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Exam

Responding Strategically to the Acknowledgment of Facts IDR

By George A. Hani*

I. Introduction

For more than two years now, the Acknowledgment of Facts (AOF) Information Document Request (IDR) has become standard practice in examinations conducted by the IRS's Large Business and International (LB&I) but it continues to cause consternation among taxpayers and practitioners alike. Generally speaking, there is no right way or wrong way to respond to the AOF IDR. Nor is there a standardized response for taxpayers to utilize. Each response depends on the particular issue and the atmosphere of the audit and should take into account a variety of strategic considerations. This column will review the background and evolution of the AOF IDR, including updates to the Internal Revenue Manual (IRM) provisions regarding the AOF IDR made in December 2018, and identify some of the strategic considerations to consider in formulating a response.

II. Background

The roots of the AOF IDR appear to be a response to an initiative by IRS Appeals referred to clarify or rest is role within our tax administration system. As part of that initiative, referred to (at least initially) as the Appeals Judicial Approach and Culture (AJAC) project, Appeals adopted a policy under which cases would be returned to LB&I exam teams if taxpayers produced "new facts" during its discussions with Appeals. As explained in the IRM, Appeals officers "are not investigators or examining officers and may not act as such."[1] Under this policy, "taxpayers may present new information or evidence to Appeals, [but] the presentation of new factual information generally will require that the case be returned to Examination."[2]

While Appeals clearly wanted all facts to be disclosed and considered during the examination phase, Appeals was not concerned with when during the examination phase those facts were examined. A fact first disclosed in a taxpayer's protest (which is part of the process to elevate disputed issues from examination to Appeals) would not be considered a new fact that would cause the case to be returned to exam. This is because the examination team has the opportunity to prepare a rebuttal to the protest before sending the case to Appeals and therefore has the opportunity to address the implications of any new fact included in the protest.

That said, examination teams understandably would want to know all the facts as early in the audit as possible. Accordingly, along comes the AOF IDR. While

something akin to the AOF IDR may have been used by exam teams previously, the practice was embraced and formalized by LB&I in early 2016 with the release of Publication 5125, the LB&I Examination Process (LEP), which replaced the Quality Examination Process (QEP), and updates to the relevant provisions in the IRM (4.46.4). Publication 5125 outlined a new examination process that would be issue-based.[3] A core theme of the new examination process is transparency and cooperation by both taxpayers and examination teams, much like the core principles of a Compliance Assurance Program (CAP) audit. In discussing the obligations of the LB&I exam team, Publication 5125 instructs them to "[w]ork transparently in a collaborative manner with the taxpayer to understand their business and share the issues that have been identified for examination."[4] Similarly, Publication 5125 provides that taxpayers (or their representatives) should "work transparently with the exam team by providing a thorough overview of business activities, operational structure, accounting systems, and a global tax organizational chart."[5]

With respect to the acknowledgment of facts, Publication 5125 provides:

> LB&I issue team members are responsible for documenting all the facts that they have secured so that they can accurately apply the law. For potentially unagreed issues, the issue team members are expected to seek the taxpayer's acknowledgment on the facts, resolve any factual differences and/or document factual disputes. The issue manager should ensure that all relevant facts, including additional and/or disputed facts, are appropriately considered before a Notice of Proposed Adjustment is issued. If a case is closed to Appeals and the taxpayer provides relevant new information that requires investigation or additional analysis, the case will be returned to exam's jurisdiction for consideration.[6]

Implementation of this idea is guided by provisions in the IRM.[7] The key element is the pro-forma IDR, which is included in the IRM as Exhibit 4.46.4-3, along with a Form 886-A (*Explanation of Items*) "to solicit the taxpayer's written acknowledgment of the facts on potentially unagreed issues."[8] The initial pro-forma IDR gave the taxpayer three choices for a response:

1. Taxpayer agrees to the facts as written;
2. Taxpayer provides additional relevant facts and supporting documentation; and
3. Taxpayer identifies disputed facts and provides clarification and/or supporting documentation.

The pro-forma AOF IDR updated in December 2018 now allows a fourth response: "Other, please explain." This seemingly minor change may ally some anxiety about the AOF IDR. With the original pro-forma AOF IDR, some taxpayers felt that they had to choose between one of the three original options (agree, provide additional facts, or identify disputed facts). Taxpayers should never have felt bound to pick between only those three and should always have had the ability to respond in whatever manner thought to be appropriate. However, the addition of the "other" option is a welcomed change to the pro-forma AOF IDR.

Both the IRM provisions and the pro-forma AOF IDR itself provide additional information that explains the purpose and use of the AOF IDR. In addition to pointing out the benefits of identifying "all relevant facts necessary to arrive at an accurate tax determination," the pro-forma AOF IDR also references the Appeals policy regarding the presentation of new facts and notes that cases may be delayed if they need to be returned to exam based on new facts introduced at Appeals. The pro-forma AOF IDR also makes explicit that the AOF IDR is not subject to normal IDR enforcement procedures and the prospect for the issuance of a summons,[9] which is a recognition that a response to such a request could not be compelled through a summons. However, and importantly to the strategic considerations discussed below, the pro-forma AOF IDR notes that the taxpayer's "response or lack of response to the IDR will be referenced as part of the final Form 886-A when the Form 5701, Notice of Proposed Adjustment, is issued."

The pro-forma AOF IDR also attempts to alleviate taxpayer anxiety by saying that the taxpayer's response to the AOF IDR "does not indicate agreement to the issue or any proposed tax adjustment." In addition, the pro-forma AOF IDR notes that "[w]hile the interpretation of the law or the amount of the proposed adjustment may be unagreed, all relevant facts should be included in the attached draft Form 886-A."

III. Responding to the AOF IDR

Responses to the AOF IDR can run the full spectrum of completely ignoring the IDR to a full-blown re-write of a comprehensive fact statement. Where along that spectrum your response falls should depend on an assessment of how your response (or various options for responding) will impact the resolution of the potential dispute.

A. Strategic Considerations

1. How Developed Is the Issue?

As a threshold matter, a taxpayer should seek a full understanding of the exam team's legal position prior to responding to

any AOF IDR. Without knowing Exam's legal position, it is difficult to evaluate the relevance or completeness of the factual statement presented. Early in the evolution of the AOF IDR, some exam teams issued AOF IDRs with only the fact section of the draft Form 886-A. This was happening despite the IRM provisions released in March 2016 specifically providing that "[w]ithout an understanding of LB&I's tax position and the law applied, the taxpayer may not have the context needed to ascertain whether all of the relevant facts have been identified for the tax issue."[10] The IRM provisions as revised in December 2018 no longer provide this very helpful and direct statement. The updated IRM provision merely provides that "the draft Form 886-A should be prepared following the format outlined in IRM [section] 4.46.6.11."[11] Those provisions provide that the Form 886-A in all LB&I cases should follow a format that includes (1) Title, (2) Facts, (3) Applicable Law, (4) Taxpayer's Position, (5) Argument, and (6) Conclusion. Although not as express as was provided in the 2016 version of the IRM, these provisions taken together make clear that the draft Form 886-A that accompanies any AOF IDR should include the applicable law and the exam team's argument. Without the full draft Form 886-A, the taxpayer should politely decline to even entertain a response to the AOF IDR until such time as the draft Form 886-A complies with the instructions in IRM pt. 4.46.6.11 and includes a description of the exam team's position.

Taxpayers should also consider what response they may take to the later Form 5701, *Notice of Proposed Adjustment (NOPA)*, which is generally accompanied by a Form 886-A. The Form 5701 includes a request for the taxpayer's response to the proposed adjustment. The IRM requires exam teams to first solicit a response to the AOF IDR before issuing the NOPA.[12] So, which part do you respond to when? The AOF IDR requests a response to the facts while the NOPA requests a response to all aspects of the proposed adjustment. Taxpayers could view this as two-bites at the apple (and respond to both), or they could wait and respond to the NOPA, or they could wait even longer and respond in the protest to the finalized Revenue Agent's Report (RAR). Depending on the taxpayer's perception of the exam team's willingness to drop or narrow the issues will be a major influence on which of these opportunities to respond is in the best interests of issue resolution.

2. Impact on Issue Resolution at Exam

Once the taxpayer has an AOF IDR worthy of a response, the first consideration should be the extent to which you believe the exam team is willing to resolve the issue. The opening provision in the IRM dealing with the AOF IDR provides that the AOF IDR is required for *potentially* unagreed issues.[13] Viewing this statement with the most optimistic lens, that must mean that there are circumstances in which the exam team may drop the issue and a fulsome response to the AOF IDR will help clarify factual misunderstandings that could lead to the exam team actually dropping the issue.

Even if the exam team is unwilling or unlikely to drop the issue, a fulsome response could have some benefits for the taxpayer. In certain circumstances, particularly if the issue is a purely legal one, clarifying factual disputes with the exam team helps streamline and focus the Appeals proceedings. Certainly, if there are substantiation issues (or even hints at substantiation issues), these are issues that are best resolved at the exam level. So, even if exam continues to pursue the issue, the Appeals proceeding is not cluttered with extraneous issues.

3. Impact of Issue Resolution at Appeals

In most circumstances, however, the exam team is likely to pursue the issue in some fashion. In these circumstances, it may be best to view the "real" audience for any response as your Appeals officer or some other decision maker. After all, the IRM (and the pro-forma AOF IDR itself) make clear that the taxpayer's response to the AOF IDR must be included in any final Form 886-A. With that in mind, how fulsome should the response be?

While not responding at all is a viable option (primarily because as noted in the IRM and the pro-forma AOF IDR itself, the IRS cannot compel a response though a summons), not responding could have consequences at Appeals. Could the Appeals discussions (and ultimate settlement if reached) be less fruitful if exam can paint the taxpayer as uncooperative or even obstinate? Of course, certain issues may be bound for litigation (even if not officially designated for litigation) and thus the lack of a response to the AOF IDR is understandable and perfectly appropriate.

Assuming that the taxpayer hopes to resolve the issue at Appeals, some response is probably better than a complete lack of a response. The response need not be substantive but should at least provide an explanation for the lack of a substantive response. This may help rebut any assertion by the exam team that the taxpayer was a "bad" taxpayer. A polite rebuff can be effective, something along the lines of "we understand that the exam team intends to propose adjustment [x] and we will respond accordingly in our protest with any factual corrections or additions at that time." An alternative responsive non-response might be something along the lines of "we provided extensive factual explanations and documentation in our responses to IDRs x, y, and z, which do not appear to be fully incorporated or accurately reflected in the draft Form 886-A." Each of these responses (or something similar) will most likely

prompt requests follow up discussions with the exam team, but it may still be advantageous to have those discussions orally with the exam team rather than in an IDR response. Keep in mind that for some exam teams, such a response may have little or no adverse impact on the relationship with the exam team, but other exam teams may view such responses as an affront to the relationship. Eroding the relationship may impact other issues for which the exam team may not be as entrenched. For all interactions with the exam team, don't lose sight of the forest for the trees.

4. How Much Editing Is Appropriate?

When responding to the AOF IDR, taxpayers need to decide to what extent it will edit the exam team's work. Especially in circumstances (noted above) in which the taxpayer hopes to turn around the exam team and provide a submission that may cause the exam team to drop the issue, the taxpayer may be better off starting from scratch and providing a whole new fact statement with legal analysis much like would be provided in a protest. This has the benefit of framing the discussion and dictating the flow in a manner most beneficial to the taxpayer. It also has the advantage of not editing the exam team's work, which can have more personal or emotional flavor despite what some might say about not having "any pride of authorship." It is hard to know what nerves can be touched when one starts editing someone else's work.

Some edits are simple enough, and some typos can be more important than others (especially when considering dates and numbers). However, even correcting simple errors may not always be in a taxpayer's best interests. If the draft Form 886-A contains clear and incontrovertible errors, and those errors remain in the final Form 886-A, that final Form 886-A forms the basis of the Appeals process and taxpayers can use those errors to undermine the credibility of the exam team.

If the taxpayer does try to edit the exam team's work, there are many sensitivities beyond the personal and emotional ones. The write-ups by exam teams are themselves advocacy pieces. These drafts will often include facts presented in an argumentative manner or characterized in a manner that is favorable to exam's position. Differentiating between a "fact" and a "characterization of a fact" can be difficult. The exam team's draft can sometimes also include statements of law or the exam team's legal position masquerading as a statement of fact. For example, what if the fact statement said that the funds transferred on a certain date constituted a capital contribution when the entire legal issue is whether that amount was debt or equity?

The pro-form AOF IDR, as revised in December 2018, now includes the following admonition: "limit your response to reviewing relevant facts, advising if relevant facts are excluded, and not providing stylistic or editorial changes." What one person may view as a "stylistic or editorial change" may be what someone else believes is necessary to avoid mischaracterizing facts, avoid stating legal conclusions as facts, or make the statement of fact objective rather than argumentative. For these reasons, to the extent the taxpayer edits the fact statement at all, it may be prudent to limit the edits to simple ones. Efforts to provide more extensive editing, no matter how provable, may take up time and resources but lead to no changes in the final Form 886-A. The taxpayer's response will be in the final Form 886-A, but other than getting brownie points for cooperating, there may not be much of an advantage as compared to preparing a wholly new fact statement either in response to the AOF IDR or in the protest.

IV. Conclusion

That AOF IDR appears here to stay. While it started as an LB&I initiative, taxpayers should expect the concept to filter out to all IRS audits. With more experience with this standard IDR, taxpayers are becoming more comfortable formulating responses to this IDR. Rather than being daunted by the IDR, taxpayers can hopefully view the IDR as an opportunity to advance their own strategic goals to resolve the issue. With a thoughtful approach to the IDR response, that can be achieved.

ENDNOTES

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1 IRM pt. 8.7.11.6.3(1) (Sept. 4, 18). For further discussion of AJAC, *see* John Keenan and Colleen Hawkins, *IRS Watch – IRS Issues Implementation Guidance for Phase 2 of the Appeals Judicial Approach and Culture (AJAC) Project*, J. Tax Practice and Procedure, Dec. 3, 2015, and James R. Gadwood, *Appeals Judicial Approach and Culture Project*, J. Tax Practice and Procedure, Sept. 29, 2015, at 31.

2 *Id*.

3 The LEP replaced the prior publication known as the Quality Examination Process (QEP).

4 Pub. 5125, at 1.

5 *Id*.

6 Pub. 5125, at 3.

7 The applicable IRM provisions originally could be found in part 4.46.4.9 but as of December 13, 2018, can now be found in 4.46.4.10.

8 IRM 4.46.4.10.3 (Dec. 13, 2018).

9 For further discussion of the LB&I IDR enforcement process, *see* Charles Rettig, *IRS LB&I Revised IDR Enforcement Process*, J. Tax Practice and Procedure, May 2, 2014, at 19.

10 IRM pt. 4.46.4.9.2(2) (Mar. 9, 2016).

11 IRM pt. 4.46.4.10.2(2) (Dec. 13, 2018).

12 IRM pt. 4.46.4.12 (Dec. 13, 2018).

13 IRM pt. 4.46.4.10(1) (Dec. 13, 2018). The IRM provisions released in 2016 did not specify that the AOF IDR should only be used for potentially unagreed issues, which left open the possibility that an AOF IDR was required for all issues, agreed and unagreed. Some exam teams in fact issued AOF IDRs for agreed issues. The change to the IRM provisions released in December 2018 is a welcome confirmation that an AOF IDR is not needed for agreed issues. An exception, however, to this direction is that the Transfer Pricing

Examination Process (TPEP), released by LB&I in June 2018, providing guidance "consistent with" Publication 5125 for planning, execution, and resolution of transfer pricing examinations. The TPEP describes as a best practice issuing the AOF IDR for all transfer pricing issues whether potentially agreed or unagreed. TPEP, at 27.

