioning to it.

TEFRA linkage plan strategy

Although a new partnership audit regime was enacted by the Bi-partisan Budget Act of 2015, TEFRA partnership examinations will continue for tax years prior to January 1 2018. The campaign will focus on creating new procedures and technology to ultimately assess tax on 'terminal investors' or the ultimate taxpayers which may be several layers deep in a multi-tier partnership or limited liability company structure. These procedures will be based on legal advice obtained by IRS Exam in IRS Office of Chief Counsel Memorandum Number AM2015-003, which advised that there is no legal requirement for the IRS to link direct partners or members on the IRS's Partnership Control System when it begins a TEFRA partnership-level examination. As a result, the IRS may now choose to assess only those ultimate taxpayers with the most significant compliance risks and can decline to push small adjustments to investors where the administrative burden is too great.

S corporation losses claimed in excess of basis

Sub-chapter 'S' corporations generally elect to be taxed as pass-through entities: the corporation's income, deductions and credits 'pass through' to the shareholders in proportion to their ownership. Shareholders' tax 'basis' in their shares is adjusted to reflect these items, as well as contributions and distributions of cash and property. Basis is critical because shareholders' use of deductions and credits from the S corporation is limited to their remaining share basis, plus money they have lent the corporation. This basis limitation on deductions and credits applies before and in addition to any other limits that might apply, such as the limitation on deductions to amounts 'at risk' and the deferral of deductions relating to passive activities.

The IRS is concerned that shareholders are failing to apply these rules correctly and are deducting current losses in excess of basis. Apart from developing a new form for shareholders to complete, it intends to start 'issue-based examinations' focusing on this issue. These types of controversy will often require reconstructing past reporting and may implicate issues concerning the structure of corporate financing (eg, it is often critical whether a third party lent to the shareholder(s) or the corporation). Even taxpayers that are not audited may find that they have to review these issues to properly prepare the new form.

Form 1120-F non-filer

A foreign company that conducts a trade or business in the United States is generally required to file a US return on which it reports its income effectively connected with that trade or business. The trade or business threshold is similar to, but typically presents a lower threshold for taxation than, the permanent establishment standard found in tax treaties: that is, a foreign company that does not have a US permanent establishment under an applicable treaty may nonetheless have a US trade or business. In such case the company must file a US return even though it might have no taxable income on account of the treaty, in order to claim the treaty protection.

A major tool for encouraging foreign companies to comply with their filing requirement is Section 882(c)(2), under which a foreign company that does not timely file a US return is denied deductions in computing its taxable income. Regulations allow relief from the disallowance of deductions if a taxpayer has reasonable cause for not filing, with a key factor being that the taxpayer comes forward before being discovered by the IRS. They also allow for the filing of 'protective returns' by taxpayers that believe they are not taxable, but want to avoid the risk of losing their deductions if the IRS disagrees. In this campaign, the IRS will issue 'soft letters' to potential identified non-filers to encourage them to come forward. It is unclear what incentives the IRS will provide to get these non-filers to comply voluntarily.

It is also unclear which non-filers the IRS intends to target. The announcement refers only generally to 'external data sources' that LB&I will use to identify non-compliant foreign corporations. Most likely, the campaign will focus on foreign multinationals with no reported US presence (ie, foreign groups that have no US subsidiaries and pay no US tax). Another target may be foreign corporations that the IRS believes have a dependent agency relationship with a US affiliate. The latter situations may be easier to identify and so present more immediate opportunities to staff involved in the campaign.

Inbound distributor

In this campaign, LB&I will assess whether returns earned by US distributors of tangible goods imported from foreign related parties are consistent with the arm's-length standard. The IRS has observed that such distributors often report small profits or even losses, which may be inconsistent with the functions performed and risks assumed. There are many reasons for a distributor to earn little or no profit in a particular year (eg, implementation of a market penetration strategy, inventory risk, exchange rate risk). Nonetheless, consistent low profits or losses, particularly for a limited risk distributor, may raise suspicions of income shifting. This campaign item is not a surprise since, as part of its knowledge management effort, LB&I published an international practice unit (IPU) to guide agents in their analysis of this issue. The IPU generally assumes that the comparable profits method is the best method and focuses on selection of tested party and profit level indicator, as well as identification of comparables. If Congress passes a destination-based cash-flow tax, this issue will become moot since a destination-based cash-flow tax, as currently framed in the Republicans' "A Better Way" platform, would not allow a deduction for imports, regardless of price.

For further information on this topic please contact Mark D Allison, Rachel L Partain or J Clark Armitage at Caplin & Drysdale, Chartered's New York office by telephone (+1 212 379 6000) or email (mallison@capdale.com, rpartain@capdale.com or carmitage@capdale.com). Alternatively, contact James E Salles at Caplin & Drysdale, Chartered's Washington DC office by telephone (+1 202 862 5000) or email (jsalles@capdale.com). The Caplin & Drysdale, Chartered website can be accessed at www.caplindrysdale.com.

The materials contained on this website are for general information purposes only and are subject to the disclaimer.