CORPORATE COUNSEL

What to Do When the IRS Comes Knocking

A 'To-Do' List for Facilitating a Smooth and Robust Audit Defense

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It's no secret that IRS resources have shrunk significantly in recent years. Nonetheless, the IRS still managed to audit around ten percent of large businesses in 2016. (Internal Revenue Service Data Book, 2016, Publication 55B, Washington, D.C., March 2017). Despite dwindling IRS resources, businesses are likely to find themselves the subject of an IRS audit at some point in their life cycle. Given this inevitability, company executives would be well-advised to implement and institutionalize certain protective procedures that can mitigate the potential consequences of an audit. With this in mind, this article sets forth a list of actions a company can take to facilitate a smooth and robust audit defense.

Establish Sound Recordkeeping Policies

When it comes to a tax audit, don't expect the IRS to just take your word for it. Although it's neither cost-effective nor prudent to retain all documents indefinitely, a company that does not retain or prematurely destroys pertinent documents will likely find an IRS audit to be an uphill, if not impossible, battle. To address these competing interests, companies should develop a comprehensive written policy for the retention and destruction of documents.

The recordkeeping policy should include specified time periods for retaining particular types of documents and comply with applicable federal and state legal requirements. At the conclusion of these specified periods, the records should be promptly destroyed absent a litigation hold. It is equally important that the policy have teeth in its application. In particular, companies should put procedures in place to prevent unauthorized destruction of documents and should hold accountable those who violate the policy.

With respect to tax-related materials, the specified time periods for records retention should meet the required retention periods set forth in IRC § 6001 and Treas. Reg. § 1.60011. Generally speaking, tax-related records must be stored as long as they are "material," which is generally considered to be at least as long as the statute of limitations remains open for the year(s) to which the records apply. However, the required retention period could be longer in certain circumstances.

Issue a Litigation Hold

Upon receipt of an audit notice, a company should issue a litigation hold. The hold should specify the issues under audit, the need for confidentiality and the different types of litigation that could result. Besides preserving relevant evidence, it should help establish the applicability of the work-product doctrine going forward.

Gather Relevant Information

Once the audit issues and years have been determined, a company should begin identifying employees with pertinent information, conducting preliminary interviews and documenting those interviews in memorandum format. To ensure maximum work-product protection, the memoranda should note that litigation is anticipated (e.g., by a "Privileged and Confidential Work Product" legend) and should weave in thoughts, impressions and opinions. If the memoranda are protected by attorney-client privilege, that should also be noted with an appropriate legend. To the extent these interviews reveal the existence of potentially relevant documents, the company should ascertain where they are stored and endeavor to extract the documents from those places.

Once extracted, the company should consolidate both the witness interview memoranda and the extracted documents into one segregated location that is searchable through an electronic database. As part of its employee interview and document review process, the company should also identify former employees and significant third-parties, including contractors and business partners whose knowledge of facts pertaining to the audit issues are potentially relevant. If the issue is important enough, the company is well-advised to reach out to these individuals in advance to find out what they know, get a sense for their friendliness or hostility to the company and/or its audit position, and what, if any, documents they may have that are not already contained in the company's own database.

Get Organized

After consolidating its relevant documents, the company should review the database for critical documents. This includes records of pertinent transactions, favorable factual documents to highlight for the IRS, negative factual documents that may need an explanation, background documents that provide context, tax accrual work papers and legal advice. The database should be searchable and grouped together in a logical order (e.g. by issue and/or type of document). Particular care should be given to segregating opinion letters, tax accrual work papers, legal advice, and any document arguably created in anticipation of litigation since these documents will need to be further reviewed to determine if they are protected by the attorney-client, work product, or IRC § 7525 tax practitioner privileges.

Once the database has been organized, the company should create a numbering system that tracks each document. By taking time to get organized at the outset of the audit, a company can greatly reduce its risk of inadvertently providing unfavorable or privileged documents to the IRS down the road.

Assemble the Audit Team

The IRS's tool of choice for collecting information about a taxpayer is called an Information Document Request (IDR). Based on the potential frequency and volume of information that could be transmitted via IDR, it is imperative that the company identify a point person for these requests and responses. This point person should, in corroboration with the rest of the audit team, devise procedures for tracking information concerning each IDR. This information should include a copy of the IDR, the date it was issued, the date the company responded, and the documents produced in that response. If privileged documents are withheld, a privilege log should also be kept with this information.

In addition to appointing someone to track IDRs, a company subject to audit should identify its primary representative to the IRS. The decision about whom to appoint as the face of the company in an audit should be based largely on when and how the audit is likely to be resolved. To the extent the issues involve pure substantiation likely to be resolved at the audit level, the company may designate its tax department or retain an outside accountant or counsel. The calculus of this decision changes when fraud, criminal, or privilege issues are involved and/or the audit appears headed toward litigation. In these cases, the scale tips heavily toward retaining outside counsel. In some instances, particularly where relations are good with the audit team, it may be advisable for outside counsel to "remain behind the curtain" for a time while the parties attempt to reach agreement. However, where an issue is of particular technical or even procedural complexity, the introduction of experienced counsel as the face of the audit can often facilitate a more efficient (and less painful) resolution.

Even if the audit is led by the tax department or an accountant, outside counsel should be consulted early and often. Otherwise, the company risks implementing a strategy at the audit stage that will ultimately be inconsistent with its strategy at the litigation stage should the matter get that far.

Negotiate a Reasonable Audit Plan

Once a company has its documents and audit personnel in place, it should proactively make contact with the IRS through its representative. During this meeting, the company should inquire into the number of issues under audit, negotiate the information necessary for each one, ask for all information requests to be in writing and designate the person within the company to whom the IRS should direct its IDRs. The company should also request the opportunity to review proposed IDRs in draft form prior to issuance and negotiate a reasonable timeframe in which to respond.

Tailor the IDR Responses

The company, through its representative, should carefully scrutinize the draft IDRs it receives. Each should relate to only one issue. For each, the company should elicit an explanation of why the requested documents are necessary. Additionally, if the request is ambiguous or incomplete, the company's audit response team should consider whether a narrow or broad interpretation of the request is in the company's best interests.

The company should carefully review its productions to the IRS before transmittal. In particular, it should subject each proposed production to a rigorous privilege review process. If privileged documents are identified, the company should prepare a detailed privilege log specifying the documents over which it will claim privilege. The privilege log should be transmitted to the IRS as a supplement to the production.

All documents transmitted to the IRS should be numbered and tracked. Because it is unlikely that all documents in a company's numbered audit database will be transmitted, and because the disclosure of that numbering system could give away the company's characterization of particular documents, a separate numbering system should be created for IRS productions.

Get as Much as you Give

Although audits may have the appearance of being a one-way flow of information from the company to the IRS, it is equally important to consider the audit process as an opportunity to learn about the other side's position. Among the things companies can learn from an audit are the IRS's interest vs. focus, known vs. unknown facts, considered vs. overlooked legal theories, and the involvement, if any, of IRS counsel and/or the IRS National Office (signifying the larger importance of the issue that may transcend the company's particular case).

Prepare Employees For Interviews

Although there are situations where employee interviews are actually in the company's best interest (i.e. to reduce the scope of intrusive IDRs), it is generally best for a company to avoid, or at least limit, these interviews. Sometimes this can be achieved by negotiating written responses to IRS questions. However, the IRS has become increasingly insistent in recent years on conducting actual interviews.
Where interviews appear inevitable, the company should consider negotiating the type and scope of these interviews. Regardless of the forum, the witness must be sufficiently prepared. The witness should be briefed on likely interview conditions, including the length, location and recording measures. If the revenue agent allows for informal interviews, the company should consider making logistical requests that will provide comfort, e.g. familiar room, comfortable chair, comfortable timing, etc.

The witness should be educated on the case. It is prudent to go over the chronology, the players and the relevant audit issues. The witness should also be educated on the IRS's objectives. These may include learning or confirming facts, locating new sources of documentation, obtaining admissions, assessing the

witness' credibility, evaluating the strength of the company's case, testing existing and potential theories and establishing the company's intent for criminal or fraud penalties reasons. The witness should be sensitized to the process. He or she should be cautioned about body language and prepared to answer standard questions about personal background, employment history, interview preparation, discussions with others, and documents personally retained or reviewed. Moreover, the witness should be taught the difference between personal knowledge and speculation, and instructed to not speculate or filling dead space or awkward pauses. Above all, he or she must understand the need to tell the truth at all times.

Evaluate the Pros and Cons of Forcing a Summons Dispute

Throughout the audit process, companies should be mindful of IRS threats to enforce informal document and interview requests through the summons process. Summons enforcement proceedings can be costly to defend, intrusive on executives' time and company resources and expose the company to unwanted publicity. However, that does not mean that the threat of a summons should necessarily push the company toward disclosures.

A company would be prudent to enlist outside counsel to advise on whether to comply or challenge IRS requests in the context of a consequential summons enforcement proceeding. It goes without saying that strategic decisions such as this, like all others in the audit process, should always be the byproduct of thoughtful deliberation. The large number of decision points that arise during the course of a typical audit punctuates the importance of having a clear understanding of the strengths and weaknesses of the company's position, a well thought out strategy to pursue the course of action likely to lead to the best possible outcome and experienced professional guidance in navigating a minefield of potential disasters.

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Companies with U.S. tax obligations are always one transaction away from a dreaded IRS audit. This is a fact that cannot be changed as long as the tax laws are primarily responsible for funding the government fisc. However, by committing to the implementation of the foregoing actions, both in advance and during a tax audit, companies can prepare for and facilitate a smooth and robust audit defense.

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