

Reproduced with permission from Daily Tax Report, 75 DTR J-1, 4/20/17. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Tax Compliance

In the fourth of a series of Mayer Brown articles regarding the IRS enforcement campaign effort, Jason Bazar, Lee Morlock and Matthew McKay look at uncertainties raised by the campaign focused on “mid-market” repatriation transactions. The IRS “has failed to delineate the taxpayers and the tax issues on which the repatriation campaign will focus,” the authors write.

IRS Campaign Program Continues Focus on Repatriation Transactions

BY JASON BAZAR, LEE MORLOCK
AND MATTHEW MCKAY

The Internal Revenue Service’s Large Business and International (LB&I) Division has announced that it will include cash repatriation transactions by “mid-market” entities as one of the 13 issues in its new “campaign” approach to tax enforcement (the “repatriation campaign”).

As explained in our first article in this series, LB&I’s campaign approach is a recently announced enforcement model under which LB&I will focus on what it perceives as high-risk compliance issues that can be brought to light through coordinated agency efforts (Brian Kittle, Thomas Kittle-Kamp and Brendan Sponheimer, “Looking for Clues in the IRS’s Campaign An-

nouncement” (56 DTR J-1, 3/24/17)). In LB&I’s Jan. 31 unnumbered document announcing the first set of 13 issues it will target in the initial wave of its campaign approach, LB&I noted that the campaigns “are the culmination of an extensive effort to redefine large business compliance work” and said that the goal of the campaigns is to “improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources.”

LB&I described its repatriation campaign in general terms that track closely with its stated overall goals for the campaign approach—to improve issue selection and increase taxpayer compliance. However, LB&I has failed to delineate the taxpayers and the tax issues on which the repatriation campaign will focus. As such, there is substantial uncertainty surrounding the scope of the repatriation campaign.

It is unclear whether this uncertainty is deliberate in order to maximize the repatriation campaign’s possible “chilling” effect or, instead, reflects an underlying uncertainty in the IRS’s objectives for this campaign. What LB&I’s description of the repatriation campaign does suggest, however, is that the campaign may shift the IRS’s enforcement strategy on repatriation issues from a transaction-focused approach to a taxpayer-focused approach.

Structure of the Campaign

In announcing the repatriation campaign, LB&I said that it “is aware of different repatriation structures being used for purposes of tax free repatriation of funds into the U.S. in the mid-market population” and that it “has also been determined that many of the taxpayers

Jason Bazar is co-leader of Mayer Brown’s Tax Transactions & Consulting practice and is based in New York. Lee Morlock is a Chicago-based partner in the firm’s Tax Transactions & Consulting practice. Matthew McKay is an associate in Mayer Brown’s Tax Transactions & Consulting practice in Chicago. The authors may be contacted at: jbazar@mayerbrown.com; lmorlock@mayerbrown.com; and mmckay@mayerbrown.com.

This article represents the views of the authors only, and does not necessarily represent the views or professional advice of Mayer Brown LLP.

do not properly report repatriations as taxable events on their filed returns.” LB&I’s stated goal for the repatriation campaign is to “simultaneously improve issue selection filters while conducting examinations on identified, high risk repatriation issues and thereby increase taxpayer compliance.”

This is in essence a restatement of the overall goals for LB&I’s campaign approach, which LB&I has said is to “improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources.”

The structure of the repatriation campaign is notable in a couple respects. Although it will use examinations as a means to gather information and increase compliance, unlike with the majority of its other campaigns, LB&I hasn’t committed itself to a single “treatment stream,” or tactical approach, for the repatriation campaign. Indeed, the repatriation campaign is one of only three campaigns for which LB&I hasn’t identified a treatment stream (the other two are the Tax Equity and Fiscal Responsibility Act linkage plan strategy campaign and the deferred variable annuity reserves and life insurance reserves campaign).

The scope of treatment streams for the rest of LB&I’s campaigns is fairly broad, ranging from the development of published guidance to full issue-based examinations. In describing the repatriation campaign, however, LB&I focused more on detailing the desired outcomes of the campaign rather than delineating how exactly it will conduct the campaign. LB&I noted that its goals for the repatriation campaign are to “improve issue selection filters” and “increase taxpayer compliance.” Although LB&I has indicated that it will use targeted examinations to address “identified, high risk repatriation issues,” the fact that it hasn’t committed to a specific treatment stream suggests that LB&I intends to use a variety of methods to achieve its stated goals.

Of particular interest is the fact that the repatriation campaign is one of only two campaigns in which LB&I designated a segment of the market for attention based on the size of the taxpayer (the other is the related party transactions campaign). In other campaigns, LB&I identified taxpayers based on their industry or their activities. Singling out the mid-market population as the focus of the repatriation campaign suggests that LB&I believes that companies in the mid-market population have common features that make them attractive targets for this campaign—namely, that they aren’t properly reporting repatriations as taxable events.

A New Approach to a Familiar Issue

By including repatriation in its set of initial campaigns, LB&I is continuing the long-running focus of the IRS and Treasury Department on repatriation issues. Indeed, in the past five years alone, the IRS and Treasury have issued three notices (Notice 2012-39, Notice 2014-32 and Notice 2016-73) addressing reorganization strategies used by taxpayers to repatriate untaxed earnings of foreign subsidiaries in a tax-free or tax-advantaged manner. In each of these notices, the IRS stated that it would issue new regulations to address transactions that, although perhaps technically compliant with existing law, it believed to inappropriately allow for repatriation of foreign earnings at limited tax cost.

The IRS has also pursued transactions in which U.S. taxpayers establish tax structures to allow them to re-

ceive distributions from foreign subsidiaries as a return of basis, rather than as a taxable dividend (see, e.g., *Ill. Tool Works, Inc. v. Commissioner*, T.C. Docket No. 10418-14). The fact that there is a repatriation campaign at all indicates that LB&I believes that, notwithstanding the significant efforts already expended, there is more to be done on this issue.

Although the repatriation campaign can be seen as a continuation of the IRS’s ongoing concern with repatriation strategies, it represents a different approach by LB&I with respect to the issue. Instead of addressing specific transactions that it believes may, as a technical matter, “work,” but achieve inappropriate results, in this campaign LB&I appears to be concerned with transactions that don’t even technically work or that taxpayers aren’t “properly reporting” on their returns.

Moreover, LB&I has changed the focus to a particular subset of taxpayers—the mid-market population. This may reflect a belief by LB&I that the most efficient use of its resources in the repatriation space is to focus on taxpayers that aren’t following the letter of the law in establishing, executing and reporting their repatriation strategies (rather than trying to shut down strategies that arguably fall within the letter of the law). That is, LB&I may believe that the repatriation methods used by mid-market taxpayers present easier cases for it to attack on audit.

The IRS also may be looking for weaker transactions to use as precedent-setting litigation vehicles. In the past, when addressing a type of transaction structure that it has disfavored, the IRS often has been highly successful in locating taxpayers with bad facts and then forcing these taxpayers into litigation. Once bad precedents have been established, taxpayers with stronger structures often find it difficult to distinguish their cases in IRS Appeals or in court—standing as vivid proof of the adage that bad facts make bad law.

Unanswered Questions

LB&I’s announcement regarding the repatriation campaign leaves many questions unanswered. Most notably, while more taxpayers may face audits of their repatriation transactions, LB&I hasn’t indicated what it considers the “mid-market population.” Although entities need to have at least \$10 million in assets in order to be included within LB&I’s purview, the largest U.S. multinationals have assets of billions of dollars. Without more guidance as to what taxpayers LB&I considers mid-market, there is substantial uncertainty among taxpayers as to whether they will be subject to the repatriation campaign.

LB&I has also not indicated the “identified, high-risk repatriation structures” on which the campaign will focus. It is possible that LB&I will continue to focus on the reorganization, merger and liquidation transactions addressed in Notice 2012-39, Notice 2014-32, and Notice 2016-73. Alternatively, it is also possible that LB&I will focus on more commonplace repatriation techniques, such as intercompany loans and other return of basis transactions that it believes are being reported improperly. Such an approach would be more consistent with LB&I’s stated goal of using its resources in the most efficient manner to incentivize taxpayer compliance with existing law.

Finally, it is worth noting that the announcement of the repatriation campaign comes at a time of intense

legislative focus on “deemed repatriation” and other international tax reform proposals that could fundamentally alter the long-discussed “lockout” issue for U.S. multinationals. As a result, although the repatriation campaign is the latest development in the ongoing repatriation saga, it may soon be overshadowed by more significant changes in the treatment of U.S. companies’ income from their foreign subsidiaries.

Taxpayer Responses

Given that LB&I hasn’t clearly delineated either the taxpayers or the transactions on which the repatriation

campaign will focus, all taxpayers that fall under the purview of LB&I should be prepared to defend all aspects of their repatriation structures. Furthermore, taxpayers should ensure that they are correctly reporting their repatriation transactions on their tax returns. Repatriation has long been on the IRS’s radar; the repatriation campaign signals that this won’t be changing anytime soon.