LB&I RELEASES GOOD NEWS/BAD NEWS IDR PROCEDURES

By Samuel A. Mitchell

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In recent years, Internal Revenue Service (IRS) management has been taking steps to make the federal income tax examination process more focused and efficient. The Large Business & International Division (LB&I) has shown a willingness to resolve a number of thorny issues on a global basis through the Industry Issue Resolution process with the insurance industry and others.[1] This has greatly reduced the audit burden for both LB&I and large taxpayers, and particularly those in the insurance industry.[2] However, not every issue is subject to global resolution, and the IRS is still conducting robust examinations. As part of the effort to make the examinations more efficient and less time consuming, LB&I management is tightening up the procedures for issuing and enforcing Information Document Requests (IDRs). This effort has involved at least two rounds of mandatory training over the last year for all the Revenue Agents and specialists who examine large taxpayers. It also has resulted in two written directives outlining the procedures. The two directives present what some may consider a good news/bad news scenario for large corporate taxpayers.

THE FIRST DIRECTIVE—REQUIRING EXAMINERS TO EMPLOY ISSUE-FOCUSED IDRS

The good news came on June 18, 2013, when LB&I management released LB&I Directive No. 04-0613-004, which has the potential to narrow the focus of IDRs and result in efficiencies and more collaboration between the IRS and taxpayers during the course of examinations.[3] In the Directive, LB&I Management refers to mandatory IDR training that all LB&I revenue agents and specialists had recently completed at the time the Directive was released. The Directive reiterates three main points of the training and documents what is expected of the agents and specialists and of taxpayers going through the IDR process. The three main points of the training are that (1) agents and specialists must make their IDRs "issue-focused," meaning they must clearly state in the IDR what issue led to the IDR, (2) they must discuss each IDR with the taxpayer ahead of time, and (3) the agents and specialists and taxpayers must agree to reasonable deadlines for responses to the IDRs. The Directive applies to all IDRs issued after June 30, 2013, and overrides any existing Memoranda of Understanding between the company's tax department and the IRS examination team that are inconsistent with the required procedures.

THE FOLLOW-UP ENFORCEMENT DIRECTIVE—REQUIRING A RIGID, THREE-STEP ENFORCEMENT PROCEDURE

The potentially bad news came on Nov. 4, 2013, with the release of a follow-up Enforcement Directive (LB&I-04-1113-009) from LB&I management that refers to a second round of training and reiterates and expands on the earlier directive's IDR issuance requirements, but also introduces a rigid, three-step procedure for IDR enforcement.[4] Regarding issuance, the Enforcement Directive has an attachment (Attachment 1) outlining 13 requirements IRS agents and specialists must follow that should be very helpful in making the IDR process more efficient. The 13 requirements more fully develop the three main points from the June directive discussed above. In general, the requirements are designed to (1) inform the taxpayer of the issue the examiners are exploring, (2) ensure that the IDRs are concise, numbered and limited to one issue each, (3) allow the taxpayer to see a draft and have the opportunity to discuss in advance both the content and timing of the response, and (4) allow the taxpayer to close the door on the response by requiring the examiners to commit on the face of the IDR to a date on which they will inform the taxpayer whether the response satisfies the request in the IDR.

The 13 requirements in Attachment 1 to the Enforcement Directive are all very helpful and should result in efficiencies. The potentially bad news for taxpayers is contained in an inflexible, three-step enforcement process described in Attachment 2 to the Directive that applies when a taxpayer does not comply with the deadline for an IDR established during the issuance process. The Enforcement Directive states that the three-step enforcement "process is mandatory and has no exceptions." The mandatory enforcement process involves three "graduated" steps to deal with non-compliance. The three steps are (1) the issuance of a Delinquency Notice, followed by (2) the issuance of a Pre-Summons Letter, and, finally (3) the issuance of a Summons.

The Delinquency Notice step requires the examination team to discuss the IDR with the taxpayer, identify what is missing, make sure the taxpayer understands the next steps of the enforcement process if the taxpayer does not timely comply, and discuss the Delinquency Notice in an attempt to convince the taxpayer to comply. The procedures require the "appropriate personnel" from the taxpayer and the IRS to take part in the discussion. The examination team is required to issue the Delinquency Notice (IRS Form Letter 5077) signed by the Team Manager no later than 10 calendar days after the original IDR due date and "should" set a deadline for compliance that generally is no more than 15 calendar days from the date of the Delinquency Notice. The examiner must have the approval of a Territory Manager if the due date is more than 15 days from the date of the Delinquency Notice. Furthermore, the examiner must provide a copy of the IDR and the Delinquency Notice to the assigned IRS Counsel.

If the taxpayer does not comply by the deadline set forth in the Delinquency Notice, the next step is a Pre-Summons Letter. This step elevates the discussion to the IRS Territory Manager and Counsel levels and to a higher level within the taxpayer's management structure. The examination team is required to discuss the non-compliance with respective Territory Managers and Counsel. Following this internal discussion, the Territory Manager must discuss the non-compliance with the taxpayer and make sure the taxpayer understands the next steps in the enforcement process. The Territory Manager then issues a Pre-Summons Letter (IRS Form Letter 5078). The Territory Manager is required to issue the letter "as quickly as possible" but no later than 14 days after the Delinquency Notice due date. The Territory Manager is required to sign the letter and address it to the taxpayer management official at a level equivalent to a Territory Manager and specifies that the management level should be above that of the level of the Delinquency Notice recipient. The letter generally has a deadline that is 10 calendar days from the date of the Pre-Summons letter. If the deadline is more than 10 days from the date of the Pre-Summons letter, a Director of Field Operations (DFO) must approve the extended response period. Furthermore, the DFO must be made aware of the Pre-Summons Letter prior to issuance.

The third "graduated" step in the enforcement process is a Summons. Prior to starting the Summons process, the team must discuss the matter with the Team Manager, Specialist Manager, respective Territory Managers and Counsel and coordinate with Counsel. The Summons procedure is described in the Internal Revenue Manual § 25.5 and is authorized under I.R.C. § 7602 for income tax matters. A Summons is not self-executing. However, the consequences for ignoring a summons can be severe. A taxpayer can be held in contempt or charged with a crime for failing to comply.[5] To enforce the

Summons, the IRS must refer the matter to the Department of Justice (DOJ) to file a Petition to Enforce in a local Federal District Court.[6] In *United States v. Powell*, the Supreme Court held that the administrative standard of relevance is very low—the DOJ must establish in its Petition to Enforce that (1) the IRS examination has a legitimate purpose, (2) the summons seeks information that may be relevant to the legitimate purpose, (3) the IRS does not already possess the information, and (4) the IRS has followed all required administrative steps.[7] These four requirements are very easy for the DOJ to establish in the Federal District Court. Typically, the DOJ procures from the IRS examining agent and files what is known as a *Powell* declaration describing the examination and explaining the four requirements. Taxpayers rarely prevail in challenging summonses, and practically speaking the only effective defenses are legal privileges or the attorney work product doctrine.[8]

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STEPS FOR TAXPAYERS TO TAKE NOW

The Enforcement Directive took effect on Jan. 2, 2014, and examiners were not supposed to issue Delinquency Notices until Feb. 3, 2014. It remains to be seen how the IRS will apply the new procedures and whether the procedures will result in a souring of the good working relationships taxpayers and examiners have established in large case examinations. That

CONTINUED ON **PAGE 14**

certainly is not the intent of the Enforcement Directive, and the procedures for working with agents and specialists and elevating disputes to higher IRS management levels should lessen the potential for bad outcomes. Moreover, it seems unlikely that very many cases will result in the need for the IRS to go to the third step involving a Summons. Summons proceedings, and particularly summons enforcement proceedings, can be very expensive and time consuming for both sides. Taxpayers should focus on the good news and view the Directives as an opportunity to engage with the examination team and negotiate procedures and deadlines that will limit the scope of IDRs and make the process ultimately less painful.

This process of engaging the examination team must start early, at the opening conference. It seems there are at least four important things to discuss and lay the groundwork for during the opening conference and to reiterate throughout the course of the examination. First, it must be made clear to the examiners that the taxpayer intends to hold them to strict compliance with all the LB&I requirements for issuing an IDR. Second, if the examiners end up issuing IDRs that are difficult to answer in a timely fashion because they are unclear, onerous, etc., or the proposed response time is too short, the taxpayer should not hesitate to elevate the issue to a higher IRS management level before the IDR is issued. The taxpayer should establish a clear understanding of what the IDR appeal process within the IRS will be and obtain a commitment that the appeal process will be followed by the examination team before a draft IDR is issued in final form. Sometimes problems can arise in coordinating with specialists (e.g., IRS Financial Products Specialists and Actuaries) who may reside in a different city and report to different managers. Taxpayers should discuss with the examination team the involvement of specialists and clearly establish the identity of the contact manager if there is a problem with a specialist's IDR.

Third, the taxpayer should try to negotiate a process in which an IDR that is issued, and turns out to be difficult to respond to in the time originally agreed upon, can be withdrawn and reissued. Although the Exam IDR enforcement process is mandatory, the Enforcement Directive does not seem to preclude withdrawal of a difficult-to-answer IDR and issuance of a new, revised IDR. Fourth, the taxpayer should assert control over the designation of the taxpayer personnel to be involved in the enforcement process and make it clear during the opening conference to whom IDR enforcement correspondence should (and should not) be sent.

On balance, the Enforcement Directive should be viewed by compliant taxpayers as a net benefit. If a taxpayer handles the examination properly, the new procedures should deter the issuance of IDRs that are unreasonable either in terms of the required information and documents or the deadlines for compliance. However, the procedures may result in some uncomfortable negotiations with examination teams and some very tight, inflexible deadlines. Company actuaries who have to provide the information and answers to the IRS' IDR queries should bear this in mind when the corporate tax department comes calling.

ENDNOTES

1 *See* Rev. Proc. 2003-36, 2003-1 C.B. 859 (Apr. 18, 2003).

2 *See* I.R.C. § 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012). For a summary of issue resolutions in other industries, see the IRS website at http://www.irs.gov/Businesses/IIR-Guidance-Issued.

3 Large Business & International Directive on Information Document Requests (IDRs), LB&I-04-0613-004 (June 18, 2013).

4 Large Business & International Directive on Information Document Requests Enforcement Process, LB&I-04-1113-009 (Nov. 4, 2013).

5 *See* I.R.C. § 7604(b) (contempt) and I.R.C. § 7210 (criminal sanctions for failure to obey).

6 *See* I.R.C. § 7604(b).

7 379 U.S. 48, 57-58 (1964).

8 The IRS recognizes in its Internal Revenue Manual (I.R.M.) that the attorney-client and tax-practitioner privileges apply and that it cannot obtain covered materials with a Summons, but the taxpayer must be prepared to prove that the privileges apply and disputes frequently arise over whether particular documents, such as bills from attorneys, are subject to attorney-client privilege. *See* I.R.M. 25.5.5.4.3. Furthermore, the IRS has special procedures in the I.R.M. that circumscribe its ability to seek tax accrual workpapers (over which taxpayers typically assert the work-product doctrine). *See generally* I.R.M. 4.10.20. The Enforcement Directive does not provide any guidance on how the new mandatory enforcement procedures interrelate with these other I.R.M. provisions and no other guidance has been released as of the time this article was submitted for publication.