TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The IRS Faces Challenges to Address Tax Avoidance Strategies of Large Multinational Corporations

August 26, 2024

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HIGHLIGHTS: The IRS Faces Challenges to Address Tax Avoidance Strategies of Large Multinational Corporations

Final Audit Report issued on August 26, 2024 **Report Number 2024-400-045**

Why TIGTA Did This Audit

This audit was initiated because an IRS employee raised concerns about IRS management's ability to effectively address large multinational corporations' use of a potentially abusive foreign tax structure.

The overall objective of this audit was to evaluate concerns regarding the IRS's policies and procedures to address tax compliance of large multinational corporations and in particular, the use of a potentially abusive tax structure.

Impact on Tax Administration

Large corporations that are centrally controlled by a parent company and conduct worldwide activities are considered multinational enterprises (hereafter referred to as large multinational corporations). The Large Business and International (LB&I) Division oversees the compliance activities involving large multinational corporations.

The IRS notes in its Strategic Operating Plan that the rising breadth and complexity of tax administration, coupled with the sophisticated ways that some taxpayers attempt to evade tax, have outpaced the IRS's resources and ability to monitor compliance and close the gap between taxes owed and collected.

What TIGTA Found

Large multinational corporations can structure their operations and transactions for tax planning and sometimes tax evasion purposes. An entire industry of lawyers, accountants, and wealth management professionals exists to help taxpayers, including large multinational corporations, reduce income subject to U.S. taxation. Much of this planning involves legitimate tax strategies; however, some strategies use the establishment of entities in foreign no-tax or low-tax jurisdictions as a sole means to hide income producing assets or underreport income from U.S. taxation.

TIGTA was provided a list of 23 large multinational corporations that were alleged to have used a foreign trust structure that had no alleged business purpose or economic substance other than to avoid U.S. taxation. TIGTA evaluated the processes, procedures, and enforcement tools the IRS has in place to address these structures and their associated transactions.

While the IRS would analyze the purpose of the trust structure's operations and its material tax effects, IRS revenue agents do not [redacted]. The LB&I Division noted that 11 of 23 examination teams considered the trust structure during their examinations.

During this review, concerns were also raised regarding policies and procedures that could appear to be favorable towards large multinational tax administration. These included that large multinational taxpayers can directly contact IRS executives, that some large multinational corporate taxpayers may not be suitable for the Compliance Assurance Process program, and that LB&I Division compliance personnel have limited communication and interaction during the appeals process. The concerns shared by and perceptions of the employees we interviewed need to be considered by management when administering IRS programs, including when implementing policies and procedures.

What TIGTA Recommended

TIGTA recommended that the IRS review its examination procedures to determine whether changes are needed in support of effective tax administration for large complex taxpayers and that the IRS Independent Office of Appeals update its policies to require inviting compliance personnel and Counsel to taxpayer conferences involving large multinational corporations.

The IRS agreed to review its examination procedures but did not agree to require inviting compliance personnel and Counsel to taxpayer conferences involving large multinational corporations. However, we continue to believe that due to the complexities of large corporate tax administration, it is important to have the involvement of compliance personnel and Counsel in the appeals process.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

August 26, 2024

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Danny R. Verneuille
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The IRS Faces Challenges to Address Tax Avoidance Strategies of Large Multinational Corporations (Audit No.: 202240024)

This report presents the results of our review to evaluate concerns regarding the Internal Revenue Service's (IRS) policies and procedures to address tax compliance of large multinational corporations and in particular, the use of a potentially abusive tax structure. This review is part of our Fiscal Year 2024 Annual Audit Plan and addresses the major management and performance challenge of *Tax Compliance and Enforcement*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Diana M. Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

Large corporations that are centrally controlled by a parent company and conduct worldwide activities are considered multinational enterprises (hereafter referred to as large multinational corporations). The Internal Revenue Service's (IRS) Large Business and International (LB&I) Division oversees the compliance activities involving these large multinational corporations. The LB&I Division's compliance activities include examinations that involve highly complex tax issues. The IRS acknowledges the challenge it has and will continue to have to address noncompliance relating to large multinational corporations. For example, in the IRS's Inflation Reduction Act (IRA)[1] Strategic Operating Plan published on April 5, 2023, one of the IRS's strategic objectives is to focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the Tax Gap.[2] The IRS notes in its plan that the rising breadth and complexity of tax administration, coupled with the sophisticated ways that some taxpayers attempt to evade tax, have outpaced the IRS's resources and ability to monitor compliance and close the gap between taxes owed and collected.

The IRS uses a multi-pronged approach to identify large multinational corporations for examination which can include both pre-and post-filing compliance programs, *e.g.*, Large Corporate Compliance; Compliance Assurance Process (CAP); focused campaigns; receipt of whistleblower claims; and referrals from other IRS functional areas.[3] Due to their complexity, the IRS's examination of large multinational corporations frequently involves LB&I executives, senior revenue agents, specialists, and IRS Counsel.[4] Figure 1 depicts the complexities of these examinations.

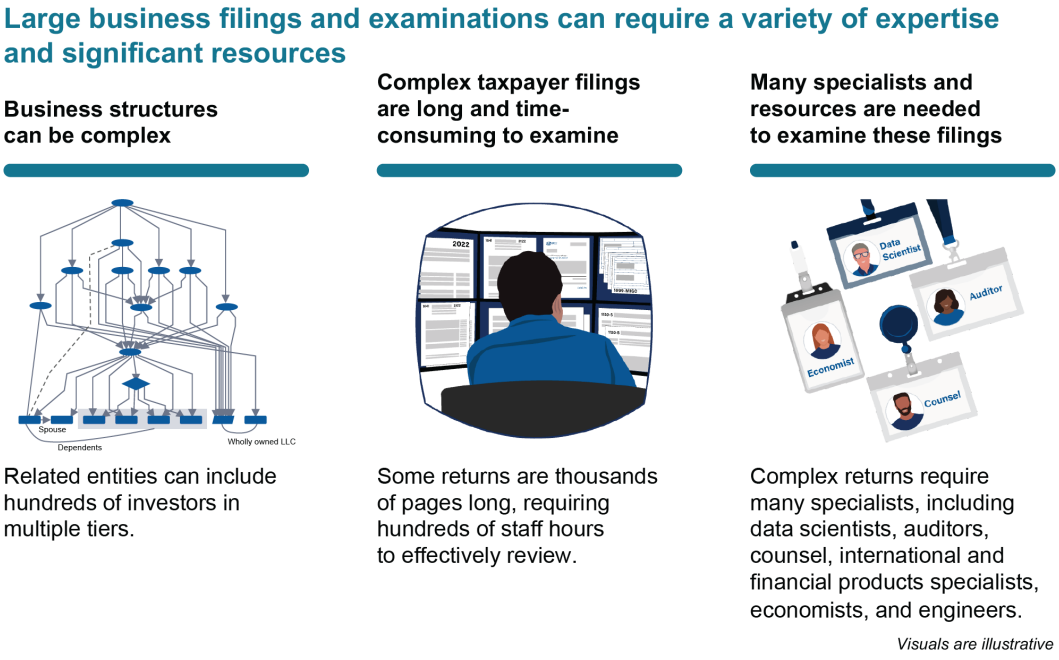
[1] On August 16, 2022, the Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818, was enacted. Sec. 10301 of the Act provided additional funding for the IRS for taxpayer services and enforcement.

[2] See Appendix IV for a glossary of terms.

[3] See Appendix II for additional details of the LB&I Division's compliance programs.

[4] Specialists can include economists, engineers, appraisers, international examiners, financial products specialists, tax computation specialists, and computer audit specialists.

Figure 1: Complexity of Large Business and International Examinations



Source: Internal Revenue Service Inflation Reduction Act Strategic Operating Plan.

Concerns raised by an IRS employee

An IRS employee raised concerns about IRS management's ability to effectively address large multinational corporations' use of a potentially abusive foreign tax structure. This employee questioned the IRS's efforts to raise the Economic Substance Doctrine argument relating to a specific foreign trust structure that large multinational corporations can use to reduce or avoid U.S. taxation. This doctrine which evolved judicially and is now codified in Internal Revenue Code (I.R.C.) § 7701(o) generally disregards a tax benefit (such as the tax-exempt nature of a transaction) if the only purpose of the transaction was for tax benefits.[5] The employee also cited concerns of undue influence on IRS policies and procedures facilitated by the revolving door and influence the largest law and accounting firms have on the IRS. Failure to consider the Economic Substance Doctrine could be one type of preferential treatment if management purposefully avoids its application due to influence from external parties *e.g.*, tax professionals representing large multinational corporations.[6]

This employee provided us with a list of 23 large multinational corporations that were alleged to use a foreign trust structure that had no substantial business purpose other than to avoid U.S. taxation. Although we used this list to ask specific questions of IRS management and to identify

[5] I.R.C. § 7701(o) provides rules for applying the Economic Substance Doctrine and clarifies that a transaction to which the doctrine applies only has economic substance if (1) it changes the taxpayer's economic position in a meaningful way and (2) the taxpayer has a substantial purpose for entering the transaction without considering Federal income tax savings under either item.

[6] We previously conducted a review that assessed the IRS's processes and procedures to identify and address potential conflicts of interest regarding tax administration matters involving large corporations. TIGTA, Report No. 2023-40-047, *Processes Are in Place to Identify and Address Potential Conflicts of Interest in Large Corporate Tax Administration* (Aug. 2023).

examination teams to meet with, we did not assess whether any of these 23 large multinational corporations engaged in potentially abusive tax planning. Rather we evaluated the processes, procedures, and enforcement tools the IRS has in place to address such structures and their associated transactions.

Results of Review

We evaluated the IRS's consideration of the Economic Substance Doctrine argument during its examinations of 23 large multinational corporations. Of specific concern was how the IRS addressed the alleged use of a potentially abusive foreign trust structure to reduce or avoid paying U.S. taxes in examinations of large multinational corporations. We found that while the IRS did not specifically address the economic substance of the foreign trust structure for the 23 large multinational corporations alleged to have used this structure, in some instances the IRS pursued the issue in the area of transfer pricing.[7]

During our review, we met with examination teams, specialists, Counsel, and IRS management to discuss the policies and procedures the IRS has in place to address tax compliance of large multinational corporations. During these interviews, IRS employees raised specific concerns regarding policies and procedures involving large corporate tax administration. The concerns included individuals' perceptions that some policies and procedures were favorable to large corporations, such as a strict approval process required for the application of the Economic Substance Doctrine. Our review did not identify instances of preferential treatment provided to large multinational corporations. However, the concerns shared by and perceptions of the employees we interviewed need to be considered by management when administering IRS programs, including when implementing policies and procedures.

Finally, the IRS Commissioner recently acknowledged that the IRS "*will focus IRA enforcement resources on hiring the accountants, attorneys, and data scientists needed to pursue high-income and high-wealth individuals, complex partnerships, and large corporations that are not paying the taxes they owe.*" However, the IRS must overcome challenges to its hiring processes to accomplish its enforcement hiring objectives.

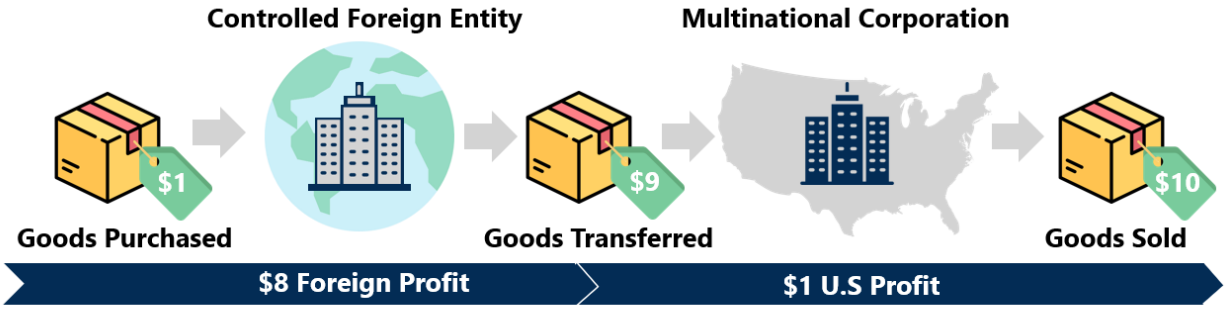
The IRS Faces Challenges to Address Tax Avoidance Strategies of Large Multinational Corporations

Large multinational corporations can structure their operations and transactions for tax planning and sometimes tax avoidance purposes. An entire industry of lawyers, accountants, and wealth management professionals exist to help taxpayers, including large multinational corporations, reduce income subject to U.S. taxation. Much of this planning involves legitimate tax strategies; however, some strategies use the establishment of entities in a foreign no-tax or low-tax jurisdiction as a sole means to hide income producing assets or underreport income from U.S. taxation.

[7] Transfer pricing involves the setting of the price for goods or services between a foreign subsidiary and its U.S.-based parent corporation, or vice versa.

In addition, large multinational corporations may use pricing methods when they conduct intercompany transactions that potentially result in evading or avoiding taxes. I.R.C. § 482 prevents a domestic corporation from artificially deflating its profits that are subject to U.S. income tax by inflating the profits of its foreign subsidiaries that are not subject to U.S. income tax. Although the two parties are related, the "transfer price" should match that of an arm's length transaction.[8] For example, a large multinational corporation could use a controlled foreign entity to transfer goods from the foreign entity to the parent corporation at a significantly marked up price. Then, the U.S. parent corporation will sell the goods and report a lower profit or loss which in turn erodes the U.S. tax base. Figure 2 shows a hypothetical example of this concept.

Figure 2: Example of Transfer Pricing



Reporting lower profit margins or losses consequently erodes the U.S. tax base.

Source: TIGTA's hypothetical example.

Revenue agents must address how to treat these transactions based on individual facts and circumstances and determine whether the transaction (or resulting structure) has economic substance, *i.e.,* has both a meaningful change to the taxpayer's economic position and substantial business purpose. If the IRS determines that the structure or transaction does not have either meaningful economic change or a substantial business purpose, the structure may be disregarded (or the transaction disallowed) for the purpose of determining the taxpayer's Federal income tax liability and a penalty of up to 40 percent may be assessed against the taxpayer. However, if the structure or transaction is deemed to have a substantial business purpose, then the IRS evaluates whether the transactions between the entities are priced at arm's length.

When we discussed the use of these specific foreign trust structures with IRS management, they noted that it can [redacted]. IRS management also noted that taxpayers have prevailed in cases where economic substance has been used to question a structure and the IRS will generally consider transfer pricing adjustments when examining these structures. IRS management noted that by addressing the transfer pricing of the transactions, the IRS is addressing large multinational corporations' tax avoidance strategies, just using a different method.

[8] The arm's length price of the transaction would be the price an unrelated or uncontrolled entity would charge for the same transaction under similar circumstances.

Moreover, IRS management notes that transfer pricing audits often result in significant proposed adjustments to tax owed. To illustrate, the IRS reported that from Fiscal Year (FY) 2018 through FY 2023 (as of July 2023) the average proposed adjustment for transfer pricing was $219 million compared to other LB&I Division adjustment types in which the average adjustment was $56 million.

Counsel support is necessary to address complexities in tax law

Because large multinational corporations engage in very large and complex tax transactions, which often involve complex areas of tax law, the IRS must make legally sound and well-developed arguments to protect the interests of the Government. As a result, IRS Counsel advice becomes a necessary consideration in the IRS's overall enforcement approach. According to IRS management, Counsel evaluates the facts and circumstances of a case across a broad range of issues, including case law and precedent. Whereas a revenue agent is evaluating the specific facts and issues of the assigned case. Counsel involvement becomes especially important when the outcome of litigation can set legal precedent for the IRS, which in turn can affect how the IRS litigates other similar cases.

We judgmentally selected and met with five examination teams.[9] Each team noted a reliance on IRS Counsel's support to pursue certain issues during their examinations of large multinational corporations. Additionally, LB&I Division management indicated that due to the overall complexity of tax issues, examination teams will not pursue an issue if Counsel's advice is that the IRS's position is not legally sound. The following examples illustrate the impact of Counsel support during an examination:

- [redacted][10].
- [redacted]

[9] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population. We selected four examinations teams that were associated with the list of 23 corporations provided that were alleged to have used a foreign trust structure to avoid paying U.S. income taxes and [redacted].

[10] [redacted].

[redacted].

The LB&I Division's awareness of and efforts to address large multinational corporations using the foreign trust structure

In response to our receiving the list of 23 large multinational corporations that were alleged to have used a similar foreign trust structure to avoid paying U.S. income taxes, and at our request, LB&I Division management asked the examination teams to determine if they were aware of the corporations' use of the foreign trust structure and if they identified the use of this structure as part of the examination risk assessment process. In April 2022, LB&I Division management indicated that 14 examination teams were aware of the foreign trust structure being used by these large multinational corporations. Further, for 11 of the 14 examinations, the examination teams' risks assessments resulted in the consideration of the foreign trust structure as part of their examinations.[11] The results for these 11 examination teams showed that:

- Four teams did not review the structure in the current examination cycle; however, three of these teams noted that the structure was reviewed in previous examination cycles.
- Three teams reviewed the structure in the most recent examination cycle but did not propose tax changes or adjustments.
- Three teams pursued the structure's transactions using transfer pricing.
- [redacted].

When we met with LB&I Division management, specialists, and the five judgmentally selected examination teams, they noted that the presence of the foreign trust structure itself would not be cause for concern because it is not uncommon for a large multinational corporation to structure its tax operations to include many foreign operations. In addition, while the IRS would analyze the purpose of the trust structure's operations and its material tax effects, the IRS would not automatically evaluate the structure in terms of the Economic Substance Doctrine.

Actions taken by IRS Criminal Investigation to address a [redacted]

As part of the concerns raised by an IRS employee, [redacted].

- [redacted]

[11] [redacted].

[redacted].

- [redacted].
- [redacted].
- [redacted].

[redacted]

[redacted].

IRS Employees Raised Concerns Regarding Policies and Practices That Could Appear to Be Favorable Towards Large Multinational Corporations

The IRS employee's concerns also included that the original Economic Substance Doctrine policy appeared to be influenced by requests from private sector firms. As part of our discussions with the LB&I Division examination teams, revenue agents, and other subject matter experts, we obtained their perspectives on pursuing the Economic Substance Doctrine. The examination teams noted difficulties such as extensive documentation requirements to demonstrate why the use of the doctrine was not appropriate and the need to get multiple approvals, including from an executive and IRS Counsel. In addition, the examination teams' perceptions were that it was almost impossible to pursue the Economic Substance Doctrine, not only because of the strict policies in place, but also because they lacked support from IRS Counsel.

Our review found that two months prior to the implementation of the July 2011 Economic Substance Doctrine policy, the Department of the Treasury and the IRS received a letter from the private sector urging them to reconsider the position that they did not, "*intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply*." The IRS Economic Substance Doctrine policy was an LB&I Division policy implemented by a former LB&I Commissioner in July 2011. The policy included that revenue agents had to complete and document the following requirements when pursuing the Economic Substance Doctrine:

1. Determine that the doctrine is likely not appropriate.
2. Evaluate whether the case circumstances merit potential application of the doctrine.
3. Obtain manager approval in consultation with counsel.
4. Obtain LB&I Division executive level approval.

When we discussed our concerns with IRS management, they noted that the intent of the guidance was to ensure that revenue agents fully developed their arguments and counter arguments on the use of the doctrine due to the potential for litigation. IRS management noted that it is not uncommon to receive input and comments from the private sector, and at the time of the codification of the Economic Substance Doctrine, the private sector was concerned with the 40 percent penalty implications that this doctrine could impose. IRS management also noted that the penalties and the potential for litigation was one of the reasons why the application of this doctrine had to go through so many layers of review and receive Counsel support.

In April 2022, LB&I Division leadership modified some of its requirements for raising the Economic Substance Doctrine argument and asserting the associated penalty. Some of the key changes to the policy were that:

- LB&I eliminated the need to first determine *why the use of the economic doctrine was likely not appropriate*.
- Revenue agents no longer need to obtain executive level approvals.

When we discussed the change in the guidance, IRS management indicated that the change was a result of gaining experience and a level of comfort in the application of the doctrine. The IRS could not provide us with the number of cases where examination teams considered the Economic Substance Doctrine. Instead, IRS management provided several examples of cases where the courts have both upheld and disallowed the IRS's adjustments using this doctrine. According to IRS management, these examples show that when developed properly and if facts and circumstances warrant, the IRS will and does pursue the Economic Substance Doctrine.

Concerns were raised over large multinational taxpayers' ability to directly contact IRS executives

During our discussions with examination teams, concerns were raised regarding the ability of large multinational corporate taxpayers to directly contact IRS executives. During our meetings with LB&I Division revenue agents, they noted that large multinational taxpayers can call IRS executives directly; and at times, some revenue agents believed that these contacts resulted in the multinational corporation influencing examination's efforts. This is because there is nothing formally documented and communicated back to these teams that summarizes what was discussed.

The LB&I Division's examination guidelines include a policy referred to as the *Principles of Collaboration*. These guidelines are intended to clarify the roles, responsibilities, and lines of authority for taxpayers or revenue agents to elevate concerns during an examination. The IRS states that its collaboration policy is designed to promote consistent tax treatment between similarly situated taxpayers, issues, or cases. It also outlines typical instances where a senior manager or executive may need to get involved in an examination such as taxpayer requests for senior leader or executive interactions. The policy also allows senior managers or executives to initiate involvement in an examination in a variety of circumstances including to discuss a strategic initiative or issue that has an impact to the taxpayer, increase their understanding of an issue, or any other reasons they deem appropriate.

In October 2022, we discussed this collaboration policy with LB&I Division leadership and expressed our concern that the *Principles of Collaboration* does not require any communication or documentation to be provided to LB&I Division revenue agents assigned to work the examination. In addition, other IRS operating divisions, such as the Small Business/Self-Employed Division, do not have a similar policy of executive involvement and/or interactions with taxpayers. IRS officials stated that they encourage elevation of complex issues due to the multi-disciplinary examinations conducted by the LB&I Division. Further, this policy reflects the Taxpayer Bill of Rights principles that taxpayers have the right to be informed and have the right to quality service, which includes speaking to a manager about inadequate service.[12]

LB&I Division management noted that allowing both employees and taxpayers to elevate concerns promotes identification and resolution of risks and challenges in an examination.

[12] Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the laws and IRS procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes. Also, taxpayers have the right to receive prompt, courteous, and professional assistance in their dealings with the IRS, to be spoken to in a way they can easily understand, to receive clear and easily understandable communications from the IRS, and to speak to a supervisor about inadequate service.

LB&I Division management also noted that executives will often consult with the examination team before discussions with one of these large corporate taxpayers so that they are aware of the examination issues.

Concerns were raised by LB&I Division revenue agents about the CAP program

During our review, concerns were also raised that some large multinational corporate taxpayers may not be suitable for the IRS's CAP program. According to the IRS, the purpose of the CAP program was to allow taxpayers to collaborate with the IRS by self-identifying potential tax issues and resolving these issues before filing their tax returns each year, *i.e.*, a real-time audit. The perceived benefits of the program were that the taxpayer achieves tax certainty with less administrative burden than through conventional examinations. In addition, this would save the IRS time and resources.

However, LB&I Division revenue agents that we spoke with, noted that large multinational corporate taxpayers did not always meet the requirements of the program. These taxpayers were not always transparent or cooperative and remained in the program even after examination teams recommended their removal. LB&I Division management noted that the CAP program has procedures to remove taxpayers that no longer meet the program's eligibility requirements. This requires the examination teams to fully document and support their assertions for removing the taxpayer from the program. In addition, the IRS notifies the taxpayer of their decision and gives them an opportunity to provide a response. However, during our discussions with revenue agents, they noted that despite their documentation, it was difficult to get a taxpayer removed from the CAP program. They were unsuccessful in their efforts until they had a management official to support the team's decision to remove the taxpayer from the CAP program.

Additionally, LB&I Division revenue agents questioned the effectiveness of the program because the intended resource savings were not being achieved due to the complexity of the issues under examination. They noted that these complexities result in continuing the examination into a post-filing environment, which is contrary to what the CAP program was intending to accomplish. We compared the cycle times and hours spent per return for the CAP and the LB&I Division's Large Corporate Compliance programs from FYs 2020 to 2022. We found no marked improvement in employee hours spent conducting examinations; however, the cycle times of a CAP examination were eight months less, on average, than a Large Corporate Compliance examination. The reduced cycle time is expected as taxpayers are required to disclose known issues prior to filing the tax return and work cooperatively with the IRS to resolve those issues. However, the shortened duration of a CAP examination did not translate to less hours spent on these examinations.

When we met with LB&I Division leadership to understand their perspective on the program, they noted that the CAP program is an avenue for the IRS to gain insight into how a taxpayer will treat certain transactions prior to filing a tax return.

Recommendation 1: The Commissioner, LB&I Division, should review the Division's examination procedures to determine whether changes are needed in support of effective tax administration for large complex taxpayers *e.g.*, large multinational corporations. This should include, but not be limited to, the use of the Economic Substance Doctrine, *Principles of Collaboration*, and the CAP program.

Management's Response: IRS management agreed with the recommendation and will review their examination procedures with this report in mind to identify opportunities for improvement. Management noted that the CAP program was recalibrated, and they updated procedures to remove unsuitable taxpayers. Likewise, management noted they also previously updated their procedures with respect to the Economic Substance Doctrine and examination teams continue to evaluate its application where appropriate. The Government has a responsibility to conduct professional examinations, and they encourage communications between IRS and taxpayers.

Concerns regarding LB&I Division compliance personnel participation in the appeals tax conference process

During our discussions with the examination teams, concerns were brought to our attention that revenue agents have limited communication and interaction with Appeals.[13] The LB&I Division revenue agents' perspective was that large corporate taxpayers often use the appeals process to their advantage to reduce additional tax assessments.

Appeals uses conferences to work with taxpayers to resolve cases by objectively assessing the facts, law, and litigating hazards. Currently, for cases involving the largest corporate taxpayers, Appeals holds a pre-conference with LB&I Division compliance personnel *e.g.*, LB&I Division revenue agents and specialists, and Counsel giving both an opportunity to explain their position and answer any questions Appeals may have about the facts and circumstances of the case. The taxpayer and their representative are also invited to attend this pre-conference. Traditionally, LB&I Division personnel and Counsel would leave after the pre-conference concluded, and Appeals would hear the taxpayer's presentations of its position and then proceed with settlement negotiations.

In May 2017, Appeals initiated a pilot program that required the participation of LB&I Division compliance personnel and Counsel in a joint discussion with the taxpayer for the largest cases worked by Appeals Team Case Leaders. The goal of the pilot program was to improve the efficiency of the conference process in large, complex cases. The pilot was intended to determine whether conducting a joint discussion with LB&I Division compliance personnel, Counsel, and the taxpayer would help narrow the scope of the disputed issues between the parties and improve everyone's understanding of the factual and legal differences. Afterwards, LB&I Division compliance personnel and Counsel would be dismissed, and the taxpayer would proceed with Appeals in settlement negotiations.

After three years, the IRS ended the pilot program on May 1, 2020. According to the announcement made by Appeals:

> *Appeals continues to conduct a formal survey of participants in cases worked during the initiative. Over the coming months, Appeals management will evaluate the survey results, as well as other sources of information, to determine whether it should be continued for these*

[13] The Restructuring Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, directed the Commissioner to ensure an independent appeals function within the IRS, including the prohibition of ex parte communications between appeals officers and other IRS employees to the extent that such communications appear to compromise the independence of the appeals officers. Revenue Procedure 2012-18 established guidance to accommodate the overall interests of tax administration, while preserving operational features that are vital to Appeals' case resolution processes within the structure of the IRS and ensuring open lines of communication between Appeals and the taxpayer/representative.

large corporate tax disputes. In the meantime, [Appeals Team Case Leaders] will operate under longstanding guidelines in effect prior to the initiative, which provide [the Appeals Team Case Leader] the discretion to include the IRS Examination team and their Counsel in the non-settlement portion of the conference, but do not mandate that the [Appeals Team Case Leader] include them.

In September 2021, Appeals published the summary of its findings related to the pilot program. This summary included the results of Appeals' survey of IRS employees who participated in the pilot program, taxpayers and their representatives, and public comments. The following are some of the feedback provided from the various stakeholders.

- The Appeals Team Case Leaders believed that involving LB&I Division revenue agents improved their understanding of the dispute and allowed both parties to articulate their positions.
- Public commenters noted that IRS compliance should not be allowed in the conference unless taxpayers consent to their participation, and IRS compliance presence may be detrimental to the case resolution.

In the summary of its findings, Appeals concluded that, while it can be beneficial to have revenue agents and IRS Counsel present at the taxpayer conference, it was not necessary in every case. Moreover, Appeals believes that the availability of the pre-conference is generally sufficient for hearing and understanding the position of LB&I Division compliance personnel and that the Appeals Team Case Leader is best positioned to determine whether additional LB&I Division compliance personnel participation would be helpful. However, LB&I Division management believed that participation in Appeals conference discussions assists the Appeals Team Case Leaders in understanding the dispute and the merits of both parties' positions, thereby fostering effective tax administration.

In discussing our observations with the IRS, Appeals noted that the decision to return to its pre-pilot policy involved consideration of all comments received, analysis of the process and outcomes, and consideration of differing viewpoints in formulating its post-pilot policy.[14] Appeals believes that rather than relying on absolute and inflexible policies, the decision as to when and whether this involvement is beneficial should be left in the hands of the Appeals Team Case Leaders who are charged with settling the case and are in the best position to determine the kind of dialogue and assistance that will be the most useful in that effort. LB&I Division management noted that they use the results of appeals decisions to help determine if their examination teams should change their strategy or if there is a systemic disagreement on certain issues.

Due to the complexities of large multinational corporate tax administration, we believe it is important to have the involvement of the LB&I Division and Counsel in the appeals process to improve understanding of the dispute and allow both parties to articulate their positions. This will ensure a balanced approach in the process for both the IRS and taxpayer while maintaining impartiality. Further, we note that the IRA Strategic Operating Plan indicates that ensuring that large corporations pay the taxes they owe is a complex endeavor and requires significant

[14] Appeals noted that third-party stakeholders, such as the IRS National Taxpayer Advocate recommended that compliance and Counsel be allowed to participate in an Appeals conference only with the permission of the taxpayer.

resources and a range of specialists. This includes efforts within Appeals that help resolve any tax controversies arising from compliance.

Recommendation 2: The Chief, IRS Independent Office of Appeals, should update policies to require inviting compliance personnel and Counsel to the taxpayer conferences for those cases involving large multinational corporations.

Management's Response: IRS management disagreed with this recommendation. Appeals' current policy of placing the discretion to invite compliance personnel and Counsel (Compliance) to taxpayer conferences with assigned Appeals technical employees (ATE) furthers Appeals' mission to act as an independent decisionmaker and balances the needs and perspectives of various stakeholders. Requiring Appeals to invite Compliance to all large case conferences, even if the ATE determines it unnecessary or potentially detrimental, could undermine Appeals' independence and compromise Appeals' ability to resolve cases. ATEs should be able to evaluate the needs of participants on a case-by-case basis and make determinations accordingly. Appeals is currently updating internal guidance to set forth criteria that must be considered by Appeals Team Case Leaders in exercising their discretion to invite Compliance to attend taxpayer conferences.

In addition, management noted that Congress is considering legislation that would require taxpayer consent to allow the participation of non-Appeals personnel in conferences.

Office of Audit Comment: We continue to believe that due to the complexities of large corporate tax administration, it is important to have the involvement of compliance personnel and Counsel in the appeals process to improve understanding of the dispute and allow both parties to articulate their positions. We believe that relying on the subjective decisions of each ATE does not promote consistency within the IRS Independent Office of Appeals on how they are handling their largest and most complex taxpayers. Moreover, although Congress may be considering legislation requiring taxpayer consent, it is unknown if this legislation will be enacted and how this legislation will address Appeals' conferences with large multinational corporations.

Enforcement Hiring Has Met Challenges

TIGTA previously reported that the IRS has faced challenges in its hiring efforts, such as finding enough qualified applicants, and keeping pace with attrition; however, the IRS is making progress.[15] Further, our discussions with examination identified concerns with their ability to accomplish their mission with limited resources. Specifically, these teams cited the need for specialists, such as economists, to help them develop and pursue the complex issues and transactions associated with examining large multinational corporations. [redacted]

[15] TIGTA, Report No. 2024-IE-R010, *Inflation Reduction Act: Continued Assessment of Transformation Efforts - Evaluation of Fiscal Year 2023 Delivery of Initiatives* (Mar. 2024) and TIGTA, Report No. 2023-30-054, *The IRS Needs to Leverage the Most Effective Training for Revenue Agents Examining High-Income Taxpayers* (Aug. 2023).

[redacted].

The IRS uses a Specialist Referral System to request specialist assistance on its examinations. From FY 2018 through FY 2023 (as of July 2023), a total of 2,204 (66 percent) of 3,354 requests for economists were denied. Some of the reasons included a lack of substantial issues, insufficient time, and lack of staffing. As noted previously, transfer pricing is one of the LB&I Division's most significant compliance efforts, yet the LB&I Division noted that they have a staffing deficit in their transfer pricing practice area. As of July 2023, the LB&I Division reported a staffing deficit of 190 employees, which is a reason why it cannot conduct more examinations of transfer pricing on large multinational corporation tax returns.

Until the passage of the IRA, the IRS's budget allowed for only minimal enforcement-related hiring. However, with the funding allocated as part of the IRA, the IRS is developing its plans to hire staff to refocus its enforcement efforts. The April 2023 IRA Strategic Operating Plan notes that the rising breadth and complexity of tax administration, coupled with the sophisticated ways that some taxpayers attempt to evade tax, have outpaced the IRS's resources and ability to monitor compliance and close the gap between taxes owed and collected. Along with using improved data analytics and technology, the Commissioner acknowledged that the IRS "*will focus IRA enforcement resources on hiring the accountants, attorneys, and data scientists needed to pursue high-income and high-wealth individuals, complex partnerships, and large corporations that are not paying the taxes they owe.*"[16]

As of February 2024, the LB&I Division had 1,025 specialists on staff. The specialist staff decreased due to internal movement and retirements. The LB&I Division's hiring request for additional specialists was 1,579 for FY 2022 through FY 2024 (as of February 2024), which includes engineers, economists, appraisers, international examiners, financial products specialists, tax computation specialists, and computer audit specialists. The LB&I Division was approved to hire 742 specialists or 47 percent of its requested specialists hiring goals during this time. LB&I Division management noted that their hiring requests always far exceed the number of approved hiring slots.

When we asked LB&I Division management about their thoughts and concerns related to hiring and the new enforcement-related initiatives, they stated that they are adjusting their workload selection and increasing large corporate coverage including partnerships. For example, LB&I Division is using data analytics to help select and expand its audit coverage of large corporations by starting an additional 60 audits of the largest corporate taxpayers. In addition, the IRS is closely examining potential noncompliance among large, complex partnerships, including 75 of the largest partnerships in the United States identified as higher risk for tax compliance with the help of new data analytics tools. LB&I Division management is concerned over the low audit rates for large corporate taxpayers but is taking steps to increase coverage. Additionally, the IRS has initiated a compliance effort focusing on large corporations with foreign entities that have patterns that could indicate an improper use of transfer pricing to avoid reporting U.S. profits. They have issued letters to approximately 150 corporate subsidiaries encouraging self-review and correction of the issue and noted that if the pattern continues their account may be subject to full examination and review.

[16] Publication 3744, *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan* (April 5, 2023).

Finally, LB&I Division management expressed concerns with their hiring efforts. They noted that pay disparity between the public and private sector for persons with the technical skills and competencies that are needed to address large corporate tax compliance is a major contributor to their inability to recruit and retain a highly skilled workforce. They noted that in years past, the Federal Government was a leader in work-life balance and benefits, which was a key to their recruitment efforts; however, the private sector currently offers the same benefits with a much higher pay. Additionally, they noted that there is also a public perception barrier whereby some are not supportive of a bigger IRS.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate concerns regarding the IRS's policies and procedures to address tax compliance of large multinational corporations and in particular, the use of a potentially abusive tax structure. To accomplish our objective, we:

- Assessed the adequacy of the IRS's processes and procedures to address potential noncompliance of large multinational corporations and their use of potentially aggressive tax avoidance structures.
- Assessed the effectiveness of the IRS's processes and procedures to use information regarding potential noncompliance by large multinational corporations.
- Determined the actions taken by the IRS either criminally or civilly to address a potentially abusive tax structure used by large multinational corporations. We judgmentally selected five examination teams assigned to examine a large multinational corporation.[1] We selected four examinations teams that were associated with the list of 23 corporations provided that were alleged to have used a foreign trust structure to avoid paying U.S. income taxes and [redacted]. We do not know the total population of large multinational corporations that use foreign trust structures.
- Determined if any of the IRS's policies, procedures, or actions taken to address potential noncompliance of large multinational corporations can be perceived as providing preferential treatment.

Performance of This Review

This review was performed at IRS National Headquarters in Washington, D.C., in addition to various field offices, *i.e.,* [redacted], during the period January 2022 through January 2024. This review was also performed with information obtained from the LB&I Division, IRS Counsel, IRS Office of Appeals, IRS CI, and IRS Whistleblower Office during the same period. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Russell P. Martin, Deputy Inspector General for Inspections and Evaluations; Diana M. Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services); Darryl J. Roth, Director; Antonina A. Hill, Audit Manager; Jaclynne O. Durrant, Lead Auditor.

[1] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the policies, procedures, and programs the IRS has in place for tax administration relating to large corporations. We reviewed these policies and programs by meeting with IRS examination teams and IRS Executives and reviewing how the IRS handled an allegation of an allegedly abusive tax structure used by large multinational corporations that had no business purpose other than to avoid U.S. taxes.

Appendix II

Large Business and International Division's Compliance Programs

The LB&I Division's compliance programs are based on risk factors, models and filters, taxpayer self-selection, and required selections. These compliance programs include:

- **Large Corporate Compliance -** The Large Corporate Compliance program employs a risk-based selection process to address certain compliance risks in the large corporate taxpayer population. The Large Corporate Compliance program uses data analytics to identify criteria such as gross assets and gross receipts to determine which tax returns are susceptible to the highest compliance risk.
- **Campaigns -** The goal of campaigns is to use a strategic approach to address various types of potential noncompliance using a combination of treatment streams. Campaigns focus on compliance issues and use the appropriate resources and a combination of treatment streams to achieve a desired outcome. In a campaign, a particular area of compliance risk will be identified by running a filter against tax return and other data associated with the LB&I Division taxpayer population to identify and evaluate compliance risk. For example, some of the campaigns that the LB&I Division has initiated include High Income Non-filer, Offshore Private Banking, and Partnership Losses in Excess of Partner's Basis.
- **Global High Wealth/Pass-Through Entities -** The Global High Wealth/Pass-Through Entities program focuses on the largest number of LB&I Division taxpayers based on the number of tax returns filed, including 1) the enterprises controlled by high-wealth individuals and high-income individuals, and 2) flow-through returns.
- **Mandatory -** The Mandatory Compliance program applies resources for work that can arise unexpectedly such as Joint Committee, National Research Program, and selected tax shelter returns and disclosures. An example of the Mandatory Compliance program consists of claims filed by taxpayers with certain Federal tax refunds or credits of more than $2 million ($5 million for C corporations) making them subject to Joint Committee review.
- **Compliance Assurance Process -** The CAP is a voluntary program for some of LB&I Division's largest and most complex taxpayers where eligible taxpayers agree to engage in an open, transparent, and cooperative relationship with the Government in a prefiling environment, *i.e.*, prior to filing of the corporate income tax return. In the CAP, material issues are reviewed in real-time with the expectation that issue resolution can be achieved before the large corporation's tax return is filed.
- **Foreign Payment Practice -** The Foreign Payment Practice program is responsible for reviewing foreign withholding matters and foreign financial institution compliance under Chapters 3 and 4 of the Internal Revenue Code.

- **Discretionary -** The Discretionary Compliance program includes, but is not limited to: Training Returns, Claims, Bankruptcy, Information Referrals and Reports, Program Action Cases, Change in Accounting Method, Emerging Issues, and Transactions of Interest.[1]

[1] An issue that may involve a new or novel set of facts relating to the improper application of the tax law. It may also be a new technical issue or a new interpretation of existing tax law. Emerging issues do not necessarily need to be abusive or fraudulent to be considered an emerging issue. Tax transactions that have the potential for tax avoidance or evasion that must also be reported to the IRS.

Appendix III

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

DEPUTY COMMISSIONER

July 15, 2024

MEMORANDUM FOR DANNY VERNEUILLE
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell
Deputy Commissioner
Douglas W. Odonnell Digitally signed by Douglas W. Odonnell Date: 2024.07.15 14:59:52 -04'00'

SUBJECT: Draft Audit Report – The IRS Faces Challenges to Address Tax Avoidance Strategies of Large Multinational Corporations (Audit # 202240024)

Thank you for the opportunity to respond to the above-referenced report. The Large Business and International Division (LB&I) conducts detailed and thorough examinations of large business taxpayers on some of the most challenging topics covering domestic and international issues. Our guiding principle is to ensure that the government's issues are well-developed and technically sound, and to operate in a manner that recognizes and respects taxpayers' rights. The recent infusion of funding from the Inflation Reduction Act positions the IRS to hire more staff and specialist expertise to address noncompliance in priority areas critical for the agency and to uphold the nation's tax laws for large corporations, partnerships and high-income taxpayers.

As part of this audit, TIGTA conducted a thorough review of LB&I's examination procedures. TIGTA's audit spanned nearly two years, with multiple employee and management interviews, and the production of thousands of documents by IRS. We appreciate TIGTA's acknowledgement in the Draft Report that their review did not identify instances of preferential treatment provided to large multinational corporations. A periodic evaluation of processes and procedures to ensure proper calibration is an important function of any organization, and we will be taking a review of our examination procedures with this report in mind to identify opportunities for improvement.

Attached is our response to your recommendations. If you have any questions, please contact me, or members of your staff may contact Donnell Lewis, team manager, at 601-292-4740 or Donnell.Lewis@irs.gov.

Attachment

Attachment

RECOMMENDATION 1: The Commissioner, LB&I Division, should review the Division's examination procedures to determine whether changes are needed in support of effective tax administration for large complex taxpayers *e.g.*, large multinational corporations. This should include, but not be limited to, the use of the Economic Substance Doctrine, *Principles of Collaboration*, and the CAP program.

CORRECTIVE ACTION: A periodic evaluation of our examination processes and procedures to ensure proper calibration is an important function of any organization, and we will be taking a review of our examination procedures with this report in mind to identify opportunities for improvement. However, we note that the CAP program did undergo a recalibration that culminated in updated procedures for removal of unsuitable taxpayers that requires discipline on both IRS and taxpayer part and has resulted in the removal of taxpayers who are not suited for the program. Likewise, we also previously updated our procedures with respect to the Economic Substance Doctrine and exam teams continue to evaluate its application where appropriate. The government has a responsibility to conduct professional examinations, and we encourage communications between IRS and taxpayers.

RESPONSIBLE OFFICIAL: LB&I Assistant Deputy Commissioner, Compliance Integration

IMPLEMENTATION DATE: September 30, 2025

CORRECTIVE ACTION MONITORING PLAN: We will monitor the corrective action as part of our internal management system of controls.

RECOMMENDATION 2: The Chief, IRS Independent Office of Appeals, should update policies to require inviting compliance personnel and Counsel to the taxpayer conferences for those cases involving large multinational corporations.

CORRECTIVE ACTION: The IRS Independent Office of Appeals (Appeals) disagrees with this recommendation. Appeals' current policy of placing the discretion to invite compliance personnel and Counsel (Compliance) to taxpayer conferences with assigned Appeals technical employees (ATEs) furthers Appeals' mission to act as an independent decisionmaker and balances the needs and perspectives of various stakeholders.

To resolve tax controversies on a basis that is fair and impartial, Appeals must function independently of both Compliance and taxpayers. Requiring Appeals to invite Compliance to all large case conferences, even if the ATE determines it unnecessary or potentially detrimental, could undermine Appeals' independence and compromise Appeals' ability to resolve cases. The ATE responsible for settling the case is best

positioned to determine whether the involvement by Compliance in a particular taxpayer conference furthers a fair and impartial resolution.

In addition, the view expressed in this recommendation is not held by all stakeholders. The IRS National Taxpayer Advocate (NTA) has recommended precisely the opposite approach—that Compliance be allowed to participate in an Appeals conference only with the permission of the taxpayer. The NTA has also proposed legislation that would codify this requirement. Currently, Congress is considering legislation that would require taxpayer consent to allow the participation of non-Appeals personnel in conferences (H.R.6332 - 118th Congress (2023-2024): Strengthen Taxpayer Rights Act of 2023).

ATEs should neither be required to invite, nor prohibited from inviting, Compliance participation in large taxpayer conferences. ATEs should be able to evaluate the needs of participants on a case-by-case basis and make determinations accordingly. Appeals is currently updating internal guidance to set forth criteria that must be considered by Appeals Team Case Leaders in exercising their discretion to invite Compliance to attend taxpayer conferences.

RESPONSIBLE OFFICIAL: N/A

IMPLEMENTATION DATE: N/A

CORRECTIVE ACTION MONITORING PLAN: N/A

Appendix IV

Glossary of Terms

Term	Definition
Attorney Client Privilege	The attorney client privilege applies when legal advice is sought from a professional legal advisor in their capacity as such, and the communications relating to that legal advice purpose are made in confidence. Communications subject to the attorney client privilege are at the client's discretion permanently protected from disclosure by the client or their adviser unless waived.
Economic Substance Doctrine	On March 30, 2010, the Health Care and Education Reconciliation Act was enacted.[1] This law amended the Internal Revenue Code to codify the Economic Substance Doctrine under I.R.C. § 7701(o). The Economic Substance Doctrine is a judicial doctrine that indicates a transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering the transaction. The Health Care and Education Reconciliation Act also amended penalty provisions under I.R.C. § 6662, I.R.C. § 6662A, I.R.C. § 6664 and I.R.C. § 6676. I.R.C. § 6662 was amended to add a new penalty to be applied to any underpayment attributable to transactions lacking economic substance. The new penalty under I.R.C. § 6662(b)(6) applies a 20 percent penalty on noneconomic substance transactions. I.R.C. § 6662(i) increases the penalty to 40 percent if the relevant facts affecting the tax treatment are not disclosed. The penalty is applicable for transactions entered into after March 30, 2010.
Ex Parte Communication	An "*ex parte* communication" is a communication that takes place between any Appeals employee, *e.g.*, Appeals Officers, Settlement Officers, Appeals Team Case Leaders, Appeals Tax Computation Specialists, and employees of other IRS functions, without the taxpayer/representative being given an opportunity to participate in the communication. The term includes all forms of communication, oral or written. Written communications include those that are manually or electronically generated.
Independent Office of Appeals	The Independent Office of Appeals' role is to independently resolve tax controversies, without litigation, in a fair and impartial manner to both the Government and the taxpayer. Appeals reviews Examination's position and support of issue(s) being rebutted by taxpayers including reasons for disallowance of credit and additional assessment(s). Through conferences, Appeals works with taxpayers to resolve cases by objectively assessing the facts, law, and litigating hazards *i.e.*, the risk that the case will not prevail in court.

[1] Pub. L. No. 111-152, 124 Stat. 1029 (codified in scattered sections of 20, 26, and 42 U.S.C.).

Term	Definition
Spousal Privilege	The spousal communication privilege protects confidential communication made between spouses while married. This privilege survives the dissolution of the marriage.
Tax Gap	The Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.
Transfer Pricing	Transactions between controlled parties which typically involve a U.S. taxpayer and foreign related parties or two U.S. entities if they are not members of the same consolidated group.
Work Product Doctrine	The work product doctrine protects materials prepared in anticipation of litigation.

Appendix V

Abbreviations

ATE	Appeals Technical Employee
CAP	Compliance Assurance Process
CI	Criminal Investigation
FY	Fiscal Year
IRA	Inflation Reduction Act
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
TIGTA	Treasury Inspector General for Tax Administration

To report fraud, waste, or abuse,
contact our hotline on the web at www.tigta.gov or via e-mail at oi.govreports@tigta.treas.gov.

To make suggestions to improve IRS policies, processes, or systems affecting taxpayers, contact us at www.tigta.gov/form/suggestions.

Information you provide is confidential, and you may remain anonymous.