

LMSB's Industry Issue Focus Approach: Applying Lessons Learned from Battling Tax Shelters to Mainstream Tax Issues

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Introduction

The IRS's Large and Mid-Size Business Division has announced a new Industry Issue Focus (IIF) program, which promises to be a significant development in the evolution of IRS's tactics for issue identification, development, and litigation. Under the new program, LMSB management designates selected substantive issues for mandatory audit, and field examiners are required to coordinate the development of these issues with an issue management team (IMT) that is responsible for the issue. In addition, the leaders of the IMTs, or Issue Owner Executives, must approve the field examiners' proposed resolution of these issues. Where a taxpayer has an IIF issue, therefore, the field examiners will have far less discretion over the conduct of the audit and the ultimate disposition of the issue.

LMSB has published a list of IIF issues, which are organized into "tiers." The list is striking in its diversity. Some of the issues have a long history with well-developed positions by both the IRS and taxpayers; other issues involve the application of new legislation where there has been little audit activity, identification of contested issues, or legal development. Indeed, the common characteristic of these issues is seemingly the large potential tax dollars at stake. In addition, certain IIF issues purport to cover broad areas where material facts will vary from taxpayer to taxpayer. One would expect the courts to pay particular attention to the underlying facts, rather than accepting a one-size-fits-all position. This raises another aspect of the IIF list: the negative connotations in a number of the issue descriptions. (For example, "§ 118 abuse.") If field examiners treat designation as an IIF issue as an indication of an "abusive" transaction, as they typically did with listed transactions, it may blind them to potentially decisive factual differences among the affected taxpayers.

LMSB management has explained the new program as a means to advance its strategic objective of more efficiently allocating the IRS's limited audit resources. That may be true, but the IIF program also represents the IRS's taking lessons learned from battling corporate tax shelters and applying them to the next generation of tax controversies. With tax shelters, the IRS used teams to select and analyze paradigm cases, develop the IRS's technical position for the generic transaction, and in some cases announce a standard settlement. Whether these tactics can succeed in the context of the more mainstream issues in the IIF program (*e.g.*, the domestic manufacturing allowance under section 199 of the Internal Revenue Code) where material facts vary from taxpayer to taxpayer, is an open question. For now, taxpayers should monitor the list of issues that LMSB has designated under the IIF program because the new program will affect the dynamics of their audits and their options for achieving a favorable resolution.

The IIF Program and its Heritage

A. Overview

Under the IIF program, LMSB plans to focus its resources on the issues having (in its view) the greatest compliance risk. LMSB established three "tiers" of IIF issues. Tier I issues are of "high strategic importance" to LMSB and have a significant effect on one or more industries. Tier II issues are those where LMSB believes there is a significant risk of noncompliance. Tier III issues, none of which have been publicly identified to date, are industry issues that LMSB teams consider when conducting their risk analysis. LMSB has placed issues in the three tiers based on several criteria, including the number of taxpayers and industries affected and LMSB's strategy to identify vehicles to further develop the law in a particular area. LMSB has been public about this new audit program, outlining the approach at meetings of Tax Executives Institute and other organizations, and even devoting a section of its website (www.irs.gov) to the IIF program and targeted IIF issues.

The lists of Tier I and Tier II issues do not conform to any particular pattern, other than their potential to generate significant tax.¹ Several issues have been around for some time, and both the IRS and taxpayer positions are fairly well established. For example, the lists include R&E credits, migration of intangibles under costs-sharing arrangements, casualty losses, and non-shareholder contributions to capital under section 118, which have long been focal points for IRS audit enforcement. Not surprisingly, then, they are on LMSB's list of coordinated issues, and thus it will be fairly easy to predict the direction of the IRS's examination team, Appeals treatment, and litigation.

In other instances, the IRS has not yet developed an approach and is simply flagging an issue for later development. For example, the IIF lists recent legislation enactments as "issues," including the domestic production deduction (section 199), foreign earnings repatriation (section 965), and nonqualified deferred executive compensation (section 409A). Given the newness of this legislation (and associated IRS guidance), there has been little audit activity, identification of live disputes, or opportunity for the IRS to develop positions covering real facts. Moreover, a number of the not-so-new issues are awaiting further development by the IRS. For example, LMSB recently released the Issue Directive on Casualty Loss Deductions noting that audit guidelines would be forthcoming "as the issue is being developed" and, in the interim, audit teams should contact the Utilities Technical Advisors for guidance and approval of Forms 5701.² On the one hand, IIF is likely to delay the IRS's examination of issues-in-progress and to enhance the unpredictability of the eventual IRS position. On the other hand, there may be opportunities to influence the IRS's understanding of

the typical facts, the underlying business concerns, and the policy considerations.

Many IIF issues are highly fact dependent. For example, the research and experimentation credit typically involves a fact-intensive inquiry into the level of substantiation that the taxpayer can muster in support of its claim. In these instances, the field examiners should play a critical role in evaluating the evidence and making the factual determinations that ultimately result in a finding regarding the validity of the credit. Including the R&E credit on the IIF list will require coordination with other IRS constituencies, which has the potential to undercut the fact-finding role of the field examiners (or, worse, serve as a signal to the field that all R&E credit claims should be challenged). In the tax shelter wars, listing a transaction as a red flag for auditors in the field and typically resulted in an adverse revenue agent's report (RAR). Optimally, LMSB management will communicate to the field that the same reflexive disallowance is improper for fact-dependent IIF issues.

The largest single group of IIF issues involves international tax: "section 936 exit strategies," "foreign tax credit generators," repatriation, hybrid instruments, cost sharing, stock options in cost sharing, and the former extraterritorial income exclusion transition rules. This is consistent with LMSB's strategic objective of focusing audit resources on international tax issues, including transfer pricing. Like the other IIF issues, the international issues are diverse in the level of prior IRS issue development and the potential variation in material facts.

Finally, the list of IIF issues reflects some issues that can only be described as opportunistic. For example, "backdated stock options" is included as a Tier I issue. The inclusion of this issue reflects, at least in part, the flurry of press coverage and SEC investigations of the backdating issue. As the IRS and taxpayers learned of the issue, it led the IRS and tax departments to flag the issue for field examiners. This kind of monitoring of press reports for corporate issues that have a tax angle seems well suited to the IIF program, if LMSB can respond quickly with a substantive position and audit guidelines for the field.

B. Tiering of IIF Issues

The IIF issues are assigned to Tiers I or II. (There also is a Tier III, but no issue has been assigned to this tier.) Among the criteria that LMSB has identified for Tier I designation are issues involving a large number of taxpayers, significant dollar risk, substantial compliance risk, and high visibility. Tier I encompasses issues on which LMSB believes the law (or at least the IRS position) is well established.³ Typically, LMSB's position on these issues is built around National Office or LMSB Field Counsel guidance, such as a Technical Advice Memorandum (TAM) or a Generic Legal Advice Memorandum (GLAM).⁴

Tier II encompasses emerging issues on which LMSB concludes there is a need for further development in the law or guidance with respect to the IRS's position.⁵ Accordingly, the required coordination on Tier II issues includes as an objective promoting the IRS's development of the law (*e.g.*, through selection of cases as vehicles for National Office guidance and litigation). With respect to Tier II issues, the Office of Chief Counsel has acknowledged that the facts

and circumstances associated with a particular case will affect the merits (and presumably the ultimate disposition) of a particular taxpayer's case. LMSB Division Counsel has explained that the IRS intends to allow the field more discretion in applying Tier II guidance based on a particular case's facts and circumstances.⁶

Tier III issues are traditional industry issues that have been developed by LMSB industry experts and Technical Advisers. LMSB team managers retain control over these issues, but they are to familiarize themselves with the existing LMSB guidance and to utilize the experts on the issue within LMSB.⁷

New IIF issues are identified and developed through a matrix management process and ultimately approved by LMSB's Compliance Strategy Council. Identification of new issues can begin at a number of sources, including information from IRS field Examiners (*e.g.*, upon review of a taxpayer's Form M-3), International Examiners and other specialists, Pre-Filing and Technical Guidance, and Chief Counsel. Additionally, the IRS may receive information from sources outside the IRS.⁸ Once they identify an issue, the relevant IRS personnel submit the issue to the appropriate LMSB industry groups for consideration. They also may raise the issue with the LMSB managers and industry specialists.

Each LMSB industry group will have an industry issue coordinator (IIF Coordinator) who is responsible for managing the issue selection process.⁹ The IIF Coordinator works with International, Field Specialists, and PFTG to evaluate the issues and determine which are of sufficient industry (or cross-industry) importance to be considered for selection as an IIF issue. In addition, the IIF Coordinator will maintain open lines of communication with Appeals, Counsel, and other IRS business units and government agencies (*e.g.*, the states) regarding IIF issues.¹⁰

In the issue selection process, the team considers the following factors: (i) visibility and public uncertainty regarding the tax treatment because of new legislation or litigation, (ii) materiality in terms of the number of taxpayers, permanent or long-term timing adjustments, or audit time spent, and (iii) the potential for abuse.¹¹ Issues that are candidates for IIF designation are then reviewed within LMSB and Counsel, and proposed Tier I and II issues are sent to the Compliance Strategy Council for approval.¹² If an IIF issue is approved for designation as Tier I or II, the new issue is posted on the IRS web site, and the IMT brings on an Appeals coordinator for the issue. If it is designated Tier I, it becomes a "national strategic initiative" that is excluded from compliance initiative projects. Thus, Tier I IIF issues typically cannot be resolved through compliance initiatives such as Fast Track, LIFE audits, of the Compliance Assurance Process (CAP).

C. Migration of the IRS's Tax Shelter Tactics into Mainstream Issues

The IIF program appears to be the most recent application of the IRS's tactic of developing generic positions that can be applied to multiple taxpayers. The IMTs evolved from the cross-functional teams that the IRS used to identify corporate tax shelters, develop uniform IRS positions on those transactions, and coordinate with field examiners to ensure consistent treatment among taxpayers. In the tax shelter context, the IMTs were cross-functional teams

that included representatives from LMSB, technical advisers, Chief Counsel, and Appeals. The tax shelter IMTs were led by "issue champions," who were typically LMSB industry executives. Under the IIF program, the IMTs also consist of cross-functional teams that are led by LMSB executives (*i.e.*, the Issue Owner Executives). As under the tax shelter program, these new IMTs develop coordination procedures for the identification, development, and disposition of taxpayer cases with IIF issues.¹³

One controversial aspect of the tax shelter program was the role of Appeals in developing LMSB's settlement position. In addition, the tax shelters were often coordinated issues within Appeals. The role of Appeals in developing LMSB's generic position on an issue, as well as the coordination, made it very difficult for individual taxpayers to get a fresh look at the issue when their cases went to Appeals. Notwithstanding these concerns, LMSB plans to involve Appeals in shaping how LMSB manages and handles IIF issues.¹⁴ Indeed, the recent additions to the Internal Revenue Manual explicitly state: "Appeals will establish a contact who will coordinate each Tier I and Tier II issue and represent Appeals on the [IMT]."¹⁵ Similarly, the Manual directs the IMTs to maintain "open lines of communication" with Appeals, Counsel, and others within the IRS "to be aware of all activities that will affect the [IIF] issue."¹⁶

Another aspect of the IIF approach that raises concerns is how the approach will mesh with the new Chief Counsel procedures governing National Office case-specific guidance. These new procedures include the expedited TAM, GLAM and the Case Specific Legal Advice Memorandum (which has been referred to as "Shazam"). There is either limited opportunity for taxpayer input in the National Office guidance (in the case of the TAM) or no opportunity for taxpayer input (in the case of the GLAM and Shazam). Moreover, the Chief Counsel, Donald Korb, has emphasized the National Office role as an advocate for the field in the context of this guidance.¹⁷ Accordingly, the IIF approach may be built around a TAM or GLAM, where the National Office acts as an advocate for the field and the affected taxpayers will have had little or no opportunity to share their views before LMSB finalizes its position.

In the tax shelter wars, the IRS was largely successful in developing generic positions that could be applied to large numbers of transactions involving a variety of taxpayers. The IRS is now applying a similar approach to the IIF program. Of course, an important factor in the IRS's success in fighting tax shelters was that promoters marketed substantially identical transactions to large numbers of taxpayers, who often implemented the transactions without any material variation from the standard. The IRS's generic approach to issue identification and development, which worked so well in the tax shelter wars, may be less successful in attacking the more fact-driven mainstream tax issues targeted under the IIF.

Detailed Discussion of the IIF Program

A. General Rules of Engagement

LMSB has published "rules of engagement" governing interactions among LMSB Executives, Team managers, Technical Advisers, and Field Specialist Leaders on IIF issues. These rules of engagement are designed to (i) clarify the roles, responsibilities, and lines of authority for LMSB personnel involved in IIF issues, (ii) facilitate

development of individual IIF cases, (iii) promote consistency across taxpayers, and (iv) promote ethical decision making.¹⁸ The rules of engagement include a management matrix that sets forth the distribution of responsibilities among the various LMSB personnel that encounter IIF issues. The matrix covers issue identification and development for emerging issues as well as the coordination and disposition for established issues.

The management matrix requires both a top-down approach (*e.g.*, on designation of IIF issues and coordination through Issue Owner Executives) and a decentralized approach (*e.g.*, on identification of emerging issues and resolving disagreements at the management level closest to the facts). When it comes to Tier I and II issues, however, these competing approaches are resolved in favor of the top-down approach. Thus, the rules of engagement are clear that LMSB executives with line authority must ensure that the Issue Owner Executive has access to Tier I and II cases so that the Issue Owner Executive can impose uniform treatment across taxpayers and industries.

With respect to Tier I issues, the rules of engagement provide that the Issue Owner Executive is responsible for ensuring that the IIF issue is identified, developed, and resolved in a consistent manner across all LMSB cases involving similarly situated taxpayers. The Issue Owner Executive has nationwide jurisdiction over disposition of cases involving the IIF issue. Accordingly, any settlement of a Tier I issue must be in accordance with the Issue Owner Executive's guidance.¹⁹

LMSB has already published a number of Industry Directives on Tier I issues, which provide guidance to the field on how to handle the specific issue. These Industry Directives are varied in the level of detail, but they tend to combine aspects of the Notices that the IRS issued on listed transactions and the audit guidelines that LMSB produces for industry examinations.²⁰ For example, on May 1, 2007, the Issue Owner Executive for the mixed service costs issued Industry Director Directive #2 on the issue.²¹ The Mixed Service Costs directive instructs the field on the nature of the issue, its strategic importance, coordination with the IMT, and how to identify and develop the issue. The directive describes the industry groups affected (utilities and retail), the tax stakes, the marketing of the issue through national accounting firms, the legal question, applicable National Office guidance, and LMSB's position. It also explains how examiners can find the issue by reviewing taxpayers' Schedules M-3, requests for accounting method changes (Forms 3115), and informal claims for refund. The directive then states that, as a Tier I issue, it is a "mandatory examination item," and directs the examiners to contact the appropriate Technical Advisers for instructions. Finally, it provides guidelines for conducting the audit.

For Tier II issues, the rules of engagement also require coordination with the Issue Owner Executive, who is responsible for ensuring that the disposition or resolution of issues does not hinder LMSB's overall strategy on the IIF issue.²² This protocol will facilitate LMSB's selection of individual cases as vehicles for pursuing guidance from Chief Counsel or litigation.²³ In contrast to the rules of engagement for Tier I issues, where the Issue Owner Executive has the final say on proposed resolutions, the LMSB teams need only coordinate with the Issue Owner Executive on the disposition of Tier II issues. If the

LMSB executives with line authority over the case disagree with the Issue Owner Executive, they must elevate the question up the LMSB management chain.²⁴ It is an open question whether this distinction concerning settlement or other dispositions of Tier I and II issues will make a difference as a practical matter.

Potential Taxpayer Concerns

LMSB's IIF program has captured the attention of the LMSB taxpayers because it promises significant changes to the way issues are handled through the administrative process and the prospects for settlement. The desire on the part of the IRS to coordinate internally on issues is not a new concept (*e.g.*, the Industry Specialization Program (ISP) and the Market Segment Specialization Program (MSSP)), and the IRS has always sought to treat similarly situated taxpayers similarly (as the IRS is required to do).²⁵ Technology and the ease of communication have allowed the IRS to better meet this goal, and the tax shelter experience spurred the IRS to develop new tactics on coordination and negotiation. Thus, the IIF program could be more effective than past coordination efforts. For LMSB taxpayers, this may mean that certain aspects of IRS audits will no longer be "business as usual." Moreover, taxpayers will need to prepare sooner to defend these issues on audit — particularly for those IIF issues where LMSB has left room for field examiners to make decisive factual calls. Last but not least, taxpayers will need to conduct a sober assessment of the facts and law surrounding their IIF issues to determine whether they should settle on the terms dictated by the IMT or are willing and ready to litigate.

A. Issue Spotting and Development

It is quite possible that LMSB audits will open with an IDR similar to the one that the IRS currently issues with respect to tax shelters. Opening conferences frequently include the issuance of IDR No. 1 related to listed transactions, asking if the taxpayer has engaged in any of the listed transactions identified on an attachment. LMSB could very well replicate this approach and require that IDR No. 2 be one that asks the taxpayer if it has taken a position on the return related to any of the Tier I or II items that LMSB would identify on an attachment. For example, the LMSB Directive on Section 118 instructs field examiners to issue an IDR asking the taxpayer to list all section 118 exclusions from income.²⁶ LMSB taxpayers should expect the issuance of this type of IDR as the IRS searches for IIF issues.

Taxpayers should become familiar with each issue on the Tier I and II lists so that they can be prepared to respond to substantive IDRs on these issues. Taxpayers should familiarize themselves with the facts and legal theories underlying their positions on any IIF issue included on their returns. They also should locate and review the available LMSB IIF directives and other IRS guidance on the issue to determine the likely direction of the IRS's inquiry. Taxpayers should take special care in responding to IDRs regarding certain categories of IIF issues, where LMSB has used a pejorative label, such as "Section 118 Abuse" and "Backdated Stock Options." An over-inclusive answer, given in the spirit of cooperation and transparency, could be interpreted by the LMSB examiners as an admission that the taxpayer engaged in an "abusive" transaction. Once tagged as an abusive transaction that requires coordination,

taxpayers may find it extremely difficult to have that tag removed — even if the taxpayer firmly believes its facts are distinguishable from the abusive situation targeted by LMSB.

Once a Tier I or II issue is identified as present in an audit cycle, the taxpayer will likely find that the local exam team has little or no control of the resolution. The requirement that the local exam team coordinate with the IMT and Issue Owner Executive on the particular issue effectively means that the field will lose control of the ultimate outcome. The taxpayer's examination team will have little or no authority to handle the issue any differently from what the IMT directs. The field examiner's role will be to develop the facts to fit the individual case into the pre-conceived paradigm that the specialist believes is abusive. Taxpayers should deal directly with the specialist or the IMT when decision points arise with respect to the taxpayer's case. That may be the only means of having any effective input into the decision-making process and avoid communication breakdowns caused by the examination team acting as the intermediary. Direct access to the specialist or IMT will be even more important with respect to Tier II (or Tier III issues, when and if any are identified) because the IMT is tasked with developing the LMSB position.

Taxpayers that find themselves with Tier I or II issues can gain insight into how the audit of an IIF issue will be conducted based on what LMSB has published in its directives. Taxpayers can use these directives to prepare in advance of the audit. Using these directives, taxpayers can anticipate the IDR questions and prepare to respond quickly with persuasive and thorough responses once the IDRs issue. By being responsive to the IRS requests, taxpayers also can maintain "clean hands" and expect that their reasonable requests for responsiveness on the part of the examination team be reciprocated. Taxpayers should also consider actively submitting their own briefing papers on the assumption that a Tier I or II issue will be audited. This would allow the taxpayer to put the facts and issues in the best light possible early in the audit, before the examination team draws adverse inferences through a hunt-and-peck audit style. This strategy may be more effective with Tier II issues, where the LMSB admits that its position is developing. For Tier I issues, the LMSB position may be so entrenched that it may not matter what the taxpayer says during the audit. In these cases, the best approach may be to ensure that examination's view of the facts is correct and leave aside for a later day (and in another forum) any discussion of the legal implication of those facts.

The presence of an IIF issue in an audit will likely lead to a series of IDRs crafted to build the IRS's case. These IDRs are often prepared by the IMT based on a one-sided view of the law and what books and records need to be kept for a taxpayer to meet its burden of proof. In some cases, answering these IDRs will be burdensome because the issue comes down to a disagreement over the law as applicable to an undisputed set of facts — rather than a factual dispute. In these cases, it would be best to start a dialogue with the exam team immediately. Because of the control exerted by the IMTs, it will be important to bring them into the discussion. Taxpayers can refer to the Rules of Engagement to determine the acceptable means to elevate the discussion of any modification of the IDR request to the proper decision maker.

Timing is always a critical aspect of any audit, and the IIF system has the potential to disrupt the timing of the audit. Coordination takes time. If a large group within LMSB must coordinate with each other to address a particular issue, seemingly simple tasks such as scheduling conference calls can become far more time consuming. Nevertheless, to be effective in achieving LMSB's goal of conducting more audits with the same examination resources, the IIF program must not undermine the goal of currency. Taxpayers with clean hands in terms of responding to IDRs and other IRS requests in a timely fashion can argue that LMSB needs to stick to its original audit timeline and wrap up the audit.

The IIF program presents the potential for audits to focus on Tier I and II issues at the expense of other issues. Recent press reports have suggested that the currency initiative has caused IRS examiners to turn their backs on some issues. Although one cannot rely on the IRS walking away from non-IIF issues, once the field examiners become engaged with one or more IIF issues, they may have less time (and less inclination) to hunt for other issues. Most LMSB taxpayers are well aware of some potential issues, and are generally substantively and emotionally prepared to defend the position when challenged in an audit. Audit angst arises when IRS examiners land upon (or create) issues that the taxpayer believes "came out of left field." The focus on Tier I and II issues, at least, may result in fewer unexpected audit issues.

B. Issue Resolution

The coordination of IIF issues may restrict the ability of taxpayers to reach an administrative resolution. As LMSB develops the issues, its position may become essentially a take-it-or-leave-it offer. Taxpayers will have only a limited ability to distinguish themselves because LMSB may disregard assertions of factual differences and insist that all taxpayers with the issue accept the same patterned settlement. In the tax shelter wars, LMSB drafted standard IDRs to identify a few basic facts, which if present, resulted in LMSB asserting the proposed adjustment. Similarly, in the name of consistency LMSB often disregarded differences among the Courts of Appeals regarding the applicable law. The few standardized NOPAs (Forms 5701) that are included in some of the IIF directives reflect a similar tendency to treat a range of taxpayers in the same manner based on a few paradigm cases. These standardized NOPAs include a generic factual description that appears intentionally designed to cast as wide a net as possible.

A taxpayer may also have limited ability to seek assistance from another arm of the IRS to reach a more reasonable resolution. The coordination expected for these IIF issues includes not only individuals from Counsel, but also individuals from Appeals. This undermines the ability of taxpayers to receive a fresh look at Appeals or the National Office. The settlement package may have already received buy-in from Appeals, and Appeals will be under pressure to view each taxpayer's IIF issue as fitting within a factual paradigm, leaving little room for an individual Appeals Officer to reach a resolution that departs from the paradigm. This may be true even for any of the specialized programs involving Appeals, such as Early Referral or Fast Track. Also, although the National Office side of Chief Counsel was once viewed as a neutral arbiter on technical is-

issues, that office has increasingly taken on the role of advocate for the field. Accordingly, taxpayers with IIF issues may have difficulty finding an objective ear within the IRS to hear their story.

Taxpayer Responses

Although the increased coordination can make it more difficult, taxpayers can still take steps to increase the prospect for a reasonable resolution short of going to court. The changes occurring within the IRS, and LMSB in particular, should lead to changes in taxpayer behavior, and not just in terms of whether to accept LMSB's standard settlements. Taxpayers need to match the IRS in terms of getting in front of issues and seizing control of the dialogue.

A. Prepare, Prepare, Prepare

The advantage for taxpayers with the IIF program is that the issues of concern to the IRS are publicly available. Taxpayers should be able to identify any of these issues as present in their return and plan well ahead of any IRS audit how the taxpayer expects to respond. Taxpayers will be able to evaluate the strengths and weaknesses of their case, as well as that of the government, and then decide what the issue is worth to them. This type of analysis will enable the taxpayer to decide not only whether it is able to litigate and win, but also whether it is willing to litigate. Against that background, the taxpayer can then assess its approach to the audit and the expected pattern settlement.


B. Be Assertive

Based on our experience in the days of the corporate tax shelters, taxpayers that come forward first may obtain a more favorable deal. This is not a reward for coming in early, but a recognition that as the IRS learns more about an issue, including examination of the cases with the worst facts, the IRS tends to become more entrenched in its position. Taxpayers with the best facts are usually the ones out front and the ones demanding a quick resolution. If you think you have a strong case, you may be better off seizing control of the dialogue rather than allowing the IRS to choose someone with worse facts as the paradigm case for an IIF issue.

Just as LMSB has made it a priority to coordinate, taxpayers should do the same. Taxpayers should reach out to other taxpayers that are confronting the same IIF issue. Taxpayers can form coalitions or agree which taxpayer has the best facts to go forward. One outgrowth of the LMSB coordination effort is that the government is taking more time to select its own litigation vehicles. Taxpayers should not relinquish that advantage to the government.

Conclusion

LMSB's IIF program promises to change the way that the IRS identifies, develops, and settles issues on audit and at Appeals. It represents a migration of IRS tactics from the tax shelter wars into mainstream audit issues. The centralization of authority with the individual IMTs reduces the local control of the audit. The demands on the fact-finding aspect of these coordinated issues may so dominate the exam team and the taxpayer's attention that the IIF issues become the basis of the audit. Taxpayers who hope to resolve the issue at exam or Appeals should consider actively engaging LMSB in

the development of the issue rather than sitting back and letting the IRS build its case against the taxpayer. The passive taxpayer who merely reacts to what the IRS does will likely find the IRS so entrenched in its IIF position that the only option left is the courthouse. 

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APPENDIX

The IRS's list of Tier I issues and Issue Owner Executives assigned to these issues are, as follows:

1. § 118 Abuse — Jo Ann Bank, Director, Field Operations West, Communications, Technology, and Media
2. § 162(f) — DOJ Settlements — John Risacher, Industry Director, Retailers, Food, Pharmaceuticals, and Healthcare
3. § 936 Exit Strategies — John Risacher, Industry Director, Retailers, Food, Pharmaceuticals, and Healthcare
4. Foreign Tax Credit Generators — Barry Schott, Industry Director, Financial Services
5. Backdated Stock Options — Laura Prendergast, Deputy Director, Field Specialists
6. Domestic Production Deduction IRC § 199 — John Risacher, Acting Industry Director, Heavy Manufacturing and Transportation
7. Foreign Earnings Repatriation — Frank Ng, Deputy Commissioner, International
8. International Hybrid Instrument Transactions — Walter Harris, Director, Field Specialists
9. Mixed Service Costs — Keith Jones, Industry Director, Natural Resources and Construction
10. Nonqualified Deferred Executive Compensation (§ 409A) — Walter Harris, Director, Field Specialists
11. Research & Experimentation (R&E) Credit Claims — Cheryl Claybough, Director, Field Operations East, Communications, Technology, and Media
12. Transfer of Intangibles Offshore/Cost Sharing — Patricia Chaback, Industry Director, Communications, Technology, and Media

13. Tax Shelter — Distressed Asset/Debt — Larry Barnes, Director, Field Operations East, Heavy Manufacturing and Transportation
14. Tax Shelter — Redemption Bogus Optional Basis — Patricia Chaback, Industry Director, Communications, Technology, and Media
15. Listed Abusive Tax Shelters and Transactions — various Issue Owner Executives.²⁷

The IRS's list of Tier II issues and Issue Owner Executives assigned to these issues are, as follows:

1. Casualty Loss: Single Identifiable Property / Capital vs. Repairs — Sergio Arellano, Director, Field Operations East, Natural Resources and Construction
2. Cost-Sharing-Stock Based Compensation — JoAnn Bank, Director, Field Operations West, Communications, Technology, and Media
3. Enhanced Oil Recovery Credit IRC 43 — Sergio Arellano, Director, Field Operations East, Natural Resources and Construction
4. Extraterritorial Income Exclusion Effective Date and Transition Rules — Larry Barnes, Director, Field Operations East, Heavy Manufacturing and Transportation
5. Gift Cards: Deferral of Income — Lori Nichols, Director, Field Operations East, Retailers, Food, Pharmaceuticals, and Healthcare
6. Healthcare Accounting Issues: Contractual Allowance — Lori Nichols, Director, Field Operations East, Retailers, Food, Pharmaceuticals, and Healthcare
7. Interchange Merchant Discount Fees — Barry Shott, Industry Director, Financial Services
8. Non-Performing Loans — Barry Shott, Industry Director, Financial Services
9. Specified Liability Loss, IRC 172(f) — Paul Cordova
10. Deferred Home Construction Contracts — Paul Cordova, Director, Field Operations West, Natural Resources and Construction
11. Super Completed Contract Method — Paul Cordova, Director, Field Operations West, Natural Resources and Construction
12. Upfront Fees, Milestone Payments & Royalties in the Biotech & Pharmaceutical Industries — Kurt Meier, Director, Field Operations West, Retailers, Food, Pharmaceuticals, and Healthcare.²⁸

1. Tier I and II issues are listed in the Appendix.
2. See Industry Directory Directive #1 on Examination of IRC Section 165 Casualty Losses, LMSB-04-0407-030 (April 27, 2007).
3. Internal Revenue Manual (IRM) § 4.51.5.1 (April 1, 2007).
4. See, e.g., Industry Director Directive #2 on Mixed Service Costs, LMSB-04-0207-011 (May 1, 2007) (relying on TAM for support of LMSB position); Industry Directory Directive #1 on Examination of IRC Section 165 Casualty Losses, LMSB-04-0407-030 (April 27, 2007) (referencing IRS position in GLAM 2006-006); IRM Ex. 4.51.5-2 (specifying that LMSB position can be stated in coordinated issue paper, GLAM, or published guidance). IRM § 4.51.5.1.
6. See BNA Daily Report for Executives, "LMSB Launches Issues Classification System to Promote Consistency, Cut Currency Time" (March 13, 2007).
7. See IRM § 4.51.1.6.2.
8. IRM § 4.51.5.2.
9. IRM § 4.51.5.2.

10. IRM Ex. 4.51.5-1.
11. IRM § 4.51.5.2.
12. IRM § 4.51.5.3. The accompanying form sets out the proposed Issue Owner Executive and the plan for developing the IIF issue. This includes discussion of the existing legal opinions and areas of controversy, the number of affected taxpayers, revenue effect, proposed LMSB direction and strategy, issue tracking, criteria for selecting taxpayer returns. It also includes target dates for further issue development, such as fact finding and analysis, obtaining legal guidance, establishing LMSB direction, and resolution. *See* IRM Ex. 4.51.5-3.
13. *See, e.g.,* Industry Director Directive #2 on Mixed Services Costs, LMSB-04-0207-011 (May 1, 2007) (directive to the field from the IMT for Tier I issue on mixed services costs).
14. *See* BNA Daily Report for Executives, "LMSB Launches Issues Classification System to Promote Consistency, Cut Currency Time" (March 13, 2007).
15. IRM § 4.51.5.3(2).
16. IRM Ex. 4.51.5-1.
17. *See* David B. Blair & Dwight N. Mersereau, "Chief Counsel Revamps Case-Specific Advice Procedure to Match LMSB's New Enforcement Paradigms," 58 Tax Executive 300 (July-August 2006).
18. *See* "Rules of Engagement for Industry Issue Focus Compliance," Tax Notes Today (April 30, 2007); IRM § 5.51.1.
19. IRM § 4.51.1.6.1, *reprinted in* "IRS Unveils Rules of Engagement for Industry Issue Focus Compliance," Tax Notes Today (April 30, 2007).
20. Industry Directives have been issued on at least the following Tier I and Tier II issues: mixed service costs, section 118, section 199, section 936 exit strategies, and inclusion of stock options in cost sharing pooled costs, casualty losses, and enhanced oil recovery credits. New directives are published regularly. For those IIF issues without a published directive, there often is other guidance from the IRS that can be useful in predicting the IRS's position. *See, e.g.,* Notice of Proposed Rulemaking, Reg. 165776-06, 72 Fed. Reg. 15081 (March 30, 2007) (explaining concerns on "foreign tax credit generator" transactions).
21. *See* "Industry Director Directive #2 on Mixed Service Costs," LMSB-04-0207-011 (May 1, 2007).
22. I.R.M. § 4.51.1.6.1, *reprinted in* "IRS Unveils Rules of Engagement for Industry Issue Focus Compliance" (April 30, 2007).
23. *See* IRM § 4.51.1.6.1. Where an LMSB manager believes that a case is a potential litigation vehicle or otherwise has the potential for setting precedent, he or she is directed to elevate the issue up the LMSB management chain.
24. *See* IRM § 4.51.1.6.2.
25. *See International Business Machines. Corp. v. United States*, 343 F.2d 914 (Ct.Cl.1965).
26. *See* Industry Directive on Section 118 Abuse, LMSB-0401106-016 (December 28, 2006).
27. *See* <http://www.irs.gov/businesses/article/0,,id=167379,00.html>.
28. *See* <http://www.irs.gov/businesses/article/0,,id=167379,00.html>.