The IRS LB&I's New Document Request Process, 18 Months Later

How It Works, and How to Make It Work

By Caroline Rule

On February 28, 2014, the IRS Large Business and International Division (LB&I) issued a directive, LB&I-04-0214-004, setting forth how LB&I intended to fundamentally change its procedures for issuing information document requests (IDR) (IRS Form 4564). The 2014 directive, following two 2013 directives on the same issue, went into effect on March 3, 2014. It provides that 1) draft IDRs will be discussed with taxpayers before final IDRs are issued, and 2) if taxpayers do not timely comply with the ensuing IDRs, enforcement through the issuance of summonses is mandatory. It should be noted that, while the 2014 directive is to be followed by all LB&I employees, it does not confer substantive rights on taxpayers.

LB&I's New Policy: Effective or Disruptive?

Tax professionals were initially concerned that the new procedures would result in an upsurge in the number of summons enforcement proceedings. Instead, the 2014 directive's provision for upfront discussions between taxpayers and examiners before an IDR is issued appears to be streamlining the IDR process.

According to the IRS, all LB&I agents and chief counsel have received training on the new procedures. LB&I generally examines wealthy individuals, partnerships, S corporations, and corporations with assets greater than $10 million. These taxpayers often face complex issues of tax law and accounting principles; to simplify matters, the 2014 directive provides that an IDR must focus on a single issue. The IDR must specify the books, papers, records, or other information requested, as well as the activity and time period involved. (Note that an IDR issued at the start of an examination, requesting basic books, records, and general information about a taxpayer's business, is not subject to the single-issue requirement.) The examiner should ensure that the IDR is customized to the taxpayer or industry, and must use numbers or letters on each IDR for clarity.

The 2014 directive provides that "meaningful communication between the IRS and taxpayers in advance of an IDR being issued is essential." These pre-IDR discussions permit the IRS to manage its examiners' time, provide for reasonable estimated closing dates, and reduce wasted time while agents wait for information. According to the directive, "taxpayers will be better able to manage their tax department resources with focused IDR requests that have reasonable time frames."

The 2014 directive predicted that "when both the IRS and taxpayers engage in robust, good faith communication in advance of an IDR being issued, enforcement procedures will be needed only infrequently." This prediction has apparently been borne out. The new procedures have now been in place for 18 months, and tax professionals are encouraged by the increased communication engendered between taxpayers and examiners.

Procedures

The 2014 directive provides that, during the early stages of an audit, an examiner should identify the auditable issues, explain how the information requested relates to an issue to be considered, and discuss why the information is necessary. The examiner will then prepare a draft IDR with no return date listed. Following further discussions with the taxpayer on substantive issues, the examiner will consult with the taxpayer to determine a reasonable time frame for a response to the IDR. If—and only if—an agreement cannot be reached, the examiner will unilaterally set a response date. The examiner will also commit to a date by which the examiner will inform the taxpayer whether the information provided satisfies the IDR.

Once set, timetables are strict. An examiner may grant one extension of only 15 days; after that, an enforcement process begins with a delinquency notice, which generally includes a response date of no more than 10 days. If the taxpayer does not respond, a presummons letter is issued, again with a response date of no more than 10 days. Finally, if a taxpayer does not respond, a summons will be issued (although there is no set timetable for its issuance).

The Pre-IDR Stage

Communication between examiner and taxpayer *prior* to issuance of an IDR is key to the success of the new process. Once the IDR is issued, its firm time frames allow the examiner less flexibility. The early stage of an audit presents an

opportunity for a taxpayer to educate an examiner as to the taxpayer's perspective on an issue, and allows the taxpayer to try to set realistic timelines for the audit. Now that an examiner is required to specifically tailor IDRs, there should be fewer broad generalized IDRs; nevertheless, once notice of examination has been issued, it is to a taxpayer's advantage to seek representation from a professional with ample experience in dealing with LB&I.

As per the 2014 directive, an examiner should ensure that the IDR is customized to the taxpayer or industry. To facilitate this, a taxpayer should address each issue under audit, citing relevant law, in order to have a meaningful voice in formulating the IDR. The taxpayer should also be prepared to educate the examiner about the taxpayer's document retention system and how long it will reasonably take to gather the requested information.

Taxpayers should be realistic about how long it will take to identify relevant documents and records from its data repositories, perform any necessary privilege review, and undertake any work needed to render the records understandable to the examiner. A taxpayer may discuss these issues by meeting with or writing to the examiner. Prior to the 2014 directive, IDR due dates were much more arbitrary, and often caused tension between examiner and taxpayer.

The pre-IDR stage of the proceedings sets the tenor of the examiner-taxpayer relationship throughout the audit, and a taxpayer should strive to establish a good working relationship with the examiner up front.

Nevertheless, a taxpayer should keep memos describing all meetings or conversations with the IRS examiner in order to establish a factual record that may be forwarded to an IRS manager if there is a disagreement with the examiner.

It is up to the taxpayer to be proactive— the taxpayer should begin to gather requested information upon receipt of the draft IDR. There is no due date at this stage, so a taxpayer can take advantage of any additional time, even if the taxpayer intends to persuade the examiner to revise the final IDR by, for example, suggesting alternate clarifying language.

Upon receipt of the draft IDR, a taxpayer should make sure that it concerns only a single issue and is written in "clear and concise language," as required by the 2014 directive. The discussion of the draft IDR and issuance of a final IDR should be completed within 10 business days.

Requesting an Extension

Although the examiner has the authority only to issue an extension of up to 15 days for a taxpayer to remedy an untimely or incomplete response, this additional time can be crucial. Consequently, a taxpayer should remain in contact with the examiner while collecting documents and let the examiner know of difficulties as they arise. This will lend credibility to any extension request. When seeking an extension, a taxpayer should identify the outstanding information, document efforts to retrieve the information, and indicate the amount of time needed to complete production.

An examiner may grant only one extension with respect to the same IDR, in two situations:

- *When the taxpayer fails to respond.* Within five business days of a failure to respond, an examiner will discuss with the taxpayer the cause of the failure and determine if an extension is warranted; or
- *When the taxpayer provides an incomplete response.* In this case, an examiner will, also within five days, discuss with the taxpayer why the response is not complete and determine whether an extension is warranted.

If granted, an extension period begins when the extension determination is "made and communicated" to the taxpayer. The 2014 directive suggests that this determination should be made within five days of the original due date. While an oral communication from the examiner granting an extension is sufficient, a taxpayer would be wise to request that the extension be documented in writing.

> **The pre-IDR stage of the proceedings sets the tenor of the examiner-taxpayer relationship throughout the audit.**

The Enforcement Process

An examiner should be held accountable for meeting the deadline for communicating to the taxpayer whether the IDR response was satisfactory, as this affects the 2014 directive's enforcement process. (If the IDR is complete, the taxpayer must be notified of this fact and the IDR is closed.) If the taxpayer does not provide a response by the IDR due date, or if the response is unsatisfactory, the examiner should discuss these issues with the taxpayer within five business days.

If a dispute arises as to whether the IDR response is complete, taxpayers should make their case concerning why the response is complete, and why they believe an examiner's expectations are unrealistic. If the dispute involves claims of privilege, taxpayers should make sure that the claims are properly documented with a privilege log. When appropriate, taxpayers should elevate the issue to an examiner's superiors (i.e., if the examiner is uncooperative or unreasonable).

The enforcement process under the 2014 directive begins either on the date when a decision denying an extension is communicated to the taxpayer or on the extended due date. Taxpayers, however, have additional opportunities to respond to an IDR before a summons is issued. The next steps in the enforcement process, the delinquency notice (IRS Letter 5077) and the pre-summons letter (IRS Letter 5078), both allow up to an additional 10 days to respond, so taxpayers will have additional time before a summons is issued.

Prior to issuing the delinquency notice, an examiner should explain to the taxpayer that the letter will be forthcoming, and explain the next steps if the taxpayer fails to respond. The delinquency notice is signed by the team manager, and will be issued to the taxpayer within 10 days of the beginning of the enforcement process. The delinquency notice will include a response date that is generally no more than 10 business days from the date of the notice. Any extension beyond 10 business days must be approved by the territory manager. A copy of the delinquency notice and the IDR will be provided to IRS counsel.

If a taxpayer does not satisfactorily respond to the delinquency notice, the examiner will discuss the taxpayer's lack of response with the IRS team manager, specialist manager, territory manager, and counsel before preparing the pre-summons letter. The appropriate territory manager must discuss the letter with the taxpayer. The pre-summons letter will be issued as quickly as possible, generally no later than 10 business days after the due date of the delinquency notice. The pre-summons letter will include a response date that is generally within 10 business days—any extension must be approved by the director of field operations. A copy of the pre-summons letter and the IDR must be discussed with IRS counsel. The letter should be sent to a taxpayer management official who is at the level equivalent to the LB&I territory manager, such as a managerial official at the taxpayer whose position is above that of the official to whom the delinquency notice was addressed. This hierarchy will not apply if the taxpayer is an individual.

If the information requested in the IDR is not provided by the response date established in the pre-summons letter, the territory manager will explain the next step in the enforcement process (i.e., issuance of a summons), to the taxpayer.

Continuing the Negotiation Process

The issuance of a summons does not end the negotiation process. An IRS administrative summons may be issued to compel a taxpayer to produce information, in the form of existing documents or testimony or both. Note that the scope of a summons may be narrower than an IDR, since an IDR may require a taxpayer to create documents or to provide written explanations of its business, which a summons cannot do.

Despite the training that examiners have received, summonses for testimony have been issued without discussion with taxpayers or without the issuance of an IDR, on the grounds that "testimony" does not fall within the definition of information covered by the 2014 directive. If this occurs, a taxpayer should take the issue to a higher level within the IRS.

Avoiding Going to Court

A taxpayer is only required to respond to a summons if ordered to do so by a court. There is likely to be a lengthy time between issuance of the summons and its enforcement by a federal district court, however; this can take anywhere from six months to one year to complete. This provides a taxpayer with additional time to try to resolve issues arising from an IDR. For example, if response time is the issue, a taxpayer can contact the IRS and indicate that it is willing to comply, but needs additional time to do so.

Even if a summons is issued under the 2014 directive's enforcement process, an IRS examiner must persuade her superiors that the summons should be enforced. The IRS Chief Counsel must agree, and then the Department of Justice—which may not have the available resources—must agree to litigate the enforcement action.

If the Department of Justice takes the matter to court, however, and the court orders enforcement of a summons, a taxpayer's refusal to comply may result in contempt sanctions. Consequently, a taxpayer should make all efforts to satisfy the summons before enforcement proceedings are brought.

The 2014 directive provides that if a taxpayer indicates that the requested information will not be provided without a summons, the enforcement process does not apply, and the IRS should move directly to the issuance of a summons.

A taxpayer may oppose a summons in court, but defeating a summons is a daunting challenge that is beyond the scope of this article. In the seminal case of *U.S. v. Powell* [379 U.S. 48 (1964)], the Supreme Court held that an IRS summons is valid if the following four conditions are met:

- It is issued for a legitimate purpose.
- It seeks information that may be relevant to that purpose (with a low standard of relevance).
- It seeks information not already in the IRS's possession.
- It satisfies all administrative steps required by the Internal Revenue Code (IRC).

Failure by the IRS to follow the procedures of the 2014 directive is unlikely to be held to violate the last element of the *Powell* test. In *U.S. v. Artex Risk Solutions Inc.* [114 AFTR 2d 2014-5956 (N.D. Ill. Sept. 11, 2014)], the court held that one of the earlier two 2013 LB&I directives on this subject was addressed to IDRs, not to the enforceability of a summons, and thus did not fall within *Powell*'s fourth requirement. In addition, the court pointed out that the directive at issue stated that it "is not an official pronouncement of law and cannot be used, cited, or relied upon as such." The 2014 directive contains the same language and it is likely to be treated the same way by the courts.

Making it Work

The new LB&I IDR procedures allow taxpayers greater input into the content and timing of IDRs than before—but if the IDRs are not complied with, the trade-off is that summonses will be issued. ❑

***Caroline Rule, JD,** is a partner at Kostelanetz & Fink, LLP, in New York, N.Y.*