The Tax Disputes and Litigation Review

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Chapter 26

UNITED STATES

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I INTRODUCTION

The Internal Revenue Service (IRS) is the primary United States government agency taxpayers face in federal tax disputes. The vast majority of tax disputes are resolved within the IRS's settlement apparatus, leading to certain important practical considerations.

i Overview of the US tax reporting and enforcement system

The United States tax system is self-reporting; each taxpayer prepares and files a return showing the amount of tax owed to the federal government.[2] For income tax returns, the starting point for every taxpayer is the gross income earned during the taxable year.[3] Various offsets, credits and deductions are applied, and a taxable income amount to which the appropriate tax rates are applied is determined. By filing a tax return, the taxpayer authorises the IRS to record an assessment of tax in that amount on its books. The IRS maintains a 'transcript of account' for each taxpayer, which reflects all the activity (e.g., the filing date of the return, date and amount of assessment, date of examination) that occurs with respect to each return filed by the taxpayer.[4]

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2 This chapter focuses on federal tax disputes; however, the 50 states and the District of Columbia have similar voluntary, self-reporting systems of taxation, and similarly enforce their revenue laws through audits and collection. United States territories, such as the US Virgin Islands, have systems similar to the states.

3 One exception is federal estate tax, which is imposed on the value of assets in the estate as opposed to income earned by the estate (for which there is a separate income tax return).

4 The Internal Revenue Code imposes numerous information reporting obligations that, if not properly carried out, can result in significant penalties. However, this chapter does not focus in any depth on information returns or the penalties associated therewith.

Any assessment other than taxpayer self-assessment (such as instances where the IRS assesses tax, interest or penalties after an examination of a return) can only arise after the IRS satisfies strict rules of procedure and notice, generally called deficiency procedures. These procedures entitle the taxpayer to judicial review of the IRS's proposed assessments prior to payment. The primary notice received by the taxpayer is formally called a statutory notice of deficiency (it is sometimes also called a 'ticket to the Tax Court') and allows the taxpayer 90 days in which to petition the United States Tax Court.[5] The Tax Court is the only forum in which a taxpayer can dispute a proposed income tax assessment without first paying the additional tax. In rare cases, such as if the IRS believes that the taxpayer may transfer assets beyond the IRS's jurisdiction to avoid payment of delinquent taxes, the IRS may make a jeopardy assessment that allows it to prescind from the normal deficiency procedures.

The great majority of individual US taxpayers pay taxes throughout the calendar year by authorising their employers to withhold from their salaries and to pay to the IRS income tax and employment taxes (e.g., social security). Depending upon the amount of their annual revenues, US corporations are required to make greater or lesser payments of tax, called estimated tax payments, each taxable quarter. Self-employed individuals have a similar quarterly payment obligation. If after the conclusion of a particular taxable period the taxpayer believes that it has overpaid its tax, it may submit a claim for a refund to the IRS.

In addition to income and employment taxes, the Internal Revenue Code (the Code) imposes a variety of excise taxes. These are imposed on the manufacture or distribution of certain goods, such as fuel, and on services, including telecommunications and air transportation. As a general matter, the consumer bears the cost of excise taxes, and the manufacturer or distributor is essentially a collection agent for the government. As with other taxes, excise taxes are also self-reported by the manufacturer or distributor and paid through periodic tax returns and deposits.

Disputes over excise taxes can be resolved both administratively and judicially.

Income earned in the United States by foreign persons is subject to withholding. Income subject to this withholding includes income that is 'effectively connected' with a trade or business within the US and certain investment income.[6] US payers to foreign persons generally act as withholding agents that collect the appropriate tax and pay it to the IRS. Tax treaties can beneficially modify the statutory withholding rules and rates. Because foreign persons are often outside the jurisdiction of the IRS, the IRS will generally audit the US withholding agent and impose any deficiencies on that person. Withholding agents can dispute assertions of deficiencies within the administrative apparatus of the IRS and can seek judicial relief if necessary.

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5 For taxpayers outside the United States, the petition must be filed within 150 days of the date of the deficiency notice being mailed. See Section 6213(a) of the Code, Title 26, United States Code (USC) (hereinafter, the Code).

6 Foreign corporations must file IRS Form 1120-F, 'US Income Tax Return of a Foreign Corporation', to report any tax due to the United States.

ii IRS enforcement and guidance roles

The IRS is a federal agency within the United States Department of Treasury. The Commissioner of the Internal Revenue is the agency head (the Commissioner's side of the house). Legal counsel for the Commissioner is the Chief Counsel of the IRS (Counsel's side of the house). Together, these executive officials determine the programmes, policies and actions of the IRS. Ultimate supervisory authority over the IRS rests in the Assistant Secretary of the Treasury for Tax Policy and the Secretary of the Treasury.

Prior to a substantial reorganisation in 1999, the IRS audit and collection offices were divided geographically. The IRS is now divided into four operating divisions:

a Wage and Investment Division;
b Small Business/Self-Employed Division;
c Large Business and International Division (formerly Large and Mid-Size Business Division); and
d Tax Exempt and Government Entities Division.

These divisions carry out the basic tasks of the IRS (primarily the audit function) with respect to the different types of taxpayers. Each division is directed by an operating division commissioner, who reports directly to the Commissioner of the Internal Revenue.

The organisational structure of the Chief Counsel mirrors that of the Commissioner. Each operating division has its own operating division counsel (ODC), who reports directly to the Chief Counsel. The ODCs supervise 'field counsel', who in turn support the IRS agents who audit taxpayers 'in the field'. Chief Counsel has numerous specialised attorneys in the IRS National Office in Washington, DC, whose task is to provide guidance to taxpayers on matters of interpretation of the Code and Treasury Regulations, and to assist with particularly technical or difficult questions on specific taxpayer cases when asked by IRS agents who are working on those cases. The Chief Counsel also maintains a cadre of dedicated trial attorneys to represent the IRS in cases filed in the US Tax Court. By statute, trial attorneys at the US Department of Justice Tax Division represent the government in tax cases in all other courts.

To handle the receipt and processing of tax returns, the IRS maintains several service centres throughout the country. These centres perform the bulk of all routine interactions with taxpayers, including issuing notices of adjustment, payment of refunds and change of address notices.

iii Enforcement

The main enforcement mechanism of the IRS is the audit function through which one or more IRS revenue agents review the tax returns of a specific taxpayer. Depending on the complexity of the tax return under examination, the revenue agent may be assisted by certain IRS specialists (such as financial product, international tax or economic experts).[7]

7 The IRS has both civil and criminal audit functions. This chapter focuses on civil audit disputes. Criminal audits involve the investigation of possible tax crimes, such as tax evasion, and are principally carried out by a special office within the IRS called the Criminal Investigation Division (CID). CID agents are trained particularly in forensic audit skills. After

The IRS uses a statistical method, which is not disclosed to the public, to select individual returns. Some large corporate returns are routinely audited. Occasionally, the IRS pursues issue-specific audit 'initiatives'. These initiatives will focus on a particular area of tax compliance, and taxpayers are selected for audit consistent with the initiative's focus and goals. For example, the IRS recently completed a worker classification audit initiative that focused primarily on the classification of workers as either employees or independent contractors. The IRS was concerned that there may have been widespread misclassification of workers. Accordingly, 6,000 US employers, including small and large businesses, were audited during the initiative. Currently, the IRS has implemented another audit initiative targeting high-wealth individuals and their related entities. This initiative was precipitated primarily by the IRS's view that such individuals had a higher likelihood of tax non-compliance, especially with respect to tax reporting regarding their foreign assets and related income.

A further enforcement mechanism is collection. Once a tax has been assessed, the IRS is authorised to perform certain collection activities. IRS revenue officers, as opposed to revenue agents, carry out collection activities. Taxpayers are entitled to certain procedural protections (the 'collection due process') prior to actual collection by the IRS. The protections can be overridden in certain cases where the IRS believes that assets may be transferred outside its jurisdiction. In that event, the only option for the taxpayer is to file a claim for a refund of taxes paid and, if necessary, pursue that claim in court.

iv Guidance

The IRS (sometimes in conjunction with the Assistant Secretary for Tax Policy) issues significant guidance every year to taxpayers. There are generally two kinds of guidance: formal and informal. Formal guidance includes Treasury Regulations, revenue rulings and revenue procedures, and form instructions. Informal guidance includes letter rulings to specific taxpayers called private letter rulings, written advice of the Chief Counsel, service centre advice and, to a lesser extent, the IRS's Internal Revenue Manual, which contains its own interpretation and implementation of the revenue laws.

II COMMENCING DISPUTES

Tax disputes begin with the IRS in one of two general ways:

a when the IRS decides to audit a tax return and disagrees with one or more of the positions reflected on the return; or

b when the taxpayer affirmatively seeks to recover tax it believes it has overpaid and the IRS refuses to repay it.

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an audit investigation has proceeded to a certain point, CID agents may refer a case to the US Department of Justice for prosecution and thereafter support the Department of Justice in any further prosecution efforts. CID agents are also authorised to seize property and assets of taxpayers, and are sometimes detailed to other federal prosecution efforts that involve financial crimes such as money laundering.

Taxpayers and the IRS can also raise disputes about the collection of taxes (e.g., a taxpayer might claim that the IRS did not follow proper procedure in levying on its bank accounts). Below, we focus on disputes over the merits of tax return positions rather than on the IRS collection efforts. In this context, almost all federal tax disputes begin in an administrative setting.

i Administrative phase of tax disputes: audits

The IRS's general authority to examine is based on Sections 6001, 6201 and 7602 of the Code. Section 6001 provides general authority for the IRS to make regulations requiring every taxpayer to keep records and file returns. Section 6201 authorises the IRS to make enquiries, determinations and assessments of all taxes under internal revenue laws. Section 7602 and the following Sections authorise the IRS to examine any books, records, papers, or other relevant data or material, of the taxpayer or third parties. Together, these provide the basic authority to conduct examination of taxpayers and to request specific information during those examinations.

Types of audit

There are two types of audit: 'face-to-face' and 'correspondence'.

In a face-to-face audit, a revenue agent meets with the taxpayer to gather information, either at the taxpayer's premises (in the field) or at the IRS office (in the office). Generally, corporate taxpayers and higher net-worth individual taxpayers are examined through a field examination, whereas lower net-worth taxpayers will be subject to an office examination. In a correspondence audit, the IRS service centre that received the return generates and delivers certain notices based on errors or discrepancies in the return. One common discrepancy involves dividends. The IRS receives notices that detail the dividend amounts received by each taxpayer in a taxable year. If the taxpayer did not fully report the dividend income on its return, the service centre will generate a notice that proposes an adjustment to the return based on the dividend income. In cases where there was a mistake in the dividend reporting to the IRS, the taxpayer can provide an explanation and an employee in the service centre will review that explanation and act accordingly.

Income tax audits are generally conducted by revenue agents and international examiners (revenue agents who specialise in the US tax aspects of cross-border activities), while employment tax audits are carried out by employment tax agents. As noted, the IRS recently completed a three-year audit initiative in which it examined the worker classifications of employers throughout the country. Audits under the auspices of this initiative were conducted by employment tax agents. Such agents specialise in classification issues (i.e., whether a worker is an employee or an independent contractor), fringe benefits issues and the employer's treatment of non-cash remuneration, such as stock options. Estate tax audits are conducted by an estate tax attorney. Unlike all other audits, the lead IRS agent in an estate tax audit is an attorney.

Initiating an audit

The IRS commences a face-to-face audit by sending a letter notifying the taxpayer that the return or returns for a particular period have been selected for audit.[8] A standard form letter is used that will indicate the specific operating division of the IRS that is performing the audit. In the letter, the IRS agent requests a time to meet with the taxpayer to discuss the development of an audit plan and issues preliminary information and document requests (IDRs). Responses to these initial IDRs are usually requested by the time of the first meeting. Prior to the audit, IRS agents will have performed background research on the taxpayer, including obtaining any publicly available information, and will have performed an overall risk analysis to identify possible return positions that the IRS considers to be aggressive. Such positions will receive extra focus during the audit.

In most circumstances, outside counsel is not retained by the taxpayer at this stage of IRS audit activity. Large companies have tax departments that include skilled tax professionals such as attorneys and accountants who can handle many audit issues. Smaller companies and individuals usually rely on their tax return preparer, who can be a certified public accountant, an attorney, a preparer service or a registered return preparer. As the audit develops and issues are brought into focus, counsel is sometimes retained. The IRS will assemble an audit team for large company audits (known as coordinated industry case (CIC) audits and formerly called comprehensive examination programme (CEP) audits). The audit team will consist of a lead agent, supporting speciality agents (possibly including international tax examiners if the audit raises cross-border issues) and an audit team manager. The taxpayer also requires a team to effectively respond to enquiries from the IRS audit team. Moreover, because it is now common for IRS large-case audit teams to include IRS field counsel at the inception of the audit, taxpayers would be well advised to seek assistance of counsel (either in-house or external) to be prepared to respond in a careful and thoughtful manner to the IRS.

The IRS examines the return (in the case of a large taxpayer, returns for a two-year period or 'cycle') and verifies the accuracy of the taxpayer's evaluation of its tax liability. On occasion, a taxpayer will amend the original return during the audit, seeking a refund based on further review of its return. The IRS agent may allow the claim at that time or defer consideration until the audit is complete. As noted above, some returns are merely informational returns. Nonetheless, these returns can also be subject to an audit. For example, if a law firm is a considered a material adviser with respect to what is called a 'reportable transaction', the law firm must file an informational return with the IRS (Sections 6111 and 6112 of the Code). If the IRS wants to evaluate the accuracy of that filing, it can initiate an audit. Another example of informational returns that are regularly audited by the IRS are those filed by tax-exempt entities. Such entities generally file an annual return reflecting the various activities they undertook during the filing period. The IRS will look at the activities of the exempt entity to determine whether they are in

8 Correspondence audits typically begin with the service centre notifying the taxpayer of proposed changes to the return and a request for information to explain the return position or positions giving rise to the adjustments. The IRS never uses email to inform a taxpayer of the commencement of an audit.

keeping with its exempt purpose, and will also review activities that may have generated unrelated business income, which is taxable.

Audit ground rules

It is important to establish ground rules concerning the conduct of the audit. To the extent that a taxpayer can define the expectations of the audit, it can generally maintain a good relationship with the auditor and keep the audit moving at an efficient pace. In addition, initiation of an audit by the IRS does not mean that the IRS has free rein in the conduct of the audit; there are recognised procedures and limits to the IRS's examination authority.

For audits of any complexity, ground rules should be established at the preliminary conference that occurs after the audit initiation letter is received by the taxpayer. The grounds rules should cover:

a who the designated taxpayer contacts are;

b how production and copying of documents occurs on-site;

c the general logistics for delivery and response to IDRs, and the maintenance of IDR logs so that the taxpayer can confirm completion of responses to the IDRs;

d scheduling of meetings; and

e establishing a hotline between the taxpayer's supervisor and the manager of the revenue agent.

On occasion, there may be misunderstandings between the taxpayer and the lead revenue agent. In those circumstances, the taxpayer should be able to seek input from the audit team manager.

The Large Business and International Division (LB&I) recently announced a new policy regarding the issuance of IDRs and the use of summonses to enforce information requested by IDRs. IRS Directive LB&I-04-0613-004 issued in June 2013, subsequently clarified by Directive LB&I-04-1113-009, requires examining agents to follow certain graduated enforcement steps in the event that information requested through an IDR is not provided by the taxpayer in a timely manner. The agent has no discretion to vary from them. The steps are: (1) issuance of a notice of delinquency to the taxpayer; (2) in the event that the information is not provided 15 days later, the agent issues a letter that warns the taxpayer of the preparation of a summons; and (3) if the taxpayer does not respond within 10 days from the date of this letter the agent must issue a summons. The tax bar has expressed concern about the mandatory nature of this directive especially in circumstances where the taxpayer encounters unforeseen difficulties in obtaining the information requested by the IDR or where the location of the information, such as overseas, makes it impossible to meet any pre-agreed IDR response date.

Form 8275 and Revenue Procedure 94-69 disclosures

A taxpayer has the option to attach Form 8275, 'disclosure statement', to its return. The Form discloses a particular position or positions taken by the taxpayer on the return, and in effect allows the taxpayer to notify the IRS that the IRS might disagree with one or more of its return positions. Such a disclosure's benefit is that it will prevent the IRS from asserting certain civil penalties against the taxpayer, specifically the Section 6662(b)(1) penalty for disregarding rules and regulations, and the substantial understatement penalty under Section 6662(b)(2).[9] It can be helpful in situations where the law is not clear on the propriety of the return position, and if the taxpayer otherwise has a reasonable basis for such a position. Should the IRS decide to audit a return that has one or more positions so disclosed, the taxpayer should be prepared for the IRS to focus its examination on those positions.

For CIC taxpayers, a similar kind of disclosure can be made after the initiation of the audit. Pursuant to IRS Revenue Procedure 94-69 (31 October 1994), if a CIC taxpayer provides a statement to the IRS no later than 15 days after such a statement is requested by the IRS, the statement will be deemed to be a qualified amended return,[10] and no penalties under Section 6662(b)(1) or (b)(2) can be imposed. As a general matter, the IRS will request such a statement at the inception of the audit.

Statute of limitations

Under Section 6501(a) of the Code, the IRS has three years from the time a return is filed to assess any additional tax with respect to that return. Whenever an audit is commenced, it is important to confirm that the IRS still has the authority to actually assess a tax with respect to the year under audit. Normally, the IRS audit team has already reviewed the statute, but taxpayers should confirm this independently. In cases of substantial omission of gross income – defined as an amount in excess of 25 per cent of the gross income stated in the return – the statute of limitations is six years from the time of filing the return (see Section 6501(e) of the Code).[11] For fraudulent or false returns, the statute remains open indefinitely. The statute also remains open in cases where no return has been filed.

If the IRS team determines that there is a year or less remaining on the statute for the return under audit, it will ask the taxpayer to consent to the extension of the statute through execution of Form 872. The request will be for a specific date in the future. As a general matter, it is prudent for taxpayers to sign these extension consents. If the IRS is faced with an expiring statute prior to the completion of the audit, it will be forced to consider issuing a protective notice of deficiency so that any potential tax collection is not lost. Protective deficiency notices are generally based on prior year return tax liabilities and adjusted upwards. As the audit progresses, if certain issues are not going to be challenged, the taxpayer may insist that an extension is limited only to specific audit issues. Form 872-R accomplishes this limited extension of the statute. As with all matters

9 Treasury Regulation Sections 1.6662-3(c)(1)-(2) and 1.6662-4(e).

10 A qualified amended return normally must be filed prior to any contact by the IRS.

11 Recent significant litigation has addressed the meaning of this provision of the Code. The *United States Supreme Court in United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), decided that Treasury Regulation Section 301.6501(e)-1(a)(iii) was invalid. This Regulation required overstatements of basis to be treated as substantial omissions of gross income under Code Section 6501(e) to the extent such overstatements resulted in a reduction of income exceeding 25 per cent of the reported gross income. Of particular importance was the fact that the Court chose not to defer to the Treasury Department's interpretation of the Code. Normally, Treasury Regulations are granted a high degree of deference by the courts.

concerning the statute of limitations, a taxpayer should carefully consider its options before consenting to the extension.

IRS methods to obtain information during an audit

The IRS has several methods by which to obtain information from the taxpayer during an audit. The standard method is the IDR. Because of the broad investigative power of the IRS, IDRs can request almost anything relating to a return position that assists the IRS in determining the accuracy of the return. The revenue agent will use Form 4564 to set forth specific questions and requests. An IDR can be used simply to pose a question (e.g., how many full-time employees did the taxpayer have during the taxable period?) As the audit proceeds, IDRs become more focused on the areas of concern to the IRS. The IRS may also ask for information informally, but for any material information, a taxpayer should make sure that this is requested through Form 4564. Generally, IDRs indicate a deadline for response. Taxpayers should make every effort to meet such deadlines, but in some cases, the revenue agent may have requested a substantial amount of information that cannot be collected within the time frame specified. In those circumstances, a taxpayer should request additional time. A taxpayer is not required to create any new documents, such as a schedule of full-time employees, if one does not already exist. However, because it is important to maintain a positive relationship with the revenue agent, a taxpayer is sometimes well advised to create such document to assist the agent in his or her review of information. An IDR may also request an interview with key taxpayer personnel or third parties to better understand the facts underlying a specific return position.

The IRS can also use extraordinary methods to obtain information from the taxpayer. Under Sections 7603, 7605 and 7609 of the Code, the IRS can issue summonses to compel taxpayers and third parties to provide information relevant to their audit. Taxpayers frequently dispute whether the IRS has such authority, even to the point of seeking a judicial resolution of whether the IRS summons is valid, but the US Supreme Court has acknowledged the broad authority of the IRS under these statutes.[12] Typically, the IRS does not use a summons unless the taxpayer has declined to provide information the IRS believes it needs for the audit. Should a taxpayer continue to decline to provide the information sought by the summons, the IRS has the option to seek judicial relief through a summons enforcement action. The US Department of Justice Tax Division will file the action on behalf of the IRS in the federal district court where the taxpayer resides or has its principal place of business. The taxpayer must be prepared to answer in court to justify its decision not to provide the requested information.

12 See *United States v. Powell*, 379 US 48 (1964) (establishing requirements of a valid summons). Arguments against the validity of a summons based on irrelevancy are routinely rejected by courts. The most successful oppositions to IRS summons rest on the protections of attorney–client privilege or work product.

There are two special types of document requests that the IRS can use against the taxpayer:

a a designated summons, authorised by Section 6503(j) of the Code, the primary effect of which is to toll the statute of limitations while the IRS waits for the information requested in the summons; and

b a formal document request authorised by Section 982(c) of the Code. A formal document request enables the IRS to foreclose the taxpayer from using foreign-based documents in litigation that were subject to the request and not provided to the IRS during the audit.

Finally, the IRS can use its summons power against third-party record keepers, such as banks or other financial institutions, under Section 7609 of the Code. A third party may hold critical information and may not object to a summons simply because the audit does not pertain to its liability. However, unlike the taxpayer, a third party can make a reasonable objection based on economic burden to comply with the summons, and should consider raising any such concerns with the revenue agent. The IRS does not generally have the authority to enforce a summons outside the jurisdiction of the United States.[13]

Should the return selected for audit involve a 'listed transaction' (i.e., a transaction that the IRS considers to be potentially abusive tax avoidance), the audit will generally be much more aggressive and is likely to include third-party summonses, testimony under oath and attacks on privilege claims.

Responding to IRS requests in audits

As a general rule, it is preferable to provide the IRS with the information requested through IDRs rather than not providing any information and forcing the IRS to decide whether to use its summons power. The key to the successful conclusion of an audit is a good working relationship with the IRS audit team. With the exception of requests that seek protected or privileged information, or that would entail an unnecessary and excessive compliance burden, taxpayers should promptly and professionally reply to each IDR presented by the IRS.

It is therefore wise for taxpayers to review each request and clarify the meaning of any language and the scope of the request. For example, a request might be for all corporate minutes without any qualifications; in such circumstance, it is perfectly acceptable to ask the IRS for a date range and also for some specificity regarding what topics in the minutes are of interest. It is also important to review response materials for completeness and accuracy. Legitimate requests for relevant, unprotected information should generally be complied with through a written response.

13 As discussed below, parties to a tax treaty can assist one another in collecting information relevant to their respective jurisdictions, even to the point of issuing a summons on behalf of a treaty partner.

Protected information

Taxpayers (even experienced corporate tax departments) can be careless in including privileged or other protected information in files that may be produced to the IRS. In the United States there are several acknowledged protections that cannot be overcome by the IRS, despite its broad summons authority.

The first is attorney–client privilege, which prevents any communication between the client and its attorney in connection with legal advice from being discovered by the IRS.

A second kind of protection is the attorney work product doctrine. Documents created in anticipation of litigation or trial are generally protected by this doctrine. The Federal Rules of Civil Procedure and federal case law have expanded the doctrine to include non-attorney representatives of a party, such as accountants or consultants. Thus, if a taxpayer has engaged a tax accountant to assist it in evaluating the strengths of its tax return position with a view to future litigation with the IRS, the evaluation created by the tax accountant would be protected under this doctrine.

A third type of protection is a statutory privilege under Section 7525 of the Code. Section 7525, in effect, imports the common law protections of the attorney–client privilege into the tax adviser–client relationship, regardless of whether the adviser is an attorney. The adviser must be a federally authorised tax practitioner (including, e.g., certified public accountants). The Section 7525 privilege thus protects communications between tax advisers and taxpayers in connection with tax advice. There are certain important limitations to this statutory privilege. It does not protect communications made in connection with the promotion of a tax shelter. Nor does it apply in the context of criminal tax proceedings. Both the attorney–client and Section 7525 privileges can be waived, however, if the communication is disclosed to third parties.

Finally, the Fifth Amendment of the United States Constitution prevents the government from compelling a taxpayer to make statements that could be viewed as an admission of criminal guilt.

Corporate tax accrual workpapers

A significant current issue for corporate taxpayers involves whether their internal tax accrual workpapers can be protected from IRS scrutiny under the work product doctrine. Workpapers typically contain sensitive tax analysis regarding the strengths of a particular tax position that a company has adopted in its return. Thus, most corporate taxpayers are not enthusiastic about providing their workpapers to the IRS. Often the workpapers are provided to a company's external financial auditors, thereby waiving any attorney–client or Section 7525 privilege that might have protected them. Nonetheless, because such workpapers contain analysis regarding the litigation hazards of a particular tax return position, corporations have taken the position that they are work product (as this protection generally is not waived upon disclosure to outside financial auditors). As a general matter, the IRS does not ask for these documents. This is known as the 'policy of restraint'.[14] Nevertheless, the IRS maintains that it has the authority to request these documents, and has litigated the issue and prevailed in one federal circuit.[15]

Negotiating and closing an audit

As a general matter, revenue agents do not have authority to settle issues based on litigation risks. Nevertheless, there are opportunities during the audit to come to an agreement about what an adjustment should be. For example, where the proposed adjustment depends upon the valuation of certain minority interests in stock, it is possible to reach an agreement with the IRS audit team as to the proper discount value applied to determine the valuation of the stock and thereby agree on a valuation. Taxpayers should therefore apply creative thinking about how to come to a mutually acceptable resolution of an audit consistent with the general limitation on the audit team's settlement authority.

At the close of the audit there are several possible outcomes:

a if the IRS agrees with the taxpayer's return, it will issue a 'no change' letter, and the return is accepted as filed;

b if the IRS has proposed adjustments with which the taxpayer agrees, the audit will be closed as an 'agreed' case, and the tax liability is adjusted accordingly;

c a taxpayer may disagree with all of the proposed adjustments, in which case the audit is closed as 'unagreed', and the revenue agent will prepare a revenue agent's report (RAR), which is delivered to the taxpayer under cover of a transmittal letter allowing the taxpayer 30 days within which to file a protest letter with the IRS Office of Appeals; or

d a case might be partially agreed. In that event, the revenue agent will issue an RAR covering the unagreed issues.

It is important to bear in mind that if the RAR contains material errors, a taxpayer may find it fruitful to make another attempt at 'agreed' resolution of the issues affected by such errors. A taxpayer should consider preparing a written submission to the IRS audit team detailing the errors, and requesting either a retraction of the RAR or a modified RAR that reflects the correct factual or legal circumstances. Given that revenue agents are increasingly imposing penalties along with tax adjustments, the possibility that such penalties are based on flimsy or erroneous grounds similarly increases. Every effort should be made to persuade the revenue agent to reconsider penalties prior to proceeding to the IRS Office of Appeals.

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14 See IRS Announcement 2010-76 (24 September 2010).

15 *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009) (tax accrual workpapers were not protected by the work product doctrine because they were not 'prepared for use in possible litigation'). But see *United States v. Deloitte, LLP*, 610 F. 3d129 (D.C. CIR. 2010) and *Wells Fargo and Company v. United States*, 2013-1 USTC Para. 50368 (D. Minn. 2013) (both recognising limits on IRS summons authority).

Appeals

The IRS Office of Appeals is the official settlement arm of the IRS for disputes arising from audits.[16] It is staffed by appeals officers located in 11 appeals offices throughout the country. The Chief of Appeals, located in the IRS National Office in Washington, DC, is the top IRS appeals executive, and is assisted by the Deputy Chief of Appeals in his or her duties. The mission of the appeals office is '[T]o resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service'. An appeals officer is charged with making an objective evaluation of the taxpayer's case based on the hazards of litigation. Importantly, the appeals office is independent from the IRS audit team that has proposed the adjustments.[17]

The appeals office learns of the taxpayer's position regarding the proposed adjustments primarily through the taxpayer's protest letter. Although the IRS provides Form 12203 to prepare a protest to the appeals office, most practitioners opt to draft a letter that contains the necessary information and explains the taxpayer's position in a manner similar to that in which a legal brief sets out the facts and supporting legal analysis before a court. The protest letter is addressed to the IRS audit team supervisor. The IRS audit team then forwards the protest letter to the appropriate appeals office, along with the audit team's written rebuttal to the protest letter.[18] Thus, it is possible that the IRS audit team, upon review of the protest letter, may change its legal analysis to respond to the taxpayer's argument, or may in fact be persuaded to concede certain issues.

The appeals office review is an informal consideration of the contrasting positions. There is no testimony or formal hearing process. Instead, the appeals officer will convene a series of meetings to assist the officer in evaluating the litigation risks for both sides.[19] These meetings may be by telephone or in person. The first (pre-conference) meeting allows the IRS audit team to explain its position on the various adjustments that it proposes. IRS field counsel are likely to assist in that presentation. Because an appeals officer may not have *ex parte* communications with the audit team, a taxpayer must be allowed to attend this meeting. After the pre-conference, the IRS audit team plays no further role in the appeals office's consideration of the case. The second (conference) meeting is between the appeals officer, the taxpayer and his or her representatives. The

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16 For disputes with the IRS that have been filed in court, the appeals office has no official settlement role (apart from Tax Court cases that have not previously been before the appeals office, which are immediately referred to the appeals office after the petition is filed in the Tax Court).

17 As noted in the instructions to Form 12203, 'Request for Review' (which is a form version of the protest letter): 'The local Appeals Office is separate from and independent of the IRS office that proposed the adjustment'.

18 The taxpayer is entitled to request an appeals office review in a location that is convenient to the taxpayer. However, the appeals office may instead to decide to assign the case to an appeals officer with particular expertise regarding the issues raised by the RAR and the protest letter.

19 If the case involves particularly technical issues, such as transfer pricing or insurance tax issues, the appeals office may assign an appeals case team to review the case, and include appeals officers with expertise in those issues on such a team. The appeals case team is led by an appeals case team leader.

taxpayer always has the option to request that this be an in-person meeting. Depending upon the complexity of the case, the taxpayer may be invited to present its side of the case, reviewing the facts and the applicable law. Afterwards, the appeals officer will engage in a discussion of the case and the merits of both sides. It is at this juncture that settlement negotiations will occur in an effort to resolve the matter. This appeals procedure is highly successful; over 90 per cent of all cases before the appeals office are settled.

If, after settlement discussions, the taxpayer and the appeals officer agree on a resolution, the appeals office will prepare an internal memorandum to record the analysis of the case, and for approval by his or her supervisor. The appeals officer will then prepare a closing agreement for the taxpayer that contractually binds the taxpayer and the IRS to the terms of the settlement.[20] If no settlement is reached, the appeals officer will prepare either a statutory notice of deficiency, giving the taxpayer the opportunity to seek relief in the US Tax Court, or a Form 870, which obtains the taxpayer's consent to immediate assessment and collection of any tax due. Most taxpayers will elect to receive a statutory notice of deficiency. However, some may wish to pursue their case in court after payment of taxes and so will request a Form 870, pay the tax due and begin proceedings for filing a tax refund action.

III THE COURTS AND TRIBUNALS

If efforts to resolve an issue within the administrative apparatus of the IRS have failed, a taxpayer has the option to file suit in federal court. A taxpayer thus is able to have its 'day in court' on the tax issue that the IRS has raised. As a matter of jurisdiction, there are four potential judicial venues in which to raise a federal tax claim: the US Tax Court, the US Court of Federal Claims, a federal district court or a bankruptcy court. However, not all of these venues are available to adjudicate a tax issue (e.g., taxpayers that are not in a bankruptcy court would not be raising any tax claim in that court).

i Choice of forum

With the exception of the Tax Court, the above-mentioned courts hear tax cases just as they hear any other dispute that comes before them. They follow the Federal Rules of Civil Procedure (or similar versions of those rules) and apply the Federal Rules of Evidence at trial. They allow for a full range of discovery of the IRS, dispositive motions, oral arguments, motions *in limine* and trial, as well as all post-trial procedures, including appeal rights to a federal appellate court, and thereafter the ability to petition the court of last resort, the US Supreme Court.[21]

The Tax Court is a court of exclusive subject-matter jurisdiction (i.e., federal tax deficiency cases), and has some different rules of litigation; however, for the most part

20 Form 906, 'Closing Agreement on Final Determination Covering Specific Matters', will bind the IRS and the taxpayer except where there has been fraud, malfeasance or misrepresentation of material facts.

21 While there is a right to appeal to the federal appellate court, there is no right of appeal to the US Supreme Court for tax cases. The Supreme Court takes these cases in its sole discretion.

it operates just as the other courts with respect to discovery, motions and litigation. For some taxpayers, the US Tax Court is not available simply because they are not seeking to avoid payment of tax asserted to be due, but to force the IRS to repay tax they believe is overpaid. Thus, the only courts available to these taxpayers are the 'refund' courts (i.e., federal district courts or the US Court of Federal Claims). However, taxpayers who face proposed tax assessments after audit can choose between the US Tax Court and the refund courts. There are several points to consider when deciding which judicial venue is the best to hear a taxpayer's case:

a which forum has the most favourable precedent;
b what the comparative cost differences are, other than the fact that payment of taxes (and possibly interest and penalties) is required to obtain refund jurisdiction;
c which forum offers the best opportunity to settle early and favourably;
d where the taxpayer is most likely to prevail in trial; and
e where the taxpayer is most likely to prevail upon appeal, if necessary.

The specific circumstances of the case and issues involved will, of course, affect the answer to some of these questions. Thus, where the precedent gives a distinct advantage on the merits of the issues, this will improve the chances of settlement in that forum and the chances of prevailing in litigation. The US Tax Court may have more or less favourable case law than the refund courts. On the other hand, the US Court of Federal Claims, a tribunal separate from the federal district courts, may have the most beneficial case law. A taxpayer should retain counsel to carefully analyse the applicable precedent in each forum, as this is one of the most important factors to consider in choice of forum.

ii Comparison of costs

The largest cost factor in any litigation is legal fees. The largest cost factor within those fees for large tax cases is the discovery phase of litigation. In general, the Tax Court rules encourage less formal discovery, and encourage stipulation to the greatest extent possible. Refund courts allow for broad-ranging discovery, including liberal use of depositions, as a way for the parties to gauge the other's case and to discover additional facts. Thus, on this basis the Tax Court overall typically incurs fewer legal fees. However, where a case is particularly contentious or involves large amounts, this potential cost advantage of the Tax Court decreases because the parties will be less willing to resort to informal exchange of discovery and stipulation of facts.

Another cost factor relates to the procedural requirements leading up to the filing of suit, where the Tax Court is generally less costly. Tax Court jurisdiction depends upon receipt of the statutory notice of deficiency. This notice gives a taxpayer 90 days within which to file a petition in the Tax Court seeking redetermination of the proposed deficiency.[22] Refund court jurisdiction requires several steps. First, a taxpayer must pay the tax asserted to be due. (In jurisdictions other than the Federal Circuit, this will

22 Depending upon the complexity of the case, the appeals office may take several weeks to draft and issue the deficiency notice. Further delaying the issuance of a notice is the practice for review and concurrence by IRS counsel.

require payment of any assessed penalties and interest.) This amount is determined after audit and reflected on Form 870, which is signed by the taxpayer and which also waives a taxpayer's right to petition the Tax Court.[23] Form 870 records the taxpayer's consent to immediate assessment of the taxes. Second, the taxpayer must file a claim for refund within two years from the time of payment. Third, the IRS disallows the claim or fails to act on the claim within six months of the filing of the claim for refund. A taxpayer then has two years from the date of disallowance of the refund claim to file suit in a refund court such as the US Court of Federal Claims or a federal district court located in the appropriate venue.[24] Because the costs involved in preparing a Tax Court petition and a complaint in refund court are comparable, the more streamlined process for reaching Tax Court will incur fewer fees overall.

A further cost factor to consider is interest. Because the Tax Court does not require prepayment of the asserted taxes, interest continues to run on the deficient amount until resolution of the case. However, in refund court, because payment, including assessed interest, must be made prior to suit, interest does not run. Any repayment of taxes to the taxpayer as a result of the litigation will come with interest paid by the government. To some extent, the interest factor can be ameliorated through the expedient of a deposit. The IRS has established procedures by which a taxpayer can deposit (not pay) an amount with the IRS to cover a proposed tax deficiency should that tax deficiency be upheld by the appeals office.

Finally, if the taxpayer loses in Tax Court, taxes (and interest and penalties) must be paid to appeal the Tax Court decision or a bond must be posted. Since posting a bond is more expensive, it is rarely the option chosen.

iii Settlement opportunities

Settlement in the Tax Court and the refund courts is not uncommon. However, as a general matter, settlement discussions can take place at an earlier stage in the Tax Court than in the refund courts. In the refund courts, the Department of Justice Tax Division, not the IRS, controls the litigation. Litigators at the Justice Department typically seek substantial discovery, including depositions of key taxpayer witnesses, prior to entering

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23 Although the Federal Circuit does not require separate payment of assessed interest for jurisdictional purposes, the IRS is not prevented from pursuing collection of any assessed unpaid item, including interest. It is possible, but unlikely, that the IRS would agree to defer collection of assessed interest and instead instruct the Department of Justice Tax Division to counterclaim for that amount in court.

24 Arguably, if the IRS does not formally disallow the refund claim there is no limitations period within which to file suit. Although the IRS may argue that a more general six-year statute of limitations applies for claims against the United States. A taxpayer may request an immediate disallowance of a refund claim and thereby accelerate the beginning of this two-year period. If possible, taxpayers should time the filing of suit to coincide with the expiration of the statute of limitations for assessment to prevent the IRS from asserting any new tax issues (and assessments) in court.

into meaningful settlement discussions with a taxpayer. In the Tax Court, the IRS typically does not require significant discovery before consideration of settlement.

One factor that may weigh against selecting the Tax Court is the potential involvement of the IRS audit team. The extent to which IRS personnel who have been involved in a case while in audit will influence any resolution by settlement is probably greater in Tax Court than in a refund court. Typically, in a refund court the Department of Justice attorney will be the first-line person to evaluate the litigation hazards, and will operate independently of IRS personnel with regard to the conduct of the litigation.[25] However, in a Tax Court proceeding, IRS personnel who were involved during the audit phase may in fact be assigned to the case in Tax Court, or act in some consultative capacity to the IRS trial team. If the IRS audit team was generally hostile, it would be reasonable to presume that this attitude might carry over into the IRS trial attorney's consideration, and thereby decrease the chances of a reasonable settlement discussion.

IV PENALTIES AND REMEDIES

The Code imposes both civil and criminal penalties. Civil penalties are located in Chapter 68, Sections 6651–6751. Criminal penalties are set forth in Chapter 75, Sections 7201–7217. Civil penalties generally are designed to encourage compliance with filing and payment deadlines, and to encourage accurate reporting of taxes and information. Criminal penalties also encourage proper reporting, but go further by punishing through fines and incarceration. As with the charge of any crime in the United States, the element of *mens rea* (i.e., intent) must be established by the government beyond a reasonable doubt to impose a criminal tax penalty.

i Civil penalties

Civil tax penalties are numerous. They include:

a an estimated tax penalty (Sections 6654, 6655) for failure to properly estimate and pay tax due throughout the taxable year;

b delinquency penalties (Section 6651) for failure to file timely returns and pay tax due;

c accuracy-related penalties (Sections 6662, 6662A) for failure to accurately report items on a return;

d penalties relating to fraud (Section 6663);

e a variety of information return penalties (Section 6652, 6721-6725) for failures to accurately or promptly report required information; and

f abusive tax shelter penalties (Sections 6662A, 6700–6703, 6707–6708).

Certain penalties, such as the estimated tax and delinquency penalties, are often imposed by the IRS service centre. As a general matter, accuracy-related penalties are imposed after IRS examination. Taxpayers are always afforded the opportunity to rebut the

25 As the client agency, the IRS routinely indicates whether the Department of Justice must consult with it prior to settling any case.

imposition of penalties either at the examination (or service centre) or appeals level. Unresolved disputes concerning penalties, such as disputes about taxes, can be litigated in the various judicial fora.

Taxpayers can avoid the imposition of most civil penalties through a showing of reasonable cause. If a taxpayer can show that he or she acted with ordinary business care and prudence in the filing and preparation of his or her return, he or she will generally be able to show reasonable cause.[26] Reliance upon a tax adviser can constitute reasonable cause where the IRS disagrees with a return position. In that case, the IRS will review a number of factors, including whether the taxpayer acted in good faith by providing his or her adviser with all necessary information and whether the proposed return position was 'too good to be true'.[27] One notable exception is the relatively new accuracy-related penalty in Section 6662(b)(6) for underpayments of tax due to a failure to meet the economic substance requirements set forth in Section 7701(o). There is no reasonable cause defence for this penalty.

ii Criminal penalties

Most tax criminals are guilty of tax evasion under Section 7201.[28]

The basic elements of tax evasion are the existence of a tax deficiency, an affirmative act constituting an evasion or an attempted evasion of the tax, and wilfulness. Evading payment of an income tax can be accomplished even when a taxpayer reports all taxable income on his or her return. A good faith misunderstanding of the law is a defence to a tax crime.

Good faith reliance on the advice of counsel or an expert tax preparer, after complete disclosure of all relevant facts to the tax adviser, is also a defence to the crime.

Other tax crimes are:

a regarding collection or payment of tax (Section 7202);

b regarding filing, payment or supplying information (Section 7203);

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26 For example, Treasury Regulation Section 301.6651-1(c), which sets forth this standard for delinquency penalties, provides: 'If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.' It is important to note, however, that for filing deadlines, a taxpayer cannot delegate his or her duty to file on time to a tax return preparer. See *United States v. Boyle*, 69 U.S. 241 (1985) (finding a penalty applied where the estate executor simply relied on the return preparer to file on time). For accuracy-related penalties, Section 6664(c) similarly provides that no penalty shall be imposed if it is shown that there was a reasonable cause for the inaccurate portion of the return and that the taxpayer acted in good faith with respect to that portion.

27 Treasury Regulation Section 1.6664-4(c).

28 Section 7201 states: 'Any person who wilfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.'

c regarding making of fraudulent and false statements (Section 7206);
d regarding delivery or disclosure of fraudulent or false return, statements or other documents (Section 7207); and
e interference with revenue laws (Section 7212).

V TAX CLAIMS

i Recovering overpaid tax

A claim for refund of income taxes is essentially an amended tax return. In the same manner as an original tax return, a claim for refund can be subject to an examination by the IRS. Should the IRS disagree with the claim, and the taxpayer is unable to resolve the claim administratively, the taxpayer has the option to file an action for tax refund in a federal district court or the US Court of Federal Claims. These are collectively known as 'refund courts'.

Taxpayers seeking a refund from the IRS must ensure that they abide by the statute of limitations for making a refund claim. Section 6511 of the Code provides generally that a refund claim must be made within three years from the time the return is filed or two years from the time that the tax sought to be recovered is paid. Failure to meet this time frame means an otherwise valid refund claim is forever barred, unless very specific mitigation criteria are met.

There are two more critical timing considerations, even if a refund claim is filed on time. Once the refund claim is filed, the taxpayer must wait six months before filing suit in a refund court. Attempts to file suit before this period has run will result in a dismissal of the lawsuit for lack of jurisdiction. Further, once the IRS formally disallows the refund claim under Section 6532(a), the taxpayer has two years within which to file suit. While the IRS and the taxpayer can agree to extend this period, once that period expires, no court has jurisdiction to hear the taxpayer's refund claim.

ii Challenging administrative decisions

Taxpayers are always able to challenge IRS administrative decisions based on substantive and procedural grounds.

To the extent that a decision of the IRS is based on a statute and that decision is contrary to the intent or policy of the statute, then a taxpayer can make an effective argument to invalidate the decision. The IRS's formal decisions, as embodied in Treasury Regulations, are accorded a high degree of deference by the courts, and taxpayers typically are hard-pressed to persuade a court to invalidate a Treasury Regulation unless there is a clear case that the regulation contravenes the statute's language or purpose. Other, less formal decisions, however, are not accorded such deference, and the taxpayer can argue with relatively increased success that these decisions should be disregarded because they are inconsistent with the relevant statutory framework. Mere arguments as to what is better tax policy will never be particularly effective, because the revenue agency is presumptively the best determiner of tax policy. Nonetheless, some courts have rejected proposed IRS action based on the theory that the agency should be treating similarly situated taxpayers in a similar manner. Thus, where there is disparate treatment among similarly situated taxpayers, courts have held that the IRS action against the complaining taxpayer is invalid.[29]

Furthermore, all federal agency action is subject to federal statutory administrative law provisions. Pursuant to those provisions, courts are empowered to reject certain types of agency action where the agency acts in a way that is 'arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law'.[30] Courts sometimes disregard the IRS's exercise of its discretion based on this standard, such as in the transfer pricing context. However, whether all IRS action is subject to this standard is somewhat unclear.

With regard to constitutional challenges, in the context of state tax rules and actions taxpayers are sometimes successful. Taxpayers have successfully argued, for example, that a particular state taxation regime violates what is known as the doctrine of the 'dormant' Commerce Clause of the Constitution. This doctrine prevents state and local tax authorities from unfairly discriminating against other states' commerce. However, constitutional arguments against the imposition and collection of federal tax have been repeatedly rejected by the Supreme Court.

With respect to disputes before the IRS Appeals Office, the IRS takes the position that it has no authority to settle cases where the taxpayer has refused to comply with the tax law because of moral, religious, political, conscientious or constitutional grounds.[31]

iii Claimants

As noted, a taxpayer must file a claim for refund of income taxes with the IRS to pursue a tax claim. Assignment of refund claims to a third party, for example, in the context of a sale of the taxpayer's business, does not give standing to the third party. In informal guidance from the Chief Counsel, a taxpayer's attempt to direct refund cheques to its purchaser failed. The IRS issues a refund only to the person who overpaid and filed the refund claim. Citing the Anti-Assignment Act, Chief Counsel stated that a claim against the government can be assigned only after the claim is allowed, the amount is decided and a warrant for payment is issued, none of which occurred before the taxpayer sold its refund claims to the buyer.[32]

With respect to excise taxes, there are specific statutory rules governing who has standing to file a claim for a refund. Depending upon the particular excise tax, standing may be limited to the person responsible for the payment of the taxes or may include third parties, such as those who bore the economic incidence of the tax, upon their satisfaction of certain procedural requirements.

29 See *IBM Corp v. United States*, 343 F2d 914 (Ct. Cl. 1965), cert. denied, 382 US 1028 (1966).

30 Final agency action is generally subject to review under this standard pursuant to the Administrative Procedure Act of 1946, Pub.L. 79–404, 60 Stat. 237.

31 Treasury Regulation Section 601.106(b).

32 Chief Counsel Advice 201111005.

VI COSTS

i Recovery of administrative and litigation costs

A taxpayer's ability to recover costs incurred in the administrative or litigation phase of a federal tax dispute is circumscribed by Section 7430 of the Code, which provides that a taxpayer who is the prevailing party in any administrative or court proceeding may be awarded a judgment for 'reasonable administrative costs incurred in connection with administrative proceedings within the Internal Revenue Service, and reasonable litigation costs incurred in connection with court proceedings'.

The statute defines 'prevailing party' as a taxpayer who substantially prevails as to the amount in controversy or with respect to the most significant issue or set of issues.[33] However, if the government can establish substantial justification for its position, then no costs can be awarded. The government has substantial justification for its position if it has a reasonable basis in both law and fact. A further test to show substantial justification is whether the government's basis could satisfy a reasonable person. A taxpayer cannot be a prevailing party if it does not meet the net worth requirements of 28 USC, Section 2412(d)(1)(B).

The position of the government in the litigation context is what is set forth in the answer to the complaint (refund court) or the petition (Tax Court). The position of the government in the administrative context is the position of the government as of the earlier of the date of the statutory notice of deficiency, or the receipt by the taxpayer of notice of the decision of the appeals office.

Both the Code and the Federal Rules of Civil Procedure allow for sanctions against taxpayers and awards of costs in favour of the IRS.

Section 6673 authorises a court to award sanctions and costs against taxpayers in favour of the IRS. There are three types of actions that can be taken pursuant to this Section 6673. First, the Tax Court can penalise a taxpayer up to US$25,000 for instituting Tax Court proceedings primarily for delay or to advance a frivolous position, or without utilising administrative remedies. Secondly, the Tax Court can impose sanctions directly against an attorney for action that 'multiplied the proceedings […] unreasonably and vexatiously'. Thirdly, any other federal court can impose a penalty of up to US$10,000 against a taxpayer pursuing a 'frivolous or groundless' proceeding under Section 7433, which authorises civil damage actions against the United States with respect to illegal collection actions of the IRS.[34]

33 See Section 7430(c)(4)(A)(i); Treasury Regulation Section 301.7430–5(a)(2).

34 In addition, Section 7482(c)(4) allows a federal court of appeals or the US Supreme Court to impose a penalty on the taxpayer where the appeal was taken primarily for delay, or where the taxpayer's position on appeal is frivolous or groundless.

Rule 11 of the Federal Rules of Civil Procedure authorise federal district courts to impose sanctions on parties and attorneys where they have signed pleadings that are not 'well grounded in fact' or not 'warranted by existing law or a good faith argument for the extension, modification or reversal of existing law'.' Rule 11 can support an award against the taxpayer for costs and other sanctions.[35]

VII ALTERNATIVE DISPUTE RESOLUTION

i ADR within the IRS

In addition to the ordinary audit and appeals process discussed in Section II, *supra*, the IRS has instituted several ADR methods. All methods require the consent of both the taxpayer and the IRS.

The more widely used methods are fast track settlement and post-appeals mediation. Fast track settlement involves an appeals officer mediating a dispute between the taxpayer and the revenue agent. Post-appeals mediation involves the use of co-mediators to help the taxpayer and the appeals officer to reach agreement. Both methods can be effective, and should be considered by taxpayers in the appropriate circumstances.

ii ADR in the courts

ADR is also available in all the courts where a civil tax case might be heard. The ADR methods are fairly similar from court to court. As is the case with the rise of ADR generally in the United States, the advent of ADR in tax cases is explained by increasing litigation costs. Taxpayers should always consider using ADR, preferably even before the case is filed. While the refund courts have had some form of ADR for a period of time, the Tax Court only recently formalised ADR in its procedural rules.

Tax Court ADR

As already noted, where a case has not already been reviewed by the appeals office, it will be automatically referred by the Tax Court for settlement.[36]

Tax Court Rule 124, Alternative Dispute Resolution, became effective in May 2011. The goal of ADR in the Tax Court is to resolve any factual issue in controversy and takes several forms: voluntary binding arbitration (Rule 124(a)), voluntary non-binding mediation (Rule 124(b)) and a more general category of 'other methods' (Rule 124(c)).

ADR in the US Court of Federal Claims

The Court of Federal Claims hears several kinds of cases against the US government, including constitutional takings, government contract disputes, military pay disputes and tax refund actions. Through its General Order No. 44, it has established and encouraged the use of ADR for any of these cases by automatically referring certain cases assigned to a roster of the judges to a settlement judge, where ADR and settlement proceedings

35 The US Court of Federal Claims and the Tax Court have similar rules. Under Rule 33(b), the Tax Court has awarded reasonable attorneys' fees. See *Versteeg v. Commissioner*, 91 T.C. 339 (1988).

36 Treasury Regulation Section 601.106(a)(1)-(2).

are held in parallel with normal litigation proceedings of the case. Under Appendix H of the Rules of the Court, there are several types of ADR methods: mediation, mini-trials, early neutral evaluation and non-binding arbitration. The settlement judge can act as a mediator or third-party neutral, or even conduct a mini-trial whereby the parties can obtain insight into how a fully litigated case might be resolved. In no case are parties compelled to pursue ADR, and any case, whether automatically referred to a settlement judge or not, can take advantage of ADR. While it is available and encouraged, ADR is not widely used in tax refund actions.

ADR in the federal district courts

The Federal Rules of Civil Procedure govern all federal district courts. Rule 26(f)(2) imposes a 'meet and confer' requirement on all parties to civil actions. The purpose of this rule is to facilitate settlement discussions between the parties at an early stage. Based on this rule, the district courts construed authority to establish and encourage the use of ADR methods.

Because each district can decide to what extent it wishes to employ ADR methods, ADR in the district courts is not uniform. For example, in the Southern and Eastern Districts of New York, mediation is the only ADR method. In the Western District of Pennsylvania, Local Rule 16.2 sets out rules for mediation, early neutral evaluation and arbitration. In the Eastern District of Tennessee, in addition to these methods, the court requires mandatory mediation under Local Rule 16.4. The Eastern District of California is perhaps the most expansive of all district courts; under its Local Rule 16-271, all ADR methods are allowed.

VIII ANTI-AVOIDANCE

Generally applicable rules of anti-avoidance in the United States are judicial or 'common law' in origin. The doctrines of economic substance (also called the sham transaction doctrine) and step-transaction are applied in tax cases throughout the nation's federal courts. During examination, the IRS will also consider the application of these rules in the appropriate circumstances. In 2010, Congress passed legislation that codified the economic substance doctrine.

The economic substance doctrine states that every transaction that reaps tax benefits must be scrutinised to evaluate whether sufficient non-tax purpose attends the transaction. If a taxpayer engages in a transaction that has no non-tax purpose and solely to obtain tax benefits, a court can reject the desired tax benefits. Such a transaction might be termed an economic 'sham'. The courts have not been uniform in whether a taxpayer's subjective intent regarding its business purpose is enough to defeat the application of the doctrine. Nevertheless, the absence or presence of a pre-tax profit is one factor courts almost uniformly consider in evaluating the economic substance of a transaction that purports to be a profit-making endeavour. There are certain fundamental exceptions to the broad application of this doctrine. For example, a taxpayer whose sole purpose in selling stockholdings is to realise tax losses to offset gains in the taxable year cannot be attacked on the basis of the economic substance doctrine. Another example is where Congress has explicitly conferred tax benefits on a particular transaction to encourage certain activity or investment. In these situations, a taxpayer should not be treated as illegally avoiding taxes where the legislature has specifically allowed for such activity.[37] Furthermore, in the context of corporate acquisitions or reorganisations, it is common to structure a transaction in a certain way so as to minimise the tax liability.

With the codification of the economic substance doctrine in 2010, transactions must now pass both an objective and subjective test. Section 1409 of the Health Care and Education Reconciliation Act of 2010[38] added Section 7701(o), which codified the doctrine and incorporated new penalty provisions (discussed above). Under Section 7701(o), a taxpayer must ensure that a transaction produces economically meaningful changes (apart from federal income tax effects) and is infused with substantial non-tax purpose (apart from federal income tax effects). The statute provides special rules where pre-tax potential is a factor in the transaction.[39]

The step-transaction doctrine states that the tax benefits of a transaction can be limited to the substance of the transaction versus its form. Thus, if a taxpayer, in structuring an otherwise *bona fide* business transaction, includes a step that is not necessary to effect the transaction for the purpose of gaining a tax benefit, that step can be ignored by the courts. Another way of looking at the application of the doctrine is that it allows for the 'stepping together' of all of the parts of a transaction to ascertain its true nature.[40] For example, where a parent corporation sold the built-in loss assets of its subsidiary, thereby generating a tax loss, and then shortly thereafter repurchased most of those assets, the transaction is recast as a non-taxable liquidation, and the claimed tax loss is denied consistent with that recharacterisation.[41]

Borrowing from these common law general anti-avoidance rules, the IRS and Treasury have developed anti-abuse rules specific to partnerships. These rules, set forth in Treasury Regulation Section 1.701-2, focus on two general types of abuse: abuse of the intent of the Code, particularly Subchapter K, which governs partnerships; and abuse of the benefits of the partnership form ('abuse of entity'). With regard to the rules against abuse of the Code and a partnership transaction, the following will be considered:

a whether the partnership is *bona fide* and the transaction at issue has a substantial business purpose;

b whether the transaction's substance matches its form; and

c whether the tax consequences of the transaction properly reflect income (aside from allowed deviations).

37 See *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) (investment in solar energy panels).

38 Pub. L. No. 111-152.

39 Due to its relative newness, this statutory economic substance rule has not yet been applied in any reported decisions.

40 *Commissioner v. Clark*, 489 U.S. 726, 738 (1989) (doctrine requires 'linking together all interdependent steps with legal or business significance').

41 *Associated Wholesale Grocers, Inc v. Commissioner*, 927 F.2d 1517 (10th Cir. 1991).

If the IRS determines that a transaction is abusive, it has authority to recast the transaction to be taxable.[42] The entity abuse rules generally empower the IRS to treat a partnership as an aggregate of its partners as appropriate to carry out the purposes of the Code and regulations.

IX DOUBLE TAXATION TREATIES

The United States has entered into numerous tax treaties with other countries.[43] These treaties generally provide for relief from double taxation in both jurisdictions. They also routinely provide for exchange of information between the jurisdictions' respective tax authorities to, among other things, facilitate tax enforcement efforts. Without such agreements, the IRS would be prohibited by the Code from sharing taxpayer return information with other countries. Agreements to share tax information about taxpayers may cover income, estate, gift and other taxes.[44]

The general rule of treaty interpretation is to construe the treaty language consistently with the expectations of the signatories. The specific rules for treaty interpretation vary depending upon whether the issue is the imposition of US tax on foreign taxpayers or the imposition of foreign tax on a US taxpayer. Interpretation for purposes of US taxation of foreign taxpayers is based on the treaty itself, any related protocols and agreements, Treasury regulations, rulings and case law. Furthermore, specific terms may vary in meaning from treaty to treaty.[45] For example, in *Harrison v. Commissioner*,[46] a German citizen and US resident employed by the German Defence Administration was not eligible for an exemption under the NATO Status of Forces Agreement because she did not qualify as a civilian of the German military under the specific definitions of that agreement. However, an established interpretation under one treaty may provide guidance as to the meaning of that term in another treaty.[47]

Recent cases requiring the application of these treaties involve both procedural and substantive issues. For example, in *Net Promotion, Inc v. United States*,[48] the French Tax Authority (FTA) began investigating the tax liability of a company with mailing addresses in France and Washington State. Pursuant to the US–France tax treaty, the FTA

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42 *Nevada Partners Fund LLC v. United States*, 714 F.Supp.2d 598 (D. Miss. 2010) (multistep strategy using tiered partnerships involved transactions lacking economic substance, and IRS's recharacterisation as taxable under Section 1.701-2 valid).

43 Currently there are 68 tax treaties in force. See www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z.

44 The US may also enter into a separate agreement called a tax information exchange agreement to further facilitate information exchange with a country.

45 IRS Publication 901 contains short descriptions of each of the various treaties in force, and helpful schedules to compare and contrast these treaties.

46 138 T.C. 17 (2012).

47 See Rev. Rul. 90-80, 1990-2 C.B. 170 (establishing the meaning of 'permanent establishment' in the US–Canada treaty in the context of other treaties).

48 110 AFTR 2d 2012-6949 (D. Minn. 2012).

wrote to the IRS requesting certain financial information, including bank statements regarding an account at US Bank National Association owned by the taxpayer or its representative. Pursuant to IRS protocols, the request was reviewed and approved by the competent US authority. The touchstone for this approval was parity. In other words, the competent US authority found that the same type of information sought by the FTA would be available to the United States upon request to France. Secondly, the competent authority judged that the FTA's request met a 'relevancy' threshold (i.e., that the requested information might produce information relevant to the taxpayer's French tax liabilities). The IRS issued a summons to the Bank that the taxpayer thereafter moved to quash in the district court. The district court evaluated the summons under the normal rules applicable to summons and found that the IRS, with the supporting affidavit of the competent authority, had made the required showing. The taxpayer argued that it had no nexus with France and therefore that the IRS improperly issued the summons. The court rejected this argument, noting that questions of whether in fact the taxpayer had French tax liabilities was not relevant to the question of the propriety of the summons. What is important to note about this case is that, as long as the IRS satisfies the procedural requirements (including requirements for summons issued through a treaty provision), a summons issued pursuant to a treaty request will be honoured. It is up to the taxpayer to dispute with the foreign authority whether in fact it has any tax liability. A court will not second-guess the determination made by the competent authority that appropriate procedures were followed, including the determination that the information sought by the foreign tax authority is relevant to its investigation.[49]

Many recent cases involve the application of treaty provisions with respect to non-US nationals. One recent case is *Retief Goosen v. Commissioner*.[50] In this case, a professional golfer disputed the imposition of tax on certain endorsement income he earned worldwide. The taxpayer, a non-resident alien, argued on various grounds, including that the US–UK tax treaty prohibited the imposition of the tax at dispute. Under the treaty, the United Kingdom taxes a UK resident, non-domiciliary on non-UK sourced income only to the extent the income is remitted to or received in the United Kingdom. The US is prohibited from taxing the UK resident on specified kinds of income to avoid double taxation. The court then focused on the taxpayer's evidence that income he had earned had in fact been remitted to or received by the UK, and concluded that the taxpayer had not carried his burden of proof regarding the actual mechanics of the remittance in question. Where treaty benefits hinge on specific facts, taxpayers should be well aware of those facts and plan ahead to ensure that they will be able to defend their claim of treaty benefits upon later IRS audit. Retief Goosen is a particularly well-known individual, and therefore someone that the IRS is more likely to audit than others, and who may, rightly or wrongly, be perceived as tending to take additional risks on his returns.

49 See also *Villareal v. United States*, 524 Fed. Appx. 423 (10th Cir. 2013) (Similarly enforcing Mexican Tax Authority request for information pursuant to US–Mexico treaty).

50 136 T.C. 547 (2011).

X AREAS OF FOCUS

Unquestionably, the IRS is devoting significant resources to enforcement in cross-border circumstances. Given today's increasing globalisation and the unprecedented mobility of taxpayers and capital, the IRS views this as a particularly fruitful area in which to crack down on abuses such as tax evasion, technical tax shelters and aggressive transfer pricing practices. As part of this focus, the IRS is working closely with certain major treaty partners to combat tax avoidance in their respective jurisdictions. The Joint International Tax Shelter Information Centre (JITSIC) provides coordination among these nations to identify and stop abusive cross-border practices. Such coordination will only increase in the future.

Recent revelations involving US taxpayers' use of Swiss banks to avoid taxation have shone a harsh spotlight on potential offshore tax abuses. The IRS's response has been equally harsh, through prosecution of US taxpayers and accomplices, and in absentia, indictments of foreign persons considered by the government to be complicit in offshore tax evasion. Switzerland's oldest private bank, Wegelin & Co, announced it would be ceasing operations after pleading guilty to facilitating tax evasion. To further combat perceived offshore abuses, the IRS has instituted an offshore voluntary disclosure programme that allows taxpayers to come forward and declare previously unreported foreign-sourced income and assets.[51] While taxpayers who do take advantage of this programme escape criminal penalties, they pay a heavy civil penalty based primarily on the highest foreign asset value during an eight-year review period.

In August 2013, the United States Department of Justice and the Swiss Government announced a disclosure programme that enables Swiss banks not currently under investigation to voluntarily disclose US account holders who are not in compliance with their US reporting obligations. Participating banks will pay substantial penalties and in return be eligible for non-prosecution agreements with the US government.

In addition to targeting offshore evasion, the IRS is devoting substantial resources to auditing taxpayers' transfer pricing reporting and methods. The IRS Chief Counsel emphasised the enforcement efforts the IRS is undertaking in this area in remarks he made to the US Congress last year:

> *The IRS has continued to marshal, coordinate and augment its resources dedicated to transfer pricing enforcement. In 2011, a new executive position was created to oversee all transfer pricing functions, to set overall strategy in the area and to coordinate work on our most important cases. In building a new function devoted exclusively to tackling our transfer pricing challenges, within the past year we have been able to recruit dozens of transfer pricing experts and economists with substantial private sector experience who are now working hard to help us stay on the cutting edge of enforcement and issue resolution. This new transfer pricing operation will operate as a single, integrated team with a global focus, a unified strategy and a robust knowledge base.*

A recent survey of transfer pricing cases filed by public companies shows that the IRS is effectively carrying out its plans. Several major companies are disputing proposed IRS

51 See www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program.

adjustments, including Accenture plc, Agilent Technologies, Inc; Amazon.com, Inc; Brocade Communications Systems; Inc; Dell Inc; Microsoft Corp and QVC Inc. Amazon filed a petition in the US Tax Court in late 2012 disputing US$1.5 billion taxes due to proposed transfer pricing adjustments.[52]

Amazon's dispute is indicative of current IRS enforcement practices in the transfer pricing area. Like many multinational companies, Amazon entered into cost-sharing arrangements with its foreign subsidiaries. Pursuant to applicable Treasury regulations, those subsidiaries were required to make 'buy-in' payments to reflect the value of pre-existing intangibles provided by Amazon for the development of the operations of its foreign subsidiaries. Among other issues, the IRS on audit focused on the value of the buy-in payment. To that end, the IRS audit team engaged outside economists to analyse and opine on the value of the pre-existing intangibles. The economists issued a report that concluded that the value of the intangibles was more than 10 times higher than the value used to determine the buy-in payment. The economists used a specific valuation method, the discounted cash flow method, and collected three sets of data (future cash flow estimates, cash flow timing and a discount rate) in the application of that method. In its petition to the Tax Court, Amazon attacked the discounted cash flow method and compared it to the method used by the IRS in the *Veritas Software* case, in which the Tax Court found that the IRS's determination was arbitrary, capricious and unreasonable.[53]

Whatever the merits of the case, it shows that the IRS is taking aggressive positions regarding buy-in payment valuation and is willing to incur the expense at the audit stage of hiring outside economists to support those positions.

The IRS is also attuned to cross-border structures, which it considers are potentially abusive and subject to economic sham analysis. For example, the IRS is currently targeting two structures: foreign tax credit generators and securities lending transactions. Foreign tax credit generators initially came to the attention of the IRS by way of information shared through JITSIC. According to the IRS, there are two kinds of abusive form of this transaction: one that is designed to recover the foreign tax claimed as a credit on the US income tax return, and one that is designed to eliminate the income that gives rise to the credit. Typically, some form of fee is paid to share the benefits of the foreign tax credit claimed by the US party to the transaction. The IRS has been battling with taxpayers over these transactions in audit and in the courts, with some success.[54]

According to the IRS, abusive securities lending transactions are designed to avoid the mandatory 30 per cent withholding on US-sourced income payments to foreign persons. The IRS has described these transactions in the following manner: typically they involve the transfer of US corporation stock held by a foreign person to a foreign affiliate

52 US Tax Court, Docket No. 31197-12.

53 *Veritas Software Corp v. Commissioner*, 133 T.C. 297 (2009).

54 See *Pritired 1, LLC v. United States*, 108 AFTR 2d 2011-6605 (S.D. Iowa 2011) and *Bank of New York Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013). But see *Santander Holdings USA v. United States*, 112 AFTR 2d 2013 – 6530 (D. Mass 2013) (IRS loss). Because of the variety of structures, the IRS has recently stated that it does not view all generator transactions as equally abusive.

of a US financial institution in a securities lending transaction. The affiliate is typically in a low-tax jurisdiction and is designated as the securities borrower. Pursuant to the transaction, the foreign affiliate will pay substitute dividends to the foreign customer in an amount equal to 70 per cent of any dividend paid on the underlying loaned shares. By relying on prior (and now modified) IRS guidance, specifically IRS Notice 97-66, the foreign affiliate argues that because both the foreign affiliate and the foreign customer were subject to the same 30 per cent US withholding tax rate, it can pay the substitute dividend to the foreign customer without withholding and paying any US tax. The transactions typically include an 'enhancement fee' valued at about 66 per cent of the lost dividend amount. According to the IRS, such enhancement fees vary depending upon the transaction. They could be direct fees paid to the foreign stockholder or increased interest income through over-collateralisation of the stock loans.

XI OUTLOOK AND CONCLUSIONS

Recent trends in IRS enforcement policy show an increasingly aggressive tax agency. These trends can be explained in large part by two factors: the desire to increase revenue in a deficit-ridden economy, and the related need to use limited resources as efficiently as possible. The IRS routinely receives fewer budgetary dollars than it requests (although recently Congress has not passed any budget), but it must nevertheless meet the demands of its master, the federal government, for revenues. Its two-pronged solution, while understandable, is not always welcome. First, it has begun to place increasing disclosure obligations on taxpayers, including disclosure of uncertain tax positions and of foreign assets. Through these disclosures, the IRS reasons, less of its audit resources have to be spent on finding potential underpayments. Second, it has pursued, both in legislation and enforcement, enhanced penalty imposition, thereby creating a more inhospitable environment for taxpayers who might take overly aggressive return positions or fail to disclose information.

i Increased taxpayer disclosure

To the consternation of many in the Tax Bar, in 2009, the IRS proposed requiring companies to attach a schedule to their income tax returns that would disclose all uncertain tax positions that were reflected on their financial statements. Many were concerned that providing such a schedule would provide a road map to the IRS of all the arguable positions in the return, and that the IRS would simply propose audit adjustments for those positions. One of the most controversial aspects of the proposal was a requirement that taxpayers describe the reason why the position was uncertain. In other words, a taxpayer would, in effect, have to tell the IRS what arguments could be made against the position it took in its return. After much discussion, the IRS proceeded with a somewhat more relaxed requirement in Form 'Schedule UTP', which was released in September 2010.[55] The IRS dropped the requirement to describe the reason for the

55 For a more complete discussion, please see www.mofo.com//files//Uploads/Images/101006-Schedule-UTP.pdf.

uncertainty of the position, and also stated that it did not want the taxpayer to reveal information that was protected by work product. Form 1120, 1120L, 1120PC and 1120F filers that issue or are included in audited financial statements, and that have total assets equal to or exceeding US$50 million, must attach the schedule to their 2012 return (US$10 million for the 2014 filing year).

As a result of legislative changes in 2010, the IRS now requires individual taxpayers to identify specified foreign financial assets with their income tax returns.[56] The IRS issued Form 8938, 'Statement of Foreign Financial Assets', on which the information must be reported. As stated in the instructions for this form, the IRS will issue regulations requiring domestic entities to file Form 8938 if the entity is formed or availed of to hold specified foreign financial assets that exceed a certain reporting threshold.

ii Increase in penalties

As already noted, the IRS is increasingly imposing accuracy-related penalties in audit situations. Moreover, its authority to impose penalties has been broadened by recent legislation. The 2010 Health Care Act, as amended by the 2010 Health Care Reconciliation Act, created a new accuracy-related penalty under Section 6662 for disallowances relating to claimed benefits from transactions without economic substance, and a new accuracy-related penalty for underpayments relating to undisclosed foreign financial understatements.

56 Taxpayers already have a requirement to file a separate 'Report of Foreign Financial Accounts', or 'FBAR', to notify the Treasury Department of foreign accounts held directly or indirectly.

Appendix 1

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Edward L Froelich is of counsel and leader of the federal tax controversy practice group at Morrison & Foerster LLP.

Mr Froelich represents clients in audit and litigation on all federal tax issues. Mr Froelich has litigated a number of tax cases and represented clients in numerous IRS audits and appeals proceedings. He is a former trial attorney of the Department of Justice Tax Division, where he litigated numerous cases, including complex corporate cases, in the US Court of Federal Claims. In private practice, he continues to litigate cases and represents clients in administrative controversies at both the audit and appeals level before the IRS. His government experience informs his approach to administrative controversies. His litigation experience has been crucial to securing the favourable resolution of matters with the IRS Appeals Office. His representation is varied and includes large public companies, privately held companies, partnerships, trusts and individuals. Many of his clients are in the finance, technology and real estate industries. He has successfully dealt with a variety of issues, including international tax issues, income tax accounting issues, research credit issues, listed transaction issues, accuracy-related penalties, privilege and work product questions.

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