Tax Executives Institute

How To Make Your Audit Successful Before It Begins… And Handle It After It Starts

Matthew D. Lerner
Steptoe & Johnson LLP
Washington, D.C.

STEPTOE & JOHNSON LLP

steptoe.com

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Preparing Your Documents For An Audit Before It Begins

Exercise Caution When Creating Documents

Document Non-Tax Business Reasons

- Document non-tax business reasons before you undertake a transaction.
  - How does the company hope to profit?
  - What economic factors went into the decision to undertake the transaction?
    - Enhanced economic return
    - Reduce costs

Case Study - Dealing With A Question Of Whether A Repair Is Currently Deductible

- We know going into a year that the key legal factors include:
  - Whether it extends life
  - Whether it adds value
  - Whether it adapts property to new or different use
- To succeed when an audit commences, you should keep records:
  - Measuring actual life of pool of assets and what the circumstances of their retirement were
  - Costs of actual repair operations
  - Cost of used replacement for asset
  - Cost of new replacement for asset
  - How the asset is used before and after
- Generally, the harder it would be to re-create data, the more important it is to collect it at the time of the transaction.

Practical Tips from the Trenches

- What are other companies doing, and what should you do?
  - Have a well-documented business purpose for every transaction
  - Make sure there is an economic benefit without tax benefits
  - Exception to above if there is clear congressional intent through a provision of the Code specifically allowing the tax benefit (e.g., low income housing)
  - Make sure you get an appropriate opinion from a competent, trustworthy and independent advisor
  - Talk to your auditors about appropriate financial reserves
  - Make sure everyone knows in advance that you will disclose the matter on the tax return if there is any doubt about it
  - Always keep senior management informed
  - Address potential issues proactively with Exam team

Practical Tips from the Trenches

- Identifying potentially troublesome transactions:
  - Do what you can to make sure lines of communication are good between the tax department and the business units and that business units are involved in all transactions.
  - Set up a process to identify potentially challenging transactions.
    - Educate the business units with respect to the tax law requirements for obtaining the desired treatment.
    - Explain to all relevant personnel the importance of maintaining records of the type described herein.

Avoid Creation of Documents that Will Undermine Your "Positive" Story

- In-house analyses focusing exclusively on the tax benefits of transaction (particularly comparisons to much smaller non-tax benefits).

- Internal memoranda and e-mails solely analyzing tax benefits of transaction with no reference to business reasons for a transaction.

- Internal memoranda and e-mails, particularly from non-tax functions, discussing limitations of transaction from a business perspective, without countervailing discussion of "pluses".

  - Be mindful of permanent nature of informal electronic communication.

Save All Relevant Documents

Important Steps for Establishing A Comprehensive Policy

- Develop a firm written policy for retention and destruction of documents, including specified time periods for particular types of documents based upon legal requirements.
- Develop a policy for tax-related materials that may be integrated with your existing policies.
- Establish that documents relevant to a matter for which an audit or litigation is contemplated will not be destroyed (e.g., audit-litigation “hold” policy).
- Establish a specific policy with respect to e-mail and other electronic data.

Important Steps for Establishing A Comprehensive Policy

- Properly designate and train employees responsible for implementing the policy.
- Apply document retention policies consistently across business groups.
- Establish significant internal penalties for failure to follow policies
- Establish guidelines for outside legal review of policies and procedures in difficult and sensitive situations.
- Require immediate disclosure of improper document destruction to senior management and counsel so that appropriate mitigating actions may be taken.

What Transactional Documents Should be Retained?

- Transaction planning documents
- Transaction agreements
- Internal business and tax analyses of contemplated and/or completed transactions
- Sales and trading records
- Financial information
- Customer records
- Administrative records

Retain Records Showing Business Justifications

- Retain profitability analyses, proof of success or reasons for failure, records of costs.

- Organize records for ease of establishing actual result and reasons for that outcome.

What Communications Should be Retained?

- Hard copy correspondence (e.g., letters, facsimiles)
- Electronic correspondence (e.g., e-mails, instant messaging)
- Records of oral communications (e.g., phone messages, memos)
- Parties with whom relevant communications may exist:
  - Fellow employees
  - Business advisors
  - Tax advisors
  - Clients
  - Shareholders
  - Board members

What Is Required for Federal Tax Purposes?

- What records?
  - Records sufficient to establish income, losses and deductions
  - For “reportable transactions,” records that “are material to an understanding of the tax treatment or tax structure of the transaction,” including promotional materials, tax opinions, correspondence.
- How long?
  - Until the statute of limitations for any year affected by the transaction at issue expires
- What are the tax consequences for failing to retain records?
  - Loss of deductions
  - Civil penalties for negligence or fraud
- What other penalties may apply?
  - Criminal penalties for failure to file return, supply information, or pay tax
  - Criminal penalties for attempting to evade or defeat tax

What Other Requirements Exist?

- Federal Laws
  - Sarbanes-Oxley Act of 2002
    - 18 U.S.C. § 1519—Destruction, alteration or falsification of records in Federal investigations and bankruptcy
    - 18 U.S.C. § 1512(c)—Tampering with a witness, victim or an informant
  - Federal Securities Law
  - Federal Commodities Law
  - Federal Money and Finance Law and Regulation
  - Federal Banking and Credit Laws and Regulations
  - Federal Commerce and Foreign Trade Law
  - Federal Labor Laws
  - Employee Benefits Laws
- State Laws
  - State Securities Laws
  - New York State Laws (e.g., UCC, banking, tax, general business, labor, workers' compensation

Organize Your Documents Before the Audit Begins

Organize Your Files To Maximize Their Benefits to You

- Gather and organize files *prior* to the beginning of the audit:
  - Allows you to understand what is in your files with respect to a particular transaction prior to the receipt of IRS Information Document Requests (IDRs).
  - Allows you to identify and develop necessary information before time passes and documents become more difficult to locate.
  - If key documents (e.g., establishing non-tax business purpose) are limited, early organization will allow you to manage the audit to focus on those that are present and draft pre-audit retrospective documents to bolster your positions, which have greater weight than documents created after the audit has begun.
  - Limits possibility of inadvertently producing negative and/or privileged documents as a result of time pressures in responding to the Service.
  - Avoids unnecessary delays in moving an issue into litigation if a favorable resolution is not possible with the Service.

Analyze Your Files to Understand the Strengths and Weaknesses of Your Tax Positions

- Retain all important documents prepared contemporaneously with the transaction at issue:
  - Comply with all regulatory requirements
- Identify key documents that will serve as the basis for your presentation of your "positive case" to the Internal Revenue Service:
  - Identify positive factual documents (e.g., establishing economic substance and non-tax business purpose for transaction) –
    - Current market data
    - Costs incurred
    - Activities performed
    - Expected and actual benefit to company
  - Identify negative factual documents that you will need to explain
  - Identify internal/external legal analyses that will assist you in evaluating your positions
  - Identify proof of comparable arms-length transactions
- Rely on input of non-tax personnel in decision-making process.

Organize Your Files To Maximize Their Benefits to You

- Group documents in a manner that will assist you during the course of the audit:
  - By transaction or issue
  - Identify certain categories of documents –
    - Specific subject matters (e.g., in support of a particular position such as business purpose, economic substance, current deductibility, etc)
    - Positive documents (including key documents)
    - Documents requiring explanation
    - Privileged documents
    - Opinion letters
    - Tax accrual workpapers
- Create a numbering system to track documents:
  - For internal use
  - For documents produced to the Service
- Organize your key documents in an electronic database.

Why Does Protecting Documents Matter?

- Encourage employees to be forthcoming and candid with their attorneys so that the attorney is sufficiently well-informed to provide sound legal advice.
- *See Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

Why Does Protecting Documents Matter?

- Avoid disclosure to adversaries of comprehensive internal and external legal analyses of transactions/issues subject to audit that will create a road map for the Service.
- Avoid disclosure to adversaries of sensitive tax reserve analyses to prevent these from being the starting point of negotiations during an audit.
- Avoid disclosure to adversaries of strategic communications with your outside advisors.
- Allow full and frank communications on a going forward basis with your tax advisors during the course of the audit and any future litigation, without fear of undermining the position.

Two 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 with external legal advisors includes:
  - Direct communications with lawyer
  - Communications with law firm employees who assist attorneys in providing legal advice
- Attorneys employed by accounting firms are generally not considered to be functioning as attorneys for purposes of the attorney-client privilege.

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.
    - The courts are also split as to whether an inadvertent disclosure is treated as an actual waiver or not a waiver of the privilege.
      - Alternative 1--An inadvertent disclosure is treated the same as a voluntary disclosure, without exception.
      - Alternative 2--To determine if an inadvertent disclosure should be treated as a waiver, a balancing test is applied, weighing the following factors: (1) whether the disclosing party took reasonable precautions to prevent disclosure; (2) the speed at which the party acted to correct its mistake; (3) the overall volume of documents provided; (4) the number of inadvertent disclosures; and (5) fairness.

Attorney-Client Privilege

- How is the privilege waived?
  - 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.
    - The Tax Court applies a three-part balancing test to determine if an implied waiver occurs:
      - Whether the assertion of the privilege was the result of an affirmative act by the asserting party;
      - Whether the asserting party put the protected information at issue through an affirmative act by making it relevant to the case; and
      - Whether application of the privilege would deny the opposing party access to information "vital" to its defense.

Attorney-Client Privilege

- 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.
    - Some courts limit the scope of the waived "subject matter" to material actually disclosed to an uncovered party.
    - Other courts take a much broader approach and treat the waiver as including any privileged material with the same general subject matter of the disclosed communications (e.g., all communications related to a particular transaction).
  - Disclosure of a privileged opinion letter to the Service for penalty protection purposes may be seen as an actual waiver of the attorney-client privilege and, depending upon the application of the "subject matter" test, could result in the waiver of privilege with respect to a much broader set of communications.

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 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"?
  - Because of Litigation Test—Majority Test
    - If in light of the nature of the document and the factual situation in a particular case, the document can be said to have been prepared or obtained at least in significant part because of the prospect of litigation. *See Adlman*, 134 F.3d at 1202.
  - "Primarily to Assist In Litigation" Test—Minority Test
    - The primary motivating purpose behind the creation of the document must be to aid in possible future litigation.
    - Applied by the Fifth Circuit Court of Appeals. *See United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981).

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?
  - Voluntary disclosure to an adversary in litigation automatically waives work-product protection with respect to the items disclosed. *See In re Steinhard Partners, L.P.,* 9 F.3d 230 (2d Cir. 1993).
  - However, voluntary disclosure of work product to a third-party who is not an adversary does not necessarily waive the protection for other materials unless the disclosure "substantially increases the opportunity for potential adversaries to obtain the information." *In re Grand Jury*, 561 F. Supp. 1247 (E.D.N.Y. 1982).
  - 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." *In re Kidder Peabody Security Litigation*, 168 F.R.D. 459 (S.D.N.Y. 1996).

Work Product Doctrine

- Courts have reached different conclusions with respect to whether disclosures to outside auditors waive work product protection
  - *Medinol, Ltd. v. Boston Scientific Corp*., 2002 U.S. Dist. LEXIS 20611, at * 10 (S.D.N.Y. 2002) (work product protection waived)
  - *In re Pfizer Inc. Sec. Litig*., 1993 U.S. Dist LEXIS 18215, at *21 (S.D.N.Y. 1993) (work product protection not waived)
  - *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.,* 229 F.R.D. 441 (S.D.N.Y. 2004) (work product protection not waived)
  - *United States v. Textron, Inc*., 507 F. Supp.2d 138 (D.R.I. Aug. 28, 2007), *aff'd* 103 AFTR 2d 2009-509 (1st Cir. 2009) (work product protection not waived), *rev'd en banc* No. 07-2631 (1st Cir. Aug. 13, 2009) (work product protection does not apply).
  - *Regions Financial Corporation v. United States* 101 AFTR 2d 2008-2179 (N.D. Ala. 2008) (work product protection not waived).

Concerns Regarding Formal Tax Opinions

Are Tax Opinion Letters Privileged?

- Opinion letters prepared by attorneys are generally privileged.
- Opinion letters prepared for the specific purpose of disclosure to the Service to avoid potential tax penalties are not privileged.

How Can Privileged Opinion Letters Be Protected from Disclosure to the Service?

- If you want a privileged opinion letter, but also need penalty protection, make sure you obtain separate opinions.
  - It would be prudent to engage separate firms to prepare opinion letters for each purpose.
- Keep opinion letters separate from non-privileged documents to avoid the possibility that they will be inadvertently disclosed to third parties, resulting in a waiver of privilege/work-product protection.
  - May waive protection by orally disclosing conclusions in audit.

How Can Privileged Opinion Letters Be Protected from Disclosure to the Service?

- If an opinion letter has been prepared for penalty protection purposes and you intend to disclose it to the Service, do not treat the opinion as a privileged document in your files and do not claim the document as privileged in response to IDRs, as this will reduce the possibility that the production of the document may be treated as a waiver of privilege.

- At a minimum, if you decide to produce opinion letters to the Service for penalty avoidance purposes for which you have previously asserted a privilege, try to obtain an agreement with the Service that it will not assert in the future that the production of the opinion constituted a subject matter waiver.

U.S. v. Roxworthy

- In *U.S. v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006) the Sixth Circuit held that two memoranda prepared by KPMG for Yum! Brands, Inc. were protected from disclosure to the IRS under the work product doctrine
- The memoranda were addressed to in-house "corporate counsel" at Yum's predecessor company, Tricon Global Restaurants, Inc. The memoranda analyzed the tax consequences of certain transactions entered into by Yum pertaining to the creation of a captive insurance company and related stock transfers. The memoranda discussed possible arguments the IRS might raise against the transactions and potential counterarguments.
- The magistrate judge ruled that the documents were not protected because they were prepared irrespective of the prospect of litigation to support Yum's tax return and avoid penalties. The district court agreed with the magistrate judge, even after Yum filed supplemental affidavits describing the purpose of the memoranda to prepare for likely litigation with the IRS over the tax consequences of the controversial transactions.

U.S. v. Roxworthy

- The Sixth Circuit reversed and held that the memoranda were protected by the work product doctrine.
- In particular, the Sixth Circuit ruled that the memoranda were prepared in anticipation of litigation and that the anticipation of litigation was objectively reasonable given the nature of the transactions.
  - "In the absence of any evidence to the contrary, the affidavits and deposition testimony supplied by Yum are adequate to demonstrate that Yum did not commission the memoranda as part of the ordinary course of business of completing the transactions and that Yum in fact anticipated litigation because of the certainty of an IRS audit, the conspicuousness of the $112 million discrepancy between tax and book loss, and the unsettled law surrounding captive insurance."
  - The Sixth Circuit applied the "because of" standard and stated, "the documents do not lose their work product privilege 'merely because [they were] created in order to assist with a business decision,' unless the documents 'would have been created in essentially similar form irrespective of the litigation.'"

Concerns Regarding Tax Accrual Workpapers

Tax Accrual Workpapers – In General

- Tax accrual workpapers include documentation of the company's analysis of tax contingencies and reserves reported on financial statements, including roll-forwards of changes to the reserves.
- The workpapers may include memoranda, analyses and schedules that reflect the company's hazards-of-litigation determinations.
- The workpapers may be prepared by company attorneys, company accountants, and other company personnel, and by outside legal or accounting advisers.
- The workpapers may be reviewed by or provided to various persons, both inside and outside the company.

Outside Auditor’s Interest in Tax Accrual Workpapers

Outside Auditor's Interest in Tax Accrual Workpapers

- AICPA Audit Standards
  - Outside auditors will seek to review tax accrual workpapers.
  - AICPA Professional Standards require that "sufficient competent evidential matter" be obtained "to afford a reasonable basis for an opinion regarding the financial statements under audit." AICPA Professional Standards, AU section 9326, *Evidential Matter: Auditing Interpretations of Section 362.*
  - The Standards specifically require that audit documentation include "sufficient competent evidential matter about the significant elements of the client's tax liability contingency analysis." AICPA Professional Standards, AU section 9326, *Evidential Matter: Auditing Interpretations of Section 362.*

Outside Auditor's Interest in Tax Accrual Workpapers

- PCAOB Audit Standards
  - Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB). PCAOB has adopted audit documentation requirements in Auditing Standard No. 3 - Audit Documentation.
  - That Standard requires documentation that:
    - Demonstrates that the audit complied with PCAOB standards
    - Supports the auditor's conclusions regarding every relevant financial statement assertion
    - Demonstrates that the underlying accounting records agreed or reconciled with the financial statement
  - All significant findings are required to be documented, including "uncertainties as well as related management assumptions."

IRS Interest in Tax Accrual Workpapers

The Service’s General Policy

- In *United States v. Arthur Young & Co.,* the Supreme Court held that tax accrual workpapers enjoy no special protection against disclosure to the Service.

- Nevertheless, in Announcement 84-46, the Service stated that it would demonstrate “administrative sensitivity” and generally would not request tax accrual workpapers.

- Until 2002, the Service would request tax accrual workpapers only in unusual circumstances.

The Service's New "Tax Shelter" Policy

- In 2002, responding to tax shelter developments, the Service adopted a new tax accrual workpaper policy, under which workpapers will be requested from taxpayers that engage in "listed transactions."

- The Service's goal was to reduce the corporate appetite for tax shelters by telling companies that, if they engage in "listed" tax shelter transactions, they will be required to disclose their tax accrual workpapers.

- The new policy was initially set forth in Announcement 2002-63, was augmented in LMSB Questions & Answers and in Chief Counsel Notice 2004-010, and was finally memorialized in Internal Revenue Manual section 4.10.20.

The Service's New "Tax Shelter" Policy

- If a taxpayer engages in one listed transaction, and properly discloses that transaction, the Service will request only the portion of the tax accrual workpapers concerning that transaction.

- However, the Service will request all tax accrual workpapers if:
  - The listed transaction is not properly disclosed, or
  - The taxpayer engages in multiple listed transactions, or
  - There are reported financial irregularities regarding the taxpayer.

- This new policy applies to tax returns filed after July 1, 2002 (some returns filed earlier also may trigger a request, if listed transactions were not disclosed).

Uncertain Tax Positions (Schedule UTP)

- Beginning in 2010, certain business taxpayers are required to report uncertain tax positions on Schedule UTP.
- In September 2010, the IRS released Announcement 2010-76 describing revisions to its Policy of Restraint as a result of the Schedule UTP requirements.
- The IRS announced that, if a document is otherwise privileged under the attorney-client privilege, the section 7525 tax practitioner privilege, or the work product doctrine and the document is provided to an independent auditor as part of an audit of the taxpayer's financial statements, the IRS will not assert during an examination that the privilege has been waived by such disclosure.
- Also, taxpayers may redact certain information related to the preparation of Schedule UTP from any tax reconciliation workpapers provided to the IRS.

Uncertain Tax Positions (Schedule UTP)

- The final regulations relating to Schedule UTP in Treas. Reg. § 1.6012-2(a)(4) and (5) do not contain any specific rules with respect to privilege.
- The preamble to the final regulations stated, "Provisions relating to the assertion of privilege are not included in this regulation, since it does not affect the existence of any applicable privileges taxpayers may have concerning information requested by a return or how they may assert those privileges."

Conflicts Between Taxpayers and the IRS Over Disclosure of Tax Accrual Workpapers

The Tug-of-War Over Tax Accrual Workpapers

- Because of the increasing number of “listed transactions” identified by the Service, the chance that a taxpayer’s tax accrual workpapers will be requested by the Service has increased significantly.

- “Listed transactions” also include transactions that are “substantially similar” to an expressly listed transaction.

- Regulations state that the “substantially similar” standard is to be broadly construed in favor of treating transactions as within the scope of the expressly listed transactions.

- Disclosure is required even for transactions that become listed transactions at a subsequent time.

The Tug-of-War Over Tax Accrual Workpapers

- As noted above, there is no special, blanket protection that can be claimed for tax accrual workpapers.

- However, when the Service requests tax accrual workpapers, a taxpayer may be able to assert three potential defenses:

  - Attorney-client privilege

  - Work product protection

  - The section 7525 tax practitioner-client privilege

- These defenses cannot be asserted broadly, but must be asserted and established on a document-by-document basis.

The Tug-of-War Over Tax Accrual Workpapers

- To prevail, the taxpayer first must prove that, given the circumstances in which each workpaper was created, the asserted privilege or protection initially applied to the document.
- This involves an analysis of:
  - What is the document?
  - Why was the document created?
  - Who created the document?
  - What are the contents of the document?
  - Was the document intended to be kept confidential?

The Tug-of-War Over Tax Accrual Workpapers

- To prevail, the taxpayer also must prove that, given the circumstances in which the workpapers were thereafter maintained, the asserted privilege or protection was not waived.

- This involves an analysis of:
  - Who within the company had access to the document?
  - Was the document stored in secure file?
  - Was the document disclosed outside the company?

- The privilege can be waived for a single document. Also, the disclosure of one document can waive the privilege for all documents that concern the same subject matter.

The Tug-of-War Over Tax Accrual Workpapers

- Tax accrual workpapers may not be privileged or protected if:
  - They are not created by or at the direction of persons who can create privileged or protected documents;
  - They contain solely business advice;
  - They were not intended to remain confidential.
- Tax accrual workpapers may lose any existing privileged status if:
  - They are widely distributed within the company;
  - They are not maintained in a secure fashion; or
  - They are turned over to a third party, including outside auditors.
- In either case, they may become subject to disclosure to the Service.

Can Tax Accrual Workpapers Be Privileged?

- In *El Paso Co.*, the Fifth Circuit said "we would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice."
  - The court held that disclosure to outside auditors waived any privilege.
  - The case was decided before the enactment of section 7525.
- In *Rockwell International*, the Third Circuit held that the determination of whether a tax reserve analysis is protected by the attorney-client privilege is dependent on several factors:
  - Does it represent legal advice, or business advice, of an attorney?
  - Who was involved in its preparation?
  - Who has control of the file?
  - Was it intended to be disclosed to third parties, such as an independent auditor?
  - Was it actually disclosed to a third party?
  - The court remanded to the trial court for factual findings on these factors
- The Service's position is that a company's auditor is a third party so that disclosure to the auditor waives privilege.
- As discussed later, in *U.S. v. Textron* the District of Rhode Island agreed that disclosure to an independent auditor waives privilege.

Can Workpapers Be Protected As Work Product?

- A tie to anticipated litigation must be firmly established.
  - The author of the document should be involved with tax litigation.
  - The document should be created, at least in part, because of the expectation of litigation.
  - The analysis should be used in making litigation decisions.
- Whether "dual purpose" documents are protected varies:
  - In "because of" jurisdictions, having a "dual" litigation and business purpose for creating a document does not prevent work product protection.
  - In "primary motivation" jurisdictions, the litigation purpose for creating the document must be primary (or even exclusive).
- Work product protection for legal analyses generally is not waived by disclosure (such as to outside auditors) because work product is usually waived only if disclosed to an "adversary."

Can Workpapers Be Section 7525 Privileged?

- The workpaper must be prepared by a qualifying "tax practitioner."
- The tax practitioner must be giving tax advice.
- The Service and the courts may presume that a tax practitioner is giving business advice, tax return advice, or financial statement advice.
- However, if the tax advice is similar to legal advice that would be attorney-client privileged, then the section 7525 privilege should apply.
- But, tax advice from non-lawyers regarding tax shelters is not protected.
- Also, the privilege can be waived through disclosure.

Textron Litigation

United States v. Textron

THE WALL STREET JOURNAL.

Tax Battle: IRS vs. Textron

The Maker of Aircraft and Golf Carts Tries to Keep Uncle Sam Out of Its Files

By Jesse Drucker

TEXTRON INC., AN AEROSPACE and defense contractor, is in an uphill legal battle with the Internal Revenue Service that could win U.S. corporations a significant new weapon in tax disputes.

The conglomerate is resisting demands by the IRS for internal documents about its use of allegedly abusive tax shelters. Tax collectors have become more aggressive in recent years in demanding such records, and most companies comply. Textron is the first company that the federal government has taken to court over the issue, the IRS says. Legal experts say the IRS has the upper hand in the fight, but tax lawyers are watching to see if the case alters the balance of power in corporate tax disputes.

It's unclear how much money is at stake. Textron makes Cessna Aircraft, Bell Helicopters, golf carts, lawn mowers and other products. It had revenue of about $10 billion in 2005, nearly a third of that from its Bell segment, which makes combat helicopters, armored vehicles, munitions and other defense products. Textron's stock, which closed yesterday at $86.67 on the New York Stock Exchange, has risen fairly steadily since the beginning of the Iraq war in early 2003, when it traded near $30.

In 2001, Textron bought several telephone networks and a railroad system overseas and then leased them back to their owners, according to a Justice Department court filing. Such arrangements can produce big tax benefits because depreciation can be claimed on the assets to reduce taxable income.

Some leasing transactions that reduce taxes are legitimate, but the IRS has tried to crack down on aggressive ones it calls "sale in, lease out" deals. In 2004, Congress outlawed future so-called SILOs, and the IRS ...

to SILOs. Toward that end, last year it ...

United States v. Textron: Facts

- IRS requests Textron's tax accrual workpapers: First reported case since *Arthur Young*.
- Presence of more than one listed transaction.
- Facts:
  - Attorneys prepared workpapers
  - Kept confidential
  - Content shared with accounting firm

United States v. Textron: Facts

- Content of tax accrual workpapers
  - List of issues (uncertain tax positions)
  - List of "hazards of litigation" conclusions, expressed as percentage chance of losing each issue in court
  - List of monetary value of each issue and reserve

United States v. Textron: Facts

- Attorneys involved: Different facts, different rules
  - Attorney/client privilege
  - FRCP 26(b)(3): Protection for work product

United States v. Textron: Issues

- Issues
  - Do workpapers include "legal advice?" If so,
    - Was attorney/client privilege waived by communication to accounting firm?
    - *See* IRC 7525 privilege for accountants providing tax advice.
    - Are auditors providing "tax advice" with respect to the items contained in tax accrual work papers?
  - Were workpapers (all or portion) prepared in anticipation of litigation? FRCP 26(b)(3) (rules relating to protected "work product.")
    - Are workpapers entitled to "super" protection because they contain "mental impressions and conclusions of attorneys?"
    - Was "work product" protection forfeited when papers were shared with accounting firm?

United States v. Textron: Issues

- Issues (continued)
  - Circuit courts have two different standards for work product protection; Fifth Circuit is most restrictive. To be work product, papers must be primarily prepared for litigation.
  - In *El Paso* (1982), Fifth Circuit rejected taxpayer's "work product" argument.
  - Most other circuits reject this rule and follow what is called "dual purpose" rule.
  - Under the "dual purpose" rule, work product can be "in anticipation of litigation" even if in the first instance it was prepared for non-litigation business purpose. *See State of Maine* (C.A.1).

United States v. Textron: Decision

- Court denied IRS petition to enforce summons
- Court reached the following conclusions:
  - Privilege
    - Tax accrual work papers were initially protected by attorney-client privilege and sec. 7525 tax practitioner-client privilege
    - However, the privileges were waived when the workpapers were disclosed to Textron's independent auditors
  - Work Product
    - Tax accrual work papers were protected by work product because they would not have been prepared "but for" the fact that Textron anticipated the possibility of litigation with the IRS.
      - *El Paso* case distinguished because it applied a "primary purpose" test. "Because of" or "But for" test controls in the First Circuit.
    - Work product protection was <u>not</u> waived because disclosure to independent auditors did not substantially increase the opportunity for potential adversaries (i.e., the IRS) to obtain the information.

United States v. Textron: Initial Appeals Court Decision

- The First Circuit initially upheld the decision of the District Court.
- In the initial hearing, the First Circuit considered three issues: (1) whether the work-product doctrine protects Textron's workpapers; (2) whether any such work-product protection was waived through disclosure to E&Y; and (3) whether the district court erred in not considering the IRS's request for E&Y's workpapers.
- The First Circuit concluded that the "ordinary course of business" exception to the work product doctrine could not be applied to require disclosure of all documents prepared with some business purpose in mind. Accordingly, the First Circuit found that dual purpose documents prepared by Textron may be protected under the work product doctrine.
- Although affirming the holding of the District Court regarding work product protection, the First Circuit remanded the case to the District Court to resolve factual issues relating to the discoverability of certain workpapers prepared by Textron's attest auditors. This group of workpapers was distinct from the workpapers prepared by Textron's in-house attorneys.
  - The workpapers at issue were prepared and retained by the attest auditors. The First Circuit observed that "Arthur Young suggests such documents are not protected and Textron has not argued otherwise."
  - As described by the First Circuit, the issue with respect to discoverability was whether Textron was considered to have possession, custody, or control of these documents, even though the documents were retained by the attest auditors. This was the issue because the summons in question was issued to Textron, not the attest auditors. The First Circuit stated that Textron may be considered to have possession, custody, or control if it has a right to access or obtain the documents from the attest auditors. The First Circuit remanded the case to the District Court to resolve this question.

United States v. Textron: Appeals Court Rehearing *En banc*

- The First Circuit vacated its initial decision and reheard the appeal *en banc*.
- The *en banc* court, divided 3-2, held that the workpapers were not protected by the work product doctrine because they were not prepared "in anticipation of litigation." According to the majority, "the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron's workpapers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters."
- The dissent criticized the majority for abandoning, but not overruling, the First Circuit's adoption of the "because of" test in *Maine v. United States*.
- According to the dissent, "the majority purports to follow *Maine*, but really conducts a new analysis of the history of the work-product doctrine and concludes that documents must be '*prepared for* any litigation or trial.'" The dissent argued that the "prepared for" rule was contrary to the broader "because of" rule and inconsistent with the policy of the work product doctrine.

Regions Financial Corporation v. United States (N.D. Ala. 2008)

- The Northern District of Alabama recently held in favor of the taxpayer and determined that documents were protected by work product from disclosure to the IRS.
- In *Regions*, the documents at issue contained legal opinions and analysis from a law firm and evaluations of that analysis by Regions' auditors. The documents at issue also included certain "derivative documents" that discussed conclusions in the "core documents."
- The court determined that all the documents were protected by work product and that disclosure of the legal analysis of the law firm to the auditors did not waive protection.

Regions Financial Corporation v. United States (N.D. Ala. 2008)

- The court determined that the primary purpose standard applicable in the Fifth Circuit did not apply in the Eleventh Circuit. The court adopted the majority "because of litigation" standard.
- The court criticized the IRS for misciting *United States v. El Paso*, 682 F.2d 530 (5th Cir. 1982) and claiming the opinion stated the standard as "primarily or exclusively to assist in future litigation" rather than "primarily to assist in future litigation."
- Regardless, the court determined that the documents at issue would be protected under either the "primary motivating purpose" test or the "because of litigation" test.
- The court noted that it "has found no support for the conclusion that a party must show that it was motivated by preparation for litigation and nothing else in order to claim that a document is protected work product."
- The court concluded that Regions met its burden of demonstrating that the documents were prepared in anticipation of litigation. The court stated, "[t]he fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities shows that it believed litigation to be likely, and this court cannot say that Regions' subjective believe was objectively unreasonable."

Regions Financial Corporation v. United States (N.D. Ala. 2008)

- The court concluded that the fact that Regions provided the documents to its auditors did not waive work product protection because the auditor was not a potential adversary.
- The court stated, “There is simply no conceivable scenario in which [the auditor] would file a lawsuit against Regions because of something [the auditor] learned from Regions’ disclosures.”

United States v. Deloitte, Case No. 08-411 (D. D.C. June 8, 2009) – District Court Decision

- The United States sought to compel Deloitte to produce two categories of documents related to a civil tax refund case brought by partnerships formed by subsidiaries of the Dow Chemical Company (referred to as the Chemtech partnerships or "Chemtech").
  - First Category. Three documents Deloitte USA was withholding on the basis of privileges asserted by Dow, including
    - June 2005 tax opinion related to Chemtech
    - September 1998 legal and tax analysis provided by an in-house attorney at Dow
    - July 1993 internal Deloitte USA memorandum recording thoughts and impressions of Dow's attorneys concerning tax issues related to Chemtech
  - Second category. All responsive documents maintained at Deloitte USA's affiliate in Zurich, Switzerland (referred to as "Deloitte Switzerland")
- The District Court for the District of Columbia held that the three documents in the first category were protected from disclosure by the work product doctrine because they were prepared in anticipation of future litigation over the tax treatment of Chemtech. The court held that the protection was not waived by disclosure to Deloitte USA because Deloitte USA, as Dow's independent auditor, was not a potential adversary, and no evidence suggested that it was unreasonable for Dow to expect Deloitte USA to maintain confidentiality.
- The court also denied the motion to compel with respect to the second category of documents. The court held that Deloitte USA did not have sufficient control over the documents maintained at Deloitte Switzerland to enable their production. The court stated that the government failed to establish that Deloitte USA had the "legal right, authority or ability to obtain documents upon demand" from Deloitte Switzerland. The court determined, "Close cooperation on a specific project does not per se, establish an ability, let alone a legal right or authority, on Deloitte USA's part to acquire documents maintained solely by a legally distinct entity.

United States v. Deloitte, No. 09-5171, (D.C. Cir. June 29, 2010) – Appeals Court Decision

- The United States appealed the District Court's decision with respect to the three documents withheld by Deloitte: (i) June 2005 tax opinion related to Chemtech; (ii) September 1998 legal and tax analysis provided by an in-house attorney at Dow; (iii) July 1993 internal Deloitte memorandum recording thoughts and impressions of Dow's attorneys concerning tax issues related to Chemtech.
- The government argued that the 1993 internal Deloitte memorandum was not work product because (i) it was prepared by Deloitte, not Dow or Dow's counsel; and (ii) it was generated as part of the audit process, not in anticipation of litigation.
  - The D.C. Circuit rejected the government's categorical arguments with respect to the first document prepared by Deloitte. The court stated that Deloitte's preparation of the document does not exclude the possibility that it contains Dow's work product. The court also stated that a document can contain protected work product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation.
  - However, the court determined that the District Court did not have sufficient evidentiary foundation for its holding that the Deloitte memorandum was purely work product. The court therefore remanded so that the District Court could conduct an *in camera* review of the document and determine whether it was entirely work product, or whether a partial or redacted version of the document could be disclosed.
- The government also argued that the other two documents were not protected from disclosure because Dow waived work product protection by disclosing the documents to Deloitte.
  - The D.C. Circuit rejected this argument and concluded that (i) Deloitte was not a potential adversary with respect to the litigation that the documents address and (ii) Deloitte was not a conduit to potential adversaries because Dow had a reasonable expectation of privacy as a result of Deloitte's obligation to refrain from disclosing confidential information.

Does Work Product Protection extend to tax reserve numbers and calculations?

- The workpapers at issue in *Textron* contained attorney analysis and support for tax reserve numbers established by *Textron*.
- The taxpayer's case may have been even more difficult if the information at issue was limited to the reserve numbers themselves and did not contain any attorney analysis.
- Arguably the reserve numbers are the result of the attorney analysis and therefore should be treated the same as the "hazards of litigation" information used to determine the reserves. However, the reserve numbers themselves are reflected in financial statements and therefore may be difficult to protect as work product.
- The calculations to determine the reserves are arguably more similar to the "hazards of litigation" information at issue in *Textron*.
- In *Regions*, the court mentioned in a footnote that "[t]he documents Regions seeks to withhold are less broad than those withheld in Textron because Regions has already disclosed the fact and amounts of its reserves."

Potential Impact of FIN 48

Issues Arising in IRS Audits in FIN 48 World

- FIN 48 workpapers are tax accrual workpapers.
- Former IRS Large and Mid-Size Business Commissioner Deborah Nolan, speaking at a DC Bar program April 12, 2007, said the IRS is currently considering whether its "policy of restraint" regarding tax accrual work papers should be changed.
- However, acting IRS commissioner Linda Stiff, speaking at a TEI event on October 22, 2007, stated that the IRS had no current plans to change the policy of restraint. Stiff did, however, note that IRS agents were being trained on financial statement analysis and FIN 48.
- It is unclear what affect, if any, the IRS win in *Textron* will have on IRS policy.

Issues Arising in IRS Audits in FIN 48 World

- Since the IRS treats FIN 48 workpapers as tax accrual workpapers, taxpayers without listed transactions should use IRS policy to protect these documents.
    - Restraint in asking for tax accrual workpapers is IRS policy. Accordingly, it should not be necessary to raise privilege to protect such documents in the ordinary course; but, the policy could change.
    - Taxpayers should rely on the IRS "restraint policy" where appropriate.
    - If "unusual circumstances" are <u>not</u> present, taxpayers should be able to oppose a request for FIN 48 workpapers.

Issues Arising in IRS Audits in FIN 48 World

- Issues where taxpayers have listed transactions.
  - FIN 48 workpapers may contain very sensitive information concerning litigation/settlement "hazards" analysis.
    - Highly prejudicial if obtained by IRS.
    - Where FIN 48 workpapers are requested, taxpayer must examine facts and law to determine if documents are privileged or protected work product.

Subsequent Recognition – Proposed FASB Staff Position

- FSP FIN 48-a Exposure Draft released February 27, 2007
- Guidance on determining whether previously unrecognized tax position is "effectively settled;" term "ultimate settlement" dropped
  - Taxing authority completed all exam procedures it is required or expected to perform for the tax position
  - No appeal or litigation is intended for any aspect of the tax position
  - Based on taxing authority's "widely understood policy," enterprise considers it highly unlikely that the tax position would be subsequently examined or reexamined, presuming taxing authority has full knowledge of all relevant information
- Final FSP will be effective upon initial adoption of FIN 48; An entity that did not apply FIN 48 consistent with the final FSP FIN 48-a will be required to apply the provisions of FSP FIN 48-a retrospectively to the date of the initial adoption of FIN 48.

Recommendations

General Policies

What Steps Can be Taken to Protect Privileged Documents and Communications from Disclosure to the Service?

- Be certain to include counsel meaningfully in communications regarding legal issues, and document their substantive role.
- Coordinate with General Counsel with respect to privileged tax documents to avoid waiver of privilege in other litigation
- Avoid inappropriate claims of privilege on documents
  - Risk of waiver
  - Credibility issues
- Enter into written agreements through counsel with third-party consultants to whom you wish to disclose privileged information (e.g., *Kovel* arrangement).
- Be aware of the potential limitations of the accountant-client privilege, particularly when considering whether to disclose sensitive documents in the context of the preparation of an opinion letter.

What Steps Can be Taken to Protect Privileged Documents and Communications from Disclosure to the Service?

- Communications between your independent auditors and your tax advisors may not be privileged; Negotiate with auditors to try to limit scope of documents reviewed, where possible.
- Par 22 of AU 326 states that ”the auditor should obtain the access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege.”
- Be aware that the disclosures of information or documents (e.g., tax opinions) to the Service pursuant to the taxpayer disclosure regulations (Treas. Reg. § 1.6011-4) may result in a subject matter waiver of the attorney-client privilege that could reach a wider range of privileged communications.

How Should Privileged, Sensitive Documents be Handled?

- Only disclose legal documents with respect to an issue to other employees/officers on a need-to-know basis.
  - The wider the distribution, the more likely it is that a court will find there has been a waiver.

- Separate and clearly mark legal documents to avoid an inadvertent waiver of privilege/work-product protection.
  - This not only protects against waiver, but can demonstrate intent.

- No privilege will attach to business documents, so store business documents in a separate location from the legal documents.

Formalize a Tax Litigation Group

- In general:
  - The Group advises the Company on the conduct of tax controversies and litigation, and advises the Company on the hazards of litigating tax issues.
    - In smaller companies, the Group does not necessarily need to consist of separate employees. However, the employees should be clearly delineated when functioning in the Group's role.
  - The Company relies on the Group's advice in deciding whether and how to proceed in litigation, whether to settle, and what settlement terms to propose or accept.
- The Group's primary purpose is handling tax controversies. In that role, it provides hazards-of-litigation analysis and legal advice regarding the Company's tax litigation.
- Secondarily, the Company uses the Group's hazards-of-litigation advice in establishing financial statement tax reserves.

Formalize a Tax Litigation Group

- The Group's leader should be an attorney, and:
  - Should be responsible for managing tax litigation
  - Should have at least a dotted line to the law department (to enjoy a presumption that the attorney-client privilege applies)
- The Group's work should be done under the leader's direction and control.
- Group members, to the extent possible, should be attorneys or act at the direction of attorneys.
- The Group should exclude persons whose responsibilities are solely the preparation of financial statements.

Control Who Creates Documents

- Documents should be created at the direction of, and under the control and supervision of, the Group's leader.

- Documents should indicate that they are prepared by attorneys or tax practitioners.

- Documents should indicate that they are prepared at the request of the Group leader for litigation purposes.
  - Careful and discriminating use of such labels is imperative.

Create Only Defined Types of Documents

- In general:
  - Confine legal analysis to litigation-oriented documents that are most entitled to privilege and work product protection
  - When creating documents, separate legal analysis from:
    - Business advice
    - Tax reserve numbers and calculations
    - Other advice not intended to remain confidential
- Create documents for disclosure outside the Group that contain:
  - Only hazards-of-litigation percentages
  - Only aggregate reserve information

Control How Documents Are Labeled

- Documents should state that they are providing legal advice to be used for litigation purposes.
- Documents should be labeled, as appropriate, to state that they contain confidential legal advice, subject to privilege and protected by the work product doctrine.
- Do not label business advice, tax return advice, or other advice not intended to be confidential, as privileged or protected.
- Do not label documents containing legal analysis and advice as documents that relate to tax reserve analysis or tax contingency analysis.

Control Access to Documents Inside the Company

- Restrict access to confidential documents.
- In each instance, distribute the least confidential document possible.
- Establish a central storage file, and restrict access to it.
- Password protect electronic files.
- Discourage the keeping of personal files, paper and electronic.
- Avoid "broadcast" emails and limit email "chains."
- Do not place legal memoranda and analyses into tax accrual workpaper files.

Enact Policies to Identify Anticipated Litigation

- Make use of document hold requests to communicate that litigation is anticipated.
- Consider formal guideline that certain counsel must be involved in issues expected to result in litigation, and then include such counsel only when litigation is expected.

Working with Your Auditors to Protect Work Product

- Enter into a confidentiality agreement with the auditors.

- Enter into a common interest agreement with the auditors, specifying that the Company is providing access to documents solely for the purpose of the parties' common interest in performing the audit, that confidentiality will be maintained, and that no waiver of privilege is intended.

- Include in auditor engagement letters a representation regarding non-adversarial relationship.

- The general rule is that, with respect to an attorney's analysis and mental impressions, work product protection cannot be waived merely by disclosure.
  - Try to avoid disclosure of the documents most clearly prepared in anticipation of litigation if auditor's rules so permit.

Handle IRS Requests for Information With Care

Negotiate Disclosures to the Service

- Require approval of the Group's leader before documents are disclosed to the Service.
- Establish a screening process to prevent disclosures that could result in a waiver of privilege.
- In tax accrual workpaper IDR responses, emphasize the litigation function of the Group, and emphasize the legal content and confidential nature of the documents.
- Prepare a detailed privilege log, stating the specific grounds that support the claim for privilege and protection.
- Be careful about representations to the Service when negotiating disclosure.

Negotiate Disclosures to the Service

- Consider disclosing the least confidential documents to the Service.
  - Do not seek protection for non-confidential documents.
  - Disclose to the Service those documents that contain no legal analysis or advice.
  - Beware of creating a subject matter waiver.

- Focus the controversy on the most protected documents.
  - Withhold those documents that contain legal analysis and advice.
  - Force the Service to determine whether it wishes to press the issue against a taxpayer that has cooperated, but that has taken careful steps to create and maintain confidential documents.

Other Pre-Audit Issues

Pre-Filing Agreement (PFA) Program

And

Compliance Assurance Process (CAP)

Is There Anything I Can I Do Before I File or When I File My Return?

- Taxpayers can be proactive and resolve tax issues before a return is even filed or by disclosing issues on the tax return itself.

- The Service offers two methods for pre-filing dispute resolution:
  - Pre-Filing Agreement (PFA) Program
  - Compliance Assurance Process (CAP)

Pre-Filing Agreement (PFA)

- Some issues can be resolved under the Service's Pre-Filing Program.
- A Pre-Filing Agreement (PFA) can be used to resolve factual issues and issues involving the application of well-established legal principles to stipulated facts.
- Note: PFAs cannot be used to resolve uncertain legal issues. If the taxpayer wants comfort regarding a legal issue that is not well-settled, the taxpayer can request a private letter ruling. Rev. Proc. 2010-1.

Pre-Filing Agreement (PFA)

- Under the original PFA program, certain taxpayers could request a pre-filing examination of certain issues in a year for which a tax return was not yet due. Rev. Proc. 2001-22. The program was extended through 2006 in Rev. Proc. 2005-12, extended through 2008 in Rev. Proc. 2007-17, and made permanent in Rev. Proc. 2009-14.
- Issues resolved in a PFA are permanently and conclusively resolved for the year(s) covered by the PFA.

Compliance Assurance Process (CAP)

- The Service formally announced Compliance Assurance Process (CAP) in December 2005. See IRS Announcement 2005-87, 2005-50 C.B.
- The program is designed to resolve all material tax issues before a return is filed. Seventeen taxpayers participated in the program in 2005, and another 22 taxpayers were invited to participate in 2006. In 2007, there were 73 taxpayers participating. See IRS Advisory Council Public Meeting Book, 2007. By the end of 2009, there were approximately 110 taxpayers participating. See "News Analysis: An Ad for the Cap Program," 125 Tax Notes 1252 (Dec. 21, 2009)
- Under CAP, an examining agent will work as an "account coordinator" with a taxpayer on getting "full disclosure of information" regarding "completed business transactions" prior to filing a return.
- All information provided to the Service through this program will be protected from disclosure by the confidentiality provisions contained in section 6103.

Compliance Assurance Process (CAP)

- If an agreement is reached, the Service will issue an acceptance letter that will minimize the need for post-filing review. Under this program, it may be possible for a taxpayer to file a return with signed closing agreements on all of the issues, thus eliminating the need for a future audit of the return.

- If all issues are not resolved prior to filing, CAP identifies the remaining issues which may be resolved through more traditional examination processes.

Disclosures to Avoid Penalties

Disclosing Issues Before Examination

- Taxpayers may be able to avoid tax penalties by disclosing issues on their tax return.
- If the item is related to a "tax shelter," disclosure alone will not prevent the imposition of penalties.
- Some issues may be disclosed on Qualified Amended Returns.
- "Audit File" disclosures are available to large taxpayers.

Can I Avoid Tax Penalties By Disclosing Issues on The Tax Return?

- Rules for non-tax shelter transactions:

§ 6662 Penalty	**Ways to Avoid**
Negligence	Reasonable cause and good faith: § 1.6664-4 Reasonable basis for the position: § 1.6662-3(b)(1) Qualified Amended Return: § 1.6664-2(c)(2) - (4)
Disregard of Rules or Regulations	Reasonable cause and good faith: § 1.6664-4 Reasonable basis for the position plus adequate disclosure: § 1.6662-3(c) Qualified Amended Return: § 1.6664-2(c)(2) - (4)
Substantial Understatement	Reasonable cause and good faith: § 1.6664-4 Substantial authority for the position: § 1.6662-4(d) Reasonable basis for the position plus adequate disclosure: § 1.6662-4(e), (f) Qualified amended return: § 1.6664-2(c)(2) - (4)
Substantial Valuation Misstatement	Reasonable cause and good faith; § 1.6664-4

Should I Disclose Transactions?

- Section 6011 may require a disclosure.
- Pursuant to section 6011, the Service has issued regulations that require the disclosure of certain types of transactions. Treas. Reg. § 1.6011-4. Successive versions of these regulations, applicable to different time periods, have been issued over the years.
- In February 2003, the Service issued final regulations effective for "reportable transactions" occurring on or after January 1, 2003. The regulations require that taxpayers that participate, directly or indirectly, in a "reportable transaction" must file a disclosure statement with their tax return, and with the IRS Office of Tax Shelter Analysis, for each year that is affected by the reportable transaction.
- The regulations describe five classes of reportable transactions: Listed transactions, confidential transactions, transactions with contractual tax benefit loss protection, transactions generating significant losses, and transactions of interest.
  - A "transaction of interest" is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest. See Treas. Reg. § 1.6011-4(b)(6).

Should I Disclose Transactions?

- Required disclosure must be made on Form 8886.
- If a taxpayer does not make a required disclosure, such failure by the taxpayer will be treated as strong evidence that the taxpayer did not act in good faith with respect to the portion of any underpayment attributable to the transaction. Treas. Reg. § 1.6664-4(d).
- Thus, a taxpayer who fails to disclose a reportable transaction is unlikely to prevail in asserting the reasonable cause defense to the accuracy-related penalty.

Should I Disclose Transactions?

- Section 6662A imposes a 20% accuracy-related penalty on “reportable transaction understatements.” For purposes of section 6662A, a “reportable transaction” is (1) a listed transaction, or (2) a reportable transaction, if a significant purpose of the transaction is the avoidance or evasion of Federal income tax. The penalty is increased to 30% if the transaction is not properly disclosed by the taxpayer. See Notice 2005-12 for interim guidance regarding the section 6662A penalty.
- In addition, section 6707A imposes a penalty on taxpayers who fail to file required disclosures with respect to a reportable transaction. The amount of the penalty is $10,000 for individuals and $50,000 for corporations. If a taxpayer fails to disclose a listed transaction the penalty is increased to $100,000 for individuals and $200,000 for corporations. Section 6707A is effective for returns that are due after October 22, 2004.
- Note that the section 6707A penalty can be imposed in addition to the section 6662 or section 6662A accuracy-related penalty, and that this penalty can be imposed regardless of whether the reportable transaction causes an understatement of tax. See Notice 2005-11 for interim guidance with respect to the section 6707A penalty. See also Rev. Proc. 2007-21 for guidance with respect to requesting rescission of a section 6707A penalty.

Should I Disclose Transactions?

- If an item is a "tax shelter," merely having a reasonable basis for the position and disclosing the item will not avoid exposure to penalties. Code § 6662(d)(2)(C); Treas. Reg. § 1.6662-4(e)(2) and (g).
- Penalties, however, may be avoided by filing a timely Qualified Amended Return and paying the tax and interest associated with the item. The payment of tax is treated as tax shown on the original return and eliminates the underpayment on which the penalty is based. Treas. Reg. § 1.6664-2(c)(3).
  - If an item is not a "tax shelter," penalties may also be avoided by filing a timely Qualified Amended Return that discloses the position and does not pay the associated tax and interest.
    Treas. Reg. § 1.6664-2(c)(4).

Should I Disclose Transactions?

- An amended return will be a "qualified amended return" only if it is filed before:
  - (1) the date an IRS examination of the taxpayer (or a pass-through entity for which the taxpayer reports a pass-through item) begins;
  - (2) the date a tax shelter promoter examination begins with respect to an activity for which the taxpayer claimed a tax benefit;
  - (3) the date a John Doe summons is served on a third party with respect to an activity of the taxpayer for which the taxpayer claimed a tax benefit; and
  - (4) the date on which the Commissioner announces a settlement initiative to compromise or waive penalties with respect to a listed transaction. Treas. Reg. § 1.6664-2(c)(3)(i).

Should I Disclose Transactions?

- If a taxpayer fails to disclose a listed transaction for which a tax benefit is claimed, an amended return will be treated as a Qualified Amended Return only if it is filed before:
  - (1) the dates described above for Qualified Amended Returns in general;
  - (2) the date the Service first contacts a person regarding an examination of that person's liability for penalties under section 6707(a) with respect to the undisclosed listed transaction of the taxpayer; and
  - (3) the date on which the Service requests from a taxpayer's material advisor (or any person who made a tax statement for the benefit of the taxpayer) the information required to be included in a list under section 6112 relating to a transaction that is the same as, or substantially similar to, the undisclosed listed transaction. Treas. Reg. § 1.6664-2T(c)(3)(ii).

Should I Disclose Transactions?

- When a tax shelter is involved, instead of being protected by mere disclosure, the taxpayer must be able to justify its position on the merits in order to avoid penalties (in situations where the tax benefits of the transaction were claimed on the original return).
- Noncorporate taxpayers may exclude tax shelter items from the amount of any understatement subject to penalty if there is substantial authority for the treatment of the item and the taxpayer reasonably believes the position is more likely than not correct. Code § 6662(d)(2)(C)(i); Treas. Reg. § 1.6662-4(g)(1)(i).

Should I Disclose Transactions?

- Corporate taxpayers must instead rely on the reasonable cause and good faith exception in section 6664. See Code § 6664(c); Treas. Reg. § 1.6664-4(g)(1)(iv). To avoid penalties, a corporate taxpayer's legal justification for its tax treatment of a tax shelter item or transaction must satisfy two requirements:
  - (1) there must be "substantial authority" for the treatment of the item (the "authority" requirement) and
  - (2) based on all the facts and circumstances, the corporation must have reasonably believed, at the time that the tax return was filed, that the tax treatment of the item was more likely than not the proper treatment (the "belief" requirement). Treas. Reg. § 1.6664-4(f)(2).
- Further, even if a corporate taxpayer satisfies the authority and belief requirements above, such corporate taxpayer may not be considered to have acted with reasonable cause and good faith and penalties may still be imposed. "[S]atisfaction of the [authority and belief] minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter." Treas. Reg. § 1.6664-4(f)(3).

Should I Disclose Transactions?

- LMSB has developed an Abusive Tax Shelters Mandatory Information Document Request for examinations started after April 23, 2002, which seeks information regarding listed transactions.
- Note that section 6111, as amended in 2004, requires each "material advisor" with respect to a "reportable transaction" (as defined in section 6707A(c)) to file a return describing the transaction and the potential tax benefits expected to result from the transaction. This provision is effective for returns due after October 22, 2004.
- If a material advisor fails to file a return required under section 6111, a penalty of $50,000 will be imposed for such failure. I.R.C. § 6707. In the case of listed transactions, the penalty is increased to the greater of $200,000 or 50% of the gross income derived by the material advisor with respect to the aid, assistance, or advice provided with respect to the transaction.

Should I Disclose Transactions?

- Moreover, section 6112, as amended in 2004, requires each material advisor with respect to a “reportable transaction ” (as defined in section 6707A(c)) to maintain a list of investors in such transaction.

- This provision is effective for aid, advice, or assistance given by the material advisor after October 22, 2004.

- If a material advisor who is required by section 6112 to maintain an investor list fails to make the list available to the Service in a timely manner, the advisor will incur a penalty of $10,000 per day, unless the failure is due to reasonable cause. I.R.C. § 6708.

Should I Disclose Transactions?

- The economic substance codification provision that passed as part of the Health Care Reconciliation Act revised the accuracy related penalty under section 6662.
- Section 6662 now imposes a strict liability penalty for an understatement attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or "failing to meet the requirements of any similar rule of law." See Section 6662(b)(6).
- The penalty is 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return and 20 percent if the transaction is adequately disclosed. See Section 6662(i)
- The meaning of "the requirements of any similar rule of law" is unclear. Footnote 359 in the Joint Committee on Taxation's technical explanation of the provision states, "It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis even if a different term is issued to describe the doctrine."

Uncertain Tax Positions (Schedule UTP)

- Under Treas. Reg. § 1.6012-2(a)(4), certain corporations are required to file a Schedule UTP, Uncertain Tax Position Statement.
- Generally, a corporation must report a tax position on its Schedule UTP when
  - (1) it has taken the position on its federal income tax return for the current tax year or a prior tax year, and
  - (2) the corporation or a related party issues audited financial statements for all or a portion of the corporation's tax year and those financial statements either record a reserve with respect to that position for federal income tax or those financial statements do not record a reserve because the taxpayer expects to litigate the position.
- However, if an uncertain tax position is listed on a Schedule UTP once, it need not be listed again in a later year.
- The Schedule UTP instructions require a corporation to rank all of the reported tax positions (including transfer pricing and other valuation positions) based on the United States federal income tax reserve (including interest and penalties) recorded for the position taken on the return, and to designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the tax positions reported on the schedule.

Uncertain Tax Positions (Schedule UTP)

- In Announcement 2010-75, the IRS announced that it will implement a five-year phase-in period for Schedule UTP for corporations with total assets under $100 million.
- Corporations that have total assets equal to or exceeding $100 million must file Schedule UTP starting with 2010 tax years. The total asset threshold will be reduced to $50 million starting with 2012 tax years and to $10 million starting with 2014 tax years.
- The IRS stated that it is still considering whether to extend all or a portion of Schedule UTP reporting to other taxpayers, such as pass-through and exempt entities, for 2011 or later tax years.

Can I Disclose Issues To The Service After The Tax Return Is Filed?

- In addition to Qualified Amended Returns, a taxpayer may utilize "Audit File" Disclosures.
- Large taxpayers are subject to the Coordinated Industry Case (CIC) Program (formerly Coordinated Examination Program (CEP)) and are audited for every year.
- Errors, affirmative issues, and other items may be disclosed by a CIC taxpayer to the Service at the start of the examination. The disclosure statement is treated as a Qualified Amended Return if certain requirements are satisfied. Treas. Reg. § 1.6664-2(c)(4); Rev. Proc. 94-69.
- This disclosure procedure will not prevent imposition of penalties if the disclosed item is attributable to a tax shelter.

The Exam

Introduction and Key Concepts

What Should You Do at the Beginning of the Audit?

- Develop a working relationship with your examination team
  - Set procedural ground rules for access to documents, use of company facilities, etc.
  - Get to know your examiners on a personal basis
- Establish ground rules for the structure of the audit
  - Select a primary contact for the examination team to work through
  - Negotiate scope of the audit
    - Investigate whether a Limited Issue Focused Examination (LIFE) is available
    - Discuss parameters for the number of Information Document Requests (IDRs) and employee interviews
  - Negotiate timing of the audit
    - Discuss time parameters for completing the audit, extending the statute of limitations

What Should You Do During the Course of the Audit?

- Consider presenting potentially significant issues to Exam up front
  - Establishes good and trusting relationship with Exam
  - Allows opportunity to set tone and primary considerations for resolution of the issues
- Proactive steps to optimize success on outstanding issues with Exam
  - Provide positive documents to the examination team up front, potentially limiting broader future requests.
  - Be cooperative, but not to your detriment.
    - Do not volunteer witnesses for interviews unless requested.
    - Limit your responses to IDRs to the questions asked.
  - Keep the audit on schedule.
    - Do not give the examination team a reason to extend the audit or address additional transactions/issues by not responding timely or completely to IDRs.
    - Stay in contact with the examination team on a regular basis.

What Role Should Outside Counsel Play?

- Assisting in the drafting of IDR responses
- Reviewing documents for privilege or work product protection
- Preparing witnesses for interviews and defending interviews
- Assisting with the drafting of responses to IRS proposed legal conclusions (Form 5701s) and Revenue Agent Reports (RARs)
- Playing the “bad cop” with respect to particular issues that arise during the course of the audit

Basic Exam Procedures

How Does The Service Conduct Field Examinations?

- The Service is authorized by statute to conduct examinations. Code § 7601.
- The time and the place of the examination must be “reasonable under the circumstances.” Code § 7605.
- Revenue agents have broad examination powers, and it is difficult to limit the examination.

Can The Taxpayer Control The Process?

- Taxpayers should ask the Service for an audit plan and a time table.
- Taxpayers should designate persons to whom the Service can direct requests for information, and should ask that the Service submit its requests for information in writing, i.e., by submitting IDRs.

How Much Time Does the Service Have To Audit?

- Section 6501 imposes a period of limitations on the Service's ability to assess deficiencies.
- Tax deficiencies must be assessed within 3 years after the filing of the return. (Under Code § 6501(c) and (e), some special rules may apply, *e.g.*, in the case of fraud, substantial omissions, etc.)
- Section 6501(c)(4) provides that the assessment period may be extended by agreement. Extensions of the assessment period are made using Form 872. (Special forms may be used in certain cases, *e.g.,* Form 872-F, 872-P, 872-S, etc.)

Do I Have To Agree To An Extension of Time?

- A taxpayer may refuse to extend the assessment period.
- However, the Service is permitted to protect itself by issuing a statutory notice of deficiency that asserts a blanket assessment.
- Taxpayers often extend the assessment period for relatively short time periods, so they can retain some control over timing.
- Alternatively, taxpayers may offer to extend the assessment period only with respect to particular issues.

Dealing with IRS Requests for Information

How Should I Respond To IRS Requests For Information?

- Revenue agents are authorized to examine books and records, and to examine persons. Code § 7602(a)(1). Agents ask for information using Form 4564, Information Document Requests (IDRs).
- If the taxpayer fails to produce the required information or person, the Service may issue an administrative summons. Code § 7602(a)(2).
- Care must be taken to read IRS information requests closely. If a request is ambiguous or incomplete, the taxpayer must consider whether it has options to comply narrowly or broadly, and must weigh the pluses and minuses of those options.
- Care must be taken when an IRS request for information encompasses information and documents that are privileged or protected.

How Should I Respond To IRS Requests For Information?

- The Service can request to interview employees. Sometimes the Service will accept written responses in lieu of an employee interview. This permits the taxpayer to provide a more considered response. If the Service insists on an interview, great care should be exercised.
- The scope of the interview, and the topics to be addressed, should be negotiated. The questions to be posed should be requested in advance of the interview. Preparation is crucial.
- The Service may record the interview. Alternatively, the examining agents may simply take notes.

Dangers of the Interview as "Deposition"

- The Service can take testimony under oath, and have it transcribed by a court reporter. I.R.C. § 7602(a)(2).
- Such testimony will constitute a "prior statement" that may be used to impeach the witness in later proceedings.
- The interview is effectively the same as a deposition.
- IRS counsel (or the agent) may conduct the questioning.
- The Service may use the interview to:
  - Lock the witness into specific factual testimony
  - Establish that the witness has no recollection of certain facts
- Note that this is occurring very early in the controversy process.
- Whether the interview is recorded or not, there can be serious repercussions for providing false or misleading information.

Ability to Participate in the "Deposition"

- The case law uniformly holds that the taxpayer has no right to attend or participate in the questioning, holding that:

  "Neither taxpayers nor their attorneys have the right to be present when the summoned parties produce records nor to participate actively in such proceedings. Nor does the taxpayer have a right to be present and cross examine witnesses when the IRS agent questions them."

  Daffin (4th Cir. 1981); *Traynor* (10th Cir. 1979); *Newman* (5th Cir. 1971); *Jones* (D.C.S.C. 1999); *Lamberth* (E.D. Va. 1979)

Ability to Participate in the "Deposition"

- However, the person summoned does have the right to legal counsel, and to the counsel of his choice. IRM 25.5.5.4.2.
- Counsel for the taxpayer may, unless a conflict exists, and after full and complete disclosure, represent the witness. IRM 25.5.5.5.
- The Service calls this a "dual representation."
- Circular 230 does not prevent attorneys from representing both parties, if there is express consent of the parties after full disclosure.
- The IRM states that dual representation is permitted, unless the attorney seeks to impede or obstruct the interview.
- Obstruction occurs if the attorney makes "frivolous objections," asserts "frivolous privileges" or otherwise disrupts the interview.

Ability to Participate in the "Deposition"

- Moreover, the IRM states that the person summoned "is permitted to have other persons present during the interview." IRM 25.5.5.4.8. The person summoned can request the taxpayer's presence.
  - However, when a witness appears pursuant to a summons and is accompanied by a person (other than the taxpayer) who does not represent the individual witness, the IRS may request that such person be excluded from the interview.
  - Note that the IRM then states that "if the witness refuses to be interviewed if that person is excluded and the person is a designee of the taxpayer within the meaning of IRC 6103(c) and its regulations, the interview will proceed unless the interviewing officer decides that continuing the interview will impede development of the case." In other words, if the IRS request to exclude the other person is refused, and the other person is a taxpayer designee, then the IRS will continue with the interview with the other person present unless it is determined that doing so will impede the development of the case.
- Obtaining the prior cooperation of the witness thus is essential.
- It is necessary to negotiate with the Service to gain access to each interview.

Obtaining Copies of the Materials and Transcript

- The person summoned has the right to audio (but not video) record the proceeding. The taxpayer could request that this be done.
- The taxpayer could arrange to have the witness represented by other counsel. The witness may consent to have that counsel cooperate with the taxpayer's attorney. Preparing a joint defense agreement usually is a good practice to keep future communications about the issue between the witness and the taxpayer confidential.
- Otherwise, the taxpayer can request the witness transcripts, under the Freedom of Information Act (FOIA) if necessary.
  - The Service may resist, claiming that, under FOIA Exemption #7, disclosure would interfere with the audit investigation.
  - Whether interference would result depends on the specific facts.
  - The interviewee may raise confidentiality or Privacy Act issues.

Information From Third Parties: The Statutory Framework

- The Service's examination power is extremely broad. I.R.C. § 7602.
  - Most information is considered "relevant or material."
  - The Service can issue a summons to any person it "may deem proper."
  - The Service can obtain documents, and take testimony under oath.
- If the Service wants to contact third parties, it must give "reasonable notice in advance to the taxpayer" that contacts may be made. I.R.C. § 7602(c).
- The taxpayer should send a written request to the Service for a list of third party contacts.
- When issuing a third-party summons, the Service must follow the special procedures set forth in section 7609.
- The taxpayer's officers and employees are not "third parties."

Timing of the Notice and Response to the Summons

- When it serves a third-party summons, the Service must notify the taxpayer within 3 days of the service date. I.R.C. § 7609(a).
- The date set for a response to the summons cannot be sooner than 24 days after the date that notice is given to the taxpayer.
- During that period:
  - The summoned party cannot comply with the summons.
  - The Service cannot accept any information sought in the summons.

Challenging the Summons

- No later than 20 days after notice of the summons, the taxpayer may bring suit in District Court to quash the summons. I.R.C. § 7609(b).
  - The summoned party has the right to intervene in that proceeding.
  - During the proceeding, the limitations period for assessment against the taxpayer is suspended.
- If the summoned party fails to respond, the Service may bring suit in District Court to enforce the summons.
  - The taxpayer has the right to intervene in that proceeding.
  - If the taxpayer intervenes, the limitations period for assessment against the taxpayer is suspended.

Joint Defense Agreement

- When the Service has targeted several parties to a transaction, the parties can agree to a joint defense agreement.
- These agreements allow the parties to disclose to each other confidential materials related to matters of common interest without waiving a privilege or protection.

Can I "Settle" Issues With The Examining Agent?

- Revenue agents have limited ability to settle issues.
- Typically, revenue agents do not have authority to settle legal issues based on hazards of litigation assessments. IRM 4.10.7.5.3.1.
- On the other hand, revenue agents do have the ability to raise or not raise issues depending on legal interpretations and factual determinations. In practice, this ability effectively gives revenue agents some leeway to "settle" issues.
- If an issue previously was settled by IRS Appeals, revenue agents are authorized to settle the issue in the examination on the same basis. Delegation Order 236.
- If an issue is a Coordinated issue, on which IRS Appeals has established written settlement guidelines, revenue agents are authorized to settle the issue in the examination according to the guidelines. Delegation Order 4-25.

Requests For Technical Advice

- Either the taxpayer or the revenue agent can ask for guidance from the IRS National Office by means of a Request for Technical Advice. In response, the National Office will issue a Technical Advice Memorandum (TAM) or a Technical Expedited Advice Memorandum (TEAM). Rev. Proc. 2011-2.

- If the revenue agents will not recognize that the position they are asserting is incorrect, the taxpayer can seek to request technical advice. When challenged, the agents may drop the issue. Or, when the request is made, the National Office may reject their position.

Requests For Technical Advice

- Exam and the taxpayer will make written submissions on the facts and applicable law. Disagreements over facts may be noted. The parties may have a conference with the National Office.
- The examining agents will follow the technical advice that they receive.
- The Service has provided for the issuance of expedited technical advice through the use of TEAMs. TEAMs allow the Service to expedite the technical advice process by issuing guidance even when the revenue agent and the taxpayer disagree as to the facts. Any issue eligible for a TAM is also eligible for a TEAM.

Will Unsettled Issues Come Back to Haunt Me?

- No – Federal Rule of Evidence 408 provides that offers in settlement, as well as statements and admissions of fact, that are made during settlement negotiations are not admissible in any subsequent litigation. *See Dow Chemical Co. & Subsidiaries v. United States*, 2003 WL 1701524 (E.D. Mich. Mar. 31, 2003).

- To ensure that a settlement communication receives this proper treatment, it should be so labeled.

Special Exam Procedures

Industry Issue Focus Program

Implementation of IIF Program

- Implemented in March 2007 by the Large and Mid-Size Business Division ("LMSB") of the IRS
- Compliance issues are identified, then prioritized/tiered based on their prevalence and level of compliance risk

IIF Program

- Understanding the rationales and goals of the IIF Program and how the program actually works is key to handling successfully a case involving tiered issues
  - Insight into the IRS approach allows you to 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

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

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 mistakenly label an issue or transaction as tiered because it has some similarity to a tiered issue.

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/her 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.
- If the issue is new and the IMT is still formulating its approach, getting cases with favorable facts in front of it may:
  - Influence pattern IDRs
  - Influence legal position
  - Increase impetus to give exam teams flexibility

Consider How Your Case Fits in With the IRS Strategy

- Consider the IRS docket on your issue.
  - Is the Service 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 the IRS has never considered, arguing the law may have some value.

Case Elevation

- IRS has said its goal is to resolve cases at the lowest possible level.
- Normal progression under IRS Rules of Engagement:
  - Team manager
  - Territory manager
  - Director of field operations
    - DFO has direct line of communication with issue owner executive
- The issue owner executive is usually not involved in specific cases.
  - But an IRS official has said that a taxpayer may want to contact the issue owner executive if he/she has tried to elevate the case under normal channels without success.

Settlements

- Exam team must present proposed settlements of tiered, listed issues to the Technical Advisor, Issue Specialist, and/or Counsel before going forward with any resolution other than full concession by the taxpayer.
- Otherwise, whether the proposed settlement of a tiered, non-listed issue needs to be presented to the Issue Management Team may depend on, according to the Internal Revenue Manual:
  - Issue "maturity" (i.e., how well-developed the IRS position is, whether other cases have been settled, etc.)
  - Whether Counsel has provided published guidance
  - Whether the issue has been designated for litigation
  - Whether the issue is being considered for litigation in a different case
- Settlement of non-tiered issues may be more difficult when you also have a tiered issue.
  - May lose "horse-trading" opportunities

Fast Track Settlement of Tiered Issues

- Fast Track may be available to resolve tiered issues.
- Taxpayer, exam team, IMT coordinator, and Fast Track coordinator all must agree to use Fast Track.
  - It is generally helpful to get support from the exam team first because the manager can contact the other constituencies.
  - Taxpayer should be prepared to address the views and concerns of all constituencies.
    - For example, Appeals may look for settlements that can be used in other cases
- Fast Track benefits:
  - Parties agree to seek a resolution within 120 days, which may conserve taxpayer resources
  - Taxpayer may be able to achieve an agreement with the IRS decision-makers (IMT and Appeals will participate in Fast Track), which may provide a higher degree of certainty that the agreement will stand
- Fast Track is a mediation process, so the taxpayer should be prepared to compromise.

Coordinated Industry Case Participants

What About Coordinated Industry Case Participants?

- Coordinated Industry Case (CIC) taxpayers have more formal examination procedures.
- At the initial meeting, the taxpayer will meet the CIC examination team.
  - In large cases, one revenue agent will be the case manager and will lead a team of agents. The case manager develops the audit plan and determines the scope of the audit.
  - One agent is the team coordinator. The taxpayer typically has most contact with this member of the audit team.
  - International, employee plan, financial products or other special examiners may be brought in for special roles.
  - Outside consultants may be brought in.

What About Coordinated Industry Case Participants?

- The taxpayer and the agents will discuss the audit plan.
  - The parties discuss office space and equipment to be provided to the agents, and the exam team's approach to the audit.
  - Timing and a completion date may be discussed.

Market Segment Specialization Program (MSSP)

- Agents with expertise in the segment will develop MSSP audit guides, which describe industry issues and audit techniques.
- The audit guide is not binding on the agent examining the taxpayer.
- Under this program, the agents auditing the taxpayer may be specialists in the taxpayer's segment.

Industry Specialization Program (ISP)

- The revenue agents will seek guidance regarding legal issues that are “coordinated” under the ISP program.
- Certain specialized industries have Industry and Issue Specialists.
- The Industry Specialists write position papers and advise examining agents regarding coordinated issues.
- Examining agents must raise coordinated issues, contact the Industry Specialist, and make adjustments in accordance with the ISP position papers.

TEFRA Partnership Provisions

- Partnership items reported on a taxpayer's return may be separately examined at the partnership level. See I.R.C. §§ 6221-6234.
- Special rules govern notification to partners, partner participation in the audit, assessments against partners, and judicial review of the proposed adjustments.
- The tax matters partner (TMP) represents the partners as the contact person with the Service.

Are There Any Special Examination Programs?

- Limited Issue Focused Examination (LIFE)
- Fast Track Dispute Resolution
- Early Referral Request
- Accelerated Issue Resolution (AIR)
- Industry Issue Resolution (IIR)
- Comprehensive Case Resolution (CCR)

Limited Issue Focused Examination (LIFE)

- Large taxpayers have the option of entering into a streamlined audit process called the Limited Issue Focused Examination (LIFE) process. *See* Internal Revenue News Release IR-2002-13; IRM § 4.51.3.

- The purpose of the program is to focus the audit only on significant issues, making the audit process faster and less costly.

- Businesses with assets over $10 million are permitted to opt into the LIFE process, which will be detailed in a Memorandum of Understanding (MOU) executed by the taxpayer and the Service.

Limited Issue Focused Examination (LIFE)

- Under the agreement, the Service agrees to limit the scope of its examination to certain identified issues. Also, the Service agrees not to raise issues, and the taxpayer agrees not to assert affirmative claims, for issues under specified dollar thresholds.
- The agreement also provides for exchanges of information, a time schedule for the audit, and other agreed upon procedures.
- Some benefits of the LIFE process include:
  - Heightened materiality threshold results in a limited number of significant items being examined
  - Time span of the examination is reduced since fewer issues
  - Increased communication between Service and taxpayer means that issues are discussed earlier and resolved earlier

Fast Track Dispute Resolution

- The taxpayer and the revenue agents can seek to resolve certain audit issues under a Fast Track Dispute Resolution process. Notice 2001-67.

- The Service established Fast Track Dispute Resolution as a pilot program, and accepted applications through November 14, 2002. The Service made the program permanent on April 4, 2003. Internal Revenue News Release IR-2003-44.

- The pilot program offered a Fast Track Mediation process or a Fast Track Settlement process.

Fast Track Mediation

- In Fast Track Mediation, an Appeals Officer acts as a mediator to help the parties resolve factual issues.

- Although Small Business/Self Employed (SB/SE) taxpayers continue to utilize the mediation program, it was unpopular with LMSB and was not made permanent.

Fast Track Settlement

- In Fast Track Settlement, the Appeals Officer helps the parties resolve factual or legal issues and exercises Appeals settlement authority to effect the settlement.

- The settlement program is viewed as successful and, as mentioned above, was made permanent. See Rev. Proc. 2003-40, which describes the eligibility criteria, the application process, and the settlement process.

- Issues must be fully developed, and the taxpayer must state its position in writing.

- Agreements are reflected in closing agreements. If no agreement is reached, the issues can be protested to Appeals.

Early Referral Request

- Taxpayers are permitted to ask Exam to refer developed, but unresolved issues to Appeals, while the revenue agents continue to audit other issues. Code § 7123(a); Rev. Proc. 99-28.
- Early referral can be a valuable tool to obtain the early resolution of "show stopper" issues.
- Exam may resist requests for early referral on the ground that the issue is not fully developed, or because the remaining issues will be completed before Appeals could resolve the early referral issue.
- ISP issues also may be referred to Appeals under the early referral program.
- Agreements with Appeals are reflected in closing agreements. Unagreed issues are returned to Exam and, if the case is protested, will not be subsequently reconsidered by Appeals.

Accelerated Issue Resolution (AIR)

- In the examination of the tax years under audit, CIC taxpayers may enter into an Accelerated Issue Resolution (AIR) agreement with the Service.

- Under the AIR agreement, the parties agree to apply the resolution of issues in the audit years to other affected tax years ending prior to the date of the AIR agreement. Rev. Proc. 94-67.

- While many issues may be the subject of an AIR agreement, Rev. Proc. 94-67 specifies a list of certain issues that cannot be addressed in an AIR agreement.

- The AIR agreement acts as a closing agreement for the issues addressed.

Industry Issue Resolution (IIR)

- The Industry Issue Resolution (IIR) program was first announced as a time-limited pilot program, but then was made permanent. Notice 2000-65; Notice 2002-20; Rev. Proc. 2003-36.
- The IIR program provides a process to obtain IRS guidance and resolve frequently disputed tax issues that are common in various industries.
- Taxpayers, or industry groups, may suggest issues in need of resolution to the Service, and can suggest possible options for resolving those issues. The goal is to obtain the resolution of issues that are the subject of repeated examinations affecting substantial numbers of taxpayers.
- Under the IIR program, the Service will issue guidance, likely in the form of a revenue ruling or procedure, that permits taxpayers to adopt the recommended treatment.

Comprehensive Case Resolution (CCR)

- The Comprehensive Case Resolution (CCR) program was first announced as a time-limited pilot program, but then was extended to allow for additional applications. Notice 2000-43; Notice 2001-13.

- The program, which is jointly administered by LMSB, Appeals, and possibly Office of Chief Counsel (if a case is docketed), allows a taxpayer to request resolution of all issues for all open years in exam, in Appeals, and even in docketed Tax Court cases.

- According to the Service and taxpayers, the CCR program has not been as successful as other IRS issue resolution programs.

Leaving Exam

How Will I Be Notified That The Agents Are Asserting A Proposed Adjustment?

- The revenue agents will assert issues by means of a Notice of Proposed Adjustment (a so-called NOPA).
- The notice is prepared on, and often referred to as, a Form 5701.
- Taxpayers may indicate whether they agree or disagree with the proposed adjustment.

What Will the Agents Do to Conclude the Examination Process?

- Section 6212 provides that the Service is prevented from making an assessment until after it has issued a statutory notice of deficiency (statutory notice, stat notice, or 90-day letter).
- The agents usually do not end the examination process by issuing a 90-day letter. Normally, the agents will issue a 30-day letter, which transmits a Revenue Agents' Report (RAR) containing their proposed adjustments.
- The RAR contains all of the proposed adjustments (usually, copies of the NOPAs), and a recomputation of tax liability showing a proposed deficiency or overassessment.
- The letter transmitting the RAR is called the 30-day letter because it gives the taxpayer 30 days to submit a protest, which generally is necessary if the taxpayer wants the proposed adjustments to be considered by IRS Appeals.

How Does Issuance of A 30-Day Letter Affect Interest?

- The issuance of the 30-day letter triggers the running of "hot interest" on large corporate underpayments.
  Code § 6621(c)(2).

  - The taxpayer can make a payment to stop the running of interest.

  - The taxpayer can make a deposit in the nature of a cash bond to stop the running of interest.

When I Receive a 30-Day Letter, What Options Do I Have?

- There are three options available to conclude the examination process after the issuance of a 30-day letter:

  - Option #1 – Tentatively agree with the proposed deficiency.

  - Option #2 – Fail to respond to the 30-day letter.

  - Option #3 – File a Protest.

Option #1 - Tentatively Agree With The Proposed Deficiency

- The taxpayer may execute a Form 870, which waives the restriction that prevents the Service from making an immediate assessment.
- As a consequence, the taxpayer waives the right to receive a statutory notice of deficiency and thus forfeits the right to go to Tax Court.
- The taxpayer does not waive the right to file a refund claim and to proceed to refund litigation.

Option #2 –Do Not Respond To The 30-Day Letter

- The Service is prohibited from making an assessment, but will issue a statutory notice of deficiency.
- The taxpayer has the right, within 90 days of the statutory notice, to file a petition in the Tax Court. No assessment will be made and the taxpayer need not pay the proposed deficiency.
- The taxpayer may pay the asserted deficiency and file a refund claim.

Option #3 - File A Protest

- Within the 30-day period following issuance of the 30-day letter, the taxpayer can file a protest with IRS Appeals. Treas. Reg. § 601.105(d).

- The taxpayer can request an extension of time to file the protest. The outer limit on extensions of time typically is 90 days.

Appeals

The Protest

Filing A Protest And Going to IRS Appeals

- The question: to protest or not to protest?
  - Why protest?
    - You obtain an additional opportunity to resolve issues. Appeals is able to settle issues on a hazards of litigation basis.
    - You keep your options to proceed to additional forums fully open.
    - You can delay payment of proposed tax increases.
    - You can learn more about the Service's position, and refine your arguments.

Filing A Protest And Going to IRS Appeals

- Why not protest?
  - You may not want the delay, if you want to litigate as soon as possible.
  - You may not want to give the Service more time to develop its position.
  - You may not want to disclose your position in detail.
  - You may not want the Service to identify new issues.
    - By rule, Appeals is not supposed to raise new issues.
    - However, Appeals can return cases to Exam for consideration of new issues.

What Are The Procedures For Filing A Protest?

- The Service specifies the required form and contents of the protest. Publication 5.
  - Taxpayers may file either a full or a skeletal protest.
  - Taxpayers may raise affirmative issues in the protest.

- The taxpayer must sign a verification, under penalties of perjury, of the facts set forth in the protest.

- The taxpayer's representative should attach a Form 2848, Power of Attorney.

Ex Parte Process

Can The Revenue Agent Respond To My Protest?

- The revenue agents may file a rebuttal.
  - The revenue agents receive the protest and may prepare a written rebuttal supporting their proposed adjustments.
  - The agents comment on legal and factual issues raised by the taxpayer in the protest.

- Formerly, Appeals Officers would meet with the revenue agents, without the taxpayer, prior to the Appeals conference, to discuss the protest and the rebuttal. Now, the Service prohibits these discussions unless the taxpayer is given the opportunity to attend.

Ex Parte Communications

- Appeals Officers are prohibited from having ex parte communications with other IRS employees to the extent those communications appear to compromise the independence of Appeals. Rev. Proc. 2000-43.

- Ex parte communications are communications between the Appeals Officer and any other IRS employee, without participation by the taxpayer, in which the merits of issues are discussed.

- If the Appeals Officer wants to discuss a case with the examining agent, the taxpayer must be offered the opportunity to participate.

Basic Appeals Procedures

Can Appeals Also Ask For An Extension Of The Assessment Period?

- Appeals also may ask for extensions of the period for assessment.
- Extensions can be effected using Form 872.
- Extensions also can be made using Form 872-A, which are open ended extensions. Open-ended extensions are terminated using Form 872-T.

What Are The Procedures For Conducting The Appeals Conference?

- Composition of the Appeals team:
  - Smaller cases may have a single Appeals Officer.
  - Larger cases will have an Appeals team, and the team will have a Team Chief, and Appeals Officers.
- Attendance at the conference:
  - Should taxpayer's in-house representatives attend?
    - Yes – provide valuable information; help with negotiations
    - No – may cause Appeals to expect instant answers; makes the attending group much larger
  - Expert consultants may attend.

What Settlement Authority Do The Appeals Officers Have?

- Appeals is supposed to seek a “fair and impartial resolution” of the case.
- Appeals should apply a “hazards of litigation” standard in considering settlement of issues.
- Appeals should not raise new issues unless the ground for opening the issue is a substantial one and the potential effect upon the tax liability is material. Treas. Reg. § 601.106(d)(1); IRM § 8.6.1.4.
- Appeals consideration is not a continuation of the examination. New issues should not be raised, or threatened to be raised, for bargaining purposes.
- Appeals is permitted to ask for a legal opinion from counsel.

Special Appeals Procedures

Are There Special Procedures That I Can Use To Resolve Issues At The Appeals Level?

- Appeals Coordinated Issues (ACI)
- Technical Advice Requests
- Appeals Mediation Program
- Appeals Arbitration Program

Appeals Coordinated Issues (ACI)

- Certain issues have been designated ACIs, in order to obtain consistency in treatment.
  - Examples of such issues include:
    - Section 302/318 Basis Shifting Transactions
    - Section 351 Contingent Liability – Capital Loss Transactions
    - Section 461(f) Contested Liabilities Transactions
- Appeals officers have restricted ability to settle ACI issues.
- A current list of the ACIs can be found at:

  http://www.irs.gov/individuals/article/0,,id=108652,00.html.

Technical Advice Requests

- The taxpayer or the Appeals officer may file a request for technical advice with the IRS National Office. Rev. Proc. 2011-2.

- If the TAM or TEAM favors the taxpayer, Appeals will follow the TAM or TEAM.

- If the TAM or TEAM favors the Service, Appeals still is able to concede or settle the issue, although practically it will be more difficult to get Appeals to compromise.

Appeals Mediation Program

- The Appeals Mediation Program is authorized under section 7123(b)(1).
- Mediation is optional and non-binding. A neutral third party mediator, without authority to impose his/her decision, assists the parties in settlement negotiations.
- The Service announced a pilot program for a limited test period (Announcements 2001-9 and 98-99) and then made the program permanent (Rev. Proc. 2002-44). The current procedures are set forth in Rev. Proc. 2009-44.
- Factual issues, legal issues, ISP issues, and ACI issues are eligible for mediation.

Appeals Arbitration Program

- The Appeals Arbitration Program is also authorized under section 7123(b)(1).
- Arbitration is optional and binding. An arbitrator imposes a binding resolution on the parties. Arbitration is available only for factual issues after unsuccessful attempts to enter into a closing agreement under §7121.
- The Service announced a pilot program for a limited test period (Announcement 2000-4) and then extended the program through June 30, 2003 (Announcement 2002-60).
- The Appeals Arbitration Program was formally established permanently in 2006 in Rev. Proc. 2006-44.

Leaving Appeals

What Options Do I Have Regarding How I Close The Case Out Of IRS Appeals?

- A resolution of issues that affects other years may be effected through a closing agreement. Code § 7121. Form 906.

- There are three major options for closing a case out of Appeals. The correct option to use depends on what subsequent course of action the taxpayer seeks to take.
  - Option #1 – Totally agreed case.
  - Option #2 – Partially agreed or unagreed case, with unagreed issues reserved for litigation in district court or the Court of Federal Claims.
  - Option #3 – Partially agreed or unagreed case, with unagreed issues left for litigation in the Tax Court.

Option #1 – Totally Agreed Case

- Compute the deficiency or overassessment due based on the resolution of the issues, and reflect that amount on Form 870-AD.

- The Form 870-AD is a waiver of the Service's restrictions on assessment. The Service will assess the tax due and send the taxpayer a notice demanding payment.

- Under the doctrine of equitable estoppel, the Form 870-AD is intended to have binding effect on both parties.

Option #2 – Partially Agreed Case, With Unagreed Issues Reserved For Litigation In District Court Or The Court Of Federal Claims

- Compute the deficiency or overassessment due based on (i) resolving the settled issues as agreed, and (ii) treating issues to be reserved for litigation as resolved in favor of the Service.
- Execute Form 870-AD reflecting the resulting deficiency, reserving the right to file a refund claim with respect to reserved issues, and listing the issues reserved for litigation. IRM § 8.8.1.2.2 ("Settlement with Reservations").
- The Form 870-AD is a waiver of the Service's restrictions on assessment. The Service will assess the tax due and send the taxpayer a notice demanding payment.
- The taxpayer must pay the tax and file a timely claim for refund based on the issues reserved for litigation.
- If the taxpayer fails to reserve an issue, the issue cannot be raised in the claim for refund.
- If the government fails to reserve an issue, that issue cannot be raised, except as an offset in refund litigation.

Option #3 – Partially Agreed Case, With Unagreed Issues Left For Litigation In The Tax Court

- Compute the deficiency or overassessment due based on resolving the settled issues as agreed.
- Execute Form 870-AD reflecting the agreed deficiency, listing the issues that have been settled. IRM § 8.8.1.2.1 ("Partial Settlement").
- The Form 870-AD is a waiver of the Service's restrictions on assessment. The Service will assess the tax due and send the taxpayer a notice demanding payment.
- The Service will issue a statutory notice of deficiency seeking the tax due with respect to the unagreed issues.
- All issues listed as settled in the Form 870-AD are resolved.
  - All other issues (raised or not raised, known or not known) remain fully in dispute
  - The Service is permitted to raise any unsettled issue in the Tax Court as a "new matter." Tax Court Rule 142.
- Having received a statutory notice of deficiency, the taxpayer may litigate in the Tax Court. Alternatively, the taxpayer can choose to pay the deficiency asserted in the statutory notice and file a claim for refund.

Post Appeals

Preparing for Refund Suit

Preparation For Refund Litigation

- If the taxpayer decides to take issues into refund litigation, the required first step is to pay the amount due.
- The second step is to file a Claim for Refund. I.R.C. § 7422. The refund claim is filed using Form 1120X.
- Each issue must be adequately described in the refund claim.
- Enough information must be provided to describe the issue to the Service adequately.

Preparation For Refund Litigation

- The refund claim must be filed within the statutory limitations period. I.R.C. § 6511.
  - If no Form 872 agreement extending the period of assessment has been executed, the claim must be filed within three years of the filing of the return (as extended).
  - If a Form 872 agreement extending the period of assessment has been executed, the claim must be filed within 6 months following the expiration of the extended assessment period. *See* Form 872.
  - Alternatively, a claim for refund can be filed within 2 years of the date a payment is made, but limited to the amount of that payment.

What Issues Can And Should I Raise In The Refund Claim?

- In order for an issue to be raised in the refund claim following a partial settlement, the taxpayer should have reserved the issue for litigation in the Form 870-AD.
- Under the Variance Doctrine, if an issue is not raised in the refund claim, that issue cannot be raised in subsequent tax litigation (the complaint cannot vary from the claim). Treas. Reg. § 301.6402-2(b).
  - Therefore, it is critical to raise in the refund claim <u>all</u> of the issues that you want to litigate.
- Taxpayers that fail to file a timely, formal, and written refund claim containing an issue that they want to litigate may be able to contend that they have made an Informal Claim for Refund. *See, e.g., Arch Eng'g Co., Inc. v. United States*, 783 F.2d 190, 192 (Fed. Cir. 1986) (the minimum requirements for an "informal" refund claim include a written request for sums paid for a particular tax year).

What Action Will The Service Take Regarding The Refund Claim?

- The taxpayer can file the refund claim accompanied by a request that the Service immediately disallow the refund claim. IRS News Release IR-1600 (Apr. 26, 1976). Also, the taxpayer may contact its examining agents and ask for immediate disallowance.
- The Service may send the taxpayer a notice of proposed disallowance of the refund claim. The taxpayer can protest the proposed disallowance to IRS Appeals if Appeals did not previously consider the issue.
  - The Service will enclose a Form 2297, asking the taxpayer to waive its right to receive a formal notice of disallowance. These forms pose a danger to taxpayers, because they start the limitations period for filing suit, usually at an ill-defined date.
- The Service may send a formal notice of claim disallowance. The notice must be sent by certified or registered mail. Code § 6532.
- The Service may not act at all on the refund claim.

Once The Refund Claim Is Disallowed, How Long Do I Have To File The Refund Suit?

- To avoid problems with the statute of limitations, the refund suit must be filed within two years of the date of the formal notice of claim disallowance.
- If the taxpayer executed Form 2297, suit must be filed within two years of the date on which the Service accepts that form.
- The statute of limitations for filing suit can be extended using Form 907, if the Service agrees to execute that form.
- If the Service does not respond within 6 months, the taxpayer is free to file suit.

If The Service Fails To Disallow The Refund Claim Can I File A Refund Suit Anyway?

- The taxpayer generally cannot file suit until after the Service denies the claim for refund.
- However, if the Service has not acted on the claim within 6 months of its filing, the taxpayer is free to file suit.
- If the taxpayer executed Form 2297, the taxpayer must wait 6 months to file suit.

Preparing for Tax Court Suit

Preparation For Tax Court Litigation

- A petition must be filed with the Tax Court.
- A petition can be filed in the Tax Court only if the taxpayer has received a statutory notice of deficiency (the statutory notice sometimes is referred to as the taxpayer's "ticket to the Tax Court").
- The petition must be filed within 90 days of the date of the statutory notice. Code § 6213.
- T. C. Rule 34 describes the required form and contents of the petition.

Choice of Forum

Choice Of Forum Issues

- Should I litigate in the Tax Court?
- Should I bring my refund suit in District Court?
- Should I bring my refund suit in Court of Federal Claims?

Important Issues to Consider – Tax Court

- What is the applicable precedent in the Tax Court?
- The appeal will go to the Court of Appeals in the circuit in which the taxpayer resides or has its principal place of business. Therefore, you should also consider the applicable precedent in that circuit.
- Consider the background, experience and expertise of the Tax Court judges. Consider the "attitude" and approach that the judges have taken regarding similar types of issues.
- Obviously, there is a great deal of tax law precedent in the Tax Court, which presents an expanded opportunity to "read the tea leaves."

Important Issues to Consider – Tax Court

- Consider the foregoing factors in light of the type of issues that your case presents, and the types of arguments you will be making. How well will your particular case "play" before the Tax Court "audience"?

- Your opposing counsel will be an IRS attorney from IRS District Counsel's office.

- The Tax Court's rules of procedure will apply.
  - The Tax Court has limited discovery procedures available for the parties.
  - In the Tax Court, the parties must stipulate to facts to the extent possible.
  - Nationwide service of process to require witnesses' appearance at trial.

Important Issues to Consider – Tax Court

- The Service is permitted to raise new issues as "new matters." T.C. Rule 142. The Service has no restrictions on its ability to raise new issues in its answer to the taxpayer's petition, and no restrictions on its ability to recover the tax associated with those new issues.

- For example, suppose the taxpayer raises one issue in its petition, and that issue involves $100 of tax. If the Service spots a new issue, involving $1000 of tax, it can raise that issue in its answer. If the taxpayer loses both issues, its tax liability is increased by $1100. (Contrast this result with the different result reached in the refund context.)

- On these "new matters," the Service has the burden of proof. However, typically this provides only a minimal advantage to the taxpayer.

Important Issues to Consider – District Court

- The taxpayer can file suit in the district in which it resides or has its principal place of business. There may be some flexibility regarding the district in which suit can be filed.

- What is the applicable precedent in the district?

- Appeal from the district court will be to the Court of Appeals in which the district is located. Therefore, you should also consider the applicable precedent in that circuit.

- Typically, in contrast to the Tax Court, district court judges will not be tax specialists, but generalist judges who encounter tax issues only periodically. Not being tax specialists, the judges may have different attitudes or approaches to tax issues.

Important Issues to Consider – District Court

- In contrast to the Tax Court, because district courts hear far more types of cases than tax cases, there may be less tax law precedent to be considered that is relevant to your issue.

- Jury trials are permitted in district courts.

  - Consider whether your case is one that you believe is suited to be heard by a jury.

- Opposing counsel will be from one of the regional litigation sections of the Tax Division of the Justice Department.

Important Issues to Consider – District Court

- Federal Rules of Civil Procedure will apply.
- Rules allow far more discovery than is permitted in the Tax Court.
- A trial subpoena can be issued only to witnesses within the district, or outside the district but within a 100 mile radius of the courtroom.
    - Thus, distant witnesses cannot be compelled to testify at the trial.

Important Issues to Consider – Court of Federal Claims

- The taxpayer may file suit in the Court of Federal Claims. This is a court with national jurisdiction, available to all taxpayers, wherever located.
- What is the applicable precedent in the Court of Federal Claims?
- An appeal from the court will be to the Court of Appeals for the Federal Circuit. Therefore, you should also consider the applicable precedent in that circuit.
- Typically, Court of Federal Claims judges will not be tax specialists, but also will not be generalist judges. The judges hear tax cases, patent cases, and claims against the United States. Consider the background, experience and expertise of these judges, and consider the “attitude” and approach that they have taken regarding various types of issues.

Important Issues to Consider – Court of Federal Claims

- No jury trials are permitted.
- Opposing counsel will be from the Court of Federal Claims section of the Tax Division of the Justice Department.
- The Rules of the Court of Federal Claims apply. These rules differ from, but are similar to, the Federal Rules of Civil Procedure.
- On a showing of good cause, the court can issue a trial subpoena to a witness that is outside the 100-mile radius of the place of trial.

How Do "New Issues" Affect Refund Litigation?

- In refund litigation, the government is permitted to raise new issues only as "offsets." The government has no restrictions on its ability to raise new issues in its answer to the taxpayer's complaint.

- However, there is a significant restriction on its ability to recover the tax associated with those new issues.

- The government cannot affirmatively collect the tax related to the "offset" issue, but can only use "offset" issues to reduce the amount of a recovery that the taxpayer otherwise would be entitled to.

How Do "New Issues" Affect Refund Litigation?

- For example, suppose the taxpayer raises one issue in its complaint, and that issue involves $100 of tax. If the government spots a new issue, involving (say) $1000 of tax, it is permitted to raise that issue as an offset in its answer. If the taxpayer wins its issue, but loses the offset issue, it recovers zero, since its $100 issue is "offset" by the issue that the government raised. However, the government is <u>not</u> able to collect the remaining $900 related to the offset issue. The "offset" issue can only reduce the amount that the taxpayer otherwise would be entitled to recover. (Contrast this result with the different result reached in the Tax Court context.)