IRS Launches 13 Issue-Based Corporate Compliance Campaigns

February 3, 2017

On January 31, 2017, the Internal Revenue Service (IRS) launched its first wave of compliance "campaigns." A campaign is an issue-based compliance process centering on focused examinations, staffed with IRS experts on the targeted subject matter. The 13 identified campaigns (click *here* to access more information) cover a broad range of topics, including TEFRA partnerships, micro-captive insurance transactions, transfer pricing, repatriation of foreign earnings, and offshore voluntary disclosure. 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 businesses and high-net-worth individuals dealing with any of the identified issues face increased IRS audit risk, and should work with their legal advisors to prepare for IRS challenges of their positions.*** In this alert, for each of the 13 campaigns, we identify the targeted issue(s), explain the IRS strategy, provide relevant insights for how the campaign will impact taxpayers, and identify Caplin lawyers with experience in the area.

1. IRC 48C Energy Credit

Section 48C of the 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 percent 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 and/or the IRS. LB&I has indicated that it will be issuing soft letters to taxpayers and commencing issue-focused examinations.

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2. OVDP Declines-Withdrawals

LB&I has also announced that it is focusing attention on taxpayers who were either denied participation in the IRS's Offshore Voluntary Disclosure Program (OVDP), or were accepted and subsequently withdrew from the program or did not follow through with the required filings. In 2009, the IRS developed OVDP allowing taxpayers with undisclosed foreign accounts to initiate specified voluntary disclosures to resolve past income tax and reporting non-compliance relating to offshore accounts and assets. The Program provided a promise of no criminal prosecution and, in general, a cap on the civil penalty exposure. Although the resolution through OVDP frequently was a less expensive alternative than the significant FBAR and foreign information return penalties that might otherwise be imposed, not every taxpayer seeking participation in the Program was eligible. For example, the IRS would reject as untimely a proposed disclosure from a taxpayer who was already under civil examination or criminal investigation at the time of the request for "preclearance," the usual first step in entering the Program. Likewise, if the IRS had become aware of the taxpayer's unreported foreign account before receiving taxpayer's request for preclearance, it would not accept the taxpayer into OVDP. Also, there were many instances where individuals sought preclearance, and even submitted certain additional required information, but then either withdrew from the Program or simply did not complete its requirements.

In June 2016, TIGTA issued a report summarizing its review of IRS's management of OVDP and recommending, among other things, that the IRS scrutinize all cases where taxpayers either were denied preclearance or failed to complete the Program. Such taxpayers are at risk for potential FBAR civil penalty assessments and even possible criminal investigations. Following TIGTA's recommendation, LB&I is allocating resources to follow up on all such cases and apparently to implement a procedure to do so. As a result, we anticipate a significant increase in the IRS's examination and possible criminal investigation of offshore noncompliance cases, especially in connection with taxpayers who were denied participation in OVDP and who did not then take steps to rectify prior non-compliance, or even continued their non-compliance. Based on our experience, taxpayers who become targets of LB&I's new effort should expect offshore noncompliance audits to be protracted and potentially result in draconian penalties. The IRS will undoubtedly look for a few cases to prosecute criminally. Taxpayers who were denied participation in OVDP or otherwise did not follow through with the Program are strongly encouraged to develop a strategy in advance of the IRS commencing its investigation.

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3. Domestic Production Activities Deduction, Multi-Channel Video Program Distributors (MVPD's) and TV Broadcasters

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 amount 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 programs 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.

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4. 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 (SB/SE) 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.

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5. 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, etc. The IRS may also be focusing here on debt-equity characterization, which is an area of particular IRS emphasis following the issuance of section 385 regulations.

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6. Deferred Variable Annuity Reserves & Life Insurance Reserves IIR

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 the provisions of Part I of Subchapter L of the Internal Revenue Code.

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7. Basket Transactions

Examinations of basket transactions is another focus of LB&I, and we have already seen several examinations commence. 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 upon the performance of a notional "basket" of actively traded securities, interests in hedge funds, and/or other specified assets.

In the fall of 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 advisors who arranged basket transactions for investors.

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8. Land Developers – Completed Contract Method (CCM)

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 capitalize costs associated with the contract, but do not report any income until the completion of the contract. It has been largely displaced by the "percentage of completion method," under which income is reported ratably as performance under the contract occurs. However, the 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." "Home construction contracts" must relate to construction of dwelling units in buildings of 4 units or less. ("Residential construction contracts" that do not qualify as "home construction contracts" are subject to another, less favorable, 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 they suspect may be prone to these issues, and "when 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, or 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, there can be numerous technical issues with applying the percentage of completion method, especially for taxpayers that are transitioning to it.

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9. 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 who may be several layers deep in a multi-tier partnership or LLC 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 Service to link direct partners or members on the IRS's Partnership Control System (PCS) 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.

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10. S Corporation Losses Claimed in Excess of Basis

Subchapter "S" corporations elect to be taxed, generally, 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 controversies will often require reconstructing past reporting, and may implicate issues concerning the structure of corporate financing. (It is often critical, for example, whether a third party lent to the shareholder(s) or the corporation.) Even taxpayers that are not audited may find they have to review these issues to properly prepare the new form.

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11. Repatriation

LB&I will be targeting taxpayers for examination, particularly in the middle-market, that are using structures to bring offshore cash back into the U.S. tax free. These structures have included related-party loans and internal reorganizations and liquidations. The IRS believes that repatriation transactions are taxable. The IRS has challenged taxpayers' reporting positions (including in a Tax Court trial) and issued guidance to combat these transactions, asserting technical arguments as well as lack of economic substance and substance over form.

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12. Form 1120-F Non-Filer

A foreign company that conducts a trade or business in the United States generally is required to file a U.S. 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 U.S. PE under an applicable treaty may nonetheless have a U.S. trade or business. In such a case the company is required to file a U.S. 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 U.S. 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 nonfilers to encourage them to come forward. It is unclear what incentives the IRS will provide to get these nonfilers to comply voluntarily.

It is also unclear which non-filers the IRS intends to target. The announcement refers only very 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 (i.e., foreign groups that have no US subsidiaries and pay no US tax). But 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.

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13. Inbound Distributor

In this campaign, LB&I will assess whether returns earned by U.S. 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, of course, many reasons for a distributor to earn little or no profit in a particular year, such as implementation of a market penetration strategy, inventory risk, exchange rate risk, etc. 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 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 becomes moot since a DBCFT, as currently framed in the Republicans' "A Better Way" platform, would not allow a deduction for imports, regardless of price.

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Since its founding in 1964 by former IRS Commissioner Mortimer Caplin, Caplin & Drysdale lawyers have been at the forefront of resolving intricate tax compliance issues for the firm's corporate and high-net-worth clients. More than 70% of Caplin & Drysdale's lawyers practice in a specific area of tax law, including TEFRA partnerships, micro-captive insurance transactions, transfer pricing, repatriation of foreign earnings, and offshore voluntary disclosure. Moreover, our ranks include professionals who served in senior roles at the IRS, the Justice Department, and the Treasury. Their deep reserve of technical skills and insights on how tax law is written and administered exposes our clients to an unlimited wealth of legal knowledge and solution-based approaches to complex issues.

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