Significant LB&I Examination Developments

By Samuel A. Mitchell

Over the last year, the IRS's Large Business and International Division (LB&I) has reorganized and started to transition to a new way of examining large corporate taxpayers that it hopes will enable it to more efficiently resolve issues with its increasingly limited resources. The new approach—referred to as a "campaign" approach—has not been fully described or implemented yet, but it is apparent that is not just a reordering of procedures or reshuffling of boxes on an organization chart. Rather, it seems at this point to be a fundamental change of practice. LB&I is moving from a continuous general examination approach to an issue-focused approach under various "campaigns." There will be many changes in practice. This piece is not intended to cover the entire scope of the changes, but just to highlight three general points that should be considered now. First, the campaign approach may present new opportunities to resolve industry issues on a global basis through Industry Issue Resolution (IIR) procedures similar to the successful insurance industry IIRs for bad debts and Variable Annuity hedging. Second, for those insurance company taxpayers that continue to be examined under the campaign approach, the administrative changes to the exam process will require more and earlier participation by tax departments and supporting actuaries and more and earlier cooperation with IRS examination teams. And third, it is apparent that not all insurance company taxpayers that have been examined in the past will continue to be examined under the campaign approach. This may seem like great news, but it presents some administrative complexities that should be considered and planned for now.

Just what is the campaign approach, and how will it affect insurance company taxpayers? As of the time of this writing,[1] LB&I has only described the overall approach and has not filled in many details, but the approach is part of an overall restructuring of the organization that is public and we at least know who is responsible for dealing with insurance issues and we have some idea of how issues for campaigns will be identified. In general, LB&I has been restructured into five subject-matter practice areas and four geographic practice areas.[2] The subject-matter practice areas are Pass-Through Entities, Enterprise Activities, Treaty and Transfer Pricing, Withholding and International Individual Compliance and Cross-Border Activities.[3] Each subject-matter practice area is led by a director, to whom other directors and senior managers report. The geographic practice areas are Northeast, East, Central and West.[4] Similarly, the geographic practice areas are led by directors who have the titles director, Northeastern [Eastern, Central and Western respectively] Compliance Practice Area. The insurance industry is being handled by the Enterprise Activities Practice Area, which will also handle other financial institutions, financial products and corporate credits. The Enterprise Activities Practice Area is currently led by Director Kathy Robbins, who is located in Houston, Texas. The director who reports to Robbins and is responsible for insurance companies is Gloria Sullivan, who is located in Oakland, California. A senior manager covering insurance, banking and finance will report to Sullivan. The senior manager is Deborah Inganamorte (program manager, Insurance, Banking and Financial Institutions), located in New York City. It appears that Inganamorte will be the point person for insurance issues.

LB&I has not described how they are identifying issues and creating campaigns, but the general idea is described in an internal memorandum entitled "FY2016 Focus Guide," from the LB&I Commissioner, Douglas O'Donnell, to LB&I staff, published in January 2016. In the memorandum to employees, Commissioner O'Donnell describes the campaign approach as follows:

> We plan to use the combined input of our workforce and data analysis to identify areas of noncompliance and strategically focus resources to these areas. 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.

The commissioner's descriptive bullet points for the campaign approach are difficult to interpret without inside knowledge or further explanation that so far has not been forthcoming. However, it seems apparent that personnel with subject-matter expertise in the practice areas described above will identify compliance issues and collaborate with others in the organization to pursue the issues in the particular industry and promote

compliance. At one point, there was some discussion of a type of hub-and-spoke system in which examiners would focus on select taxpayers in an industry, identify issues, and then leverage that experience into more limited scope examinations of other industry taxpayers that may have the same issues—this may be one type of "treatment stream" referenced in the commissioner's comments.

INCREASED POTENTIAL FOR GLOBAL RESOLUTIONS

The issue identification and development for "treatment streams" probably will allow for a flexible approach that will encompass a number of different issue-identification methods and implementation processes. As of the time of this writing, LB&I has announced the formation of three campaigns, which include one insurance campaign.[5] The insurance campaign is focused on captive insurance, and this topic likely emerged as a campaign because it is on the guidance plan and has been the subject of significant recent litigation.[6] This flexibility in the "campaign" issue identification and "treatment stream" approach may present opportunities for insurance company taxpayers and other taxpayers to resolve more issues with LB&I on a global basis. For example, industry participants could submit Industry Issue Resolution (IIR) requests under the process described in Rev. Proc. 2016-19, 2016-13 I.R.B. 497, similar to successful efforts in the recent past for insurance company bad debts and variable annuity hedging, which resulted in safe harbor approaches described in LB&I Commissioner Directives. The IIR process is not an examination process *per se*, but a global resolution "treatment stream" is consistent with the resource-saving rationale that underlies the campaign approach as described so far. An LB&I official said as much in a conference earlier this year, noting that the campaign approach might not always involve an examination and may include such things as soft letters or IIRs.[7] Insurance company taxpayers should be encouraged by this possibility, and particularly so in light of the significant examination efficiencies companies and LB&I have achieved in the two recent insurance industry IIRs involving bad debts and variable annuity hedging.

PROCEDURAL CHANGES THAT WILL AFFECT WORK-FLOW

Along with the new and developing methods for selecting issues for examination and enforcement, LB&I has changed its procedures for the taxpayers that will be examined. These changes were explained for the most part in IRS Publication 5125, which was finalized in February 2016, and have since been incorporated in the Internal Revenue Manual (I.R.M.).[8] In general, Publication 5125 explains that an examination will have three phases, which are a planning phase, an execution phase and a resolution phase. The phased approach is not all that different from prior procedures, but some of the details encompass significant changes in procedure that will affect the work-flow of tax departments and supporting actuaries. The two most significant procedural changes that will result in work-flow changes pertain to informal refund claims and the fact gathering procedures that agents must follow before sending un-agreed issues to IRS Appeals.

Regarding refund claims, the new procedures explained in Publication 5125 provide that taxpayers should bring informal claims to the attention of the examination team as soon as the taxpayer becomes aware of any potential claim for refund. The publication furthermore explains that LB&I will only accept informal claims that are asserted within 30 calendar days of the opening conference. Claims raised after the 30-day mark must be submitted on amended tax returns (*i.e.*, a Form 1120X) that are filed under normal refund claim procedures unless the issue is identified for examination or unless the taxpayer can convince LB&I senior management to grant an exception. The amended returns will be subject to the procedures for evaluating examination resources and may or may not be included in the current examination. Although this change is intended to result in resource efficiencies, it is a significant departure from past practice that may actually have an adverse effect on efficiency for both LB&I and taxpayers. In the past, taxpayers answering Information Document Requests (IDRs) or just simply reviewing the tax return filings would find and routinely assert affirmative claims that were not necessarily related to the issues under examination but nevertheless were discovered in the process of dealing with those issues. The new requirement to file amended returns for such issues will just delay the ultimate resolution of each examination cycle and may cause further delays after an appeal.

If an issue has to be filed on an amended return, it may be in the taxpayer's best procedural interest to file it at the end of the IRS's assessment statute in order to close the assessment statute as soon as possible and to minimize the expenses involved in corollary state filings. This means that taxpayers may have the incentive to file latent claims—that they did not discover early on—very late in the process, after a cycle has gone through an administrative appeal and the IRS's assessment statute has closed. The Internal Revenue Code allows taxpayers a period of six months after the IRS's assessment statute closes to file a refund claim if the assessment statute has been extended past its normal date,[9] and virtually all examinations result in extended statutes. In view of these potential delays, LB&I likely will adopt a common-sense approach to dealing with claims that taxpayers discover after the 30-day mark, particularly when it is evident from the surrounding circumstances that the taxpayer is not attempting to game the system. However, because the new rules literally require amended returns for late-discovered issues, it will be in the taxpayer's best interest to be more proactive in finding and asserting issues before the opening conference and the 30-day period begins. This obviously will accelerate the workflow of tax departments and the supporting actuaries.

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The other procedural change that may accelerate workflow pertains to the facts that are forwarded to the IRS Appeals Division on unagreed issues. Publication 5125 explains that the examination team is required during the execution phase of the examination to attempt to procure a written acknowledgement in an IDR of all the relevant facts before issuing a Notice of Proposed Adjustment to the taxpayer. The fact-acknowledgement IDR process is intended to conform the exam procedures with the new Appeals Division approach, known as Appeals Judicial Approach and Culture (AJAC), under which the Appeals Division will refer a case back to the Examination Division if either the examination division or the taxpayer attempts to introduce new facts into the appeal that were not considered during the examination. The I.R.M. was recently updated in order to incorporate procedures for the fact-acknowledgement process. I.R.M. Exhibit 4.46.4-3 provides a pattern IDR for the acknowledgement. Under the pattern request, the examination team provides the pattern IDR that incorporates a pro-forma Form 886-A that contains a fact statement and a statement of the exam team's proposed position and adjustment. The pattern IDR seeks a check-box type of acknowledgement with respect to the fact statement in the Form 886-A that (1) the facts are accurately stated; (2) the taxpayer is providing additional facts and supporting documents; or (3) the taxpayer is identifying disputed facts and provides additional clarification and/or documentation.

It is difficult at this stage to know exactly how taxpayers should respond to the fact-acknowledgement IDRs because, at least so far, the fact statements appear to differ little from the fact statements in revenue agents' reports that have been sent to the Appeals Division under prior procedures. It is only natural for an exam team drafting facts to draft the facts in a way that is spun in favor of the team's position. This places taxpayers in a difficult position. So far, the best approach in response to these IDRs appears to be to provide a written response in which the taxpayer (1) points out obvious errors, (2) reserves the right for further objections, (3) incorporates by reference the information that has been provided during the examination, and (4) provides any additional information and documents that were not covered by the earlier issued IDRs. Taxpayers have some flexibility in the level of response to fact-acknowledgement IDRs because the I.R.M. clarifies that the IDRs are not subject to the summons enforcement and other strict procedures that apply to other IDRs.[10] However, because of the Appeals Division AJACs approach regarding new facts, it is critically important to provide any relevant facts and documents that the examination team perhaps should have asked for but did not in the IDR process. Although this will accelerate the work-flow of the tax department and actuaries, it will save time and resources for both the taxpayer and LB&I in the long run as they go through the administrative appeal process.

REDUCTION IN EXAMINATIONS

Whatever final form the new campaign approach takes, it is important to understand that the process is inconsistent with the Coordinated Industry Case (CIC) examination process that large life insurance companies have grown accustomed to over the years.[11] CIC taxpayers have essentially experienced continuous examinations under two-year examination cycles. Under the campaign approach, many CIC taxpayers may not be examined as regularly or at all in the future unless they encounter an IRS "campaign" as the CIC procedures are phased out. As mentioned above, fewer examinations may seem like great news, but

there are procedural problems that may make things even more complicated for taxpayers that are used to a continuous examination process. The most significant problem relates to the correction of mistakes on the filed returns. There are no tax returns that are any more complex than a large life-nonlife consolidated tax return and inevitably mistakes occur. Revenue Procedure 94-69, 1994-2 C.B. 804, permits CIC taxpayers to avoid negligence and substantial understatement penalties with respect to mistakes and other items on the examined returns through filing written statements (Qualified Amended Returns, or QARs) during the examination. It has been routine for taxpayers to correct items like reserve errors through this process. At this point, the only clearly defined method for taxpayers that no longer have the Rev. Proc. 94-69 QAR process to correct mistakes will be to file amended tax returns, which is a labor intensive process that involves corollary state filing obligations. Taxpayers that have been notified that years may be skipped for examination or that they are not going to be examined should open discussion now with LB&I regarding how to deal with potential QARs on the skipped years.

CONCLUDING THOUGHTS

Over the last few years as the IRS's overall budget has been constrained it has become apparent that LB&I has had to struggle and innovate to keep up with its enforcement mission in the large business and international segment. Thus far, LB&I has done an admirable job of making procedural changes, such as the IDR procedures released in 2013 and 2014 that are designed to make the examination process more efficient,[12] and cooperating with taxpayers through such mechanisms as the Industry Issue Resolution process to resolve significant issues in a resource-sensitive way. The new campaign approach appears to be a natural step in this movement toward more efficiency, although it will present some administrative filing difficulties and may create some additional burdens. As the process is rolled out and completed, insurance company taxpayers would be wise to seek opportunities to take advantage of additional possible global resolutions and be cognizant of the potential procedural problems that may arise. ■

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ENDNOTES

1 July 2016.

2 *See* the LB&I Division Directory, available at https://www.irs.gov/businesses/large-business-and-international-lb-i-division-directory, referenced here as of July 2016.

3 *Id.*

4 *Id.*

5 Comments of Cheryl Teifer, Director, Field Operations Transfer Pricing Practice Area, at a tax conference, as reported in Stephanie Soong Johnston, "New IRS LB&I Campaigns Approved With More Under Evaluation," Tax Analysts Highlights & Documents, June 10, 2016, at 5273.

6 *See, e.g., Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014), *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225; *see also* Office of Tax Policy and Internal Revenue Service 2015-2016 Priority Guidance Plan.

7 Comments of Thomas Kane, LB&I Division Counsel, at a tax conference, as reported in Amy S. Elliott, "LB&I's First Audit Campaigns to Be Announced Soon," Tax Analysts Highlights & Documents, June 9, 2016 at 5200.

8 *See* generally I.R.M. section 4.46.4 Executing the Examination.

9 I.R.C. § 6511(c)(1).

10 *See* I.R.M. section 4.46.4.9.3.

11 The campaign approach also may have implications for the future of the Compliance Assurance Process (CAP) program for large taxpayers under which the taxpayer and the examination team collaborate on potential issues during the return filing process. The CAP program consumes LB&I resources and may be in jeopardy.

12 *See* LB&I 04-0214-004 (Feb. 28, 2014); LB&I 04-1113-009 (Nov. 4, 2013); and LB&I 04-0613-004 (June 18, 2013).