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Representing Clients in Audits and Controversies in Today's Tax Enforcement Environment

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Representing Clients in Audits and Controversies in Today's Tax Enforcement Environment[1]

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I. INTRODUCTION

A. Trends and Developments

1. General Overview.

   a. IRS collected $50.2 billion in FY 2012, a drop of 9 percent from the $55.2 billion in FY 2011 and 13 percent less than the $57.6 billion collected in FY 2010.

   b. Interesting to note that the 13 percent loss of enforcement revenue comes at a time when there was a 14 percent reduction in enforcement personnel.

   c. From FY 2011 to FY 2012, the IRS's budget decreased from $12.1 billion to $11.8 billion. In FY 2013, the combination of a continuing resolution and sequestration further reduced the IRS's budget by $600 million.

   d. Overall examinations were down 4 percent from FY 2010, but examinations of corporate, S corporation, partnership and gift tax returns increased in recent years.

2. Correspondence Audits.

   a. In fiscal year 2012, the IRS conducted 1.1 million correspondence audits, recommending approximately $9.2 billion in additional taxes.

   b. Based on a report by Treasurer Inspector General for Tax Administration, TIGTA has recommended that IRS create procedures to show how correspondence audit results are used in deciding whether to examine prior or subsequent year returns.

   c. If your client receives a correspondence audit notice identifying only single tax year under examination, you should consider having your client review open tax years to determine if there are tax exposure points.

3. IRS E-Services.

   a. Two IRS e-services online applications are being phased out because of low usage: (1) Disclosure Authorization (DA), and (2) Electronic Account Resolution (EAR). These options were removed from e-services online on September 2, 2013.

   b. Representatives should continue to submit IRS Form 2848, Power of Attorney to the appropriate CAF units to be able to access e-services.

4. LB&I Implements Changes

   a. In 2012, LB&I took steps to realign its domestic operations based on geography for all industry groups except global high-wealth group.

   b. Current Industry Groups:

      (1) Communications, Technology, and Media;

      (2) Retailers, Food, Transportation, and Healthcare;

      (3) Natural Resources and Construction;

      (4) Heavy Manufacturing and Pharmaceuticals;

      (5) Financial Services; and

      (6) Global High-Wealth.

   c. LB&I also announced its intention to streamline the audit and appeals process for its audits of the biggest taxpayers to free up resources to focus more on flow-throughs, financial products, and businesses with less than $250 million in assets.

   d. LB&I eliminated the tiered issue process and replaced the process with a knowledge management system.

      (1) Domestic issues will be managed through issue practice groups (IPGs).

         (a) Taxpayers have the right to ask whether the IRS has reached out to an IPG for help on an issue.

      (2) International issues will be managed through the International Practice Networks (IPNs).

B. <u>Withdrawal of Tax Lien.</u>

1. On June 28, 2013, the IRS reissued guidance on guidelines for the Withdrawal of Tax Lien Notice when taxpayers are in an established Direct Debit Installment Agreement ("DDIA").

2. IRS laid out several conditions for a request for withdrawal under the DDIA provision:

   a. The aggregate balance of assessment be $25,000 or less,

   b. Total tax liability will be paid within 60 months, and

c. Taxpayers are in compliance with other filing and payment requirements.

C. Fast Track Settlement Changes.

a. Now Fast Track Settlement (FTS) is available to taxpayers under review by IRS Tax Exempt and Government Entities Division (IRS Announcement 2012-34)

b. This decision provides an opportunity for taxpayers with issues under examination by the Tax Exempt and Government Entities Division to use Fast Track Settlement to expedite case resolution.

c. Generally, TE/GE FTS is available for cases involving income tax; exclusion of income from interest paid on municipal obligations; employment tax; estate and gift taxes; excise tax; exemption, foundation or qualification issues; or other such TE/GE functional issues as appropriate when:

(1) Issues are fully developed;

(2) The taxpayer has stated a position in writing; and

(3) There are a limited number of unagreed issues.

D. Innocent Spouse – Proposed Amendments to Treasury Regulations (Treas. Reg. §§ 1.66-4, 1.6015-5, and 1.6015-9)

1. Background on Innocent Spouse

a. Section 6103(a) permits taxpayers who are husband and wife to file a joint Federal income tax return; there is several and joint liability imposed under section 6013(d)(3).

b. Section 6015 provides relief from joint and several in certain circumstances.

(1) Understatements of tax attributable to erroneous items of the other spouse if the taxpayer had no reason to know of the understatement and it is inequitable to hold the taxpayer liable;

(2) Taxpayer, who is divorced or legally separated from, or no longer living with, the spouse or former spouse with whom the joint return was filed, may elect to allocate a deficiency to the other spouse, as if the spouses had filed separate tax returns;

(3) Taxpayer may request, under "procedures prescribed by the Secretary," relief from a tax understatement or underpayment when the taxpayer does not qualify for relief under the other two subsections and it would be inequitable.

2. Proposed Amendments.

a. On August 12, 2013, the IRS proposed amendments to regulations relating to relief from joint and several tax liability under section 6015, and relief from Federal income tax liability resulting from the operation of state community property laws under section 66.

b. The proposed regulations provide guidance to taxpayers on when and how to request relief.

c. IRS released proposed amendments to Treas. Reg. sections 1.66-4, 1.6015-5, and 1.6015-9 formalizing the extended deadline set forth in IRS Notice 2011-70 for a taxpayer to apply for equitable innocent spouse relief under section 6015(f).

d. The proposed amendments are consistent with Notice 2011-70, which provides that a request for equitable relief under section 6015(f) is not subject to the two-year deadline after the IRS begins collection activity unlike the rules for requests made under section 6105(b) and (c) are subject.

E. <u>IRS Releases Guidance on Filing Status for Taxpayers in Same-Sex Marriages (Rev. Rul. 2013-17)</u>

1. Revenue Ruling 2013-17.

a. First Issue: Whether the terms, "spouse," "husband and wife," "husband," "wife," and "marriage" include an individual married to a person of the same sex, if the individuals are lawfully married under state law. Also, is "marriage" applicable?

(1) The IRS concludes that gender-neutral terms in the Code that refer to marital status, include, respectively,

(a) An individual married to a person of the same sex if the couple is lawfully married under state law, and

(b) Such a marriage between individuals of the same sex. The IRS also concludes that the terms "husband and wife", "husband", and "wife" should be interpreted to include same-sex spouses.

b. Second Issue: Whether the IRS recognizes same-sex marriage of individuals domiciled in a state which does not recognize the validity of same-sex marriages.

(1) IRS has determined to interpret the Code as incorporating a general rule, for Federal tax purposes, that recognizes the validity of a same-sex marriage that was valid in the state where it was entered into, regardless of the married couple's place of domicile.

c. Third Issue: Whether the term "marriage" includes registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law.

(1) The term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under the state's law.

II. SUPREME COURT REVIEW OF TAX CASES

A. <u>Severance Payments - United States v. Quality Stores, Inc.</u>

1. District Court (<u>United States v. Quality Stores, Inc</u>., 105 AFTR 2d 2010-1110 (W.D. Mich. 2010)

a. Holding: Severance payments made to employees pursuant to an involuntary reduction in force are not "wages" for FICA tax purposes, and thus no withholding is required.

b. Facts: Taxpayer closed 63 stores and 9 distribution centers, and terminated 75 employees before bankruptcy proceedings. After the bankruptcy petition date, the taxpayer closed their remaining 311 stores and 3 distribution centers, and terminated the remaining employees. Taxpayer made severance payments to employees during both periods. The payments were made "pursuant to [severance plans]." The severance payments were included in the employees' gross income and the taxpayer reported the severance payments as wages on the W-2 forms while withholding federal income tax and the employees' share of FICA tax.

c. Rationale: Reasoned that any statutory exemption from "wages" like that provided for these involuntary severance benefits must be deemed to extend to FICA taxes as well, unless the IRS provides a different rule by regulation.

2. Sixth Circuit Court of Appeals (<u>United States v. Quality Stores, Inc</u>., 693 F.3d 605 (6th Cir. 2012)

a. Holding: Affirmed the district court judgment.

b. Rationale: Reasoned that Congress has provided that supplemental unemployment compensation benefits are not "wages" and are treated only as if they were "wages" for purposes of federal income tax withholding, such payments are not "wages" for purposes of FICA taxation.

c. The government filed a petition for rehearing en banc, which was denied.

d. Effect: Sixth Circuit expressly declined to follow the Federal Circuit's contrary decision in <u>CSX Corp. v. United States</u>.

3. Supreme Court

a. The Supreme Court is scheduled to consider the Petition for Certiorari on September 30, 2013.

B. <u>Penalties Imposed on TEFRA Partnership - Woods v. Commissioner</u>

1. District Court (<u>Woods v. United States</u>, 794 F. Supp. 2d 710 (W.D. Tex. 2010)

a. Facts: Taxpayer participated in COBRA, a tax shelter marketed by Ernst & Young. COBRA entailed a number of transactions. The end result of COBRA is that the basis of each partnership's property was the cost of "long" currency options, while "short" options could be disregarded. The long position resulted in an ordinary loss for tax purposes.

b. Holding: Granted the government's motion for judgment as a matter of law with respect to the disallowance of the ordinary and capital losses claimed on the partnership returns.

c. Rationale: Taxpayer entered into transactions that were "totally lacking in economic substance and was for the sole purpose of creating a tax benefit."

d. Issue that remains unresolved is whether the IRS was justified in imposing certain penalties in addition to the income taxes due and owing as a result of the adjustments.

2. District Court (<u>Woods v. United States</u>, 794 F. Supp. 2d 714 (W.D. Tex. 2011)

a. Issue: Whether the imposition of accuracy-related penalties was justified

b. Facts: IRS imposed three categories of accuracy related penalties: (1) a penalty for gross or substantial misstatement of valuation; (2) a penalty for negligence or disregard of rules and regulations; and (3) a penalty for substantial understatement of income tax. The court discussed each penalty.

(1) Penalty for Gross or Substantial Misstatement of Valuation – The district court reversed these penalties. Reasoned that it is clearly established that "whenever the [IRS] totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction. Relying on <u>Heasley v. Commissioner</u>, a Fifth Circuit Court of Appeals case, the court here noted that "underpayment is not attributable to a valuation overstatement; it is attributable to claiming an improper deduction."

(2) Penalty for Negligence or Disregard of Rules and Regulations – The district court upheld these penalties. Reasoned that given the taxpayer's sophistication with tax matters and general business dealings, taxpayer knew or should have known, "that these transactions did not possess economic substance compelled by business or regulatory realities."

(3) Penalty for Substantial Understatement of Income Tax – The district court upheld these penalties. Taxpayer does not fall under the statutory "reasonable cause" exception to the underpayment of tax penalty. Court reasoned that taxpayer could not claim reasonable reliance because it is not objectively reasonable since he knew or should have known that the COBRA tax benefit was "too good to be true" in light of all the circumstances.

c. Holding: IRS' imposition of a penalty for misstatement of valuation is reversed.

3. Fifth Circuit Court of Appeals (<u>Woods v. United States</u>, 471 Fed. Appx. 320 (5th Cir. 2012).

a. In a short opinion, the Court affirmed the district court because the issues regarding the penalties are "well settled."

b. Petition for Rehearing En Banc was denied.

4. Supreme Court

a. The Supreme Court granted the government's Petition for Certiorari on March 25, 2013.

(1) Government had asked for petition because of a circuit conflict over whether a taxpayer's underpayment of tax can be "attributable to" a misstatement of basis where the transaction that created an inflated basis is disregarded in its entirety as lacking economic substance. The 9th and 5th Circuits differ from the eight other circuits.

b. Added an additional issue for the parties to brief - Whether the district court had jurisdiction in this case under Section 6226 to consider the substantial valuation misstatement penalty. This issue involves the general question under TEFRA of which issues are to be resolved in a partner-level proceeding and which should be resolved at the partnership level.

C. Foreign Tax Credits- PPL Corp. v. Commissioner

1. Tax Court (PPL Corp. v. Comm'r, 135 T.C. 15 (2010)

a. Issue: Whether a 1997 windfall tax imposed by the U.K. government on previously privatized industries is a creditable income tax under U.S. rules

b. Facts: In the early 1990s, the Conservative government (of the U.K.) privatized government-owned monopolies, including regional electricity companies. In 1997, the new Labour government (of the U.K.) announced a tax aimed at windfall profits previously realized by formerly government-owned enterprises. This one-time, retrospective tax was justified by assertions that the windfall profits resulted from the prior government's decision to sell off the companies at too low a price.

c. Holding: Ruled for the taxpayer – the U.K Windfall Tax imposed on certain British utilities is a creditable tax under Section 901.

d. Rationale: Reasoned that the windfall tax was to tax an amount that may be considered excess profits realized, and did, in fact, reach the net gains in the normal circumstances. Thus, the "predominant character was that of an income tax in the U.S. sense."

e. The government appealed.

2. Third Circuit Court of Appeals (PPL Corp. v. Comm'r, 665 F.3d 60 (3rd Cir. 2011)

a. Holding: Reverse the Tax Court – U.K. Windfall Tax does not qualify for a foreign tax credit.

b. Rationale: Reasoned that the windfall tax failed the "gross receipts" test for proving that it reaches net gain in normal circumstances, and thus its predominant character wasn't that of "income tax in U.S. sense"

c. PPL's Petition for Rehearing En Banc was denied.

d. PPL filed a Petition for Certiorari shortly thereafter to resolve the circuit conflict created by the Entergy case in the Fifth Circuit.

3. Supreme Court (<u>PPL Corp., et al. v. Comm'r of Internal Revenue</u>, 569 U.S. ___ (2013).)

a. On October 29, 2012, the Supreme Court granted the petition for certiorari and will decide the question of availability of the foreign tax credit for payments of the U.K. Windfall Tax.

b. American Electric Power co. filed amicus briefs in support of PPL.

(1) It contained a detailed description of how the U.K. Windfall Tax came to be enacted, and states that the Third Circuit decision "disregards the real operation of the tax at issue"

(2) This brief argued that the windfall tax is akin to that of a traditional U.S. excess profits tax that has always been regarded as creditable.

c. Justice Thomas, writing for the majority, reinforced the predominant character standard as the controlling test in determining whether a foreign tax is creditable.

(1) Court held that the predominant character test [of the foreign tax credit regulations] means that "a foreign tax that operates as an income, war profits, or excess profits tax in most instances is creditable, even if it may affect a handful of taxpayers differently."

(2) Justice Thomas further held that the foreign statutory language is not dispositive, instead the economic effect of the tax is the crucial inquiry.

(3) In a 9-0 decision, the Supreme Court ruled in favor of PPL.

d. The Supreme Court decision will lend support to litigants who want to rely on pre-regulation case law in future foreign tax credit cases.

D. <u>Six-Year Statute of Limitations –*Home Concrete*</u>

1. Background:

a. Code Section 6501(a) generally provides that a valid assessment of income tax liability may not be made more than 3 years after the later of the date of the tax return was filed or the due date of the tax return.

b. Code Section 6501(e)(1)(A) allows a 6 year statute of limitations on assessment when a taxpayer "omits from gross income" an amount that is greater than 25% of the amount of gross income stated in the return.

c. Text of Code Section 6501(e)

Except as otherwise provided in subsection (c) —

(1) Income taxes. In the case of any tax imposed by subtitle A—

(A) General rule. If the taxpayer omits from gross income an amount properly includible therein and—

(i) such amount is in excess of 25 percent of the amount of gross income stated in the return, or

(ii) such amount—

(I) is attributable to one or more assets with respect to which information is required to be reported under section 6038D (or would be so required if such section were applied without regard to the dollar threshold specified in subsection (a) thereof and without regard to any exceptions provided pursuant to subsection (h)(1) thereof), and

(II) is in excess of $5,000,

the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(B) Determination of gross income. For purposes of subparagraph (A) —

(i) in the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

(C) Constructive dividends. If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed.

2. Colony, Inc. v. Commissioner, 357 U.S. 28 (1958)

a. Background: Real estate developer that miscalculated profits from the sale of realty by erroneously including an excessive item of cost of the realty.

b. Issue: Under the predecessor statute to 6501(e), did the taxpayer omit from gross income some taxable item?

c. Holding: The extended period of limitations in applies to situations where specific income receipts have been "left out" in the computation of gross income, and not something put in and overstated.

d. Rationale –

(1) When a taxpayer omits an item, the IRS is at a disadvantage in detecting errors. In such cases the return on its face provides no clued to the existence of an omitted item. However, in an overstated basis issue the face of the return the Commissioner is not at a disadvantage because the basis is disclosed.

3. 1954 Code Changed/Clarified Code Section 275(c) (now 6501(e))

a. Congress made modifications to the 3-year/6-year issue in response to court decisions. In each instance, Congress limited the 6-year statute to cases in which the taxpayer left out items of income.

(1) New Heading on Code Subsection– "Substantial Omission of Items" replaced "Omission from Gross Income."

(2) Exception from 6-year statute if adequate disclosure is provided.

(3) Redefined gross profit as including only the revenue side.

4. IRS Litigation Position: Treasury Regulation 301.6501(e)-1(e) (T.D. 9511).

a. Background: In December 2010, the IRS issued final regulations which held that an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis is an omission of gross income for purposes of the 6-year period for assessing tax.

(1) IRS disagrees that the holding of Colony applies to Section 6501(e)(1)(A). The IRS takes the position that when Congress enacted the 1954 Code, it limited what became the holding of Colony under the 1934 Code.

(2) The Regulations provide that any overstatement of basis that results in an understatement of gross income under Code Section 61(a) is an omission from gross income under Code Section 6501(e)(1)(A).

b. Validity of Regulations under Mayo (Mayo Foundation For Medical Residents V. United States, 131 S. Ct. 704 (2011).

(1) On January 11, 2011, the Supreme Court addressed the validity of Treasury regulations dealing with employment taxes for medical residents and other student-employees.

(2) Issue: Whether medical residents are exempt from FICA taxes based on the exception for service performed in the employ of a school, college, or university if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university.

(3) The Treasury regulations promulgated in 1951 provide that the exception only applies to students who work for their schools as incident to and for the purpose of pursuing a course of study. See Treas. Reg. §31.3121(b)(10)-2(d).

(4) In 2004, Treasury amended the regulations so that the exception only applies only when the educational aspect predominates over the service aspect. Specifically, student working a full-time schedule (scheduled more than 40 hours a week) are not within the exception.

(5) The Mayo Foundation and the University of Minnesota challenged the validity of the amended regulation. The District Court agreed in part relying on the National Muffler decision (National Muffler Dealers Ass'n Inc. v. United States, 440 U.S. 472 (1979)). (Mayo Found. For Med. Res. v. United States, 503 F. supp. 2d 1164 (D. Minn. 2007).

(6) However, the 8th Circuit reversed the lower court ruling finding that the regulation was valid under the Chevron standard (Chevron U.S.A. Inc., v. Natural Resources Defense Council Inc., 467 U.S. 837 (1984)) (Mayo Found. For Med. Res. v. United States, 568 F. 3d 675 (8th Cir. 2009).

(7) The Supreme Court unanimously affirmed the circuit court opinion (131 S. Ct. 704 (2011) and held:

(a) Chevron, not National Muffler controls;

(b) Section 3121(b)(10) is silent or ambiguous as to the definition of the student exception; and

(c) The amended regulations reasonably interpret section 3121(b)(10).

c. Application of Mayo/Chevron.

(1) Determination

(a) Step 1 – Did Congress have an intention on the precise question at issue? If so, that intent is controlling. If the regulation takes a different position, the regulation is invalid.

(i) Ask -- Is the statutory provision ambiguous?

(ii) Ask – Can the judge look to other guidance to determine Congressional intent such as legislative history or should the focus be solely on the text of the statute?

(b) Step 2 – If Congress did not have an intention on the precise question at issue, then a government agency can adopt any reasonable interpretation.

(i) Ask – Is the regulation reasonable interpretation of the statute?

(2) Generally, for a taxpayer to be successful in challenging the validity of a regulation, the taxpayer must win at Step 1. If the statutory provision is found to be ambiguous, the burden on the taxpayer to show that the interpretation is unreasonable is quite steep. However, it is not impossible to convince a court that the agency determination is unreasonable.

5. Supreme Court -- Home Concrete & Supply, LLC v. United States (566 U.S. ___, 132 S. Ct. 1836 (2012)).

a. On September 27, 2011, the U.S. Supreme Court granted certiorari. Many people were surprised that the Supreme Court chose to select this case as opposed to the taxpayer's petition in Beard v. Commissioner. Beard had been decided earlier and had the support of the U.S. Justice Department. However, Home Concrete addressed a wider range of issues in its opinion including the validity of the Treasury regulations (T.D. 9511) issued under Section 6501(e).

b. Issue Before the Supreme Court:

(1) Whether an understatement of gross income attributable to an overstatement of basis in sold property is a gross omission that triggers the six-year assessment period.

(2) Whether final regulations promulgated by Treasury are subject to judicial deference.

c. Facts:

(1) Robert Pierce and Stephen Chandler owned Home Oil and Coal Company. They planned to sell the business. Prior to engaging in a sales transaction, the two owners participated in a variety of transactions including short sales of U.S. Treasury Bonds. These transactions were designed to increase their basis in certain assets and decrease their tax liability upon the actual sale of the business.

(2) When they initiated the sales of the U.S. Treasury bonds, they transferred the short sale proceeds and margin cash to Home Concrete & Supply, LLC ("LLC") as capital contributions. The contributions created an outside basis in the LLC. When the LLC closed the short sale transactions by purchasing and returning almost identical U.S. Treasury bonds to the open market.

(3) Home Oil & Coal Company transferred all of its business assets to the LLC as a capital contribution.

(4) Pierce and Chandler transferred percentages of their respective partnership interest in the LLC to Home Oil as a capital contribution.

(5) LLC sold substantially all of its assets to a third-party purchaser.

(6) On its 1999 tax return, the LLC made a Section 754 election to adjust or step up its inside basis to equal the taxpayer's outside basis in the LLC. The LLC then adjusted its inside basis and as a result reported a modest gain on the sale of its assets.

(7) On September 7, 2006, the IRS issued a Final Partnership Administrative Adjustment ("FPAA"). In the FPAA, the IRS did not allow the basis step-up, which resulted in a substantial increase in the LLC's gain on the sale of the assets.

(a) The IRS rational for the adjustment was that the partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interest.

(8) Home Concrete paid the amount due and filed a refund suit in the U.S. District Court for the Eastern District of North Carolina

(9) The Taxpayers alleged that the FPAA was barred by the Code Section 6501(a) 3-year limitations period.

d. District Court's Holding (Home Concrete & Supply, LLC v. U.S. (E.D. NC 2008) – Held in Favor of the IRS:

(a) Holding: Granted partial summary judgment in the IRS's favor.

(b) Rationale: Held that where a taxpayer overstates basis, and as a result, leaves an amount out of gross income, the taxpayer omits an amount from gross income for purposes of Code Sec 6501(e)(1)(A).

(c) Therefore, the 6-year statute applied, not the 3-year.

e. Fourth Circuit's Holding (Home Concrete & Supply, LLC v. United States, 634 F. 3d 249 (4th Cir. 2011) – Held in Favor of the Taxpayer:

(a) Holding: Overruled District Court and found that the 3-year statute of limitations not the 6-year statute applied, which meant that the FPAA was untimely.

(b) Rationale: Held that the Supreme Court holding in Colony continued to apply to Code Section 6501(e)(1)(A) and that an overstated basis in property is not an omission from gross income that extends the period of limitation.

(c) Home Concrete's overstated basis in the short sale proceeds did not trigger the 6-year statute of limitations.

(d) The Colony decision construed the phrase "omits from gross income" separate from being dependent on the taxpayer's identity as a trade or business selling goods or services. The language of the statute that was at issue in Colony is identical to the language at issue in Home Concrete.

(e) The 4th Circuit held that because the Treasury Regulation at issue was interpreting language that the Supreme Court held to be unambiguous when it decided Colony, the regulation was not entitled to controlling deference.

f. Supreme Court Review: Effect of Mayo

(1) In Mayo, the Supreme Court gave the government wide latitude when regulations are issued. There is confusion regarding how broad these powers extend. Can the IRS do whatever it wants when it issues regulations? Did Congress intend to permit the IRS to issue retroactive regulations with such a broad scope when used to bolster a litigation position?

(2) Does Colony still apply post Chevron/Mayo?

(3) Step 1 - -Will the Supreme Court find the statute ambiguous?

(a) In aiding their determination, will the Supreme Court look past the statutory provision to legislative history and Congressional reports?

(4) Step 2 – If it is ambiguous, are the retroactive regulations reasonable?

(a) Do the regulations meet the Administrative Procedures Act standards – did Treasury provide adequate explanation for the regulations?

g. Taxpayer's Response to Government's Certiorari Petition

(1) Argued that legislative changes to section 6501(e) have never overruled Colony, which remains good law because it is not limited to goods or services.

(2) Argued that the final regulations are not applicable even if the six-year statute applies because the retroactive nature of the regulations violates due process and does not deserve judicial deference.

h. Supreme Court Opinion (U.S. v. Home Concrete & Supply, LLC, 566 U.S. ___, 132 S. Ct. 1836 (2012))

(1) Holding: The six-year statute of limitations does not apply to an overstatement of basis.

i. Rationale: The Court in Colony had concluded that Congress had definitively resolved the legal issue and left no gap to be filled by a regulatory interpretation; obliged by stare decisis to follow it.

III. BACK TO BASICS: OVERVIEW OF A TAX EXAMINATION

A. Phases of an Audit. There are six potential phases of an examination.

1. Opening phase,

2. Information gathering phase,

3. Issue presentation phase,

4. Examination closing phase,

5. Appeals phase, and

6. Litigation phase.

B. Setting Goals for the Audit

1. Taxpayer's Audit Goals:

a. To manage and control the audit process by:

(1) Maintaining a good working relationship with the examiner;

(2) Maintaining knowledge of and control over the information the examiner receives;

(3) Avoiding extraordinary information gathering techniques (i.e., summons, Internal Revenue Code (I.R.C.) § 982 requests); and

(4) Avoiding penalties.

b. To complete the audit within a reasonable time, because:

(1) A prolonged audit is expensive for the taxpayer;

(2) As the audit/appeals process drags out, taxpayers may become increasingly concerned with the continuing uncertainty or need for financial disclosure;

(3) Taxpayers have the burden of proof. The longer the period between the return and the resolution of issues, the more difficult it is to develop documentary and testimonial evidence; and

(4) To resolve most issues on a reasonable basis prior to consideration by the Appeals Division.

(5) To prepare and preserve difficult issues for Appeals Division or Litigation.

(6) To agree on favorable facts underlying the difficult issues.

(7) To minimize the impact of the current audit on other years, cases, and state tax returns.

2. IRS Goals for Audit:

a. To identify and fully develop important issues for resolution at audit or subsequently.

b. To avoid poor issues.

c. To increase revenue for the Treasury through successful resolution of large adjustments.

d. To keep audit within IRS management time limitations and meet efficiency goals, and to improve coordination among all participants in the audit team.

e. To obtain taxpayer agreement to most adjustments, limiting the number of issues which must be taken to the Appeals Division.

f. To treat related cases consistently (industry issues, transaction issues, whipsaw cases.)

g. Increasingly, to improve "sustention" rates (i.e., winning more issues in Appeals or Litigation).

C. Planning for the Audit

1. Internal Preparation.

a. Set your goals at the outset, and communicate your goals, what you want to accomplish, and the timing for the audit. This communication needs to involve all those within the company (management, operations and staff) who will participate in or be significantly affected by the audit of the IRS. If operations people will be used for support, it is important that you let them know in advance why their efforts will be significant. Remember to keep your goals and objectives reasonably flexible, so that you are sensitive to and can adapt to any changes in circumstances.

2. Select and communicate a basic tone for the audit.

a. Hard-nosed vs. professional (firm, but cordial, cooperative). Your tone can force the IRS to reciprocate (positively or negatively). I recommend being cordial, cooperative, and firm. You can be professional without being hard-nosed, you can be helpful without losing sight of the fact that you are on opposing sides.

b. Your ability to meet your procedural commitments can force the IRS examiners to live up to theirs.

c. Try to build and maintain credibility throughout the audit. Credibility can be developed through admitting the obvious and meeting pertinent procedural commitments. Credibility is essential during negotiations.

3. Establish procedures and responsibilities for your staff.

a. Procedures for recording, processing and responding to Information Document Requests (IDRs) from the IRS auditor can be critical to keeping the audit on schedule. IDRs are discussed in detail, below. IDRs need to be logged in and out, and responsibility for processing needs to be tracked. A log must be kept of each document submitted in response to the IDR, the date submitted, whether the document was copied and the date returned.

b. Have clear procedures for how IRS examiners' access to information (both documents and people) will be controlled. Despite the tendency to become lax with internal procedures, these rules must be enforced.

(1) Decide who will and will not deal with the examiners.

(2) Decide who will receive and release IDRs to the examiners.

c. Review documents prior to delivery for purposes of potential exposure and privilege issues. Privileges that may protect a taxpayer's documents from disclosure to the IRS are discussed below. Determine the issue that is under inquiry, if possible. Oftentimes, more than one document may respond to the IDR. Make sure that you are responding in the most favorable manner. When appropriate, consider when it will be advantageous to develop information schedules or interpretations that, for example, place facts in the proper context rather than to provide discrete information in raw document form.

4. Establish good communication between the client's tax staff and financial staff.

a. Most of the information requested by the IRS will have to come from financial staff. They will carry the burden.

b. Make sure that the financial staff understands why time will be of the essence during the audit. Financial staff will be particularly sensitive to the problem of compounding interest cost.

c. Make sure that the financial staff understands your procedures for dealing with IRS examiners. Explain the IDR request to the financial staff and jointly determine the best document to utilize in response to the request.

d. In large, multi-location businesses (particularly if there are to be support audits), you may need to prepare the financial staff at each location.

5. What should your client provide to its tax advisors before initial meeting/interview:

a. All correspondence, notices, reports, etc., from the IRS;

b. Tax returns for the relevant years;

c. All correspondence, etc., from the company to the IRS; and

d. Issue-related documentation such as receipts, books and records.

6. Examine correspondence from the IRS:

   a. Examining correspondence from the IRS enables you to spot the important issues facing your client. You and your staff should determine whether the matter is in audit, appeals, or collection. One of the most significant pieces of information on some IRS correspondence is the name of the IRS employee handling the file. It is always preferable to deal with a human as opposed to the error-prone IRS computer system. IRS correspondence can also alert you to important time deadlines such as a 30-day letter, 90-day letter, or a Notice of Intent to Levy. Tax returns are, of course, absolutely necessary in most cases. Reviewing prior correspondence to the IRS can avoid nasty surprises such as unknown concessions, admissions, or stipulations by the company. Prior correspondence is also sometimes useful in persuading the IRS to abate some penalties. Many tax controversies have been won or lost depending upon the documents uncovered by a taxpayer's representative.

7. Know Your Client's Records.

   a. I.R.C. § 6001 requires maintenance of records.

      (1) What records do you have? Where are your gaps?

      (2) Where are financial and tax records located? How long will they remain there? Will you need records other than financial and tax records to provide your case?

      (3) Are any of your records being held by third parties? What should be done about third party records?

      (4) If you have record retention problems, devise your strategy to deal with them prior to the examination in order to maintain your audit credibility.

   b. Isolation of privileged documents.

      (1) What areas are likely to have legal analysis in the files?

      (2) Cull attorney opinion letters and other privileged documents from the files.

      (3) Restrict access to privileged documents in order to maintain the privilege.

8. Know the IRS.

    a. If a significant agent or a case manager is new to your audit, try to talk to taxpayer's staff from his/her prior audit. If you have worked with the IRS personnel previously, consider what you know about their methods and personalities that will affect this audit.

D. <u>Preparing the IRS at the Beginning of the Audit.</u>

1. Use the opening conference to set the tone you choose for the audit. Make them aware of your expectations of them, and what they can expect from you.

2. Specific topics for the opening conference:

    a. Your commitment to the audit, the resources you will use, the personnel involved, who will be their contact person.

    b. Agreement on the duration of the audit. This agreement should be in writing and it should be clear that the reasonable date for completion which has been agreed by the parties will be enforced by not granting extensions of the statute of limitation.

    c. The scope of the audit. Which entities will be examined? What schedules of the tax return will be examined?

    d. Accommodations for examiners, location of office space, copying facilities, security provisions, access to areas outside their office space.

    e. Access to computers and computer files.

    f. Location of books, records, and returns. Existence of amended returns or supplemental adjustments. Access to minute books of board of directors and committees. Availability of other accounting worksheets and schedules. Procedures for obtaining any materials which are not originally located in the examiners' office space.

    g. Weigh whether to discuss "known audit adjustments" or pending refund claims that affect (or are affected by) the audit. Note that refund claims should be reviewed by those who would have to pursue them in court before being tendered to the IRS.

    h. Ground rules for Information Document Requests (IDRs).

        (1) Absolutely <u>all</u> IDRs to be in writing.

(2) Need for specificity and focus in drafting IDRs. Make clear that you will ask for clarification of any IDRs which are too broad.

(3) Agree on a number system for all IDRs. This is critical to your tracking system.

(4) Explain your commitment to a response time goal. This reinforces the need for specificity and the numbering system.

(5) Identify issues (international, for example) which will need additional response time. This will force the IRS to plan ahead for requests in these areas.

(6) Establish a procedure for regular status meetings to monitor the progress of IDR responses and to cover recurring problems in IDRs.

i. Notices of Proposed Adjustment from the IRS auditor provide an important opportunity to deal effectively with developing issues.

(1) Discuss a procedure for tracking and responding to proposed adjustments.

(2) Establish a numbering system and expectations of submission and response time.

j. Agree on a procedure for discussing issues. Clarify which taxpayer personnel (if any) are authorized to discuss issues. Agree to a system of position papers (from both parties) on unagreed issues. Clarify which taxpayer personnel have authority to resolve issues.

k. Agree on procedures for closing the audit. Make clear that lead time is necessary to allow closing of support audits in time for agreed closing date of the main audit.

E. <u>Other Pre-Audit Investigation Responsibilities.</u>

1. IRS Documents. The IRS possesses numerous documents which might be useful to you. The company might have been audited in prior years, or you may have been hired after the audit is already underway. Documents which you should obtain include:

a. Tax returns or refund claims;

b. The Initial Notice of Audit;

c. Information Document Requests (IDRs) or Administrative Summonses;

d. Notices of Proposed Adjustments;

e. Agent workpapers;

f. Audit letter, Audit Reports or Revenue Agents Reports (30-day letter);

g. Notices of Deficiency (90-day letter);

h. Tax Court petitions, documents, or decisions; and

i. Tax account information.

2. Administrative file. If your case is in Audit, Appeals or Tax Court, the Agent will usually have most of these documents, if they exist, in the administrative file. You can ask the Agent for copies of these documents, which will usually be provided. If the Agent withholds a critical document such as a tax return, speak to his manager and emphasize the importance of the document to your preparation of the company's records for audit.

3. Service Center. You should also formally request relevant documents from the Service Center where the company filed its returns. This should be done as soon as possible since it may take months for the Service Center to copy the documents. For certain types of requests, the IRS has adopted specific formats. You should also routinely request the other documents from the IRS Service Center with a letter. When you request documents, remember that the IRS is probably the largest information-gathering agency in the country. If they know something about your client that you don't, you may be at a severe disadvantage. Even if you are fully informed, it pays to know what the IRS knows or does not know.

4. Tax Returns or Refund Claims. Obviously, these are necessary documents in most tax controversies. Taxpayers have sometimes lost their copy or have kept only an unsigned draft copy. If at all possible, you should obtain a signed copy with the IRS date stamp indicating "FILED." This date stamp is necessary in order to determine when the statute of limitations expires and whether certain penalties are appropriate.

5. Initial Notice of Audit. The initial audit correspondence between the IRS and your client might be useful in determining the goal of the audit. For example, a computer-generated letter from the Service Center document matching program usually results in a single-issue mail audit. A letter personally signed by a Revenue Officer or an Agent from the Criminal Investigation Division is a much more serious matter.

6. IDRs or Administrative Summons. When an Agent wants specific information, it can be to your advantage to request an IDR. The IDR will specify the information the Agent seeks and might alert you to the issues being investigated. The advantage of requesting an IDR is that you control the flow of information to the Agent. If you do not respond to an IDR, the Agent may have an Administrative Summons issued. Under most circumstances, you must comply with a summons.

7. Notice of Proposed Adjustment. When the Agent has made a tentative decision on an issue, he may issue a notice of proposed adjustment. An Agent is sometimes willing to change his mind on these notices if you provide an alternative in a timely fashion

8. Agent Workpapers. If a prior audit took place, the Agent's workpapers will allow you to see the positions and goals of the IRS. Contrary to popular opinion, these papers are often obtainable, either after audit or in the Tax Court.

9. Audit Letters, Audit Reports and Revenue Agents' Reports (RARs). When the Agent has reached a definite conclusion, an audit report is issued. Depending upon the case, the taxpayer may receive anything from a simple letter to a very large RAR with numerous exhibits. These documents are also referred to as "30-day letters" since they grant the taxpayer 30 days in which to appeal the findings to the IRS Appeals Division.

10. Tax Account Information. In order to determine what taxes the company has paid and what taxes, interest, or penalties are due, you need tax account information. The Agent should be able to provide you with a copy for the relevant years. Sometimes checks are posted to the wrong accounts or in the wrong amounts. The tax account can help locate those errors. If you cannot obtain the information from an Agent, write a letter to the appropriate Service Center.

11. Oral or Written Communications. Generally, frequent oral communication with the IRS employee handling the case is recommended. You will have many opportunities to get acquainted with the Agent and to understand the audit objectives. You can answer some questions or provide information quickly and informally. Many issues can be disposed of informally in this manner. Some issues will be incapable of oral settlement. In these cases the Agent may require documents to be provided. A cover letter should be sent with the documents, with a copy kept in your files. That way, you know exactly what information has been provided to the IRS. You cannot rely in a court on the oral statements of an IRS employee. Advice by the IRS is binding only if it is in writing and certain other requirements are met see I.R.C. § 6404(f). Nevertheless, most IRS Agents will uphold any oral agreements which they personally have made.

12. Finding Out What They Really Want. One primary goal of your pre-audit investigation is to find out what the IRS is looking for. This will help you prepare more effectively and will save your time and your client money. If the case is a simple one -- a single-issue mail audit, for example -- you do not need to prepare for a full-blown audit. Conversely, you do not want to be under-prepared and surprised when the Agent arrives.

13. Prepare for audit interview. Even though you have identified likely audit issues and have assembled the relevant records, you are not yet ready for the audit. Before the audit begins, you should have your tax professionals:

    (1) Prepare document summaries;

    (2) Examine the statute of limitations;

    (3) Research the applicable law;

    (4) Evaluate the company's position; and

    (5) Discuss settlement with you.

F. <u>Conducting the Audit</u>

1. Powers of Attorney.

    a. At the initial interview, you should sign a Form 2848, Power of Attorney and Declaration of Representative. The Power of Attorney allows your tax advisors (accountants, lawyers) to contact the IRS on the company's behalf. When received, the IRS enters the Power of Attorney into its nationwide computer system. IRS personnel are instructed not to talk to anyone else about a taxpayer unless a Power of Attorney is on file. To avoid delays, always send a copy of the Power of Attorney to each IRS employee during your first contact with that person. Otherwise, the Power of Attorney may not have been entered into the computer properly and you may be delayed several days before you can mail a new copy to the appropriate IRS official.

2. Locate Gaps.

    a. One advantage of reviewing the company's documents with a tax professional prior to your interview is that it enables you to locate the gaps in the records.

3. Stay Focused. Keep your goals in focus throughout the audit.

    a. Stick to Schedules & Procedures. Maintain procedures and commitments established prior to audit and insist on IRS conformity with agreed procedures. Keep the audit deadline before the IRS personnel. Ask for regular (quarterly or monthly) status meetings with the IRS (preferably the case manager) to review progress.

b. Managing IRS Information Requests. Understand the scope of the IRS's authority to obtain testimony, information, and documents.

(1) The IRS's sources of information. The IRS gathers information for use in an examination from the following sources:

(a) The taxpayer's tax and information returns;

(b) Information returns filed by third parties;

(c) The taxpayer's books and records;

(d) The workpapers of the taxpayer's accountant;

(e) Information provided to the IRS by the taxpayer, the taxpayer's employees, or other third parties; and

(f) Information provided from summonses issued to third parties.

4. "Experts." Taxpayers must be prepared to develop an effective strategy, in the particular circumstances, for dealing with the various technical and legal "experts" who are not on the audit team but have a significant influence over audit issues. Several previously noted points are pertinent:

a. You should consider asking whether any issue is being developed as a designated litigation vehicle. The IRS is supposed to tell taxpayers this before Appeals, but the sooner you know this the better.

b. You may want to consider using company tax counsel or outside tax counsel, or both to deal with Area Counsel or the specialists.

c. It may be worthwhile to provide an expanded response to a notice of proposed adjustment that strongly indicates that your client's situation does not present the best situation for a test case.

d. You may want to be more thorough in your networking with third parties who were involved in the transaction or events underlying the audit issue, so as to influence the factual development of the case.

e. It may be a good time to begin developing privileged document files for later litigation.

f. It may be prudent to consider what, if any, steps should be taken to minimize exposure to penalties.

g. Be sensitive to all IRS relationships under the circumstances, since there may be potential tensions:

   (a) Area Counsel may be at odds or have limited credibility with experienced examiners or Appeals officers.

   (b) Appeals may similarly have a strained relationship with Examination.

h. Be open to opportunities to provide computational support to agents in the development of issues or completion of revenue agent reports. This may be an opportunity to influence its presentation or avoid the future unnecessary refinement of figures on either agreed or unagreed adjustments. It is usually to the taxpayer's benefit to have the numbers agreed on an adjustment.

5. Dealing with an Overreaching Revenue Agent. Some tactics to use in response to overreaching by the Revenue Agent:

   a. Ask for clarification of information sought or negotiate a detailed IDR with the Revenue Agent, then cooperate by literally complying with the request. Consider the risks: General, though broad, requests may be subject to interpretation; specific, though narrow, requests may leave little room for interpretation and may highlight issues or weak points.

   b. If attempts to negotiate are unsuccessful, wheel up a tractor-trailer or give the agent keys and a map to the warehouse. Consider the risks: The Revenue Agent may find the needle in the haystack.

   c. Tell the Revenue Agent to have the summons enforced. The summons enforcement procedures may result in his/her coming back with a more reasonable request. Consider the risks: The summons may be enforced as originally drafted; resistance may leave the Revenue Agent antagonized and suspicious.

   d. If a legal issue exists, as opposed to a factual issue or an issue on the applicability of the law to the facts, see if there is a way to dispose of the legal issue prior to complying with information requests, e.g., ask for an Area Counsel lawyer or seek technical advice.

6. Statute of Limitations. Managing the statute of limitations during the audit process can be an important element in a successful conclusion.

a. The basic three year period under I.R.C. § 6501 will rarely be sufficient for a taxpayer of substantial size.

b. Agents will request extensions early in the audit and should monitor extension deadlines to prevent running of the statute.

   (1) Open-ended extension (Form 872-A) prevents the statute from running until the 90-day letter is sent or until 90 days after a taxpayer or Service files a Form 872-T. See Kinsey v. Commissioner, 859 F.2d 1361, 1364 (9th Cir. 1988), cert. denied, 109 S. Ct. 1540 (1989); Estate of Camara v. Commissioner, 91 T.C. 957, 961 (1988). An executed Form 870 (consenting to an immediate assessment), Form 870-AD (consenting to assessment and barring reopening of case) or a defective 90-day letter does not terminate a Form 872-A extension. See Roszkos v. Commissioner, 850 F.2d 514 (9th Cir. 1988) and Courson v. Commissioner, 59 T.C.M. (CCH) 429 (1990).

   (2) Fixed-period extension (Form 872) prevents the statute from running until the date specified in the form. IRS must receive another extension prior to such date or the statute runs. See Estate of Taft v. Commissioner, 57 T.C.M. 1291 (1989).

c. There are several tactical considerations using Forms 872 and 872-A (indefinite extension).

   (1) Failure to extend the statute or filing the 872-T (terminating an open-ended extension period) will cause issuance of 90-day letter. It may also give rise to document summons if the Service believes it needs more information. Typically, the IRS will proceed to issue the 90-day letter and pursue the administrative summons, if not satisfactorily answered, in a federal district court. The Tax Court proceedings may or may not be stayed during the enforcement action.

   (2) Taxpayers will generally be asked to provide Forms 872 with original signatures. Faxed signatures will likely only be accepted if the statute of limitations is about to expire and the faxed signature is the only way to extend the limitations period.

d. Whether fixed or open-ended, your control over the statute is one of your best ways to encourage the agents to stick to the schedule. But don’t be unreasonable or use up all of your goodwill negotiating over statute extensions.

G. Settlement. Settling issues during the audit.

1. Formally, the agent's authority is limited. The agent is bound by Revenue Rulings and nonacquiescence. However, this may be changing.

   (1) As a practical matter, never underestimate the power of good case negotiation. If you have a strong argument, it is probably a good idea to press it, emphasizing the favorable facts.

   (2) As the involvement of specialists and Area Counsel in audit increases, your ability to win with a strong argument on examination may increase. The Service may not want its position tested by your strong case.

2. Agents are not supposed to consider hazards of litigation.

   (1) It may be necessary to help the agent appear not to be using hazards of litigation by structuring settlements along factual lines which can be supported by principle.

   (2) If performance evaluation continues to focus on Appeals sustention rates, agents may be less willing to send weak issues up to Appeals.

3. Factual issues have the best chance of settling in Examination.

4. The increased involvement of IRS attorneys and experts in examination have identified Hot Issues and made them harder to settle.

5. The IRS has recently made it clear that agents are not to use penalties as bargaining chips in audits.

H. Concluding the Audit.

1. If all issues are agreed, the agent will ask for the taxpayer to execute a Form 870 consenting to immediate assessment.

   (1) Form 870 waives your right to litigate in the Tax Court, except in rare situations when later raised issues before the statute of limitations expires result in a 90-day letter. It also does not prevent filing of a claim for refund and subsequent suit in the District Court or Federal Claims Court. Form 870-AD does bar refund claims unless the issue is specifically excepted.

   (2) Form 870 can be signed to cover only agreed issues so that tax can be paid (and interest stopped) on those issues, while unagreed issues go to Appeals or to Tax Court. Interest can

be stopped on unagreed issues by posting a bond or paying part of the proposed deficiency. This must be done carefully, so as not to lose access to the Tax Court.

2. If some issues are unagreed, the agent will prepare a revenue agent's report (RAR) describing proposed adjustments and reasons for the agent's position.

(1) A draft RAR may be supplied to taxpayer near the close of the audit.

(2) The final RAR is formally sent with a "Preliminary Notice of Deficiency" or 30-day letter.

(3) The 30-day letter advises the taxpayer of its rights, which are:

(a) To go to Appeals and follow the administrative protest procedures; and

(b) To do nothing, in which case a Statutory Notice of Deficiency (90-day letter) will be issued.

(4) If a 90-day letter is issued, the taxpayer has two further choices:

(a) File a petition in the U.S. Tax Court. I.R.C. § 6213(a); or

(b) Wait for assessment following the 90-day period, pay the tax, file a refund claim, and then sue for a refund in federal district court or the Court of Federal Claims.

IV. INFORMATION GATHERING IN DEPTH

A. Introduction

1. During the last few years, the IRS has made a concerted attempt to obtain as broad a swath of client documents as possible. The environment surrounding tax reporting and filing has changed. As a result, and in order to properly defend a tax controversy, it is imperative for taxpayers to understand the various information production privileges available to them. This risk is one which cannot be ignored; increasingly, it is clear that what you say and the thought processes and deliberations that went into that statement can and will be used against you in a court of law.

2. There are a number of privileges that may protect the deliberative process from inadvertent or involuntary disclosure to the IRS. The most significant privileges are the attorney-client privilege (both as to communications with lawyers and federally authorized tax practitioners) and the work-product doctrine.

3. Recent practice has identified a number of situations where clients have been forced to disclose to the IRS and other tax authorities their candid, honest and internal discussions of tax risks related to business transactions. This forced disclosure not only provided tax auditors with a road map, but it also gave the government ammunition to use in challenging the company's tax position.

4. In most cases, what caused this forced disclosure of internal tax discussions was inadvertent – and fully avoidable. It resulted from the failure of company personnel to preserve privilege and confidentiality during their early-stage discussions with third-parties. And, in several cases, it resulted in a waiver of attorney-client privilege and attorney work product confidentiality for the entire issue – meaning that the law department's files became subject to discovery.

B. <u>IRS Information Gathering Techniques</u>

1. On-site Visits. During an examination, an IRS agent may request an onsite inspection of the taxpayer's premises. Any such inspection permitted by the taxpayer should be highly controlled so that IRS personnel are not free to casually wander about the premises, question employees, or copy random documents. Oftentimes, the IRS can be persuaded to view a "dog and pony" show based on a slide or video presentation with imported operations personnel. This approach can offer several potential benefits.

a. Taxpayer Interviews. Although the IRS cannot compel a taxpayer to submit to an interview without a summons (discussed further, below), the IRS frequently requests that taxpayers or their employees submit to an interview during the audit process. Taxpayers should keep the following considerations in mind when dealing with requests for interviews:

(1) Insist on compliance with your Power of Attorney Form. Often the IRS will attempt to get information from you even after a Power of Attorney is filed. This is improper and may damage your case severely. Advise your staff to simply refer the IRS to your tax advisor and to volunteer nothing. Your lawyer or accountant should decide if and when the IRS can interview someone from the company. If the IRS employee continues to contact you directly, your advisor should report the improper conduct.

(2) Preparing for the Interview. If your tax advisor allows the IRS to speak with company staff, tax staff should set up the interview with the IRS. If IRS examiners need information from company personnel, require the same focus and specificity of information which was established for IDRs.

(a) Control IRS access to company personnel. The tax staff should choose the company personnel who will provide information to the IRS in an interview. Do not allow IRS examiners to formally or informally interview anyone from the company without a member of the tax staff present. This is particularly important with respect to financial personnel and operations personnel who are associated with the IRS audit Hot Issues.

(b) Prepare the witness. Tax staff should meet with company personnel prior to the interview to make sure that they understand the purpose of the interview, the principles of being a good witness and how the interview will be conducted. If necessary, attorneys should be brought in to prepare the witness.

(c) Make sure witnesses know their rights. I.R.C. § 7521 affords certain rights to taxpayers in connection with any in-person interview by a Service employee. These rights include:

(i) The right not to appear unless a summons is issued;

(ii) The right to tape-record the interview if 10-days advance notice is given to the IRS. See IRS Notice 89-51, 1989-1 C.B. 691;

(iii) The right to obtain a transcript of the IRS's recording of the interview, at the taxpayer's expense;

(iv) The right to stop the interview if the taxpayer clearly expresses the desire to consult with an attorney; and

(v) The right to be represented by counsel at the interview.

(3) Conducting the Interview. If IRS personnel other than the examining agents will be present, consideration should be

given to having attorneys or other appropriate personnel present. If the IRS asks questions that require research or further consideration, no immediate answer should be given. When an answer is provided, it should be in writing. Tax staff should maintain notes or memoranda of what the examining agents were told. If the Service has misunderstood what company personnel said, the notes or memoranda will be necessary to highlight the misunderstanding.

(a) Follow Consistent Procedures. This witness procedure should be maintained for any contact between the IRS and non-tax staff personnel, so that using the procedure does not highlight significant or Hot Issues.

C. <u>Overview of Authority</u>

1. The Administrative Summons.

a. IRS Authority to Issue Summonses. The IRS has extremely broad authority to issue summonses requiring the production of books and records or testimony by any person relevant to the determination of the taxpayer's tax liability.

b. Authorized Purposes. I.R.C. § 7602(a) gives the IRS the power to issue summonses for the following purposes:

(1) Ascertaining the correctness of any return;

(2) Making a return where none has been made;

(3) Determining the tax liability of any person or the tax liability at law or in equity of any transferee or fiduciary of any person; or

(4) Collecting any such tax liability.

c. Scope of the Summons. I.R.C. 7602(a) gives the IRS authority to use its summons power to:

(1) Examine any books, papers, records, or other data which may be relevant or material;

(2) Summon a person liable for tax or required to perform an act, or their officers or employees, or any person having possession, custody, or care of books of account containing entries relating to the business of such people, or any other person the IRS deems proper, and require them to appear at

a time and place named in the summons and to produce books, papers, records, or other data, and to give sworn testimony, as may be relevant or material; and

(3) Take testimony of a person, under oath, as may be relevant or material.

d. Use of the Summons. As a general rule, the IRS will issue a summons only after it has failed to receive compliance with an IDR or other informal request for information. The constitutionality of the section 7602 summons procedure has been upheld against Fourth and Fifth Amendment challenges. A summons is not self-executing. See I.R.C. § 7604. Therefore, if a summoned party refuses to comply with the summons, the IRS must bring on an enforcement action. To do so, the IRS must petition a United States District Court.

e. Form of a Summons. A summons must contain the following information:

(1) The name and address of the person whose taxes are being inquired into along with the periods under consideration. See I.R.M. 4022.62 (1977);

(2) The identity of the person summoned. A summons directed at a corporation must be served on a corporate official, director, management agent, or other person authorized to accept service of process. See I.R.M. 4022.63 (1977);

(3) A description of the items summoned, which must be described with reasonable certainty. See I.R.C. § 7603. The summoned party must know what is required of him with "sufficient specificity to permit him to respond adequately to the summons"; and

(4) The date, place, and time for compliance. See I.R.M. 4022.65 (1994). The summons must provide at least 10 days for the party to respond. See I.R.C. § 7605(a).

A summons is required to be served by delivery in hand or left at the taxpayer's last and usual place of abode. See I.R.C. § 7603(a). The taxpayer may move to quash the summons in court, as explained below.

f. Third-Party Summonses.

(1) The IRS has authority to issue a summons to a third party record keeper for the production of business records of an identified person. See I.R.C. § 7603(b). It may serve the

third party record keeper summons in person or by certified or registered mail. A third party record keeper is a financial institution, consumer reporting agency, credit card lender, broker, attorney or accountant, enrolled agent, barter, exchange, regulated investment company, and any owner or developer of a computer software source code. See I.R.C. § 7603(b)(2). An employer is not a third party record keeper.

(2) Each person identified in the summons is entitled to notice and a copy of the summons within three days, but not later than twenty-three days before the date of compliance. See I.R.C. § 7609(a). Notice to the taxpayer may be made by mailing the third-party summons to the taxpayer.

g. Motion to Quash a Summons. The taxpayer has the right to protest the enforcement of a summons by filing a motion to quash and the third party record keeper may intervene in this proceeding. See I.R.C. § 7602(b). The summoned party has no independent ability to initiate a proceeding to quash the summons.

(1) Timing. The taxpayer has 20 days to file the petition to quash the summons. The 20 days begins to run on the date the IRS mails the summons, NOT the date the taxpayer receives it. Also, the petition to quash must actually be filed, not merely mailed to the Court for filing, within the 20 day period

(2) Effect on the Statute of Limitations. When a taxpayer files a petition to quash, its statute of limitations will be suspended beginning on the date the petition is filed. See I.R.C. § 7609(e)(1). Similarly, in the absence of the resolution of the summoned party's response to the summons, the taxpayer's statute of limitations will be suspended beginning on the date which is six months after the Service's issuance of the summons. See I.R.C. § 7609 (e)(2)(A). The suspension period ends when the proceeding is concluded, including any appeals thereof. Treas. Reg. § 301.7609-5(b). The summoned party's full or partial compliance with the summons does not have any effect on the tolling of the statute of limitations.

In certain situations, it might be advantageous for the IRS to issue a very broad (and maybe even unenforceable) summons under I.R.C. § 7609 to a taxpayer who refuses to extend the statute of limitation in hopes that the taxpayer will file a petition to quash.

(3) Requirements to Quash. The United States Supreme Court has established the standard for evaluating an IRS summons and the requirements for enforcement/quashing. See United States v. Powell, 379 U.S. 48, 57-58 (1964):

(a) The IRS investigation must have a legitimate purpose;

(b) The summoned materials must be relevant to that investigation;

(c) The information sought is not already in the IRS's possession; and

(d) The IRS has followed the procedural steps required by Section 7603.

(4) Generally, the IRS will try to make this showing by an Affidavit from the revenue officer issuing the summons.

(5) Once the IRS makes this shown, the burden switches to the taxpayer to show that enforcement of the summons would be an abuse of the Court's process. This occurs if the summons is issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the investigation.

(6) Summonses Not Subject to the Motion to Quash. The Restructuring Act expanded the section 7609 procedures to quash a summons applicable to third party record keepers to all summonses issued to third parties with respect to a taxpayer. Accordingly, a taxpayer whose liability is being investigated will now receive notice of all summonses and may bring an action to quash the summons in district court. See I.R.C. § 7609(a)(1). However, a taxpayer may not move to quash a summons issued to it or any of its officers or employees. Other exceptions include a summons:

(a) Issued to determine whether business records have been made or kept;

(b) Issued solely to determine the identity of a person with a numbered account;

(c) Issued to aid collection of a taxpayer's or a transferee's tax liability;

(d) Issued by an IRS Special Agent in connection with investigation of a criminal tax offense and served on a person who is not a third-party record keeper; and

(e) Any "John Doe" summons or where notice of the summons may lead to destruction or concealment of records or the intimidation of witnesses, etc. <u>See</u> I.R.C. § 7609(f) and (g).

(7) Failure to Comply with a Summons. Absent an effort to seek enforcement through the Federal courts, IRS summons apply no force to taxpayers; no consequences whatsoever can befall a taxpayer who refuses, ignores, or otherwise does not comply with an IRS summons, until that summons is backed by a Federal court order. <u>See</u> <u>Schulz v. IRS</u>, 395 F.3d 463 (2d Cir. 2005).

D. <u>IRS Initiatives</u>

1. Other expansions of IRS review of taxpayers include increased attempts to access data and corporate records which, traditionally, the IRS has not sought, including:

a. E-mails and other correspondence describing the tax benefits – and the tax risks – of specific transactions;

b. Internal financial analysis of alternative tax strategies; and

c. Management presentations regarding negotiation strategies.

d. The IRS is also expanding efforts to access auditor workpapers, including the increasingly detailed FAS 5 tax accruals and valuation analysis.

E. <u>Increased Use of Summonses (including SB/SE cases)</u>

1. IDRs - The IRS gathers information using multiple techniques. The IRS will issue Information Document Request ("IDR") to the taxpayer. Either the taxpayer or its representative routinely discusses any problems or issues relating to providing responses to these requests with the examining agent. If a taxpayer does not comply or cooperate with the agent, the agent has the power to issue summons for the information requested in the original IDR. <u>See</u> IRC §7602.

2. Section 7602 limits the ability of the IRS to request documents and records to only items that are relevant or material to their inquiry. However, the standard for relevance in this regard is very low. As long as the items requested are helpful or shed light on the correctness of the inquiry, the request will be allowed.

3. The IRS also will attempt to gather documents from third parties in the course of the audit. The IRS will issue summons to third-party recordkeepers. These third parties may include banks, brokers, attorneys, and accountants. In most situations, the IRS will provide the taxpayer notice of the issuance of a third party summons to give the taxpayer the opportunity to challenge the summons. However, the IRS does not have to provide notice if it is issued in the aid of collection of an assessment or judgment. See IRC 7609(c)(2)(D).

4. IRS Large Business & International Division issued a directive on June 18, 2013 to address the increase in summons usage (LB&I-04-0613-004). The directive outlined compliance procedures for IRS agents issuing IDRs (122 DTR G-2, 6/25/13) in hopes of establishing better communication with taxpayers to minimize the need for summonses.

    a. The IRS examiner must discuss the IDR with the taxpayer in advance of issuing the request

    b. Both parties must discuss a reasonable time frame for the taxpayer's response.

F. Attorney Client Privilege

1. Under the most common formulation, determining if a communication deserves protection under the attorney-client privilege requires an analysis of six separate elements -- all of which must be satisfied for the privilege to apply. The attorney-client privilege protects:

    a. Communications from a client.

    b. To a lawyer.

    c. Related to the rendering of legal advice.

    d. Made with the expectation of confidentiality.

    e. Not in furtherance of a future crime or fraud.

    f. As long as the privilege has not been waived.

G. Work Product Doctrine

1. General Considerations

    a. Work product is *NOT* privilege.

    b. Work product is based on notions of fairness in litigation. Courts consider it unfair to require a party in litigation to disclose all their thinking and strategy on a case to the other side.

c. Work product, unlike attorney-client privilege, does not require an attorney.

d. In order to apply, the document or analysis at issue must be prepared “because of” litigation *rather* than in the ordinary course of business.

2. Objectively reasonable expectation of litigation

a. Burden of proof is on the party claiming protection, and should be documented.

b. In U.S. Tax Court, an expectation of an audit by the IRS is ***not*** considered an objectively reasonable basis to expect litigation, and therefore, work product protection will not attach in Tax Court. However, in U.S. District Court (in which federal tax claims may also be brought), a more liberal rule is available. See U.S. v. Roxworthy, 457 F.3d 590 (6^{th} Cir. 2006).

3. Subjective Expectation of Litigation

a. Burden of proof is on the party claiming protection, and should be documented.

H. Differences Between the Work Product Doctrine and the Attorney-Client Privilege

1. Unlike the attorney-client privilege, the work product doctrine:

a. Has a fairly modest purpose. United States v. Frederick, 182 F.3d 496, 500 (7th Cir. 1999); Bowman v. Brush Wellman, Inc., No. 00 C 50264, 2001 U.S. Dist. LEXIS 14088 (N.D. Ill. Sept. 13, 2001).

b. Is a creature of statute and rule.

c. Applies to non-lawyers.

d. Arises only at certain times.

e. Only protects communications made "because of" litigation.

f. May be asserted by the client or the lawyer.

g. May not last forever.

h. May be overcome if the adversary really needs the information.

i. Is not easily waived.[2]

2. Unlike the attorney-client privilege, the work product doctrine:

a. Does **not** rest on the **intimacy** of the attorney-client relationship -- a lawyer does not even have to be involved in its creation.

b. Does **not** rest on the **confidentiality** within that intimate relationship -- it protects such materials as pictures of accident scenes, measurements of skid marks, interviews with strangers, etc.

c. Does **not** rest on **communications** within that intimate relationship -- the work product doctrine can protect materials that have never been communicated to anyone.

d. The work product doctrine is <u>both</u> narrower <u>and</u> broader than the attorney-client privilege.

e. It is <u>**narrower**</u> because: the work product doctrine only applies at certain times (during or in anticipation of litigation); and is not actually a privilege, but rather a qualified immunity that can be overcome under certain circumstances.

f. It is <u>**broader**</u> because: anyone can create work product (without a lawyer's involvement); and work product can be shared more easily with third parties without causing a waiver of its protection.

3. Lawyers and their clients considering both the attorney-client privilege and the work product doctrine should remember that both, either or none may apply in certain circumstances.

a. For instance, communications between lawyers and their clients occurring when no one anticipates litigation can never be work product, but may deserve privilege protection.

b. Materials reflecting lawyers' communications with those other than clients (or the lawyers' own agents) can rarely if ever be privileged, but may well be work product -- such as notes of a witness interview.

I. <u>Waiver of Work Product</u>

1. Whereas the attorney-client privilege is *always* waived by any disclosure outside the attorney-client relationship, disclosing work product to third parties does <u>not</u> automatically waive that protection. <u>Viacom, Inc. v.</u>

[2] Thomas E. Spahn, <u>Ten Differences Between the Work Product Doctrine and the Attorney-Client Privilege</u>, 46 Va. Law. 45 (Oct. 1997).

Sumitomo Corp. (In re Copper Mkt. Antitrust Litig.), 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001).

2. This difference in waiver principles between the attorney-client privilege and the work product doctrine sometimes means that sharing materials protected by both the attorney-client privilege and the work product doctrine might waive the former but not the latter. Calvin Klein Trademark Trust v. Wachner, 198 F.R.D. 53 (S.D.N.Y. 2000) (sharing information with a public relations firm).

3. Disclosure to third party other than an adversary generally causes a waiver only if the disclosure makes it likely that the work product will "fall into enemy hands" -- ending up with the adversary. Bowman v. Brush Wellman, Inc., No. 00 C 50264, 2001 U.S. Dist. LEXIS 14088, at *7 (N.D. Ill. Sept. 13, 2001); In re Doe, 662 F.2d 1073, 1081, 1082 (4th Cir. 1981), cert. denied, 455 U.S. 1000 (1982). Sharing with friend or ally does not waive protection. Sheets v. Ins. Co. of N. Am., No. 4:04CV00058, 2005 U.S. Dist. LEXIS 27060 (W.D. Va. Nov. 8, 2005) (holding that a personal injury plaintiff did not waive the work product protection by sharing work product with others involved in a boating accident; noting that those to whom the plaintiff disclosed the work product shared the plaintiff's interest in obtaining insurance coverage for the boating accident).

4. **PRACTICE NOTE:** Given this difference between the attorney-client privilege and work product doctrine, it makes sense to share work product only under a confidentiality agreement. A confidentiality agreement would not prevent waiver of the attorney-client privilege, but might demonstrate that the party disclosing work product did not increase the chance the adversary would obtain access to the work product. Blanchard v. EdgeMark Fin. Corp., 192 F.R.D. 233, 237-38 (N.D. Ill. 2000).

5. Disclosure of Work Product to Outside Auditors

    a. Courts have held that sharing protected work product with outside auditors does **not** result in waiver of work product protection. Merrill Lynch & Co. v. Allegheny Energy, Inc., 229 F.R.D. 441, 444, 447, 448, 449 (S.D.N.Y. 2004).

    b. In case closely watched as one of the government's first efforts to get tax accrual workpapers through court proceedings from a financial services subsidiary of conglomerate Textron, Inc. United States v Textron, Inc., No. 06-198T (D.R.I. August 29, 2007).

        (1) District Court Phase: Textron Victory

(a) The U.S. District Court for the District of Rhode Island denied the government's petition to get the 2001 tax accrual workpapers from Textron, Inc.'s financial services subsidiary.

(b) Facts: Textron, Inc. (Textron), a publicly traded corporation with approximately 190 subsidiaries, had a subsidiary that provided commercial lending and financial services (Textron Financial Corp. or TFC) relied on Textron attorneys, private law firms, and outside accounting firms for advice regarding tax matters. IRS learned that TFC had engaged in nine "sale-in, lease-out" (SILO) transactions involving telecommunications equipment and rail equipment. Because the transactions were considered to be of a type engaged in for the purpose of tax avoidance, IRS issued more than 500 IDRs to Textron. In June 2005, the IRS manager examining Textron's return issued an administrative summons for all of the tax accrual work papers for Textron's tax year ending Dec. 29, 2001. Textron refused to produce its tax accrual work papers asserting that they were privileged and that the summons was issued for an improper purpose. During the course of an audit conducted by Textron's independent auditor, Textron permitted the auditor to examine the final tax accrual work papers at issue in the case with the understanding that the information was to be treated as confidential.

(c) Reasoning: The District Court at trial said determination of any tax owed must be based on factual information, none of which is contained in the work papers and all of which is readily available to the IRS through the issuance of information document requests (IDRs) and by other means. The District Court said that, in its view, the papers sought by the IRS would have little bearing on calculating Textron's tax liability. "The opinions of Textron's counsel, either favorable or unfavorable, would have little to do with that determination, and forced disclosure of those opinions would put Textron at an unfair disadvantage in any dispute that might arise with the IRS," the court found. The District court ruled the requested documents are protected by the work product privilege, supporting Textron's claims. "The IRS has failed to carry the burden of demonstrating a 'substantial need' for ordinary work product, let alone the heightened burden applicable to Textron's tax accrual work papers, which constitute opinion work product," the court said in a 34-page opinion.

(2) 1st Circuit Phase - Government Victory (United States v. Textron, 577 F. 3d 21 (1st Cir. 2009) (en banc)).

(a) The 1st Circuit Court of Appeals held that Textron's tax accrual workpapers were not protected from discovery by the IRS.

(b) Reasoning: The workpapers were independently required by statutory and audit requirements and; therefore, the work product privilege did not apply.

(c) The Court stated that unless the document was prepared for use in potential litigation, the Court did not believe the work product privilege applied. Tax accrual workpapers are prepared in support of financial statement certification by independent auditors, not potential litigation.

(d) The dissent in Textron argued that the test adopted by the majority is more narrow and restrictive than prior precedent. The dissenting opinion saw no reason to require a taxpayer to provide the IRS their assessment of the likely outcome of litigation simply because it was created for a business purpose.

(3) Supreme Court - In 2010, the Supreme Court denied Textron's petition for certiorari. (Textron v. United States, 130 S. Ct. 3320 (2010)).

c. This new debate has caused great concern to in-house lawyers, who find themselves pressured by outside auditors to disclose litigation-related analyses, litigation outcome predictions, etc. -- yet justifiably worry about waiving the work product protection that would otherwise entitle the companies to withhold such documents from the private plaintiffs against whom they are litigating.

d. IRS releases internal memoranda on FIN 48. *"FIN 48 Disclosures . . . should be considered by examiners and others when conducting risk assessments."* (Deborah Nolan, LMSB Commissioner). The battle wages on despite such court decisions like the Textron decision.

e. Since its release on July 13, 2006, FIN 48 has generated considerable interest and concern. Many taxpayers fear that the disclosures required by FIN 48 and the workpapers prepared in connection therewith will serve as a "roadmap" for IRS examinations. The IRS Office of Chief Counsel has determined that FIN 48 Workpapers are Tax Accrual Workpapers (TAW), and are therefore subject to the IRS' current policy of restraint as contained in IRM 4.10.20. IRS officials have stated, however, that the current TAW Policy is being evaluated to ensure that it is still appropriate in today's environment.

f. The memorandum captioned "FIN 48 Implications LMSB Field Examiner's Guide," lists ten common questions and answers related to the requirements of FIN 48. The first question, and the one most likely on taxpayers' and IRS examiner's minds is, "Are FIN 48 Disclosures a Roadmap for the IRS?" The memorandum does not answer this question with a simple "yes" or "no," but it is clear from the answer that, at a minimum, IRS examiners should use the FIN 48 disclosures to point them in the right direction. The answer notes that FIN 48 disclosures may lack specificity, and therefore, it may be difficult, for example, to know whether the disclosure has a U.S. tax or foreign tax implication. Nevertheless, the answer goes on to state, "Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 Disclosures, should be carefully reviewed and analyzed as part of the audit planning process.

g. The second question and answer in the memorandum addresses the impact of FIN 48 on the IRS' TAW Policy. While the answer states that FIN 48 Workpapers are TAWs, and therefore, subject to the policy of restraint, FIN 48 Disclosures are another matter. "On the other hand, FIN 48 Disclosures reported in quarterly and/or annual financial statements, and any other public documents, are not subject to the policy of restraint, and should be considered by examiners and others when conducting risk assessments."

h. A number of the questions and answers address taxpayers' concerns about obtaining certainty on tax issues more quickly through closing agreements, restricted consents to extend the statute of limitations, and the IRS' pre-filing programs (Industry Issue Resolution, Pre-filing Agreements, Advance Pricing Agreements, and Compliance Audit Program) and post-filing programs (Joint Audit Plan, LIFE, Advance Issue Resolution, Appeals Fast Track Program, Accelerated Issue Resolution, and Early Referral to Appeals). In this regard, the memorandum notes, "We can remind taxpayers that candor, transparency and the right motivations, coupled with programs and processes we have in place today can quickly generate certainty on tax issues."

i. Question and Answer #8 addresses the situation in which a transaction that has closed becomes a Listed Transaction. Under the Jobs Creation Act, the statute of limitations is extended until one calendar year after the IRS receives proper disclosure of Listed Transactions. In the case of a closed transaction that becomes a Listed Transaction, the answer states that, until one year after proper disclosure to the IRS, interest must be accrued in the P&L on the unrecognized tax benefit (perhaps all of the benefit because the "more likely than not" threshold may not have been met) under the rules of FIN 48, and the tax benefit taken on the tax return will never be recognizable in the financial statements. As a result, each year the accrued interest increases and the P&L is negatively affected.

j. The memorandum states that LMSB has consulted FASB on this point and FASB agrees that this is the result. The memorandum advises that "it may be a good practice to remind taxpayers about this provision affecting Listed Transactions and the way they impact on the application of FIN 48 in their financial statements."

k. It is clear from the memoranda that the IRS is preparing its LMSB examiners to focus carefully on FIN 48 Disclosures. The statement that LMSB is evaluating the policy of restraint with respect to FIN 48 Workpapers suggests that LMSB examiners may be increasing their requests for FIN 48 Workpapers. LMSB has created a "TAW Cadre whose members are available to assist with the review of documents received in response to TAW IDRs [information document requests]. The primary objective of the Cadre is to assist LMSB examiners in determining whether items received fulfill the IDR, whether additional documents should be requested, and in considering the risk assessment related to the review of those tax accrual workpapers."

J. <u>Post Textron Decision Events on Tax Accrual Workpapers – *Deloitte* (United States v. Deloitte LLP, 610 F. 3d 129 (D.C. Circ. 2010))</u>

1. Background:

a. To aid examining agents in the audit of taxpayers, the IRS has increased requests for a taxpayer's tax accrual workpapers. These papers document the taxpayer's decision-making process and rationale for creating tax reserves for financial accounting purposes. Taxpayers are concerned that providing these documents will provide the IRS with an audit roadmap. (Similar to the arguments against Uncertain Tax Position reporting).

b. A taxpayer generally prepares the workpapers in connection with assistance from inside and outside counsel. The workpapers include information relating to the making of legal judgments relating to certain positions taken on returns. The taxpayer usually needs the assistance of counsel to properly estimate the audit risk and, if necessary, litigation risks.

c. Taxpayers generally assert the Work Product Privilege in their attempts to defeat the IRS's ability to obtain these workpapers. The Work Product Privilege prohibits discovery of "documents and tangible things…prepared in anticipation of litigation or for trial" when discussed with a taxpayer's representative (usually an attorney or accountant).

(1) This privilege finds its origin in the U.S. Supreme Court decision Hickman v. Taylor, 329 U.S. 495 (1947) (where the Court granted protection from disclosure materials prepared by a party "in anticipation of litigation.") The disputed materials consisted of summaries of witness statements gathered by an attorney during trial preparation.

(2) In 1970, a rule was added to the Federal Rules of Civil Procedure to address the issue. FRCP 26(b)(3) provides that "a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial or for another party or its representative."

(a) The rule is different from the holding in Hickman in two regards. The rule does not protect from disclosure:

(i) intangible work product; or

(ii) work product prepared by non-attorneys (this issue was not addressed in Hickman).

(b) Courts generally apply the "because of" test to determine if the material has been prepared in anticipation of litigation.

d. As of 2009, the IRS official policy is that tax accrual workpapers will not automatically be requested in every audit. Recent trends have shown that the IRS is requesting these workpapers more and more. In contrast, once a matter goes forward to the litigation phase, the IRS routinely asks for copies of tax accrual workpapers as part of their informal discovery.

2. Deloitte – D.C. Circuit – Taxpayer Victory (United States v. Deloitte LLP, 610 F. 3d 129 (D.C. Circ. 2010)).

   a. Rationale: In contrast to Textron, the D.C. Circuit focused on the content of the materials at dispute. The D.C. Circuit determined that Deloitte's tax accrual workpapers contained work product which includes the thoughts and opinions of counsel developed in anticipated of litigation.

   b. The Court also stated that the disclosure of the work product to the taxpayer's independent auditor did not constitute a waiver of the privilege because Deloitte was not a potential adversary and a reasonable expectation of confidentiality was expected.

   c. The IRS did not seek Supreme Court review in this case.

3. Wells Fargo – Dual Purpose Documents (District Court Minnesota)

   a. On September 1, 2010, Wells Fargo & Co. asked the court to quash a subpoena issued to its independent auditor, KPMG LLP relating to requests for tax accrual workpapers.

      (1) The summons asked for "any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes."

      (2) Wells Fargo & Co is attempting to protect from disclosure the following items from its files and from the files of its auditor:

         (a) Company memoranda based on advice of in-house tax controversy attorneys identifying and evaluating the legal merits of its UTPs and selecting a reserve percentage based on the likelihood of settlement;

         (b) Meeting agendas and emails identifying and/or evaluating litigation risks associated with its UTPs; and

         (c) Spreadsheets, reports, and electronic data files identifying UTPs with potential analysis relating to evaluating appropriate legal tax reserve percentages and reserve amounts.

(3) The question for the Court included whether the work product doctrine applies to dual purpose documents prepared by taxpayers to support their FASB Interpretation No. 48 tax reserves. The tax reserves would not be necessary but for the anticipated litigation.

(4) Government's Position – the documents were prepared in the ordinary course of business as part of Wells Fargo's obligations under regulatory requirements not for anticipated litigation. The government also asserts that any work product privilege was waived when Wells Fargo provided the documents to its auditors.

(5) After conducting a four-day evidentiary hearing in July 2011, the U.S. District Court for the District of Minnesota ruled on June 14, 2013 that Wells Fargo measurement of and analysis with respect to its so-called uncertain tax positions, or UTPs, is entitled to work product protection, but that the identification of the types of UTPs is not.

(a) The District Court rejected Wells Fargo's argument that all tax accrual workpapers are created "because of litigation," but ultimately held that the recognition and measurement analyses reflected in the tax accrual workpapers were prepared in anticipation of litigation.

4. Effect of UTP Reporting on the Tax Accrual Workpaper Issue

a. On September 24, 2010, the IRS released materials relating to the new reporting requirements for uncertain tax positions (UTPs) including the final form of Schedule UTP.

b. For 2010, private or public companies with total assets of $100 million or more that issue or are included in audited financial statements and that file a Form 1120, 1120-L, or 1120-PC must file a Schedule UTP. The schedule will be phased in for taxpayers with assets of less than $100 million.

c. Schedule UTP requires filers to rank UTPs by the amount of reserves.

d. Schedule UTP requires a concise description of relevant facts affecting the tax treatment of the position and information to apprise the IRS of the identity of the tax position and the nature of the issue. The statement does not have to include the rationale for the filing of the UTP.

e. The IRS plans to process Schedule UTP through an established centralized process under LB&I. This will enable LB&I to select issues and returns for audit.

f. It is to be seen whether the reporting requirements for Uncertain Tax Positions will moot future disputes over tax accrual workpapers.

g. The asset threshold for filing Schedule UTP drops down to $50m beginning with the 2012 tax year, and to $10 million in 2014.

(1) No indication whether it has made moot future disputes over tax accrual workpapers.

V. APPEALS

A. Introduction

1. Appeals Division (Appeals). Appeals is not an administrative law tribunal of the type governed by the Administrative Procedures Act.

a. Rules. Appeals is established under procedural rules governing the operation of the Internal Revenue Service. See 26 C.F.R. § 601.106. These rules are published in the Federal Register, but they are signed by the Commissioner of Internal Revenue under the authority of 5 U.S.C. § 22 which empowers department heads to prescribe rules for the conduct of their departments. The rules establishing Appeals are not Treasury Regulations with the force and effect of law.

b. Part of Chief Counsel's Office. Appeals operates under the direction and supervision of the Chief Counsel.

(1) Appeals was consciously separated from the Service's audit branch to avoid conflicts of interest and to insure taxpayers an impartial review.

(2) Appeals is established in each Service Region with offices in most major U.S. cities.

c. Not an independent tribunal. Appeals representatives are IRS employees. They are not independent tribunals who hear evidence and decide cases on an impartial basis.

d. No legal entitlement. Because the Appeals process is established only by Service rules, the courts have held that the denial of an Appeals hearing does not deprive a taxpayer of due process or otherwise invalidate a notice of deficiency. See, e.g., Rosenberg v. Commissioner, 450 F.2d 529 (10th Cir. 1971).

e. Optional. Appeals proceedings are optional to the taxpayer. There is no requirement that a taxpayer go to Appeals as a prerequisite to filing a claim for refund. Going to Appeals is a prerequisite, however, for eligible net worth taxpayers to obtain reimbursement for costs and attorneys' fees under I.R.C. § 7430.

2. Appeals Mission. The purpose of Appeals is to settle cases.

a. Official statement: "The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." See I.R.M. 1.1.7.1.

3. Appeals Personnel. Generally, Appeals conferees are competent and impartial.

a. Profile. Appeals conferees are usually former examining agents who have been promoted to be Appeals officers. Most are accountants by training. Very few are lawyers, but the lawyers in the group tend to be assigned to the large case teams and in the estate tax area.

b. Multiple conferees. In cases involving many issues and substantial adjustments, more than one conferee may be assigned. One of the conferees, typically a Team Chief, will generally act as lead conferee and will designate the other members of the team and assign issues to them.

4. Role of Personnel Outside of Appeals.

a. Historically, the Examination Division and Area Counsel had only limited contact with the Appeals conferees handling a case. The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) prohibits ex-parte communications between Appeals Officers and other IRS employees to the extent such contacts appear to jeopardize the independence of the Appeals Officers. In Rev. Proc. 2000-43 I.R.B. 404, the IRS determined that the taxpayer must be given a reasonable opportunity to participate in any communication between the Appeals officer and the examining agent when the matter involves more than merely ministerial, administrative, or procedural matters or the communication addresses the substances of the case. This prohibition does not prevent appeals from working with Area Counsel on large docketed cases.

b. National Office Advice. Appeals is still allowed, under the IRS Restructuring Act, to obtain legal advice from the Office of Chief Counsel, however, the Appeals officers must independently evaluate the merits of the case and cannot rely upon chief counsel for settlement recommendations.

5. Appeals Jurisdiction. A taxpayer can obtain Appeals consideration of its income tax audit in one of three ways. The choice involves a large number of factors to be considered by the taxpayer, including the ultimate forum in which the taxpayer intends to litigate any unresolved issues.

6. Thirty-day letter. The traditional approach to Appeals is to file a protest in response to the notice of proposed deficiency (30-day letter) issued by the Division at the conclusion of the audit.

(1) The 30-day letter encloses the Revenue Agent's Report (RAR) for the unagreed issues raised on audit. Also enclosed is a form 870 used to consent to immediate assessment of the tax.

(2) The Service will not issue a 30-day letter unless at least six months remain before the statute of limitations bars any assessment for the tax year.

(a) If less than six months remain, the Service will request the taxpayer to sign a form 872 (extending the period for assessment for a definite period of time) or a form 872-A (extending the period for assessment for an indefinite period of time cancelable upon notice by either party). Strategy considerations may dictate the extension conferred by the taxpayer.

(b) The taxpayer may be able to execute a partial form 870 with the Service, consenting to a portion of the adjustment, in order to permit payment of the tax and interest attributable to tax on the agreed portion.

(3) Filing a protest to a 30-day letter essentially preserves the status quo. Payment of the tax is deferred. The Service can raise new issues at Appeals and the taxpayer would have the burden of proof on those issues. The taxpayer retains a choice of forum because, after Appeals, the taxpayer can file a petition with the Tax Court or pay the tax and file a refund claim in the appropriate Division Court or the Claims Court.

7. Docketed case. The taxpayer may ask for a statutory notice of deficiency (90-day letter) and file a petition in the United States Tax Court.

(1) Under the provisions of Rev. Proc. 87-24, 1987-1 C.B. 720, Appeals and Division Counsel[3] will share authority over the case.

(a) The case will be transferred to Appeals for settlement consideration unless Appeals issued the 90-day letter and Division Counsel decides that settlement is unlikely.

(b) For cases involving more than $10,000, Appeals will return the case to Division Counsel if no progress is made in settling the case or if the Tax Court places the case on a trial calendar (and Division Counsel has not extended the time for Appeals consideration).

(c) Appeals or Division Counsel generally has sole settlement authority while the case is in their respective offices.

(d) Appeals and Division Counsel may mutually agree to otherwise share responsibility for settling the case. For instance, the case may be returned to Division Counsel for trial preparation while settlement negotiations continue at Appeals. The taxpayer will have notice of who has settlement authority in the case at all times.

(2) Payment of the tax is deferred in a docketed case. The taxpayer can stop the accrual of interest without the loss of Tax Court jurisdiction by paying the deficiency plus interest after issuance of the 90-day letter. The Service can raise new issues in the Tax Court, but the Service will bear the burden of proof with regard to those issues. Filing a petition also prevents another audit because the Appeals office will not send the case back to the Division for further fact development. In addition, a docketed case may receive expedited consideration at Appeals.

8. Refund claim. The taxpayer may circumvent the 90-day letter by consenting to an assessment on form 870, paying the tax, and requesting a refund.

(1) Appeals may consider proposed rejections of refund claims by the Division Office in the same fashion as proposed adjustments made in a 30-day letter. See Prop. Reg. §§ 601.106(a)(1)(ii), (d)(2)(ii).

[3] Division Counsel is now referred to as Area Counsel.

(a) The Division Office should issue an RAR proposing to deny the refund claim which is essentially similar to the RAR issued with the notice of deficiency.

(b) Taxpayers should coordinate with the Division in pursuing this approach to Appeals to insure the refund is not immediately denied (commencing the two-year statute of limitations for filing refund litigation) or pocketed without action.

(2) Under this approach, the taxpayer must litigate its refund claim in either the appropriate federal district court or the Court of Federal Claims. If the refund claim is filed after the expiration of the statute of limitations for assessment, the Service cannot raise a new issue except as an offset against the refund claim. Thus, if the Service has missed an issue on audit and the taxpayer wants to foreclose the Service from raising that issue while still pursuing a settlement with the Service, a refund claim may be desirable. A refund claim may result in some delay while the Division Office reviews the claim.

B. <u>Ex Parte Guidelines</u>

1. Ex Parte Background

a. Section 1001(a) of RRA 1998 directs IRS commissioner to ensure: "an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of ex parte communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the appeals officers."

Comports with Appeals' Mission – This comports with Appeals' fundamental mission "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." Internal Revenue Manual 8.1.1.1(2) (2003).

b. The current ex parte guidelines are contained in Rev. Proc. 2000-43, which finalized rules first proposed in Notice 99-50.

(1) Purpose of Rev. Proc. 2000-43 - Approach taken therein is to "accommodate the overall interests of tax administration, while preserving operational features that are vital to Appeals case resolution processes within the structure of

the IRS and ensuring more open lines of communication between Appeals and the taxpayer/representative." Rev. Proc. 2000-43, §2.

(2) Protect Appeals Independence - Guidelines are intended to preclude written or oral ex parte communications between Appeals and originating functions that could jeopardize the appearance of Appeals' independence.

(3) Substantive Communications Only - Communications that are ministerial, administrative, or procedural in nature are not precluded by the Guidelines.

(4) Reasonable Opportunity to Participate - Communications are not ex parte if the taxpayer is provided a ''reasonable opportunity'' to be present.

(5) Enforcement/Sanctions - Neither Congress in Section 1001(a) of the RRA 1998, nor Rev. Proc. 2000-43 provide for any form of sanctions when ex parte violations occur.

c. IRS' misperception of, and internal procedures to handle, ex parte guidelines jeopardize Appeals' independence.

(1) Administrative/Ministerial - IRS classifies ex parte communications as administrative or ministerial when in reality they may be at least partially substantive.

(2) Harmless Error - IRS asserts communications result in harmless error.

(3) Good Faith – IRS asserts communications are made in good faith (i.e., they are intended as factual development)

(4) Lack of Procedures and Processes – No procedure for disclosures to occur, and no process for when a disclosure does occur.

2. Notice 2011-62 - On July 19, 2011, the IRS proposed for public comment updates to the Appeals ex parte guidelines contained in Rev. Proc. 2000-43.

a. Convert the guidelines into narrative format from question-and-answer format.

b. Incorporate much of the guidance issued in Rev. Proc. 2000-43.

c. Adopts a series of guiding principles that, in theory, are designed to help with the interpretation and understanding of the ex parte restrictions.

d. New and Continuing Causes for Concern:

(1) Little Taxpayer-Favorable Change – Little in the new guidance provides for new restrictions or rules that favor taxpayers. Old concerns remain, and additional new concerns have arisen.

(2) Self-Enforcement - No procedures have been established by which a taxpayer can inquire or test whether an improper ex parte communication has occurred, nor are any remedies established for violations. Taxpayers should continue to be vigilant in inquiring as to potential prohibited communications and in requesting to participate in all communications of which they are given advance notice.

(3) Chief Counsel Field Attorney Communications – Appeals' communications with Chief Counsel field attorney advising the originating IRS function is an ex parte communication only if the field attorney "personally" advised or advocated on the issue. Whether this was the case now dependent on an internal assessment (one not likely to be shared with the taxpayer) of the "extent and nature of the field attorney's involvement." This is a change from the old rules of Rev. Proc. 2000-43 in which Appeals was not permitted to communicate "ex parte regarding an issue in a case pending before them with Counsel field attorneys who have previously provided advice on that issue in the case to the IRS employees who made the determination Appeals is reviewing."

(4) Chief Counsel Recommendations of Settlement Ranges – New guidelines state that Appeals officers are responsible for independently evaluating the strengths and weaknesses of the specific issues in the case and need not follow Counsel's advice. This is a departure from the stronger language in prior guidelines which provided that "Counsel attorneys will not provide advice that includes recommendations of settlement ranges for an issue in a case pending before Appeals or for the case as a whole."

3. Ex Parte Communications Internally – Rev. Proc. 2012-18 (2012):

a. A field attorney should not communicate ex parte with Appeals employees regarding an issue in a case pending before Appeals if that field attorney personally provided legal advice regarding the same issue in the same case to the originating function or personally served as an advocate for the originating function regarding the same issue in the same case.

(1) Extent and nature of the field attorney's involvement in the case is determinative.

(2) Restriction only applies while Appeals is performing its duties of evaluating the strengths and weakness of the specific issues in the specific cases and the overall hazards of litigation for those cases

(a) For example, the restriction doesn't apply however, if the Appeals employee is preparing a statutory notice of deficiency.

4. In a review of FY 2013 / Statutory Review of Restrictions on Directly Contacting Taxpayers, TIGTA analyzed how well the Office of Appeals has ensured that its personnel are appropriately including taxpayers' representatives in its activities (pursuant to I.R.C. sections 7521(b)(2) and (c).

a. 96 of 72,239 cases closed by Appeals showed that Appeals personnel did not always involve representatives appropriately in some key actions.

b. 11 of 96 sampled cases, Appeals personnel deviated from procedures by attempting to contact the taxpayer directly by telephone or not ensuring that copies of the taxpayer correspondence were sent to the taxpayer's authorized representative.

(1) 2 of the cases, Appeals personnel attempted to contact the taxpayer directly by telephone instead of contacting the representative designated on the power of attorney.

(2) 9 of the cases, Appeals personnel did not document in the Appeals Centralized Database System case history narratives whether copies of taxpayer correspondence were sent to the power of attorneys.

c. In FY 2012, approximately 2.2 million individual taxpayers exercised their right to grant power of attorney to an individual to act on their behalf in dealing with the IRS in a variety of tax matters.

d. The provisions of section 7521 generally:

(1) Prohibit IRS personnel from bypassing a qualified representative once a taxpayer authorizes one to act on his or her behalf and informs the IRS of that authorization,

(2) Require IRS personnel to stop a taxpayer interview whenever a taxpayer requests to consult with a representative, and

(3) Require IRS personnel to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative is responsible for unreasonably delaying the completion of an audit or investigation.

e. Recommendations

(1) The Chief, Appeals, should provide additional guidance to first-line managers and Appeals personnel that will reinforce the importance of ensuring that taxpayer representatives are involved in all case activities.

(2) IRS management agreed; updates to Internal Revenue Manual 1.4.28, and 8.6.1 to reinforce the importance of ensuring representatives are involved in all activities

(a) Implementation date – September 15, 2014

C. <u>Factors which Influence Protest Filing Decision</u>

1. 30-Day Letter. The main issue facing the taxpayer who has received a 30-day letter is whether to protest the 30-day letter and follow the protest procedure or bypass the protest procedure and file a Tax Court petition. As already mentioned, the Appeals Office will retain jurisdiction even if the Tax Court petition is filed. However, a number of considerations may affect the decision to pursue an administrative appeal.

2. Factors in Favor of Filing Protest:

(1) A protest will avoid the expense of litigation through settlement procedures. Appeals Officers will weigh the "hazards of litigation" even when no case is actually pending. Hazards of litigation include costs involved both in financial terms and in manpower and the possibility of setting unfavorable precedent.

b. Appeals process allows the taxpayer to keep open the option of filing a petition in Tax Court or seeking District Court or Federal Claims Court review. This can prove advantageous to the taxpayer by allowing him to see how authority on the issue develops in the different forums. He may then be able to follow the most favorable avenue if settlement cannot be reached.

c. Protesting a 30-day letter allows for extended negotiations. When a case is docketed, and a trial status order has been issued by the Tax Court, Appeals cannot consider the case without Area Counsel's consent.

d. Protesting allows the taxpayer to defer payment of the deficiency for more time and delays collection proceedings such as levy and lien. It may not always be advisable to put off the payment of the deficiency because of the compounding of interest. This cost should always be considered.

e. The taxpayer may use the appeals process to "feel out" the IRS's position on a matter. The taxpayer may be able to prove the Agent or Division was wrong, and avoid a court case entirely, so that for cost containment purposes this may be the preferred procedure.

f. An informal opportunity for discovery is inherent in the appeals process, which might not be available under the limited discovery rules of the Tax Court. (Remember that in tax cases, you control most information. Most discovery is done by the government against you!)

g. Protesting allows the taxpayer more time to prepare its case before the suit is started and provides it with an opportunity to judge the reactions of the Appeals Officer in order to evaluate which of its arguments are strongest.

h. In whipsaw cases (i.e., cases involving the tax liabilities of related taxpayers, where a decision in one case could have a contrary effect in another), there is more flexibility in resolving them before the Appeals Officer than if one of the taxpayers involved goes to court.

i. I.R.C. § 7430 may preclude a taxpayer from receiving attorneys' fees even if it should prevail in Tax Court, if the taxpayer has failed to exhaust its administrative appeals.

3. Factors in Favor of Bypassing Appeals Process:

a. New issues and grounds are less likely to be raised if the taxpayer goes directly to Tax Court. Appeals officers have more tax expertise than Revenue Agents; therefore the risk of new issues being raised by them upon their review is possible.

b. New issues raised by the Appeals Officer when the 90-day letter was issued by the Appeals Office (as opposed to the Division Office) places the burden of proof on the taxpayer to disprove these issues. Therefore, if there is a substantial likelihood that new issues may be raised, the taxpayer may want to go to Tax Court where the IRS bears the burden on new issues or pursue refund litigation where new issues cannot be used affirmatively to collect any additional tax.

c. In smaller cases, the fact that a taxpayer has filed in Tax Court may indicate to the Appeals Officer that the taxpayer is convinced it is right. Psychologically, this may facilitate settlement. In cases involving larger amounts, however, the validity of this proposal is more questionable.

d. The taxpayer may wish to speed up the disposition of the case. Service procedures seem to encourage more expedited case hearings for docketed cases.

e. Settlements in docketed cases have more finality than settlements in non-docketed cases. Docketed case agreements are reflected in Tax Court decisions, while non-docketed settlement agreements are by definition not binding where there is concealment, misrepresentation of materials facts, fraud or malfeasance.

f. Taxpayers should also be aware of possible trends that may arise by virtue of who is representing them in their appeal. Accountants usually settle with the least litigation costs to the taxpayer. Attorneys may be more prone to consider litigation if they are more sensitive to new issues that might be raised.

g. Where the Service is locked into a position on a particular matter which might preclude settlement, it might be more advantageous to fight the issue out in Tax Court if you believe the Service’s position is incorrect.

h. Appeals is generally a waste of time if the issue is coordinated against you (i.e., IRS is set on litigation and will not settle).

D. <u>Protest</u>

Regardless of the approach, the written protest is the “ticket to Appeals.”

1. Time for Submission. The time within which the protest must be submitted varies depending upon the route to Appeals chosen by the taxpayer and the indulgence of the District and/or Division.

a. 30 days. The taxpayer has 30 days to file the written protest in response to a 30-day letter. The 30-day period starts with the date of the 30-day letter, NOT THE RECEIPT of the 30-day letter. The timing is more flexible in docketed cases.

b. Extensions. The possibilities of extensions of time to file protests vary. Some rarely grant extensions of more than 30 days. Others routinely grant longer extensions.

c. Advanced preparation. If the taxpayer's Division is reluctant to grant extensions, the taxpayer should begin preparing the protest on the basis of the forms 5701 (notices of proposed adjustments) which precede the 30-day letter. The forms 5701 are essentially drafts of the RAR.

d. "Skeletal protest." If time is a problem, the taxpayer may file an abbreviated form of protest.

2. Formal requirements. There are few requirements that a protest must meet before acceptance by the Service.

a. The procedural regulations state that where required to do so, the taxpayer must file "a written protest setting forth specifically the reasons for his refusal to accept the findings" of the examining agents. *See* Treas. Reg. § 601.106(f)(5).

b. The publication which is sent to the taxpayer with the RAR principally lists for inclusion in the protest detailed procedural items, such as the taxpayer's name and address and the date and symbols on the letter transmitting the proposed adjustments. *See* Internal Revenue Service, *Publication No. 5*, (Rev. 11-90). Publication No. 5 also requests a "statement of facts supporting your position in any contested factual issue," and a "statement outlining the law or other authority on which you rely."

c. As a practical matter, the Division will accept a skeletal protest that merely recites the issues and very briefly states the basis for the taxpayer's disagreement.

3. Follow up. If a skeletal protest is filed, it can be followed up with supplements filed directly with Appeals for all issues which the taxpayer is seriously contesting. Appeals will generally agree to a timetable for submitting the supplements in coordination with conferences on the issues.

4. Depth of Issue Development. The final protest submitted should always be a full exposition of the strongest factual and legal arguments available to support the taxpayer's position.

a. Agent's position rational. In the RAR, the examining agents have usually prepared at least a superficially rational analysis supporting the proposed adjustment. The appeals conferee is an IRS employee who is generally predisposed to upholding the adjustment.

b. Burden on taxpayer. The burden of persuasion is clearly on the taxpayer and is best met by a full development of the facts and law.

c. Conferee's report. The conferee must explain why the examining agent's proposed adjustment was rejected or compromised. A well-reasoned protest gives the conferee the basic material for this report and provides him with confidence that he will not be criticized or overruled by his reviewer.

d. Protest supplements. During consideration by Appeals, further development of the issues may be necessary or appropriate. Supplements to the original protest may be necessary or desirable.

5. Content. The protest is the key document in presenting the case to Appeals, and the selection of its contents is crucial to an effective presentation of the taxpayer's case.

a. Selecting and ordering issues. In general, the protest should begin with relatively strong issues, leading with one with a significant amount in dispute. The protest should also end with an issue on which the taxpayer's position is strong. This builds on the fact that a reader's concentration is greatest at the start of a document, and people remember best the most recent thing they have read.

b. Addressing the RAR. The RAR states the Service's position with respect to the proposed adjustment. Where the issues are significant, the RAR generally discusses the important facts and the legal authorities bearing on those facts. In general, the taxpayer's protest must squarely address the issues raised in the RAR.

(1) The agents frequently have a limited understanding of the legal issues and often do not present the strongest possible case for the Service. If possible, the agent's arguments should be refuted without addressing legal issues not raised by the RAR.

(2) Failure to meet the agent's arguments head on seriously compromises the persuasive force of the protest. Such a failure indicates to Appeals that the taxpayer cannot refute the arguments.

(3) Restricting the protest to the specific issues raised by the agent allows the taxpayer to avoid raising latent issues not addressed by the RAR. If these issues are raised by Appeals, supplemental submissions may be filed.

c. Factual development. The taxpayer's superior access to the facts is one of the principal advantages of the taxpayer. The agent generally has neither the time nor training to fully develop the relevant facts, and Appeals relies principally on the agent's work.

(1) The taxpayer should first review all Information and Document Requests (IDRs) to assess precisely what facts have been provided to the Service.

(2) Key employees should be interviewed to establish the important facts. You must know "the facts -- the exact facts and all the facts."

(3) The rules of evidence are not applicable in Appeals hearings. Hearsay and other types of evidence, inadmissible in court, can and should be offered in the Appeals process.

d. Affidavits and other evidence. The protest may be supplemented by affidavits or other documentary evidence to support the taxpayer's case. These may be attached as exhibits to the protest or submitted at the conference with Appeals. Appeals officers frequently request copies of relevant contracts and agreements to verify the facts.

9. Legal and ethical considerations. The superior knowledge of the taxpayer with respect to the facts, and in some cases the applicable law, can raise issues regarding the degree to which the taxpayer must educate Appeals.

a. Legal requirements. It is clear that taxpayers have a legal, not a moral, requirement to fully disclose the facts relating to the issues actually raised by the examining agents.

(1) The protest must state: "Under penalties of perjury . . . the facts presented . . . are to the best of my knowledge and belief, true, correct and complete." Internal Revenue Service, Publication No. 5 (Rev. 11-90).

(2) The taxpayer is under no legal obligation to raise legal issues the agent has not raised. The taxpayer need not provide stronger alternative positions for the Service. The taxpayer is likewise under no affirmative obligation to provide the Service with precedents in support of the Service's position. Cf. Rev. Proc. 89-1, 1989-1 C.B. 740,

747 (in applying for a ruling from the Service, the taxpayer is "encouraged" to discuss authorities contrary to the taxpayer's position but is not required to do so).

b. Ethical requirements. The question arises, however, whether the taxpayer has an ethical obligation to raise new issues (or legal authorities) not raised by the agents, or discuss facts which potentially would lead the conferee to those issues.

(1) The relevant American Bar Association opinion generally requires the ethical practices applicable in dealing with another lawyer representing an opposing party rather than imposing the duties of disclosure owed by a lawyer to the courts. The opinion thus finds no ethical obligation to disclose weaknesses in the taxpayer's case. See ABA Comm. on Professional Ethics, Formal Op. 314 (1965).

(2) The lawyer's duty of pursuing his client's interest with "warm zeal," however, does not justify sharp practices. The ABA opinion points out that, "the lawyer is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, either by misstatements or by silence or by permitting his client to mislead." Id.

10. Relative weight of authorities. Appeals (in contrast to an examining agent) has the authority to compromise issues based upon the hazards of litigation. Appeals will generally be concerned with how a court would decide the issue.

a. As an employee of the Service, the Appeals conferee will be most impressed with official pronouncements of the Service such as regulations, published rulings, and occasionally private letter rulings. Conferees give published rulings far more deference than such rulings receive in court.

b. Cases in the taxpayer's circuit will be accorded more weight than decisions in other circuits which are only persuasive authority in potential litigation.

11. Informal refund claims. Appeals may consider a claim for refund made in the protest even when the taxpayer has not made a formal claim for refund with the District.

a. Appeals may insist that the taxpayer's refund claim be formally presented to the Division Office for consideration.

b. If Appeals does not allow the claim, the taxpayer should formally present the claim on the requisite form before the statute of limitations expires. The protest may not be sufficient to constitute the refund claim which is a prerequisite to refund litigation.

6. Filing procedures. The protest is filed with the Division Office and reviewed by the agents. The agents file a report with the agents' comments which is forwarded to Appeals with the protest. This report is not automatically made available to the taxpayer. However, the Appeals conferee may refer to the report during settlement considerations. The agents' silence on key points may be construed by the Appeals conferee as acquiescence to the taxpayer's arguments.

E. <u>Appeals Conference</u>

1. Conferences. In any complex case, one or more conferences will be required with the Appeals conferee or conferees to discuss the issues and try to negotiate a settlement. The conference will represent the culmination of considerable preparatory efforts by both Appeals and the taxpayer's representative.

2. Preparation by Appeals. In general, the participants on the Appeals team will be well prepared for the conference.

   a. Review of available information. In all cases, the responsible Appeals conferees can be expected to have reviewed the information available to them. The Appeals conferees' information is dependent upon the materials received from the examining agent and may be quite limited in some circumstances.

   b. The Appeals conferees' sources for the facts include: the RAR, all IDRs and taxpayer responses, workpapers and other data from the administrative file, other materials provided by the taxpayer to Examination or Appeals. The conferee will also have the agent's written response to the protest.

   c. The Appeals conferees' written sources for applicable legal principles include: the RAR analysis, the protest and any other taxpayer position papers, the cases, rulings, and other authorities cited therein, the agent's response to the protest (if any), and perhaps some independent research.

   d. Area Counsel will have access to everything provided to the Appeals conferee.

3. Taxpayer Preparation. Careful preparation for the conference can determine whether a favorable result is obtained. Do not be lulled into "unpreparedness" by the informality of a conference. Many of the Appeals conferees will have advanced degrees, a few are attorneys (especially in estate tax area and on large cases), and virtually all of the rest are CPAs.

a. Review. The taxpayer representative should review the RAR, the protest, and all supporting documents prior to the conference.

b. Exhibits. If exhibits are desirable, such as transaction documents, charts and summaries, photographs, or computation spreadsheets, they should be prepared.

c. Prepare outline. An outline of the arguments for each issue should be prepared in anticipation of being able to present the argument orally to the conferee.

   (1) In general, it will be preferable to approach the issues in the same manner as that taken in the protest.

   (2) Favorable arguments based upon the purpose of the provision at issue or practicalities and common sense can be more effective in person and should be used if possible.

   (3) Even if the conferee prefers to proceed without the taxpayer making a formal presentation, the exercise of outlining the issues and preparing to argue the case will be invaluable preparation for any give and take discussion.

d. Ordering issues. The order and emphasis of the discussion of issues at conference should be fully explored and planned before the conference. The actual order in which the issues are discussed, however, may be determined by the conferee.

4. Conducting the Conference. The manner in which conferences are conducted involves a number of considerations, some of which should be left to the discretion of the Appeals conferee.

a. Number of meetings. In the initial contact with the conferee, it should be determined whether multiple conferences will be necessary. Cases in which there are numerous issues, or even a complex single issue, may require more than a single meeting.

   (1) An initial organizational conference may be held to discuss how to schedule and run the subsequent meetings on substantive issues.

   (2) Successive meetings may be arranged to cover several issues at each meeting. Meetings may be conducted on an issue-by-issue basis, or, for very complex issues, meetings may be held on sub-issues.

b. Who should attend? If outside counsel is retained to prepare the protest and present the case to Appeals, an initial question is whether representatives of the taxpayer should attend the conferences.

(1) There are advantages to taxpayer participation. The taxpayer gets firsthand experience of the conferee's positions and demeanor; the taxpayer may build credibility with the conferee; the taxpayer is fully informed of the content of negotiations that lead to settlement.

(2) There are also disadvantages to taxpayer participation. The conferee may feel outnumbered and uncomfortable; the taxpayer may be drawn into an emotional defense of the issues; the taxpayer may be subject to direct factual questioning and deprived of an opportunity to frame an appropriate response.

(3) If the taxpayer attends, it can be desirable to set some basic rules with the Appeals conferee with regard to participation, e.g., the taxpayer will not comment, no direct questions to the taxpayer, etc.

(4) The taxpayer may wish to present factual witnesses at the conference.

(a) Outside witnesses can be useful whenever expert testimony would be useful for technical issues or primarily factual issues such as valuation or how a technical process works.

(b) Like all material presented at Appeals, the substance of the expert's presentation and the contents of any written report will eventually end up with Area Counsel.

c. Establishing credibility. The taxpayer's representative must make establishing credibility a major goal of the conference.

(1) Convey personal conviction. The conferee must be convinced that the taxpayer genuinely believes in the merits of the issues, has honestly presented the facts and law, and is prepared to litigate if a reasonable solution cannot be negotiated.

(2) Methods of building credibility:

(a) The taxpayer's representative should be thoroughly prepared on all aspects of the issues, both factual and legal. In particular, possible concerns of the Service should be anticipated and countered.

(b) The taxpayer's representative should take reasonable positions. Issues with no merit should be conceded; strong issues should be adequately and fully presented; settlement talks should be gauged in relation to the true value of all issues.

(c) Personalities should not be allowed to interfere. The taxpayer's representative should avoid personal attacks on the Examining Agent, dispel hostilities that may exist, and be polite and firm without blustering. Do not be chatty and never, ever volunteer information!

d. Presentation of issues. The conference itself is generally a low-key, informal proceeding, not a courtroom hearing. There are essentially two forms the actual presentation of the issues may take.

(1) Formal presentation. One alternative is for the taxpayer's representative to begin by giving a short, oral-argument type of presentation. This should follow the outline discussed above and would highlight the factual and legal strong points of the taxpayer's position.

(2) Informal give-and-take. Another alternative is a discussion initiated by the conferee asking questions for more information. The conferee's understanding of the issue may be limited, and he may prefer to ask questions about the protest without a preliminary presentation.

(3) Taking charge v. following conferee. The taxpayer's representative should follow the preference of the conferee in choosing a method of proceeding.

(4) Generally, you should only make the strongest arguments at the conference or your credibility will be lessened. Tangible evidence is important, and should be used as support for arguments. Pointing out authority or facts that the examining agent failed to disclose or consider is very important. Only by presenting the strongest case for your client, both factually and legally, will the relative merits of the parties' positions emerge. This is necessary as it will provide the Appeals Officer with a basis upon which to evaluate settlement offers. The Appeals Officer must justify his decision in writing, and the practitioner must give him the information with which to do so.

(5) A number of things should be taken into account in preparing and arguing your case at the conference:

(a) The rules of evidence do not apply. All evidence should therefore be presented which is most favorable to the taxpayer's position;

(b) Statement of facts or concessions made, either in the protest or at the conference, can be used as admissions at a trial if no settlement is reached. Evidence that the taxpayer offered to settle the case and the terms of that settlement are not admissible at a subsequent trial;

(c) Legal authority on an issue is rarely dispositive and should therefore be emphasized in the protest, not at the conference; and

(d) IRS pronouncements should be emphasized at the conference since they will be given more weight by the Appeals Officer than court decisions.

e. Raising new issues. An Appeals conferee is not to reopen issues settled at the Division level or raise entirely new issues unless the grounds for doing so are "substantial," the effect on tax liability would be "material," and it is quite certain the government would prevail in litigation over the matter. See IRS Policy Statement P-8-49, IRM 1.2.1.8.6.

c. "New issue." A new issue is broadly construed to include anything that was not raised by the RAR, the statutory notice, or the taxpayer's protest or petition.

d. "Substantiality." The test of "substantiality" requires an Appeals officer to have strong reasons to suspect that the treatment of an item by the taxpayer is incorrect. New issues are not to be raised for bargaining purposes.

e. Right to appeal. The Appeals conferees construe these standards themselves, and there is no practical recourse from their determination that it is appropriate to raise a new issue.

f. Negotiating tactics. The essence of effective negotiating tactics is the art of maintaining strength of conviction while remaining open to compromise.

(1) One-on-one. Whether one or more representatives of the taxpayer attend the conference, an effective presentation

technique is for the taxpayer's representative to project the appearance of being convinced of the essential merits of the taxpayer's case, but being willing to listen to the other side to try to find common ground.

(2) Good guy/bad guy. This approach can be employed by two representatives of the taxpayer at the same conference, one hard-nosed and the other more conciliatory. It can also be employed over the course of multiple conferences by a conciliatory representative who takes proposals to the tougher taxpayer.

F. <u>Settlement</u>

1. Evaluation of the Strength of the Case from the Taxpayer's Viewpoint.

a. The taxpayer considers all relevant legal authority, its weight and persuasiveness, the Service's position, and policy arguments. Factual issues involve not only determination of the facts themselves but also determination of what can be proven with admissible evidence if tried.

b. In general, more factual investigation and legal research will yield a better evaluation. There are exceptions where the circumstances call for discontinuing these efforts because there appears to be little or no hope of success.

c. In addition to factual investigation, legal research, and briefing, it may be helpful to hold a few "mock conference" sessions as a practice and preparation exercise. This helps to spotlight weaknesses, sharpen positions, etc.

2. Special Factors Affecting the Taxpayer's View of a Settlement.

a. "Real" cash effect, in light of carrybacks or similar factors, timing v. permanent issues, interest (to or from IRS), etc.

(1) Often the impact a settlement will ultimately have on the taxpayer's earnings drives the decision on whether the settlement is financially acceptable.

(2) Questions that should be considered include: What is the real financial impact of each issue? What is the effect of various combinations of issues that might be potential settlement offers? Is the potential liability already fully reserved on the taxpayer's books? Can the taxpayer pay?

(3) Many adjustments will have complex inter-related effects on other return items or state income taxes. *E.g.*, foreign tax credit, investment tax credit, limitations on deductions, unused NOLs, etc. The taxpayer should consider all of these in formulating settlement options.

(4) Somewhat surprisingly, the IRS is often not aware of the real financial impact of these relationships. This affords creative opportunities for taxpayers in crafting settlements. In many cases, for example, the IRS is willing to trade timing differences for permanent issues.

(5) It is usually helpful for taxpayers to run "what if" analyses of the related tax effects that will result from all of the various combinations of possible settlements. Computer spreadsheet programs can easily be adapted for this purpose.

b. Effect of settlement on issues that will or will not recur in later years.

(1) The existence of the same issues or sets of facts, or collateral effects, in subsequent years should be investigated. The taxpayer will always have a better understanding than the IRS of issues that will be coming up in the future. It is therefore often possible to trade a non-recurring item for an item the taxpayer realizes will be recurring.

(2) Note that the Internal Revenue Manual encourages Appeals to enter closing agreements to bind the taxpayer and the IRS for future years. IRM 8.8.1.3. Indeed, this is the only way to obtain an agreement that is binding on Examination in the future.

(3) Watch for related issues with potentially inconsistent treatments. Some may not have been adjusted or even examined. While not encouraged to do so, Appeals may raise new issues if they are "substantial" and have a "material" effect on tax liability. <u>See</u> Treas. Reg. § 601.106(d)(1); IRS Policy Statement P-8-49 (Dec. 23, 1960) IRM 1.2.1.8.6.

c. Non-tax considerations, such as business disruption, financial accounting treatment, criminal liability, etc., need to be evaluated.

3. Formulating a Settlement

a. Appeals Settlement Policy.

(1) The Service's official policy with respect to settlements at Appeals is set forth in both Treas. Reg. § 601.106(f)(2) and Policy Statement P-8-47 (April 6, 1987):

> Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in light of the hazards which would exist if the case were litigated. However, no settlement will be made based upon nuisance value of the case to either party.

(2) Appeals aims to arrive at a "fair and impartial" resolution of the case. This is defined as "one which reflects on an issue-by-issue basis the probable result in event of litigation, or one which reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation." See IRM 8.6.1.3.

b. Recognizing Opportunities.

(1) Awareness of how other taxpayers have settled similar issues helps to formulate plans.

(a) The "network" of taxpayers in an industry should be exploited. Find out how other taxpayers have resolved issues like yours. This should be done as early in the process as possible in order to provide maximum flexibility in framing issues and resolving disputes.

(b) For example, are there partners or joint venturers involved, and if so what was their result on the issue? More broadly, is the issue of a recurring type, even if the specific problem here will not have any impact on other years or industry members?

(c) Is this issue a good "test case" for the industry, or do others have better facts? Is there any chance of coordinating with them?

(d) If you have a strong case, it can be very important to be the first taxpayer to resolve an issue. On the other hand, if your case is weak, it may be advantageous to let another taxpayer go first.

(e) There may also be differences in how Appeals offices handle an issue, or even in the personality and idiosyncrasies of individual Appeals officers. Again, use the network to find out.

c. Strengths or weaknesses may be either factual or legal.

(1) For example, meeting the taxpayer's burden of proof may require enormous disruption of normal business or obtaining expensive outside expertise.

(a) Or, there may be legal authority on the issue that was misinterpreted or not reviewed by the agent.

d. How an issue is framed may influence settlement prospects.

(1) For example, an issue involving a weak legal position may be presented so as to emphasize the factual questions on which attention then becomes focused. Or an issue may be framed as primarily a legal one if the taxpayer cannot develop stronger facts.

(2) Certain kinds of issues lend themselves to one characterization or the other. For example, valuation cases will inevitably be largely factual.

(3) Taxpayers should exercise caution in framing issues as factual disputes. If it appears that the facts have been inadequately developed, or new evidence is produced by the taxpayer for the first time at Appeals, Appeals may send a case back to Examination for further development. <u>See</u> Treas. Reg. § 601.106(f)(6).

e. "No concession" issues for both sides should be identified early in the Appeals negotiations to avoid wasting further time on them.

f. Conferee Invites Offer v. Taxpayer Makes Offer.

(1) Appeals conference guidelines require that the taxpayer make the first offer.

(2) Treas. Reg. § 601.106(f)(2) and Policy Statement P-8-47 (April 6, 1987) provide:

> If the taxpayer makes an unacceptable proposal of settlement under circumstances indicating a good-faith attempt to reach an agreed disposition of the case on a basis fair both to the Government and the taxpayer,

the Appeals official generally should give an evaluation of the case in such a manner as to enable the taxpayer to ascertain the kind of settlement that would be recommended for acceptance.

g. As a practical matter, there is some flexibility in who goes first. Some Appeals officers will arrive at a bottom-line figure quickly and then suggest that the taxpayer make an offer in line with it. Knowing the Appeals officer's methods of operation may be quite helpful.

h. Kinds of Settlements. The Internal Revenue Manual identifies three kinds: "mutual concession" settlements; "split-issue" settlements; and "nuisance value" settlements.

(1) Mutual concession settlements. The Internal Revenue Manual says these settlements are appropriate "where there is substantial uncertainty in event of litigation as to how the courts would interpret and apply the law, or as to what facts the courts would find . . . . In such a case there is substantial strength to the position of both parties, so that neither party, with justification, is willing to concede in full the unresolved area of disagreement." IRM 8.6.1.3.1:(1). See Policy Statement P-8-47.

(a) "Principled" or "gross amount"? Resolving issues one by one may be necessary, especially if they have carryover effects or are continuing issues. In such instances it may be necessary to reach a principled basis for the result on each issue, and only then net them to arrive at a final settlement amount.

(b) "Issue-by-issue" or "package"? In a multi-issue case, the taxpayer may make an overall bottom-line offer, leaving open the possibilities of shaping the parties' mutual concessions on an issue-by-issue basis. This leaves some flexibility and may meet both parties' concerns with the bottom-line number.

(c) A primary tactical decision is how to order the issues for discussion and negotiation at the Appeals conference. The order of presentation should not necessarily be the same as in the protest.

(2) Split-issue settlements. This is a form of mutual concession settlement of an issue which, if litigated, would result in a decision completely for the Government or the

taxpayer. The distinguishing feature of this kind of settlement is that the agreed result would not be reached if the issue were tried. See IRM 8.6.1.3.2:(2).

(a) Appeals policy is that this form of settlement is not favored and should be used only if no other method is appropriate. See Policy Statement P-8-48 (Dec. 23, 1960); IRM 8.6.1.3.2:(1).

(b) Appeals officers are cautioned to consider carryovers, carrybacks, and other related effects in this kind of settlement.

(3) "Nuisance value" settlements.

(a) Appeals conferees are not permitted to consider "nuisance value" settlements, i.e., those designed simply to help either side avoid the expense of litigation. See IRM 8.6.1.3.3:(1).

(b) There is no fixed percentage number, although as a general rule of thumb settlements below 20 percent are considered to be based on "nuisance value." This is just an informal guideline; it does not appear in any policy statements.

(c) The "nuisance value" rule can work both ways to encourage complete concessions. For example, the conferee will not insist on 10 or 15 percent for the Government just because of the nuisance to the taxpayer in litigating; at the same time, a taxpayer who proposes paying over 80 percent is probably better off conceding in full and asking for a similar IRS concession on another issue. The "nuisance value" rule can be used by taxpayers to build credibility and generate momentum for a full settlement.

(4) Partial Settlement with Option to Litigate Balance.

(a) Not only can some issues be left out of the settlement in full; issues can be settled in part and left open in part. No hard and fast rule requires settlement at Appeals.

(b) Treas. Reg. § 601.106(f)(2) and Policy Statement P-8-47 (April 6, 1987) provide:

> Appeals may defer action on or decline to settle some cases or issues (for example, issues on which action has been suspended nationwide) in order to achieve greater uniformity and enhance overall voluntary compliance with the tax laws.

(c) The closer you get to a complete settlement, however, the more pressure there is to settle the entire case. The Internal Revenue Manual itself encourages resolution of all issues in a case.

(5) The pressure to settle can also be used to the taxpayer's advantage. For example, the hardest issues may be left until last, when the incentive to settle is greatest. The tactical decisions concerning the order and method of presentation should be made early, as part of the process of analyzing various settlement options.

4. Giving Effect to the Settlement

a. Justifying the Settlement for the Conferee's Reviewer.

b. Since the Appeals officer himself is not delegated final settlement authority, all settlements must be reviewed by the Chief or Associate Chief of Appeals. <u>See</u> IRM 8.7.1-7. The reviewer is required to inspect all documents related to the case, including particularly the supporting statement and closing documents for the proposed settlement.

c. The settlement package is different from the protest. If an agreement is reached in principle, you should <u>give</u> the Appeals officer a rationale for inclusion in his supporting statement. Your explanation of why the settlement is appropriate is often more likely to withstand review than one developed by the Appeals officer. <u>See</u> IRM 8.7.1-5 for the elements of a formal supporting statement.

d. If the settlement recommendation is not approved by the Chief of Appeals or other reviewer, the taxpayer may obtain a conference with him. <u>See</u> Treas. Reg. § 601.106(f)(3); IRM Policy Statement P-8-36 (Dec. 23, 1960).

5. Closing Agreements.

a. I.R.C. § 7121(a) authorizes closing agreements. There may be more than one closing agreement for any period, and each agreement may deal with as little as one item. See Treas. Reg. §§ 301.7121-1(b)(1), 601.202(a)(2). Generally the parties use Form 906, "Closing Agreement on Final Determination Covering Specific Matters," but Form 866, "Agreement as to Final Determination of Tax Liability," may also be used.

b. Chiefs and Associate Chiefs of Appeals offices, and Appeals Team Chiefs (with respect to team cases), may enter into closing agreements for cases within their jurisdiction. See Treas. Reg. § 601.202(c)(4); Del. Order No. 97 ¶4 (Rev. 27) (Oct. 31, 1987).

c. Because closing agreements are essentially binding contracts, often of unlimited duration absent a change in the facts or law, the IRS has an institutional reluctance to execute them. The taxpayer usually prepares them, and they will generally be reviewed by Area Counsel before the IRS agrees.

d. Form 870-AD; Collateral Agreements.

(1) Contrast Form 870 and Form 870-AD.

(a) Form 870 consents to assessment. The IRS may reopen the case for any reason.

(b) Form 870-AD contains language stating that the case will not be reopened by the Commissioner "in the absence of fraud, malfeasance, concealment or misrepresentation of a material fact, an important mistake in mathematical calculation, or excessive tentative allowances of carrybacks."

(c) Form 870-AD also seeks to bind the taxpayer not to file a refund claim to reopen a settled issue at a later time. The courts are split as to whether a taxpayer is foreclosed from filing a refund claim. Courts allowing the taxpayer to do so rely on the fact that a closing agreement is the only method provided by law to have this effect. <u>See</u> *e.g., Whitney v. United States*, 826 F.2d 896 (9th Cir. 1987); *Uinta Livestock Corp. v. United States*, 355 F.2d 761 (10th Cir. 1966). Other courts analyze the issue under *estoppel* principles and base the decision on whether the taxpayer made a misrepresentation in agreeing not to file a refund claim. <u>See</u> *e.g., Elbo Coals, Inc. v. United States*, 763 F.2d 818 (6th Cir.

985); *Stair v. United States*, 516 F.2d 560 (2d Cir. 1975).

(2) Reservations and exceptions provide another opportunity for creativity in crafting the terms of the settlement.

(3) A collateral agreement can also be used to record the settlement reached. As a practical matter, a collateral agreement probably binds the IRS to the same extent as a Form 870-AD even though only the taxpayer signs it.

VI. FOREIGN TAXES – RECENT DEVELOPMENTS

A. The Bank Secrecy Act enacted in 1970, requires the filing of an annual FBAR where:

1. A U.S. person, including U.S. citizens, U.S. residents, and domestic entities, had a direct financial interest in, an indirect financial interest in, signature authority over, or some other type of authority over, one or more financial accounts, located in a foreign country, and the aggregate value of such account or accounts exceeded $10,000, at any time during the calendar year at issue.

B. In October 2004, as part of the American Jobs Creation Act, Congress enacted new FBAR penalties.

1. Prior (McBride era) – government could asset civil penalties against taxpayers only where it could demonstrate that they "willfully" violated the FBAR rules; penalties ranging from $25,000 to $100,000.

2. Current – IRS may impose civil penalties on any person who fails to file an FBAR when required, unless the violation is due to reasonable cause; the penalty for nonwillful or unintentional violations is $10,000 per violation

a. Higher penalties where willfulness exists - $100,000 or 50% of the balance in the account at the time of violation, whichever about is larger

C. Williams

1. District Court (United States v. Williams, 106 AFTR 2d 2010-6150 (E.D. Va. 2010))

a. Holding: The district court issued its opinion in favor of the taxpayer in September 2010.

b. Rationale: The court first indicated that the government did not adequately differentiate between simply failing and "willfully failing" to disclose an interest in foreign accounts. And subsequent disclosures by the taxpayer corroborated his lack of willfulness with respect to 2000.

2. Court of Appeals (110 AFTR 2d 2012-5298 (4th Cir. 2012))

   a. Holding: Fourth Circuit went on to state that the district court clearly erred in finding that the taxpayer did not willfully violate the FBAR rules for 2000.

   b. Rationale: Willfulness can be inferred from a taxpayer's conduct designed to conceal financial information, and willfulness also can be inferred from a taxpayer's conscious effort to avoid learning about reporting. Actions or inactions of taxpayer here constituted, at a minimum, "reckless conduct, which satisfies the proof requirement [for civil willful FBAR penalties.]"

D. <u>United Sates v. McBride, 908 F. Supp. 2d 1186 (D. Utah 2012)</u>

   a. Williams sparked much controversy and confusion because the standard of willfulness can be established by showing mere recklessness, which exists where a taxpayer does not read and understand every aspect of a tax return. Taxpayer's motive for not filing an FBAR is irrelevant.

   b. Facts: Jon McBride, an equal partner in Clip Company, LLC, anticipated a significant increase in revenue and began seeking ways to reduce or defer taxes. He entered into an agreement with Merrill Scott and Associates (MSA) after reviewing several pamphlets about the intended financial plan. The pamphlets contained warnings about the requirement to report any foreign bank accounts, securities accounts, etc.

   c. Burden of Proof – U.S. government must prove willfulness by a preponderance of the evidence. Willfulness has two components:

      (1) Knowledge; and

      (2) Recklessness

   d. Holding: The district court held that McBride had actual knowledge of the FBAR filing requirement.

E. <u>Offshore Voluntary Disclosure Programs</u>

1. In 2009, the IRS announced the first special offshore voluntary disclosure initiative for U.S. taxpayers with undisclosed foreign bank accounts and unreported taxable income. This offered noncompliant U.S. taxpayers the opportunity to come clean about their hidden offshore assets and income

in exchange for a substantially reduced civil penalty structure and a strongly implied promise that the Criminal Investigation Division would not refer these taxpayers to the Department of Justice for criminal prosecution.

a. What the IRS offered from the beginning was simply the assurance that, if a person was accepted into the OVDP and complied with its requirements, such conduct would be considered by IRS in determining whether or not to recommend to the Department of Justice that the taxpayer be criminally prosecuted.

2. According to a Government Accountability Office report, as of December 2012, IRS's four offshore programs have resulted in more than 39,000 disclosed and more than $5.5 billion in revenues.

a. Of the 10,000 cases closed so far from the 2009 OVDP, the median account balance was $570,000.

3. The IRS began an open-ended offshore voluntary disclosure program (OVDP) in January 2012 on the heels of strong interest in the 2011 and 2009 programs. The IRS notes that it may end the 2012 program at any time in the future. The 2012 OVDP has a higher penalty rate (27.5% instead of 25%) than the previous program but offers clear benefits to encourage taxpayers to disclose foreign accounts now rather than risk detection by the IRS and possible criminal prosecution.

F. <u>Lessening FBAR Penalties – IRS Streamlined Filing Compliance Questionnaire, Instructions for Nonresident, Nonfiling Taxpayers</u>

a. On June 26, 2012, the IRS announced new streamlined filing compliance procedures for non-resident US. taxpayers to help those living abroad who failed to timely file U.S. income tax returns or FBARs.

b. Procedure eligible for non-resident U.S. taxpayers who have resided outside the U.S. since January 1, 2009 and have not filed a tax return during the same period; must present a low level of compliance risk

G. <u>New provision of FATCA, taking effect in July of 2014, requires foreign financial institutions to report information about their U.S. account holders to the IRS.</u>

1. This includes U.S. citizens and "green card" holders living both in the U.S. and abroad.

2. Nearly 20 countries or other jurisdictions have signed or are close to signing agreements with the U.S. to ease the transfer of tax information under FATCA.

3. Almost 30 more are in talks to do so; China has taken tentative steps towards an agreement, and this summer Hong Kong enacted legislation that could lead to one.

4. Ty Warner, the owner of Ty Inc., the maker of Beanie Babies, paid the highest offshore-account penalty ever disclosed: $53.6 million.

5. More than 38,000 U.S. taxpayers have avoided prosecution through the amnesty program; repatriated more than $5.5 billion held offshore.

H. Department of Justice and the Swiss Federal Department of Finance announced in August a program on tax evasion investigation with Swiss banks (169 DTR I-2, 8/30/13).

VII. RULES AND PROCEDURES

A. Mailing Address (TEFRA):

1. Estate of Simon v. Comm'r, T.C. 708-12, T.C. Memo 2013-174 (2013).

a. The U.S. Tax Court held that the Internal Revenue Service gave proper final notice of a final partnership administrative adjustment when it used an address provided on the partnership's return, because the taxpayers did no update their contact information in the manner required by the applicable regulations.

b. IRS sent the FPAA to the address both listed as the business address for Charlevoix, the entity through which taxpayer conducted the transactions, and as the residence of the Simons. The Simons moved to a different address in early 2001 but never informed the IRS (pursuant to section 301.6223(c)–1(T)).

c. U.S. Tax Court Judge Thornton said section 6223(c)(2) "explicitly establishes that the IRS is required to use additional information only if it is furnished in the manner set forth in the regulations. The Simons "have not explained why they did not send in the referenced statement to change their address … The fact that an FPAA was not mailed to the [correct] address is due to their own inaction."

B. Tax Debt Discharge through Bankruptcy

1. Section 523(a)(1)(B)(i) of the Bankruptcy Code provides that bankruptcy discharge does not discharge a tax debt for which no return was filed.

a. Chief Counsel Notice CC-2010-016 set forth that not every tax for which a return was filed late is non-dischargeable. Dischargeability of a late filed return is determined based on the date the return was filed or the date of the assessment.

b. Notice provides guidance that the IRS must determine dischargeability in accordance with procedure set out in therein. To determine if the outstanding liability is subject to discharge, the caseworker must first determine if outstanding assessments are due to a Substitute for Return under I.R.C. section 6020(b) or from a tax return received by the IRS.

C. <u>Amendment to Rules of Practice & Procedure</u>

1. On July 6, 2012, Judge Thornton announced that the U.S. Tax Court has adopted amendments to its Rules of Practice and Procedure.

a. Rule 23. Number of Copies Filed, Font Requirements, and Return of Papers

(1) Number Filed: For each document filed in paper form, there shall be filed the signed original and one conformed copy, except as otherwise provided in these Rules.

(2) Size and Style –

(a) Typewritten or printed papers shall be typed or printed only on one side, on opaque, unglazed paper 8 1/2 inches wide by 11 inches long.

(b) Margins on both sides of each paper that are no less than 1 inch wide, and margins on the top and bottom of each page that are no less than 3/4 inch wide.

(c) Text and footnotes shall appear in consistent typeface no smaller than 12 characters per inch produced by a nonproportional print font, or a 14-point type produced by a proportional print font, with double spacing between each line of text and single spacing between each line of intended quotations and footnotes.

(3) Acceptance by the Clerk

(a) The Clerk must not refuse to file a paper solely because it is not in the form prescribed by these Rules.

b. Rule 175 deleted - Number of Copies Filed in Small Tax Cases

(1) The number of papers required to be filed in all cases would be the original and one conformed copy

c. Rule 26 - Mandatory eFiling for Most Represented Parties

(1) Court will accept for filing papers submitted, signed or verified by electronic means that comply with procedures established by the Court

(a) Paper filed electronically is a written paper for purposes of these Rules.

(2) Electronic filing is required for all papers filed by parties represented by counsel in open cases, but mandatory electronic filing does not apply to: (1) petitions and other papers not eligible for electronic filing in the Court, (2) self-represented petitioners, and (3) any counsel in a case who is granted an exception.

d. Rule 70 - Protection for Trial Preparation Materials and Draft Expert Witness Reports

(1) The Federal Rules of Civil Procedure was amended to provide those drafts of expert witness reports and certain pretrial communications between counsel and experts are not discoverable.

(2) Rule 70 is amended to provide the same protections from discovery as does Rule 26 of the Federal Rules of Civil Procedure

e. Conforming Changes to Rule 121, Summary Judgment

(1) Similarly here the Court amends its rules to conform its terminology to that used in Rule 56(a) and its amendment that substituted the term “genuine dispute” for the term “genuine issue.”

f. Use of Rule 155 Computations with Dispositive Orders

(1) Rule 155 is amended to clarify that the rule also applies to dispositive orders; originally, it applied only to deficiency and liability proceedings, but was later not limited to the aforementioned but permits the filing of computations in all cases–including dispositive orders.

g. Rule 241 - Notice by the Tax Matters Partner of the Filing of a Petition

(1) Rule 241(f) is amended to make the time periods provided for the notice furnished by the tax matters partner to the partners consistent with the time period provided by the regulations

h. New Rule 345 - Privacy Protections for Filings in Whistleblower Actions