

# Managing IRS Examinations: Large Business and International Taxpayers

A Discussion of the New LB&I Structure and its Impact on Audits

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Managing the IRS examination process can be intimidating for any business. Understanding how LB&I selects companies for examination can be as important as understanding what a company must do to prepare after being selected. In this paper we provide an overview of the IRS LB&I organization, its processes for examination selection, what a company can do to prepare for the examination and understanding the various resolution modeling options available to the taxpayer.

## Overview of LB&I

Since the overall structure of the IRS was reorganized around the year 2000, the Large and Mid-Size Business Division has been the division that focused on corporations and partnerships with more than \$10 million in total assets reported on the balance sheet in their income tax returns. Recently, due to an increased emphasis on international matters, the scope of this division has been changed as has its name, which is now the Large Business and International (LB&I) division. In addition to dealing with large and mid-size businesses, the division now houses all things international for the IRS; to emphasize the growing importance of IRS's international focus it has its own separate Deputy Commissioner, International (LB&I).

LB&I divides its constituency into six groups of industries, each of which is headed by an Industry Director, who reports to the Deputy Commissioner (Operations, and the Commissioner of LB&I). The first five "industries" listed below were the original ones. Within the last two years, the sixth (Global High Wealth) was added.

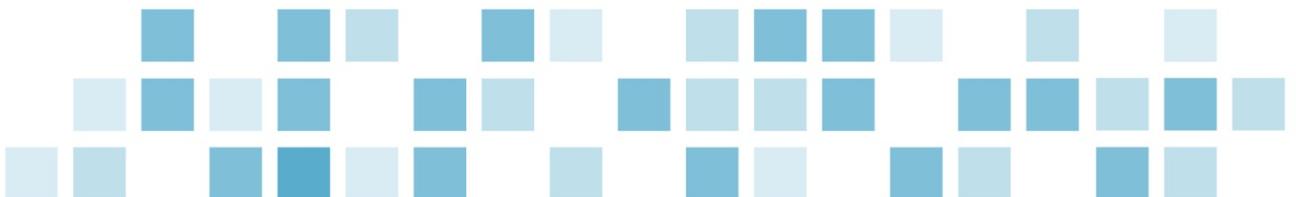
- Financial services (banks, credit unions, insurance, etc.)
- Communications, technology and media (telecom, television, high tech, etc.)

- Natural resources and construction (oil and gas, mining, heavy construction, etc.)
- Retailers, food, pharmaceuticals and healthcare (as named)
- Heavy manufacturing and transportation (all things automobile-related, airlines, railroads, trucking, etc.)
- Global high wealth (centralizes and focuses IRS compliance expertise involving high-wealth individuals and their related entities, and can often have an international component).

Each Industry Director has two Directors of Field Operations (DFOs), one for the East and one for the West. The DFOs and their several Territory Managers oversee the activities of the Team Managers and their audit teams in the field that actually conducts the audits. Depending on various factors, an audit is either a Coordinated Industry Case (CIC) or an Industry Case (IC). In general terms, a CIC case involves a very large taxpayer with complex issues, some of which are international issues, where a team of Revenue Agents and usually some number of Specialists audit a taxpayer on a continual basis at the taxpayer's site. Today, there are only around 800–900 CIC cases; the other LB&I audit cases are IC cases. Usually an IC case audit is conducted by one or two Revenue Agents; the audit lasts nine months or less, and the taxpayer is not audited again for a number of years.

The enforcement activities of these six industries are supported by personnel in the Pre-Filing and Technical Guidance (PFTG) function and the Field Specialists function. The former group has Technical Advisors that are the LB&I experts in an industry, an issue or a code section, and they serve as consultants to LB&I audit teams. PFTG personnel initiate and monitor nationwide coordination of issues that cross industry lines and act as consultants to provide assistance on these issues to examination teams. These personnel also serve as team members on task forces that design LB&I programs and processes, and along with their dedicated Counsel from the Office of Chief Counsel and others, they stake out LB&I positions on complex emerging issues. Field specialists, on the other hand, include computer audit specialists, engineers, economists, employment tax specialists, etc., and they become members of LB&I audit teams on a referral basis, if such expertise is deemed needed for a particular audit.

LB&I's Deputy Commissioner, International has divided that organization into four basic groups. One group focuses primarily on transfer pricing matters, which is a major focus of the international organization. Another group focuses on cross-border coordination of international issues, negotiates double taxation relief with authorities from other countries, and issues Advance Pricing Agreements that provide relief from double taxation on an advanced, or pre-filing, basis. Due to the nature of the work done by these two groups, their personnel often work together on specific taxpayer matters. The other two international functions focus on compliance, with one group focusing on individual compliance and one on business compliance. These last two



groups will attend to the Qualified Intermediary program, withholding tax, nonresident alien tax returns, providing certificates of residency, etc.

LB&I's "law firm" is the Office of Chief Counsel. The IRS website, [www.irs.gov](http://www.irs.gov), provides the following overview of that office:

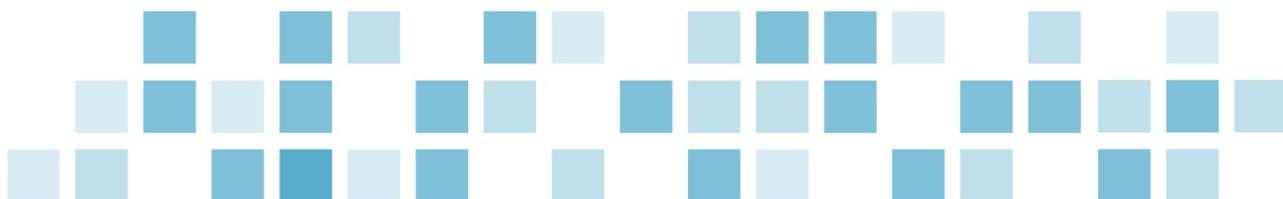
The Chief Counsel is appointed by the President of the United States with the advice and consent of the U.S. Senate. As the chief legal advisor to the IRS Commissioner on all matters pertaining to the interpretation, administration and enforcement of the Internal Revenue Laws (as well as all other legal matters) the Chief Counsel provides legal guidance and interpretive advice to the IRS, Treasury and to taxpayers.

The IRS Chief Counsel reports directly to the General Counsel of the Treasury. While many of Chief Counsel's National Office attorneys write regulations, revenue rulings and procedures, letter rulings, etc., many other attorneys are directly aligned to operational functions within the various IRS divisions. While these attorneys have line authority to and from IRS Chief Counsel, they are paired with LB&I individual personnel or functional groups on a dedicated basis. For example, the Commissioner of LB&I is served by the LB&I Division Counsel, each Industry Director has an Industry Counsel, each Technical Advisor in PFTG has a dedicated counsel that specializes in the advisor's technical area, and so forth. LB&I's Division Counsel has a staff of attorneys that provide legal expertise in various subject areas, and each Industry Counsel oversees the activities of the field counsel that align with audit teams along industry and geographical lines and assist the audit teams in various ways.

LB&I is currently focusing on five strategic initiatives:

- Identifying and addressing abusive tax avoidance transactions
- Examining compliance risks for global transactions
- Reengineering and institutionalizing issue management strategies and processes
- Managing compliance information
- Managing human capital

In pursuing those initiatives, LB&I will continue to examine "tiered issues," "listed transactions" and "transactions of interest." Key elements in delivering on the initiatives will be coordination, consistency and collaboration. Standardized programs, processes and procedures, such as pattern information document requests (IDRs) and pattern settlements will be used. A more collaborative process, with the use of issue management teams and issue practice groups to develop and resolve issues, will be employed. LB&I will continue to involve IRS Counsel, with an emphasis on the Quality Examination Process (QEP). The enhanced focus on



international issues will be highlighted by increased international examiner staffing and better coordination with foreign jurisdictions.

### **Examination Selection Process for LB&I: How returns are selected**

LB&I uses several risk analysis systems and tools to determine which returns are examined. Some electronic screening systems, e.g., DAS and AICS, rely on the use of taxpayers' historical return data. Other systems rely on the analysis of information collected from e-filed returns and such forms and schedules as Form 8886 for Reportable Transactions, Forms 8275 and 8275-R used to acquire accuracy-related penalty protection and the new Schedule UTP. In addition, there are check-the-box questions on returns, such as, for example, Form 1120, Schedule B, question 10, which asks whether a position was taken relative to Sec. 118, contributions to capital by a non-shareholder (which is a tiered issue). There are also issues identified through National Research Projects which might be evident from information on returns and that add to the decision to examine a return.

Publicly available information is also used in performing risk analyses. This would include SEC filings that contain financial statements, FIN 48 tax disclosures and other footnote disclosures, as well as other available SEC information about restatements and sanctions. The IRS also looks at press coverage. While at one time this involved IRS personnel clipping and filing news articles, currently it involves online research, examining company websites, announcements of M&A activity and lawsuits, and settlements reported in the press.

Through the processes described in the preceding two paragraphs, the IRS is looking for hints or outright evidence of certain strategic issue areas, as well as general tax risk, in a return. The most provocative issues include:

- Tax Shelters. These are areas the IRS cares about because of the possibility of illegally sheltering or evading U.S. tax.
- Reportable Transactions. These are required to be reported on Form 8886. Listed transactions are reported, as well as other reportable transactions that may be indicative of the existence of tax shelters.
- Tier One issues. The presence of one of these issues (e.g., the research and experimentation credit) could be the sole reason for being selected for examination.
- Transactions of Interest. While not very common these days, these are transactions being studied by the IRS to determine if they are abusive and should be classified as listed transactions.
- Transactions reported on Form 8275 and Form 8275R. These are transactions disclosed by a taxpayer in order to acquire protection from an accuracy-related penalty, either because of the low level of authority that



exists in support of the position or because the position is in direct opposition to the regulations.

LB&I may select for examination returns that are related to other returns already determined for examination. For example, there are many more partnership examinations than ever before, and as a result of the audit of a partnership, the IRS may also put the partners under exam. This is especially risky to partners in the case of a TEFRA partnership audit, where the partners' statute of limitations is automatically extended for partnership-level items flowing into their returns from the TEFRA partnership. In the same vein, there are many employment tax audits being conducted in conjunction with LB&I audits of corporations and other entities. Also to be considered are examinations of recently acquired subsidiary corporations. While an examination of a recently acquired subsidiary will not generally trigger the examination of the new parent company, it could raise issues and audits, and trigger audits of a parent's consolidated return that affect post-acquisition years.

Whistleblower activity is another area where LB&I can obtain information about tax risk. The IRS Whistleblower Office reports directly to the IRS Commissioner and it receives a significant number of anonymous tips each year that it must examine and consider. Information reported to that office can lead to audits by LB&I or any other IRS division (depending on the nature of the matter). In addition, a company's own whistleblower program could be the source of information in an LB&I audit because of the IRS's summons power. Unless a company's whistleblower program is set up in such a way that information received is privileged, revenue agents may obtain tax-sensitive information through the audit processes that lead to tax deficiency assessments.

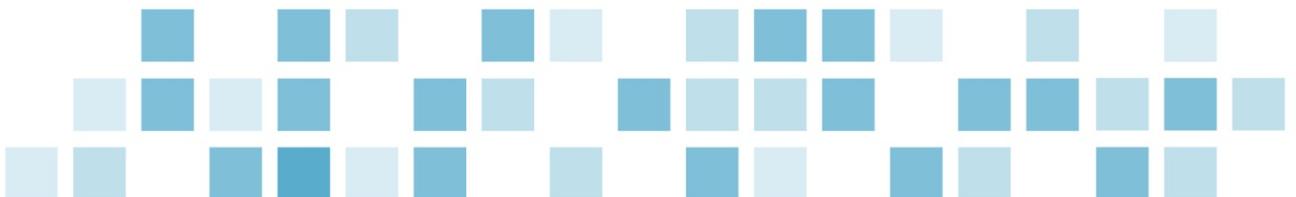
## Preparing for the IRS Examination

### Self-evaluation

The first step a company should take in preparation for an exam is a self-evaluation. And this should actually begin during the return preparation process. If a taxpayer has any significant risk areas that are recognized while the return is being prepared, documents should be collected and/or created at that point that support those positions. Transactional documents, as well as any research that might be relevant, should be kept readily available in the event questions are posed on exam.

When notification is received from the IRS that there will be an examination, several areas should be reviewed, potential IRS questions should be hypothesized, and potential answers prepared along with supporting documentation.

IRS exam teams are usually interested in the merger and acquisition area. If the company made acquisitions of subsidiaries during the years under exam, and those subsidiaries' prior year returns were not examined previously, these prior year tax returns should be carefully reviewed to see if there are any issues that could come



up. Due diligence reports and contemporaneous acquisition reserve analyses should be helpful. If there were IRS exams of an acquired sub's prior years, those audit reports should be examined to see what issues were encountered at that time, as these may be continuing issues. If weak areas are spotted in this review, the facts and legal analyses should be documented prior to the commencement of the audit, so the positions can be efficiently defended.

As previously stated, before commencing an audit, the IRS usually reviews publicly available taxpayer information. In addition to financial information in a public company's SEC filings and comment letters, this may include news clippings, and the taxpayer's own website and press releases. All these should be reviewed to see if there is anything likely to attract the IRS auditors' interest and cause an issue to arise.

The Service still maintains its policy of restraint over Tax Accrual Workpapers. However, those tax reserve workpapers list items that were thought to be tax uncertainties at the time of the independent audit and they should be reviewed to see what issues could likely come up on audit. For years that come under audit in the future and for years when Schedule UTP is filed, if any items are disclosed to the IRS on Schedule UTP, presentations of the facts and legal analysis should be prepared in advance of the opening audit meeting, as these will be the first issues to be reviewed by the examining agent.

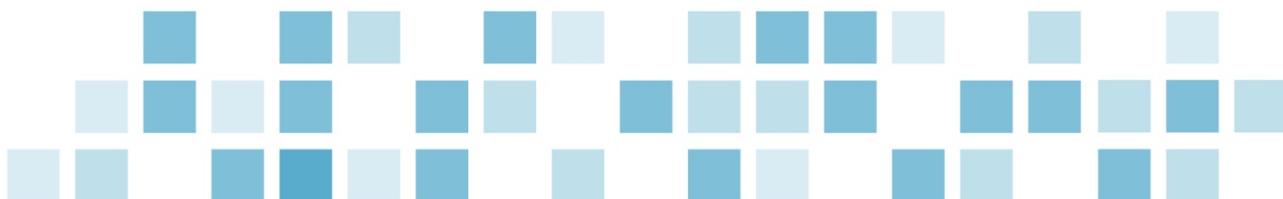
### **Documentation**

Once a company has identified potential problem areas that could arise in the audit, it should ensure that records have been retained with which to substantiate tax positions taken and that the basic recordkeeping system meets IRS requirements.

For acquisitions and dispositions of business operations, the proper paperwork should include:

- Documentation of basis. Have workpapers handy that prove basis, without extraneous notes and comments.
- Contingent purchase price. Its impact on future years should be documented.
- A target's transaction costs. Due diligence analysis may show specific documentation needs.
- Support may also be needed for other areas of IRS interest, such as acquiror's transaction costs (which can be supported by investment banker letters or documentation of legal fees paid), acquisition reserves, appraisals and Sec. 1060 purchase price allocations, or the identification and documentation of acquired tax attributes (e.g., carryovers, 382 limitations, etc.).

If transfer pricing is at issue, the transfer pricing methodology (including intercompany transaction policies, intercompany notes, overhead allocations, and



documentation of compliance with policies) should be explained. Any existing transfer pricing studies or reports, be they formally done by a third party or internally created, should be reviewed for adequacy and in order to be properly explained to the auditors. If there are no reports, now will be the time to have one done; gather support to document comparable profits, and then complete a report.

There may be economic substance questions concerning some of the company's transactions. If so, the taxpayer should document a non-tax business purpose and economic impact. There may be questions about a transaction's structure; while the choice of a structure is generally not challenged, certain listed transactions need certain structures in order to achieve the anticipated tax benefits and, if similar-looking structures seem to exist, suspicion could arise as to business purpose. It is best to document the business purpose and why a specific structure was chosen.

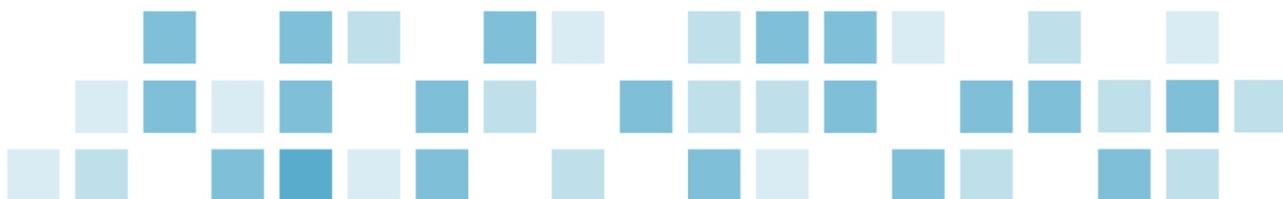
If technical guidance is available or formal opinions were relied on, the company should document its reasonable reliance on the authorities and advice from its tax advisors, as well as the due diligence it performed on the guidance or opinions provided by independent tax advisors. It might also be a good idea to have cost segregation studies done if new construction has occurred.

If employee statements and memoranda will be used to support return positions, it is best to obtain these while the data or transaction is fresh. For employees that have left the company, it would be a good idea to contact them and get the proper documentation and corroborate the ex-employee's statements and analysis with factual support.

There may be a need for documentation for items reported on Schedule UTP, as well as for research and experimentation credit studies and any domestic production activities deductions.

### **Identifying the examination support team**

In preparing for the examination, the company's exam support team must be identified. Though several company personnel may become involved in the audit process, only one person should be the funnel for all communications and documents passed between the IRS and the company. That will minimize potential inconsistencies and miscommunications. That point person can be a company employee or an outside professional representative. Whoever in the company is responsible for the audit should alert the other functions in the company that an audit is being conducted, that they may need to provide information to the company's point of contact for delivery to the IRS within a stated time frame, and that no conversations or meetings are to be had with the IRS without prior approval of, and attendance by, the company's single point of contact and other relevant company personnel.



If outside advisors are going to be involved, research and interviews should be conducted in time to ensure that those advisors have the expertise to handle the issues that may arise. In addition, policy and procedures need to be put in place to create and protect any necessary privileges (including the accountants' privilege).

As previously stated, if former employees will be called on to provide information or support documentation, or to be witnesses in the process, they should be interviewed and engaged as early as possible, in order to ensure that they become well-prepared. They should then be given whatever documents they need to refresh their memories or create support information.

Consideration should also be given as early as possible to whether expert witnesses (such as valuation experts, economists, engineers, etc.) may be necessary for the audit. They should also be vetted and engaged as soon as it becomes clear they will be needed.

### **Statute of limitations (SOL) issues**

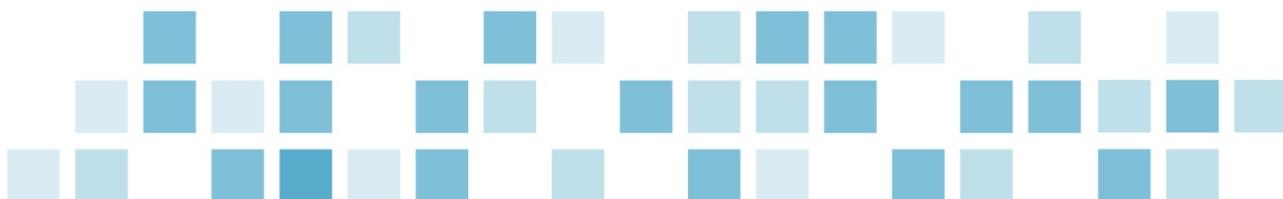
The period for assessment is generally three years from the date the return is filed. However, there may be differences in SOLs for potential claims and affirmative issues. If net operating loss or credit carrybacks are involved, the SOLs governing adjustments, assessments and refunds may be different. Note that the source year for carryover items can be examined (even though the normal SOL for assessment has expired on the source year) for the purpose of adjusting the carryover item, and the impact of that adjustment can result in an additional tax assessment in the year in which the carryover item is claimed or deducted.

### **Resolution Modeling**

Various resolution scenarios must be examined and evaluated. It must be determined what is needed to secure the best resolution for the company; possibly, resolution sensitivity modeling should be performed.

The impact of any resolution of an IRS examination needs to be determined. If amended state returns will be required, document the required filing dates (which could be triggered as issues are agreed to with the IRS). There may be interest issues that need to be resolved to determine the best year to obtain the settlement. It is a good practice to obtain a copy of the company's IRS transcripts for each year on or near the last day of the tax year (and at the start of the IRS examination) to get the most up-to-date information on the status of the company's tax account with the IRS.

If there is a possibility of penalties, the company should attempt to best protect itself by determining potential penalties and documenting the support needed to avoid their imposition. If an IRS adjustment could result in the imposition of the accuracy-related penalty, document the authoritative support for the return position and retain the analysis.



## Penalty protection through disclosure

### Initial Return

In certain situations, if a taxpayer has a reasonable basis for taking a position and, with its original return, adequately discloses that position to the IRS, the taxpayer may be protected from some penalties that would otherwise be imposed. Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) and certain white paper disclosures can be used to avoid such penalties. The taxpayer would need to file Form 8886 (Reportable Transaction Disclosure Statement) for any reportable transactions.

There is a question of whether a “white paper” disclosure would be sufficient to avoid penalties. However, the answer specifically depends on the information involved and the specific instructions to these forms. While white paper disclosures may be most helpful to explain things that are not otherwise clear or where estimates are used due to a lack of facts, some forms specifically must be used for their particular type of disclosure. Examples of the latter are Form 8275 and Form 8275-R, Form 8886 for Reportable Transactions and Schedule UTP for reporting uncertain tax positions. Interestingly, if a disclosure item would be disclosed on Form 8275 but involves a book-tax difference, the same disclosure protection can be obtained by instead sufficiently describing the item on Schedule M-3 or M-1, whichever applies. For more information, see Rev. Proc. 2011-13.

### Superseding Return

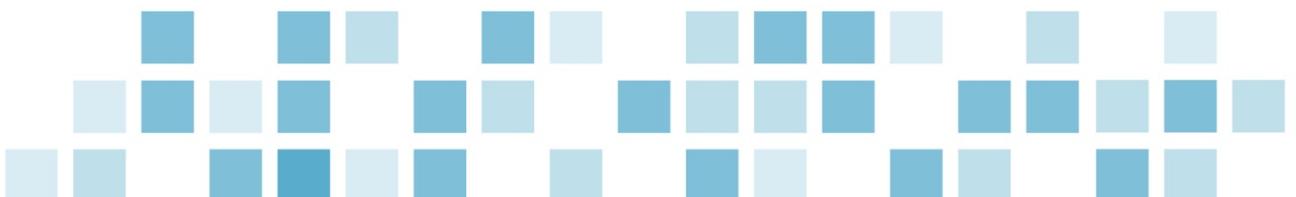
In some circumstances, a superseding return may be used to cure defects and include items that may have been omitted from, or erroneously reported on, the initial return. However, such a return must be filed before the initial return’s extended due date and must be labeled as a superseding return.

### Qualified Amended Returns (QARs)

After the extended deadline for filing has passed, qualified amended returns (QARs) can provide some protection from penalties. However, a QAR must be filed prior to notice of examination or, for certain tax shelter-type transactions, before the promoter is notified with IRS inquiries about the transaction and its investors. Once notified of an examination, this option is no longer available. Reg. section 1.6664-2(c)(3) should be reviewed to determine if a QAR is available.

### 15-Day Disclosures for CIC taxpayers

Rev. Proc. 94-69 provides that, if CIC taxpayers (i.e., those taxpayers that are under continuous examination), within 15 days after being notified of the commencement of an examination, report in writing to the IRS examiners adjustments to the original filed returns, such disclosure will constitute a QAR. All items disclosed under this

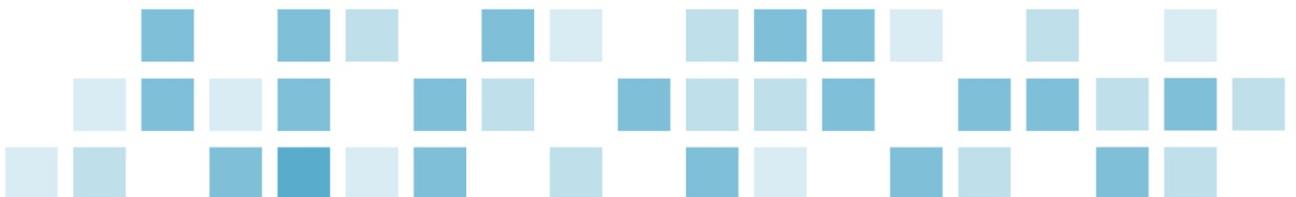


rule will be protected from substantial understatement penalties and accuracy-related penalties, as if they had been disclosed on a QAR as regularly defined.

This penalty relief provision allows CIC taxpayers to accumulate all adjustments they become aware of before an examination and lay them all out at once at the start of the exam, so as to avoid filing a series of QARs. Such disclosures should include all positive and negative tax adjustments. Documentation should be prepared in advance for all adjustments and any offsets or affirmative issues, and given to the examining agents along with the disclosure statement.

### **Conclusion**

It is important to understand that these recent changes in the IRS organizational structure may affect many companies before and when they are examined. LB&I taxpayers must be aware that the IRS has strengthened its audit powers when focusing on international issues and in dealing with global high-wealth taxpayers. These taxpayers need to know how income tax returns are selected for examination (and how this process has changed), the steps they should take to prepare for being audited, and how they can protect themselves and avoid certain penalties through proper disclosure of information.



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