



March 2022

ABUSIVE TAX SCHEMES

IRS Could Improve Its Reviews of Offshore Insurance Audits and Investigations

GAO Highlights

Highlights of [GAO-22-104180](#), a report to the Ranking Member, Committee on the Judiciary, U.S. Senate

Why GAO Did This Study

Tax evasion schemes involving offshore insurance are complex and resource-intensive for IRS to pursue, making it important for IRS to conduct compliance programs effectively.

GAO was asked to review how IRS conducts enforcement on offshore insurance compliance issues. This report evaluates to what extent IRS (1) reviews its guidance on offshore insurance to ensure that the guidance has its intended effect; (2) aligns oversight of its audit activities on taxpayers who may be abusing micro-captive insurance tax shelters with IRS audit policies and guidance; and (3) reviews its investigation activities on promoters who market abuses of offshore insurance tax shelters.

GAO reviewed IRS procedures on issuing guidance and on reviews of audits and promoter investigations, reviewed files on audits related to micro-captive insurance tax schemes, interviewed IRS officials, and compared IRS procedures with IRS policies and selected federal standards for internal control.

What GAO Recommends

GAO is making seven recommendations to improve how IRS oversees, through managerial reviews and independent quality reviews, its taxpayer audits and promoter investigations involving micro-captive insurance arrangements. IRS disagreed with the recommendations, stating that its current procedures are sufficient and citing resource constraints. However, GAO maintains that IRS's procedures should be refined and can be done so with minimal use of resources.

View [GAO-22-104180](#). For more information, contact Jessica Lucas-Judy at (202) 512-6806 or lucasjudj@gao.gov.

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What GAO Found

To encourage voluntary compliance with tax laws concerning offshore insurance arrangements, the Internal Revenue Service (IRS) uses feedback from internal stakeholders and the public to review and modify applicable guidance. Offshore insurance has legitimate uses but also can be structured to hide U.S. taxpayers' assets or falsely claim tax benefits. Treasury and IRS have opportunities to better solicit public input on certain guidance, including for offshore insurance, as GAO recommended in its April 2021 report. Treasury neither agreed nor disagreed with the recommendation, but GAO maintains that the recommendation remains valid.

One offshore insurance issue that IRS has prioritized with enforcement is micro-captive insurance arrangements—that is, when small insurance companies insure related business entities. For example, micro-captive insurance has been included on IRS's "Dirty Dozen" tax schemes list. To ensure micro-captive insurance audits are conducted properly, IRS generally uses two approaches:

- **Managerial reviews:** These consist of various types of written reviews, including in-process case reviews and workload reviews, among others, performed by the managers overseeing the audit.
- **Quality reviews:** These are conducted by independent reviewers outside of the audit work-stream to ensure that all processes meet IRS's standards.

IRS officials said that current oversight practices were sufficient to ensure that micro-captive audits were conducted accurately. For example, IRS cited that from fiscal years 2016 through 2020, the Small Business and Self Employed Division's (SB/SE) managerial reviews found that performance on attributes of micro-captive insurance audits were conducted appropriately about 97 percent of the time, compared to about 92 percent for all audits in general.

However, IRS's application of its review approaches could be enhanced. For example, SB/SE's managers have little guidance in the Internal Revenue Manual for when an audit should be subjected to managerial review and Large Business and International Division (LB&I) managers lack systems through which to record and analyze certain managerial reviews. By clarifying guidance and establishing a formal review system, SB/SE and LB&I would have better assurance that they are effectively auditing micro-captive insurance.

IRS also investigates whether promoters of micro-captive insurance schemes violate tax law. IRS's oversight of promoter investigations has no systematic method that would enable IRS to evaluate the effectiveness of its micro-captive promoter investigation program. For example, SB/SE lacks a systematic method to identify micro-captive promoter investigations for quality review. From fiscal years 2016 through 2020, LB&I did not apply quality reviews to any micro-captive insurance promoter investigations. Conducting formal reviews more systematically would better assure the quality of IRS's promoter investigations on micro-captive arrangements.

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Abbreviations

| | |
|-------------|--|
| Agencies | Executive Departments and Agencies |
| Check Sheet | LB&I Manager's Case Quality Measurement Check Sheet |
| DCI | Data Collection Instrument |
| EQRS | Embedded Quality Review System |
| FATCA | Subtitle A of Title V of the Hiring Incentives to Restore Employment Act, commonly known as the Foreign Account Tax Compliance Act |
| FinCEN | Financial Crimes Enforcement Network |
| FSEQ | Field and Specialty Exam Quality |
| IRC | Internal Revenue Code |
| IRM | Internal Revenue Manual |
| IRS | Internal Revenue Service |
| LB&I | Large Business and International Division |
| LQMS | LB&I Quality Measurement System |
| OMB | Office of Management and Budget |
| NAIC | National Association of Insurance Commissioners |
| NQRS | National Quality Review System |
| Plan | Priority Guidance Plan |
| QRA | Quality Review and Analysis |
| SB/SE | Small Business and Self-Employed Division |

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March 23, 2022

The Honorable Charles Grassley
Ranking Member
Committee on the Judiciary
United States Senate

Dear Senator Grassley:

Federal law generally allows U.S. taxpayers to enter into insurance policies with offshore entities and provides certain tax benefits, such as income-tax deductions for insurance premiums, for genuine offshore insurance transactions.¹ Our 2020 report on offshore insurance discusses examples of ways that taxpayers may legitimately claim these tax benefits, for example by acquiring offshore life insurance.²

However, when structured in abusive ways, offshore insurance products can be designed to hide U.S. taxpayers' assets or falsely claim federal income tax benefits. Furthermore, the Internal Revenue Service (IRS) has identified instances where taxpayers have used offshore insurance products in abusive tax schemes to improperly claim reduced tax liabilities. Our 2020 report also describes examples of how offshore insurance can be abused for tax purposes.

These abusive tax schemes can involve sophisticated tax shelters, devised and marketed to taxpayers by accountants, estate planners, and attorneys. These arrangements also may be constructed or recommended by professionals who have established relationships with taxpayers.

IRS officials have said that when insurance is held offshore, it can be more resource intensive to identify abusive insurance tax schemes and take enforcement action. Consequently, it is important that IRS properly

¹For purposes of this report, offshore insurance products include both genuine insurance products and insurance products that purport to be insurance but are not considered insurance for federal tax purposes.

²GAO, *Abusive Tax Schemes: Offshore Insurance Products and Associated Compliance Risks*, [GAO-20-589](#) (Washington, D.C.: July 30, 2020).

manages its methods for encouraging and enforcing compliance on offshore insurance.

The federal government has lost significant amounts of revenue to abuse of insurance products. For example, in 2016, IRS estimated that hundreds of millions of dollars of certain insurance premiums have been used by taxpayers and promoters to improperly claim tax deductions.³ When taxpayers abuse insurance products, they threaten our tax system's integrity and fairness and contribute to the tax gap, which is the difference between the taxes people and businesses owe and what they annually pay voluntarily and on time in the United States.

You asked us to review what guidance IRS provides about complying with laws related to offshore insurance accounts and how IRS conducts enforcement on offshore insurance-related non-compliance. This report assesses the extent to which IRS:

- reviews its guidance on offshore insurance to ensure that the guidance has its intended effect;
- aligns oversight of its audit activities on taxpayers who may be abusing micro-captive insurance tax shelters with its audit policies and guidance;⁴ and
- reviews its investigation activities on promoters who market abuses of micro-captive insurance tax shelters.⁵

In addition to these objectives, in appendix I of this report, we describe available data sources on offshore insurance companies and related

³IRS estimated this amount in 2016 based on certain average annual captive insurance premiums paid by taxpayers. IRS has not recomputed the amount. While many businesses choose to insure their risks through commercially available insurance policies, some choose to create their own insurance companies that can provide tailored and sometimes more affordable risk coverage. These insurance entities, called captive insurance companies, are generally wholly owned by the same or related persons as the businesses they insure and provide insurance products. Some of these products are particularly vulnerable to use as abusive tax schemes.

⁴In this report, we use the term "micro-captives" to refer to small captive insurance companies that elect to be taxed only on their taxable investment income.

⁵The term "promoter" generally means a person who (1) organizes an investment plan or arrangement affecting taxes or participates in selling it and (2) makes a statement about its tax benefits. See 26 U.S.C. § 6700.

transactions and discuss whether IRS could use such data in its audit selection.

To assess the extent to which IRS reviews its guidance on offshore insurance, we first identified relevant guidance. We included guidance that IRS officials considered non-regulatory guidance relating to offshore insurance. We compared IRS activities on developing and reviewing these types of guidance with IRS's Internal Revenue Manual (IRM), relevant best practices from the Office of Management and Budget (OMB), and relevant principles of federal internal control standards on risk assessment and control activities.⁶ We also interviewed relevant agency officials on IRS's guidance development process as it pertains to offshore insurance.

To assess the extent to which IRS aligns oversight of its audit activities on taxpayers who may be abusing micro-captive insurance tax shelters with IRS policies and guidance, we reviewed documentation describing objectives, procedures, and standards for IRS audits of potentially abusive offshore insurance tax arrangements. We focused our review on micro-captive tax shelters because IRS has publicly prioritized its efforts to reign in abusive micro-captive tax shelters and has data on these enforcement efforts. We reviewed the IRM; documentation and guidance specific to the IRS business operating divisions; previous GAO and Treasury Inspector General for Tax Administration reports, and IRS micro-captive insurance audit data. We also interviewed IRS staff.

Based on the findings of our initial review, we obtained the relevant criteria to evaluate IRS examinations of micro-captive insurance tax shelters. These criteria consisted of a list of required or recommended documents or activities that should be documented in an audit case file. We selected these criteria based on the IRM and other agency guidance documents for conducting micro-captive insurance audits. We then identified and requested a non-generalizable sample of 30 IRS micro-captive insurance audit case files that closed in fiscal year 2019 and

⁶[GAO-20-589](#); *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014); and *Digital Television Transition: Increased Federal Planning and Risk Management Could Further Facilitate the DTV Transition*, [GAO-08-43](#) (Washington, D.C.: Nov. 19, 2007).

compared the case files to our criteria.⁷ We recorded where case files were missing supporting documentation of required or recommended examiner activities and aggregated our results.

In addition, we reviewed IRS documentation of internal managerial and quality reviews of micro-captive insurance audits conducted in fiscal year 2019 to describe how the agency evaluated its audits. We collected data from IRS on both the number and score of managerial and quality reviews conducted from fiscal years 2016 through 2020. We reviewed the data for accuracy by confirming that IRS's data sets matched data reported in managerial and quality review documents. We interviewed agency officials to determine how the quality scores were determined. We found the data sufficiently reliable to report both the number and quality scores of such reviews. We also compared IRS managerial review procedures listed in the IRM and described by agency officials to relevant federal internal control standards on control activities, monitoring controls, and documentation of the internal control system.

To assess the extent to which IRS reviews its investigations of promoters who market abuses of micro-captive tax shelters, we identified relevant procedures that were in place for identifying, investigating, and reviewing investigations of promoters of potentially abusive tax schemes. Again, we focused our review on micro-captive tax shelters to provide a more detailed analysis of IRS's related enforcement activities and to reflect IRS's publicly stated priority of enforcing tax laws on promotion of abusive micro-captive tax shelters. We also assessed the extent to which these procedures align with relevant federal internal control standards on control activities, information and communication, and monitoring.

For a more detailed discussion of our methodology, see appendix II.

We conducted this performance audit from April 2020 to March 2022 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 objectives. We believe that

⁷Each of the 30 case files is representative of one tax return for one taxpayer. However, an audit may include multiple case files, which include associated tax returns for multiple taxpayers in what IRS refers to as a "case family." The 30 case files we reviewed were associated with five case families.

the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Offshore Insurance Tax Shelter Compliance Challenges

Federal law provides certain tax benefits for transactions involving genuine insurance products, including insurance products held offshore. While taxpayers may lawfully hold offshore insurance products, certain features of these products make them vulnerable to abuse.

Offshore insurance products can be highly technical and individualized, making compliance and enforcement challenging, according to IRS officials. They also may cross numerous tax forms, business types, and reporting requirements.

Furthermore, insurance is largely regulated at the state level. States may use standards to determine if an arrangement constitutes insurance that are different from those used under federal tax law, according to IRS officials. Insurance also is not defined by federal statute. These factors collectively can make determining what constitutes genuine insurance for federal tax purposes difficult, despite the fact that a body of federal case law exists establishing criteria for determining whether an arrangement is to be treated as insurance for federal tax purposes.

U.S. taxpayers may qualify for tax benefits associated with certain types of insurance. However, they remain responsible for ensuring that

- they accurately report assets to the U.S. government on applicable tax forms and information returns,
- they only claim these tax benefits as appropriate, and
- they pay appropriate taxes based on the type of financial instrument.

These principles apply whether taxpayers hold assets, income, and financial instruments in the United States or offshore.

Tax shelters can be legitimate to the extent they take advantage of various provisions in the tax code to lawfully avoid paying federal taxes; however, abusive tax shelters result in unlawful tax evasion. Abusive offshore insurance tax schemes include transactions that are also considered unlawful tax shelters.

IRS requires taxpayers and firms to report certain information that may include offshore insurance information. The exact nature and combination of forms that taxpayers must file depends on the nature of the insurance product and the associated tax benefits, and as a result may vary with each taxpayer.

Our July 2020 report on offshore insurance listed nine types of tax returns and nine types of information returns that could indicate whether the filer conducted a transaction involving offshore insurance.⁸ IRS checks for compliance by auditing these forms, as well as taxpayers' tax returns and other information returns related to taxpayers' returns.

Examples of forms include

- *IRS Form 8966, FATCA Report*, which is filed by certain foreign financial institutions and could include information on certain cash value insurance accounts;⁹ and
- Financial Crimes Enforcement Network (FinCEN) Form 114, *Report of Foreign Bank and Financial Accounts*, which could include information about a taxpayer's offshore insurance account worth more than \$10,000.

Our July 2020 report also described the variety of guidance IRS has issued to taxpayers to help them voluntarily comply with existing laws and filing requirements related to offshore insurance.¹⁰

Oversight of Taxpayer Compliance for Offshore Insurance

One way IRS enforces laws regarding offshore insurance tax shelters is through audits conducted by the Large Business and International Division (LB&I) and the Small Business/Self-Employed Division (SB/SE). LB&I and SB/SE rely both on IRS-wide policies and division-specific audit and investigation procedures to guide how they conduct enforcement

⁸[GAO-20-589](#).

⁹Subtitle A of Title V of the Hiring Incentives to Restore Employment Act is commonly known as the Foreign Account Tax Compliance Act or FATCA. Pub. L. No. 111-147, §§ 501–541, 124 Stat. 71, 97–117 (2010).

¹⁰For a discussion of guidance relevant to this report, see [GAO-20-589](#), app. I. The list includes a range of notices, revenue rulings, written determinations, and other guidance published on IRS's website. Some of this guidance is issued in the Internal Revenue Bulletin (IRB) in coordination with the Department of the Treasury. Other guidance is issued by IRS itself. IRS officials said that in certain circumstances, operating divisions may be involved with issuing IRB guidance. IRS officials said the Department of the Treasury and the Office of the Chief Counsel also consider input from stakeholders, such as insurance industry representatives, or other public input.

activities. If IRS finds the insurance transaction to be abusive, the taxpayer may be liable for additional taxes, interest on any unpaid taxes, and may be subject to penalties, such as an accuracy-related penalty.

LB&I carries out issue-based plans called campaigns to address taxpayer compliance. Campaigns are among LB&I's highest-priority compliance efforts. These campaign efforts can involve, among other activities, issue-based audits, delivery of training, public guidance, and issuance of "soft-letters." According to IRS officials, a soft letter generally is directed at a particular filing position taken by a taxpayer and seeks information or suggests a course of action.

Since 2016, LB&I has conducted a campaign on micro-captive insurance abuse, which represents one of IRS's most identifiable efforts to address a tax issue that may include offshore insurance. While LB&I leads the campaign, SB/SE also audits micro-captive insurance tax shelters. Both LB&I and SB/SE conducted audits of micro-captive insurance tax shelters prior to the start of the campaign in 2016. LB&I and SB/SE have jointly handled audits of abusive micro-captive transactions since 2012. From that year to February 2021, LB&I and SB/SE conducted thousands of audits of micro-captive insurance tax shelters that assessed hundreds of millions of dollars in additional taxes owed.

Since 2019, IRS also reached settlements with hundreds of taxpayers through a cross-division private resolution initiative.¹¹ In total, hundreds of settling taxpayers agreed to pay IRS millions of dollars in additional taxes. Additionally, IRS officials said starting in March 2020, they began sending soft letters to taxpayers who engaged in micro-captive arrangements. The letter requested that taxpayers review their micro-captive insurance filing positions and notify the IRS in writing by the response due date stated in the letter, if they have discontinued taking deductions or other tax benefits from a micro-captive insurance transaction. The officials said the letter also encouraged taxpayers to consult with an independent tax advisor in regard to prior year filing positions and consider filing amended returns to bring themselves back into compliance if warranted.

¹¹The private resolution initiative allows IRS to offer to settle cases with individual taxpayers as a means to rapidly complete the audit process and avoid potential litigation. The agency offered to close the audit if the taxpayer agreed to leave the abusive tax scheme and pay a portion of the taxes owed from participating in the scheme. If the taxpayer declined the offer, the audit continued.

Promoter Investigations

In addition to auditing taxpayers, IRS can investigate persons who sell, organize, or otherwise promote offshore insurance tax shelters.¹² Certain promoters are considered by IRS to be a type of material advisor and are subject to the same reporting requirements and penalties for non-compliance as other material advisors.¹³ During promoter investigations, IRS evaluates whether a promoter is subject to penalties or injunctive action because of the promoter's involvement in or marketing of abusive arrangements.

Completed promoter investigations do not result in increased tax liability for the promoter. If promoters are found to be in violation of tax laws, they may be subject to penalties, referred to the Department of Justice for injunction, or both.

Offshore Insurance Issue: Micro-captive Insurance

As previously mentioned, one method by which some taxpayers have abused offshore insurance is through abuse of micro-captive insurance products.¹⁴ Micro-captive insurance products involve small insurance companies that elect to be taxed only on investment income and are owned by the same or related persons as the businesses they insure, according to IRS officials. According to IRS officials, abuse occurs if a taxpayer improperly deducts premiums in a micro-captive arrangement that is not legitimate insurance for federal tax purposes.¹⁵

IRS officials said they expend significant resources reviewing micro-captive insurance transactions because of the varied ways those schemes work, and IRS public statements have demonstrated that micro-captive insurance compliance is a high-priority issue for the IRS. One way IRS has expended resources addressing micro-captive insurance arrangements is by specifically tracking the issue in its audit enforcement

¹²See 26 U.S.C. § 6700.

¹³A material advisor is an individual, trust, estate, partnership, or corporation that provides any material aid, assistance, or advice with respect to the organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, such as a micro-captive insurance arrangement. 26 C.F.R. § 301.6111-3(b).

¹⁴IRS does not specifically track whether a micro-captive insurance audit is conducted on an offshore domiciled insurance arrangement. However, some such arrangements may be located offshore, and IRS cited offshore domiciled micro-captive arrangements as potentially abusive. See [GAO-20-589](#) for a more detailed discussion of micro-captive insurance abuse.

¹⁵For additional information about how micro-captive insurance operates, see [GAO-20-589](#).

data. IRS also has periodically included micro-captive insurance compliance on its “Dirty Dozen” list of top tax schemes since 2014.

Additionally, IRS designated certain Internal Revenue Code (IRC) section 831(b) micro-captive insurance transactions as reportable transactions of interest in 2016.¹⁶ According to IRS officials, participants are required to report certain micro-captive insurance transactions on Form 8886, *Reportable Transaction Disclosure Statement*, while material advisors use Form 8918, *Material Advisor Disclosure Statement*. Taxpayers submitted thousands of disclosures of micro-captive insurance transactions per year from calendar years 2016 through 2020. During that period, IRS also collected thousands of disclosures from material advisors who provide advice to taxpayers regarding micro-captive insurance. IRS uses this information, among other sources, to select returns for audit. Figure 1 below summarizes key differences between how IRS audits taxpayers who participate in potentially abusive micro-captive insurance tax shelters and how it investigates promoters of such tax shelters.

¹⁶Notice 2016-66 references 2016-47 I.R.B. 745. Taxpayers who engage in these or substantially similar transactions are required to report them to IRS. 26 U.S.C. § 6111; 26 C.F.R. § 1.6011-4(b)(6). The enforceability of reporting requirements for certain micro-captive transactions under Notice 2016-66 of micro-insurance as a reportable transaction has been challenged in federal court and the plaintiff has been granted a preliminary injunction barring IRS from enforcing Notice 2016-66 against it. *CIC Servs. v. IRS*, No. 3:17-cv-110 (E.D. Tenn. Sept. 21, 2021).

Figure 1: Micro-captive Insurance Income Tax Audits vs. Micro-captive Promoter Investigations

| | Micro-captive insurance income tax audit | Micro-captive insurance promoter investigation |
|---|---|--|
| Who conducts the review | Examiners from the Small Business/Self-Employed (SB/SE) Division and the Large Business and International (LB&I) Division | Examiners from SB/SE and LB&I if civil investigation, IRS's Criminal Investigations Division if criminal investigation |
| How IRS selects cases | Generally selected from Form 8886 disclosures, ^a promoter investigations, lists of material advisor clients, and other exam selection procedures | May be selected from Form 8918 disclosures, ^b identified via external tip; identified by the Office of Tax Shelter Analysis and referred to appropriate team; and identified through internal information, such as through an audit |
| Purpose of IRS review | Determines tax compliance and liability | Determine whether a promoter used false statements about tax benefits or gross valuation misstatements in the establishment or sale of an entity or arrangement |
| IRS assesses taxes owed | Yes | No, investigation is not a tax determination |
| May result in penalties if violation of tax law is found | Yes | Yes |

Source: GAO analysis of Internal Revenue Service information. | GAO-22-104180

^aParticipants are required to disclose their involvement in a reportable transaction, such as a micro-captive insurance arrangement, on IRS Form 8886, *Reportable Transaction Disclosure Statement*.

^bCertain promoters who are material advisors as defined by IRC 6111 must disclose information related to reportable transactions on IRS Form 8918, *Material Advisor Disclosure Statement*.

IRS Relies on Public and Internal Comments to Adjust Guidance and Would Face Complications Implementing Additional Reviews

IRS does not have procedures specifically calling for formal reviews of published, non-regulatory guidance specifically to ensure whether the guidance meets stated objectives. However, IRS officials said they review issued guidance by collecting feedback they receive from the public and from within IRS. Collecting public input to update guidance is consistent

with IRS procedures, which require IRS officials to consider whether “public comments are necessary or helpful” when issuing guidance.¹⁷

IRS officials said that they conduct guidance reviews as part of updating their annual Priority Guidance Plan (Plan). IRS and the Department of the Treasury annually are to list their guidance production priorities through this Plan. Since 2015, the Plan has listed guidance relevant to offshore insurance more than a dozen times. For example, the 2021-2022 Plan lists guidance on the use of foreign statement reserves for measuring qualified insurance income. According to the IRM and IRS officials, as part of preparing the Plan, IRS also considers public input. To collect public input, IRS and Treasury annually publish a notice inviting the public for items to be included in the plan for the upcoming year. IRS Chief Counsel officials also said that to seek public input, they attend and participate in professional development programs where they receive significant and timely feedback. IRS officials said they have no documented plans to issue new guidance directly relating to offshore insurance, including micro-captive offshore insurance, beyond what IRS now makes available.

In addition to collecting public and internal feedback and updating the Plan, IRS could adopt practices and performance metrics to periodically review whether guidance relating to offshore insurance has achieved its intended objective, as supported by OMB best practices and federal internal control standards.¹⁸ Such metrics could address, for example, the guidance’s effects on taxpayer compliance rates, the number of relevant reportable transaction disclosures filed, the number of promoters assessed a penalty, or whether users understand and use the guidance. IRS could conduct reviews by, among other things, analyzing relevant data on compliance or surveying industry professionals.

¹⁷IRS policies and procedures for working with the Department of the Treasury and IRS on producing guidance, both for publication in the IRB and elsewhere, generally are contained in sections of the IRM collectively called the Chief Counsel Directives Manual, which contains the Chief Counsel Regulation Handbook and the Chief Counsel Publication Handbook. The former addresses regulations, which IRS also may refer to as guidance, and the latter lists procedures for non-regulatory guidance, such as revenue rulings, revenue procedures, notices, and other announcements. For more on IRS’s nomenclature on guidance, see *Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-standing Exemptions of Tax Regulations and Guidance*, [GAO-16-720](#) (Washington, D.C.: Sept. 6, 2016).

¹⁸For more information on the internal controls we considered, see app. II.

However, we found two issues that would likely complicate IRS's adoption of such reviews of offshore insurance guidance. First, such reviews may go beyond existing legal requirements for non-regulatory guidance. For example, Executive Order 13563 recognizes the importance of periodic review of existing significant regulations to identify rules that are outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned.¹⁹ However, this applies to significant regulations, not non-significant regulations or non-regulatory guidance, such as the guidance on offshore insurance reviewed here.²⁰ Adopting performance metrics could be more appropriate for reviewing whether significant regulations are meeting their objectives.

In combination with the legal issues, IRS faces resource limitations that may render assigning metrics to issued relevant guidance problematic, particularly considering the breadth of guidance IRS provides, as we described in our earlier work.²¹ For example, we identified more than 600 written determinations that potentially could involve offshore insurance. Additional procedural steps for each of these pieces of guidance may be burdensome for the agency.

Nonetheless, recent administrative actions still may provide opportunities for IRS to improve public notification (and by extension, reviews) of any additional guidance on offshore insurance it decides to produce. For example, on January 20, 2021, the President sent a memorandum to the heads of executive departments and agencies instructing "the Director of OMB, in consultation with representatives of executive departments and agencies (agencies), as appropriate and as soon as practicable, to begin

¹⁹*Improving Regulation and Regulatory Review*, Exec. Order. No. 13563, § 6, 76 Fed. Reg. 3821, 3822 (Jan. 21, 2011). The order directs agencies to develop and submit to the Office of Information and Regulatory Affairs a preliminary plan, consistent with law and its resources and regulatory priorities, under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives.

²⁰"Significant regulations" are defined in Executive Order 12866. In general, the order states that significant regulations are those that have an annual effect on the economy of \$100 million or more; create a serious inconsistency or interfere with an action taken or planned by another agency; materially alter the budgetary impact of entitlements, grants, user fees, or loan programs; or raise novel legal or policy issues out of legal mandates, the President's priorities or the principles set forth in E.O. 12866.

²¹[GAO-16-720](#) and [GAO-20-589](#).

a process with the goal of producing a set of recommendations for improving and modernizing regulatory review.”²²

The memorandum also said these recommendations should “identify reforms that will promote the efficiency, transparency, and inclusiveness of the interagency review process, and *determine an appropriate approach with respect to the review of guidance documents*” [emphasis added].

In our 2021 report on international taxation, we found that OMB’s memorandum provides an opportunity for IRS to re-examine the processes for obtaining public comment on future IRS guidance.²³ In that report, we recommended that IRS, in light of the government-wide regulatory review, identify ways to provide public comment opportunities for significant guidance documents when appropriate. Our recommendation applies to guidance on other emerging tax schemes that may involve offshore insurance and that IRS may identify moving forward, to the extent that the guidance is significant guidance.

Treasury and IRS neither agreed nor disagreed with our recommendation. Instead, Treasury stated that Treasury and IRS recognize the value of public comment for all levels of tax guidance and seek to provide opportunities for comment when appropriate.

Treasury also noted that it is not always appropriate or feasible to provide such opportunities when balanced against the immediate needs of taxpayers for greater clarity and the requirements of tax administration. We agree that there may be situations in which Treasury and IRS should act to quickly publish guidance, but we continue to encourage Treasury and IRS to limit the instances in which they publish guidance without seeking public comments.

²²The Executive Office of the President, Memorandum for the Heads of Executive Departments and Agencies: Modernizing Regulatory Review (Washington, D.C.: Jan. 20, 2021).

²³GAO, *Tax Cuts and Jobs Act: Future Rulemaking Should Provide Greater Detail on Paperwork Burden and Economic Effects of International Business Provisions*, [GAO-21-277](#) (Washington, D.C.: Apr. 28, 2021).

IRS Could Better Ensure That Taxpayer Audits of Micro-captive Insurance Meet Quality Standards

SB/SE and LB&I ensure the accuracy of taxpayer audits of micro-captive insurance arrangements through a variety of methods, including in-audit practices, such as examiner collaboration with subject matter experts, IRS counsel and formal and informal reviews. When we asked IRS officials how they evaluate the implementation and results of the micro-captive insurance audit program, they cited, among other practices, the use of formal managerial and quality review systems, which are described below.²⁴ IRS officials said that they have no formal review process in place that is specific to micro-captive insurance audits. However, we found that IRS has opportunities to improve its oversight of micro-captive insurance audits by expanding its use of formal review systems.

SB/SE Could Clarify How to Apply Formal Managerial Review to Audits, while LB&I Could Formalize the Use and Tracking of Such Reviews

SB/SE and LB&I managers oversee how well examiners perform the audit of micro-captive insurance arrangements by conducting activities we will refer to collectively as “managerial review.”²⁵ While managerial review supplements other actions IRS takes to oversee audits of micro-captive insurance arrangements, the use of formal, documented managerial review provides unique opportunities for SB/SE and LB&I to improve their audits.²⁶ Each division has different approaches to managerial review, which come with different advantages and limitations.

SB/SE Managerial Review

In conducting formal managerial review, SB/SE managers analyze an examiner’s audit of compliance issues, including micro-captive insurance tax arrangements, and then document the results (for additional information about SB/SE’s managerial review process, see appendix III).

²⁴In addition to the managerial and formal quality reviews described in this section, micro-captive insurance audits are subject to further oversight: Closing agreements and Statutory Notices of Deficiency are reviewed by Technical Services and counsel and agents conducting audits work closely with subject matter experts and counsel in conducting audits. In addition, when a case is closed by an examiner, the group manager should review the case to ensure it is procedurally and technically correct

²⁵In general, formal managerial reviews consist of various types of written reviews, including performance appraisals, in-process case reviews, workload reviews, and technical time report reviews, among others. Both SB/SE and LB&I also conduct informal reviews, which are not required to be documented, and oversight activities of audits.

²⁶LB&I and SB/SE oversight of audits also includes, for example, informal and formal managerial review, collaboration with subject matter experts and counsel, and, upon audit closure, formal approval of audit determinations by managers, counsel and other key staff. The IRM requires that every audit be checked by a manager for procedural and technical accuracy upon closure of the audit. IRM §§ 1.4.40.4.22(1), 4.46.6.6(1).

Generally, SB/SE's formal managerial reviews evaluate and assign a "yes," "no," or "N/A" rating and a narrative description of the findings based on whether an examiner's performance met agency standards in six attribute groups, including planning, income determination, audit technique, timeliness, customer relations, and documentation.²⁷ The SB/SE formal managerial reviews of micro-captive insurance audits that we inspected also addressed, among other topics, whether examiners correctly interpreted and applied tax law relevant to micro-captive insurance audits, how examiners collaborated with subject matter experts to analyze a micro-captive's structure, and how effectively examiners communicated IRS's position on micro-captive insurance with audited taxpayers.

SB/SE has the capacity to document, track and analyze the results of formal managerial reviews in the Embedded Quality Review System (EQRS).²⁸ IRS officials said that EQRS allows SB/SE managers to generate reports that can identify trends in examiner performance and identify top and bottom scoring attributes across a group, or geographic region. While IRS did not design EQRS to evaluate specific compliance issues, SB/SE lacks an alternative means for managers to electronically document and compare the results of formal audit reviews.

Implementing formal managerial review helps managers determine whether individual audits meet agency audit standards and contribute to agency goals. Furthermore, storage of reviews and data in EQRS can allow managers to evaluate both audit activity across the wider compliance issue and the review system itself for trends and weaknesses. These activities are consistent with the IRM's quality principles and federal internal control standards.²⁹ By analyzing

²⁷According to Embedded Quality Review System (EQRS) documents we reviewed, formal managerial reviews do not uniformly respond to these six attribute groups alone. Attribute groups also include a variety of sub-components, which are individually rated. Managers have discretion to decide which attributes they wish to review the audit against, per both the IRM and agency guidance.

²⁸Managers conducting a formal review produce both a narrative description of their findings and ratings that indicate whether the reviewed attribute of the audit meets agency standards. The EQRS system stores the type and number of attribute ratings that did or did not meet agency standards for each audit. The audit's ratings are aggregated in EQRS as overall "scores" with other managerial reviews, which allows all the scores to be compared and analyzed.

²⁹IRS Internal Revenue Manual (IRM) § 1.2.1.2.2; [GAO-14-704G](#), para. 16.01.

aggregated attribute scores in EQRS, managers can better identify gaps in examiner activity and target corrective action.

SB/SE officials said that current oversight practices, including the use of managerial review, were sufficient to ensure that micro-captive insurance audits were conducted accurately. From fiscal years 2016 through 2020, SB/SE's managerial reviews found that, overall, attributes of micro-captive insurance audits were conducted appropriately about 97 percent of the time, while managers found that attributes of all audits were conducted appropriately approximately 92 percent of the time. SB/SE officials said that given the high scores of micro-captive insurance audits, they did not believe that expending more resources to conduct additional managerial reviews of such audits was warranted.

However, in some years and for specific attributes, micro-captive insurance audits were found to meet audit attribute standards less than the average for all audits. For example, in fiscal years 2018 and 2019 managers scored the audit attribute "work papers support conclusions" lower for micro-captive insurance audits than for all audits on average. In fiscal year 2019 managers also scored the audit attributes "pre-plan activity" and "confidentiality" lower for micro-captive insurance audits than all audits on average. Subsequent scores in fiscal years 2020 and 2021 increased to above average for these attributes, which SB/SE officials said demonstrated managers' ability to identify gaps in audit activity and target corrective actions using EQRS.

In addition, while IRS officials stated that SB/SE Area Directors issue annual managerial review documentation requirements and expectations, the IRM provides little guidance on when or how regularly SB/SE managers should subject an audit to managerial review. The IRM defines eight tools that managers can apply to review an audit, none of which are always mandatory.³⁰ The IRM either does not provide specific

³⁰Formal application of the eight review tools are required to be conducted through and saved in EQRS. The managerial review tools listed for SB/SE in the IRM include but are not limited to the Group Manager Concurrence Meeting; In-Process Case Reviews; Workload Reviews; On-the-Job Visit; Closed-Case Review; Review of Examination Technical Time Reports (ETTR); Day/Morning After reviews and On-Going observation. IRM § 1.4.40.7.

instructions, or refers managers to use their judgment to determine if and when a formal review is necessary.³¹

From fiscal years 2016 through 2020 SB/SE managers subjected at least 106 micro-captive insurance audit cases to a managerial review according to data provided by IRS.³² During that same period, IRS started thousands of audits of tax returns that reported micro-captive insurance arrangements.³³ Due to the small portion of micro-captive insurance audits reviewed in EQRS out of all audits, and the judgmental manner in which audits are selected for formal managerial review, SB/SE should not assume that the high scores of managerial reviews it conducted are representative of all such audits.

We reviewed 30 case files for audits of tax returns closed in fiscal year 2019 that included micro-captive insurance arrangements to assess whether examiners performed and documented the results of required and recommended audit procedures. None of the audits that we reviewed were subjected to formal managerial review through EQRS.³⁴ Further, our sample is too small to extrapolate findings to the entire population of micro-captive insurance audits and our review did not address whether or not the examiner reached a correct or incorrect audit determination. However, our review found multiple examples where examiners either did

³¹Of the eight managerial review tools listed, the IRM does not provide explicit guidance for when the manager should use the tool for five of them. Of the remaining three, the IRM provides some guidance but still leaves aspects of the managerial review selection up to the manager. The IRM mandates managers to use the Group Manager Concurrence Meeting for audits conducted by IRS employees rated GS-12 or lower, but optional for those conducted by GS-13 staff. The IRM requires the manager to perform a cursory inspection of every closed case but leaves the option of conducting a formal closed case review up to the manager's discretion, and does not provide guidance as to when a formal review should be conducted. The IRM leaves decisions on when and how an audit is subjected to an ETTR to be based on guidance from the Area Director or Territory Manager. IRM § 1.4.40.7.

³²SB/SE officials told GAO that some formal managerial reviews of audits are not tracked in EQRS with an identifying code that allows viewers to determine if the review applies to a micro-captive promoter investigation. While the data IRS provided to us listed 106, an unknown additional number of formal managerial reviews were conducted.

³³SB/SE managers reviewed tens of thousands of audit cases of all compliance issues in EQRS from fiscal years 2016 through 2020. During that same period, SB/SE officials said they started hundreds of thousands of audits of tax returns of all compliance issues. SB/SE officials said that while IRS tracks audit data by tax return or taxpayer, IRS's EQRS system tracks information by "case," which may include multiple tax returns or taxpayers.

³⁴For more detail on how case files and case families were counted see app. II.

not perform, or did not document that they performed required or recommended audit procedures. Additionally, we found instances where required or recommended forms were not included in the case file.

For example, the IRM requires that managers and examiners complete a risk analysis to determine the initial scope and depth of an audit, to adjust the audit at the mid-point and when significant events necessitate a change.³⁵ Examiners use risk analysis to determine if it is in the government's best interest to continue with the audit. Of the case files we reviewed, more than half of the applicable case files did not include a copy of the risk analysis.

In another example, according to the IRM and IRS audit guidance if IRS examiners identify any information that indicates the presence of large, unusual or questionable activity in a tax return, which indicates that an audit is necessary or should be continued, the information should be documented in the case file.³⁶ However, in multiple case files we reviewed, while the examiner conducted a full audit, there was no specific record of what information or activity was found to be large, unusual or questionable.³⁷

Finally, IRS micro-captive insurance audit guidance requires examiners to determine if a taxpayer is claiming a benefit from a micro-captive insurance arrangement.³⁸ If so, the taxpayer should include a valid 831(b) election signifying such an arrangement.³⁹ According to the IRS micro-

³⁵IRM § 4.10.3.2.

³⁶IRM § 4.10.2.3.

³⁷This occurred in fewer than 10 case files. We generally do not report tax data of values fewer than 10 to prevent improper disclosure of federal tax information.

³⁸IRS, *Non-Life Insurance Practice Network: Audit Guide and Suggested IDR Questions for IRC § 831(b) Election To Be Taxed Only on Taxable Investment Income*. (June 8, 2018).

³⁹A taxpayer makes an 831(b) election by including certain documentation with their Form 1120-PC tax return. The taxpayer is required to check box (D) in the 1120-PC, and submit schedule forms B, I, L, and M-1. Regulations also require the taxpayer to attach a statement to the return for the first taxable year for which the election is to be effective. 26 C.F.R. § 301.9100-8(a)(3). The statement must (1) contain the name, address, and taxpayer identification number of the electing taxpayer; (2) identify the election; (3) indicate the election is being made under section 831(b); (4) specify, as applicable, the period for which the election is being made and the property or other items to which the election is to apply; and (5) provide any information required by the relevant statutory provisions such as the information necessary to show that the taxpayer is entitled to make the election. The instructions for Form 1120-C do not state this requirement.

captive insurance audit guidance, the examiner is responsible for determining if the 831(b) election, and the insurance arrangement it describes, is valid or if the taxpayer is primarily using a micro-captive insurance arrangement to avoid paying taxes. To make this determination, examiners are required to collect a copy of the 831(b) election and evidence supporting the election. However, in one-third of the case files where this requirement was applicable, the 831(b) election was not documented in the case file. IRS officials stated that in both examples documents could be missing for a variety of legitimate reasons. However, in both these and other examples, we were unable to locate several required or recommended documents.

IRS officials said that the absence of documents from the case file may not necessarily be an indication that audits have reached the wrong tax liability determination. However, federal internal controls standards require that IRS establish and maintain effective application controls to ensure the accessibility and reliability of IRS's data and documents. Further, federal internal controls standards require that agency management should design control activities to achieve objectives and respond to risks and implement these activities, which include periodically reviewing the effectiveness of relevant policies, procedures and control activities. Internal control standards also require that management monitor the internal control system, which includes performing ongoing monitoring through regular management and supervisory activities and may include use of automated tools that can increase objectivity and efficiency by electronically compiling evaluations of controls.⁴⁰

Particularly in times of limited resources, effective internal controls provide reasonable assurance that programs are achieving their objectives. We found that SB/SE lacks an alternative electronic review system to EQRS and explicit agency guidance in the IRM on when to conduct managerial review. We also found that a relatively small portion of the managerial reviews applied to micro-captive insurance audits. Considering these findings, the existence of gaps in the case files we reviewed raises the possibility that managerial reviews that are judgmentally selected may not be an effective control for ensuring that taxpayer audits, including those of micro-captive insurance arrangements, are conducted and managed according to agency standards. By providing managers with clearer guidance in the IRM on the use of various managerial review tools and the frequency with which reviews should be

⁴⁰[GAO-14-704G](#), para. 16.05.

LB&I Managerial Review

conducted, SB/SE could be better assured that audits of micro-captive insurance are being conducted in accordance with agency standards.

According to LB&I officials, audit managers conduct checks of micro-captive insurance audits and document checks with signatures in audit case files. LB&I officials said that these checks and sign-offs, which are required by the IRM, were sufficient to ensure that audits were conducted according to agency standards.⁴¹ However, LB&I officials said that the IRM does not have a more formal process for its managerial reviews, such as specific procedures or suggested forms for conducting and documenting managerial reviews. Further, in contrast with SB/SE, LB&I does not have a means to record and compare written assessments of audits in an electronic system. As a result, it has less data to use for analysis of micro-captive insurance audits.⁴²

Our analysis of LB&I case files suggests the division could benefit from formal and documented managerial review of its audits, including micro-captive insurance audits. We reviewed files for cases that were prepared and audited by LB&I and found that each of the files was missing documentation of at least one required and recommended check and form.⁴³ For example, audit case files of micro-captive insurance tax returns for tax years 2016 or later are required to include a copy of Form 8886.⁴⁴ However, none of the applicable case files we reviewed included this required form. We are not able to generalize as to whether the reviewed files are indicative of the entire population of audits and we did not review the accuracy of the examiner's audit determination. Still, we

⁴¹IRM §§ 4.46.5.8, 4.46.6.2.5.

⁴²LB&I reviews the performance of IRS employees but such appraisals are limited to the staff member, not an audit, and cannot be analyzed based on the compliance issue the employee was working on. LB&I managers record such individual employee appraisals in the Employee Performance File and IRS's human resources system of record, HR Connect. These systems are intended only for use as a means to review individual employee performance, not identify trends or attributes of cases and audits. Employee appraisals are not considered or shared with other staff when appraising the results of a compliance issue, such as micro-captive insurance audits.

⁴³The number of files reviewed was fewer than 10. We generally do not report tax data of values fewer than 10 in order to prevent improper disclosure of federal tax information.

⁴⁴IRS Large Business and International. *LB&I and SBSE Micro-Captive Insurance Tiger Team Training: Notice 2016-66 – Transaction of Interest*. (May 5, 2020).

found that some required documentation has not always been included in the audit case file.

LB&I collects and monitors data from the results of its micro-captive insurance audits and campaign, such as whether and how an audit was closed and any potential additional tax assessments, but this data does not address whether an audit was conducted appropriately and cannot substitute as an evaluation of audit conduct. And while LB&I managers review and assess how a micro-captive audit is conducted, LB&I does not have a means to collect, evaluate, and compare these reviews and assessments.

The IRM requires that IRS collect useful information and develop evaluative systems to identify the need for corrective action and measure the performance of its programs.⁴⁵ The IRM also requires that IRS establish formal reporting requirements and collect reported data into a single system, whenever possible.⁴⁶ Federal internal control standards require managers to design control activities to achieve objectives and respond to risks, and implement these activities, which includes documenting in the policies the internal control responsibilities of the organization. Internal control standards also require that management develop and maintain documentation of its internal control system to meet operational needs, establish and communicate responsibilities to personnel, and enable controls to be monitored and evaluated.⁴⁷ Establishing a formal review system—including a formal method to record and analyze the results of managerial reviews that could be applied to individual audits, including micro-captive insurance audits—could improve LB&I’s ability to evaluate both the compliance issue and its oversight process for trends and problems.

IRS’s Approach to Ensuring the Quality of Audits Has Limited Applicability to Micro-Captive Insurance Audits

SB/SE and LB&I also subject a selection of their closed audits to formal “quality review.”⁴⁸ SB/SE uses the National Quality Review System (NQRS) and LB&I uses the LB&I Quality Measurement System (LQMS) to conduct and document quality reviews. According to IRS officials, while both SB/SE and LB&I conduct in-audit oversight practices—such as collaboration between examiners, subject matter experts, counsel, and

⁴⁵IRM §§ 1.2.1.2.2(2)(e), 1.2.1.2.26(2)–(3).

⁴⁶IRM § 1.2.1.2.26(3)–(4).

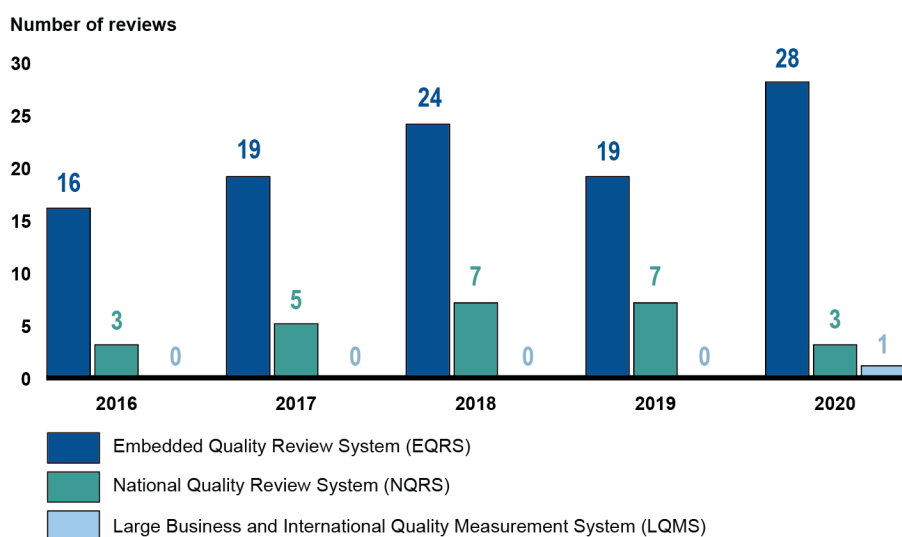
⁴⁷GAO-14-704G, paras. 3.09, 3.10, 3.11.

⁴⁸For more information about the quality review process, see app. III.

the cross-division micro-captive strategy team—formal quality review provides additional opportunities to improve audit quality. In contrast to in-audit oversight practices and managerial reviews, quality reviews are intended to give IRS an independent means to formally identify, document, and correct gaps across a division’s audit process. While managerial review is conducted by the manager overseeing a specific audit, quality reviews are conducted by independent reviewers outside of the audit work-stream. Independent reviewers can evaluate the audit work of both the examiner and the audit manager to ensure that all processes meet IRS’s standards.

While micro-captive insurance audits can be identified and have been reviewed through both NQRS and LQMS, these quality review systems, per the IRM and agency officials, provide data that are statistically valid only at a functional level, not for specific projects or programs. SB/SE and LB&I lack an alternative means for IRS evaluators who are independent of the audit process to document and compare the results of audit reviews. Figure 2 shows how frequently SB/SE and LB&I subjected micro-captive insurance audits to formal quality reviews through NQRS and LQMS and how SB/SE subjected such audits to formal managerial review through EQRS from fiscal years 2016 through 2020.

Figure 2: Formal Managerial and Quality Reviews of Micro-Captive Insurance Audits Conducted from Fiscal Years 2016 through 2020



Source: GAO analysis of Internal Revenue Service data. | GAO-22-104180

SB/SE Quality Review

Reviewers of SB/SE's audits determine whether an examiner complies with 17 specific audit attributes, including whether the examiner included pre-plan activity in the case file, conducted an audit interview, charged time appropriately, and conducted the audit with appropriate confidentiality. While IRS has indicated that micro-captive insurance is a high priority compliance issue for the agency, SB/SE reviewed 25 closed micro-captive insurance audits, in comparison to more than 7,000 audits of all compliance issues in NQRS, from fiscal years 2016 through 2020. During this same period, SB/SE closed audits on thousands of tax returns that reported micro-captive insurance benefits and closed audits on hundreds of thousands of tax returns for all compliance issues. Specifically in fiscal year 2019, SB/SE reviewed seven micro-captive insurance audits in NQRS, which represented a small percentage of the population of all such cases closed that year.⁴⁹

According to IRS officials, NQRS review scores for the reviews completed on micro-captive insurance cases were higher than the overall Field Exam quality scores, though not as high as indicated by managers in EQRS scores.⁵⁰ From fiscal years 2016 through 2020, NQRS reviews conducted on micro-captive insurance cases found audit attributes were conducted appropriately by the examiner on average 91 percent of the time. While not perfectly comparable due to micro-captive insurance audits not having been subjected to a statistically valid number of quality reviews, during the same period, NQRS reviews found that all SB/SE Field Exam audit attributes were met appropriately on average 87 percent of the time.

IRS officials said that the results of these reviews show that additional quality reviews did not appear to justify additional use of agency resources. However, SB/SE's positive attribute scores are not generalizable to all micro-captive insurance audits because the number of audits evaluated through NQRS is statistically insufficient to draw a

⁴⁹Fiscal year 2019 is the only year for which we have the data for closed micro-captive audit cases. We cannot compare the number of closed tax returns to formal quality reviews as SB/SE subjects an entire case to quality review. As discussed earlier in this report, a case may include multiple tax returns for multiple taxpayers. For more detail on how case files and case families were counted, see app. II.

⁵⁰Attribute scores for NQRS and EQRS are broadly comparable. While NQRS quality reviews and EQRS managerial reviews are conducted by different reviewers, and use a different number of attributes, the systems share the same types of attributes and these attributes are commonly defined. The NQRS and EQRS reviews are two different tools operated in a parallel review and tracking system.

conclusion on the quality of the entire population of micro-captive insurance audits. SB/SE officials stated that NQRS reviews are selected by a statistical sample of all closed audits, and that the sample is designed to be representative of the entire population of closed SB/SE audits, not for specific compliance issues such as micro-captive insurance audits. The IRM also states that quality review results stratified to any lower organizational segment, such as when comparing results of an individual compliance issue, are not statistically reliable measures of the quality of the casework conducted at those levels.⁵¹

LB&I Quality Review

Like SB/SE, LB&I supplements in-audit oversight and managerial review with formal quality review. Reviewers of LB&I's audits determine if audits across the division were conducted consistent with agency standards on audit planning, execution, and resolution. To address each standard, reviewers respond to almost 100 yes/no questions and also provide narrative descriptions.

LB&I has the capability to review micro-captive insurance audits through LQMS, but it has applied such audits to quality review on a limited basis due to the purpose of these reviews and the method by which audits are selected for review. While IRS has indicated that micro-captive insurance is a high priority compliance issue for the agency, LB&I reviewed one closed micro-captive insurance audit through LQMS from fiscal years 2016 through 2020 and during that same period reviewed 2,051 audits of all issues in LQMS. For comparison, LB&I closed audits of hundreds of tax returns that reported benefits from micro-captive insurance and over one hundred thousand audits of tax returns for all compliance issues. In fiscal year 2019, none of the micro-captive insurance cases that LB&I closed were reviewed through LQMS.⁵² LB&I officials said that the frequency of occurrence for any particular issue within the sample should represent the frequency of the entire population of cases. Quality reviewers select cases for LQMS review through random statistical sampling of all cases closed by LB&I to produce a sample that is generalizable across the division, but not to specific compliance issues, such as micro-captive insurance. In addition, LB&I officials said that, due

⁵¹IRM § 4.2.8.8(2).

⁵²Fiscal year 2019 was the only year for which we could make a comparison between closed micro-captive cases and LQMS reviews. We cannot compare the number of closed tax returns to formal quality reviews as LB&I subjects an entire case to quality review.

Quality Review across Divisions

to there being only one example, they could not compare the quality of the micro-captive insurance audit to other audits.

According to agency officials and the IRM, both NQRS and LQMS are limited by design in their applicability to individual compliance issues.⁵³ Further, due to the large number of unique income-tax compliance issues, it would be unrealistic for IRS to apply specific quality review attributes and standards to every individual compliance issue. However, IRS has demonstrated that audits of micro-captive insurance tax shelters are a high priority, as discussed earlier. Given this priority, micro-captive insurance audits may warrant targeted audit quality control.

Federal internal control standards require that management monitor the internal control system and evaluate results, including ongoing activities, separate evaluations, or a combination of the two.⁵⁴ Ongoing monitoring includes routine activities performed by managers and supervisors that are built into the agency's operations and performed continually, such as the analysis of the results of managerial reviews previously described. Separate evaluations are performed periodically to assess the design and operating effectiveness of the internal control system at a specific time or of a specific function or process, such as the reviews of audit quality noted above, or can cut across operating units and across functions. The scope and frequency of separate evaluations typically depend on the assessment of risks, the effectiveness of ongoing monitoring, and the rate of change within an entity or its environment.

In light of the limitations of quality reviews, and given the high priority IRS has given to micro-captive insurance tax schemes, changes to IRS's approach to conducting quality reviews of closed micro-captive audits may be warranted. Changes to the manner that audits are selected and the number of audits selected also would be responsive to the IRM requirements that all divisions, including LB&I and SB/SE, develop evaluative systems consistent with and reflective of the quality principles, and that officials secure the information necessary to measure performance and detect situations that require corrective action.

By subjecting a sample of micro-captive insurance audits to formal quality review, either through NQRS, LQMS, or an alternative system, SB/SE and LB&I would have stronger evidence that such audits are being

⁵³IRM §§ 4.2.8.6, 4.2.8.8, 4.46.5.8.1.

⁵⁴[GAO-14-704G](#), paras. 16.04–16.08.

conducted appropriately. Greater implementation of formal quality review process would help both SB/SE and LB&I confirm if all micro-captive insurance audits are being conducted at as high a quality as their initial reviews suggest. Alternatively, if expanded use of formal quality review identifies deficiencies in the micro-captive audit process, SB/SE and LB&I should be able to use formal quality review data to identify specific attributes that require targeted intervention to correct. This expansion of the use of quality review would allow SB/SE and LB&I to ensure that micro-captive insurance audits are evaluated commensurate with the IRM policy that ensuring quality work is “first among equals with schedule and cost.”⁵⁵

Use of IRS’s Assessment Tools Would Better Assure That Investigations of Micro-captive Audit Promoters Meet Agency Standards

IRS Could Better Conduct, Document, and Assess Managerial Reviews of Micro-Captive Insurance Promoter Investigations

Similar to audits, IRS uses managerial review, among other oversight methods, to ensure adequate oversight of micro-captive promoter investigations. SB/SE and LB&I officials said that micro-captive promoter investigations are overseen through a variety of activities that occur through the process of the investigation. According to IRS officials, such oversight activities include collaboration with subject matter experts and counsel staff, and informal and formal reviews conducted by managers, Technical Services, and Chief Counsel staff members, who should agree with any penalty determination. However, SB/SE and LB&I could improve oversight of micro-captive insurance promoter investigations and better ensure that such investigations are conducted according to agency standards by expanding the use of managerial review.

The IRM requires that managers continually evaluate the effectiveness of the penalty program, of which micro-captive insurance promoter

⁵⁵IRM § 1.2.1.2.2(2)(a).

investigations are a subset. The IRM also requires managers to recommend changes where applicable.⁵⁶ This requirement is consistent with the fundamental purpose of federal internal control standards to help federal managers achieve desired results through effective stewardship of public resources. This is made possible in part through management's evaluation of the effectiveness of the entity's internal control systems.⁵⁷

While IRS oversees micro-captive promoter investigations through a variety of activities, the use of formal documented managerial review in EQRS allows IRS to summarize and compare attributes of investigations in a documentable and reviewable system. IRS officials stated that EQRS was not designed to serve as a means to compare specific investigations. Yet, neither SB/SE nor LB&I has an alternative, electronic, and systematic method that would allow them to better comply with IRM requirements to evaluate the effectiveness of their micro-captive promoter investigation programs and federal internal control requirements to monitor controls designed to achieve program objectives, including through the use of automated tools.

SB/SE Managerial Review Practices and Technical Limitations

In SB/SE, while IRS officials stated that SB/SE area directors issue annual managerial review documentation requirements and expectations, the IRM leaves decisions about when and how to conduct managerial reviews to the applicable group managers.⁵⁸ SB/SE managers said they subjected seven micro-captive insurance promoter investigations to formal managerial reviews in EQRS from fiscal years 2016 through 2020.⁵⁹

SB/SE's ability to analyze the review data for trends is limited by a technical aspect of EQRS. SB/SE does not have a means to easily identify promoter investigations in EQRS, such as a digital code or number by which to specifically differentiate an investigation from an

⁵⁶IRM §§ 20.1.1.1.4, 20.1.6.1.4.

⁵⁷[GAO-14-704G](#), para. OV1.03.

⁵⁸IRM §§ 1.4.40.3.6, 1.4.40.7.

⁵⁹We are not reporting exactly how many SB/SE and LB&I cases were started, closed, and are currently under investigation to avoid disclosure of Federal Tax Information. However, we report the number of cases reviewed through IRS's managerial and quality review systems because not all cases are formally reviewed and therefore not indicative of the number of promoter investigations conducted. In addition, a formal review of an investigation is an internal process to IRS and cannot be used to identify an individual investigation.

audit. According to SB/SE officials, in providing information for our review, SB/SE identified the seven promoter investigations through a manual process in which officials reviewed every EQRS review with a captive-insurance project code to determine if it involved a promoter investigation. SB/SE officials said that while promoter investigations can be tracked in other data systems, such as the Examination Return Control System, this limitation exists because micro-captive promoter investigations and participant audits are currently assigned the same project code.

As a result of these technical limitations, SB/SE officials said they have not produced any comparative analysis of the results of managerial reviews of micro-captive promoter investigations documented in EQRS. IRS officials said EQRS was not explicitly designed to compare specific investigations or compliance issues. However, we found no alternative electronic mechanism to conduct comparative analysis. Federal internal control standards require that management should design the entity's information systems and related control activities to achieve objectives and respond to risks, which includes evaluating information-processing objectives, such as completeness and validity, to meet program information requirements. Internal control standards also require that management should use quality information to achieve the entity's objectives. This includes identifying information requirements that consider the expectations of internal and external users and permit the processing of data into information that management can use to evaluate program performance in relation to objectives, compare the relationship of data elements, and take appropriate action.⁶⁰

Having the ability to perform comparative data analysis in an electronic system, such as EQRS, would enhance the ability of SB/SE managers and other officials to review and analyze promoter investigations to identify trends in the attribute scores. The ability to perform comparative analysis also would enhance SB/SE's ability to more efficiently determine the presence of deficiencies in micro-captive insurance promoter investigations, and better demonstrate adherence with federal internal control standards to ensure that agency operations are effectively stewarding public resources.

EQRS functionality is updated on an annual basis and IRS officials said that it is technically possible to add additional codes and operating divisions to the system. However, the officials said that adding an

⁶⁰[GAO-14-704G](#), paras. 10.03, 11.01, 11.09, 13.05.

operating division to the system would require additional activity, such as system modifications, preparing technical guidance, and training staff.

By adding a code or other identification and tracking method to EQRS, SB/SE would be able to more efficiently identify, isolate, and subsequently analyze micro-captive insurance promoter investigations and better ensure that such investigations are conducted appropriately and effectively. This also would be more consistent with IRM requirements to evaluate the effectiveness of penalty investigations, such as those of micro-captive insurance promoters. Finally, by combining implementation of such a code simultaneously to applying managerial reviews to micro-captive insurance investigations, SB/SE would have more opportunity to determine the effectiveness of its micro-captive insurance audits and ensure that micro-captive insurance audits are conducted according to agency standards.

LB&I's Managerial Review Practices

LB&I also has opportunities to apply managerial review to its micro-captive promoter investigations. LB&I's Promoter Team Manager is responsible for ensuring that promoter investigations are conducted timely and accurately, and for conducting biannual written performance appraisals of examiners.⁶¹ The LB&I Promoter Team does not use a tracking system like EQRS to document and analyze the results of formal managerial review of all promoter investigations, including micro-captive insurance promoter investigations.

Instead, LB&I officials said that managers conduct thorough checks of micro-captive insurance audits, such as through in-person and electronic inspection of the examiner's workpapers and sign off on audit case files. In addition, managers may use the LB&I Manager's Case Quality Measurement Check Sheet (Check Sheet) to evaluate an audit. However, the Check Sheet is not mandatory, and IRS officials said no results from use of the Check Sheet are collected or analyzed. By applying a more formal managerial review methodology to micro-captive investigations, and collecting and analyzing the reviews in an accessible system, LB&I could better identify trends and address any deficiencies in the micro-captive promoter investigation process. Additionally, by implementing a

⁶¹According to LB&I officials, written mid-year and year-end performance reviews rate promoter examiners as "exceeds," "meets," or "fails" on critical job elements for the examiner's position description. Critical job elements include aspects such as tax laws, issue identification and resolution, research and analysis, and completion of assignments, among other elements.

formalized managerial review process, LB&I would have better evidence on whether it is complying with the IRM requirement to implement an ongoing quality review system.⁶²

According to LB&I officials, LB&I allows for a high degree of managerial discretion in conducting managerial reviews, which is generally consistent with the IRM and federal internal control standards. However, a more regularized and formalized review process would give LB&I better opportunities to ensure that IRS's micro-captive promoter investigations are consistently analyzed. Additionally, by issuing clear guidance for when and how frequently managers should formally review micro-captive insurance investigations, LB&I could better determine the quality of its micro-captive insurance investigations and ensure that those investigations are conducted according to agency standards. Applying formalized managerial review to micro-captive promoter investigations also would allow LB&I to implement an effective internal control system and ultimately better manage agency resources and respond to risks.⁶³ Additionally, instituting formalized managerial review would allow LB&I to more efficiently identify deficiencies and allocate resources to resolve those deficiencies in its investigations of promoters of micro-captive insurance.

SB/SE and LB&I Could Better Assure that Micro-Captive Promoter Investigations Meet Agency Standards by Subjecting Such Investigations to Quality Review

IRS also has opportunities to apply formal review methods to evaluate the quality of micro-captive insurance promoter investigations. SB/SE and LB&I officials said that their formal quality review systems were not designed to evaluate specific investigations and compliance issues, but SB/SE and LB&I lack an alternative documentable and comparable means for investigations to be reviewed by independent IRS evaluators.

SB/SE Quality Review Practices

IRS guidance in the IRM excludes promoter investigations from NQRS because NQRS was only designed to review and compare tax examinations, whereas promoter investigations are a type of penalty case. Penalty cases investigate whether tax laws have been violated and penalties should be levied. These cases do not assess tax liability. While

⁶²IRM § 20.1.6.1.4.

⁶³[GAO-14-704G](#), para. OV1.03.

the IRM thus excludes promoter investigations from NQRS, the IRM still calls for investigations to be evaluated for their effectiveness in promoting voluntary compliance.⁶⁴ However, SB/SE does not have a system by which to subject promoter investigations of all types to independent quality review.

Federal internal controls also direct management of agencies to establish activities to monitor their internal control systems and evaluate the results against an established baseline.⁶⁵ Without such a baseline, managers lack context or criteria by which to evaluate the progress of their programs. Formal evaluation of the conduct and results of micro-captive insurance promoter investigations would provide more opportunity for SB/SE to verify the quality of its investigations and identify efficient methods to address deficiencies. Subjecting promoter investigations to formal quality review would also allow SB/SE to better meet federal internal control standards to ensure the validity of agency internal control systems by conducting separate evaluations, which provide greater objectivity when performed by reviewers who do not have responsibility for the activities being evaluated.⁶⁶

By developing a method to assess the quality of promoter investigations and applying the method to micro-captive insurance promoter investigations, SB/SE would have more opportunities to assure that such investigations are compliant with agency investigation standards. By subjecting micro-captive insurance promoter investigations to quality review, SB/SE could better identify any deficiencies in its investigation program and prioritize corrective action to address those deficiencies. Finally, subjecting promoter investigations to formal quality review tools could give SB/SE opportunities to determine if investigations are effectively contributing to the agency meeting its goal to eliminate the use of abusive micro-captive insurance schemes.

LB&I Quality Review Practices

Unlike SB/SE, LB&I has the ability to subject micro-captive promoter investigations to independent quality reviews through LQMS. Quality reviews of investigations conducted through LQMS, like those of audits, determine if an investigation was conducted consistent with agency

⁶⁴IRM §§ 1.2.1.12.1(12), 4.2.8.4(2).

⁶⁵GAO-14-704G, paras. 16.02, 16.03.

⁶⁶GAO-14-704G, para. 16.07.

standards on planning, execution, and resolution. To address each standard, reviewers respond to almost 100 yes/no questions and provide narrative descriptions.⁶⁷

However, from fiscal years 2016 through 2020, LB&I did not subject any micro-captive promoter investigations to quality review in LQMS. This is because LQMS uses division-wide random statistical sampling of closed cases to select cases for quality review and no micro-captive promoter investigations were among those randomly selected.

LB&I officials said that there is no provision in the IRM or otherwise established process for conducting a quality review of the investigation process. However, the IRM states that “supervisors should institute, on an ongoing basis, a quality review system that evaluates the timely and correct disposition of penalty cases and encourages consistent administration of penalties.”⁶⁸

An IRS internal evaluation of LB&I’s promoter investigation program also recommended enhanced use of quality review to ensure that investigations are conducted effectively. IRS conducted an analysis of LB&I’s promoter investigation programs in the second quarter of fiscal year 2021, which recommended, among other things, that the agency conduct an internal review to establish a baseline of quality and determine if goals are being met. LB&I generally agreed with the recommendations and officials said LB&I is implementing other recommendations. However, LB&I is not implementing the recommendations to establish a formal baseline and implement a project to improve investigation quality. The lack of a formal baseline from which to evaluate promoter investigation contrasts with federal internal control standards requirements that management monitor the entity’s internal control system by first establishing a baseline to enable ongoing monitoring and separate evaluations, the results of which can then be evaluated. By implementing its own recommendation to establish such a baseline, LB&I could better ensure that it can evaluate micro-captive promoter investigations and determine if the overall promoter investigation program is meeting agency goals.

Finally federal internal control standards state that management should design and implement control activities to achieve objectives and respond

⁶⁷See app. III for additional information on how LQMS is used to conduct quality review.

⁶⁸IRM § 20.1.6.1.4(2).

to risks that include establishing and reviewing performance measures and indicators so that analysis and appropriate actions can be taken and the integrity of the measures and indicators can be validated. This suggests that formal evaluation, such as quality review, is a critical means of ensuring that micro-captive promoter investigations, as well as investigations of other compliance issues, are conducted in compliance with agency standards. Subjecting investigations to quality review would give LB&I greater opportunity to identify and correct problems with investigations, which could eventually save the agency both time and monetary resources.

In addition to not subjecting any micro-captive promoter investigations to division-wide quality review from fiscal years 2016 through 2020, LB&I does not have quality review tools specifically designed to evaluate the quality of micro-captive promoter investigations. As noted previously, LB&I reviews almost 100 attributes of cases in LQMS. However, these attributes are standardized across all compliance issues. By applying a set of metrics specifically relevant to micro-captive promoter investigations, LB&I could better evaluate the quality of these cases commensurate with their expressed priority to the agency, and subsequently identify and address any potential deficiencies in the investigation program.

Conclusions

Tax arrangements involving micro-captive offshore insurance can be complex and contribute to the tax gap when abused. To better ensure taxpayer and promoter compliance with the laws governing offshore insurance arrangements, while at the same time ensuring the best use of existing IRS resources, it is important for IRS to properly conduct enforcement activities, such as audits and investigations.

To this end, SB/SE has opportunities to better target micro-captive audits with managerial reviews, while LB&I could benefit from formally documenting managerial reviews of audits and using such documentation to resolve detected deficiencies. Additionally, IRS has opportunities to better leverage its quality review program concerning audits of micro-captive insurance tax arrangements by more precisely targeting micro-captive insurance.

Similar opportunities exist for investigations concerning promoters of micro-captive insurance tax schemes. As with audits, IRS has opportunities to more rigorously target micro-captive promoter investigations for formal managerial and quality review, begin to track and document managerial and quality reviews with data, and establish metrics

that would help IRS better determine how well it conducts investigations of promoters.

By taking actions to ensure the quality of audits and promoter investigations, IRS would be more confident that its audits and promoter investigations were being conducted properly and using its resources effectively.

Recommendations for Executive Action

We are making the following seven recommendations to IRS:

The Commissioner of Internal Revenue should have SB/SE provide more specific guidance on when SB/SE should use various managerial review tools and the frequency with which such reviews should be conducted on high-priority matters such as those surrounding micro-captive insurance arrangements. (Recommendation 1)

The Commissioner of Internal Revenue should have LB&I adopt formal managerial reviews of its audits and establish methods and procedures for recording and analyzing managerial review data that allow it to isolate high-priority cases, including micro-captive insurance audits, and use the data to assess the quality of its audits. (Recommendation 2)

The Commissioner of Internal Revenue should have SB/SE and LB&I subject a sample of their micro-captive insurance audits to a formal quality review process. Based on the findings of this review, SB/SE and LB&I should take corrective action to remedy any deficiencies. (Recommendation 3)

The Commissioner of Internal Revenue should have SB/SE design and implement an identification and tracking method in EQRS to allow agency officials to readily identify and compare managerial reviews of micro-captive promoter investigations, both to other micro-captive promoter investigations, and promoter investigations generally, and use the data to assess the quality of its promoter investigations. (Recommendation 4)

The Commissioner of Internal Revenue should have LB&I adopt formal managerial reviews of micro-captive insurance promoter investigations, establish a reliable way to store and track managerial review data of promoter investigations that allows it to isolate high priority cases, issue guidance on how often and by what method such investigations should be subjected to managerial review, and use the data to assess the quality of its promoter investigations. (Recommendation 5)

The Commissioner of Internal Revenue should have SB/SE develop a method to assess the quality of promoter investigations and apply this method to micro-captive promoter investigations. Based on these reviews, SB/SE should take corrective action to remedy any deficiencies uncovered in its analysis. (Recommendation 6)

The Commissioner of Internal Revenue should have LB&I establish and implement metrics on promoter investigation quality and subject a set of micro-captive promoter penalty investigations to formal quality review procedures to establish a baseline measure of micro-captive promoter investigation quality. Based on these reviews, LB&I should take corrective action to remedy any deficiencies uncovered in its analysis. (Recommendation 7)

Agency Comments and Our Evaluation

We provided a draft of this report to IRS for review and comment. In its comments, which are reproduced in appendix IV, IRS disagreed with our recommendations. IRS also provided technical comments, which we incorporated as appropriate.

In its letter, IRS stated that micro-captive insurance audits are subject to further oversight beyond the managerial and formal quality reviews, and that this additional oversight helps ensure case quality and consistency. IRS also said it has been effective in addressing abuses involving micro-captive insurance arrangements and that expending additional resources to address our recommendations is not warranted and would come at the expense of other organizational priorities.

We respect IRS's concern about allocating resources, and agree that IRS consider its resources and the possible effects on other programs when responding to our recommendations. However, we maintain that IRS's current procedures should be further refined to help it address this high-priority compliance issues, and we believe IRS can do so with minimal use of resources.

We summarize IRS's comments and our response for each recommendation below.

- **Recommendation 1:** After receiving our draft report, IRS stated in its letter that SB/SE area directors annually issue guidance on requirements for minimum review and documentation to their managers, and provided examples of such guidance. However, none of the information IRS provided fully addresses the specifics of our recommendation. First, the annual guidance examples do

not consistently provide managers with expectations for reviews of priority work and types of cases to be reviewed. Second, while SB/SE states that the annual guidance documents are consistent with the IRM, the IRM does not provide direction or guidance as to how or when high-priority cases should be subject to managerial review. Finally, the IRM does not clearly state that all types of managerial review will be conducted according to the SB/SE area director's annual guidance. SB/SE could implement our recommendation by, for example, documenting in the IRM specifically what the area director's responsibilities are concerning guidance to managers on conducting reviews and stating whether there is priority work that requires additional managerial scrutiny.

- **Recommendation 2:** IRS stated in its letter that LB&I audit managers use a checklist to ensure quality and that subject matter experts and IRS Chief Counsel staff assist in ensuring the quality of individual audits on micro-captive cases. However, our recommendation concerns how LB&I assesses audit quality more broadly, not only during the conduct of each audit. The checklists IRS described in its letter (referred to as "check sheets" in this report) do not address the part of our recommendation calling for establishing a method to track or evaluate managerial reviews of high-priority audits. As stated in our report, LB&I does not have a means to record and compare written assessments of audits in an electronic system. Furthermore, there is no indication of how frequently or at what point in the audit managerial reviews occur specifically on micro-captive audits. LB&I did not provide any examples of staff using the checklist. IRS could implement this recommendation by, for example, electronically compiling a sample of LB&I managerial reviews and use that electronic data to analyze quality. This would help assure IRS that LB&I maintains quality in its reviews moving forward.
- **Recommendation 3:** IRS stated that program results indicate that current quality review processes are sufficient for micro-captive audits. However, our recommendation addresses quality assurance at a higher level than the conduct of the audit itself and would provide greater assurance of audit quality on micro-captive audits moving forward. Furthermore, as we indicated in our report, only a small portion of micro-captive audits have been subjected to formal quality review. For example, in fiscal year 2019, none of the micro-captive insurance cases that LB&I closed were reviewed through LQMS. IRS already has the ability to identify micro-

captive audits electronically. It could fulfill this recommendation by, for example, reviewing a statistically valid sample of micro-captive cases every 2 or 3 years as long as the issue remains a high priority for IRS.

- **Recommendation 4:** IRS stated that SB/SE officials can use project codes in EQRS to identify, track, and compare managerial reviews of micro-captive cases. However, as noted in our report, officials relied on a manual process to distinguish micro-captive investigations from micro-captive audits. This makes comparison across audits and investigations labor intensive. IRS could address this recommendation first by showing whether the cost of implementing a new code exceeds the cost of manually sorting cases. If the cost of implementing the code exceeds the manual process, SB/SE could instead, for example, conduct its analysis only as long as micro-captive arrangements remains a high priority. In addition, in response to the IRS comments, we changed the wording of our recommendation from “assess the *effectiveness* of its promoter investigations” to “assess the *quality* of its promoter investigations,” which more accurately reflects the intent of this recommendation.
- **Recommendation 5:** IRS stated that LB&I promoter investigations already are subject to 100 percent managerial review. However, as mentioned in our report, these reviews are not all documented in a way that LB&I could compile and analyze. The IRM requires that managers evaluate and recommend changes to their penalty program, which includes micro-captive promoter investigations. However, LB&I lacks an electronic method to identify, document, and analyze managerial reviews of such investigations for trends, anomalies, or potential deficiencies. IRS could address this recommendation by, for example, electronically compiling a narrow sample of reviews, issuing guidance that corresponds with the sample scope, and analyzing the sample. Such analysis could be conducted semi-annually for only as long as micro-captive insurance arrangements remain a high priority. IRS also noted that we did not review investigations as part of our review, but this observation is not relevant to our recommendation to help assess the procedures for ensuring the quality of high-priority investigations. Instead, our recommendation addresses oversight procedures that did not require a review of the investigation case files. In addition, in response to the IRS comments, we changed the wording of our

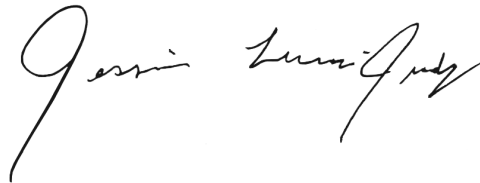
recommendation from “assess the *effectiveness* of its promoter investigations” to “assess the *quality* of its promoter investigations,” which more accurately reflects the intent of this recommendation.

- **Recommendation 6:** IRS stated that SB/SE already has a method to assure investigation quality and that the success of these investigations shows that the quality assurance methods in place are sufficient. However, as described in our report, SB/SE managerial reviews are only made during the investigation process. IRS would be better assured of the overall quality of its micro-captive investigations more broadly with higher-level, independent reviews. IRS could implement this recommendation by, for example, leveraging existing quality reviews it already uses for audits and conducting the analysis semi-annually for only as long as micro-captive insurance arrangements remain a high priority. IRS again noted that we did not review investigations as part of our work. This observation is not relevant to this recommendation to help assess the procedures for ensuring the quality of high-priority investigations.
- **Recommendation 7:** IRS stated that LB&I promoter investigations are subject to managerial review and that developing metrics would not provide meaningful insight because each case is “so unique that setting metrics applicable to the entire population would not provide meaningful insight.” We believe that if IRS can create quality standards for LB&I audits, it can do so for LB&I investigations and perhaps can look to its LQMS quality review procedures as a model for possible metrics in fulfilling this recommendation. IRS noted that we did not review investigations as part of our work. This observation is not relevant to this recommendation to help assess the procedures for ensuring the quality of high-priority investigations.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-6806 or LucasJudyJ@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs are on the last page of this report. GAO staff who made key contributions to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in blue ink that reads "Jessica Lucas-Judy". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Jessica Lucas-Judy
Director, Tax Issues
Strategic Issues

Appendix I: Sources of Offshore Insurance Data Do Not Offer Clear Opportunities to Enhance IRS Audit Case Selection

Internal Revenue Service (IRS) officials said they largely depend on information such as tax returns, reportable transaction disclosures, promoter investigations, and whistleblower reports to identify potentially abusive insurance tax schemes.

We reviewed potential sources of additional offshore insurance data from privately run data sources, state insurance information, and existing tax information and tax return information (table 1 lists the sources).¹ We did not find any that had sufficient information to improve IRS's efforts in identifying potentially abusive offshore insurance tax schemes.

Table 1: Offshore Insurance Data Sources GAO Reviewed with Examples of Available Data

| Source name | Example of data on offshore insurance |
|--|---|
| Internal Revenue Service (IRS) Form 1065, <i>U.S. Return of Partnership Income</i> | Filers may report deductions taken on premiums paid for business insurance. |
| Schedule B (Form 1040), <i>Interest and Ordinary Dividends</i> | Filers may report financial interests or signature authority over a financial account located in a foreign country, including insurance policies with cash value that are located in a foreign country. |
| Schedule C (Form 1040 or 1040-SR), <i>Profit or Loss from Business (Sole Proprietorship)</i> | Filers deduct premiums paid for business insurance. |
| Form 1120-PC, <i>U.S. Property and Casualty Insurance Company Tax Return</i> | Certain foreign insurance corporations may elect to be treated as a domestic corporation for filing purposes. |
| Form 1120, <i>U.S. Corporation Income Tax Return</i> | Filers may report deductions related to insurance premiums. |
| Form 1120-S, <i>U.S. Income Tax Return for an S Corporation</i> | S-corporations may report deductions related to insurance premiums. |
| IRS Form 1120-L, <i>U.S. Life Insurance Company Income Tax Return</i> | Foreign corporations may elect to be treated as a domestic corporation. |
| Form 8865, <i>Return of U.S. Persons With Respect to Certain Foreign Partnerships</i> | Filers may report deductions for insurance premiums. |
| Form 8991, <i>Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts</i> | Filers report premiums and other considerations paid for insurance and reinsurance. |
| Form 8938, <i>Statement of Specified Foreign Financial Assets</i> | Filers report information on their foreign cash-value life insurance accounts, including tax benefits related to insurance account. |
| Form 8966, <i>FATCA Report</i> | Foreign financial institutions may provide information about the cash-value insurance contracts. |
| IRS Form 8886, <i>Reportable Transaction Disclosure Statement</i> | Filers report various information related to Section 831(b) micro-captive insurance transactions, including the expected tax benefits generated by the transaction. |

¹For a description of how these sources were selected and evaluated, see app. II.

Appendix I: Sources of Offshore Insurance Data Do Not Offer Clear Opportunities to Enhance IRS Audit Case Selection

| Source name | Example of data on offshore insurance |
|---|---|
| IRS Form 8918, <i>Material Advisor Disclosure Statement</i> | Filers report various information related to one or more reportable transaction, including Section 831(b) micro-captive insurance transactions. These filers are required to disclose the role of foreign entities if they are needed to obtain the intended tax benefits generated by the transaction. |
| Schedule M (Form 5471), <i>Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons</i> | Certain U.S. persons who are officers, directors, or shareholders in certain foreign corporations report premiums paid for insurance and reinsurance to this controlled foreign entity. |
| Form 5472, <i>Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business</i> | Filers report premiums received for insurance or reinsurance and premiums paid for insurance or reinsurance. |
| Form 720, <i>Quarterly Federal Excise Tax Return</i> | Filers report insurance premiums paid for various foreign insurance products, including life insurance and casualty insurance. |
| Form 8975, <i>Country-by-Country Report</i> | Certain U.S. persons report various information on constituent entities that may include insurance companies. |
| Form 990, <i>Return of Organization Exempt From Income Tax</i> | Organizations may report insurance expenses. |
| Form 990-T, <i>Exempt Organization Business Income Tax Return</i> | Organizations may report deductions for insurance premiums paid. |
| Schedule L (Form 990 or Form 990-EZ), <i>Transactions With Interested Persons</i> | Organizations provide information on certain financial transactions, including insurance contracts, between the reporting entity and certain disqualified persons. |
| Form 8275, <i>Disclosure Statement</i> | Filers may report their investment in offshore life insurance on Form 8275, according to IRS officials. |
| FinCEN Form 114, <i>Report of Foreign Bank and Financial Accounts</i> | Filers report various information related to foreign financial accounts, including insurance policies, over which the filer has a financial interest or signature authority. |
| AM Best's Financial Suite | Database contains financial information on foreign insurance companies, including the company's premiums paid and collected, per a company official. |
| Bloomberg Intelligence | Bloomberg offers clients the ability to generate a list of foreign companies and see a breakdown of the company's gross premiums paid or net premiums collected, per company officials. |
| S&P Global Market Intelligence | S&P collects reinsurance information from all reinsurance arrangements, including non-U.S. insurers, associated with the filing domestic insurer. |
| National Association of Insurance Commissioners (NAIC) Annual Statement Blank | Insurers may report basic information for reinsurance arrangements, including those that are outside of the United States, according to NAIC officials. |
| NAIC Quarterly Statement Blank | Insurers may provide the name and location of the insurance company to which the filer ceded insurance premiums as the cost for a reinsurance contract. |

Source: GAO analysis of IRS, FinCEN and private data source documentation. | GAO-22-104180

First, of the privately run data sources we identified, none collected information in formats that could help IRS identify specific U.S. taxpayers who might use offshore insurance tax arrangements for audit selection. For example, LB&I officials said that it could not use data from AM Best, a credit rating agency that specializes in insurance businesses, for audit

selection because the type of entities that IRS would be interested in examining would likely not be captured in the public filings that AM Best uses to gather information on insurance companies. IRS officials said that examiners may use sources such as AM Best or Bloomberg for legal research or for research once a taxpayer is under exam.

For state information about insurance companies, IRS officials said they could not use the National Association of Insurance Commissioners (NAIC) Annual Statement Blanks because the data from these forms are too general and may not be detailed enough to identify potential abusive transactions.² Additionally, IRS officials said that foreign intermediary insurers involved with micro-captive arrangements generally do not file NAIC statements.

Finally, of the information returns and tax returns that we identified, IRS officials said they do not use several of these sources for audit selection because the sources lack useful information for identifying potentially abusive offshore captive or other insurance tax arrangements. For example, IRS said it could not use Financial Crime Enforcement Network's (FinCEN) FinCEN Form 114 for its case selection process because the usefulness of the data is limited by how taxpayers report the offshore insurance accounts. In another example, IRS officials said that insurance interest and dividends reported on Form 1040 (Schedule B) may be difficult to identify solely for offshore insurance.

In April 2019, we recommended that Congress consider amending the Internal Revenue Code, the Bank Secrecy Act of 1970, and other statutes, as needed, to address overlap in foreign financial asset reporting requirements for the purpose of tax compliance.³ In addition, we recommended that the Commissioner of Internal Revenue should employ a comprehensive plan for managing efforts to leverage Foreign Account Tax Compliance Act (FATCA) data in agency compliance efforts.⁴ As of March 2022, Congress has not made such amendments to the Internal Revenue Code or the Bank Secrecy Act, nor has IRS developed a

²NAIC officials said that U.S. companies operating across state lines submit the Annual Statement Blanks as part of the NAIC's insurance accreditation program.

³GAO, *Foreign Asset Reporting: Actions Needed to Enhance Compliance Efforts, Eliminate Overlapping Requirements, and Mitigate Burdens on U.S. Persons Abroad*, [GAO-19-180](#) (Washington, D.C.: Apr. 1, 2019).

⁴Subtitle A of Title V of the Hiring Incentives to Restore Employment Act is commonly known as the Foreign Account Tax Compliance Act or FATCA. Pub. L. No. 111-147, §§ 501–541, 124 Stat. 71, 97–117 (2010).

comprehensive plan for FATCA compliance efforts. IRS said that resources that would be dedicated to update a comprehensive plan unique to FATCA are better spent on enforcement activities. Furthermore, IRS said that its strategy for FATCA compliance will be part of IRS's LB&I overall portfolio management strategy and that it has developed or is committed to enhance and deploy FATCA compliance initiatives. We maintain that while IRS does not have to revise and reemploy its current FATCA plans, it can employ a comprehensive plan as part of LB&I's portfolio management strategy to evaluate FATCA enforcement activities already in place, and determine the extent to which these activities improve voluntary compliance and address noncompliance with FATCA reporting requirements.

Addressing these recommendations would help provide IRS with additional information it could use to identify suspicious information useful in a potential audit. For example, if IRS were to further develop a comprehensive plan uniquely for FATCA compliance efforts, it could better allocate resources and avoid unnecessary costs.

Appendix II: Objectives, Scope, and Methodology

Our objectives in this report were to assess the extent to which the Internal Revenue Service (IRS) (1) reviews its guidance on offshore insurance to ensure that the guidance has its intended effect; (2) aligns oversight of its audit activities on taxpayers who may be abusing micro-captive insurance tax shelters with its audit policies and guidance; and (3) reviews its investigation activities on promoters who market abuses of micro-captive insurance tax shelters. We also describe available data sources on offshore insurance companies and related transactions and discuss whether IRS can use such data in selecting cases for audit.

To assess the extent to which IRS reviews its guidance on offshore insurance, we first identified relevant guidance. We reviewed what IRS officials considered nonregulatory guidance relating to offshore insurance. We compared the procedures for developing and reviewing these types of guidance from IRS's Internal Revenue Manual (IRM) and IRS testimony with relevant best practices from the Office of Management and Budget (OMB), and relevant principles of federal internal control standards. The IRM sections we identified as relevant include what IRS refers to as the Chief Counsel Directives Manual, primarily IRM section 32.2. The OMB best practices come from the *Final Bulletin for Agency Good Guidance Practices*.¹ The relevant internal control principles include that management should define objectives and risk tolerances; design control activities to achieve its objectives and respond to risks; implement control activities through policies; and evaluate issues and remediate deficiencies.² We also interviewed or received written comments from relevant officials on IRS's guidance development process.

To assess to what extent IRS aligns oversight of its audit activities on taxpayers who may be abusing micro-captive insurance tax shelters with its policies and guidance, we reviewed documentation describing objectives, procedures, and standards for IRS audits of potentially abusive offshore insurance tax arrangements. This review included documents from the IRM; documentation, guidance, previous GAO and Treasury Inspector General for Tax Administration reports; and interviews with knowledgeable IRS staff and industry professionals. Based on the findings of our initial review, we developed attributes based on IRS' guidance, policies, and procedures by which to evaluate IRS examinations of micro-captive insurance tax arrangements. The attributes

¹72 Fed. Reg. 3432 (Jan. 25, 2007).

²For internal controls, see GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: Sept. 2014).

consisted of 30 required or recommended documents or activities that should be documented in a micro-captive insurance audit. We then developed a data collection instrument (DCI), with which we could verify and record if each of the 30 attributes were present in a micro-captive insurance audit case file. Two analysts tested the DCI against an initial sample case file, the results of which were not included in the overall case file review.

We requested a non-generalizable sample of closed IRS micro-captive insurance audit case files by (1) interviewing agency officials to determine what data and files were available; (2) collecting and analyzing a set of data that described the full population of micro-captive insurance audits closed in fiscal year 2019, which at the time we conducted our review was the most recent year that data and case files were available; and (3) developing a sample of files. We drew our sample from files that were associated or potentially associated with a foreign micro-captive insurance arrangement, associated with an insured taxpayer, and whose audit had been completed in fiscal year 2019. We then requested a sample of the available files. Due to logistical constraints placed on IRS's ability to provide a larger sample of files, we received a nongeneralizable sample of 30 audit case files out of the population of micro-captive insurance audits closed in fiscal year 2019.³

We then compared the documentation in the case files with the criteria in the DCI. An analyst reviewed the case files, then a second analyst verified the first's DCI. Any discrepancies between the analysts' reviews were documented and resolved. We recorded where case files were missing documentation of required or recommended examiner activities in the DCI and aggregated the resulting data. In addition, we reviewed IRS documentation of internal managerial and quality reviews of micro-captive

³Each of the 30 case files was representative of one taxpayer's return for one specific tax year. However, IRS may also group together related case files where they apply to related returns or taxpayers into a case family. Not every case file in a case family includes records of audit activity and may consist only of the specific tax return relevant for the tax year and taxpayer under audit. Of the case files we reviewed, 19 included audit documentation, while 11 case files included no documentation other than the tax return.

insurance audits, to compare agency findings with the findings of our review of case files.⁴

We collected and reviewed data from IRS's AIMS – Centralized Information System on the total number of started and closed audits and from the Embedded Quality Review System (EQRS), Large Business and International Division (LB&I) Quality Measurement System (LQMS) and the National Quality Review System (NQRS) on the number, rate, and content of IRS managerial and quality reviews to assess if IRS is subjecting micro-captive insurance audits to similar scrutiny as other compliance issues. We interviewed agency officials about how the data are internally checked, reviewed agency documentation, and performed manual review of electronic data, including checks to ensure that no data were missing and the data values provided to us did not include obvious errors. We found the collected data to be sufficiently reliable to be used as descriptive data in this report. We compared IRS managerial review procedures listed in the IRM and described by agency guidance to relevant principles of the control activities and monitoring components of federal internal control standards. The principles relevant to this objective include that management should design control activities, including those of the entity's information systems, to achieve objectives and respond to risks, implement control activities through policies, and monitor the internal control system and evaluate the results. We also reviewed IRS managerial review procedures against federal internal control requirements for developing and maintaining documentation of the internal control system.

To assess to what extent IRS reviews its investigation activities on promoters who market abuses of micro-captive insurance tax shelters, we reviewed procedures listed in the IRM or specific to IRS divisions for identifying, investigating, and subsequently reviewing investigations of

⁴IRS applies quality review tools, such as NQRS to an entire case family, not individual case files. Because a case family may include multiple tax returns from multiple years from multiple taxpayers, elements of the case family may close at different times. The 30 case files we reviewed all closed in fiscal year 2019, but not every element of the related case families closed at the same time. While an NQRS review would have been applied to an entire case family, we were only able to review files that had closed in 2019. Of the three NQRS reviews conducted on files applicable to our case review, none of the quality reviews were applied to files that contained audit documentation. Audit documentation was contained in other case files that may have closed in a prior fiscal year or were not included in our reviewed files. This is not a deficiency, but means only that we cannot compare our findings from the file review to the NQRS quality review findings for these examples. We were able to review NQRS, LQMS and EQRS reports and compare their general findings to our findings in the case file review and other evidence.

promoters of potentially abusive tax arrangements. We similarly limited our review from all offshore insurance to micro-captive tax shelters to provide a more detailed analysis of IRS's related enforcement activities and to reflect IRS's publicly stated priority of eliminating promotion of abusive micro-captive tax shelters. To identify applicable procedures, goals, and internal control standards, we reviewed the IRM and supplemental division-specific documents and guidance and conducted interviews with knowledgeable IRS staff. We collected and reviewed, among other evidence, IRS's internal guidance for conducting managerial reviews through the EQRS and quality reviews through the LQMS and NQRS. We also reviewed managerial and quality review procedures for promoter investigations as described in the IRM.

We assessed the extent these procedures align with relevant principles of the control activities, information and communication, and monitoring components of federal internal control standards. The principles relevant to this objective include that management should design the entity's information systems and related control activities to achieve objectives and respond to risks; that management should use quality information to achieve the entity's objectives; and that management should monitor the internal control system and evaluate the results. In addition, we examined how internal managerial and quality reviews of IRS' investigations of abusive tax-scheme promoters compared with such reviews of audits of taxpayers who may abuse insurance tax shelters.

To determine any differences between review procedures for promoter investigations and taxpayer audits, we compiled and analyzed summary descriptive data of IRS micro-captive promoter investigations gathered from IRS. We collected data from the Small Business/Self-Employed Division Lead Development Center's promoter investigation tracking database, and from IRS's micro-captive insurance exam inventory database that reported the number of open and closed promoter investigations. To determine the reliability of the data we interviewed agency officials and reviewed the data for descriptive errors, such as including an incorrect IRS tracking code, and for arithmetic accuracy. We found the data to be sufficiently reliable to report the number of active and completed promoter investigations. However, the data were of such a small number that we have included only limited discussion of micro-captive promoter investigation data to prevent potential disclosure of taxpayer information.

We also collected and analyzed data from EQRS, NQRS, and LQMS that described the number, rate, and type of IRS managerial and quality

reviews of both micro-captive insurance audits and promoter investigations. To determine the reliability of the data, we interviewed agency officials about how data are checked in the respective systems, and reviewed the data for accuracy by confirming that IRS's data sets matched attributes reported in managerial review documents. We found the data to be sufficiently reliable to report the number of micro-captive promoter investigations subjected to managerial review in EQRS. We also collected documentation of such managerial reviews. We then compared IRS's investigation review procedures with the results of our review of internal control standards, to determine if gaps in IRS's internal controls existed. We could not review data or documentation for quality reviews of micro-captive promoter investigations in LQMS and NQRS as no such reviews were completed by the agency.

To describe available data on offshore insurance companies, related transactions, and whether IRS may use such data, we compiled a non-exhaustive list of public and IRS data sources by requesting comments from IRS officials and industry professionals. We also identified these sources from referrals from our own literature searches. For our literature search, we reviewed Google and academic search engines using terms such as "offshore insurance," "reinsurance," and "data sources." For a list of sources we considered, see appendix I, table 2. We then compared the available data sources to six attributes we developed to assess whether the data would be useful for examination selection.

1. **Identifies relevant insurance transactions.** The source has a section where a filer can report either insurance expenses or deductions taken for insurance premiums paid.
2. **Identifies the name of the insurance company.** The source has a section where a filer can report the name of the insurer that is associated with an offshore insurance arrangement.
3. **Identifies the location of the insurance company.** The source has a section where a filer can report the location of the offshore insurance company.
4. **IRS or industry representatives says source can be used to potentially identify noncompliance schemes prior to audit examination.** IRS or industry representatives had identified that the source can be used for identifying noncompliant schemes prior to a full audit examination.
5. **Availability.** The source would be accessible to IRS and the information collected by the source is available in a manner and

format that is suitable for IRS's efforts to identify potentially abusive offshore insurance tax schemes.

6. **Whether IRS already uses source for its audit selection process.**

The source already is routinely used by IRS for its audit selection process.

The attributes listed above are not intended to be mutually exclusive for every data source. Additionally, we gave more weight to attributes 4 and 5 listed above because there may be significant factors, such as data availability and usability, which would hinder the usefulness of the source for identifying abusive offshore insurance tax schemes prior to an audit. If attributes 4 and 5 were not met initially, we did not consider the other attributes.

Appendix III: IRS's Audit and Promoter Investigation Managerial and Quality Review Systems

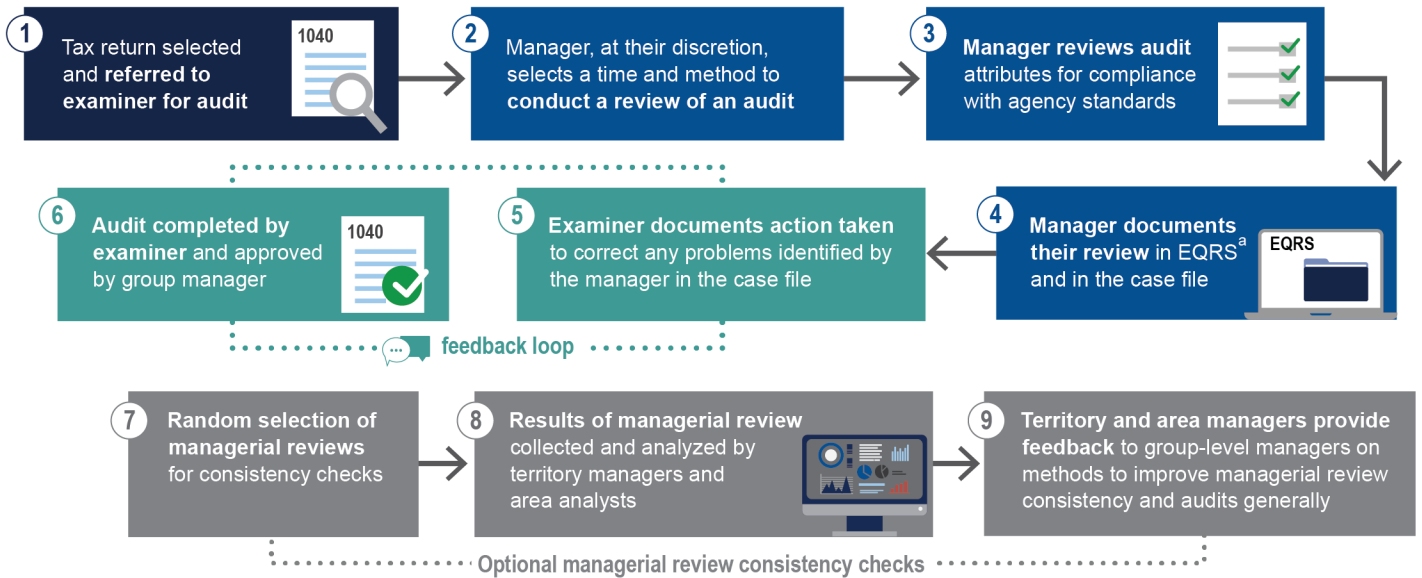
The Internal Revenue Service (IRS) oversees its audits and promoter investigations through a variety of procedures to ensure that enforcement activities are conducted effectively. In addition to training staff, issuing guidance, and conducting informal oversight procedures by managers, IRS also subjects its audits and promoter investigations to various forms of formal managerial and quality reviews.

Managerial Review

In formal managerial reviews, audit managers analyze an examiner's audit of compliance issues, including micro-captive insurance tax arrangements, and then document the results. Audit managers evaluate the examiner's performance and indicate whether the audit was conducted in accordance with key audit attributes. According to IRS officials, quality attributes are rated "yes," "no," or "NA," to measure an employee's adherence to exist policies and procedures. They also said that the Embedded Quality Review System (EQRS) automatically links the quality attributes to an examiner's critical job elements. The system also captures the manager's narrative feedback for the employee.

Managerial reviews allow managers to identify problems and take corrective action. According to the Internal Revenue Manual (IRM) and agency officials' description of agency standard procedure, if a managerial review finds that an examiner failed to complete an attribute of an audit appropriately, the manager and examiner should document the problem and the solution they agreed to in the audit case file. See figure 3 for a visualization of the managerial review process.

Figure 3: Process Flow of Internal Revenue Service Managerial Review



Source: GAO analysis of Internal Revenue Service documents. | GAO-22-104180

^aEQRS: Embedded Quality Review System

Small Business and Self-Employed Division (SB/SE) and Large Business and International Division (LB&I) managerial reviews differ in that, while SB/SE records managerial reviews in an electronic review system, (described below), LB&I does not record formal managerial reviews in a dedicated system that allows such reviews to be compared and analyzed for division or program-wide trends.

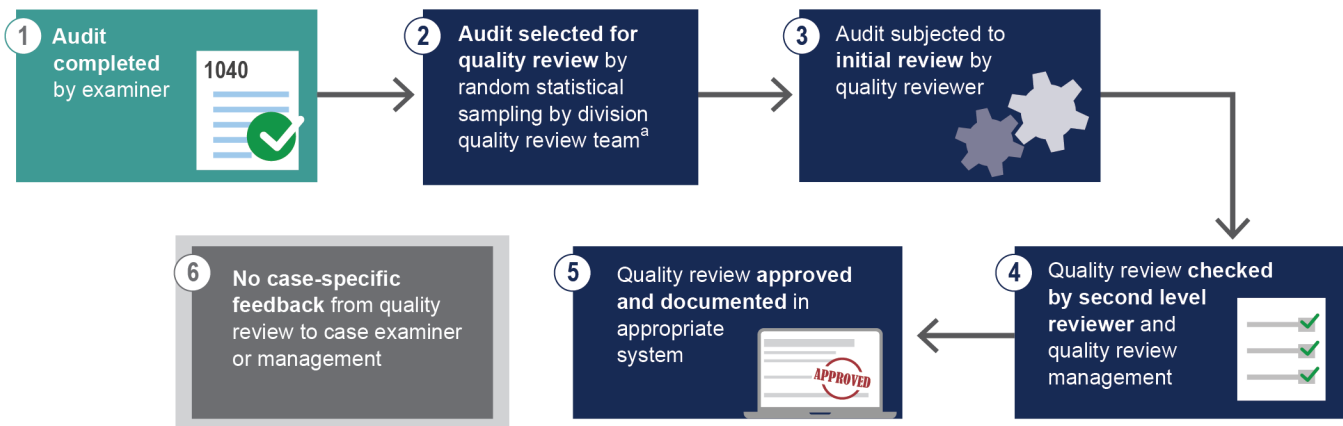
Quality Review

IRS also subjects audits and investigations to quality reviews. Quality reviews are conducted independent of the audit team or team management. Quality reviews for SB/SE are conducted by Field and Specialty Exam Quality, and quality reviews for LB&I are conducted by Quality Review and Analysis. Quality reviews are selected as part of randomly generated samples of audit cases, and reflect SB/SE or LB&I cases generally, but not specific compliance issues. IRS officials said they apply quality reviews only to completed audits and investigations, while managerial reviews may be applied to open or completed audits and investigations.

Unlike managerial reviews, quality reviews are not intended to identify or correct deficiencies in specific cases. According to IRS officials, quality review systems are intended to identify division or organizational trends.

While quality reviews do identify if individual audits or investigations comply with agency standards, the quality review process does not provide examiners and investigators with similar feedback as provided in the managerial review process. Figure 4 shows a schematic of the quality review process.

Figure 4: Process Flow for Internal Revenue Service Quality Review



Source: GAO analysis of Internal Revenue Service documents. | GAO-22-104180

^aFormal quality review conducted by units specific to each division. In Small Business and Self-Employed division quality review is conducted by Field and Specialty Exam Quality. In the Large Business and International Division, quality review is conducted by Quality Review and Analysis.

Electronic Review Systems

IRS implements managerial and quality review through a variety of electronic review systems. Review systems provide managers and independent reviewers with criteria and consistent procedures with which to evaluate audits and investigations. According to IRS officials, electronic review systems also serve as repositories of review data, and allow IRS officials to analyze data to identify trends or deficiencies in the agency's enforcement activities.

This report describes three electronic review systems maintained by the LB&I and SB/SE divisions. IRS has other electronic review systems; however, we are not discussing them here as they were not relevant to the agency's enforcement of abusive micro-captive insurance schemes.

The review systems discussed in this report share some common features, including:

- An electronic interface by which the reviewer can enter qualitative and quantitative information.

- A list of attributes of the compliance activity that serve as criteria for reviewers to evaluate the audit or investigation.
- A scoring system by which a reviewer documents whether the enforcement activity met an attribute.
- Narrative descriptions of the review, by which the reviewer can provide context and explain their decision to mark an attribute as passed or failed.
- A data and document storage system by which the agency retains records of the review of the compliance activity for future analysis.

Despite these commonalities, the three review systems include distinct features and address different purposes. For a summary of the common and distinctive features of the three of IRS electronic review systems described in this report, see table 2.

Table 2: Characteristics of Internal Revenue Service's Formal, Electronic Review Systems

| Tool | Division | Managerial or independent quality review? | Method of selection | Standardized format to review similar audit or investigation? | Tool is applied to promoter investigations? |
|---------------------------------|--------------------|---|-----------------------------|---|---|
| Embedded Quality Review System | SB/SE ^a | Managerial | Managerial discretion | no, managers have discretion to choose which attributes to review | yes |
| National Quality Review System | SB/SE | Independent Quality | Statistical sampling | yes | no |
| LB&I Quality Measurement System | LB&I ^b | Independent Quality | Random statistical sampling | yes | yes |

GAO analysis of IRS documents. | GAO-21-104180

^aSB/SE: Small Business/Self-Employed Division

^bLB&I: Large Business and International Division

Embedded Quality Review System

EQRS is SB/SE's tool to allow managers to evaluate active and completed audits and investigations. EQRS is used to document managerial review. EQRS is used by managers with direct day-to-day oversight over audits and investigations to provide and document formal feedback to examiners and investigators. Below, we describe how a managerial review is selected and conducted by the reviewer, if any methods are used to verify the findings, and if any limitations exist for the review systems.

- **Selection.** Managers choose to subject an audit or investigation to a review in EQRS. An audit or investigation does not have to be subjected to a managerial review in EQRS.
- **Conduct of review.** When an audit or investigation has been selected for review, a manager may conduct a variety of review types, such as an on-the-job visit, in-process case review or closed case review, among others. The manager has discretion to select which attributes of the audit or investigation they want to review, but if the manager does conduct a formal review, they must document the review in EQRS.
- **Verification methods.** IRS officials said that managerial reviews in EQRS are subjected to a variety of consistency checks including, quarterly reporting of potential inconsistencies in managerial attribute scores and random selection of managerial reviews for consistency analysis, among other means.
- **Limitations.** Since managers have discretion to determine when and how to conduct a review, reviews saved in EQRS are not as standardized as those in other review systems. EQRS reviews are also conducted by a manager who is actively involved in the audit or investigation, so there is a risk that the reviews may be less objective and impartial than those conducted by an independent reviewer.

National Quality Review System

The National Quality Review System (NQRS) is SB/SE's tool to allow independent quality reviewers to evaluate whether completed audits were conducted according to agency standards. Below we describe how an NQRS review is selected and conducted by the reviewer, if any methods are used to verify the findings, and if any limitations to the review systems exist.

- **Selection.** NQRS reviews are selected from among closed audits by random division-wide statistical sampling. IRS officials said that NQRS is not used to review promoter investigations.
- **Conduct of Review.** A review is conducted by an independent reviewer from SB/SE's Field and Specialty Exam Quality (FSEQ) unit. The audit is reviewed against a standardized list of attributes and the reviewer determines if the audit sufficiently meets those attributes.
- **Verification methods.** NQRS reviews are subject to consistency checks by an FSEQ manager, who may, for example, critique completed case reviews and provide feedback or hold group meetings to discuss specific attributes and case scenarios.

- **Limitations.** NQRS is not used to review promoter investigations. NQRS only applies to audits that determine tax liability. Since a promoter investigation is used to determine applicability of a penalty rather than tax liability, they are excluded from the review system. Because IRS selects audits to generate a random sampling across all SB/SE closed audits, the reviewed audits may not necessarily reflect a generalizable population of a particular compliance issue, such as micro-captive insurance audits, according to IRS officials. Agency guidance prohibits NQRS reviews from being used to evaluate individual or case performance, and instead are intended to provide aggregate and area-wide data.

LB&I Quality Measurement System

The LB&I Quality Measurement System (LQMS) is LB&I's process for allowing independent quality reviewers to evaluate whether completed audits and investigations were conducted according to agency standards. Below, we describe how an LQMS review is selected, how it is conducted by the reviewer, if any methods are used to verify the findings, and any limitations to the review systems.

- **Selection.** LQMS reviews are selected from among closed audits and investigations by random division-wide statistical sampling.
- **Conduct of review:** A review is conducted by an independent reviewer from LB&I's Quality Review and Analysis unit (QRA). The audit or investigation is reviewed against a standardized list of attributes and the reviewer determines if the audit or investigation sufficiently meets those attributes.
- **Verification methods.** LB&I quality reviews are verified through multiple steps in the LQMS process. QRA analysts' initial reviews are subject to multiple internal reviews by lead reviewers and subsequently given final approval by QRA management.
- **Limitations.** Because IRS selects LQMS reviews to generate a statistical sample of the entire population of closed audits and investigations, the reviewed enforcement activities may not necessarily reflect a generalizable population of a particular compliance issue, such as micro-captive insurance audits and promoter investigations, according to IRS officials. IRS officials also said completed LQMS reviews are shared with the original examiner only "as a courtesy."

Appendix IV: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

February 16, 2022

Jessica Lucas-Judy
Director, Tax Issues, Strategic Issues Team
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Lucas-Judy:

Thank you for the opportunity to review and provide comments on the draft report, *"Abusive Tax Schemes - IRS Could Improve Its Reviews of Offshore Insurance Audits and Investigations"* (GAO-22-104180). This report follows GAO's prior report *"Abusive Tax Schemes – Offshore Insurance Products and Associated Compliance Risks"* (GAO 20-589) in which there were no recommendations.

The IRS's strategic response to abusive micro-captive transactions has been a high priority area of focus that spans SB/SE, LB&I, Office of Promoter Investigations (OPI), Office of Chief Counsel, and others. We have conducted promoter investigations, thousands of participant examinations, assessed hundreds of millions of dollars in additional taxes owed, assessed penalties, and launched a successful settlement initiative. The IRS's activities have been sustained by the Independent Office of Appeals and the IRS has won all micro-captive Tax Court cases, decided on their merits, since 2017. As a result of our efforts, some material advisors have ceased promoting these transactions, and thousands of taxpayers have voluntarily settled prior to litigation or otherwise exited the transaction. In furtherance of the IRS's strategy to address abusive transactions, the Promoter Investigations Coordinator position was established in 2020 and the OPI was established in 2021. These developments again highlight our increased focus on promoters of abusive tax avoidance transactions. OPI is coordinating efforts across multiple business divisions to address abusive arrangements and transactions and will develop strategic plans, programs, and policy.

The bulk of the report and recommendations focus on the IRS's processes and procedures for managerial and other quality reviews rather than issues specific to offshore insurance audits. As noted in the report, GAO's review of the IRS was not related to whether the examiner reached a correct or incorrect audit determination.

SB/SE and LB&I use their quality review systems to assess overall examination quality at an organizational level. These reviews assess the completeness and accuracy of audits as well as adherence to agency audit principles. The cases subjected to quality

2

review are randomly selected based upon statistically valid samples determined at the organizational and Area levels only. As indicated in your report, the micro-captive insurance cases subject to SB/SE quality review reflected an average quality score of 91% and no significant weaknesses were identified. In addition to the managerial and formal quality reviews, micro-captive insurance audits are subject to further oversight. While these may not be formal reviews, the additional oversight helps ensure case quality and consistency. Subject Matter Experts and Counsel work closely with the examiners during income tax examinations and the report writing stage. Closing agreements and Statutory Notices of Deficiency are also reviewed by Technical Services and Counsel.

Managers have systems to record managerial reviews for both income tax and promoter examiners and their case files. Managers document formal reviews and record them in an Employee Performance File. These files were not requested by GAO. An employee's annual performance appraisal is documented in the HR Connect system and this information was also not requested by GAO. It's important to note that an employee's annual performance is based on the totality of their work; not just their work on one issue.

Despite the challenges of developing and resolving micro-captive cases, we have been effective in addressing these transactions and abuses. Expending additional resources to address GAO's recommendations is not warranted and would come at the expense of other organizational priorities.

Attached please find our response to the recommendations. If you have any questions, please contact me, or a member of your staff may contact Scott Ballint, Director, Enterprise Activities Practice Area, Large Business, and International Division at 304-238-8235.

Sincerely,

Douglas W. O'Donnell Digitally signed by Douglas W. O'Donnell
Date: 2022.02.17 06:41:22 -05'00'

Douglas W O'Donnell
Deputy Commissioner for
Services and Enforcement

Enclosure

Enclosure

GAO Recommendation and the IRS Responses to GAO's Recommendations in the Draft Report on *Abusive Tax Schemes - IRS Could Improve Its Reviews of Offshore Insurance Audits and Investigations* (GAO-22-104180).

Recommendation 1:

The Commissioner of Internal Revenue should have SB/SE provide more specific guidance on when SB/SE should use various managerial review tools and the frequency with which such reviews should be conducted on high-priority matters such as those surrounding micro-captive insurance arrangements.

Comment:

We disagree with this recommendation. SB/SE Area Directors issue specific minimum review/documentation requirements and expectations to the managers in their areas yearly. These expectations generally address the frequency and types of reviews (e.g., workload reviews, on-the-job visits, in-process reviews) managers should conduct on each employee during the fiscal year. Expectations for reviews of priority work and types of cases (e.g., promoter, preparer, Abusive Transaction Investigation (ATI), Special Enforcement Program, Offshore) are also often communicated. In addition, IRM 1.4.40, SB/SE Field and Office Examination Group Manager, provides guidance regarding formal and informal case reviews and discussions, including but not limited to group manager concurrence meetings, in-process case reviews, workload reviews, on-the-job visits, closed case reviews, and Examination Technical Time Reports (ETTR) reviews.

Managerial reviews are generally conducted in the Embedded Quality Review System (EQRS). EQRS was designed to capture reviews based on the evaluation of quality attributes that crosswalk to employees' Critical Job Elements. Managerial reviews conducted in EQRS are not designed to provide oversight or evaluate the effectiveness of the micro-captive insurance program or other priority work. IRS policies prohibit the use of predetermined quantitative standards, enforcement results, or quotas to influence the evaluation of an examiner's performance. Measuring the effectiveness of the micro-captive insurance program may require analyzing these quantitative elements.

Recommendation 2:

The Commissioner of Internal Revenue should have LB&I adopt formal managerial reviews of its audits and establish methods and procedures for recording and analyzing managerial review data that allows it to isolate high priority cases, including micro-captive insurance audits; and use the data to assess the quality of its audits.

Comment:

We disagree with this recommendation. As indicated in the report, managerial reviews occur as discussed in various IRM sections and managers can use the LB&I Quality

Measurement System checklist as a guide to ensure case quality. In addition to the managerial and formal quality reviews described, micro-captive insurance audits are subject to further oversight. Subject Matter Experts, Managers, and Counsel assist in the examinations and review Notices of Proposed Adjustments (NOPAs). Form 906 closing agreements and Statutory Notices of Deficiency are reviewed by Technical Services and Counsel. More importantly, it is not clear how this recommendation will improve examination quality as there has been no indication that examiners are not reaching appropriate conclusions on micro-captive audits or promoter investigations.

Recommendation 3:

The Commissioner of Internal Revenue should have SB/SE and LB&I subject a sample of their micro-captive insurance audits to a formal quality review process. Based on the findings of this review, SB/SE and LB&I should take corrective actions to remedy any deficiencies.

Comment:

We disagree with this recommendation. As evidenced by program results, the existing oversight and control of micro-captive insurance audits, including coordination with subject matter experts, managers, and Counsel who assist in the examinations and review NOPAs, as well as Technical Services' and Counsel's review of Form 906 closing agreements and Statutory Notices of Deficiency, supplemented by the combination of formal and informal reviews of micro-captive insurance audits is sufficient to ensure case quality. In fact, throughout the audit and investigation processes, micro-captive cases are subject to greater organizational scrutiny and review than most other types of work. There has been no indication that examiners are not reaching appropriate conclusions in micro-captive insurance audits. Instead, results from documented formal and informal reviews of in-process and closed case files point to a finding that case quality is at a high level and GAO's closed case reviews do not contradict this. The volume of GAO's case reviews is statistically insufficient to evaluate the quality of the entire micro-captive insurance audit population and GAO did not review whether examiners reached the correct audit conclusion on the cases it reviewed.

Recommendation 4:

The Commissioner of Internal Revenue should have SB/SE design and implement an identification and tracking method in EQRS to allow agency officials to identify and compare managerial reviews of micro-captive promoter investigations both to other micro-captive promoter investigation, and promoter investigations generally; and use the data to assess the effectiveness of its promoter investigations.

Comment:

We disagree with this recommendation. Agency officials can already use project codes in EQRS to identify, track and compare managerial reviews of micro-captive promoter investigations.

In addition, effective January 31, 2021, SB/SE Field Examination ATI Area groups were realigned under centralized leadership in the Southwest Area. The groups were restructured to account for attrition, provide a more effective geographic footprint, and an enhanced focused mission. The ATI territory is comprised of eight groups and three senior program analysts who report to a territory manager, under the Southwest Area Director. Generally, as a result of this realignment, managerial reviews of promoter and preparer penalty cases will be concentrated within this territory.

Recommendation 5:

The Commissioner of Internal Revenue should have LB&I adopt formal managerial reviews of micro-captive insurance promoter investigations, establish a reliable way to store and track managerial review data of promoter investigations that allows it to isolate high priority cases; issue guidance on how often and by what method such investigations should be subjected to managerial review; and use the data to assess the effectiveness of its promoter investigations.

Comment:

We disagree with this recommendation. LB&I promoter investigations are already subject to 100% managerial review of the actions taken to develop and resolve the case. The GAO did not conduct any type of review of promoter investigations. There has been no indication that examiners are not reaching appropriate conclusions in micro-captive promoter investigations and that existing managerial and Counsel involvement are not sufficient. Each micro-captive promoter investigation is so unique that a check sheet or one-size fits all review strategy would not ensure that the right actions were taken during the investigation. The promoter examiners follow standard report writing procedures as outlined in IRM 4.46.6.10. This penalty report is then highly scrutinized by promoter management, local and National Office Counsel to ensure the likelihood of the penalty being upheld in Appeals or judicial proceedings prior to any penalty assessment.

Recommendation 6:

The Commissioner of Internal Revenue should have SB/SE develop a method to assess the quality of promoter investigations and apply this method to micro-captive promoter investigations. Based on these reviews, SB/SE should take corrective action to remedy any deficiencies uncovered in its analysis.

Comment:

We disagree with this recommendation. SB/SE already has a method in place to assess and ensure the quality of promoter investigations, including micro-captive promoter investigations. As evidenced by program results, the existing oversight and control of micro-captive promoter investigations, including coordination with subject matter experts, managers, and Counsel who assist in the investigations, as well as assisting in case development, supplemented by the combination of formal and informal reviews of

micro-captive insurance investigations is sufficient to ensure case quality. In fact, throughout the promoter investigation process, micro-captive cases are subject to greater organizational scrutiny and review than most other types of work. The GAO did not conduct any type of review of in-process or closed promoter investigations. Given the limitations on IRS resources, and the fact that there have been no identified deficiencies in micro-captive insurance or other promoter investigation case quality, expanding the IRS resources devoted to such reviews is not warranted and would come at the expense of allocating resources to other organizational priorities.

Recommendation 7:

The Commissioner of Internal Revenue should have LB&I establish and implement metrics on promoter investigation quality and subject a set of micro-captive promoter penalty investigations to formal quality review procedures to establish a baseline measure of micro-captive promoter investigation quality. Based on these reviews, LB&I should take corrective action to remedy any deficiencies uncovered in its analysis.

Comment:

We disagree with this recommendation. LB&I promoter investigations are already subject to 100% managerial review of the actions taken to develop and resolve the case. Each promoter and transaction is so unique that setting metrics applicable to the entire population would not provide meaningful insight. The GAO did not conduct any type of review of promoter investigations. There has been no indication that examiners are not reaching appropriate conclusions in micro-captive promoter investigations and that existing managerial and Counsel involvement are not sufficient.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Jessica Lucas-Judy at (202) 512-6806, LucasJudyJ@gao.gov

Staff Acknowledgments

In addition to the contact named above, the following staff made key contributions to the report: Neil Pinney (Assistant Director); Tara Carter (Assistant Director), Eric Gorman (Analyst-in-Charge), Topher Hoffmann, Genesis Galo, Gina Hoover, Amalia Konstas, Ben Legow, Krista Loose, Scott E. McNulty, Ed Nannenhorn, Andrew J. Stephens, Leanne Violette, and Alicia White.

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