Tax Controversy Services

IRS Insights
A closer look.

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In this issue:

LB&I Issues Updated Examination Process

On February 25, 2016, the Large Business & International (LB&I) Division of the IRS released Publication 5125, the LB&I Examination Process (the “Publication”). The Publication replaces Publication 4837, the Quality Examination Process, and goes into effect on May 1, 2016. LB&I had previously released a draft version of the Publication on October 30, 2014.

Overview

The LB&I Examination Process (the “Process”) provides an organizational approach for examiners to conduct examinations from the initial contact with the taxpayer through the final stages of issue resolution. Pursuant to the Publication, the Process will be discussed at the first engagement with the taxpayer to ensure that both the taxpayer and LB&I have a clear understanding of the Process and expectations. Specifically, the exam team is expected to get an understanding of the taxpayer’s business and share the issues they have identified for examination; work with the taxpayer to develop the audit steps and potential timeline for the issues selected; follow the Information Document Request (“IDR”) procedures; and provide status updates to the taxpayer. In addition, as part of the new Process, the exam team is instructed to provide written documentation of all facts and seek taxpayer acknowledgement of the facts. In the case of an unagreed issue, LB&I should appropriately document the disputed facts. The exam team should also prepare well-developed Notices of Proposed Adjustment (“NOPAs”), and make an effort to resolve issues at the earliest appropriate point.

The taxpayer is expected to provide its global tax organizational charts to the IRS, as well as an overview of the taxpayer's structure, business activities, and accounting systems. Like the exam team, the taxpayer should also follow the IDR procedures, and should work with the exam team to ensure that each IDR is properly focused. As part of the Process, taxpayers should provide the requested workpapers and supporting documents; provide support for any disputed or additional facts; timely respond to NOPAs; and attempt to resolve issues at the earliest appropriate point.

Process Stages

The Publication also provides an overview of the three stages of the LB&I examination process: Planning, Execution, and Resolution. During the Planning phase, LB&I and the taxpayer will collaboratively establish the steps necessary to complete the examination in a timely manner. The parties are expected to leverage technology to enhance interaction. In addition to effective communication and collaboration, the Planning phase also involves assembling an issue team, comprised of LB&I employees with knowledge about a specific issue, to successfully develop and manage each issue examined. The Publication emphasizes the value of transparency to ensure proper issue development and a clear understanding of LB&I and the taxpayer's positions. At the conclusion of the Planning phase, LB&I's agreements with the taxpayer will be incorporated into the issue-focused examination plan.

During the Execution phase, the priorities for the parties include determining the facts, applying the law to the facts, and understanding the tax implications of the issue. LB&I will develop the facts by using the IDR process and gaining information through interactive discussions with the taxpayer. The exam team may also issue NOPAs during this stage. Finally, as part of the Resolution phase, the goal is for the exam team and the taxpayer to reach an agreement as to the tax treatment of every issue examined. The LB&I team may issue a Revenue Agent Report to the taxpayer. Critical components of the Process, during all three stages, are increased transparency, enhanced communication, and improved collaboration between the exam team and the taxpayer.

Informal Refund Claims

The Process provides that LB&I will only accept informal claims for refund that are provided to the exam team within 30 calendar days of the opening conference. LB&I will not require a formal claim for refund if an issue has been identified for examination, unless the IRS's published guidance specifically requires formal claims to be filed for that issue. For example, Notice 2008-39 requires a formal claim for credit or refund under section 41, relating to the research tax credit. After the 30-day window, claims for refund for issues not identified for examination must be filed using Form 1120X, Form 1040X, or Form 843, as required by the Treasury Regulations. An exception to this rule that was not contained in the draft version of the Publication provides that, in limited circumstances, exceptions to the formal claims process may be granted by LB&I senior management.

The Publication specifies that both formal and informal claims for refund are required to meet the standards of Treas. Reg. § 301.6402-2. LB&I will discuss any deficiencies in meeting the requirements outlined in the Treasury Regulations and provide the taxpayer with the opportunity to correct the deficiencies, but will not act on an incomplete or invalid claim. To the extent the taxpayer files a formal claim for refund, the taxpayer is advised to concurrently provide a copy of the claim to the LB&I team, along with the documentation required for LB&I to make a tax determination of the issues without having to issue additional IDRs. As part of the new Process, claims will be risk assessed in the same manner as any other audit issue.

IRS Releases Fiscal Year 2015 Enforcement Statistics

On February 22, 2016, the IRS released the Fiscal Year (“FY”) 2015 Enforcement and Service Results (“Enforcement Report”). A few key areas of the Enforcement Report are summarized below.

During FY 2015, the IRS collected enforcement revenue of $54.2 billion, which is a decrease of $2.95 billion from FY 2014. This overall revenue decrease is primarily attributable to a decrease in Examination revenue, which was $7.32 billion in FY 2015 as compared to $12.51 billion in FY 2014, and is the IRS’s lowest amount in ten years. Appeals revenue also dropped slightly in FY 2015. The decreases for Examination and Appeals revenue were partially offset by an increase in Collection revenue of $2.54 billion, and a $190 million increase in revenue from Document Matching, which includes amounts collected through Information Reporter and Automated Underreporter programs, compared to FY 2014. The Enforcement Report reflects a downward trend in collection enforcement actions during FY 2015, with the lowest number of levies, liens and seizures in the prior ten years, despite the increase in Collection revenue in FY 2015.

The Enforcement Report details that staffing for IRS key enforcement occupations, *i.e.*, Revenue Officers, Revenue Agents, and Special Agents, has continued to decrease and is the lowest in recent years. Specifically, there were 34% fewer Revenue Officers during FY 2015 as compared to FY 2010. Similarly, Revenue Agents have decreased by 22% and Special Agents have decreased by 15% since FY 2010. These personnel decreases equate to a reduction in personnel of 5,502, as compared to FY 2010 staffing levels.

Despite the reduced staffing, the number of business returns examined by the IRS in FY 2015 increased by 7.8%, compared to FY 2014, with the IRS conducting a total of 61,677 examinations for an overall coverage rate of 0.60%. For purposes of the Enforcement Report, business returns include: large corporate returns, small corporate returns, Subchapter S returns and partnership returns. The increase in business return examinations primarily stems from an increase in Subchapter S and partnership return examinations. During FY 2015, the IRS examined 18,595 Subchapter S returns, which is 2,278 more returns than in FY 2014. Similarly, the IRS examined 19,212 partnership returns in FY 2015, which is an increase of 3,433 returns compared to FY 2014. For Subchapter S and partnership returns, this level of activity equates to coverage rates of 0.40% and 0.51%, respectively.

The Enforcement Report reflects a decrease in examinations for large corporate returns, defined as corporations with $10 million or greater, with 7,410 examinations conducted, equating to an 11.15% coverage rate in FY 2015, compared to 7,855 examinations with a

12.23% coverage rate in FY 2014. The Enforcement Report breaks down this category further into asset classes, as detailed below:

Asset Class	Returns Examined (FY 2015)	Coverage (FY 2015)
$10 million < $50 million	2,000	5.77%
$50 million < $100 million	913	11.31%
$100 million < $250 million	1,185	14.25%
$250 million and greater	3,312	21.45%

Of the large corporate taxpayers, the most significant change related to examinations of corporate taxpayers with $250 million or greater in assets. As shown above, the IRS examined 3,312 returns with a coverage rate of 21.45%, which is a rate decrease of 4.65%, as compared to FY 2014. Examinations of corporations with between $10 million and $50 million of assets were relatively stable with a minor reduction of 0.41% in the coverage rate. For corporations with assets between $50 million and $100 million, and corporations with assets between $100 million and $250 million, the number of returns examined and coverage rates increased slightly from FY 2014 to FY 2015.

With regard to smaller corporations, defined as corporations with assets under $10 million, there were fewer examinations in FY 2015 than in FY 2014, which resulted in a coverage rate of 0.92%. This represents a minor decrease of .03% in the coverage rate from FY 2014.

In FY 2015, the IRS conducted a total of 1,228,117 individual examinations, including field and correspondence examinations, with an overall coverage rate of 0.84%. These figures reflect the lowest number of examinations and coverage rate in the prior ten years. Additionally, the Enforcement Report shows a significant decrease in field examinations in FY 2015, while there was an increase of correspondence examinations. In FY 2015, the IRS conducted 267,075 field examinations, which is a decrease of 24,567 examinations compared to FY 2014. However, the number of correspondence examinations rose by 10,205 as compared to the prior year.

The most significant shift to correspondence examinations occurred related to examinations of individuals with income of at least $1 million. Per the Enforcement Report, the IRS examined 39,753 returns in this category with 25,972 of those examinations being conducted through correspondence. In FY 2014, the IRS conducted a total of 34,361 examinations with 19,332 being conducted by a correspondence examination. Thus, correspondence examinations in this category increased by 6,640 in FY 2015, as compared to FY 2014. The other two income categories, individuals with less than $200,000 in income and individuals with income of $200,000 to $1 million, similarly showed decreases in field examinations with increases in correspondence examinations, as compared to FY 2014.

In addition, the Enforcement Report provided taxpayer service statistics for FY 2015, which included statistics on the following areas: electronic filing of individual returns, toll-free assistor level of service, toll-free tax law accuracy, toll-free customer satisfaction rating, webpage visits on irs.gov and online refund status checks. The most significant change reported was the decrease in toll-free assistor level of service from 64% in FY 2014 to 38% in FY 2015.

The Seventh Circuit Holds Second Inspection of Prior Year Records was not Barred When Relevant to Year under Examination

In *United States v. Titan International, Inc.*,[1] the IRS issued an administrative summons to Titan International, Inc. ("Taxpayer") to inspect certain books and records of the Taxpayer from its 2009 tax year in connection with the IRS's examination of the Taxpayer's income tax return for its 2010 tax return. The Taxpayer did not produce the requested information and the United States sought an order to enforce the summons.

The Taxpayer argued the summons should be quashed on the grounds that the request constituted an impermissible second inspection of its 2009 books and records under IRC § 7605(b) as the IRS had previously inspected these items during an examination of the Taxpayer's 2009 tax year. The United States asserted it was not a second examination of the 2009 tax year as the IRS sought to verify the amount of the net operating loss deduction claimed on Taxpayer's return for tax year 2010.

Under IRC § 7602, the IRS has wide latitude in the information that it may request to determine whether a return is correct or determine the proper tax liability. In part, IRC § 7602(a) provides that for the purpose of ascertaining the correctness of any return, the IRS is authorized to examine any books, papers, records, or other data which may be relevant or material to such inquiry and can issue a summons requiring the appropriate to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to its inquiry.

IRC § 7605(b) provides a limitation on the authority in IRC § 7602:

> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

In this instance, the Taxpayer asserted that, due to the prior examination of its 2009 tax year, the summons was invalid under IRC § 7605(b). The Taxpayer argued that the phrase "each taxable year" in IRC § 7605(b) related to the year of the records, and thus the IRS was barred from inspecting its 2009 books and records in both examinations. The Taxpayer further noted that the IRS had adjusted the amount of the Taxpayer's net operating loss in the prior examination of Taxpayer's 2009 tax year. The United States asserted that the IRS was not attempting to make an additional assessment with respect to the Taxpayer's 2009 tax year, but, rather, it sought to verify the amount of a deduction claimed on Taxpayer's 2010 tax return.

The Seventh Circuit Court of Appeals disagreed with the Taxpayer and held that the phrase "each taxable year" under IRC § 7605(b) refers to the year under examination, not the books

[1] 2016 US App. LEXIS 1687 (7th Cir. 2016).

and records year. The court cited to two cases, *Reineman v. United States*[2] and *Digby v. Commissioner*,[3] to affirm its interpretation of the statute. In *Reineman*, the Seventh Circuit concluded that there was a second inspection under IRC § 7605(b) when the IRS re-examined a prior year's records for purposes of making an adjustment solely related to the prior tax year, essentially reopening an exam. Conversely, in *Digby*, the Tax Court held that an inspection of a prior year's records, which were previously examined, was not barred by IRC § 7605(b) as this inspection was undertaken to determine the taxpayer's basis in an S-corporation for the examination year.

The Seventh Circuit noted that the Taxpayer's situation was similar to the *Digby* case, and that it was necessary for the IRS to inspect the 2009 records to verify the net operating loss deduction claimed on the 2010 return. Accordingly, the court held the inspection of the 2009 records was not limited by IRC § 7605(b), and the IRS was not required to show necessity and provide written notification. Thus, the summons was valid.

This case illustrates that the IRS has a broad range of authority to inspect books and records that may be relevant to a taxpayer's return. This authority includes the ability to inspect prior year books and records when a tax attribute, such as a net operating loss, is being utilized in the current period even if these items have been previously inspected in a different year's examination.

PATH Act Makes Amendments to Sections 6664 and 6676 and IRS Issues Corresponding Advice

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") was signed into law. The PATH Act amended the definition of "underpayment" under section 6664,[4] which is used to calculate the accuracy-related penalty under section 6662 and the fraud penalty under section 6663. The PATH Act also changed the defense to the erroneous claim for refund or credit penalty under section 6676 from reasonable basis to reasonable cause. In response to these amendments, the IRS issued a Chief Counsel Notice and a Chief Counsel Advice addressing the effect of the changes.

Section 6664

Sections 6662[5] and 6663[6] impose penalties on the portion of an underpayment of tax required to be shown on a return. Section 6664 provides that the term "underpayment" means the

[2] 301 F.2d 267 (7th Cir. 1962).
[3] 103 T.C. 441 (1994).
[4] P.L. 114-113, Div Q, Title II, § 209(a), 129 Stat. 3084.
[5] IRC § 6662(a) provides "[i]f this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies."

correct amount of tax, minus the sum of the amount of tax shown on the return and any amount previously assessed or collected, minus the amount of rebates made.

In *Rand v. Commissioner*,[7] the Tax Court considered whether certain disallowed refundable credits would be taken into account when determining the amount of tax shown on a return, and whether those credits could reduce the amount of tax shown below zero. The parties in *Rand* agreed on the correct amount of tax, but did not agree on the amount of tax shown on the return. The IRS argued that because the tax return claimed refundable credits, the amount of tax shown on the return was reduced by the amount of the refundable credits claimed, and was therefore a negative amount. The taxpayer argued that the amount of tax shown on the return was the amount of tax before it was reduced by the refundable credits, and was therefore the same as the correct tax liability. The Tax Court held that the amount of tax shown on the return was reduced by the amount of the refundable credits, but not below zero.

The PATH Act amended section 6664 to be consistent with the IRS' position in *Rand*,[8] that is, that the amount of tax shown on the return for purposes of calculating the amount of the underpayment is reduced by the amount of the refundable credits, and that such reduction can reduce the amount below zero. This amendment applies to returns filed after December 18, 2015, and returns for which the assessment statute of limitations under section 6501 had not expired as of that date.

Section 6676

Section 6676 imposes a penalty on income tax claims for refund or credit made for an excessive amount, which is defined as the amount by which the claim for refund or credit exceeds the allowable amount of the claim. Before the PATH Act, section 6676 provided that the penalty applied unless it was shown that the claim for refund or credit had a reasonable basis. Reasonable basis is a standard of tax reporting that is significantly higher than not frivolous or not patently improper, but lower than substantial authority. In order to have reasonable basis, a return position must be reasonably based on one or more specified authorities; it is not sufficient that it is merely arguable or merely a colorable claim.

The PATH Act amended section 6676 to provide that the penalty will now apply unless it is shown that the claim for refund or credit is due to reasonable cause.[9] Reasonable cause, on the other hand, is a facts and circumstances analysis that requires the taxpayer to demonstrate that it exercised ordinary business care and prudence in the filing of its return.

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[6] IRC § 6663(a) provides "[i]f any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."
[7] 141 T.C. 376 (2013).
[8] Specifically, section 6664(a) was amended to provide that "[a] rule similar to the rule of section 6211(b)(4) shall apply for purposes of this subsection". Section 6211(b)(4) provides that any excess of the sum of the refundable credits over the tax imposed (determined without regard to such credits), and any excess of the sum of such credits as shown by the taxpayer on the return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits), shall be taken into account as negative amounts of tax.
[9] P.L. 114-113, Div Q, Title II, § 209(c), 129 Stat. 3084.

The amendment to section 6676 applies to claims for refund or credit filed after December 18, 2015.

New IRS Advice

In response to the PATH Act amendments to sections 6664 and 6676, the IRS issued new advice regarding the effects of the changes. With respect to section 6664, the IRS issued Chief Counsel Notice 2016-004, which directs Chief Counsel attorneys to calculate penalties under sections 6662 and 6663 in accordance with the new definition of underpayment in section 6664, which will result in larger penalties than were previously allowed under *Rand*, since the amount of the underpayment can now be larger since refundable credits can reduce the amount of tax shown on the return below zero. Notice 2016-004 also obsoletes Chief Counsel Notice 2014-007, which had been issued after *Rand*, and which directed Chief Counsel attorneys to calculate penalties under 6662 and 6663 under the definition of underpayment as determined in that case.

The IRS also issued Chief Counsel Advice 201607027, which notes that *Rand* created a situation in which the disallowance of a refundable credit could give rise to a deficiency, but not an underpayment, in which case the penalty under section 6676 applied, since the penalties under sections 6662 and 6663 only applied to an underpayment. The Tax Court had previously held that when a penalty is dependent on the determination of a deficiency, that penalty is subject to deficiency procedures, which meant that the penalty under section 6676 was sometimes subject to deficiency procedures. The IRS explained in the Chief Counsel Advice that, due to the change in the definition of underpayment under section 6664, the section 6676 penalty will now never apply to a situation where there is a deficiency, since sections 6662 or 6663 would apply instead. As a result, the penalty under section 6676 will no longer be subject to deficiency procedures.

Financial Crimes Enforcement Network Issues Proposed Regulations to Modify Certain FBAR Filing Requirements

On March 1, 2016, the Financial Crimes Enforcement Network (“FinCEN”) issued a Notice of Proposed Rulemaking (“NPRM”) to revise and clarify certain provisions of the requirements for Reports of Foreign Bank and Financial Accounts (“FBAR” or “Form 114”).[10] These revisions include an expansion of the current exception for US persons with signature authority, but no financial interest in accounts related to their employment, and changes to the reporting obligations of filers with more than 25 foreign financial accounts.

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[10] The current FBAR form is FinCEN Report 114, *Report of Foreign Bank and Financial Accounts*.

Background

Under 31 USC. 5314 of the Bank Secrecy Act, the Secretary of the Treasury[11] has the authority to require any resident or citizen of the United States to keep records and file reports on transactions or relationships with a foreign financial entity. In 2011, FinCEN issued updated regulations ("2011 regulations") contained in 31 CFR 1010.350, 1010.306 and 1010.42 on the FBAR filing requirements.

Generally, an FBAR is required to be filed by US persons who have a financial interest in or signature authority over at least one financial account located outside the United States, and the aggregate value of all foreign financial accounts exceeded $10,000 at any point during the calendar year, subject to certain exceptions. As noted, the NPRM proposes certain changes to filing requirements of FBARs. A few key areas are detailed below.

Signature Authority Exception

Currently, under 31 CFR 1010.350 there are limited filing exceptions for certain US persons employed by regulated entities that have signature authority, but no financial interest, over foreign financial accounts directly held by their employers. After issuance of the regulations in 2011, FinCEN received questions related to the reporting exceptions. While examining the issue, FinCEN issued several notices[12] postponing the filing obligation for additional classes of filers with signature authority, but no financial interest, for foreign financial accounts held by their employers or related entities (collectively, "employers").

In the NPRM, FinCEN proposes to eliminate the FBAR filing requirement for officers, employees and agents of US entities to report signature authority over accounts owned by the entity for which the officer, employee, or agent has no financial interest, if those accounts are required to be reported by their employer, or any other entity within the same corporate or other business structure. In conjunction, the employers would be required to maintain a list for five years, available upon request, of all officers and employees with signature authority over its foreign financial accounts.

The NPRM provides that the proposal is based on a policy decision regarding the benefit of the filings as compared to obligation on filers. As stated in the NPRM, FinCEN estimates that a significant portion of FBARs filed to report signature authority, but no financial interest, in foreign accounts were related to the individual's employment. FinCEN also noted that the initial value of a "double-check" by having duplicate filings may be of limited value as many employers are assisting employees in reporting accounts related to their employment.

25 or More Accounts Exception

The proposal also seeks to remove the exemption on providing specific account information when a US person has a financial interest in, or signature authority over, 25 or more foreign financial accounts contained in 31 CFR 1010.350(g)(1)-(2). As reflected on Form 114, a filer with more than 25 reportable accounts is not required to complete the detailed financial

[11] This authority was delegated to the Director of FinCEN in Treasury Order 180-01.
[12] See FinCEN Notices 2011-1, 2011-2, 2012-1, 2012-2, 2013-1, 2014-1, 2015-1

information contained in Part II or III, which includes maximum account balance, type of account, financial institution name, and account number.

The NPRM notes that this proposal is based on the significant gap of information for filers with a large number of accounts, which measure at over 5 million accounts in 2013, or 56% of all foreign accounts.[13] In addition, FinCEN believes that it now has increased capability to deal with the reporting of numerous accounts.

Filing Date and Electronic Filing

In addition, FinCEN has proposed several changes to update the filing date for FBARs to reflect the April 15 due date, and electronic filing requirements. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, enacted in July 31, 2015, modified the due date for FBARs from June 30 to April 15, with an ability to request a six month extension, for FBARs filed for the 2016 calendar year and forward. Beginning in 2014, FinCEN mandated that all FBARs, for current and prior periods were required to be electronically filed.

[13] The NPRM cites to statistics from 2013, which reflect that 10,800 FBARs were filed in 2013 that reflected 25 or more accounts, with a combined total of over 5 million accounts or approximately 56% of all foreign accounts reported in 2013.

Have a question?
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