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Client Alert

Tax Practice Group

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New Mandatory Enforcement Process For Information Document Requests in Large Business and International Tax Examinations

On January 2, 2014, the Large Business & International ("LB&I") Division of the Internal Revenue Service began using a new mandatory enforcement process for delinquent information document requests ("IDRs") in tax examinations. The IRS issues IDRs in virtually all corporate audits as its primary means of obtaining business records and information from taxpayers. Compliance with an IDR technically is not mandatory and IDRs cannot be enforced directly. [1] Rather, the IRS must first issue a summons for the same information, which then has to be enforced in federal district court. LB&I's new procedures, outlined in a November 4, 2013 directive ("new directive"), mandate strict, uniform, and swift compliance with IDR response dates, and eliminate the discretion previously possessed by LB&I exam teams to grant extensions to taxpayers who, for whatever reason, could not meet IDR deadlines. Under the new policy, once an IDR deadline passes, the following three-step enforcement process begins: (1) issuance of a delinquency notice; (2) issuance of a pre-summons letter; and (3) issuance of a summons. The new IDR enforcement process is "mandatory and has *no exceptions*."

Due to the inflexibility of and accelerated timeframes outlined in the new IDR procedures, taxpayers under examination should create an evidentiary record that supports the reasonableness of their actions. That record could be useful to a taxpayer in the event of a subsequent summons enforcement proceeding. Taxpayers must also critically assess and evaluate, as soon as possible, their document production capabilities and limitations, and whether they possess: (1) large volumes of potentially responsive electronically stored information and the format of that data; (2) potentially responsive materials housed in multiple locations; (3) potentially responsive information located in foreign jurisdictions; and (4) substantial volumes of privileged documents that may be relevant to issues under examination. Often such information is time consuming to locate, access, organize, review and produce.

The new directive constitutes a significant change in the examination process. The change is especially noteworthy given that innumerable legitimate reasons may account for taxpayer delay in responding to IDRs. Unforeseen but good faith delays are commonplace, for instance, in

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voluminous document productions, as well as in productions involving significant volumes of privileged material. On the other hand, a very small minority of taxpayers simply refuse to cooperate with IDRs and engage in foot-dragging or outright obstruction. LB&I exam teams previously possessed the discretion and authority to distinguish between those extremes and could "consider the issuance of a summons" for failing to comply with an IDR, but they were not required to issue one. The new directive makes clear that the discretion exam teams previously possessed regarding the issuance and enforcement of summonses is now gone. As discussed in the following section, however, the new directive indicates that exam retains a measure of discretion *before* the IDR is finalized and issued. Although that is beneficial, taxpayers who successfully negotiate response dates but concomitantly fail to account for unexpected delays or to document potential concerns could find their ability to challenge a later summons enforcement action undercut.

IDR Requirements

The new directive states that all LB&I examiners must follow a series of steps before they may finalize and issue IDRs. Specifically, Attachment 1 to the new directive sets forth twelve mandatory IDR requirements. Three of these steps were highlighted last year in another directive issued by LB&I that addressed best practices for information gathering in LB&I examinations. That directive, dated June 18, 2013 (the "June directive"), focused on the following items: First, all IDRs must identify and state the issue that led the examiner to request the information included in the IDR. Second, the examiner must discuss the IDR with the taxpayer in advance of issuing it. And third, "both parties must *discuss and determine a reasonable timeframe* for response."

The fact that both parties must discuss and determine a reasonable timeframe for response makes clear that exam teams still possess discretion—as they have had in the past—before the IDR is issued. It thus provides taxpayers with some flexibility in negotiating response dates, and allows examiners to take into account the taxpayer's unique circumstances. Taxpayers should be cognizant of the location and type of potentially responsive information, and should determine whether potentially privileged information might be implicated, before agreeing to IDR response deadlines. Taxpayers also should understand possible production issues and logistical complexities, and should clearly document and convey all of their concerns and challenges to the exam team. If the parties cannot agree on timeframes following these discussions, however, the new directive indicates that the exam team possesses unilateral discretion to "set a *reasonable* response date for the IDR." Before the IDR is finalized, the exam team must provide a draft of the IDR to the taxpayer. In the event the exam team does not comply with any of the required IDR steps, that fact should be addressed immediately, both at the exam level and higher, if necessary.

Taxpayers who are able to negotiate response dates successfully, as well as to clarify the scope and terms of an IDR, may be asked to enter into a memorandum of understanding (MOU) memorializing those agreements.[2] Taxpayers should be wary of doing so (unless the MOU provides for unexpected delays, a possibility likely foreclosed by the new directive) for a number of reasons. First, the IRS has unilaterally terminated MOUs in the past. The June directive, for instance, simply declares that "existing" MOUs relating to IDR management that do not comply with LB&I's new policies "are no longer effective." MOUs thus offer taxpayers thin assurance. Second, taxpayers who successfully negotiate response dates, memorialize those in writing, but then experience unexpected delays and fail to meet the agreed upon timeframes, are stuck with the response dates in the IDRs and will receive a delinquency notice (described below), even if circumstances were unforeseen or otherwise beyond the taxpayers' control and all other objective indicia demonstrate that the taxpayer acted reasonably. Taxpayers in that situation will have voluntarily consented, in writing, to production dates that they can no longer meet, which may hamper their ability to seek redress from senior executives within IRS during the IDR enforcement process. Finally, and most importantly, in the event of a subsequent summons enforcement proceeding the MOU could be viewed as an admission by the taxpayer that the original response dates were reasonable. Thus it could be used to undermine the taxpayer's ability to contest a summons and/or obtain additional time to produce the information before the imposition of judicial sanctions.

Three Step IDR Enforcement Process

1. Delinquency Notice

In the event a taxpayer fails to provide a "complete response" to an IDR by the response date stated in the IDR, the exam team must issue a delinquency notice (Letter 5077). The IDR directive does not define "complete response," which may be interpreted differently by different exam teams. The exam team is required to discuss the delinquency notice with the taxpayer before issuing it. They must tell the taxpayer what information they believe is missing from the IDR response, as well as the consequences for missing the next response date and, once issued, must provide a copy of the delinquency notice to IRS counsel.

The exam team must issue the delinquency notice within 10 calendar days of the original IDR response date and must include a new response date. The new response date cannot be more than 15 calendar days from the date of the delinquency notice. The exam team has no ability to extend the response date beyond 15 days. Only a Territory Manager may, in rare but appropriate circumstances, authorize a longer response period. Taxpayers who anticipate or encounter production delays should elevate those concerns to a Territory Manager immediately—and certainly before missing the response date. According to a November 22, 2013, statement by Heather Maloy, IRS LB&I Division Commissioner, taxpayers won't be able to avoid a delinquency notice if they miss the original IDR deadline. Examination teams may begin issuing delinquency notices to taxpayers who miss IDR response dates starting on February 3, 2014.

2. Pre-Summons Letter

Second, if a taxpayer fails to provide a complete response to the IDR by the response date in the delinquency notice, the exam team must issue a pre-summons letter (Letter 5078), signed by a Territory Manager. Before issuing the pre-summons letter, the exam team is required to discuss it with the Team Manager, Specialist Manager, the respective Territory Managers and IRS counsel. A Territory Manager must then discuss the pre-summons letter with the taxpayer.

The exam team must issue the pre-summons letter "as quickly as possible," and no later than 14 calendar days after the due date of the delinquency notice. The pre-summons letter must be addressed to an individual who is a level of management above the person that received the delinquency notice. It must include a new response date that is generally 10 calendar days from the date of the pre-summons letter. Neither the exam team nor the Territory Manager has the ability to extend the response date beyond 10 days. Only a Director of Field Operations may, where exceptional circumstances warrant, authorize a longer response period. Taxpayers who cannot produce documents by the delinquency notice response date should notify a Director of Field Operations before missing the deadline.

3. Summons and Summons Enforcement

Finally, if the taxpayer fails to provide a complete response to the IDR by the response date in the pre-summons letter, the exam team must issue a summons. Before issuing a summons, the exam team is required to discuss it with the Team Manager, Specialist Manager, the respective Territory Managers, the Director of Field Operations, and IRS counsel. The exam team must then "coordinate the issuance of the summons" with IRS counsel. Once begun, the summons enforcement process moves quickly within the IRS. After IRS counsel receives a request from the exam team for enforcement of a summons, they ordinarily review and refer the case to the U.S. Department of Justice for judicial enforcement within six workdays.

Summons enforcement actions are public proceeding that are litigated by U.S. Department of Justice lawyers from either the Tax Division or the U.S. Attorney's office in federal district court. Because the government must establish the relevance (broadly defined) of the summoned information, the petition for enforcement will contain background information, descriptions and explanations of the information sought, and inevitably involves the disclosure of previously confidential tax information. Attorneys at the Department of Justice have discretion over whether and how to enforce summonses. Taxpayers may be able to negotiate with DOJ lawyers to work through logistical issues and to obtain additional time to produce records if they can demonstrate that they acted reasonably. In the event the number of summons enforcement actions significantly increases due to the new IDR enforcement process—adding further strain to DOJ's limited resources—that may enhance taxpayer opportunities for post-referral cooperation with DOJ attorneys. Following judicial enforcement of a summons, any taxpayer who fails to provide the summoned information promptly may be subject to civil contempt, and possibly even criminal prosecution.

According to the June directive, the IDR best practices are meant to complement the IRS's goals of making the process more "efficient," and creating "less need to enforce IDRs though summonses," presumably by conserving the government's scarce resources for use in the most egregious cases. Yet this assumption is unsupported in the guidelines and is potentially belied by the reality that rigid, inflexible timetables for enforcement likely will result in referrals to the Department of Justice that would never have been made, but for the new procedures.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

[1] Although taxpayers are not necessarily required to comply with IDRs, by statute they still must maintain records sufficient to substantiate items reported on their federal income tax returns and, under most circumstances, bear the burden of proving that an IRS determination is erroneous. *See e.g.*, I.R.C. §§ 6001; Treas. Regs. 1.6001-1(a), (e); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). Additionally, taxpayer representatives may have independent obligations requiring them to furnish information requested by the IRS. *See e.g.*, 31 C.F.R. § 10.20 ("A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.").

[2] A model MOU can be found in the I.R.M. at § 4.46, Exhibit 4.46.4-2 (11-25-2011).