

# 31<sup>st</sup> Annual High Technology Tax Institute

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## 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

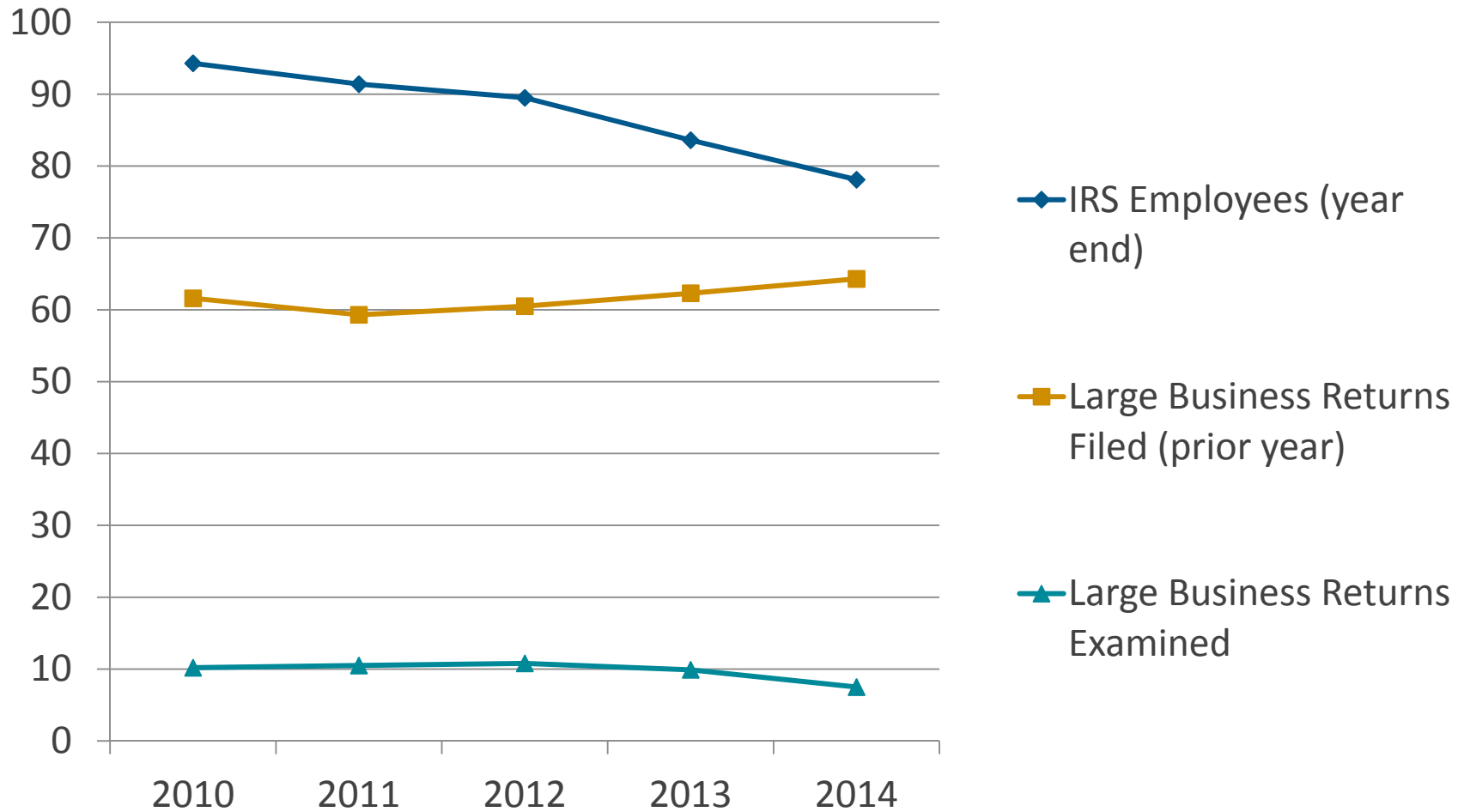
- Budget Cuts

- 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

## LB&I Organization Chart

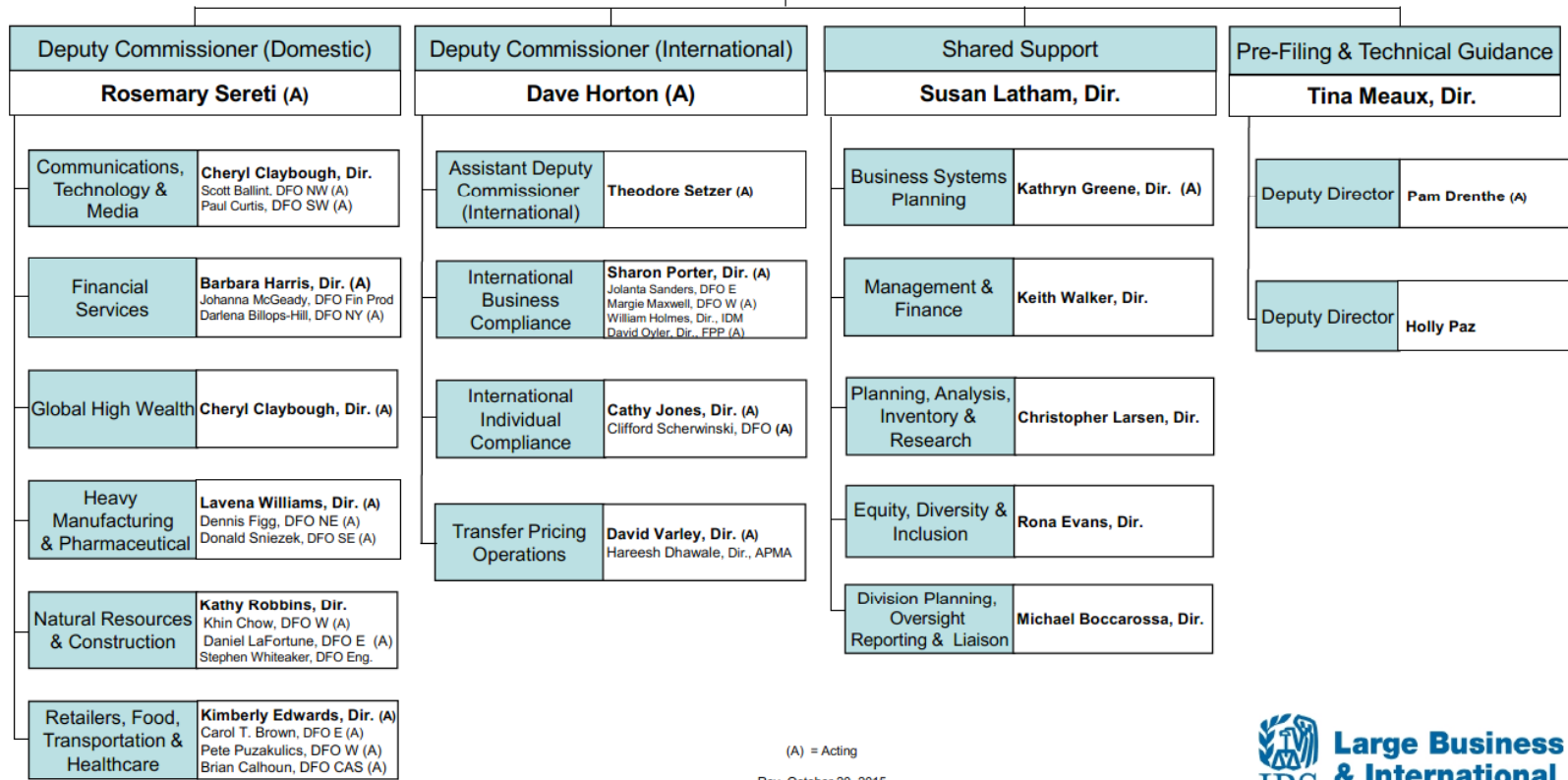
- Elizabeth Wagner, Sr. Advisor to LB&I Commissioner
- Rosemary Daly, LB&I Executive Champion for ConOps Implementation
- Kathryn Houston, LB&I Executive Champion Training and Learning Strategy
- Deborah Palachek, Assistant to the Deputy Commissioner, Int'l (A)
- Nick Gaudio, Executive Assistant (Commissioner)
- Janice Larkin, Executive Assistant (Commissioner)
- Robert Aug, Executive Assistant (Operations) (A)
- Imelda Deniz-Vasquez, Executive Assistant (Technical) (A)
- Lillie Williams, Executive Assistant (Operations) (Int'l) (A)
- Steve Martin, Executive Assistant (Technical) (Int'l) (A)

LB&I Commissioner

Douglas O'Donnell

- Donna Helm, Executive Assistant (Operations) (HMP) (A)
- Kevin Schlatmann, Executive Assistant (Technical) (HMP)
- Amy Liberatore, Executive Assistant, (Technical) (PFTG)
- Samaa Taylor, Executive Assistant, (Operations) (PFTG) (A)
- Brenda Jackson, Executive Assistant, (Operations) (NRC)
- Neena Rane, Executive Assistant, (Technical) (NRC)
- Deborah Patel, Executive Assistant (Shared Support)
- Cathie Schiesl, Executive Assistant, (M&F)
- Christopher Johnson, Executive Assistant, (PAIR)

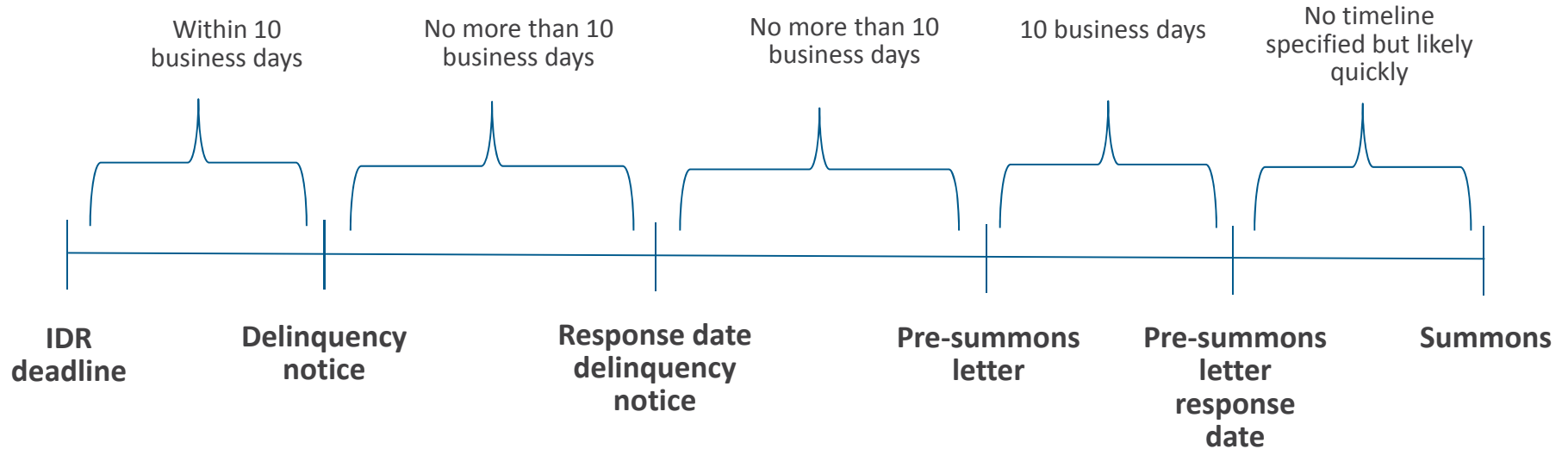
- Valerie Addison, Executive Assistant, (BSP)
- Antoine Shabazz, Executive Assistant, (Technical) (CTM) (A)
- Kim Orlowaki, Executive Assistant, (Operations) (CTM) (A)
- Dwight Redigo Phillips, Executive Assistant (SHW) (A)
- Cathy J. Vaughn, Executive Assistant, (Operations) (RFTH)
- Diane R. Wright, Executive Assistant, (Technical) (RFTH) (A)
- Stella Kui, Executive Assistant, (Operations) (FS)
- Deborah Inganamonte, Executive Assistant, (Technical), (FS)



# Changing LB&I Exam Process

- Replacing current “Quality Exam Process” by incorporating recent changes
  - Information Document Request Enforcement Directive - timeline
  - 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

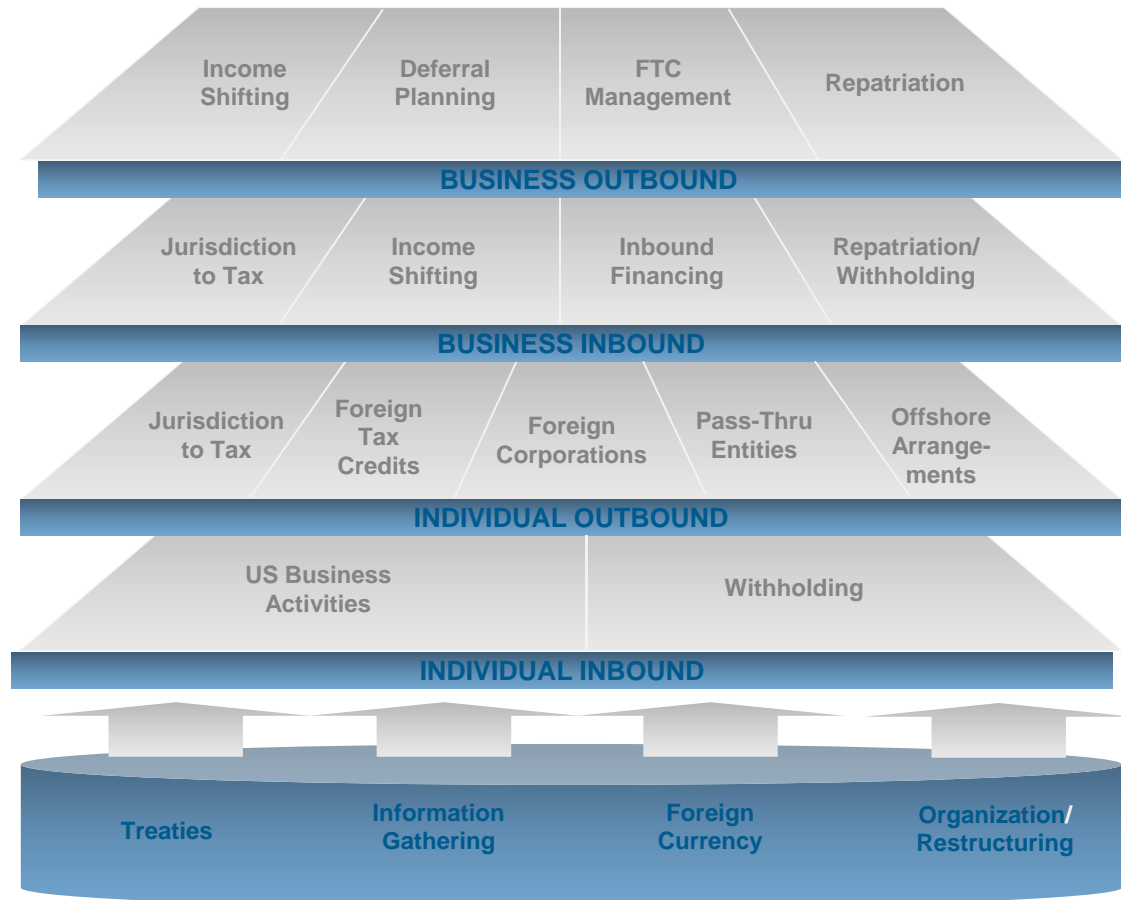
- Partnerships and TEFRA
- RICs, REITs and REMICs
- S-Corporations and Cooperatives
- Non-Life Insurance
- Compensation and Benefits
- Penalties
- Deductible and Capital Expenditures (DCE)
- Corporate Distribution and Adjustments
- Corporate Income and Losses
- Business Credits
- Energy Credits
- Life 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 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



# 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
  - <http://www.irs.gov/Businesses/Corporations/International-Practice-Units>
- 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

Type of Information Received	Action to be Taken
1. Taxpayer provides Appeals with information that LB&I previously requested during the examination.	Appeals will release jurisdiction of the case to LB&I.
2. Taxpayer, on its own initiative, provides Appeals with information not previously shared with LB&I during the examination.	Appeals will release jurisdiction of the case to LB&I
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.	Appeals will provide LB&I with an opportunity to review and comment on the information within a specified time frame (generally 45 days)
4. Taxpayer makes a new argument (not including new information).	Appeals will provide LB&I with an opportunity to review and comment on the new argument within a specified time frame (generally 45 days).

## What Does AJAC Mean to You, cont'd

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

## How Do You Add to the Factual Record?

- Strategic use of IDRs
- Some tips for adding information after IDRs:
  - 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!