

# Managing Complex IRS Audits of Midsize Business Taxpayers

---

Presented to [CPAAcademy.org](https://CPAAcademy.org)

Jamie Brown  
October 11, 2018

© 2018 Ivins, Phillips & Barker



# Contents

- Pre-Audit Best Practices
- Issue and Return Selection
- Overview of Audit Process
- Information Document Requests and Summonses
- Strategic Implications of 2014-2016 Developments
- Privileges
- IRS Interviews and Meetings
- Period of Limitations on Assessment
- Pre 30-Day Letter Resolution Tools



# Pre-Audit Best Practices

- Document transactions
  - Contemporaneous documentation is strongest type of evidence
  - IRS agents, judges, juries disfavor “ex-post” analysis
- File required schedules and disclosures
- Self-evaluate audit risks
  - Know how IRS selects business returns
  - Review returns
  - Review prior audit cycle results
- Audit Ready Files



# ISSUE AND RETURN SELECTION



# Types of Audit

- Small Business/Self-Employed Division (SB/SE) - businesses with assets under \$10 million
- Large Business and International (LB&I) - examines corporations, subchapter S corporations, and partnerships with assets greater than \$10 million



# LB&I Reorganization – Centralized Issue Selection

- “Campaigns”
  - Centralized, not local, issue selection
  - Select current and emerging compliance concerns
  - Move away from selection of taxpayers, and of returns
  - Goals: flexibility, efficient resource allocation
- “Treatment streams”
  - Identify intended compliance outcome
  - Use multiple enforcement tools
  - Example: offshore enforcement
- Better issue selection tools
  - Data analysis
  - “Integrated feedback loop,” e.g. examiner feedback



## LB&I Reorganization – Practice Areas

- Five substantive “Practice Areas”
  - Pass Through Entities
  - Enterprise Activities
  - Cross Border Activities
  - Withholding & Individual Compliance
  - Treaty & Transfer Pricing Operations
- Four geographic “Compliance Practice Areas”
  - Western, Central, Eastern and Northeastern
- Will evaluate compliance issues within their area of expertise or region and suggest campaigns



# LB&I Reorganization – Campaign Announcements

- 40 campaigns as of October, 2018
- Available at [www.irs.gov/businesses/large-business-and-international-compliance-campaigns](http://www.irs.gov/businesses/large-business-and-international-compliance-campaigns)



# Pre-Contact Analysis

- Review case file to Identify Large, Unusual, or Questionable Items (LUQs) beyond those selected by case classifier:
  - Review complete tax return
  - Review data from IRS computer systems and internet
  - Preliminary legal research

See IRM 4.10.2.3



# OVERVIEW OF AUDIT PROCESS



# LB&I Exam Process - General

- Publication 5125, and IRM 4.46.
- Sets forth process, effective May 1, 2016, for conduct of audits by LB&I.
  - Replaced prior procedures (“QEP”) from 2010.
- Identifies responsibilities of both LB&I and taxpayers
- Divides audit process into phases: Planning, Execution and Resolution



# LB&I Exam Process – Example

Phase	Timeline	Events
<b>Planning</b>	-3 Months	Pre-contact examination
	-2 months	Initial contact letter and IDRs
	0 months	Opening conference
	1 month	Examination plan
<b>Execution</b>	1-12 months	Tailored IDRs, witness interviews
		Exchanges of views on factual and legal issues
<b>Resolution</b>	14 months	Draft Notice of Proposed Adjustment (NOPA)
	16 months	Resolution meeting
	18 months	30-day letter and NOPA



# LB&I Exam Process - Emphases

- Planning:
  - Communication
  - Issue team concept
- Execution:
  - Communication
  - New “acknowledgment of facts” IDRs
  - Comprehensive consideration and documentation of facts
- Resolution:
  - Early resolution
  - Fast Track Settlement
  - Appeals Judicial Approach and Culture (AJAC) changes
  - Taxpayer responsibility to address all issues



# Planning Phase Strategy

- Opportunities to convince IRS are fewer in Execution phase
- Cut off as many issues as possible
  - Offer documents?
  - Offer write-ups or presentations?
- Limit scope of further investigation
- Establish clear lines of communication



# Planning Phase Resources

- Practice Units
- Audit Techniques Guides



# INFORMATION DOCUMENT REQUESTS AND SUMMONSES



# IDR

Form **4564**  
(Rev. June 1988)

Department of the Treasury — Internal Revenue Service

## Information Document Request

Request number

To: *(Name of Taxpayer and Company Division or Branch)*

Subject

SAIN number

Submitted to:

Dates of previous requests

*Please return Part 2 with listed documents to requester identified below*

Description of documents requested



# LB&I IDR Directive

- Finalized February 28, 2014. Now IRM 4.46.4.5.
- Two components: Requirements for issuance; enforcement process
- To extent followed, important protections from fishing expeditions, overbreadth and otherwise unreasonable inquiries



# IDR Issuance – Key Requirements

- Discuss the issue related to the IDR with the taxpayer
- Discuss how the information requested is related to the issue under consideration and why it is necessary
- Ensure IDR clearly states the issue that is being considered and that the IDR only requests information relevant to the stated issue
- Prepare separate IDRs for each issue
- Provide a draft of the IDR and discuss its contents with the taxpayer
  - Generally, within 10 business days
- After discussion is complete, determine with taxpayer a reasonable timeframe for a response to the IDR



# IDRs – Enforcement Process

Timing	Step	Description
Within 5 business days after IDR response	IRS determines whether response is complete	IRS can in its discretion grant extension of up to 15 days
Within 10 days after application of enforcement process	Delinquency Notice	Issued by Team Manager. 10 business days to respond
Within 10 business days after Delinquency Notice deadline	Pre-Summons Letter	Issued by Territory Manager., with involvement of IRS Counsel. Addressed to management level at least one level above official who received delinquency notice
Thereafter	Summons	



# IRS Summons Authority

- IRC § 7602(a)(2)
  - For the purpose of ascertaining the correctness of any return, . . . , the Secretary is authorized—
    - (1) [ . . . ].
    - (2) ***To summon the person liable for tax . . . , or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax . . . , or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry;*** and
    - (3) [ . . . ].
- (Emphasis added).



# Summons Authority - Scope

- IRC § 7602: IRS can summons evidence that “***may*** be relevant or material.”
- Test is whether requested records “might throw light upon” the correctness of the return under examination. *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 813 n. 11 (1984).
- IRS can summons even *potentially relevant* evidence. *Id.*, p. 814.
- Courts: relevance threshold is low because IRS needs to detect non-compliance.



# Limitations on Relevance

- Disproportionate and overbroad summonses
- “Fishing expeditions”
- *U.S. v. Richards*, 631 F.2d 341, 345 (4th Cir. 1980).
- *See also* LB&I IDR Directive



# Responding to IDRs

- General rule: provide exactly what the IDR asks for, and not more
- Review documents for privilege and work product protection



# IDRs – Examples

- Provide any and all emails related to the XYZ transaction
- Provide a chart . . .
- Provide a summary . . .



# Acknowledgment of Facts (AOF) IDRs

- Relatively recent process
- Exam uses routinely
- In response to AJAC procedures
- If case not fully developed factually, may be sent back
- Exam wants taxpayer to agree to facts



# AOF IDRs – Language

*The purpose of this IDR is to ensure that all relevant facts, whether favorable to the taxpayer or LB&I, are being considered before the Form 5701, Notice of Proposed Adjustment (NOPA), is issued.*

*Please review the attached Form 886-A and respond accordingly in writing to the LB&I issue team by the agreed-upon date (MM/DD/YYYY):*

- (a) Taxpayer agrees to the facts as written.*
- (b) Taxpayer provides additional relevant facts and supporting documentation.*
- (c) Taxpayer identifies disputed facts and provides clarification and/or supporting documentation.*

*Appeals will return the case to exam if the taxpayer presents new information during the Appeals process that was not shared with LB&I during the examination. Therefore, the taxpayer has the primary responsibility to ensure all relevant facts are provided to the LB&I issue team.*



# AOF IDRs – Best Practices

- Should you cooperate?
- Review carefully before answering
- Has Exam identified its legal position?
  - Can you identify all relevant facts without?
  - Consider pushing back before response if the legal issues have not been identified
- Do not underestimate time to respond



# AOF IDRs — Best Practices

- Remove mixed statements of fact and law, and shading of facts
- If relevant facts omitted, supply in response
- Consider counter fact statement
- Qualify response for good faith errors; further investigation; and changes in IRS theories of adjustment



# STRATEGIC IMPLICATIONS OF 2014-2016 DEVELOPMENTS



# 2014-2016 Developments

- LB&I Information Document Request (IDR) Directive (Feb. 28, 2014)
- Appeals Judicial Approach and Culture (AJAC) (Sep. 2, 2014)
- Publication 5125 (May 1, 2016)—LB&I Exam Process
- LB&I Reorganization and Campaigns (early 2016)
- Acknowledgment of Facts (AOF) IDRs (May 1, 2016)



# Appeals Judicial Approach and Culture ("AJAC")

- Judicial approach to Appeals by using what is in the case file.
- Effective for non-docketed case receipts after September 2, 2014. For docketed case receipts, effective October 3, 2016.
- The good news:
  - Appeals does not engage in factual development, and does not return cases to Exam for further factual development.
  - Instead, Appeals will treat undeveloped facts as a litigation hazard for the government.
  - Appeals does not raise new issues, or reopen issues.



# AJAC - Hazards

- If a taxpayer raises a new issue, Appeals refers case back to Exam.
- If a taxpayer provides new information or evidence that, in Appeals' judgment, requires additional analysis or investigation by Exam, Appeals refers case back to Exam.
- If a taxpayer raises a new theory or argument that, in Appeals' judgment, requires further development, Appeals retains jurisdiction but requests Exam to review and comment.



# Strategic Implications

- Sophisticated, coordinated strategy by LB&I and Appeals
- But tools and opportunities for taxpayers
- Some issues should be easier to avoid or resolve, others harder
- Fewer situations where “keeping your powder dry” makes sense



# PRIVILEGES



# Why Privilege Matters

- Privilege and work product protection are *only* grounds for withholding sensitive documents



# Privileges – In General

- **Attorney-Client Privilege**
  - Protects confidential communications between an attorney and client.
- **Tax Practitioner Privilege**
  - IRC Section 7525
- **Work Product Doctrine**
  - Protects certain documents prepared in anticipation of litigation.



# Attorney-Client Privilege – Elements

- Confidential communication
- From client to attorney for the purpose of obtaining legal advice; or
- From attorney to client and either (i) contains legal advice or (ii) reveals confidential information on which client seeks advice
- Dual purpose documents protected if “primary purpose” is legal advice



## § 7525/Accountant-Client Privilege

- Enacted in 1998
- With respect to tax advice, communications between a taxpayer and any “federally authorized tax practitioner” are privileged to the same extent as communications with an attorney
- But . . .



# Section 7525 - Limitations

- Only applies with respect to tax advice
- Does not apply to foreign accountants
- Only applies in federal tax proceedings
- Cannot be asserted in any criminal matter
- Does not apply to communications relating to the promotion of any tax shelter
- Accountants wear lots of hats



# Work Product Protection –Elements

- Prepared in anticipation of litigation, or in other words “because of” the prospect of litigation
- By or for a party or its representative
- Protects litigation strategies and analyses of litigation hazards
- When is litigation anticipated in tax planning?
  - Likely IRS Appeals?
- Joint purpose document: would it have been prepared in substantially similar form if litigation had not been anticipated?



# Waiver

- Attorney-client and section 7525
  - Voluntary disclosure to a third party results in broad waiver as to all documents concerning the same subject matter
- Work product protection
  - Waiver only as to specific document
  - Waiver only when disclosure is inconsistent with purpose of maintaining secrecy from adversaries
- Compare:
  - *U.S. v. Textron* (1st Cir. 2009) (Textron waived *attorney-client privilege* by disclosing to outside auditor);
  - *U.S. v. Deloitte* (DC Cir. 2010) (Dow Chemical did not waive *work product protection* by disclosure to outside auditor)
- “At-issue” waiver



# IRS INTERVIEWS AND MEETINGS



# IRS Interviews and Meetings

- IRS defines an “interview” as any meeting (including by phone) between the taxpayer (or its representative) and IRS. IRM 4.10.3.3
- Not limited to IRS interrogating a specific witness about specific issues
- Includes planning conferences and settlement discussions



# IRS Interviews and Meetings - Purposes

- Initial Interviews: “[P]rovide information about the taxpayer’s financial history, business operations, and books and records.”
- Subsequent Interviews: “[O]btain leads, develop information, and establish evidence.”
  - “The testimony of witnesses and statements made by taxpayer or their representatives are major factors in resolving tax cases.”
  - Testimony can “provide information not otherwise available from physical documentation, corroborate return information, provide relevant information not reflected on the return, and establish the taxpayer’s intent.”
- IRM 4.10.3.3



# IRS Interviews and Meetings – Taxpayer Rights

- If during an IRS interview (other than pursuant to a summons) the taxpayer states that it wishes to consult a representative, IRS must suspend the interview.
- A taxpayer can authorize any licensed practitioner with a power of attorney to represent it in an IRS interview.
- IRS “may not require a taxpayer to accompany the representative” unless the interview is pursuant to a summons.
  - IRS may, however, request the taxpayer’s voluntary presence at the interview (including initial conferences) “as a means to expedite the examination process.” IRM 4.10.3.3.1

IRC Sec. 7521(b)(2), (c).



# IRS Interviews - Techniques

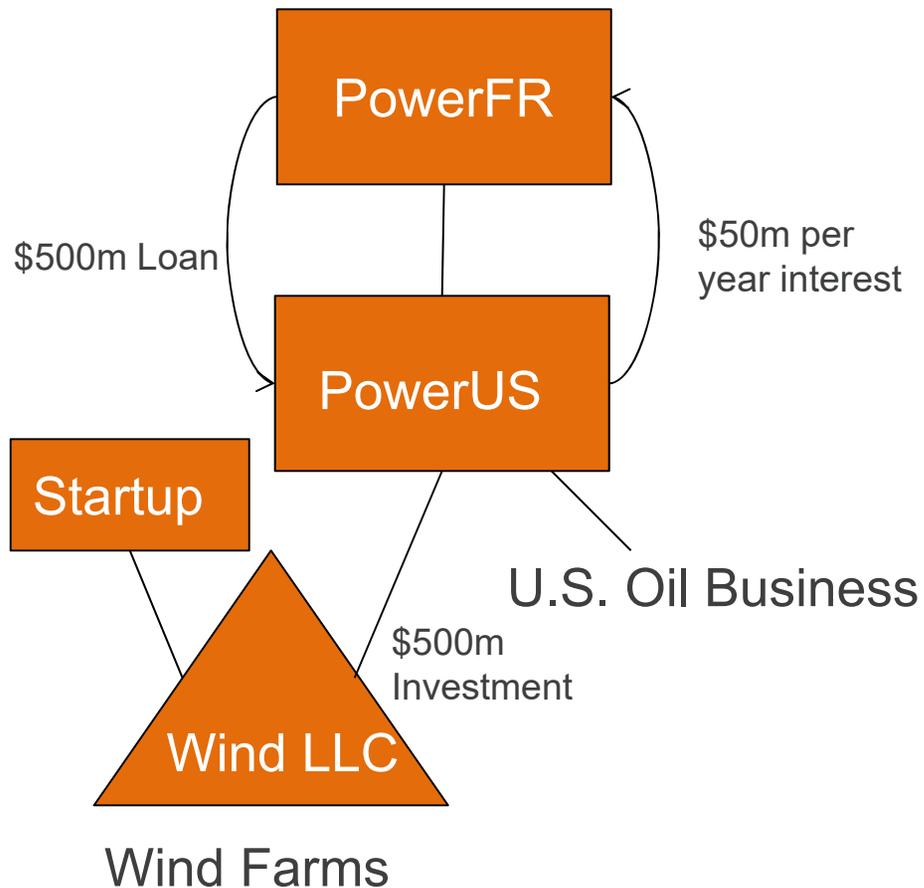
- IRM includes list of best practices for conducting interviews, addressing for example:
  - Friendly and professional demeanor
  - Not being beholden to pre-planned questions
  - Listening
  - Asking good follow-up questions
  - Establishing a rapport
  - Asking open-ended questions
  - Establishing a “conversational atmosphere”

## IRM 4.10.3.3.7 (Interview Techniques)

- Goal: taxpayer volunteers maximum of information



# IRS Interviews and Meetings - Example



- 2010 Financing of New Wind Farm Investment
- Lump sum payment of principal in 50 years
- 2011-2013 interest payments from oil profits
- 2014 default
- Debt/Equity Audit
- IRS interviews PowerUS CFO



# PERIOD OF LIMITATIONS



# Period of Limitations

- IRS generally has 3 years from the due date of a return or the actual filing date of the return (whichever is later) to audit and to assess additional tax. IRC § 6501(a).
    - IRS procedures generally require exam team to request issuance of notice of deficiency with at least 6 months remaining
  - Major exceptions:
    - False or fraudulent returns - unlimited
    - No return filed - unlimited
    - Material omissions or misstatements on (or unfiled) disclosure forms related to cross-border transactions or foreign assets, such as:
      - Form 926, Return by U.S. Transferor of Property to a Foreign Corporation, Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation, and Form 8865, Return of U.S. Persons With Respect To Certain Foreign Partnerships
    - generally 3 years after correction
- (Continued . . .)



## Period of Limitations – Major Exceptions Continued

- Failure to report listed transactions – special rule, IRC § 6501(c)(10), generally 1 year after correction
- Omissions from gross income in excess of 25% of gross income stated on return – 6 years
- Extension by agreement
  - Very commonly requested
  - “If the taxpayer does not consent to extend the statute, the examiner will initiate action, as necessary, to issue a statutory notice of deficiency or initiate other means to assess tax deficiencies before the statute expires.” IRM 25.6.23.6.6.



# Period of Limitations – Extend?

- Case by case, but ask: what does taxpayer gain?
- Conventional wisdom: in most situations, extend
  - Consider limited extension
  - Consider restricted consent
- Considerations:
  - Has IRS raised every troubling issue?
  - Has IRS requested right information and documents?
  - Has IRS been prompt and respectful of resources?
  - What is likelihood of resolution at audit level?
  - Does taxpayer want to protest to Appeals?



# PRE 30-DAY LETTER RESOLUTION TOOLS



# Tools

- Agreement with LB&I Manager
- Fast Track Programs
  - Fact Track Mediation and Fast Track Settlement
- Early Referral of Issues to Appeals



# Resolution with Manager

- IRS cannot “settle” issues in exam, but has broad authority to “resolve” issues based on applying law to facts. See, e.g., IRM 4.46.5.3.
- LB&I managers have final authority to resolve issues. See IRM 4.46.5.8(1).
- Resolution at exam level is generally through “agreed RAR.”



# Fast Track Programs

- Appeals mediates dispute between exam team and taxpayer while case is still in examination
- IRS and taxpayer have to agree to participate
- IRS and taxpayer have to agree to any settlement
- Taxpayer may withdraw at any time
- Taxpayer retains all traditional Appeals rights
- Prohibition against *ex parte* communication between Appeals and IRS does not apply



# Fast Track Programs

- Fast Track Mediation
  - Only available in SB/SE audits. Certain exceptions apply.
  - Goal of resolution within 40 days
  - See IRS Publication 3605 and Rev. Proc. 2003-41.
- Fast Track Settlement
  - Available in most LB&I and SB/SE audits.
  - In LB&I cases, available only after NOPA and taxpayer's written response to NOPA. In SB/SE cases, taxpayer submits written statement of position.
  - Goal of resolution within 120 days for LB&I taxpayers, and 60 days for SB/SE cases.
  - See Rev. Proc. 2003-40 for LB&I cases; Announcement 2011-5 for SB/SE cases.



# Early Referral to Appeals

- Request transfer of developed but unagreed issue to Appeals while other issues in the case continue to be developed in Exam.
- Taxpayer must request early referral and exam must approve it.
- “Appropriate issues for early referral are limited to those that:
  - (1) If resolved, can reasonably be expected to result in a quicker resolution of the entire case;
  - (2) Both the taxpayer and the District agree should be referred to Appeals early;
  - (3) Are fully developed; *and*
  - (4) Are part of a case where the remaining issues are not expected to be completed before Appeals could resolve the early referral issue.”
- Regular Appeals procedures apply.
- If no agreement reached (or taxpayer withdraws), Appeals will not reconsider the issue if the entire case is later protested to Appeals, unless there has been a substantial change in circumstances.
- See Rev. Proc. 99-28.



# Thank You For Listening

**IVINS, PHILLIPS & BARKER**  
CHARTERED



Jamie Brown: (202) 662 3418; [jbrown@ipbtax.com](mailto:jbrown@ipbtax.com)



# Disclaimer

- This webinar provides a very high level overview of selected considerations that can arise during IRS audits. It is not legal advice and should not be relied on as such.
- When responding to IRS audits, taxpayers should consult with qualified advisors to ensure consideration of all relevant laws and procedures as applied to their specific facts and circumstances.