Managing Tax Audits and Appeals

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Washington, DC
September 29-30, 2016
Introduction

But in this world nothing can be said to be certain, except death and taxes.

(Benjamin Franklin 1789)
Agenda

- Introduction
- New LB&I Examination Process
- Privilege and Work Product
- SALT Audits
- Lunch (Legislative Update)
- Partnership Audits Changes
- ADR and Appeals
- Resolving Tax Accounting Issues
- Concluding Remarks
LB&I’s New Issue-Focused Audit Paradigm

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Current State of IRS: Doing Less with Less

• Over $1 billion in budget cuts since 2010
  – Small increase in 2016 ($250 million) allocated to customer service/telephone assistance/fraud detection/cybersecurity

• Overall staffing down by 20%, from 94,700 to 76,500
  – Effectively a hiring freeze
  – Revenue Agents down 25% from almost 14,000 to 10,600
  – Appeals Officers down from 1,000 to 760 last year, back up to 1,000
  – Significant increases in executive/senior management retirements
  – 51% of executives and 41% of managers eligible to retire in 2016
  – 25% of overall workforce eligible to retire in 2015 (40% by 2019)

• Audit rate lowest since 2004: large business audits declined 22% since last year
The only constant is change.  Heraclitus (535-475 BC)
Concept of Operations (CONOPS) and the IRS “Future State”

• Began development in 2014 in response to IRS challenges
  – Significant budget reductions since 2010
  – Increased responsibilities: unfunded mandates of FATCA and ACA implementation
  – Technology concerns: identity theft, cyber attacks

• High level restructuring initiative across major divisions including LB&I and SB/SE
  – Guiding principles would change the way that the IRS operates
  – Goal was to increase efficiency in era of declining resources

• Became the cornerstone of the LB&I reorganization
  – Intended to fundamentally transform IRS interactions with taxpayers
Objectives of Reorganization

• Change the way LB&I is structured
  – One LB&I, practice areas, compliance areas

• Issue focus: select work based on compliance risk
  – Choose issues by employing data analytics and specialized staff

• Collaboration: seek ways to involve taxpayers in Exam process and create incentives for cooperation

• Develop better training and career paths and better tools and support
  – Knowledge management, deployment, mentors

• Define the compliance outcomes of all LB&I work
2016 LB&I Reorganization In Context

- CONOPS in development (2014)
- IDR Directive (March 2014)
- Centralized risk assessment pilot program (April 2014)
- Appeals judicial approach & culture (July 2014)
- LB&I reorganization announced (Sept 2015)
- IRS enterprise concept of operations (CONOPS) (March 2016)
- Pub. No. 5125 (February 2016)
- IRM updated (March 2016)
- New process for cases starting as of May 1, 2016; transition for cases in process May 1st
LB&I Reorganization Overview

• Changes to LB&I organization chart create “one LB&I”
  – Single Deputy Commissioner
    ▪ International/Domestic Deputy Commissioners merge
  – Two Assistant Deputy Commissioners: International, Compliance Integration
  – Eliminate industry designations
  – Move to issue-based examinations

• 9 new practice areas:
  – A Practice Area is a group of employees organized together to focus on one or more areas of expertise
  – Each Practice Area will study compliance issues within their area of expertise and suggest campaigns to be included in the compliance plan
LB&I High-Level Organization

Double-lined boxes indicate Executive Level
Practice Areas

- 5 substantive practice areas:
  - Passthrough Entities
  - Enterprise Activities
  - Cross-Border Activities
  - Withholding & International Individual Compliance
  - Treaty and Transfer Pricing Operations

- 4 geographic practice areas:
  - Western (Oakland)
  - Central (Houston)
  - Eastern (Downers Grove)
  - Northeastern (New York)
Issue-Focused Exam Process: Identification of Issues

- Centralized risk model for case/issue selection
  - Greater use of predictive analytics
- Focus on streamlined audits with issue-focused approach
- Develop “campaigns” to alter taxpayer behavior
- Create tailored treatment streams to address areas of noncompliance
- Eliminate Coordinated Industry Case (CIC) Program
  - Audit Issues Rather Than Returns, But . . .
    - Largest Taxpayers Still Under Continuous Audit
    - Examiners May Still Identify Their Own Issues
  - Implications
    - Rev. Proc. 94-69 disclosures
    - Designated summonses
    - Delegation orders
**Risk Identification**

- Centralization of issue selection
  - Governance Board decides issues to address and how
  - Issues pre-identified for examiners
  - Separation of classifiers from examiners

- Role of Compliance Planning and Analytics (CPA)
  - Brings all workload selection areas into one office
  - Increased focus on data analytics
  - More data becoming available (e.g., country-by-country reporting)

- Goal is to move from a reactive return-focused risk approach to a more proactive position
Campaign Approach

- Identify areas of greatest non-compliance
- Deploy resources to those areas
- Transparent to taxpayers (eventually)
- Focus on mid-market companies
- Examples:
  - Inbound distributors and transfer pricing
  - Captive Insurance
  - Basket options
  - Section 199
  - R&E credit
- International practice units
“Bob, do you have time for a tax audit?”
Publication 5125: LB&I Examination Process

- To be provided to taxpayers at opening conference
- Goal: To complete exam in an efficient and effective manner through collaborative efforts.
- Provides expectations for both IRS and taxpayers
- Outlines 3-Phase Exam process
  - Planning Phase
  - Execution Phase
  - Resolution Phase
- Details set forth in IRM 4.46.1, .3, .4, and .5, all updated in March 2016
Issue-Focused Exam Process: The Examination

• Issue Team to take responsibility
• Collaboration with taxpayer emphasized
• Resolve issues at earliest appropriate point
  – Exam to seek taxpayer agreement on facts before NOPA
  – Exam Team required to consider Fast Track Settlement
• Rules of engagement
  – Prior system relied on domestic chain, which failed to resolve problems on international issues
  – New system allows moving up substantive, geographic chains, no one decision maker for all of the issues
  – Accountability is diffused
Roles and Responsibilities of IRS Team
(IRM 4.46.1)

- Case Manager – holds overall responsibility of the examination; but is not granted “51% control” over the case
- Issue Manager – oversees planning, execution, and resolution of the issue; one issue manager per issue under examination
- Other member – Team Coordinator; Issue Team member
  - Principles of Collaboration (IRM 4.46.1.4) replace Rules of Engagement (formerly IRM 4.51.1)
- Emphasis on collaboration among all parties and timely elevation of concerns
- Provides guidelines for when internal elevation may be appropriate
Planning the Examination (IRM 4.46.3)

- Focuses on internal collaboration to effectively prepare for the opening conference with the taxpayer
- Emphasizes the importance of cooperation between the issue team and the taxpayer to assist in defining the scope and expectations of the examination
- Goal of the planning phase is for both parties to collaborate on completing an effective and efficient examination plan
- Describes three examination plan options
  - Issue-based examination plan
  - IC examination plan
  - CIC examination plan (this section was not updated, but most likely will be in the future as the CIC designation may be phased out as part of the LB&I reorganization)
Execution Phase (IRM 4.46.4)

- Focuses on cooperation and transparency between the issue team and the taxpayer
- Information-gathering to be conducted by Information Document Request (IDR)
  - Exchange of information
  - Develop facts
- Mutually agree upon timelines
IDR Process (IRM Exhibit 4.46.4-1)

- Requirements for issuing IDR s
  - IDRs to be single issue, “issue focused”
  - The issue, the information sought, and how the information relates to the issue to be discussed with the taxpayer prior to issuance
  - “Reasonable timeframe” to be discussed with taxpayer, set by exam
- Timely review and follow-up by Exam concerning responses once submitted
IDR Enforcement Process (IRM Exhibit 4.46.4-2)

- IDR Enforcement Process
  - IDRs issued in compliance with IDR process subject to mandatory three-Step IDR enforcement process:
    - Delinquency Notice
    - Pre-Summons Letter
    - Summons

*Deadline may be extended by up to 20 days - 5 business days for the agent to discuss delinquency with the taxpayer and an extension of up to 15 business days for the taxpayer to resolve non-response or incompleteness.
IDR Best Practices

• Respond to IDRs because of IRS summons power, use to guide responses
• Careful to provide only information requested
• Interpretations almost always necessary
  – Reducing burden is significant concern
  – Strategic decision whether to clarify in discussions with IRS
• Assert privileges and protect against waiver
• Keep log of receipt of IDR and date of response
• Maintain organized copies of all responses
IDR Best Practices

• Consider taxpayer presentations on significant issues prior to IDR issuance
  – May reduce the number of IDRs

• Develop agreements with Exam teams regarding IDR process
  – All IDRs in draft and discussed before issuance
  – Focus the IDRs on documents necessary and readily available
  – Due dates based on realistic discussions

• Push back on any IDRs that do not follow the IDR directive
  – Not focused (challenge “any and all” and kitchen-sink-type IDRs)
  – Not discussed with taxpayer prior to issuance

• Use management’s involvement in the IDR process to elevate noncompliant IDRs and other issues
Acknowledgment of Facts (AOF) (IRM 4.46.4.9)

• IRS is required to prepare a statement of facts on Form 886-A as part of its consideration of each issue
• IRS is also expected to issue a pro-forma IDR to seek to obtain a written AOF from the taxpayer and to incorporate any additional facts in the write-up
• IRM provides instructions to Exam if the taxpayer
  – Agrees with the facts,
  – Provides additional facts,
  – Identifies disputed facts, or
  – Does not respond to the AOF IDR
Acknowledgment of Facts: Form IDR

Form 4564
(Rev. September 2008)

Department of the Treasury — Internal Revenue Service

Information Document Request

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

Subject

SIN number

Submitted to:

Dates of Previous Requests (mm/dd/yyyy)

Please return Part 2 with listed documents to requester identified below

Description of documents requested

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

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

(a) Taxpayer agrees to the facts as written.

(b) Taxpayer provides additional relevant facts and supporting documentation.

(c) Taxpayer identifies disputed facts and provides clarification and/or supporting documentation.

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

While the interpretation of the law or the amount of the proposed adjustment may be unagreed, all relevant facts should be included in the Form 886-A.

Your response to the facts does not indicate agreement to the issue or any proposed tax adjustment. It is only to acknowledge that all of the relevant facts have been identified.

Your response or lack of response to the IDR will be included in the Form 886-A when the NOPA is issued.
Claim for Refund Procedures (IRM 4.46.3)

• Informal claims within first 30 days
  – Should include factual support so that no IDRIs necessary
  – Discuss deficiency in claims and provide opportunity to correct
  – Claims risk assessed like other issues
  – Claims can extend audit timeline

• Later claims require formal amended return
  – Form 1120X with supporting documentation
Special Topics: CAP

• Compliance Assurance Process (CAP)
  – IRS and taxpayer work cooperatively and collaboratively to identify and resolve issues contemporaneously prior to filing tax return
  – Memorandum of Understanding establishes framework for audit
  – Phases:
    ▪ Pre-CAP (closing years under examination)
    ▪ CAP
    ▪ Compliance Maintenance (less burdensome review)
Special Topics: CAP

Special Topics: CAP

• Compliance Assurance Process (CAP)
  – Rosemary Sereti, others at LB&I evaluating CAP
  – LB&I has closed the CAP program to new entrants
  – Those currently in program may remain, for now
  – Discussion of creating CAP-like program that is less resource intensive
Special Topics: State Aid

- The European Commission has recently opened at least 7 in-depth investigations on State aid tax issues:
  - Two cases against Luxembourg (Fiat Finance and Trade; Amazon); in Fiat, the European Commission has issued a final decision that the arrangements constitute State aid; Fiat is on appeal to the EU General Court. The Amazon case is awaiting a final decision by the EC.
  - One case against Ireland (Apple); EC has issued a final decision that the arrangement constitute State aid; appeal expected.
  - One case against The Netherlands (Starbucks); the European Commission has issued a final decision that the arrangements constitute State aid; case on appeal to the EU General Court.
  - Two cases against Belgium and France regarding tax exemptions related to ports.
  - One case against Belgium for “excess profits” rulings; the EU has issued a final decision that the arrangements constitute State aid; case on appeal to the EU General Court.
Special Topics: State Aid

- EU Competition law (non-tax) prohibits:
  - An advantage in any form whatsoever conferred on a selective basis by public authorities
  - That distorts or threatens to distort competition and has a negative effect on trade between EU Member States
  - General measures open to all enterprises are not covered by this prohibition and do not constitute state aid

- **Rationale:** prevent EU Member States from granting **distortive aid**, in any form
Special Topics: State Aid

• Key questions:
  – What is the baseline? Is it the tax law of the Member State or does EU law play a role?
  – Does it matter that other taxpayers could have gotten a similar ruling?
  – Does it matter that such rulings were “available” only to multinationals?
Special Topics: State Aid

• Consequences if a tax ruling is state aid:
  – Member State must collect the back taxes
  – Look-back period is 10 years
  – If creditable in the United States, the real aggrieved party is the U.S. Treasury
Traditionally, new legislation was followed by temporary, and then final regulations.

Today, guidance process is slower:
- Resource constraints
- APA challenges proliferating
- Post- *Mayo*, IRS and Treasury taking more time to build file, explain decisions, respond to comments, and limit temporary regulations to “must-have settings”
Special Topics: IRS Guidance

Guidance Documents in the Internal Revenue Bulletin and IRS Chief Counsel Hours Worked on Guidance
Special Topics: IRS Guidance

Hierarchy of IRS Guidance

- **Legally binding statute**
- **Legally binding interpretation of statute**
- **Taxpayers can rely on it as authoritative and as precedent because IRS is bound by it**
- **Binding on the IRS as to the specific taxpayer and facts and can only be relied on as authoritative and as precedent by addressee taxpayer**
- **Source of general information, but taxpayers should not cite to sustain a position as authoritative and as precedent**

*Source: GAO analysis of IRS documents.*