IRS Announces New Compliance Programs Targeting International Taxpayers and Financial Institutions

The US Internal Revenue Service (IRS) Large Business and International (LB&I) Division has announced on 3 November 2017 the identification and selection of 11 new compliance campaigns, in addition to 13 already announced at the beginning of 2017. Compliance campaigns are areas identified for specific review and enforcement efforts, including but in many cases not limited to examinations of taxpayer filings.

Many of these new campaigns will directly impact US-resident individuals and corporations with international tax issues, and some will impact non-US corporations, including financial institutions, with US tax and reporting obligations. Among the areas recently identified include compliance of taxpayers with accounts identified under the Swiss Bank Program.

LB&I announced the rollout of its first 13 campaigns to be implemented on 31 January 2017. With this latest announcement, LB&I continues to focus on issue-based examinations and a compliance campaign process where the IRS decides which compliance issues are deemed to present a risk. The IRS will then focus on these issues in the form of one or multiple so-called “treatment streams” to achieve its compliance objectives. This approach makes targeted use of IRS knowledge and deploys its resources to address these specific issues.

The recently identified issues affect both individuals and corporations, including many financial institutions that incur US tax and reporting obligations as intermediaries or withholding agents for payments. The IRS may address each issue through a variety of treatment streams, including examination of taxpayers’ filed tax returns.

Issues Affecting Individual Taxpayers

Among the recently identified international compliance campaign issues primarily affecting individuals are the following:

- **Swiss Bank Program Campaign**

  In 2013, the US Department of Justice (DOJ) announced the Swiss Bank Program as a path for Swiss financial institutions to resolve potential criminal liabilities. Banks participating in the Swiss Bank Program have provided information to the IRS and DOJ on US persons with beneficial ownership of foreign financial accounts. This campaign will address noncompliance involving those taxpayers who are, were, or may be beneficial owners of accounts identified through the Swiss Bank Program.
• **Foreign Earned Income Exclusion Campaign**

Individual US taxpayers who meet certain requirements may qualify for the foreign earned income exclusion and/or the foreign housing exclusion or deduction. Generally, this exclusion applies to US citizens or residents living abroad and whose tax home is in another country. Further, such individuals must meet either a *bona fide* resident test or be present in the other country during at least 330 days in a consecutive 12-month period. This campaign addresses taxpayers who have claimed these benefits but do not meet the requirements.

• **Verification of Form 1042-S Credit Claimed on Form 1040NR**

This campaign is intended to verify the amount of withholding tax credits, and the election of a refund/credit claimed on Form 1040NR (US Nonresident Alien Tax Return) by non-US taxpayers with US source income. The campaign is also intended to address whether the taxpayer has properly reported the income reflected on Form 1042-S (Foreign Person’s US Source Income Subject to Withholding), which is required to be filed by the non-US financial institution reporting the payment such income. Before a refund is issued or credit allowed, the IRS will verify the withholding credits reported on the Form 1042-S.

• **Individual Foreign Tax Credit (Form 1116)**

Individual US taxpayers may file Form 1116 (Foreign Tax Credit) to claim a credit against US income tax for the amount of foreign income taxes paid on foreign source income, which serves to reduce their US income tax liability. This campaign addresses taxpayer compliance with the computation of the Foreign Tax Credit limitation on Form 1116. Due to the complexity of computing the Foreign Tax Credit and challenges associated with third-party reporting information, some taxpayers may claim an incorrect Foreign Tax Credit amount.

**Issues Affecting Corporate Taxpayers and Financial Institutions**

The following recently identified compliance campaigns are targeted at corporate taxpayers, also including non-US financial institutions and intermediaries:

• **Form 1120-F Chapter 3 and Chapter 4 Withholding Campaign**

This campaign is designed to verify refund claims made on Form 1120-F (US Income Tax Return of a Foreign Corporation) in connection with US income tax withheld at source. To make a claim for refund or to elect to credit the withheld tax as estimated tax paid with respect to any tax withheld under US source income or FATCA withholding rules, a foreign entity must file a Form 1120-F. Before a refund claim is paid or credit is granted, the IRS must verify that withholding agents have filed the required returns with respect to the tax withheld. This campaign focuses on verification of the withholding credits before the claim for refund or credit is allowed.
Corporate Direct (Section 901) Foreign Tax Credit

Domestic corporate taxpayers may elect to take a Foreign Tax Credit (FTC) for foreign taxes paid or accrued instead of a deduction. The goal of the Corporate Direct FTC campaign is to improve the selection of corporate tax returns that claim a direct FTC for examination, as well as the issues reviewed during such examination, and the utilization of IRS resources in connection with examination of these returns. This campaign will focus on taxpayers who are in an excess limitation position (where foreign tax rates are lower than US tax rates). The IRS has further announced that this is the first of several FTC campaigns. Future FTC campaigns may address indirect credits and FTC limitation issues.

Section 956 Avoidance

If a Controlled Foreign Corporation (CFC) makes a loan to its US parent corporation (USP), US tax law generally requires that the USP include in its income an amount equal to the loan amount. This campaign focuses on situations where a CFC loans funds to a USP, but the USP does not include the amount of the loan in its income. The goal of this campaign is to determine to what extent taxpayers are utilizing cash pooling arrangements and other strategies to improperly avoid the tax consequences of this income inclusion requirement.

What is Next?

In the era of FATCA, CRS, and Country-by-Country Reporting, the automatic exchange of information will continue to allow tax authorities to focus on more targeted international compliance goals, using the account and payment information now available. In addition, the IRS will continue to leverage its information from the QI Program, the Swiss Bank Program, and other targeted enforcement efforts. Both individual and corporate taxpayers, including financial institutions subject to intermediary and withholding agent requirements, should take note of these and other existing IRS enforcement initiatives and in all cases ensure careful compliance with their information reporting and tax obligations.

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This alert was prepared by Gregory Walsh (Zurich).