



AUDIT ROADMAP: THE ART & SCIENCE OF NAVIGATING A TAX AUDIT

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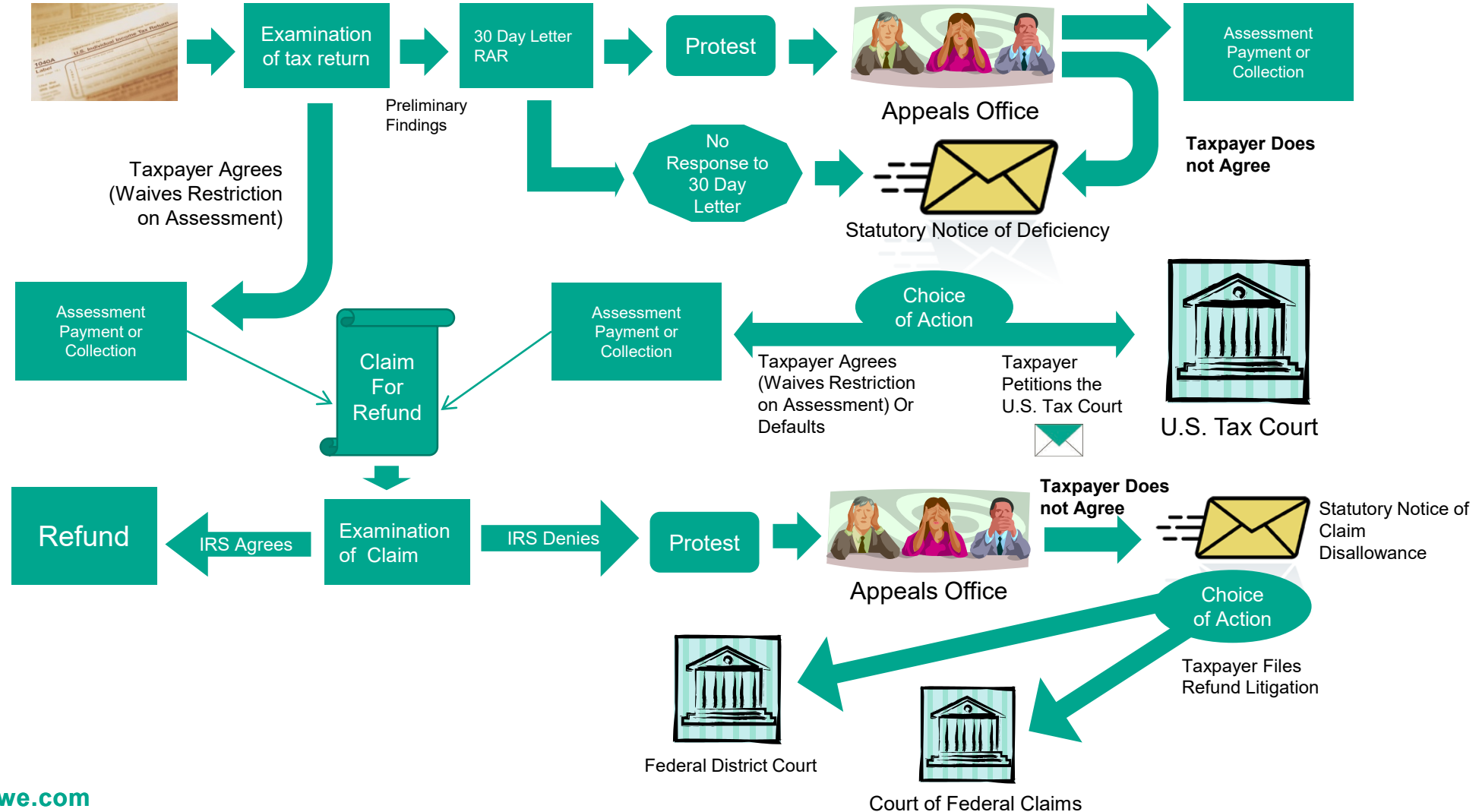
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EXAM IS THE FIRST STOP ON THE CONTROVERSY JOURNEY



SHARED OBJECTIVES OF THE TAXPAYER & INTERNAL REVENUE SERVICE (IRS) AT THE BEGINNING OF EVERY EXAMINATION

- Efficient professional audits conducted fairly and with as little delay as possible
- Generally, both sides work to meet those objectives throughout all phases of an audit:
 - Planning for the Audit;
 - Execution of the Audit; and
 - Resolution of the Audit Results

BUT RECOGNIZE THAT TAXPAYERS & THE IRS MAY HAVE DIFFERENT DESIRED OUTCOMES

Taxpayer

- Strategic and result-oriented approach
- Goal is to pay the least amount of tax allowed by law

IRS

- Tax Principle Approach: To apply the tax laws and determine their reasonable meaning with neither a government nor a taxpayer point of view
- Goal is to determine each taxpayer's correct tax liability in a reasonable, practical manner
 - Service officials should never overreach or adopt a strained construction of the law in the belief that they are "protecting the revenue"

WHEN AN AUDIT NOTICE ARRIVES:

1. Understand what type of audit you are facing
2. Think proactively about risk
3. Anticipate IRS information gathering
4. Respond strategically
5. Know the role of all the players
6. Consider options for post-audit resolution

UNDERSTAND WHAT TYPE OF AUDIT YOU ARE FACING



COMPLIANCE, EXAMINATION & ENFORCEMENT PROCEDURES

- IRS Campuses
 - Automated Underreported Program
 - Correspondence Examinations
- Office Examinations
- Field Examinations
- Research Examinations

TYPES OF AUDITS

- Income tax
 - Large Business & International (LB&I) campaign
 - Global High Wealth (GHW)
 - Small Business / Self-Employed (SBSE)
- Estate or gift tax
- Exempt organizations
- Employment tax

➤ Any of these could be an eggshell audit

EGGSHELL AUDITS

- If your initial review of the facts revealed potential criminal exposure or other significant liability **or**
- If the auditor's questions raise red flags **or**
- If the client reveals bad facts at any point, **then**
- You are in an “eggshell” audit and must practice the art of fulfilling your professional and ethical obligations while minimizing your client's exposure

LB&I – ISSUE FOCUSED AUDITS

- Audit of “Issues” that present particular types of non-compliance
- No longer audit of returns
- Issue focused audits follow “Campaigns”
 - Strategic approach to identify, prioritize and allocate resources to areas of compliance risk

LB&I – GLOBAL HIGH WEALTH AUDITS

- Historically, IRS focused on a single type of tax return for a single taxpayer and the assigned examiner focused on particular areas within his/her core expertise
- GHW
 - Uses enterprise approach to target compliance issues previously missed and buried within layers of related entities
 - Coordinates a team of examiners and specialists to analyze complex domestic and foreign arrangements
 - Follows LB&I procedures that used to apply only to the largest businesses to wealthy individuals and families

THINK
PROACTIVELY
ABOUT RISK



IDENTIFY & QUANTIFY RISKS

- Evaluate merits of uncertain positions in light of current law and knowledge of relevant facts
 - Quantify tax exposure attributable to each item
- Consider pros and cons of disclosing any tax opinions
- Assess additional exposures
 - Identify any conduct that the IRS may uncover that could expose the client to criminal liability, significant civil liability or personal strife
 - Quantify potential penalties and interest

CONSIDER LIKELIHOOD OF RISK

- Assess probable audit approach
 - Likelihood that uncertain items will be discovered
 - Litigating and audit position of IRS
 - Appeals coordinated issues
 - Past experience with IRS examiner
 - Consider what information is already in IRS possession
 - Prior filings
 - Treaty information from foreign countries

ANTICIPATE IRS INFORMATION GATHERING



THE EXAMINATION PROCESS

1. Audit letter
 2. Scheduling conference
 3. Initial meeting – taxpayer interview
 4. Information Document Request (IDR)
 5. Third party contacts and information gathering
 6. Interviews and site visits
 7. Proposal of adjustments or no change
 8. Agreement or partial agreement
 - a. Form 4549 or Form 870 (Waiver of Restrictions on Assessment Forms)
- OR
- Unagreed or partially unagreed
- a. Thirty (30) day letter

INFORMATION GATHERING TECHNIQUES USED IN AUDITS

- Information Document Requests (IDR) and Summonses
 - LB&I IDR Enforcement Process – LB&I-04-0214-004 (February 28, 2014)
 - The IDR Enforcement Process includes three graduated steps if taxpayers decline to cooperate:
 - 1) a Delinquency Notice;
 - 2) a Pre-Summons Letter and
 - 3) the Summons
- Interviews of taxpayers and their advisors
- Tours of business sites and inspection of residences
- Evaluating books and records
- Requesting and analyzing records from third parties, such as banks, co-investors, counter-parties, etc.

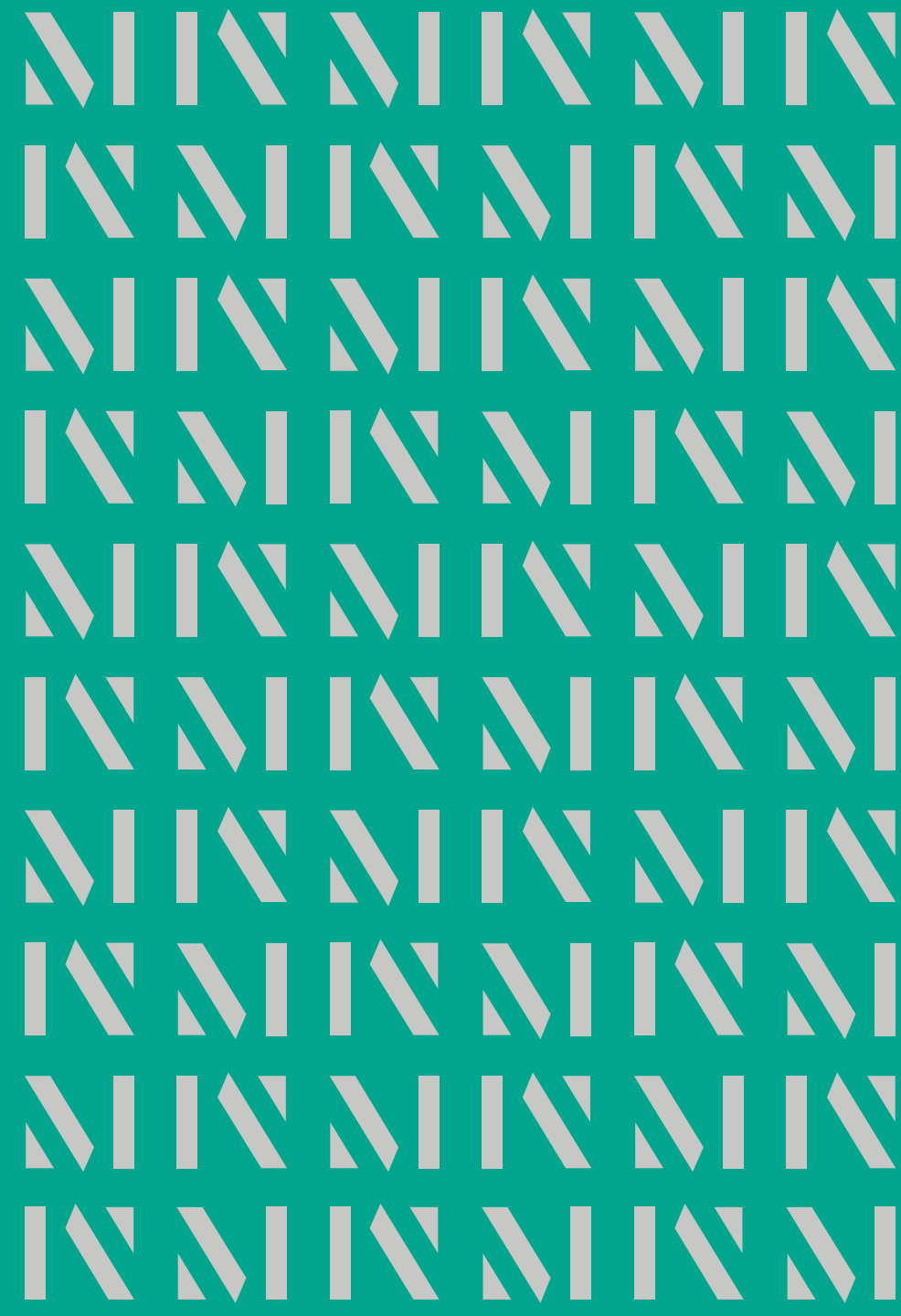
§7602(C) NOTICE OF CONTACT OF THIRD PARTIES

1. **General notice.** An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made.
2. **Notice of specific contacts.** The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.
3. **Exceptions.** This subsection shall not apply—
 - a. to any contact which the taxpayer has authorized;
 - b. if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person; or
 - c. with respect to any pending criminal investigation.

THIRD PARTY CONTACTS

- Notice is now provided in the latest version of the IRS appointment letter so §7602 (e) is satisfied without separate notification
- IRS does not have to identify the third party, but it must maintain a list of the persons contacted and make the list available if the taxpayer requests it

RESPOND STRATEGICALLY



IDR RESPONSES

- Consider scope of summons authority
 - *United States v. Powell, 379 U.S. 48 (1964)*
 1. The investigation is conducted pursuant to a legitimate purpose
 2. The inquiry is relevant to that purpose
 3. The information sought is not already within the IRS's possession
 4. The administrative steps required by the Internal Revenue Code (IRC) have been followed
- Taxpayers need not produce or create documents that are not within their possession or control, **BUT** it may be advantageous to do so

IDR RESPONSES

Circular 230 § 10.22 – diligence as to accuracy

- A. In general, a practitioner must exercise due diligence
 1. In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
 2. In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
 3. In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

IDR RESPONSES

- Shifting the Burden of Proof – IRC § 7491
- IDR responses are key for allowing the taxpayer a chance to shift the burden of proof to the IRS in litigation
- To shift the burden of proof, the taxpayer must:
 - Comply with requirements to substantiate any item,
 - Maintain all records required and cooperate with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and
 - In the case of a partnership, corporation, or trust have a net worth that does not exceed \$7 million

KNOW THE PLAYERS



PARTICIPANTS IN THE AUDIT PROCESS

- Examiner
- Manager
- Senior team coordinators
- Technical specialists
 - International examiners
 - Financial products specialists
 - Economists, engineers, employment tax specialists, computer audit specialists
- Higher management
- National office
- Counsel

CHOOSE YOUR BEST AUDIENCE

Evaluate who will be most receptive to your position by considering:

- the nature of your arguments
- the availability of relevant precedent or lack thereof
- the examiner's knowledge, seniority and reputation
- the manager's knowledge, seniority and reputation
- whether your case involves a coordinated issue
- the issues and risks that each audience considers

CONSIDER OPTIONS FOR POST-AUDIT RESOLUTION

CONCLUSION OF AN EXAMINATION

1. A “no-change”
 - No-Change Letter issued
 2. Fully agreed
 - Form 870 signed
 3. Partially disagreed
 - Form 870 signed; 30 day letter issued
- OR
- Fully disagreed
- 30 day letter issued

RESOLUTION OPPORTUNITIES DURING & AFTER THE AUDIT

There are realistic options for achieving settlement with the IRS at several stages if you cannot convince the examiner to see your point of view:

- Escalating the issue to a Manager or above
- IRS Alternative Dispute Resolution (ADR) programs
 - Protest to the Independent Office of Appeals (traditional appeals)
 - Fast track settlement / Rapid Appeals Process (RAP)
 - Appeals early referral procedures
 - Post Appeals Mediation (PAM)
- Appeals conference after filing in Tax Court (docketed appeals)
- Settlement with IRS Counsel after filing in Tax Court
- Settlement with Department of Justice (DOJ) Tax Division after filing in District Court or Court of Claims

MAKING A QUALIFIED OFFER

Making a qualified offer can jump start settlement negotiations because IRS may be on the hook for the taxpayer's litigation costs, including fees for attorneys and experts, if the litigated result is no more favorable to the IRS than the offer

- IRC §7430(c)(4)(E)(i) makes the taxpayer the “prevailing party” for purposes of IRC §7430 as long as the judgment in the proceeding is as favorable to the taxpayer as the taxpayer's qualified offer
- To recover costs, taxpayer's net worth must not be greater than \$2M for individuals or \$7M for entities
- A taxpayer can only recover costs incurred on or after the date of the qualified offer, so an offer should be made as early as possible
- The “qualified offer period,” as defined in IRC §7430(g)(2), begins when the first letter of proposed deficiency that allows a taxpayer the opportunity for review in Appeals is sent, and ends thirty (30) days before date on which the case is first set for trial
- A qualified offer can remain open for a limited time (later of 90 days or start of trial), so it can inspire IRS action in a languishing case

AVAILABLE FORUMS FOR LITIGATION

Tax Court	District Court	Court of Claims
Prepayment of tax is not required	Prepayment of tax is required	Prepayment of tax is required
Judges are traditionally tax experts	Judges are generalists	Judges are generalists
Jury trial is not available	Jury trial is available	Jury trial is not available
Tax Court Rules govern • Limited discovery • Stipulations required	Federal Rules of Civil Procedure govern • Formal discovery	Rules of the U.S. Court of Federal Claims • Formal discovery pursuant to FRCP
IRS Chief Counsel's office litigates and has settlement authority. Appeals also retains SA for first 4 months after NOD issues (unless Appeals issued NOD).	DOJ Tax litigates and has settlement authority	DOJ Tax litigates and has settlement authority
Taxpayer's burden is to show erroneous assessment (not a requirement to establish correct tax)	In a refund action, taxpayer's burden is to prove both entitlement to a refund and exact amount to which he is entitled	In a refund action, taxpayer's burden is to prove both entitlement to a refund and exact amount to which he is entitled
Located in Washington, D.C. or throughout U.S.	Refund actions must be brought in the district where the taxpayer resides at the time the litigation is filed.	Located in Washington, D.C. or throughout U.S.

THANK YOU

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Large Business & International Examination Process

The Large Business & International (LB&I) Examination Process provides an organizational approach for conducting professional examinations from the first contact with the taxpayer through the final stages of issue resolution. Our compliance program takes a strategic approach to effective tax administration. Not all examinations are the same in scope, size, and complexity; therefore, portions of this publication may be more applicable to some cases than others. One example is specific guidance in our Internal Revenue Manual for taxpayers who interact with our International Individual Compliance operation.

The LB&I examination process will be discussed at the initial engagement so that both the taxpayer and LB&I have a clear understanding of the process and expectations. The examination can be efficient if the examination team and the taxpayer work together in a spirit of cooperation, responsiveness, and transparency. There is a greater likelihood that the taxpayer and LB&I will benefit in terms of resource utilization and tax certainty when the parties have open and meaningful discussions of the issues throughout the examination process.

LB&I Exam Team

- Work transparently in a collaborative manner with the taxpayer to understand their business and share the issues that have been identified for examination
- Engage the taxpayer in the development of the audit steps and potential timeline appropriate for the issues selected in the examination plan; provide a final copy to the taxpayer
- Follow the IDR procedures by:
 1. *Discussing the Information Document Request(s) (IDRs) with the taxpayer before issuing to ensure that requests identify the issue and are properly focused*
 2. *Timely reviewing IDR responses and providing feedback to taxpayers regarding the adequacy of their response*
 3. *Following the LB&I IDR enforcement process if complete responses are not received by the agreed date*
- Keep the taxpayer informed of the status of each issue on a regular basis
- Provide written documentation of all relevant facts, seek taxpayer acknowledgement, and if the issue is unagreed, appropriately document all disputed facts
- Apply the law to the facts in a fair and impartial manner
- Prepare well-developed Notices of Proposed Adjustment, Forms 5701/Forms 886-A
- Resolve issues at the earliest appropriate point using the appropriate issue resolution tool

Taxpayer (or their Representatives)

- Work transparently with the exam team by providing a thorough overview of business activities, operational structure, accounting systems, and a global tax organizational chart
- Identify personnel for each issue with sufficient knowledge who can provide input when establishing initial audit steps, timelines, and actively assist in the development of the issues selected by the exam team
- Follow the IDR procedures by:
 1. *Reviewing and discussing IDRs with the issue team before issuance to ensure that they are properly focused and identify the issue*
 2. *Working with the issue team to reach a reasonable response date for each IDR*
- For issues identified for examination, provide work papers and supporting documents requested, including those the taxpayer relied on when preparing the return
- Collaborate with the issue team to arrive at an acknowledgment of the facts for unagreed issues; provide support for any additional or disputed facts
- To foster early resolution, respond timely to each Form 5701 by providing a written legal position for issues in dispute
- Resolve issues at earliest appropriate point using an issue resolution tool

Expectations with Respect to Claims for Refund

To deploy our resources efficiently, all claims for refund should be brought to the attention of the exam team as soon as the taxpayer becomes aware of any potential claim for refund. LB&I will only accept informal claims that are provided to the exam team within 30 calendar days of the opening conference. Claims filed after the 30-day window create resource challenges. LB&I will not require a formal claim if an issue has been identified for examination, unless IRS published guidance specifically requires formal claims to be filed for an issue (e.g. Notice 2008-39 for research credit claims). After the 30-day window, claims for refund for issues not identified for examination must be filed using Form 1120X, Form 1040X or Form 843 as required by Treasury Regulations. In limited circumstances exceptions to the formal claims process may be granted by LB&I senior management. Netting of claims does not preclude the requirement for filing a formal claim for refund.

All claims for refund, formal and informal, must meet the standards of Treasury Regulation Section 301.6402-2, which provides that a valid claim must:

- Set forth in detail each ground upon which credit or refund is claimed
- Present facts sufficient to apprise the IRS of the exact basis for the claim and
- Contain a written declaration that it is made under penalties of perjury

LB&I will discuss deficiencies not meeting the Treasury Regulations and provide the taxpayer an opportunity to correct the deficiencies. LB&I will not act on an incomplete or otherwise invalid claim for refund.

Taxpayers will file a formal claim with the Campus and should concurrently provide a copy of the claim to the LB&I team which is fully documented and factually supported, that may permit LB&I to make a tax determination of the issues on a claim without requiring the use of IDRs. This will allow LB&I to quickly determine whether to accept or examine a claim. Claims will be risk assessed in the same manner as any other audit issue. If an issue on a claim needs to be examined, LB&I and the taxpayer will discuss the potential need for additional resources and extend the statute and examination timeline as necessary.

There are three stages to the LB&I examination process: Planning, Execution and Resolution

PLANNING PHASE

This phase of the examination process determines the scope of the audit. Issues selected for examination should have the broadest impact on compliance regardless of the size or type of entity. Once LB&I determines the issues to be examined, we will work together to establish effective steps to complete the examination in a timely manner. LB&I processes and procedures for conducting an examination will be explained at the opening conference.

Communication

Initial planning discussions lay the groundwork for a mutual exchange of information and understanding that will assist both LB&I and the taxpayer in defining the scope and carrying out the examination process. Working together in a transparent environment will lead to resource savings for both LB&I and the taxpayer. Leveraging technology such as transmitting data via Electronic Fax or entering into a Secure Message agreement with LB&I can enhance interaction. The exam team will explain to the taxpayer why each issue is being considered. The taxpayer should share their input on how each issue can be effectively examined. Establishing a communication strategy to monitor the progress of the examination provides an excellent opportunity for continued communication and collaboration.

Issue Team Concept

An issue team is comprised of LB&I employees who will work with taxpayer personnel, who are most knowledgeable about a given issue, to ensure the successful development and management of each issue examined. The size of an issue team will depend upon the complexity of the issue. Each issue team will work with the taxpayer in a transparent manner to develop the examination procedures tailored to the issues selected, in order to establish the relevant facts and ensure that each party's position is fully understood.

Under the LB&I examination process, the case manager will have overall responsibility for the case. Each issue will have a designated manager assigned who will collaborate with the case manager. The issue manager will be a manager of one of the technical team members. The issue manager has oversight over the planning, execution and resolution of the issue. This will include ongoing risk assessment and ensuring coordination with Subject Matter Experts as appropriate. The issue manager will also evaluate the strengths and weaknesses of each side's tax position and seek resolution at the earliest appropriate point.

Examination Plan

At the conclusion of the planning phase, agreements made with the taxpayer will be jointly reviewed and incorporated into the examination plan. The examination plan will be issue focused and also contain the following: the issues identified, audit steps, timeline(s), and communication agreements. The plan is intended to be nimble and agile and when warranted adjusted throughout the examination. Both parties should make a clear commitment of resources to be provided to achieve the established case and issue timelines.

EXECUTION PHASE

Stages of issue development include determining the facts, applying the law to those facts, and understanding the various tax implications of the issue. The parties will conduct interactive discussions, using the Information Document Request (IDR) process to develop the facts. Every effort should be made to resolve any factual differences. If required, Notices of Proposed Adjustment will be provided throughout this phase to present the government's legal position to the taxpayer. The taxpayer's response to these proposals will allow LB&I to gain an understanding of the taxpayer's position to facilitate issue resolution at the earliest appropriate point.

Issue Development Process

Proper issue development means that all relevant facts are identified, documented and that legal positions are clearly presented. The issue team and the taxpayer should actively discuss their factual differences, legal disputes and other areas of disagreement. The issue team will make timely use of all available tools to resolve issues at the earliest appropriate point and will consider appropriate issue resolution strategies throughout the examination. During issue development the issue team may consult counsel or other subject matter experts.

A meaningful discussion between the IRS and taxpayers in advance of issuing an IDR will result in a more effective process. After having an initial discussion on the IDR, secure e-mail and e-fax can be used to make information sharing more efficient. The issue team and the taxpayer will establish reasonable timeframes with firm response dates. Upon receipt of the taxpayer's IDR response the issue team will review the response and inform the taxpayer, by the date committed, whether the response is complete. Incomplete or late responses to the IDR will require the team to initiate standard enforcement procedures consisting of a Delinquency Notice, a Pre-Summons Letter, and/or a Summons.

Written Acknowledgment of the Facts for Unagreed Issues

LB&I issue team members are responsible for documenting all the facts that they have secured so that they can accurately apply the law. For potentially unagreed issues, the issue team members are expected to seek the taxpayer's acknowledgment on the facts, resolve any factual differences and/or document factual disputes. The issue manager should ensure that all relevant facts, including additional and/or disputed facts, are appropriately considered before a Notice of Proposed Adjustment is issued. If a case is closed to Appeals and the taxpayer provides relevant new information that requires investigation or additional analysis, the case will be returned to exam's jurisdiction for consideration.

RESOLUTION PHASE

The goal of the resolution phase is to reach agreement if possible on the tax treatment of each issue examined and if necessary, issue a Revenue Agent Report (RAR) to the taxpayer. Starting with the development of the issue and continuing through resolution, early and frequent discussions are crucial for a complete understanding of the respective merits of an issue.

Issue Resolution

Many tools are available to resolve issues. These tools, or strategies, are designed to reduce examination time, save resources, and lessen the burden on both parties. LB&I encourages the use of all appropriate issue resolution strategies but requires that the issue team consider Fast Track Settlement for all unagreed issues. Fast Track is a mediated effort where the taxpayer, the issue team and Appeals must agree to participate and agree to a mutual resolution. Other issue resolution strategies may be appropriate depending on the type and timing of the particular issue.

Confirming the facts during execution phase enables the issue team and the taxpayer to work productively using appropriate issue resolution strategies. In all situations, the taxpayer has the primary responsibility to ensure that all facts and legal arguments are provided during the examination process so that the issue team can adequately consider them. The issue team is responsible for insuring that it documents the facts and arguments, adequately considers them, and presents them objectively to Appeals if it cannot resolve the issue with the taxpayer. In order to adequately consider both sides of an issue, all cases received in Appeals must have at least 365 days remaining on the statute of limitations. If the taxpayer raises a new issue or submits relevant new information which merits investigation or additional analysis during the Appeals process, the case will be returned to exam's jurisdiction for consideration. If the taxpayer presents a relevant new theory or legal argument during the Appeals process, Appeals will engage Exam for their review and comment, but will retain jurisdiction of the case.

Exit Strategy

The goal of the resolution phase is to resolve tax controversies so that both the taxpayer and LB&I can achieve tax certainty. Both parties must engage in good faith discussions to do so. In many instances, at the conclusion of this phase taxpayers and LB&I will perform a joint critique of the exam process and will recommend improvements. Among the items the parties should address is the future tax treatment of agreed issues to eliminate carryover and recurring adjustments.

SUMMARY

LB&I and taxpayers share an interest in obtaining tax certainty by completing examinations in a fair, efficient, and timely manner. The tax returns that LB&I examines are among the most complex returns the IRS receives. This publication provides an overview of the process to execute a professional examination from the first contact through the final stages of issue resolution.

**Additional taxpayer information resources are available on the IRS Website,
www.irs.gov and IRM 4.46 LB&I Examination Process.**