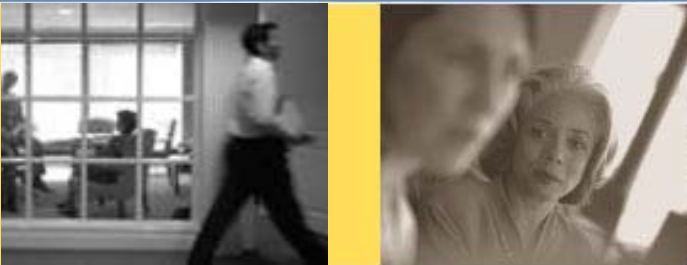


Southern Federal Tax Institute  
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# A Good Audit Gone Bad



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- Internal Revenue Service Circular 230  
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# Introduction

- The outline included with your material provides general guidelines on audit procedure.
- Today, the focus of my presentation is on the ways an audit may become more contentious and the steps you should take when it does so.

# Handling Tiered Issues

# Overview

- One of the ways corporate audits currently turn more problematic is when the Exam Team determines that the return includes a “tiered issue.”
- Understanding the rationales and goals of the Industry Issue Focus (IIF) Program and how the program actually works is key to successfully handling a case involving tiered issues
  - Insight into the IRS approach allows you to better develop your strategy and defense
  - Understanding the documentation the IRS will demand enables you to retain the appropriate materials

# General Goals of IIF Program

- Stated IRS goals include:
  - Consistency in resolution across industry lines
  - Improved currency
  - Increased coverage of non-compliant taxpayers by maximizing limited resources
  - Greater oversight on and accountability for important issues

# Anticipated Benefits of IIF

- The IRS states that the IIF program will have the following benefits:
  - ❑ Ability to concentrate on high-risk tax issues
  - ❑ Flexibility of program allows LMSB to respond to changes in business practice
  - ❑ Can resolve issues across industry lines
  - ❑ Consistency
  - ❑ Allows flexible deployment of resources

# Development of the Three Tiers

- Issues are classified by the Industry Directors
- Potential Tier I or Tier II issues are presented to the Compliance Strategy Council for approval
  - If approved, an issue is assigned to the primary affected industry or another LMSB executive to develop a compliance strategy
- Tier I issues are examined in monthly meetings to reevaluate their placement

# The Three Tiers

- Tier I:
  - High strategic importance
  - Significant impact on one or more industries
  - Two categories:
    - Compliance Issues
    - Shelter Issues
  - IRS says Tier I identification doesn't necessarily mean "bad" or "shelter" but rather of high importance
- Tier II
  - Potentially high non-compliance and/or significant compliance risk
- Tier III
  - Generally industry-related
  - Have been identified as issues that should be considered by LMSB teams when conducting risk analysis
  - No issues have been assigned to Tier III to date

# Tier I Compliance Issues

- Section 118 Abuse
- R&E Credit Claims
- Section 482 Cost Sharing
- Foreign Tax Credit Generators
- International Hybrid Instrument Transactions
- Domestic Production Deductions (Section 199)
- Mixed Service Costs
- Government Settlements
- Section 936 Exit Strategies
- Foreign Earnings Repatriation (Section 965)

# Tier I Shelter Issues

- All Listed Abusive Tax Shelters and Transactions
- “Redemption Bogus Optional Basis”
- Distressed Asset/Debt

# Tier II Issues

- Backdated Stock Options
  - Moved from Tier I status to Tier II status on April 22, 2008
- Casualty Loss: Single Identifiable Property/Capital vs. Repairs
- Cost Sharing Stock-Based Compensation
- Enhanced Oil Recovery Credit (Section 43)
- Extraterritorial Income Exclusion Effective Date and Transition Rules
- Gift Card Deferral of Income
- Healthcare Accounting Issues: Contractual Allowance
- Interchange and Merchant Discount Fees
- Non-performing Loans
- Specified Liability Losses (Section 172(f))
- Super Completed Contract Method
- Upfront Fees, Milestone Payments and Royalties in Biotech and Pharmaceutical Industries

# IIF Players

- Issue Owner Executive
- Issue Management Team (“IMT”)
- Issue Specialization Team (“IST”)
- Examination Team

# Issue Owner Executive

- Selects IMT
- Creates action plan
- Communicates internally and with external stakeholders as appropriate
- Facilitates requests for legal advice and guidance

# Issue Management Team

- Provides direction to the field on tiered issues and facilitates development and resolution of significant issues
- Considers whether issue needs to be addressed through litigation
- Identifies best case or cases for factual and legal development
- Seeks Appeals issue coordination where appropriate
- Develops audit technique

# Issue Specialization Team

- Used for complex, time-consuming, or wide-spread tiered issues
- Teams contain Senior Agents, Revenue Agents, and Specialists
- Assists the examination team
- Drafts IDRs
- Examines taxpayer records
- Drafts Forms 5701 and 886
- Participates in meetings with taxpayers

# Examination Team

- Issues IDRs, summonses, proposed adjustments, as developed by IST or IMT
- Secures records for IST issue
- Deals with all other taxpayer issues besides the tiered issue assigned to the IST
- Goals should be to gather similar information from all taxpayers, identify common issues and treat them consistently
  - Should not delay audits excessively

# Handling Tiered Issues

## Practice Guide for Tiered Issues

# Be Proactive

- You need to know whether you may have a tiered issue before your audit
  - Recognize that agents will be suspicious of packaged products sold by consultants
  - International tax issues are likely to be scrutinized
- Understand the facts in IRS guidance and distinguish your facts from the start
- Your response to initial IDRs may be critical in defining the direction the examiners take
- Don't let an agent label mistakenly an issue or transaction as tiered because it has some similarity to a tiered issue

# Try to Develop a Good Relationship With the Agent

- If you cooperate, provide information as requested, and generally keep the audit moving, the agent may use a more favorable tone in his report to the issue specialist or issue owner executive
  - This tone may have a significant impact on the specialist or issue owner's involvement
- If one of your audit issues has some similarity to a tiered issue, provide the agent with accurate and complete information to ensure that your issue is not labeled incorrectly
- Don't wait until the last second to provide information or to work with the agent—establish a good relationship from the beginning so you can work to “manage” the examination as much as possible

# Understand How the IRS Approaches Your Issue

- Read published guidance: Directives, Settlement Guidelines, Audit Guidelines, Notices, Rulings, Coordinated Issue Papers, Regulations, etc.
- Consider how your case fits in
  - Do you have better/worse facts?
  - What has the IRS approach to this issue been?
  - What is the IRS record on this issue?

# Understand the IRS's General Litigation Strategy on Tiered Issues

- Anecdotal evidence indicates that the IRS is trying to get the cases with the worst facts into court
  - The IRS is likely to try to delay or settle cases with better facts early on in an issue's development so it can develop law with cases with bad facts

# Distinguish Your Facts

- Distinguishing your facts is critical
  - Be prepared early in your audit to distinguish and defend your facts
- Consider the facts given in any IRS guidance
  - May be difficult if guidance is vague and facts given are generic
- Identify other taxpayers with similar issues and learn about their facts
  - Try to accelerate the strongest taxpayer's case

# Work With Taxpayers With Similar Issues

- Learn other taxpayers' facts
- Learn how the IRS is approaching your issue with other taxpayers

# Consider How Your Case Fits in With the IRS Strategy

- Consider the IRS docket on your issue
  - Are they litigating? What are the facts in these cases?
    - Distinguish your facts
  - What is the strength of the cases further along than yours?
  - Coordinate with other taxpayers and consider which cases you want to go first
- For example, if you have a strong case and your issue hasn't been tested:
  - Put pressure on the audit to move quickly to make your case one of the first
  - Show the IRS it doesn't want your case to be the first: the issue owner executives don't want to make law with cases that have good facts

# Don't Argue the Law

- IRS legal position is developed with consideration by multiple parties
- One person doesn't have authority to change position himself or herself
- Agent will take a very pro-IRS view of the law and won't listen to your alternative arguments
- If you have an argument they have never considered, arguing the law may have some value

# Contentious Issues in Audits

# General Power

- IRS can compel testimony and production of documents
- Power is limited by privilege and relevance
- If criminal case has been referred to the DOJ IRS loses summons power
- Types of Summonses
  - Taxpayer
  - Third Party
  - John Doe

# IRS Use of Summonses

- Used to be a last resort for failure to answer or lack of cooperation for IDRs
- IRS has become more aggressive in its use especially around perceived tax shelter transactions
- Corporate tax shelters have created mistrust so agents are more likely to resort to summonses

# Rights of Taxpayer for Interviews

- Interview Pursuant to Summons
  - Must be provided notice of third-party summons
  - Right to counsel or designated representative
    - Prepare witness with role-playing
  - Can consult with accountant for technical matters during an interview
  - Person summoned can have transcript of testimony
  - Can make audio recording of interview
  - All privileges apply (including 5<sup>th</sup> Amendment)
  - Can be an observer in third-party interviews if witness agrees
  - May move to quash

# How to Challenge Summonses

- Show not reasonably related to return
  - IRS must show that information is relevant and not already accessible
  - Taxpayer can then rebut the IRS's case
  - Can include evidence of burden or overbreadth
- Show sought in bad faith, to harass, or to coerce taxpayer
- Assert relevant privileges

# Three Different Protections

- There are three different doctrines that protect documents from disclosure.
  - Attorney-client privilege
  - Statutory accountant-client privilege
  - Work product protection
- Attorney-client privilege and attorney work product differ in how they are created and when they are waived.
- It is important to understand the distinctions to protect documents to which one or both may apply.

# Attorney-Client Privilege

- What is it?
  - (1) Where legal advice of any kind is sought
  - (2) from a professional legal adviser in his capacity as such,
  - (3) the communications relating to that purpose,
  - (4) made with an expectation of confidentiality
  - (5) by the client, or by the legal advisor containing such communications by the client,
  - (6) are at his instance permanently protected
  - (7) from compelled disclosure by himself or by the legal adviser,
  - (8) unless the protection is waived

# Attorney-Client Privilege

- What decides whether a document is privileged?
  - The document must contain a privileged communication.
  - Giving a document to your lawyer does not make the document privileged.

# Attorney-Client Privilege

- Communications involving in-house counsel
  - Communications with employees for purposes of providing legal advice are privileged.
  - Tax advice provided by in-house counsel with respect to the legal consequences of transactions is privileged.
  - The mere funneling of tax work done by non-attorneys through in-house counsel does not attach attorney-client privilege to documents.
  - Practically speaking, courts will examine assertions of privilege with respect to in-house counsel more closely because of the dual business/legal roles common to company lawyers.

# Attorney-Client Privilege

- How is the privilege waived?
  - Actual Waiver
    - The privilege is waived when a privileged communication is voluntarily disclosed to a party not covered by the privilege.
    - The privilege may be waived when a privileged communication is involuntarily disclosed to a party not covered by the privilege.
  - Implied Waiver
    - An implied waiver of the privilege occurs when a privilege holder makes an assertion of fact that in fairness requires examination of protected communications.
  - Scope of Waiver
    - The waiver generally applies to all communications of the same “subject matter,” but the scope of how to define “subject matter” differs significantly among courts.

# Federal Statutory Accountant-Client Privilege

- Applies to communications
  - After July 22, 1998
  - Between “federally authorized tax practitioners” and client
- Intended to apply the same common law protections as the attorney-client privilege
- Only applies to the extent that the communication would be considered a privileged communication if it were between a taxpayer and an attorney
- Does not apply to certain “tax shelter” transactions (i.e., transaction with a “significant” purpose of tax avoidance or evasion)
  - For communications prior to October 22, 2004, does not apply to “corporate” tax shelters
  - For communications after October 22, 2004, does not apply to any tax shelters
- The privilege may only be asserted by a taxpayer or accountant on the taxpayer’s behalf in any noncriminal proceeding before the Service or any noncriminal tax proceeding brought in Federal court.

# Federal Statutory Accountant-Client Privilege

- Based upon one court's analysis, tax opinion letters prepared by accountants may not be protected from disclosure by the accountant-client privilege.
  - *United States v. KPMG, LLP*, 237 F. Supp. 2d 35 (D.D.C. 2003)
    - Tax opinion prepared by accountants is not protected by the accountant-client privilege because the analysis in the opinion letter was "prepared in connection with preparation of a tax return" as the opinion related to a transaction to be disclosed on the taxpayer's tax return.
- Tax opinion letters prepared by accountants may be protected from disclosure to the Service by the work product doctrine. *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998) (see discussion in following slides).

# Work Product Doctrine

- What is this protection?
  - Documents prepared “in anticipation of litigation” or for trial by or for another party, or by or for that other party’s representative, are protected from disclosure.
  - Mental impressions of attorneys/other representatives are protected.
  - Substantial need exception may be asserted to overcome the work product protection, but a heightened standard is generally applied by the courts to protect mental impressions as opposed to factual information.

# Work Product Doctrine

- What is “in anticipation of litigation?”
  - Need to be already thinking about and anticipating potential litigation.
  - Helpful if litigation is in fact likely and not just a possibility.
  - Mere risk of challenge by IRS on audit may not be enough without actual anticipation of litigation.

# Work Product Doctrine

- How is work product protection waived?
  - Disclosure to an adversary automatically waives work-product protection with respect to the items disclosed
  - Disclosure to a third-party who is not an adversary does not necessarily waive the protection. This may include outside auditors
  - Some courts have also limited a waiver of the work-product protection to only factual materials disclosed, maintaining the protection with respect to documents involving “core attorney mental processes”

# Considerations before Challenging Summonses

- Low likelihood of success
- Increases adversarial nature of the audit
- Whether there is a possibility of criminal investigation
- Risk of waiving privileges if comply
- Delay of the examination
- Possibility that IRS will not pursue enforcement

# Section 7491 Cooperation

- Shifts the burden of proof to the IRS
- Burden shifting often of limited value, but IRS may use this section to push for greater cooperation
- Taxpayer must provide credible evidence to the court on the underlying issue
- Taxpayer must have cooperated with the Service

# Section 7491 Cooperation

- Cooperation involves
  - Complying with a requirement to substantiate any item
  - Maintaining all required records
  - Cooperating with requests for witnesses, information, documents meetings and interviews
  - Exhausting administrative remedies
  - Does not require extension of Statute of Limitations

# IRS Use of Penalties

- IRS previously was less aggressive in using penalties
- Involved in more cases now, especially for potential tax shelters
- Effects
  - Cases more costly to challenge
  - Can be used as leverage to increase starting amounts for settlement agreements
  - Can force cases into Tax Court due to cost

# Addressing and Fighting Penalties

- Important to understand the rules behind the penalties
  - Ensure that the agent followed the I.R.M. rules for imposing penalties (IRM 20.1.1)
    - Similar cases and similarly-situated taxpayers treated alike
    - Purpose is to promote voluntary compliance
  - IRS must provide notice of the penalty including name, section of the code and computation
  - Penalty must be approved by the immediate supervisor of the agent
    - Approval paperwork can be requested under the Freedom of Information Act

# Addressing and Fighting Penalties

- Contest the penalty on the merits, do not rely on protest of underlying tax
- Challenges usually based on
  - reasonable cause
  - good faith
  - disclosure
  - lack of intent
    - Lack of willfulness
    - Reliance on expert advice

# Going Criminal

# Criminal Offenses

- Tax evasion
- Willful failure to collect or pay tax
- Willful failure to file
- Willful filing of false returns
- Interference with the administration of laws
- Conspiracy to defraud the United States

# Requirements for Prosecution

- Willfulness
  - Usually inferred but can be shown through overt acts (destruction of records, fake invoices etc.)
- Intent
  - Defined as “voluntary intentional violation”
- Statute of Limitations

# Criminal Investigations

- Purpose is to result in convictions with incarceration
- Conducted by Special Agents who have more power
  - Can execute and serve search warrants
  - Can make arrests
  - Can seize property subject to forfeiture
  - Can conduct undercover operations
- Different Taxpayer rights
  - Summons to third-party recordkeepers excluded from standard procedures, so taxpayer does not get notice or have a chance to quash
  - Communications with tax practitioners not confidential under Section 7525
  - Special Agents must provide Miranda-type warnings and the interview must end if taxpayer exercises his rights

# Civil to Criminal Transfer

- Civil audit is often the source for the criminal investigation
- All information provided in the civil audit will be transferred
- Civil agent is looking for indications of fraud
  - Fraud case begins with recognition of affirmative indications of fraud
  - When agent gathers sufficient evidence of fraud, agent and superiors develop a plan to show that sufficient acts exist and will suspend the audit
  - If agent stops too early then the criminal investigation may not have enough evidence to function
  - Agent will attempt to gather evidence of fraud by noting from whom and when the information was obtained and will get the taxpayer's explanation for the evidence

# Civil to Criminal Transfer

- Indications of fraud that the agent is looking for before transfer to CI
  - ❑ False statements about material facts
  - ❑ Attempts to hinder the examination – failure to answer questions, cancelling appointments, refusing to provide records
  - ❑ Testimony about irregular business practices
  - ❑ Destruction of books or records
  - ❑ Transfer of assets for concealment

# Civil to Criminal Transfer

- First versus Firm Indication of Fraud
  - Initial contact with the taxpayer important for fraud cases
    - Agent may get information that is not available later once a more in-depth investigation is started
  - Firm indication is not first indication
    - Agent will be keeping historical record of investigation to support transfer
    - Attorney should also keep a similar record in order to note strengths and weaknesses in Service's case
- Parallel Investigations
  - Criminal investigation has priority, so civil audit is suspended for the same tax and period
  - Civil audit on other issues may continue
  - Attorney must be very cautious that civil examination does not produce any information that could be used by the criminal investigation

# Eggshell Audits

- A civil audit that has the potential for becoming a criminal investigation
- Revenue agent will be looking for indications of fraud
- No requirement for agent to inform taxpayer of suspicions
- Agent can not give false or misleading information, so taxpayer should ask if he suspects a potential criminal investigation
  - Courts will suppress evidence if it finds that the agent misled the taxpayer on the nature of the investigation

# Eggshell Audits

- Important to try to preempt the transfer to criminal
  - Disclosure and cooperation may be helpful at this point
  - Consider whether to address the possible issues proactively
- Ensure that taxpayers know that any information provided will be transferred
- Preparation of witnesses and documents needs to be thorough to prevent the appearance of obstruction or concealment and inconsistencies.
  - Grave risk is to create separate obstruction of justice issue

# Handling a Criminal Investigation

- Focus on defense of the criminal requirements, not the underlying tax issue
  - Lack of Willfulness
    - Negligence of the taxpayer is not enough for criminal prosecution
    - Service looks for a pattern to show willfulness, so try to show that only one year is involved
  - Mistake of Law
    - Taxpayer must still show good faith
  - Reliance on Advice of Expert
    - Requires disclosure of all relevant facts and taxpayer following expert's advice

# Handling a Criminal Investigation

- Taxpayer can't talk his way out
- Taxpayer can't explain it all
- Taxpayer needs a lawyer who is prepared

# Handling a Criminal Investigation

- Focus of agent is on evidence so lawyer should try to control the presentation of evidence as much as possible
  - Try to provide written affidavits rather than depositions
  - Use all the privilege protections available
    - But be aware of reliance on counsel defense
  - Know possible adverse witnesses
  - Early in the process alert the agent to weaknesses in the case

# Handling a Criminal Investigation

- Prevent inconsistent statements by sufficient preparation of witnesses and review of documents submitted
  - False or misleading statements represent a willful attempt to evade in and of itself
  - Interview taxpayer about
    - Any prior statements taxpayer made to revenue agent
    - Sources of information
    - Potential witnesses
    - Any prior examinations or dealings with the Service
    - Taxpayer's personal background
  - Interview witnesses
    - Make sure that questions do not show the areas that you are concerned with because the questions may not be protected
    - Should be attended by two people

# Handling a Criminal Investigation

- Will generally need an accountant, but ensure work product privilege is retained
- Keep responses to agent limited to the specific issue addressed
- Special agent may not be conducting a full-scale investigation but rather investigating a specific information item, so providing an explanation may avoid a full investigation

# Risks and Concerns in Criminal Investigations

- Disclosure
  - Voluntary Disclosure may be considered by the IRS in determination of whether to prosecute
    - Disclosure is not voluntary if it occurs after an investigation (criminal or civil) has started
    - Does not automatically provide immunity
  - Amended return can be a risk if voluntary disclosure is not possible
    - It can be considered an admission of fault
    - If incorrect can be considered a false statement or attempt to evade
    - Can be considered a waiver of self-incrimination privilege

# Risks and Concerns in Criminal Investigations

- Cooperation
  - Can be used to deny consciousness of guilt, or show a lack of intent
  - Generally will only help mitigate penalties not affect prosecution
  - Risk of providing the agent with too much information or waiving privilege
  - Lack of cooperation could be interpreted as obstruction of justice
  - Balancing act between benefits and risks to taxpayer

# Attorney Communications

- Attorney is the main person interacting with Agent
- Try to get as much information as possible from the agent
- Important not to make any statement that could be a vicarious admission or waive any privilege
- No off-the-record conversations
- Keep chronological record of any conversations with the agent
- Always be up-front and honest with the agent
  - Withholding evidence or representing that a partial response is complete can be used as evidence of fraud

# After the Investigation

- Taxpayer may request a conference before the special agent's report is finished
- Once case is transferred to CI Division Counsel, a conference is generally offered
  - Among other issues Counsel will look at voluntary disclosure, dual prosecution, and the age and mental condition of the taxpayer
  - Any statement made by the representative at the conference constitutes a vicarious admission
- Case is then referred to the Justice Department Tax Division
  - Tax Division declines prosecution of 10-20 percent of cases
  - Taxpayer should request a conference with the Tax Division when notified of transfer
  - Conference has different vicarious admission rules