IRS Examination Developments for High Tech Firms

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Agenda

• Introduction

• Current Enforcement Trends and Developments
  – IRS Large Business & International Division (LB&I) residuals for Structure Rollout to Externals
  – Running an audit under IRS budget constraints
Running an Audit under IRS Budget Constraints
Agenda

• IRS Resource Constraints and Why It Matters for You
• The Constraints – Let’s Do the Numbers
• Impact on Tax Administration
• Impact on LB&I and Your Audits
• A Changing LB&I Audit Process
• IPGs and IPNs – Dealing with One-Size-Fits-All Audits
• AJAC Calling
• Major Changes for LB&I Audits Announced for 2016
IRS Resource Constraints and Why It Matters for You

• LB&I is a highly structured organization

• Some changes are not readily adopted in the field (IDRs, faster audit process - CAP, Fast Track Settlement, early decision making), while others are readily adopted (complete factual records, AJAC)

• Biggest catalyst for change at LB&I is budget constraints

• If you understand LB&I’s constraints, you will be better prepared to manage your audits:
  – What are the challenges for you?
  – What are best practices for addressing those challenges?
  – How do you manage expectations within your organization?
The Constraints – Let’s Do the Numbers

• Budget Cuts
  – FY15 - $10.9 billion – reduction of $1.2 billion or 10% since FY10
  – Reduction of 3,000(+) employees in FY15 and 13,000 since FY10
  – Training and travel reduced by $248 million or 74% since FY10

• Cutbacks and Impact
  – Decline in taxpayer call service –
    • Less than 50% of calls get answered – down from 64% in FY14
    • Call wait times over 30 minutes / over 45 days to answer letters
  – Fewer IRS audits and fewer Chief Counsel rulings/advice
  – More automated notices
    • Increased international information return penalties
    • Form 1099 matching notices
The Constraints on Large Business Returns Filed and Examined (thousands)
The Constraints on LB&I Locally

• Attrition losses in LB&I domestic agents in SF and SJ by 50%
• High rate of attrition for IRS engineers
• Hard to attract new talent
• Why? It’s expensive here!
  – LB&I uses “locality pay”
  – Locality pay for SF > Manhattan
  – Still not enough to attract new talent
• IRS is most successful in hiring during recessions
Impact of Budget Constraints on Tax Administration

The IRS is:

• Engaged in fewer large business continuous audits, audits will be based on issues not size of entity – getting away from coordinated industry case (CIC) distinction

• Facing challenges to maintain historical audit coverage, voluntary compliance and currency rates

• Leveraging new technology to deliver taxpayer services due to diminished employee resources

• Placing a greater emphasis on detecting and prioritizing high-risk areas of noncompliance by research and data analytics to help target enforcement

• Leveraging tax return information reporting data and exchanges of information
Impact of Budget Constraints on Tax Administration – cont’d

The IRS is:

• Revising its examination approach and process for large business and flow through entities with an increased audit focus on specific tax issues that require greater specialization and knowledge sharing

• Placing more focus on engaging in joint enforcement activities and collaborating with treaty partners and other governmental agencies, resulting in increased information sharing
Impact on LB&I

• Organizational Leadership Changes
  – 6 top executives departures including Commissioner, Deputy Commissioner (International, Domestic, Transfer Pricing Director, Director APMA, Director International Strategy)
  – New cadre of LB&I executive appointments

• Budget affect on exam resources
  – Significant headcount reduction and limited attrition hiring
  – LB&I reorganization announced on Sept. 17, 2015
Current LB&I Organizational Chart

- Elizabeth Nagon, Sr. Advisor to LB&I Commissioner
- Noreen Betsi, LB&I Executive Champion for Common Implementation
- Kathleen Malloy, LB&I Executive Champion, Training and Learning Strategy
- Deborah Petschek, Assistant to the Deputy Commissioner, Int (A)
- Nick Langan, Executive Assistant (Binational)
- Joseph Atkinson, Executive Assistant (International)
- Robert Aug, Executive Assistant (Operations) (A)
- Jennifer Stamey, Executive Assistant (Technical) (A)
- Lita Williams, Executive Assistant (Operations) (A)
- Steve Martin, Executive Assistant (Technical) (A)

**Deputy Commissioner (Domestic)**
- Rosemary Sereti (A)

**Deputy Commissioner (International)**
- Dave Horton (A)

**Shared Support**
- Susan Latham, Dir.

**Pre-Filing & Technical Guidance**
- Tina Meaux, Dir.

**Business Systems Planning**
- Kathryn Greene, Dir. (A)

**Management & Finance**
- Keith Walker, Dir.

**Planning, Analysis, Inventory & Research**
- Christopher Larsen, Dir.

**Equity, Diversity & Inclusion**
- Rona Evans, Dir.

**Division Planning, Oversight, Reporting & Liaison**
- Michael Boccassina, Dir.

- Deena Flock, Executive Assistant (Operations) (IPF) (A)
- Kevin Michael, Executive Assistant (Technical) (IPF)
- Amy Erbland, Executive Assistant (Technical) (IPF)
- Susan Foy, Executive Assistant (Operations) (IPF) (A)
- Michael Adams, Executive Assistant (Operations) (IPF)
- Dzhul Adam, Executive Assistant (Operations) (IPF) (A)
- Deborah Fenton, Executive Assistant (Operations) (IPF) (A)
- Catherine Nisbet, Executive Assistant (IPF)
- Christopher Johnson, Executive Assistant (IPF)
- Victoria Atkinson, Executive Assistant (IPF)

**Communications, Technology & Media**
- Cheryl Claybough, Dir.
- Scott Rabin, DFO MW (A)
- Paul Curts, DFO SW (A)

**Financial Services**
- Barbara Harris, Dir. (A)
- Johanna McDonald, DFO PN-PA
- Danika Biloski, DFO NY (A)

**Global High Wealth**
- Cheryl Claybough, Dir. (A)

**Heavy Manufacturing & Pharmaceutical**
- Lavens Williams, Dir. (A)
- Dennis Pigg, DFO NE (A)
- Donald Smiezek, DFO SE (A)

**Natural Resources & Construction**
- Kathy Robbins, Dir.
- Khrin Chow, DFO W (A)
- Daniel LaFortune, DFO E (A)
- Stephen Whitaker, DFO Eq

**Retailers, Food, Transportation & Healthcare**
- Kimberly Edwards, Dir. (A)
- Carol T. Brown, DFO (A)
- Pete Papaloukas, DFO W (A)
- Brian Calhoun, DFO CAS (A)

(A) = Acting

Rev. October 20, 2015
Changing LB&I Exam Process

• Replacing current “Quality Exam Process” by incorporating recent changes
  – Appeals Judicial Approach and Culture (AJAC)
  – Establishment of Issue Practice Groups (IPG) and International Practice Networks (IPN) to promote knowledge sharing
  – Process for centralized issue identification and selection
  – Possible exams limited to pre-identified issues, and
  – Examinations managed and conducted by various “issue teams”
  – Exit Strategy - Joint critique of the exam to recommend improvements, and to address future tax treatment of issues, eliminate carryover or recurring issues
Changing LB&I Exam Process – IDRs

Under the directive, the IDR process – from the date of the initial draft IDR to the initiation of the summons process – can take approximately 140 days.

New process of draft IDRs and issue identification has generally been a good development for taxpayers.
Changing LB&I Exam Process – Agreement on the Facts, Fast Track, and Informal Claims

• Require formal acknowledgement of the facts
  – Taxpayer opportunity to provide statement on disputed facts

• Fast Track Settlement (FTS) must be considered on all unagreed issues before sending to Appeals
  – 365 days required on statute of limitation when sent to Appeals

• Will require Informal claims to be submitted to the exam team within the first 30 days after the opening conference, after which the taxpayer must file formal claim
  – Fully documented claims will be risk assessed similar to other issues
  – The claim could be accepted or worked separately from the current examination
LB&I Coordinated Industry Cases (CIC) Pilot

• LB&I initiated a CIC pilot on April 30, 2014
  – Pilot to run for 18 months – ending October 2015

• Currently, CIC cases are:
  – Front-end staffed into the LB&I compliance plan
  – Limits flexibility to allocate resources to other compliance activities

• Under the pilot process, all CIC returns would;
  – Undergo a consistent classification process to determine compliance risk and to identify issues for examination

• Pilot return classification process includes:
  – Issue identification, written explanations on compliance risks, and documentation to support compliance risk conclusions
    • Pre-classification of issues
    • All info will be included in case file for use during an examination
Issue Practice Groups (IPG) – an IPG is...

• Focused on domestic issues - replaced the tiered issue process
  
  – Comprised of an IPG coordinator, one or more full-time subject matter experts (SMEs), supplemented with a number of part-time SMEs who spend 25% or less of their time on the IPG, and an IPG analyst
  
  – SMEs can be field agents, technical specialists or managers. In addition, each IPG includes representatives from LB&I Counsel and National Office Counsel with jurisdiction over the issue

• Accessible to LB&I managers and examiners – both can participate on periodic IPG calls to discuss issues or consult with SMEs about the issues

• LB&I’s process for knowledge sharing
Current List of Domestic IPGs

- Partnerships and TEFRA
- RICs, REITs and REMICs
- S-Corporations and Cooperatives
- Non-Life Insurance
- Compensation and Benefits
- Penalties
- Deductable and Capital Expenditures (DCE)

- Corporate Distribution and Adjustments
- Corporate Income and Losses
- Business Credits
- Energy Credits
- Life Insurance
- Financial Instruments
- Inventory and 263A
- Methods of Accounting and Timing
International Practice Network (IPN) and International Practice Units (IPU)

• IPNs are employee communities seeking to network in broad areas of international compliance

• Organized around the segments of the International Matrix (next slide), IPNs are the focal point for international strategy, training, and data management

• International examiners (IEs) are regarded as experts on international issues, and the IPNs provide the tools they need to broaden, enhance, and share their expertise

• IPNs provide international employees the opportunity to both learn from and teach their colleagues

• Income Shifting IPN was expanding to include an Economist IPN group
International Matrix - foundation for the LB&I Integrated International Program

Matrix

BUSINESS OUTBOUND
- Jurisdiction to Tax
- Income Shifting
- Foreign Tax Credits
- Inbound Financing
- Repatriation/Withholding

BUSINESS INBOUND
- Jurisdiction to Tax
- Foreign Corporations
- Pass-Through Entities
- Offshore Arrangements

INDIVIDUAL OUTBOUND
- US Business Activities
- Withholding

INDIVIDUAL INBOUND
- Treaties
- Information Gathering
- Foreign Currency
- Organization/Restructuring
International Practice Network (IPN) and International Practice Units (IPU) - continued

• LB&I publicly released the IPUs which were developed through internal collaboration and serve as both job aids and training materials on international tax issues

• LB&I welcomes feedback on the IPUs via email

• LB&I is publishing additional units at a fast clip:
  – July 2015: 3 new IPUs dealing with Subpart F issues
  – August 2015: 14 new IPUs, including section 482
  – September 2015: 2 new IPUs, including accounting for intangibles and services associated with the sale of tangible property (outbound)

• Best Practice: Read the IPU for issues before audit starts!
Managing Challenges Outside Your Exam Team

• Issue Practice Groups (IPGs) and Issue Practice Networks (IPNs)
  – How does IPG/IPN involvement come about
  – Can it ever be helpful?

• What does it mean when IPN/IPG gets involved in your case?
  – Dynamics with the Exam:
    • Who owns the issue?
    • Specialists typically on recurring issues – What are the keys to collaboration and getting the facts?

• IRS Counsel
AJAC Calling

• Major changes for Your Audits
  – Statute of Limitations – Must have 1 year remaining for Appeals
  – No new issues raised by Appeals
  – Issues previously agreed to by taxpayer and Examination will not be reopened
  – Appeals will attempt to settle a case on factual hazards when case submitted by Examination is not fully developed and taxpayer presents no new information or evidence
  – If a taxpayer provides Appeals with new information, Appeals will return the case to Examination.
  – If a taxpayer raises new arguments at Appeals, Examination will be given the opportunity to review and comment on the arguments, but Appeals will maintain jurisdiction

• Best Practice:
  – Complete the factual record you need while in exam
  – Make all your arguments in the Protest!
Questions?
With a View Toward Appeals: Strategically Managing Unagreed Issues in Exam
Agenda

• Introductions

• Managing Unagreed Issues in the New Appeals Judicial Attitude and Culture (AJAC) Environment

• Managing Challenges Outside Your Exam Team

• Alternative Dispute Resolution

Questions are welcome throughout!
Managing Unagreed Issues in the New Appeals Judicial Attitude and Culture (AJAC) Environment
What is AJAC?

• AJAC Phase 1: Key examination changes (effective 7/18/13)
  – Revised Policy Statement 8-2 – Appeals will not raise new issues or reopen issues agreed to by taxpayer and Compliance (except in the case of fraud or malfeasance)
  – Appeals will attempt to settle a case on factual hazards when case submitted by Compliance is not fully developed and taxpayer presents no new information or evidence
  – Compliance obtained a centralized formal dissent procedure
What is AJAC, cont’d

• AJAC Phase 2: Key examination changes (effective 7/2/14)
  
  – Statute of Limitations (SOL): new cases in Appeals must have at least one year on the SOL
  
  – New information/New Issue: If a taxpayer with a nondocketed case raises a new issue or submits new information that merits investigation and/or requires additional analysis, Appeals will return the case to Compliance to examine the information/issue
  
  – New Theory or Legal Argument: If a taxpayer raises a relevant new theory or legal argument on a nondocketed case, Appeals will engage Compliance for review and comment on the new theory or argument
## Appeals Judicial Approach and Culture

### Appeals/LB&I Matrix

<table>
<thead>
<tr>
<th>Type of Information Received</th>
<th>Action to be Taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxpayer provides Appeals with information that LB&amp;I previously requested during the examination.</td>
<td>Appeals will release jurisdiction of the case to LB&amp;I.</td>
</tr>
<tr>
<td>2. Taxpayer, on its own initiative, provides Appeals with information not previously shared with LB&amp;I during the examination.</td>
<td>Appeals will release jurisdiction of the case to LB&amp;I</td>
</tr>
<tr>
<td>3. Taxpayer provides information in response to a question or request from Appeals to clarify or corroborate information contained or referenced in the RAR, Protest or Rebuttal.</td>
<td>Appeals will provide LB&amp;I with an opportunity to review and comment on the information within a specified time frame (generally 45 days).</td>
</tr>
<tr>
<td>4. Taxpayer makes a new argument (not including new information).</td>
<td>Appeals will provide LB&amp;I with an opportunity to review and comment on the new argument within a specified time frame (generally 45 days).</td>
</tr>
</tbody>
</table>
What Does AJAC Mean to You, cont’d

<table>
<thead>
<tr>
<th>More Favorable</th>
<th>Less Favorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>If Taxpayer does not raise new issue/facts, case will not be returned to Compliance</td>
<td>Compliance has increased involvement in cases going to Appeals, including the need to specify which facts are disagreed.</td>
</tr>
<tr>
<td>Any issues agreed between Compliance and taxpayer cannot be revisited by Appeals – even if critical to the case</td>
<td>Moving a case to Appeals requires taxpayers to work sufficiently with Compliance so that the case is “fit.”</td>
</tr>
<tr>
<td>If the facts are poorly developed by Compliance, Appeals must assess the case as if “it went to court today” – no second bite.</td>
<td>More Taxpayer actions or submissions can lead to remand to Exam, after which there may be no end in sight.</td>
</tr>
</tbody>
</table>
How Do You Add to the Factual Record?

• Strategic use of IDR

• Some tips for adding information after IDR:
  – AJAC rules can help
  – Managing expectations
  – Protest as the last opportunity to set out the factual record

• Which additions are easier ... more difficult?

• Alternatives: Is it ever a good strategy to wait until you are in Appeals?

• How do you document your disagreement on the facts?
How Do You Handle Disagreements About the Factual Record?

• There is a difference between disagreements about the facts and disagreements about what the facts mean
  – Therefore, many or most Appeals cases can be properly positioned as having agreed facts

• Use the procedures for disagreed facts to reduce the chances of a remand by Appeals
  – List of unagreed facts
  – Review to determine if you or even Appeals will want more facts

• You may need to employ a rule of reason about disagreed facts
  – The notorious IRS request, “In our draft NOPA, please identify all facts that are incorrect.”
How Do You Introduce a New Argument?

• Many “new” arguments are variations on a prior argument
  – Golden Rule to test if an argument is truly new
  – Your credibility may be implicated by how you handle
• Keep it simple
  – Do you want to align it with a prior argument? Or create a separation?
  – Don’t bury your new argument, but avoid superlatives.
• When is it best to do nothing?
  – Weak NOPAs
  – Challenging generally leads to more development/improvement
• Have you thought strategically about Joint Committee on Taxation review?
How Far Should You Go in Your Protest?

• Protest must effectively advocate without triggering a re-engagement with the Exam Team
  – Perception that AJAC increases risk of Exam retaining the case
  – Stringing citations
  – Remind your representative who the audience is
But LBI Won’t Release Your Case Why? ...

• Avoiding additional work with Exam

• Do you disclose new facts to exam as part of your protest?
  – Exam holds protest and then issues new IDRs
  – Happening w/surprising frequency
    • Sometimes rescinding 30 Day Letter; sometimes they don’t

• “Facts warranting additional consideration”
  – What can you do?
    • Have 30 day letter rescinded. (Requires Territory Manager approval?)
    • Other options
    • Pros and cons
When and How to Escalate in Exam?

• Insufficient issue development
• Misapplication of the law
• Challenging penalty assertion
• Minimizing friction with Exam Team in escalation
  – Follow the “rules of engagement”
  – Involve the Team whenever possible
  – Drafting memos for IRS management review
Managing Challenges Outside Your Exam Team
Alternative Dispute Resolution
Alternative Dispute Resolution

• When Exam offers Fast Track (Rev. Proc. 2003-40)
• Delegation Orders 4-24 and 4-25
• Accelerated Issue Resolution (AIR) (Rev. Proc. 94-67)
• When should you request Early Referral of an issue in your case? (Rev. Proc. 99-28)
• What is the Rapid Appeals Process (RAP) and why does my Exam Team want me to use it in Appeals? (IRM 8.26.11.1)
Thank you!