

IRS Hot Topics

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IRS is significantly increasing the number of Forms 1120F they will be examining in 2012

Over the last year, the IRS Large Business and International organization (LB&I) has been making a significant shift in the type of tax returns they are placing under audit. This has been seen in the number of flow-through returns such as Form 1065 partnership returns and Form 1120S corporate returns the IRS has been putting into the audit pipeline. There now appears to be a coordinated effort by LB&I to examine many more Forms 1120-F, "*U.S. Income Tax Return of a Foreign Corporation*."

Issue

IRS International Examiners have been instructed to increase the number of Forms 1120-F selected for examination. These examinations are being conducted for several reasons. First, the IRS has recently established a Compliance Initiative Project ("CIP")

for Forms 1120-F in order to determine if the level of compliance for 1120-F filers is adequate. There is a concern within the International division of LB&I that there has been an increase in income shifting and inbound financing by foreign entities. The second reason for the increase in the number of Forms 1120-F being examined, is the IRS has placed a greater emphasis on the examination of trade or business/permanent establishment cases. Seemingly, the IRS believes that foreign companies are increasing the amount of activity they conduct in the United States without operating here as a branch or subsidiary. A U.S. branch is required to file a Form 1120-F, and there are significant penalties stemming from the failure to do so. Indeed, many foreign corporations will file a protective 1120-F to avoid such penalties. The increased audit activity raises a concern that a permanent



establishment or a U.S. trade or business may exist and whether the correct amount of income from U.S. activity is being reported. Accordingly, protective Forms 1120-F are also being selected for examination by International Examiners.

What is a CIP?

The CIP Program is one of several methods used by the IRS to identify and examine a group of taxpayers that may have a specific area of tax non-compliance.

Background

Until recently, IRS International Examiners have conducted most of their examinations as a result of referrals from a domestic examination group. As a result, not many returns submitted on Forms 1120-F were selected for examination. In addition, over the years, the IRS has initiated a number of programs to identify areas of non-compliance with U.S. tax laws (e.g., Return Compliance Programs, Information Gathering Projects, and Compliance 2000 Projects). CIP is a program that seeks to identify areas of taxpayer non-compliance. The Internal Revenue Manual (IRM) defines a CIP as any activity "involving contact with specific taxpayers and collection of taxpayer data within a group, using either internal or external data to identify potential areas of non-compliance within the group, for the purpose of correcting the non-compliance." Although the CIP

Program is a relatively small part of the entire IRS Compliance Plan (approximately 1%), the projects emanating from this program have been very successful in enabling the IRS to identify pockets of non-compliance and to reallocate resources to address these concerns.

PwC observations

The IRS recently restructured what is now the Large Business & International Division. This has resulted in an increased IRS focus on transfer pricing issues, withholdings on payments to foreigners, and now the activities of the U.S. branches of foreign business entities. While in the past IRS International Examiners (IEs) have worked on cases stemming from referrals from Domestic Agents, the IEs can also now work on their own inventory of returns. This gives them the opportunity to focus on returns they deem likely to present areas of non-compliance for international issues. Due to the increased probability of an audit, taxpayers that file Form 1120-F - both regular and protective - should be aware of the issues agents can raise and should also be prepared to understand the authority the IRS has to request documents and records located in a foreign country.

The PwC Tax Controversy and Dispute Resolution team has members in offices around the country who understand the issues surrounding the examination of Form 1120-F and can advise clients appropriately. For further information, please call any of these individuals or the persons listed below:

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