Practice

What to Expect from Newly Announced LB & I Compliance Campaigns

By Charles P. Rettig

The IRS Large Business and International division recently announced the identification and selection of various "compliance campaigns," an issue-based compliance process centering on focused examinations backed up by IRS-targeted subject matter experts. LB & I serves corporations, subchapter S corporations and partnerships with assets greater than $10 million. These entities typically have large numbers of employees, deal with complicated issues involving tax law and accounting principles and conduct their operations in an expanding global environment.

In 2016, LB & I transitioned from an enterprise-based examination system to an issue-focused examination system. The transition modified the historical focus on comprehensive, ongoing audits of the largest businesses to an approach focused primarily on centrally identified tax compliance risk issues. In conjunction with this transition, LB & I was restructured into nine "Practice Areas" organized on either a geographic basis or oriented toward specific subject-matters. The subject-matter Practice Areas include Passthrough Entities, Enterprise Activities, Cross Border Activities, Withholding and International Individual Compliance and Treaty and Transfer Pricing Operations. Multiple Practice Areas can be assigned during a single examination, each to address their designated Practice Area issue or issues and all included in the overall compliance plan.

Campaigns are intended to identify specific areas of potential noncompliance, identify intended compliance outcomes, identify specific, tailored treatment streams to achieve those outcomes, identify the resources needed to execute these tailored treatment streams, identify training, guidance, mentors and other support needed and effectively use feedback from employees to quickly modify our approach as needed. There is a designated lead executive responsible for overseeing the implementation of each campaign with assigned examiners and subject-matter specialists utilizing "tailored treatments" that concentrate on an inventory of specific centrally identified risk issues. Campaigns are intended to articulate observed or perceived noncompliance, describe expectations of compliance and create specific plans to move toward expected compliance. LB & I has indicated that it intends to retain an appropriate audit presence with some large taxpayers.

Campaigns are intended to focus on the right issues, using the right resources and using the right combination of treatment streams to achieve the intended compliance outcome. A campaign might involve an examination and/or some type of alternate treatment such as outreach or guidance. In addition, they could result in the provision of "soft touches" or "soft letters" alerting a particular taxpayer to

CHARLES P. RETTIG is a Principal with Hochman, Salkin, Rettig, Toscher & Perez, P.C. in Beverly Hills, California. Mr. Rettig is Past-Chair of the IRS Advisory Council, a member of the Advisory Board for the California Franchise Tax Board, a past-member of the Advisory Council for the California State Board of Equalization and a Regent and Elected Fellow of the American College of Tax Counsel.

LB & I concerns or comments with an activity the taxpayer has completed or is planning to complete.

It is important to note that, historically, examination processes and areas of perceived noncompliance are often identified within one function of the IRS organization but it is not uncommon for these processes to later be implemented elsewhere within the organization. Taxpayers having any involvement with any of the identified issues should anticipate an increased risk of a detailed examination and now begin coordinating information supporting positions reported within their returns. The 13 initial campaigns identified by LB & I are:

The IRS Large Business and International division recently announced the identification and selection of various "compliance campaigns," an issue-based compliance process centering on focused examinations backed up by IRS-targeted subject matter experts.

Withholding & International Individual Compliance Practice Area

- **OVDP Declines-Withdrawals Campaign.** The Offshore Voluntary Disclosure Program (OVDP) allows U.S. taxpayers to voluntarily resolve past noncompliance related to unreported offshore income and failure to file foreign information returns. This campaign addresses OVDP applicants who applied for pre-clearance into the program but were either denied access to OVDP or withdrew from the program of their own accord. Taxpayers, who have yet to resolve their noncompliance and who meet the eligibility criteria, are encouraged to consider entering one of the offshore programs currently available. The IRS will address continued noncompliance through a variety of treatment streams including examination.

  In June 2016, TIGTA issued a report "Improvements Are Needed in Offshore Voluntary Disclosure Compliance and Processing Efforts"[1] recommending, in part, that the IRS review all denied or withdrawn offshore voluntary disclosure requests for potential FBAR penalty assessments and criminal investigations; develop procedures for reviewing denied and withdrawn cases for further compliance actions; and centrally track and control OVDP requests. Following TIGTA's recommendation, LB & I is now allocating resources to follow up on the denied or withdrawn OVDP requests. Taxpayers who were denied participation in OVDP and who did not then take steps to resolve their earlier noncompliance, or otherwise did not follow through with their OVDP application should consult competent tax counsel.

Enterprise Activities Practice Area

- **Code Sec. 48C Energy Credit Campaign.** Code Sec. 48C 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.

  Taxpayers must apply in advance and have their facilities selected by the IRS as described in Notices 2009-72 and 2013-12. Only those taxpayers whose advanced energy projects have been approved by the Department of Energy, and who have been allocated a credit by the IRS, are allowed to claim the credit. These credits must be pre-approved through extensive application to the DOE. The treatment stream for this campaign will be soft letters and issue-focused examinations.
- **Domestic Production Activities Deduction, Multi-Channel Video Program Distributors (MVPDs) and TV Broadcasters.** Code Sec. 199 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. Multi-channel Video Programing Distributors (MVPDs) and TV Broadcasters often claim that "groups" of channels or programs are a qualified film eligible for the Code Sec. 199 deduction. The IRS is concerned that taxpayers are asserting that they are the producers of a qualified film when distributing channels and subscriptions packages that often include third-party produced content. Additionally, MVPD taxpayers maintain that they provide online access to computer software for the customers' direct use (incident to taxpayers' transmission activities, including customers' use of the set-top boxes). LB & I has developed a strategy to identify taxpayers impacted by these issues and will develop training to aid revenue agents in examining them.

  The IRS recently issued a private ruling determining that a Subscription Package is not a qualified film within the meaning of Code Sec. 199(c)(6) or Reg. §1.199-3(k)(1) because it is not property described in Code Sec. 168(f)(3) ("any motion picture film or video tape"), or "live or delayed television programming" within the meaning of Reg. §1.199-3(k)(1). Further, the IRS determined that the gross receipts derived from its Subscription Packages were not from the disposition of a qualified film produced by Taxpayer and are not domestic production gross receipts under Code Sec. 199(c)(4)(A)(i)(II) and Reg. §1.199-3(k).[2] The IRS is developing treatment streams for this campaign that include the development of an externally published practice unit, potential published guidance and issue-based exams, when warranted.

- **Micro-Captive Insurance Campaign.** This campaign addresses transactions described in Transactions of Interest Notice 2016-66,[3] in which a taxpayer attempts to reduce aggregate taxable income using contracts treated as insurance contracts and a related company that the parties treat as a captive insurance company. Each entity that the parties treat as an insured entity under the contracts claims deductions for insurance premiums.

  The IRS believes there are situations of abuse involving a legitimate tax structure involves certain small or "micro" captive insurance companies. The Code authorizes businesses to create "captive" insurance companies to enable those businesses to protect against certain risks. The insured makes payments to the captive and treats the payments as insurance premiums that are within the scope of Reg. §1.162-1(a) and deducts the payments as ordinary and necessary business expenses under Code Sec. 162. Often, the premiums end up with the captive insurance company owned by same owners of the insured or family members.

  The captive treats the payments received as premiums for insurance coverage. If the captive is not a domestic corporation, the captive makes an election under Code Sec. 953(d) to be treated as a domestic corporation. The micro-captive transaction is structured so that the captive has no more than $1.2 million in net premiums written (or, if greater, direct premiums written) for each tax year ($2.2 million for tax years beginning after December 31, 2016) in which the transaction is in effect. The captive makes an election under Code Sec. 831(b) to be taxed only on taxable investment income and excludes the premiums from taxable income.

  In some situations, underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The IRS believes the manner in which the contracts are interpreted, administered and applied may be inconsistent with arm's-length transactions and sound business practices. The policies may cover ordinary business risks or esoteric, implausible risks for exorbitant "premiums," while the insureds continue to maintain their far less costly commercial coverages with traditional insurers. Captive "insurance" policies may attempt to cover the same risks as are covered by the entities' existing commercial coverage, but the captive policies' "premiums" may be double or triple the premiums of the policy owners' commercial policies. Congress responded in The Protecting Americans from Tax Hikes (PATH) Act, effective Jan. 1, 2017, to curb micro-captive abuses by establishing diversification and reporting requirements for new and existing captives. LB & I has developed a training strategy for this campaign. The treatment stream for this campaign will be issue-based examinations.
- **Related Party Transactions Campaign.** This campaign focuses on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from the corporation to related passthrough entities or shareholders. LB & I is allocating resources to this issue to determine the level of compliance in related party transactions of taxpayers in the mid-market segment. The treatment stream for this campaign is issue-based examinations.
- **Deferred Variable Annuity Reserves & Life Insurance Reserves IIR Campaign.** The IRS and Chief Counsel have accepted the Deferred Variable Annuity Reserves and Life Insurance Reserves issues into the Industry Issue Resolution program (pursuant to Rev. Proc. 2016-19) to develop guidance to address uncertainties on issues important to the Life Insurance Industry. The issues include amounts to be taken into account in determining tax reserves for both deferred variable annuities with Guaranteed Minimum Benefits, and Life Insurance contracts. The campaign's objective is to collaborate with industry stakeholders, Chief Counsel and Treasury to develop published guidance that provides certainty to taxpayers regarding these related issues.
- **Basket Transactions Campaign.** This campaign addresses structured financial transactions described in Notices 2015-73 and 74,[4] in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The term "Basket Transaction" refers to a transaction to which either Notice 2015-73 or Notice 2015-74 applies. The difference between the two notices is the type of contract used and the assets in the reference basket. The taxpayer treats the option or other derivative as open until a barrier event

occurs, and, therefore, does not recognize or report current period gains. The gains are deferred until the contract terminates, at which time the overall net gain is reported as a Long Term Capital Gain. LB & I has developed a training strategy for this campaign.

Taxpayers take the position that if the Basket Transaction is held for more than one year, the gain realized upon the disposition of the Basket Transaction is treated as long-term capital gain. Taxpayers effectively defer reporting income from the performance of the reference basket until the transaction terminates. Also, the character of the income generated by the reference basket, such as short-term capital gain, interest income, dividend and other ordinary periodic income from the performance of the reference basket, is purportedly converted to long-term capital gain. The IRS is concerned that taxpayers may be using Basket Transactions to inappropriately defer income recognition or convert ordinary income or short-term capital gain into long-term capital gain. In some cases, taxpayers also may be mischaracterizing the form of the transaction to avoid application of Code Sec. 1260. The treatment streams for this campaign will be issue-based examinations, soft letters to Material Advisors and practitioner outreach.

- **Land Developers—Completed Contract Method (CCM) Campaign.** The IRS believes that large residential land developers may be improperly using the Completed Contract Method (CCM) of accounting. A developer, whose average annual gross receipts exceed $10 million, may only use the CCM under a home construction contract. In some cases, developers may be improperly deferring all gain until the entire development is completed.

  Under the CCM, costs associated with the contract are capitalized, but income is not reported until the completion of the contract. Under the different "percentage of completion method" income is reported ratably as performance under the contract occurs. However, Code Sec. 460(e) 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 four units or less. "Residential construction contracts" that do not qualify as "home construction contracts" are subject to another, less favorable, special rule. LB & I will provide training for revenue agents assigned to work this issue. The treatment stream includes development of a practice unit, issuance of soft letters and follow-up with issue-based examinations when warranted.

Passthrough Entities Practice Area

- **TEFRA Linkage Plan Strategy Campaign.** As partnerships have become larger and more complex, LB & I has regularly revised processes to assess tax on the terminal investors (the ultimate taxpayers who may be several layers deep in a multi-tier partnership or LLC structure). The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") added Code Secs. 6221 through 6232 providing unified partnership audit and litigation procedures for partnerships (except certain small partnerships) filing Form1065, *U.S. Return of Partnership Income (TEFRA partnerships)*. Under the unified partnership audit and litigation procedures, the TEFRA partnership return is subject to a single audit and court proceeding binding on all the direct and indirect partners. A new partnership audit regime was enacted by the Bi-partisan Budget Act of 2015. However, TEFRA partnership examinations will continue for tax years prior to January 1, 2018.

  The IRS uses its Partnership Control System computer database to link to the TEFRA partnership return under examination the tax returns of the direct and indirect partners, to mechanically generate the required notices and to flow any adjustments made in the partnership examination through to the partners. Legal advice set forth in IRS Office of Chief Counsel Memorandum Number AM2015-003 provides that there is no legal requirement for the IRS to link any, all or some partners or members on the IRS's Partnership Control System (PCS) when it begins a TEFRA partnership-level examination. Further, the IRS is not required to issue any notice to a partner if it decides not to make adjustments to the partnership return and it does not need to notify a partner that it will not be making an assessment. This campaign focuses on developing new procedures and technology to assist the revenue agent conducting the TEFRA partnership examination to identify, link and assess tax to the terminal investors that pose the most significant compliance risk.
- **S Corporation Losses Claimed in Excess of Basis Campaign.** S corporation shareholders report income, losses and other items passed through from their corporation. The Code limits losses and deductions to their basis in the corporation. Unlike a C corporation, each year a shareholder's stock and/or debt basis of an S corporation increases or decreases based upon the S corporation's operations. If a shareholder is allocated an item of S corporation loss or deduction, the shareholder must have adequate stock and/or debt basis to

claim that loss and/or deduction item. In addition, even when the shareholder has adequate stock and/or debt basis to claim the S corporation loss or deduction item, the shareholder must also consider the at-risk and passive activity loss limitations and therefore may not be able to claim the loss and/or deduction item. In computing stock basis, the shareholder starts with their initial capital contribution to the S corporation or the initial cost of the stock they purchased (the same as a C corporation). That amount is then increased and/or decreased based on the flow-through amounts from the S corporation. An income item will increase stock basis while a loss, deduction or distribution will decrease stock basis.

LB & I is concerned that shareholders are failing to comply with the foregoing rules and might be claiming losses and deductions to which they are not entitled because they do not have sufficient stock or debt basis to absorb these items. LB & I has developed technical content for this campaign that will aid revenue agents as they examine the issue. The treatment streams for this campaign will be issue-based examinations, soft letters encouraging voluntary self-correction, conducting stakeholder outreach and creating a new form for shareholders to properly compute their basis.

Cross Border Activities Practice Area

- **Repatriation Campaign.** The IRS is aware of different repatriation structures being used for purposes of tax-free repatriation of funds into the United States in the mid-market population. LB & I believes that many taxpayers do not properly report repatriations as taxable events on their filed returns.

  Taxpayers may utilize a variety of devices to conceal transfers of money or other property to a foreign entity, where the income it generates may be hidden. The simplest method of diverting income is sending skimmed income to an offshore account or entity. Other methods used to transfer money or other property offshore include the use of payments disguised as deductible expenses (for example, rents or purchases) paid to entities controlled by the taxpayer and generally located in a tax haven jurisdiction. Some of the most popular methods of repatriating funds include the following:
  - Credit cards that simply draw on the U.S. taxpayer's offshore account
  - Loans from mystery offshore lenders
  - Loans from domestic lenders in amounts beyond the taxpayer's apparent borrowing power (may be secured by offsetting deposits of offshore funds)
  - Use of property titled to offshore entities at zero or below-market rental
  - Bogus transactions designed simply to transfer funds to or from offshore entities, such as sales of property to offshore entities in jurisdictions where it is unlikely the property will actually be used or sold
  - Gifts
  - Scholarships for taxpayer's children
  - "Payable Through" accounts

  The goal of this campaign is to simultaneously improve issue selection filters while conducting examinations on identified, high-risk repatriation issues and thereby increase taxpayer compliance.
- **Form 1120-F Nonfiler Campaign.** Foreign companies doing business in the United States are often required to file Form 1120-F to report the income, gains, losses, deductions, credits and to figure the U.S. income tax liability of a foreign corporation. LB & I believes that many of these foreign companies are not satisfying their filing obligations. A foreign corporation that maintains an office or place of business in the United States must generally file Form 1120-F by the 15th day of the fourth month after the end of its tax year. A foreign corporation that does not maintain an office or place of business in the United States must generally file Form 1120-F by the 15th day of the sixth month after the end of its tax year.

  In this campaign, LB & I will use various external data sources to identify these foreign companies and encourage them to file their required returns. The treatment stream for this campaign will involve soft letter outreach. If the foreign companies do not take appropriate action, LB & I will conduct examinations to determine the correct tax liability. The goal is to increase voluntary compliance by foreign corporations with a U.S. business nexus.

Treaty and Transfer Pricing Operations Practice Area

- **Inbound Distributor Campaign.** U.S. distributors of goods sourced from foreign-related parties have incurred losses or small profits on U.S. returns, which LB & I believes are not commensurate with the functions performed and risks assumed. In many cases, LB & I believes the U.S. taxpayer would be entitled to higher returns in arm's-length transactions. LB & I will evaluate whether a transfer price charged in a controlled transaction is arm's length by comparing the gross profit margin realized in a controlled transaction to gross profit margins observed in uncontrolled transactions.

  In order to determine if the transaction is arm's length, the transactions or companies must be sufficiently comparable to the controlled transaction. Some of the key elements of comparability are functions performed, assets employed, contractual terms, risks, economic conditions and property and/or services. Factors that could affect prices or profits include functions performed, contractual terms, risks borne, economic conditions and property or services. LB & I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this Code Sec. 482 issue. The treatment stream for this campaign will be issue-based examinations.

These campaigns represent the initial wave of LB & I's issue-based compliance work. More LB & I campaigns will continue to be identified, approved and launched in the coming months. Tax practitioners should be aware of the focused nature of these and other campaigns since the IRS can be expected to bring together a team of specialists to coordinate the compliance review and, if necessary, detailed examinations. When facing an examination involving issues described in an LB & I campaign prepare, prepare, prepare … and then prepare some more.

ENDNOTES

[1] TIGTA *Improvements Are Needed in Offshore Voluntary Disclosure Compliance and Processing Efforts* (June 2, 2016; Reference Number: 2016-30-030).

[2] IRS TAM 137619-15 (Number: 201646004; Release Date: Nov. 10, 2016).

[3] *See* IR–2016–25 discussing characteristics of an abusive micro-captive insurance structure.

[4] *See also* CCA 201547004 setting forth various substantive arguments the service might use to challenge Basket Transactions.