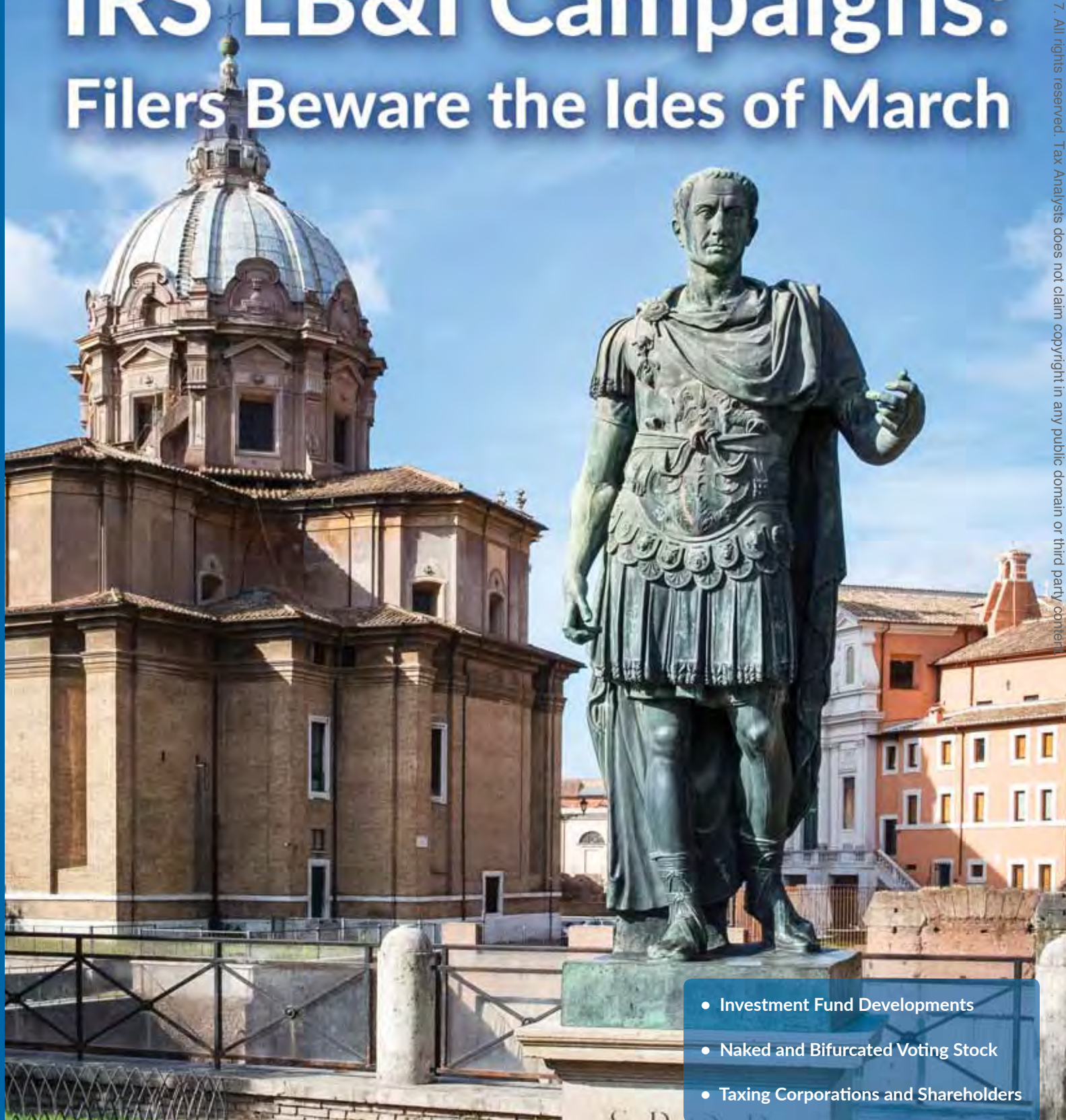


IRS LB&I Campaigns: Filers Beware the Ides of March



- Investment Fund Developments
- Naked and Bifurcated Voting Stock
- Taxing Corporations and Shareholders

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by Gary M. Wells

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In this article, Wells analyzes the application of the IRS's future state initiative, focusing on how it will affect the Large Business and International Division's new campaign-style enforcement goals and initial 13 targets.

The Latin phrase “Veni, vidi, vici” (“I came, I saw, I conquered”) is attributed to Julius Caesar. It succinctly described, from Caesar’s perspective, the prosecution and outcome of his campaign against Pharnaces II from its initiation, planning, and successful resolution. It is easy to draw a comparison between the IRS and Caesar for their large number of foes and willingness to defend their own states’ interests.

The IRS Large Business and International Division might have set its sights on a similar result in its goal to challenge noncompliance and other return filing issues. This is reflected in LB&I’s choice of the moniker “campaign” for its new audit program approach. What taxpayers want to know is whether that campaign will produce decisive results, like Caesar’s, or merely expend limited IRS resources in a war of attrition.

Future State Initiative

In early 2016, LB&I publicly announced a reorganization and reform plan to accommodate the transition away from the enterprise-wide

approach to examinations to a campaign-style, issue-based approach to address noncompliance.¹ Although the IRS had undergone numerous reorganizations over the previous 40 years, many of them merely shifted personnel, expertise, and responsibility for the subject matter across the agency, without changing the fundamental approach to the examination process.² Under pressure to do more with less as a consequence of shrinking budgetary resources, a declining number of employees, and additional tax priorities (for example, identity theft and Affordable Care Act requirements), the IRS leadership stepped forward in September 2015³ by posing its own defining vision of the future state.

In the future state, the IRS essentially adapts all facets of its central mission and then reconstructs and refines its needs assessment to acknowledge the tighter budgetary demands and additional unfunded mandates of Congress. The future state initiative seeks to reshape the process “to improve taxpayer service, enforcement and operations in an environment of limited resources and rapid changes in technology.” The IRS announced its intent to reorient itself to the issues facing the agency’s personnel, including enforcement objectives and its approach to taxpayers. The future state initiative enlisted IRS leadership and line personnel to consider and participate in six strategic themes to arrive at the future state:

- improve the online return filing experience;

¹ See IRS FY 2016 Focus Guide, “Working Together in New Ways to Enhance Taxpayer Compliance,” Doc. No. 11809 (rev. Jan. 2016).

² The IRS announced its current divisional structure September 28, 2000, with the introduction of the Wage and Investment, Small Business/Self-Employed, Large and Midsize Business (later renamed Large Business and International), and Tax-Exempt/Governmental Entities divisions.

³ IRS leadership announcement at the TEI/IRS Financial Services Conference in New York (Sept. 17, 2015).

- understand noncompliant taxpayer behavior and find new ways to deter and alter it;
- leverage and collaborate with external stakeholders about tax administration issues to gain insight into risks that exist to a safe and secure tax system;
- cultivate a well-equipped, diverse, skilled, and flexible IRS workforce;
- take advantage of the latest technologies to identify emerging issues and better detect tax noncompliance; and
- find ways to make IRS operations more efficient and effective across the board.⁴

The themes reflect the high-level objectives for the IRS and its divisions to consider when marshaling their assets and reworking their processes to reach the future state. All these objectives, on their face, should be applauded as noble and appropriate. Each of the divisions has been tasked with translating the future state's strategic goals to action and addressing and updating their own work plans and work streams. No doubt each division will confront different obstacles not only in reaching its desired destination but, more immediately, in starting that process. To date, only two of the four IRS divisions — the Small Business/Self-Employed Division and LB&I — have made any noticeable progress toward the future state. The latter division has gone further. Table 1 summarizes the taxpayers each of the four IRS divisions (customer-facing only) serve.

Table 1. Structure of the IRS

IRS Division	Current Commissioner	Taxpayer Profile
Large Business and International Division	Douglas O'Donnell	Serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million; U.S. citizens and residents with cross-border activities; and nonresidents with U.S. activities.

⁴Speech by IRS Commissioner John Koskinen to the American Institute of CPAs (Nov. 15, 2016).

Table 1. Structure of the IRS (Continued)

IRS Division	Current Commissioner	Taxpayer Profile
Small Business/Self-Employed Division	Mary Beth Murphy	Serves approximately 57 million taxpayers, including self-employed persons (about 41 million), small businesses with assets of less than \$10 million (9 million), and filers of employment (about 7 million), excise, estate, and gift tax returns. Serves individuals reporting company income on schedules C, E, and F of Form 1040 and companies with assets less than \$10 million.
Wage and Investment	Ken Corbin	Serves most of the 120 million individuals who pay taxes only through withholdings. More than half of the individuals prepare their own returns. Most filers interact with the IRS once a year, and most receive refunds. ^a
Tax Exempt and Government Entities	Sunita Lough	Serves approximately 3 million customers divided into three segments: employee plans, exempt organizations, and government entities. ^b

^aInternal Revenue Manual section 1.1.1.4, "Structure of the IRS" (June 2, 2015). See also Wage & Investment Division, "At-a-Glance."
^bIRM section 1.1.1.4.

LB&I Reorganization, Enforcement Goals

LB&I serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million; U.S. citizens and residents with cross-border activities; and nonresidents with U.S. activities. An estimated 250,000 entities

(corporations and partnerships) fall within LB&I's jurisdiction.⁵ Any LB&I change is a matter of great importance to corporate tax departments, because they are responsible for defending their company's interests against potential incursions under LB&I's enforcement powers.

In February 2016 the IRS took its first substantial step toward the future state with a reorganization of LB&I. The nine industry-based practice areas were folded into four geographic practice areas (Northeastern, Eastern, Central, and Western) and five subject matter practice areas (passthrough entities, enterprise activities, cross-border activities, withholding and international individual compliance, and treaty and transfer pricing operations).

The new practice areas are less recognizable as industry-focused areas. They center on different taxpayer groups based on income type, income origination (for example, U.S. or foreign source), and taxpayer-type (for example, corporate or passthrough). As is readily apparent, three of the new practice areas focus on international issues. The cross-border activities area captures international issues not falling within treaty and transfer pricing or withholding and international individual compliance.⁶

Although some former LB&I industry groups migrated to a specific practice area in the future state reorganization, the new subject matter practices appear to have a broader mandate than the prior industry practice areas and, as a consequence, will serve entity types and tax reporting constructs more so than specific industries. In one case, a former industry practice area was folded into a geographic group: global high-wealth migrated to Western.

Under the realigned LB&I a taxpayer, like a multinational enterprise, may be subject to multiple practice areas when the examination covers multiple issues. For example, a U.S. bank in New York with international operations could be subject to the Northeast, enterprise activities, treaty and transfer pricing operations, and withholding and international compliance areas.

Table 2 outlines the former nine industries and how the examiners were apparently reallocated in the future state, based on a review of the organization chart.

Table 2. Reallocation of Industry Practice Area

Industry Practice Area Name Before Future State (pre-Feb. 2016)	New Subject Matter Practice Area Name in Future State
1. Communications, Technology, and Media	Enterprise Activities (corporate) or Passthrough Entities
2. Financial Services	Enterprise Activities (all)
3. Heavy Manufacturing and Pharmaceutical	Enterprise Activities (corporate) or Passthrough Entities
4. Natural Resources and Construction	Enterprise Activities (corporate) or Passthrough Entities
5. Retailers, Food, Transportation, and Healthcare	Enterprise Activities (corporate) or Passthrough Entities
6. Global High-Wealth	Western Compliance
7. International Business Compliance	Cross Border Activities
8. International Individual Compliance	Withholding and International Compliance
9. Transfer Pricing Operations	Treaty and Transfer Pricing Operations

On January 31, LB&I identified its first 13 campaigns, providing a glimpse into how it will put into operation its move away from industry- and enterprise-level reviews.⁷ The shift to issue-focused examinations creates an opportunity for a radical change in how the IRS selects returns for audit.

Although new LB&I campaign-style audits will account for more than half of new examinations, many LB&I-type taxpayers will continue to face invasive enterprise-level or coordinated industry case (CIC) examinations.⁸ However, fewer than 50 percent of total

⁵ *Id.*

⁶ EY webcast, "New and Notable in Tax Controversy: LB&I Campaigns — a Conversation With IRS LB&I Executives," at 9 (Mar. 28, 2017).

⁷ See IRS, "IRS Announces Initial Rollout of Campaigns."

⁸ See TIGTA, "The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results," No. 2016-30-089, at 4 (Sept. 14, 2016).

examinations will be CIC. Still, the typical path to examination selection remains relevant for the reduced population subject to an enterprise-wide examination.

Since 1962 the IRS has used computers to aid the taxpayer selection process. The sophistication and types of information available in various public and tax filings have grown; thus, the selection factors and their weighting likely have changed. The IRS keeps the selection process secret, however, to prevent taxpayers from trying to avoid selection and to ensure that the selected targets hold the greatest potential for unreported income.

The automated selection process applies primarily to non-LB&I taxpayers. The IRS compiles several factors in a discriminant index function (DIF) mathematical formula, and a baseline formula is developed based on National Research Program (NRP) data. The IRS designed and implemented NRP for gathering data to measure payment, filing, and reporting compliance. NRP helps deliver data to various IRS divisions to satisfy their development needs for strategic plans and improved workload identification needs — including enforcement planning.⁹ The higher a return's DIF score, the higher the likelihood the IRS will select it for examination.¹⁰ The DIF mathematical formula and the taxpayer scores are strictly confidential and not shared by the IRS. The agency forwards the high-DIF score returns to field or campus personnel to review before deciding to open an examination.

High-asset tax return filings (so-called large cases, involving assets of at least \$10 million) do not receive DIF scores but are automatically referred to LB&I's main campus in Ogden, Utah, for additional screening and review.¹¹ Individuals with offshore activities, and thus subject to LB&I enforcement jurisdiction, are still subject to DIF scoring and return selection criteria. The automatic case referral occurs for large C and S

corporations, but the Internal Revenue Manual lists partnerships as subject to computer scoring under the DIF system and remains silent on whether partnerships with assets of \$10 million or more are subject to automatic referral to LB&I's Ogden campus.¹²

Why the IRS decides to formally initiate a large-case examination based on the direction and review of Ogden team members is not publicly disclosed. LB&I examiners probably engage in a similar risk analysis as that undertaken by the NRP and identify filings that the IRS considers to have a high likelihood of unreported income based on business intelligence gathered from the return and other sources. The examiner and the large-case taxpayer engage in the following steps during an examination:

LB&I Examination Process¹³
<p>Planning Phase — scope development process</p> <ul style="list-style-type: none"> • communication — establish groundwork for mutual information exchange; • issue team concept — tailor examination procedures for issues selected; and • examination plan — develop issue-focused plan and agreement.
<p>Execution Phase</p> <ul style="list-style-type: none"> • issue development — identify all relevant facts, apply the law, and evaluate tax implications; and • written acknowledgement of the facts for unagreed issues — resolve factual differences or document disputes.
<p>Resolution Phase — reach agreement, if possible</p> <ul style="list-style-type: none"> • issue resolution — use tools or strategies to reach agreement; and • exit strategy — discuss tax controversies resolution and achieve tax certainty.

Before the introduction of campaigns, the IRS selected taxpayers based on various factors and then assigned an examination team that requested documents and tried to find errors and pockets of

⁹ See IRS, "Privacy Impact Assessment — National Research Program, NRP System Overview."

¹⁰ Internal Revenue Manual section 4.1.3.2, "Discriminant Index Function (DIF) Overview" (Aug. 10, 2012).

¹¹ IRM section 4.1.3.2.3, "Corporate Returns" (Aug. 10, 2012); and IRM section 4.1.3.2.4, "S Corporation Returns" (Aug. 10, 2012).

¹² IRM section 4.1.3.2.1, "Types of DIF Returns" (Aug. 10, 2012).

¹³ IRS Publication 5125, "Large Business & International Examination Process" (Feb. 2016).

noncompliance. The campaign approach identifies an issue that the IRS believes taxpayers may have either treated incorrectly on a return or not reported at all, and the LB&I team identifies similarly situated taxpayers that are expected to face the same issue. In many respects, the issue identification process becomes the prerogative of the LB&I leadership and less of the field examiners when a campaign has been rolled out. So if the IRS has the proper intelligence about the universe of taxpayers within a particular campaign, the selected taxpayers will be involved in fairly targeted examinations, and the issue identification process will be streamlined.

In the pre-campaign era, LB&I might conduct several levels of risk assessment. The assessment would go through Ogden campus members, followed by industry LB&I examiners, and then field-level examiners, before a decision was reached to open an examination. The multiple levels were considered necessary to ensure that the target selection process benefited from the collective institutional knowledge and the experience of LB&I personnel regarding underreported income or other tax issues by the selected taxpayers. The campaign approach eliminates LB&I's heavy reliance on issue spotting at several levels, including by the field examiners, which removes a substantial burden on the examination team to find additional issues to fill up budgeted audit time.

The field team (or single examiner) generally opens a case by notifying the target, then requesting a meeting and additional basic data (for example, a trial balance and general ledger, and acquisition and disposition records). Under a 2014 change in IRS procedure, each information document request (Form 4564 or IDR) provided to the taxpayer must relate to a single issue-focused topic.¹⁴ In the planning phase, the exam team develops and winnows down the number of issues before pursuing them in the execution phase. The IRS may request additional data from the taxpayer through IDRs in the execution phase to narrow the issue, facts, and law.

¹⁴LB&I, "Updated Guidance for Examiners on Information Document Requests Enforcement Process," LB&I-04-0214-004 (Feb. 28, 2014).

Although large cases (or CICs) continue in the future state, large cases are de-emphasized as the standard operating procedure. The former reliance on large cases created heavy burdens on examiners and taxpayers and often failed to lead to adjustments benefitting the national fisc. In fact, in a study of cases closed during 2015, the Treasury Inspector General for Tax Administration noted a high no-change rate (ranging from 35 to 50 percent) for industry case (IC) audits of C corporations, S corporations, and partnerships — meaning that the audits were closed with no recommended change to the tax liability reported by the taxpayers.¹⁵ A high no-change rate indicates that the IRS has spent resources without receiving an adequate return on its enforcement investment and that it has quite possibly placed an unnecessary burden on compliant taxpayers.¹⁶

The use of campaigns to select returns for examination will change which taxpayers receive additional scrutiny and how they receive it. The shift away from an industry-focused approach to an issue-focused approach makes sense in theory but may prove difficult to sustain in practice. The IRS has stated on several occasions that it needs more resources to close the federal tax gap.¹⁷ Yet the campaign process introduces the need to adopt a data-driven analytical approach to LB&I's enforcement strategy. An issue-focused examination places a heavier burden on the IRS's case selection criteria to help narrow the tax gap, by allocating resources and selecting campaign issues that hold great promise and thereby lead to a decrease in underreporting and nonfiling populations. At the same time, LB&I needs to demonstrate agility and flexibility to withdraw from campaigns that are no longer promising or that disproportionately sap its resources.

¹⁵See TIGTA, *supra* note 8. IC taxpayers are typically less complex entities than CIC taxpayers, and their examinations usually involve a single revenue agent rather than a team of revenue agents and specialists, as in many CIC audits. *Id.* at 1.

¹⁶IRS, "Report to Congress: IRS Tax Compliance Activities" (July 15, 2003).

¹⁷See Publication 1415, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008-2010," at Tax Gap Map, Tax Year 2008-2010 Annual Average (\$Billions), Attachment 1 (May 2016).

The IRS acknowledges that only 2 percent of the annual collected tax amount can be directly tied to its enforcement efforts, so the federal government depends on voluntary compliance by taxpayers for almost all its revenue needs.¹⁸ The cost to close the tax gap completely by increasing audit coverage would be prohibitive. Moreover, Congress has foreclosed that option by cutting the IRS budgets in recent years. Thus, LB&I appears to have resolved that its path forward will depend on using existing information sources to better handicap each issue and then selecting returns by adopting a campaign approach focused on the noncompliant taxpayer population. In some instances, the campaign approach tries to determine whether a return was filed, and if not, why.

Although the IRS states an intent to engage taxpayers collaboratively, few taxpayers that have gone through an LB&I examination would term the process collaborative on the whole.¹⁹ Some aspects may be viewed as collaborative — like setting expectations of the IDR process and other scheduling matters — but collectively reaching a single conclusion on relevant facts and the overall tax treatment of items clearly has an adversarial tone. The campaign announcements mentioned the pursuit of noncompliant taxpayers, which is a foe that deserves the IRS's full attention, as opposed to further burdening compliant taxpayers. It is unclear, however, whether the initial 13 campaigns will target only noncompliant taxpayers or instead subject compliant taxpayers to a continuing barrage.

The campaigns offered to date involve several inherently difficult issues that might draw in otherwise compliant taxpayers. Filers and nonfilers alike may assert reasonable arguments in response to contentious, subjective determinations offered by the IRS concerning the underlying subject matter of the campaigns. Besides the two industry-focused campaigns (the video content broadcaster issue and the land

developer issue), many of the other topics concern fairly complex tax matters in terms of their breadth, assessment, and calculation — like transfer pricing and other international tax topics.

Indeed, most commentators find the IRS's challenges to a taxpayer's transfer pricing report contentious, subjective, and difficult.²⁰ The fact that the campaign list includes many international issues will lead to additional controversy for LB&I taxpayers confronting the IRS on these topics. The question remains whether the IRS will prevail over many of the perceived foes targeted by the campaigns.

At the end of this report is a table listing the "treatment streams." It provides a brief summary of the 13 campaigns and how LB&I will pursue the issues and interact with the targets.

One important treatment stream is the so-called soft letter. The IRS will send soft letters to taxpayers informing them that it believes there is a specific compliance problem and requesting that the taxpayer respond by providing further facts, filing a new or amended return, or both. The soft letter doesn't constitute an opening of an examination under section 7605 but alerts the taxpayer of the IRS's possible intent to proceed to an issue-focused examination if the taxpayer takes no remedial action or if the IRS believes the action taken is insufficient. Receipt of the soft letter does not trigger any procedural safeguards for the taxpayer.

LB&I's Battle Plan to Take the Offensive

The selection of the original 13 campaigns raises several interesting questions, including whether a claim of noncompliance translates to actual noncompliance. Another question is whether the complex nature of the campaign issues will present burden of proof problems that, coupled with the continuing limitation on IRS resources, will decrease LB&I's prospects of quick, decisive victories over the targeted taxpayers. The challenges cannot be readily addressed, but demand an assessment of the taxpayers, the examination team, and the parties' available

¹⁸ Equals underpayment tax gap (\$39 billion) divided by tax eventually collected (\$2,090 billion), *id.* at 3. See IRS, "National Taxpayer Advocate Delivers Annual Report to Congress; Focuses on Taxpayer Bill of Rights and IRS Funding," IR-2014-3 (Jan. 9, 2014).

¹⁹ Publication 5125, *supra* note 13 ("The examination can be efficient if the examination team and the taxpayer work together in a spirit of cooperation, responsiveness, and transparency."); LB&I, "Taxpayer Experience of the Future, Experience Expectations."

²⁰ Marc M. Levey and Daniel A. Rosen, "The Changing Landscape of U.S. Transfer Pricing Examinations," 41 *J. Corp. Tax'n* 3 (Nov./Dec. 2014).

resources. LB&I leadership has hosted several webcasts on the campaign topics.²¹

As noted earlier, under the campaign regime, target identification generally doesn't focus on specific industries, with the obvious exceptions of the video content broadcaster issue and the land developer issue. The pursuit of each campaign requires reviewing and finding specific facts in past filings, or reviewing other business intelligence that indicates a higher likelihood of a particular fact pattern for a particular entity or group of taxpayers. As expected, IRS personnel have stated that more campaigns will be added to the current list.²²

Generally, each taxpayer should try to review and document whether it has a campaign issue, either directly or tangentially, and update that assessment annually to reflect any newly added or removed campaigns. For those worried about whether the campaign approach will put them in LB&I's crosshairs, it is important to note that most of the targets of the initial 13 campaigns are relatively easy for the IRS to identify because the campaigns focus on specific issues and the taxpayer reports the relevant item separately on a tax return. Therefore, the IRS has a record of the tax attribute to risk-assess the target based on specific information from prior filings. For example, for the campaigns on section 48C and offshore voluntary disclosure program decline-withdrawals, the IRS has received filings from the target population claiming tax credit benefits or requesting admission into the OVDP, respectively. The IRS should be able to contact the target population without much effort and begin the work to remedy any alleged underreporting and nonfiling.

A review of several of the campaigns is useful to better understand the tactical ambitions of LB&I's reform. For example, the advanced energy credit authorized under section 48C requires that the Department of Energy approve the investment project and that the IRS allocate a credit amount based on an application and agreement between the taxpayer and the IRS. The credits allocated by the IRS must be publicly disclosed.²³ According to the IRS's list compiled as of August 16, 2016, 139

taxpayers received almost \$2.3 billion of qualifying advanced energy project credits.²⁴ The campaign summary intimates that section 48C credits also were claimed by taxpayers that didn't satisfy the two basic requirements of Department of Energy approval and IRS credit allocation. The section 48C campaign should yield an easy victory for the IRS against a noncompliant taxpayer group, at least initially.

However, the IRS may later decide to expand the mission and extend the campaign to the 139 approved taxpayers. This would be a fairer battle but a more difficult one for the IRS because it would require investigating and developing several difficult proof issues that flow from the statutory credit requirements, such as determining the eligible investment property basis (to differentiate tangible personal property from the structural components of the building). The following high-level tasks will undoubtedly slow down the resolution of the campaign and the calculation of the correct credit amount²⁵:

- verifying the qualifying assets' placed-in-service dates to ensure the statutory time limit was satisfied;²⁶
- inquiring about other state and local incentives that the company received and their effect under the section 49 at-risk limitations, which apply to the otherwise eligible property;²⁷
- verifying that if the eligible qualifying equipment has been disposed of by the taxpayer, the IRS will explore the application of the credit recapture provisions;²⁸ and
- reviewing application of the uniform capitalization rules for the capitalization of all direct costs and some indirect costs allocable to real property and tangible personal property produced by the taxpayer.²⁹

²⁴ See IRS public disclosure of section 48C allocations.

²⁵ Section 48C(b).

²⁶ The project must be placed in service no later than three years from the date the IRS issues the project certification. Section 48C(d)(2)(C).

²⁷ See section 49.

²⁸ Section 50(a).

²⁹ Reg. section 1.263A.

²¹ See, e.g., EY webcast, *supra* note 6, at 10-11.

²² IRS, "Large Business and International Launches Compliance Campaigns" (Jan. 31, 2017).

²³ Section 48C(d)(5).

An issue-focused examination of advanced energy projects appears to be a difficult slog for the approved participants because the transaction volume to construct the investment requires them to agree to draw lines between matters that might be best described as subjective and hence complicated in their application. For example, one side may argue that a local tax incentive received on a project benefits the tangible personal property, whereas the other side would argue that it benefits the structural component instead. The former constitutes a qualified investment, and the latter does not. Some of these questions will no doubt defy quick analysis and resolution by the parties.

Similarly, the OVDP campaign also will draw controversy. The IRS has reported the ongoing success of its offshore voluntary compliance effort — the collection of more than \$10 billion of back taxes, interest, and penalties through October 2016.³⁰ This was achieved through the design and implementation of the Foreign Account Tax Compliance Act, which enlists the aid of foreign governments to disclose the U.S. taxpayers' financial holdings and accounts in their jurisdictions. That information helps verify taxpayer income and reporting. But to successfully assert the full panoply of civil and criminal penalties in this area against taxpayers that do not participate in the OVDP, the IRS must show that the taxpayer willfully evaded taxation. Because willfulness is a high threshold to prove, the IRS wants all taxpayers to enter its OVDP, regardless of any extenuating facts. Many taxpayers objected to the one-size-fits-all nature of the OVDP, as well as the formula for calculating the account penalty, interest, and other civil penalties, which can range from 27.5 to 50 percent of the highest account balance during the period the account went unreported.³¹

Other issues, especially those concerning transfer pricing, have corresponding practice units, which provide examiners information on the basic facts of transactions and the relevant tax

law. The examiners are thus better prepared to frame the dispute and develop a reference base for when examination issues arise. Indeed, practice units will continue to play a role in helping examiners learn and apply the collective knowledge of the IRS in the new campaign era. Moreover, LB&I has committed to adding new practice units for the domestic production activities deduction campaign and the land developers-completed contract method campaign, so the practice units should remain a valuable resource for examiners. Moreover, the practice units are public documents that may give taxpayers perspective on the IRS's battle plan for specific campaigns. Table 3 matches several of the campaigns with the practice unit name.

Table 3. Campaign Match to Issue Practice Unit

Campaign Name	Practice Unit Name	Practice Unit Publish Date	Document Control No.
Basket Transaction	Basket Transaction	Jan. 31, 2017	FIN/T/73_05_08-01
Inbound Distributor	Inbound Resale Price Method Routine Distributor; and Others	Mar. 18, 2016	ISI/9422.07_08(2013)
OVDP-Decline-Withdrawals	Basic Offshore Structures Used to Conceal U.S. Person's Beneficial Ownership of Foreign Financial Accounts and Other Assets	Dec. 1, 2015	OAR/9435.04_01(2015)

How to Measure Campaign Spoils?

Caesar's Pharnaces success was abundantly clear to all observers upon his adversary's quick surrender. Although LB&I likely won't achieve a similar success across the board, the question is how the IRS will measure and judge the outcome of the campaigns in a data-driven environment.

³⁰IRS, "Offshore Voluntary Compliance Efforts Top \$10 Billion; More Than 100,000 Taxpayers Come Back Into Compliance," IR-2016-137 (Oct. 21, 2016).

³¹IRS, "IRS Makes Changes to Offshore Programs; Revisions Ease Burden and Help More Taxpayers Come Into Compliance," IR-2014-73 (June 18, 2014).

Previously, LB&I measured its enforcement success by simply managing so-called inputs (available staff resources) and outputs (the number of completed examinations).³² The IRS did not measure those inputs and outputs against proposed adjustments to taxable income — a reasonable measure of the return on its enforcement expenditures. The agency has high-level data on total receipts by entity type and by estimated unreported and underreported income, but historically it has provided no more than the bottom-line estimates.³³

Further, the IRS lacked an adequate management system to track enforcement time by issue and by proposed or actual adjustment. The ability to measure the cost and return on enforcement efforts for particular issues would help the agency better determine which issues are worth pursuing. And there is little doubt that a heavy time commitment by the IRS is often matched by an additional burden on the responding taxpayer's resources.

TIGTA noted a lack of integrity in the code-based internal management system used by most LB&I revenue agents to track proposed adjustments by issue. The report cited infirmities in the coding itself (some codes were too general to be helpful), errors and omissions by examiners in entering the codes, and failure of IRS leadership to consistently correct those problems. Thus, the system has not led to the dissemination of useful information, such as a data-driven analysis of compliance risk.³⁴

The current systems do not adequately track LB&I's effort in developing issues (for example, worker hours assigned to a particular issue), nor do they provide an accurate reading of the proposed or actual adjustments resulting from those expenditures of time. The IRS's inability to track hours and compile tax adjustments prevents a meaningful assessment of the enforcement value of each tax issue and inhibits the agency's ability to draw conclusions about the efficacy of CIC, IC, and the campaigns. A quantifiable cost-

benefit analysis of each campaign is needed to justify the allocation and expenditure of additional resources to a particular issue and to measure success.

Essentially, the IRS has flown blind on many fronts, besides the OVDP, and its enforcement efforts may be best described as indiscriminate. This highlights a significant deficiency that LB&I's leadership must remedy. IRS leadership responded to the deficiencies noted by TIGTA by committing to working to adopt a more data-driven model and using its management systems to track the cost-benefit nature of the campaigns, at least on the international issues.³⁵

One challenge LB&I faces is the ability to discover emerging compliance issues and effectively respond to them by introducing new campaigns. A data-driven environment, as outlined above, will measure known risks but do little to help uncover new issues. The discovery process for LB&I must come from various sources, such as ongoing CIC examinations, IRS personnel, and whistleblowers. The success of the campaign approach depends on the IRS's ability to timely adapt to new compliance issues. LB&I has announced that it will use the agile development model to succeed on this front.³⁶ The model includes several steps that form a closed loop to proceed from idea generation through exploitation and resolution of the idea.

In 2015, the IRS created an enterprise risk management (ERM) program to help it assess risk and exercise judgment. The IRS established the program to serve several enforcement needs that dovetail with many of the themes of the future state initiative.³⁷ The goals of the ERM program are as follows:

- reveal key risks and related controls;
- determine what risk areas could hurt the IRS's ability to carry out its mission;
- identify resources, processes, policies, and procedures needed to proactively manage risk;

³² TIGTA, *supra* note 8, at 8.

³³ The IRS estimates that the gross tax gap (before collection of penalties and interest) for the most recent tax period (2008-2010) equals \$458 billion annually. See IRS, *supra* note 17.

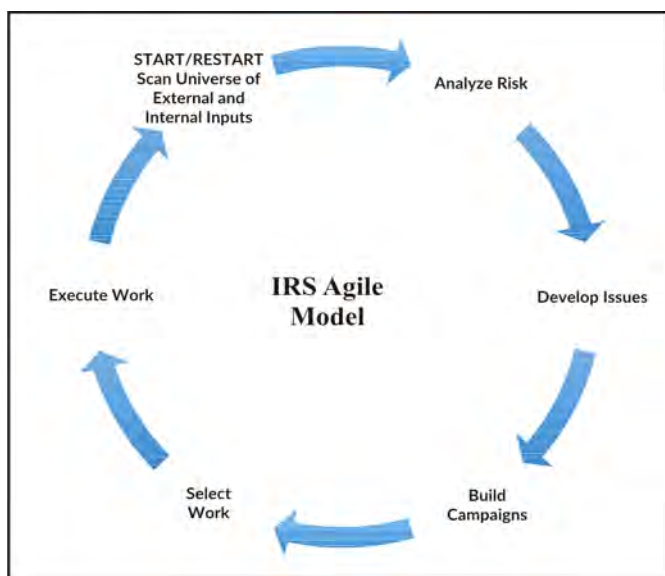
³⁴ TIGTA, *supra* note 8, at 8 and 11.

³⁵ *Id.* at 38-39.

³⁶ IRS, *supra* note 1.

³⁷ IRM section 1.1.1, "IRS Mission and Organizational Structure" (June 2, 2015).

- create awareness and leverage any existing risk management infrastructure in the operating units;
- provide a coordinated and common framework for capturing and reporting risk information; and
- share risk mitigation practices across the IRS.³⁸



Future State and Future Taxpayer Reaction

If the change in LB&I's enforcement approach is to succeed, it will require a change in taxpayer behavior as well as a change in the IRS's internal procedures. For campaigns to work, the IRS must generate new issues to build momentum. Some campaigns, like the advanced energy project, may be of short duration (absent an expansion to the publicly disclosed group of taxpayers) because the underlying provision has a sunset. The agile model contemplates the addition of new campaigns.

An important question is how the various campaign treatment streams will alter taxpayer behavior. Risk-averse taxpayers may review their tax positions against the campaign list and adopt non-optimal tax positions — that is, accept the IRS's position expressed in the campaign as

correct to avoid future controversy. No doubt taxpayers and their financial statement auditors will begin to view the campaign list and any future additional campaigns as a starting point for analyzing the tax provision and reserves under Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (ASC 740-10), commonly known as FIN 48.

However, as noted above, many of the questions present difficult proof issues that require a great deal of study before reaching a defensible conclusion. In many cases, the determination remains in the eye of the beholder, and the taxpayer, financial statement auditor, and the IRS may reach different conclusions about the controlling facts and the tax law. In those cases, further controversy will arise until the issue reaches the arbiter or a court, or additional regulations are promulgated.

LB&I's introduction of a campaign approach informs taxpayers which compliance issues the IRS considers important. Financial statement auditors may take the cue and require taxpayers to acknowledge whether those issues directly or tangentially affect them (through a checklist or representations). To the extent a campaign could rightly or wrongly ensnare a taxpayer, the taxpayer should quantify the potential financial impact of the issue on its business and the related effect on current and prior filings. At a minimum, all taxpayers should consider which campaign issues directly affect them and consider what actions must be taken to substantiate their position if it diverges from the campaign's outline. The LB&I webinars have provided greater clarity on this front. In cases in which the guidance remains unclear or noncompliance is found, LB&I taxpayers may need to take additional steps to justify any existing or new uncertain tax position reserve (FIN 48) and consider amending tax returns when necessary and prudent.

Only time will tell whether LB&I's new campaign approach or LB&I taxpayers will prevail, and whether nonfilers will suffer the same fate as Caesar on the Ides of March — the non-extended corporate filing date.

³⁸ Daniel Werfel, "Charting a Path Forward at the IRS: Initial Assessment and Plan of Action," IRS, at 47 (June 24, 2013).

Table 4. LB&I Initial Campaign List

Campaign Name	LB&I Practice Area	Summary	Treatment Streams				
			Soft Letter	Issue-Focused Exam	Externally Published Practice Unit	Other Published Guidance	Improve Issue Selection
1. Section 48C Energy Credit	Enterprise Activities	Challenges credits claimed for energy projects, not satisfying Department of Energy and IRS approval requirements	✓	✓			
2. Domestic Production Activities Deduction, Multi-Channel Video Program Distributors, and TV Broadcasters	Enterprise Activities	Taxpayers/producers claiming section 199 deduction as producer of a qualified film when content produced by third-party		✓	✓	✓	
3. Micro-Captive Insurance	Enterprise Activities	Taxpayer attempts to reduce taxable income when insurance offered by related company		✓			
4. Related-Party Transactions	Enterprise Activities	In middle-market business segment, ensure deduction standards for transactions between commonly controlled entities properly applied		✓			
5. Deferred Variable Annuity Reserves and Life Insurance Reserves IIR	Enterprise Activities	Determine allowable tax reserve amounts for both guaranteed minimum benefits and life insurance contracts				✓	
6. Basket Transactions	Enterprise Activities	Address structured financial transactions mentioned in Notice 2015-73 and Notice 2015-74 that try to convert ordinary income into capital gain	✓	✓			
7. Land Developers — Completed Contract Method (CCM)	Enterprise Activities	Review proper use of CCM by developers constructing residential communities	✓	✓	✓		

Table 4. LB&I Initial Campaign List (Continued)

Campaign Name	LB&I Practice Area	Summary	Treatment Streams				
			Soft Letter	Issue-Focused Exam	Externally Published Practice Unit	Other Published Guidance	Improve Issue Selection
8. OVDP Declines-Withdrawals	Withholding and International Individual Compliance	Seeks to resolve noncompliance for OVDP applicants that were denied access to OVDP or elected to withdraw from program and have not remedied their noncompliance		✓			
9. Repatriation	Cross Border Activities	Capture the improperly reported tax-free repatriation of funds into the United States by midmarket population					✓
10. Form 1120-F Non-Filer	Cross Border Activities	Ensure foreign companies doing business in the United States and required to file Form 1120-F satisfy their filing obligation	✓	✓			
11. Inbound Distributor	Treaty and Transfer Pricing Operations	Ensure U.S. distributors of goods treated as sold by foreign related party properly apply the arm's-length standard and report a return (profit) based on the functions and risk borne by the U.S. distributor		✓			
12. TEFRA Linkage Plan Strategy	Passthrough Entities	Address the terminal investors of large and complex partnerships					✓
13. S Corporation Losses Claimed in Excess of Basis	Passthrough Entities	Enforce tax law limits on losses and deductions claimed by S corporation shareholders to the extent of tax basis	✓	✓		✓	