Tax Controversy in the Post-Shelter Era

By Lawrence B. Gibbs

I would like to share with you six observations about what our tax controversy dealings with the Internal Revenue Service in the post-shelter era may be like, and seek your reactions about what you believe we should expect from the IRS and how taxpayers and their representatives should respond.

My first observation, from which most of my remaining ones follow, is that the IRS today is in a full compliance mode, largely because of the IRS's response to tax shelters over the last five years, led primarily by former Commissioner Mark Everson. The Large & Mid-Size Business Division, with which most large companies interact, is placing primary emphasis on perceived tax non-compliance by large and medium-size businesses. Congressional oversight panels have made it very clear to the IRS that more emphasis on tax compliance by business is expected. Accordingly, we are likely to see LMSB use techniques it developed to deal with tax shelters in the foreseeable future.

LMSB's new Industry Issue Focus program will target specific issues for development, audit, and potential litigation because LMSB will have determined that these issues have the greatest tax compliance risk for large and mid-size companies. The development of this new program suggests that if your company has a significant, potentially difficult tax issue that LMSB characterizes as a Tier I, Tier II, or Tier III issue, you are likely to encounter the same IRS audit problems, confusion, and frustration we often experienced over the last five years in dealing with LMSB's coordinated, matrix management system for tax shelter issues. Thus, you may find it difficult to determine who in LMSB and Chief Counsel has authority for what and who is willing and has the capability to make good decisions about your significant, potentially difficult tax issues. In such an environment, we expect the knowledge we developed in the tax shelter era about how and with whom to deal in LMSB's matrix management to secure taxpayer-favorable decisions will be important.

Even if your company was never involved in a tax shelter and does not encounter this new IIF program, IRS announcements over the last year suggest the likelihood of heightened LMSB audit scrutiny of such diverse but relatively routine activities as transfer pricing, cost sharing arrangements, domestic and international restructurings, R&D programs generating tax credits, derivatives, executive compensation and other section 409A programs, costs qualifying for the Domestic Production Deduction under section 199, and issues raised by Schedule M-3 or FIN 48 disclosures. Clearly, a major portion of LMSB's future focus will be on international issues. Because of the increasing cooperation among the federal, state, and foreign tax authorities, stakes will undeniably rise for multinational companies in the post-shelter tax controversy area. I predict that as the IRS gets more and more pressure from politicians and the media to collect taxes already owed to avoid having to raise tax rates for compliant taxpayers (especially individuals who vote), the business community will find dealing with LMSB and its attorneys more demanding and potentially difficult than in the past. Let me explain why.

In my experience, attorneys in the IRS Office of Chief Counsel are playing an increasingly important role in many of LMSB's cases. During the tax shelter days, many of the listed transactions required Counsel's participation to develop the facts and law applicable to complex transactions, the terms of and closing agreements for any settlements, and the preparation for litigation of cases that could not be settled. With Counsel's assistance, LMSB became more adept and intrusive in its issue development by using more precise IDRs, summonses, and in some cases requests for tax accrual workpapers. These close working relationships between LMSB and their attorneys appear to be carrying over to post-shelter audits of companies' transactions to develop significant issues LMSB finds troublesome.

It may be difficult, at least initially, to identify who in Counsel is advising your LMSB audit team and what advice they are giving on significant issues. Depending upon the type and size of the issue, it often is as difficult as it is important to know whether Area Counsel attorneys in the field or Chief Counsel attorneys in the National Office are providing the advice given to your LMSB team. In some cases, we have seen increased tension between LMSB field attorneys and National Office attorneys over which of them will "call the shots." This tension may be the unavoidable result of LMSB's currency initiative because the desire for faster decision-making by LMSB audit teams may conflict with the more deliberate approach of the National Office attorneys. Accordingly, LMSB teams are turning seemingly more often to their field attorneys than to the National Office for advice, and the field attorneys appear to be more willing than National Office attorneys to provide support more expeditiously, even if the legal conclusions may be questionable or even at odds with other IRS positions.

My second observation, therefore, is that in the post-shelter era it will be important for you to be as knowledgeable about LMSB's attorneys and their roles, policies, and procedures in your audits as you are about LMSB's personnel, policies, and procedures in order for you to deal effectively with LMSB. This will be particularly true in the future if you have to deal with Tier I, II, and III issues and, therefore, are confronted with the challenges of dealing with the matrix management system of LMSB's new IIF program.

To meet the demands of the IRS audit currency initiative, LMSB is likely to continue to rely on required disclosures of potentially difficult issues by companies, just as it relied on taxpayers' required disclosures during the tax shelter era. It will be interesting to see how the IRS combines tax return disclosures with its requirement that companies file their returns electronically, making it easier for LMSB to use such disclosures to identify audit issues. It will also be interesting to see if the present "standard," or pro forma, tax shelter IDR issued at the beginning of each LMSB audit is modified to include Tier I, II, and III disclosures. You and your companies should anticipate being called upon more often than ever before to identify potential issues for the IRS to audit in the future.

You should also expect some of the issue identification techniques to become contentious. Think, for example, about the IRS's possibly becoming more adept and aggressive in using a company's FIN 48 disclosures. Some believe that LMSB's recently announced review of the longstanding IRS policy of restraint in requesting a company's tax accrual workpapers means the policy is likely to change, and that

LMSB auditors will be permitted to request tax accrual workpapers more frequently. Others suggest that a possible compromise might be for LMSB to require a company to identify each issue in each year's tax reserve but not the company's estimate of its chances of prevailing on each issue. In any event, LMSB is taking a hard look at the present policy of restraint, so this is an area that bears watching.

A potential wildcard in this area is the pending *Textron* case, where the court is concerned with whether a company may rely on the attorney-client privilege or the work product doctrine to protect its tax reserve workpapers. Some believe the scope and reasoning of the *Arthur Young* decision by the Supreme Court in 1984 make the taxpayer's case difficult. Others believe the strength of the taxpayer's facts makes the government's case difficult, especially in attacking the application of the work product doctrine. If Textron prevails, I would expect more litigation by the government and other taxpayers in this context and more insistence on transparency by the SEC, PCAOB, and the AICPA.

My third observation, therefore, is that the pressure on companies to disclose their major tax issues to the IRS will continue and is likely to increase. Accordingly, your company should anticipate that it may have to notify the IRS of your most significant, potentially difficult tax issues in the future. Transparency has become the new IRS mantra, which means that the IRS is going to expect you and your advisers to be more forthcoming by disclosing instances and areas of potential tax non-compliance to the IRS. In this regard, the tax area may be catching up to the financial reporting area in the demand for increased transparency. Reports are that some LMSB agents already are making expansive requests for FIN 48 information. With demands under the currency initiative that IRS audit teams complete audits more quickly but also detect potential areas of non-compliance, companies should anticipate that LMSB may increasingly rely on companies to disclose the soft spots in their returns to IRS.

Another predicable trend in the post-shelter era involves the use of penalties by LMSB audit teams, in light of their experiences with penalties in the tax shelter era. This leads to my fourth observation, which is that, at least for the foreseeable future, LMSB audit teams are likely to be permitted to use potential penalties as leverage to initially cause companies to identify soft spots and then to encourage companies to resolve otherwise unagreed issues at the examination level. During the tax shelter days, corporate taxpayers frequently encountered situations in which LMSB used very real threats of penalties to develop cases and then to obtain concessions. For example, after one company paid the tax in full and expressed the intention to litigate, LMSB issued summonses to senior executives and board members to conduct what amounted to discovery interviews, allegedly to explore a basis for imposing accuracy penalties, as well as IDRs to explore imposition of civil fraud penalties based on the handling of a transaction by the company's tax personnel. The company reluctantly elected to concede the tax benefits rather than litigate and risk damaging its reputation if the IRS ultimately decided to assert penalties, even though the company believed the IRS had no basis to sustain any penalty assertion.

Recently, in post-shelter cases we have seen, and heard from others about, instances in which LMSB raised the prospect of penalties to obtain information about, and concessions of, issues. During the tax shelter days, these were considered hardball tactics that LMSB felt were justified to deal with listed transactions. But because some revenue agents and their attorneys learned these kinds of tactics in the tax-shelter cases and discovered that some companies could be intimidated by the threat of damage to their reputations, it is not unreasonable to assume that agents and their attorneys may use of similar tactics in post-shelter cases. Some of us who litigated tax cases in the 1990s can recall IRS attorneys who used hardball litigation tactics learned in trying tax shelter cases in the 1980s to try to gain advantage in later non-shelter cases.

If the economic substance doctrine is codified, it may become the lever of choice for some LMSB audit teams to compel company disclosures and concessions because of the strict liability penalty provision that accompanies the legislative proposal. In my experience, the threat of a non-waivable penalty up to 40 percent of the amount of any tax deficiency would be a sobering sanction for any company to face in deciding whether to contest or try to resolve issues with LMSB. If such a penalty is enacted, the IRS will ideally provide adequate management review safeguards to prevent inappropriate assertions of the penalty.

In any event, utilization of the various IRS dispute-resolution procedures to resolve tax issues before issuance of the 30-Day Letter in order to avoid any risk that LMSB might propose any penalty could become an attractive approach. And this leads me to my fifth observation. In the post-shelter era, if your preference is to resolve or settle your significant tax issues, it could become more important to consider the use of programs such as the compliance-assurance-process, pre-filing agreements, early referrals to Appeals, fast track, and other pre-filing and post-filing programs available to LMSB taxpayers.

To summarize: In light of recent IRS activities and pronouncements, post-shelter tax controversies are likely to become more contentious and potentially more difficult for your companies as LMSB audit teams with the assistance of their attorneys refine and apply issue identification and penalty techniques they learned during the tax shelter days in order to try to make you identify your most significant, difficult issues and to try to compel your company to make concessions it might not otherwise be willing to make.

Now let's turn to the obvious question this raises. What can you and your company do to deal with the risks raised by this more intrusive, hostile tax controversy regime in the future?

My sixth, final, and most important observation is this: If the IRS becomes more aggressive in the manner in which it treats your company on one or more significant issues raised during an audit, you must know — preferably before LMSB raises the issue — how you are going to respond. To be more precise, you must know whether or not your company is *willing* and *able* to litigate any significant issue that LMSB may raise. Let me repeat that: You must know whether or not your company is both *willing* and *able* to litigate any significant, potentially difficult issue that LMSB raises in the future. By saying that you must know if you are "able" to litigate an issue, I mean you must know whether or not you have sufficient admissible evidence —including documents, testimony, and an otherwise credible position in litigation — to be able present your case to a judge in an appropriate forum, so that in light of the relevant, applicable tax authority, you have what you consider to be a sufficient chance of winning the issue to make litigation worthwhile.

By saying that you must know if your company is "willing" to litigate, I mean that even if you believe you are able to litigate

an issue, you must know if the potential risks of litigation —including but not limited to the risk of losing — are such that your company is willing to bear the economic consequences of the tax, interest, and any penalty that may be asserted by the IRS as well as the publicity and reputational risks to the company of litigating. In today's environment of aggressive IRS auditors and attorneys, Sarbanes-Oxley Section 404 controls, FIN 48 financial disclosures, SEC disclosures to shareholders, investigative business reporters, and potential plaintiff lawyers' derivative suits, your senior executives and board of directors must be *willing* to litigate, even if you otherwise are *able* to litigate. In our experience these days, a company's willingness to bear the risks of litigation is at least as important as its ability to litigate and its chances of winning when a company decides whether to contest a tax issue in the courts.

The reason that I say you must determine your company's litigation capability in advance is that the difference between a company's ability to do well or to really get hurt during a tax controversy depends upon how well the company has thought through its options and how well it is prepared to deal with IRS if LMSB raises one or more significant, difficult issues during an audit. Companies that do well are those that know whether or not they are willing and able to litigate a contested issue. When push comes to shove, if you know you either are or are not willing to litigate, you can develop an appropriate strategy to deal with the IRS. Regardless of whether or not litigation is an ultimate option, you can develop the best strategy to minimize the tax cost, including any potential penalty risk. On the other hand, to put it directly, if you discover that you cannot litigate only after LMSB and its attorneys are in the midst of their issue development and are inclined not to settle without a penalty, the audit cycle can become very expensive. Remember, too, that life after the audit cycle ends in coping with the difficulties of being characterized as a non-compliant taxpayer by LMSB can become an even more trying and expensive proposition.

If you are willing and able to litigate, you are likely to have many more IRS strategy options. If you are not willing and able to litigate, the best option often may be to select a strategy designed to resolve the issue before any 30-Day Letter is issued by LMSB, usually because of the risk of a penalty assertion if the case leaves LMSB on an unagreed basis. This, in turn, may cause you to pursue one or more of the IRS alternative dispute resolution programs. Your ability to accomplish your strategy objective, however, usually depends on how well you can respond when LMSB first raises the issue. And this means that the sooner you can evaluate and take steps to maximize your chances of winning a significant issue, determine your capability of litigating the issue, and develop your strategy to deal with the IRS on the issue, the better off you will be.

We often deal with companies facing tough decisions on significant, difficult issues that have more likely than not opinions, usually written by someone who never tried a case and had no access to anyone else who did. In such situations, the opinion is not very helpful in part because the issue really is not whether theoretically there is more or less than a 50-percent chance of prevailing. Instead, the issue is very simple: Are the company's odds of winning based on its ability to litigate such that the company is willing to litigate and bear whatever risks litigation entails?

Some companies that recently have asked for our assistance do not have opinions on specific issues or transactions. Instead, we are seeing, in the context of real business deals, very complex transactions that have been structured to maximize the tax benefits of the business deals, with long, detailed tax memoranda that often cannot be protected from disclosure by privilege or work product claims. These transactions were created by tax professionals who often neither thought about the potential difficulty of litigating the transactions nor anticipated the analysis in recent court decisions like *Coltec* and *Black & Decker* that may embolden government attorneys to attack the portions of real business transactions that appear to have been done to maximize the tax benefits of such transactions. Tax shelter litigation has trained government attorneys to better deal with and use to their advantage the large size and complexity of today's corporate transactions, even those done in the context of real business deals. The rough and tumble of tax shelter litigation also has prepared them to obtain any tax planning materials that are not protected from disclosure by privilege or work product. As a result, LMSB audit teams and their attorneys are no longer daunted by the prospect of having to parse, understand, and prepare to litigate large, complicated transactions. That is an important change from five years ago.

The reality most tax executives face today is that they are still expected to maintain a competitive overall tax rate in a global economy with competitors based in foreign countries whose tax administrators have neither the same attitudes toward nor the same capabilities to enforce tax compliance as those of the IRS. At the same time they are expected to minimize or avoid any reputational or other damage to the company as a result of your tax planning. With the aggressiveness of not only the IRS and other tax authorities around the world but also that of the SEC, the FASB, and the PCAOB and the demands of external auditors, the challenges in the tax area have become increasingly difficult and certainly more complex.

In summary, my two principal messages are:

First, the IRS in the post-shelter era is likely to become more aggressive, intrusive, and difficult to deal with in part because of lessons learned, techniques applied, and attitudes developed by IRS agents and their attorneys in the tax shelter era; therefore, your future tax controversies involving your most significant, difficult issues are likely to become more contentious and risky.

Second, your best defense is to get on the offense — to prepare in advance how you are going to respond to the IRS when you know you have a significant, potentially difficult tax issue by carefully determining whether your company is willing and able to litigate the issue and then developing and pursuing the best strategy to deal effectively with the IRS.

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