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**TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**



***A Strategy Is Needed to Assess the  
Compliance of Corporate Mergers and  
Acquisitions With Federal Tax Requirements***

**September 5, 2019**

**Reference Number: 2019-30-050**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

2 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

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## HIGHLIGHTS

### A STRATEGY IS NEEDED TO ASSESS THE COMPLIANCE OF CORPORATE MERGERS AND ACQUISITIONS WITH FEDERAL TAX REQUIREMENTS

## Highlights

Final Report issued on  
September 5, 2019

Highlights of Reference Number: 2019-30-050  
to the Commissioner of Internal Revenue.

### IMPACT ON TAXPAYERS

Corporate mergers and acquisitions can be large dollar, complex transactions that potentially have large tax implications. Some of those transactions can be tax-free depending on the structure. It is important that the IRS ensure that these complex transactions are in compliance with the tax law and that the appropriate amount of tax is paid.

### WHY TIGTA DID THE AUDIT

The Institute for Mergers, Acquisitions, and Alliances reports that there were 14,540 mergers and acquisitions in the United States in Calendar Year 2018, with a value of almost \$1.9 trillion. There have been approximately 120,000 domestic corporate mergers and acquisitions in the last 10 calendar years, totaling \$15.3 trillion. The Internal Revenue Code permits tax-free treatment for transactions that meet certain technical requirements, and taxpayers sometimes make the form of the transaction appear to satisfy those requirements while the substance does not. The Large Business and International Division (LB&I) has been transitioning to issue-based audits and has adopted a "campaign" approach to auditing specific issues. TIGTA performed this review to determine whether the IRS had an effective strategy with respect to the compliance risks presented by mergers and acquisitions.

### WHAT TIGTA FOUND

The IRS does not have an overall strategy to address potential tax noncompliance of merger and acquisition transactions. IRS Examination

managers TIGTA spoke with asserted that issues related to mergers and acquisitions generally receive the same attention as any other issue.

IRS data indicate that adjustments were proposed in 400 (8 percent) of the 4,965 instances in which mergers and acquisitions were potentially an issue in closed cases from Fiscal Years 2015 through 2018. When LB&I Division examiners were able to propose an adjustment to merger and acquisition issues, the proposed adjustments were significant: an average of approximately \$15.2 million per issue.

The IRS collects information on mergers and acquisitions from taxpayers engaging in those transactions but does not use it to identify potential noncompliance. Taxpayers that engage in a tax-free reorganization must notify the IRS with their next tax return by including a statement. When TIGTA asked the IRS to provide the number of these statements filed for Tax Years 2015 through 2017, the IRS explained that while these statements are part of the taxpayer's return, it was unable to provide the information.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, LB&I Division: 1) establish a strategy for assessing compliance risk and promoting tax compliance in the mergers and acquisitions area, including determining if returns with high-risk merger and acquisition transactions can be identified before they reach the field; and 2) determine whether the merger and acquisition tax forms, and information provided on them, could be used as a compliance tool within a larger strategy to assess risk and ensure that corporate merger and acquisition transactions are compliant with the tax code.

The IRS disagreed with the first recommendation and agreed with the second. The IRS stated that it already has a strategy consistent with the goals of the recommendation. TIGTA believes the IRS's described approaches to merger and acquisition transactions have been limited, separate, and distinct from one another and support the need for a consolidated strategic approach.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**  
**WASHINGTON, D.C. 20220**

September 5, 2019

**MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE**

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT** Final Audit Report – A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements (Audit # 201830015)

This report presents the results of our review to determine if the Internal Revenue Service (IRS) had established and implemented an effective strategy to ensure that large corporations meet their tax obligations related to taxable U.S. corporate mergers and acquisitions. This audit is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Improving Tax Reporting and Payment Compliance.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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***Abbreviations***

FY	Fiscal Year
IMS	Issue Management System
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
M&A	Merger and Acquisition
TY	Tax Year

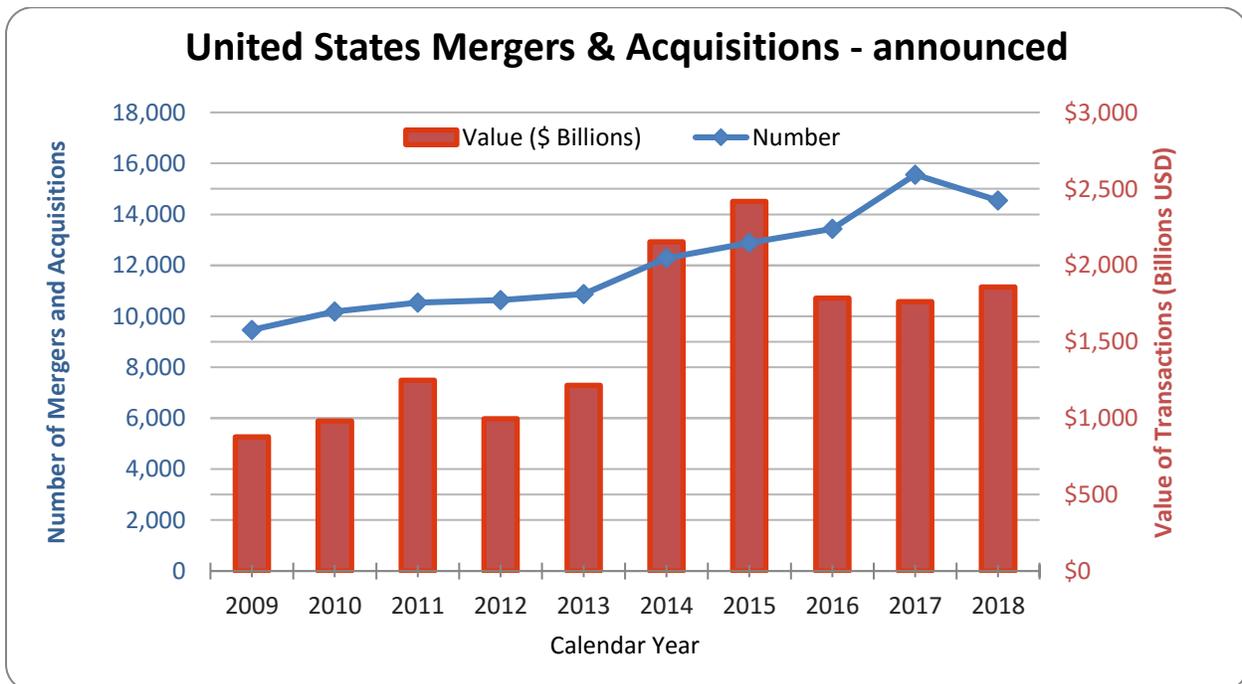


## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

### **Background**

The Institute for Mergers, Acquisitions, and Alliances reports that there were 14,540 merger and acquisition (M&A) transactions in the United States in Calendar Year 2018, with a value of almost \$1.9 trillion. There have been approximately 120,000 corporate M&A transactions in the United States in the last 10 calendar years, totaling \$15.3 trillion. Figure 1 shows the number, trends, and the dollar value of announced U.S. M&A transactions for Calendar Years 2009 through 2018.

***Figure 1: The Number and Dollar Value of Announced Mergers and Acquisitions in the United States***



*Source: The Institute for Mergers, Acquisitions, and Alliances.*

M&A transactions can take many different forms. Generally, in a merger, the target corporation merges into the acquiring corporation and ceases to exist as a corporate entity. In one type of tax-free merger, an acquiring corporation may obtain a controlling interest in a target corporation through an exchange of stock. In an acquisition, a corporation typically acquires any portion of the target corporation's assets or stock, and such transactions are generally taxable to the seller.

Some of these transactions can also be tax-free depending on the structure. In order for a merger to be a tax-free reorganization, the acquiring corporation generally exchanges its stock, or the



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stock of its parent corporation, for the assets or stock of the target corporation.<sup>1</sup> The basic regulatory requirements of most tax-free reorganizations include, but are not limited to:

- **Continuity of Interest Test:** Treasury Regulations require that in substance a substantial part of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is generally preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the acquiring corporation or the acquiring corporation's parent.<sup>2</sup>
- **Continuity of Business Enterprise Test:** Requires that the issuing corporation either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets in a business.<sup>3</sup>

Some amount of cash or property in a tax-free transaction is permissible; however, any cash or property in such a transaction may be subject to tax. If cash or property constitutes more than 50 percent of the total consideration, then the transaction may fail to meet the continuity of interest requirement of a reorganization and may be taxable.

For example, in *Tribune Co. v. Commissioner of Internal Revenue*, corporate taxpayers attempted to structure a transaction to appear to be a tax-free reorganization but which, in substance, failed to satisfy the technical requirements of the law.<sup>4</sup> Although technically a stock-for-stock transaction, the only asset owned by the entity whose stock was received by the seller transferor corporation was \$1.375 billion in cash, and therefore, the economic substance of the transaction was a taxable sale, not a tax-free merger.

This review was performed in the Examination offices of the Large Business and International (LB&I) Division in Bethpage, New York, and Pittsburgh, Pennsylvania, with information provided by LB&I Division Examination offices in Glendale, California; Washington, D.C.; Schiller Park, Illinois; Houston, Texas; and Roanoke, Virginia, during the period January 2018 through February, 2019.

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

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<sup>1</sup> Internal Revenue Code (I.R.C.) Section (§) 354(a) provides the general rule that "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." I.R.C. §368 sets forth definitions of corporate reorganizations that qualify for nontax treatment under I.R.C § 354(a).

<sup>2</sup> Treas. Reg. § 1.368-1(e).

<sup>3</sup> Treas. Reg. § 1.368-1(d).

<sup>4</sup> In *Tribune Co. v. Comm'r*, 125 T.C. 10 (2005), a corporate taxpayer exchanged the shares of the stock of a subsidiary engaged in the publishing business in return for shares of the acquirer's subsidiary; however, the IRS took the position that the only asset of the subsidiary was \$1.375 billion in cash. The Tax Court agreed holding that in substance the transaction was a taxable sale.



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based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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***Results of Review***

***The Internal Revenue Service Does Not Have a Strategy to Address Tax Compliance for Corporate Mergers and Acquisitions***

Every year, trillions of dollars worth of M&A transactions are completed by business entities. Corporate taxpayers are required to provide the Internal Revenue Service (IRS) detailed information regarding these transactions. However, the IRS does not have an overall strategy or systematic approach to identify and address potential noncompliance of M&A transactions. During our fieldwork, IRS Examination managers we spoke with asserted that issues related to M&As generally receive the same attention as any other issue.<sup>5</sup> These issues would generally be identified as part of the risk assessment process associated with the return. The revenue agent<sup>6</sup> or group manager would first have to identify and evaluate the transaction. The risk associated with the transaction and related issues would be considered and used to determine whether further examination is needed.

M&A transactions are generally addressed the same way many other issues are addressed in that they are evaluated if a tax return happens to be selected for examination. Once a return is selected, the LB&I Division has different examination methods depending on the type and size of the taxpayer, including large to mid-size businesses and high-wealth individual taxpayers. For example, the LB&I Division engages a relatively small number of large corporate taxpayers using the Compliance Assurance Process. The Compliance Assurance Process is described by the IRS as a method of identifying and resolving tax issues through open, cooperative, and transparent interaction between the IRS and LB&I Division taxpayers prior to the filing of a tax return. Through the program, the IRS works with the taxpayer to achieve tax certainty sooner and with less administrative burden than conventional post-file examinations. The LB&I Division also uses the Discriminant Analysis System and Research Developed Models to rank and prioritize tax returns to reflect which returns have the highest compliance risk.

The LB&I Division audits other corporations in the traditional field examination process through its Coordinated Industry Case or Industry Case process. A Coordinated Industry Case includes a large taxpayer and its effectively controlled entities that warrant the application of examination procedures requiring a team of revenue agents and specialists. These taxpayers are identified

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<sup>5</sup> Using the Issue Management System, we selected a judgmental sample of eight managers that had M&A experience (using Standard Audit Index Number 703 (Mergers)).

<sup>6</sup> See Appendix IV for a glossary of terms.



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through a variety of criteria, such as gross/total assets, gross receipts, and foreign assets.<sup>7</sup> Whereas, Industry Case taxpayers are assigned to an individual examiner, augmented by specialists if needed.

As revenue agents require additional work, group managers request returns through an analyst. According to Examination group managers we spoke with, obtaining productive cases from the traditional return selection process can be difficult. Some managers told us that they may request 20 tax returns in order assign two or three that have exam potential to their revenue agents. They believe that it is difficult to identify returns that have unreported tax and even more difficult to identify a productive M&A issue.<sup>8</sup>

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<sup>7</sup> The Large Corporate Compliance Program is scheduled to replace the Coordinated Industry Case process. The LB&I Division has described the program as converging the fields of computer science, statistics, and tax/business expertise to better understand the risk profiles of the LB&I Division's largest Form 1120, *U.S. Corporation Income Tax Return*, filing population. The program would automate the Internal Revenue Manual pointing criteria and use an algorithm to predict risk for the LB&I Division's largest corporate returns. The LB&I Division began transitioning from the Coordinated Industry Case process in early Fiscal Year 2019.

<sup>8</sup> An issue is one single aspect or characteristic of a tax return that Examination may identify as a risk of not being in compliance with the tax code. Regarding M&A transactions, examples include but are not limited to Capitalization of Legal Fees, Worthless Stock, or a Net Operating Loss.



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In an effort to focus on auditing specific issues, the LB&I Division established a concept it describes as “campaigns.”<sup>9</sup> To date, 53 campaigns have been approved, and two of the 53 pertain to M&A-related issues. Since 2016, there have been seven campaign submissions proposed for M&A issues.<sup>10</sup> For example, there is a campaign related to the costs that facilitate tax-free distributions pursuant to I.R.C. §355; however, the campaign is narrow and does not focus on identifying transactions that might fail the requirements of a tax-free transaction. There is also a campaign associated with transactions involving the treatment of property used to acquire parent stock or securities in triangular reorganizations involving one or more foreign corporations.

Data provided from the Issue Management System (IMS), shown in Figure 2, indicate that there were proposed adjustments in 400 (8 percent) of the 4,965 potential issues associated with M&A transactions included in closed cases from Fiscal Years (FY) 2015 through 2018. Conversely, the LB&I Division identified 4,565 M&A issues (92 percent) included in closed cases that did not result in an adjustment. However, when LB&I examiners were able to propose an adjustment to M&A issues, the proposed adjustments were significant: an average of approximately \$15.2 million per issue.

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<sup>9</sup> LB&I campaigns announced on September 10, 2018: Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; Interest Expense/Home Office Expense; Foreign Base Company Sales Income (Manufacturing Branch Rules); Individuals Employed by Foreign Governments and International Operations; I.R.C. § 199 – Claims Risk Review; and Syndicated Conservation Easements. Campaigns announced on July 2, 2018: Repatriation via Foreign Triangular Reorganizations; Restoration of Sequestered Alternative Minimum Tax Credit Carryforward; S Corporation Distributions; I.R.C. § 965 Transition Tax; and Virtual Currency. Campaigns announced on May 21, 2018: Nonresident Alien Tax Credits; Nonresident Alien Tax Treaty Exemptions; Nonresident Alien Schedule A and Other Deductions; Interest Capitalization for Self-constructed Assets; Form 1042/Form 1042-S, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons/ Foreign Person’s U.S. Source Income Subject to Withholding*; Form 3520/Form 3520-A, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts/ Annual Information Return of Foreign Trust With a U.S. Owner*; and Noncompliance and Campus Assessed Penalties. Campaigns announced on March 13, 2018: Sale of Partnership Interest; Partnership Nonfiler; Partial Disposition Election for Buildings; and Costs that Facilitate I.R.C. § 355 Transactions. Campaigns announced on November 1, 2017: Verification of Form 1042-S Credit Claimed on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*; Swiss Bank Program; I.R.C. § 956 Avoidance; Individual Foreign Tax Credit (Form 1116); Form 1120-F Chapter 3 and 4 Withholding; Foreign Income Tax Exclusion; Energy Efficient Commercial Building Property; Economic Development Incentives; Deferral of Cancellation of Debt Income; Corporate Direct (I.R.C. § 901) Foreign Tax Credit; and Agricultural Chemicals Security Credit. Campaigns announced January 3, 2017: TEFRA Linkage Plan Strategy (TEFRA = Tax Equity and Fiscal Responsibility Act of 1982); S Corporation Losses Claimed in Excess of Basis; Repatriation; Related Party Transactions; Offshore Voluntary Disclosure Program Decline-Withdrawals; Micro Captive Insurance; Land Developers; I.R.C. § 48C Energy Credit; Inbound Distributor; Form 1120-F Nonfiler Campaign; Domestic Production Activities Deduction Multiprogram Video Distributors; Deferred Variable Annuity Reserves and Life Reserves; and Basket Transactions.

<sup>10</sup> These seven campaign submissions from employees included duplicates or submissions categorized as M&A but focused on asset purchase issues.



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**Figure 2: The Number of Potential Issues in LB&I M&A Transactions and the Dollars Adjusted for FYs 2015 Through 2018<sup>11</sup>**

	<b>Total M&amp;A Issues</b> (a)	<b>M&amp;A Issues With at Least One Adjustment</b> (b)	<b>Percent of Issues Adjusted</b> (c)	<b>Total M&amp;A Proposed Adjustments</b> (d)	<b>Average Proposed Adjustment for Adjusted M&amp;A Issues</b> (d / b)
<b>FY 15</b>	1,415	129	9.1	\$1,053,576,542	\$8,167,260
<b>FY 16</b>	1,269	114	9.0	\$3,760,212,128	\$32,984,317
<b>FY 17</b>	1,210	100	8.3	\$950,862,024	\$9,508,620
<b>FY 18</b>	1,071	57	5.3	\$296,210,825	\$5,196,681
<b>Total</b>	<b>4,965</b>	<b>400</b>	<b>8.1</b>	<b>\$6,060,861,519</b>	<b>\$15,152,154</b>

Source: IMS data provided by the IRS. Analysis performed by the Treasury Inspector General for Tax Administration.

The Internal Revenue Code (I.R.C.) permits tax-free treatment for transactions that meet certain technical requirements, and taxpayers sometimes make the form of the transaction appear to satisfy those requirements while the substance does not.

While the LB&I Division has been transitioning to a campaign approach to identify specific issues, the difficulty in identifying and examining productive M&A issues may be due to the complexity of M&A transactions. Each transaction is unique and may not represent the same compliance risk. For example, large publicly held corporations engaging in transactions that are disclosed publicly through filings with the Securities and Exchange Commission or through media reports may have a lower compliance risk than transactions by smaller entities that are privately held. In addition, revenue agents, many of whom are not experts in M&A transactions, need to have access to those who are. The IRS provides this expertise by way of subject matter experts in many complex areas including M&As, but consulting them on every issue may not be realistic given available resources.

The LB&I Division started a project related to M&As in the summer of 2017. The objective of the project was to provide field examiners assistance in planning and examining selected M&A transactions, help them understand the transactions, identify issues of highest compliance risk, and reduce the time spent examining low-risk or compliant issues. One purpose was to address the concern that there was a significant amount of time spent on unproductive M&A issues. The LB&I Division reported that between FYs 2014 and 2016 there were 25,170 staff days spent on M&A issues with no resulting adjustments. We analyzed data provided by the IRS and obtained similar results. We determined from FYs 2015 through 2018, there were 27,874 staff days spent on issues that were not adjusted.

<sup>11</sup> The information in Figure 2 reflects data provided from the IMS for LB&I Division examinations closed in FYs 2015, 2016, 2017, or 2018. These data reflect Standard Audit Index Number 703.



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The project's design involved identifying potential issues in the field, at which point the project team is made available to assist with the development and risk assessment of the issues. The project team consists of field examiners with expertise in M&A transactions and members of the Corporate Distributions and Adjustments practice network who are full-time subject matter experts in M&A issues and primarily responsible for providing assistance during examinations of corporate acquisitions, dispositions, distributions, liquidations, and reorganizations. The mix of project team members was expected to offer an opportunity to leverage and share skills and knowledge.

The Corporate Distributions and Adjustments practice network recommended the following factors be weighed when selecting cases for the project: were significant staff days planned; was the team early in the examination process; did complex issues exist; and where would the project team's assistance be most beneficial. Based on these factors, the geographic practice areas recommended 23 cases with M&A transactions.

Many of the cases had multiple M&A issues that examination teams had started or planned to examine. The M&A project team provided risk analysis and issue development assistance on a variety of M&A transactions and issues. In total, 62 M&A issues were analyzed and the M&A team provided assistance to the examiner or examination team in assessing risk on those potential M&A issues identified. LB&I Division management stated that of the 62 M&A issues, the risk analysis resulted in a recommendation to not examine 41 of the issues. The remaining 21 were provided a risk analysis recommending the issue be pursued and frequently narrowed the focus of the issues to pursue. We do not have the results of those examinations because they are still in process. LB&I Division management indicated that the project received positive feedback from those involved, and they plan to propose expanding or establishing the process as a best practice.

Background information on the project, provided by LB&I Division management, indicate that M&A transactions remain an area of potential compliance risk with the potential for large adjustments, but a significant number of staff days are often spent concentrating on no or low-risk M&A issues instead of M&A issues with audit potential. Although the project was attempting to help the field identify productive issues, the project was not successful in identifying whether high-risk or potentially more productive transactions could have been identified before they reached the field. The project relied on the LB&I Division's geographic practice areas identifying high-risk M&A issues given certain criteria, in consultation with subject-matter experts, after the tax returns were delivered to the field for examination.<sup>12</sup>

Given the complexity and potential productivity associated with noncompliant M&A transactions, as well as the market as a whole, the LB&I Division should consider whether a

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<sup>12</sup> Each geographic practice area is generally responsible for the full range of pre-filing, filing and post-filing programs and activities for large and mid-size businesses within a specific geographic area (for example, Eastern, Western, etc.).



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formal strategy or establishing a practice area may be more appropriate. Other complex areas, such as research credits, have a Service-wide compliance strategy structured around them, and large complex issues, such as transfer pricing, are of such concern and compliance risk that the LB&I Division has developed a practice area around it.

### ***Recommendation:***

**Recommendation 1:** The Commissioner, Large Business and International Division, should establish a strategy for assessing compliance risk and promoting tax compliance in the M&A area. In addition, determine if returns with high-risk M&A transactions can be identified before they reach the field.

**Management's Response:** IRS management disagreed with the recommendation and stated that they already have a strategy and that their current efforts are consistent with the goal of the recommendation and sufficiently address tax compliance in the M&A area. IRS management stated that while adjustments to M&A issues are material, the rate of noncompliance is low. They also cited current M&A campaigns and noted that they are evaluating other ideas for potential new campaigns. IRS management stated that they use subject matter experts to identify compliance risks before they reach the field through the Large Corporate Compliance program and campaigns. They referenced the M&A risk project to help identify potential material M&A transactions once they reach the field. IRS management also stated that even with the various approaches to identifying potential noncompliance, an audit is required to develop the facts of the underlying transactions and issues.

**Office of Audit Comment:** We acknowledge that the IRS has made an effort to identify more productive M&A transactions campaigns, as well as through the M&A risk project. However, while IRS management stated that their various approaches constitute a strategy, we found these approaches to M&A transactions to be limited, separate, and distinct from one another and support the need for a consolidated approach.<sup>13</sup> Of the various complex M&A transactions allowed under the tax law, approved campaigns focus on only a few types. In addition, one purpose of the risk project was to address the significant amount of time spent by field examiners on unproductive M&A issues. Although the project provided needed expertise to examiners in the field, it did not substantially affect how these issues were being identified or delivered to examiners. While the LB&I Division may consider the 8 percent of issues being adjusted as low compliance risk, they also acknowledge that when noncompliance is identified the adjustments can be significant. External data suggest that M&A transactions have

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<sup>13</sup> The LB&I Division's Business Performance Review, dated May 22, 2019, estimated that the Large Corporate Compliance Program was to be implemented in May 2019, after our field work was substantially complete. As such, we did not review this process for identifying potentially noncompliant M&A transactions.



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generally increased over the past several years, at the same time the number of examinations with these issues have declined in each of the past four years. The LB&I Division should more effectively consolidate their efforts to identify and provide more productive M&A issues to their limited resources in the field.

### ***The Internal Revenue Service Does Not Use Merger and Acquisition Information to Ensure That Potentially Noncompliant Merger and Acquisition Transactions Are Sent for Further Evaluation***

The IRS collects information on M&A transactions from taxpayers engaging in those transactions but does not use that information to identify potential noncompliance. Taxpayers that engage in a tax-free reorganization must report the following detailed information about the transaction on their tax return for the year in which the transaction closes:

- Parties to the reorganization.
- Date of the reorganization.
- Value and basis of assets, stock, or securities of the target corporation that were transferred.<sup>14</sup>
- Date and control number of any private letter rulings issued by the IRS in connection with the reorganization.

The information contained in these statements can be an important factor for performing a risk assessment. For instance, a statement may provide the necessary details that explain the absence of any gain or loss, when other information on the return indicates the occurrence of a large transaction. While a statement of reorganization is required, there is no form or schedule associated with the reporting requirement under the regulation and taxpayers generally provide these details as an attachment to their return. Formatting is at the discretion of the taxpayer, but the information is generally formatted similarly, with taxpayers listing the necessary details as outlined in the regulation.

The value of tax-free reorganization transactions can be substantial. The IRS has indicated that taxpayer statements describing transactions should be considered during the return risk assessment phase in order to determine whether to examine a return as well as to identify whether the transaction should be examined.

When we asked the IRS to provide the number of these statements filed for Tax Years (TY) 2015 through 2017, the IRS was unable to provide the information. The IRS explained that while these statements are part of the taxpayer's return, \*\*\*\*\*2\*\*\*\*\* The IRS did provide an approximation, stating

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<sup>14</sup> Treas. Reg. 1.368-3. The basis of consideration transferred is to be determined immediately before the transfer and aggregated.



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that it had received 2,464 statements in TY 2015, and 2,560 in TY 2016 from electronically filed corporate tax returns.

We also inquired as to whether the same, or similar, information is required to be included on other forms filed by taxpayers. The IRS indicated that while similar information may be filed on Form 8806, *Information Return for Acquisition of Control or Substantial Change in Capital Structure*, not all reorganizations involve an acquisition of control or substantial change in capital structure, so Form 8806 does not apply to all reorganizations.

Form 8806 is an information return and notification to the IRS that a merger has taken place. Generally, the purpose of Form 8806 is to capture mergers in which the consideration (cash or property exchanged) is \$100 million or more, in which there has been a change of control, or a substantial change in capital structure.<sup>15</sup> Considering the filing criteria and exceptions for Form 8806, only 48 corporations filed the form from TYs 2015 through 2017.

\*\*\*\*\*2\*\*\*\*\*

\*\*\*\*\*2\*\*\*\*\* LB&I Division

management noted that manual transcription of the information on Form 8806 did not begin until FY 2014. In October 2017, the LB&I Division began storing the information in the DataMart, where data from the form can be accessed. According to the IRS, as of February 2019, data from 182 Forms 8806 reside in the DataMart; however, according to DataMart representatives we spoke with during our fieldwork, no one has ever requested data and filing information related to Form 8806.

An additional information return related to M&A transactions and Form 8806, is Form 1099-CAP, *Change in Corporate Control and Capital Structure*. Corporations that file a Form 8806 must also file a Form 1099-CAP with the IRS and furnish a copy to each shareholder who receives cash, stock, or other property as a result of the acquisition of control or substantial change in capital structure, and who is not an exempt recipient. An exempt recipient must meet certain criteria such as having an exempt certificate or less than \$1,000 in stock. Moreover, if the corporation can reasonably determine that the receipt of such stock would not cause the shareholder to recognize gain, the corporation is not required to report the fair market value of any stock provided to a shareholder. See Figure 3 for the number of Forms 8806 and Forms 1099-CAP filed during the last three years.

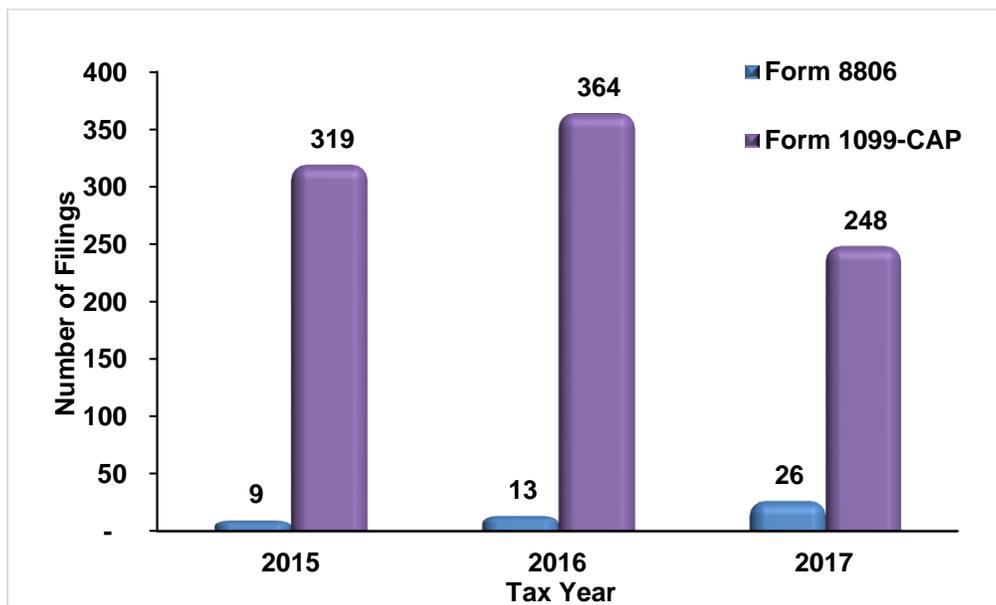
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<sup>15</sup> Considering other criteria, the Form 8806 excludes stock-for-stock mergers.



## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

**Figure 3: The Number of Forms 8806 and Forms 1099-CAP Filed by Tax Year<sup>16</sup>**



Source: IRS LB&I Division's DataMart.

In addition to Forms 8806 and 1099-CAP, we identified 11 other tax forms with the primary purpose of reporting information about M&A transactions. We also identified more than 15 other forms not generally associated with reporting domestic M&A activity but which have the potential to include significant information related to a transaction, such as Form 1120, *Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More* or Form 1099-MISC, *Miscellaneous Income*.<sup>17</sup> Forms filed with the tax returns contain information to support tax calculations and computations for the reporting of tax liabilities, and it is the combination of these forms and information that are important in evaluating complex M&A transactions.

Examples of forms associated with M&A transactions filed with tax returns include, but are not limited to:

- Form 8594, *Asset Acquisition Statement Under Section 1060*.
- Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*.
- Form 8883, *Asset Allocation Statement Under Section 338*.
- Form 1099-CAP.

<sup>16</sup> The data are provided by the IRS and reflect all returns filed as of September 26, 2018.

<sup>17</sup> Some of these forms are information returns used to notify the IRS about an impending or completed transaction.



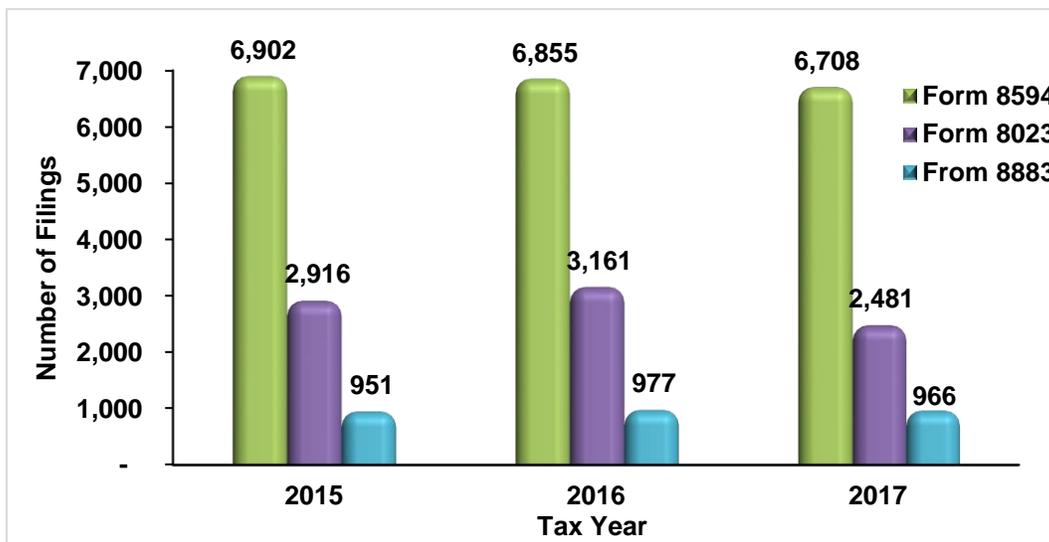
## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

- Form 4797, *Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))*.

\*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*

An acquiring corporation and the target corporation must file Form 8594 when the assets that constitute a trade or business are acquired. Form 8883 must be filed when the acquiring corporation has made an election under I.R.C. § 338 to have a qualified stock purchase treated as an acquisition of assets.<sup>18</sup> Both Forms 8594 and 8883 are to be filed with the return for the tax year in which the transaction closes and in any subsequent tax years in which the total purchase price or the allocation of the purchase price to the assets changes. Forms 8594 and 8883 must be filed regardless of the value of the assets. In our analysis of Forms 8594 filed from TYs 2015 through 2017, 31,519 acquiring corporations filed Form 8594, but only 16,689 target corporations filed the form. See Figure 4 for the numbers of these forms filed with the IRS for the most recent tax years.

***Figure 4: The Number of Certain Corporate Tax Forms Associated With M&A Transactions Filed by Tax Year<sup>19</sup>***



Source: IRS LB&I Division's DataMart.

<sup>18</sup> Generally, in an asset purchase transaction, the purchaser allocates basis to the different acquired assets by value and is then able to depreciate and/or amortize the tangible and intangible assets over their useful life. With a stock purchase, the purchaser generally assumes the basis in the assets of the seller and is not able to allocate the purchase price among the assets of the business. In the case of a qualified stock purchase, I.R.C. § 338 allows an election to treat the transaction as the purchase of the target corporation's assets, thus allowing a "stepped-up" basis (equal to the consideration amount) to be allocated among the acquired assets.

<sup>19</sup> The IRS provided the data which reflect all returns filed as September 26, 2018.



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## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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As discussed previously, the LB&I Division is moving toward issue-based campaigns. One campaign submission involved an employee suggestion \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*

During interviews with group managers, revenue agents, and subject matter experts, the majority indicated that the M&A related forms are useful during examinations and on a case-by-case basis can be used to ensure that taxpayers’ transactions are compliant with the relevant tax law. In addition, as mentioned earlier in the report, from FYs 2015 through 2018, when M&A issues were adjusted, those proposed adjustments were significant. As such, the information on M&A related forms may be useful in performing high-level risk analysis to eliminate low-risk transactions and identify potentially productive cases to deliver to the field for further review and examination. Given that the LB&I Division’s vision is to “...apply...innovative approaches to compliance,” the IRS should expand on the use of tax forms and the information provided by taxpayers to promote M&A compliance.

M&A transactions can be very complex. The forms we have previously detailed represent only a small portion of the information that may be filed with the IRS. The IRS should use the information provided by taxpayers to help ensure that corporate M&A transactions are compliant. However, considering the complexity and characteristics of the individual M&A transactions, along with the filing criteria and exceptions in filing, certain forms used to report M&A transactions may not be providing sufficient information to identify noncompliance. If the IRS finds that the forms do not contain information sufficient for identifying potential noncompliance in M&A transactions, it should consider amending the filing criteria and information required in the forms to develop useful compliance tools.

### ***Recommendation:***

**Recommendation 2:** The Commissioner, LB&I Division, should determine whether the M&A forms and information provided on them could be used as a compliance tool within a larger strategy to assess risk and ensure that corporate M&A transactions are compliant with the tax code.

**Management’s Response:** The IRS agreed with this recommendation, stating that it will continue to consider how to use M&A information in its compliance efforts.

**Office of Audit Comment:** The IRS described their use of M&A forms and information as part of the Large Corporate Compliance and campaign program, as well as by examiners and subject matter experts. As we stated in our comment to recommendation 1, we found these approaches to M&A transactions to be limited, separate, and distinct from one another. In addition, the forms previously detailed



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represent only a small portion of the information that may be filed, and certain forms used to report M&A transactions may not be providing sufficient information to identify noncompliance. The IRS should continue to evaluate the benefits of these forms and return information, but in the context of a consolidated approach to M&A transactions.



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## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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### **Appendix I**

#### ***Detailed Objective, Scope, and Methodology***

The overall objective of this review was to determine if the IRS had established and implemented an effective strategy to ensure that large corporations meet their tax obligations related to taxable U.S. corporate M&As. To accomplish our objective, we:

- I. Reviewed the I.R.C., Treasury Regulations, and internal IRS documents and interviewed IRS officials to gain an understanding of the filing requirements and tax reporting obligations related to taxable large corporate M&As.
- II. Identified and evaluated internal IRS performance results related to large corporate M&As.
- III. Determined through interviews with IRS management and LB&I Division Research personnel, and review of the DataMart, practice networks, campaigns, and documents, whether the IRS has performed research or evaluated the risk, at a macro-level, associated with large corporate M&As.
- IV. Determined whether the IRS has developed and incorporated a strategy to ensure that large corporate M&As are in compliance with tax obligations. We identified any treatment streams and assessed whether the IRS is leveraging tax information in any specific efforts to reduce taxpayer noncompliance.
- V. For weaknesses in the treatment of taxpayers filing and reporting compliance, or the lack of a strategy to consider such corporate activities, as identified in Sub-Objectives II through IV, analyzed and considered alternative resources that may be used to improve the IRS's process to promote filing and reporting compliance.
- VI. Evaluated the risk for fraud, waste, and abuse related M&A transactions.

#### ***Data validation methodology***

During this review, we relied on information from the LB&I Division's IMS. The IMS is used by leadership, management, and staff to accurately quantify work performed related to cases. It captures information impacting resources, issues, and workload from Industry Cases and Coordinated Industry Cases, all Specialist work, open cases, and closed cases. The information captured is related to cases, returns, issues, and cycles. The IMS consists of two components - a laptop application and a centralized data repository. The IMS is substantially dependent upon information entered by LB&I Division employees; however, case closing procedures include instructions and controls to check for errors and omissions in the IMS data. We did not assess these internal controls because doing so was not applicable within the context of our objective. However, we did assess the reliability of the data to the extent possible. We ensured that each



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data extract contained the specific data elements requested and that the data elements were accurate. We also reviewed the data for duplicate or omitted fields and traced summary data to individual issue entries. We consider the data sufficiently reliable for the purposes of our report.

### **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 I.R.C., Treasury Regulations, and IRS procedures, policies, and practices for the M&A workload and case selection, including campaigns and performance measures. We evaluated these controls by interviewing management and revenue agents, reviewing Internal Revenue Manual procedures and other related guidance, and analyzing IMS data and campaign information.



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**Appendix II**

***Major Contributors to This Report***

Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)

Glen Rhoades, Director

Curtis Kirschner, Audit Manager

John Chiappino, Lead Auditor

James Flood, Senior Auditor



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**Appendix III**

***Report Distribution List***

Commissioner, Large Business and International Division  
Deputy Commissioner, Large Business and International Division  
Assistant Deputy Commissioner Compliance Integration  
Director, Enterprise Audit Management



***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

**Appendix IV**

**Glossary of Terms**

<b>Term</b>	<b>Definition</b>
Basis of Assets	Basis is generally the amount of your capital investment in property for tax purposes. The cost is the amount you pay for it in cash, debt obligations, and other property or services. Cost includes sales tax and other expenses connected with the purchase.
Basket Transactions	A type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain.
Campaigns	LB&I Division's strategic approach to address types of potential noncompliance. Campaigns are designed to be adjusted in real time based upon experience and feedback as a campaign is executed.
Coordinated Industry Case	A case identified by a point system that measures such things as gross receipts, gross assets, operating entities, foreign assets, foreign tax credit, and other items. A Coordinated Industry Case is controlled by a team manager and all examination activities are managed by a team coordinator.
DataMart	A resource of return data from electronically filed returns, Optical Code Recognition (Scanned Returns) LB&I Division paper filings (via Data Capture System), and the Master File.
Discriminant Analysis System	A mathematical system that LB&I Division uses to identify corporate returns that may merit selection for audit.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Geographic Practice Area	A practice area is an area with groups of employees organized together to focus on one or more areas of expertise. Geographic practice areas are organized geographically.



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<b>Term</b>	<b>Definition</b>
Issue Management System	A computer application that supports existing and new examination processes. It captures information from Industry Cases and Coordinated Industry Cases, all Specialist work, open cases, and closed cases. The information captured is related to cases, returns, issues, and cycles.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Practice Networks	Teams of tax law specialists who support their respective issues. They are organized under practice areas.
Repatriation	The sending of money back to one's own country. For example, the repatriation of profits by foreign investors.
Revenue Agents	Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes ( <i>e.g.</i> , excise tax returns).
Standard Audit Index Number	A numbering system for Examination workpapers.
Tax Year	The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

### **Appendix V**

## **Management's Response to the Draft Report**



COMMISSIONER  
LARGE BUSINESS AND  
INTERNATIONAL DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

July 30, 2019

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell   
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2018-30-015, A Strategy Is Needed to  
Assess Compliance of Corporate Mergers and Acquisitions with  
Federal Tax Requirements

Thank you for the opportunity to respond to the above referenced draft audit report. We agree that it is important to ensure that mergers and acquisitions (M&A) are tax compliant as such transactions are complex and involve large dollar amounts.

As noted in your report, we undertook a project related to M&A transactions in the summer of 2017 with a focus on identifying high-risk transactions that warranted examination, and are currently working on potential filtering and testing capabilities for improved selection of potential non-compliance. For taxpayers in our Compliance Assurance Process (CAP), an M&A transaction is almost always a material issue that would be in scope for the CAP review. Also, as we transition to our Large Corporate Compliance (LCC) program, which identifies risks across a broader pool of corporate returns, there is the potential to identify more M&A transactions for risking and review. We will continue our focus on M&A issues, and refine our existing strategy based on our experience, findings and changes in the law.

It is important for us to broadly allocate our limited examination resources to have a compliance impact across all areas of noncompliance, and to tailor our efforts and resource allocation according to the level of compliance risk presented by a particular issue. As shown in Figure 2, LB&I examined a significant number of merger and acquisition issues. Examiners, with the support of the Corporate Distributions and Adjustment Practice Network subject matter experts, consistently identify these issues and narrow their focus by using forms and documents attached to the return and other information not on the return. This occurs during the risk analysis process and throughout the examination. An examination is necessary to then identify potential non-compliance. It has not been our experience that taxpayers make the form of the transaction appear to satisfy tax-free treatment while in substance they do not. Any non-compliance generally relates to other issues. The report demonstrates that we review these transactions frequently, but the rate of non-compliance is low. Therefore,



## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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while we will continue our focus on this issue, our goal is not to increase the number of examinations of these transactions, but rather focus our limited resources on the transactions with the greatest compliance risk. We believe that our current efforts are consistent with your recommendations.

Attached is a detailed response outlining our corrective actions that address your recommendations. Also, please see the attached redaction request. If there are any disagreements with the request, I would appreciate the opportunity to discuss.

If you have any questions, please contact me, or a member of your staff may contact De Lon Harris, Assistant Deputy Commissioner Compliance Integration.

Attachment



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## ***A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements***

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### **Attachment I**

#### **RECOMMENDATION 1:**

The Commissioner, Large Business and International Division, should establish a strategy for assessing compliance risk and promoting tax compliance in the M&A area. In addition, determine if returns with high-risk M&A transactions can be identified before they reach the field.

#### **CORRECTIVE ACTION(S):**

Our existing strategy and current efforts are consistent with the goal of this recommendation and sufficiently address tax compliance in the M&A area; therefore, we do not agree with the need to implement this recommendation.

The IRS has a strategy to address potential non-compliance and allocate resources commensurate with the associated compliance risk. As shown in Figure 2, LB&I examined a significant number of merger and acquisition issues. While the adjustments are material, the rate of non-compliance is low. In addition, we have active merger and acquisition campaigns and are evaluating other ideas for potential new campaigns. We already use subject matter experts to identify compliance risk on returns before they reach the field through the Large Corporate Compliance (LCC) Program and campaign process. Finally, we have the M&A risk project to further help identify potential material transactions and issues once they reach the field. The project ensures resources are used effectively by only applying them to areas of potential non-compliance. However, even though we use these various approaches to help identify returns with potential non-compliance, factual development of the underlying transaction and issues is required via an audit to determine if any adjustments are warranted.

#### **IMPLEMENTATION DATE:**

NA

#### **RESPONSIBLE OFFICIAL:**

NA

#### **CORRECTIVE ACTION(S) MONITORING PLAN:**

NA



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**RECOMMENDATION 2:**

The Commissioner, Large Business and International Division, should determine whether the M&A forms and information provided on them could be used as a compliance tool within a larger strategy to assess risk and ensure that corporate M&A transactions are compliant with the tax code.

**CORRECTIVE ACTION(S):**

We agree with this recommendation and will continue to consider how information can assist our compliance efforts. We use some of these forms in the Large Corporate Compliance and campaign programs. In addition, examiners and subject matter experts use the forms as part of their risk analysis in determining whether to examine a taxpayer, the issues to examine, and during issue development. We continually evaluate the benefits of these forms and other return information during the return selection and risk assessment process to help identify potential non-compliance.

**IMPLEMENTATION DATE:**

Implemented

**RESPONSIBLE OFFICIAL:**

Assistant Deputy Commissioner Compliance Integration

**CORRECTIVE ACTION(S) MONITORING PLAN:**

NA