Title: IDR vs. FDRs – IRS Tools to Discover Taxpayer Documents at Home and Abroad

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Agenda

• IRS Audits
  – Responding to IDR
  – Protecting Privileged Documents
The Information Document Request (IDR):

- Provides a check list to assist in organizing documents
- Each IDR # helps to track the audit
- Documents the deadline to be ready or have information to IRS
- Gives you a “road map” to what the IRS agent is looking for.

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<tr>
<td>6500 Meeker Dr., Jackson, XX XXXXX</td>
<td>(xxx) xxx-xxx-xxxx</td>
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Information Document Requests (IDR)

- IRS IDRs must be narrowly tailored to issues
- IDRs must be written using clear and concise language.
- IDRs can be problematic
Information Document Requests

• Discussion with the Taxpayer about IDR is VERY IMPORTANT:
  • Discuss how the issue is related to the IDR.
  • Discuss how the information requested is related to the issue under consideration and why it is necessary.
• What documents does the Taxpayer have?
• What documents do not exist?
• What documents cannot be produced?
IMPORTANT QUESTIONS TO THINK ABOUT

• After consultation with Taxpayer, determine what information you will produce.
  – Should you put them in order?
  – Is the IRS asking you to make summaries?
  – Is there a mileage log issue?
  – Do you need to recreate documents?
  – What if there are no receipts?
  – What should you do if the auditor keeps asking for more information? (i.e. you are now on IDR number 8)
  – What should you do if the auditor is getting into a sensitive area?
  – Can you say no?
• IRM section 25.5.4.2(5) states “[a] summons can only require a witness to appear on a given date to give testimony and to bring existing books, papers, and records. A summons cannot require a witness to prepare or create documents, including tax returns that are not currently in existence”.

• It then reiterates, “[b]y issuing an administrative summons, the Service cannot force a taxpayer to create a document, including a Collection Information Statement or a delinquent tax return.” IRM section 25.5.4.2.1(1).
• Under the authority granted in Internal Revenue Code § 7602(a)(1, 2), IRS is authorized to request the production of “books, papers, records, or other data.”

• Congress did not authorize IRS to require the creation of documents or other data for examination. I.R.C. § 7602, United States v. Brown, 536 F.2d 117 (6th Cir. 1976).

• The courts have held that when the government seeks either oral testimony or the generation of new documents, the requests are not enforceable. Id., 536 F.2d at 123; United States v. O’Shea, 662 F.Supp.2d 535, 549 (S.D.W.Va. 2009).
Acceptable Backup

- The receipt and the form of payment
- If a credit card is used be sure to show the taxpayer is the holder of the card
- When a receipt is from a store such as Costco, it will be needed with explanations.
- When no receipt is present it will be at the auditors discretion to allow
- What if there are no documents?

  **Note:** though they want original receipts the auditors understand that originals do not hold up well, and will accept copies in most cases
Mileage Logs

- Whether claiming standard mileage rate or actual expenses a mileage log is needed
- The more detail the better: who, where, and why
- The total mileage driven will also need to be supported, have repair receipts available to show the odometer reading
- What if there is no mileage log? Should the taxpayer create one?
Once a document is turned over, an admission is put in writing, a spreadsheet is created at the examiner’s request, or a recorded interview is complete, you CANNOT take back the document, the admission, the spreadsheet, or the interview responses.

• Turn over only what is asked, required, and not privileged.
Responding to IDRs

• Creating a “Record”
  – Responses create an administrative record of the matter
    • Written Responses
    • Interview Responses
    • Documents

– How to Respond to the Questions Asked
  • Direct and complete responses
  • Avoid tangential and expansive remarks unrelated to the question

– Assert Appropriate Privileges
  • Attorney/client privilege
  • Work Product
3 Step Process:

1. Delinquency Notice;
2. Pre-summons Letter;
and
Rule 4.4, Circular 230 and Privileges
No Delay Tactics

• Model Rule 4.4(a):
  – In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.

• Circular 230
  – 10.23 Prompt disposition of pending matters. A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.
Circular 230

• 10.20(a)(3): When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

• 10.20(b) Interference with a proper and lawful request for records or information. A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.
Privileges

• Must consider privileges including:
  – Fifth Amendment privilege;
  – attorney-client privilege;
  – the tax practitioner privilege;
  – the joint-defense/common interest privilege; and
  – marital privileges; and
  – work product doctrine.
Tax Practitioner Privilege

- I.R.C. § 7525(a)(1) entitles to tax practitioner to the same common law protections that would be recognized between an attorney and a client, if:
  - the person is a tax professional as defined by I.R.C. § 7525;
  - the client came to the tax professional for tax advice unrelated to a tax shelter; and
  - the matter is not criminal.
Fifth Amendment Privilege

• The Fifth Amendment privilege states that “no person shall be…compelled in any criminal case to be a witness against himself.” United States Const. Am. V.

• The IRS may deem a witness who fails to invoke his Fifth Amendment privilege as waiving it regarding further questioning on the same subject.
The Fifth Amendment privilege is only validly invoked when the witness has a reasonable and good faith belief that answering a question would create a "substantial hazard" of incriminating himself.

The Fifth Amendment privilege does not extend to testimony or production of documents by third parties. However, third-party testimony or production of documents may be protected by another privilege. Couch v. United States, 409 U.S. 322 (1973).
Fifth Amendment (cont’d)

• Fifth Amendment privilege must be asserted on a *question-by-question basis* during the interview or on a document-by-document basis prior to the interview.
• The Fifth Amendment privilege does not apply when the compelled testimony could subject the witness to prosecution in a foreign country, as opposed to the United States.

• However, if the witness was compelled to give testimony to a foreign government in violation of the witness’ Fifth Amendment rights, the compelled foreign testimony cannot be used in U.S. courts.
Attorney-Client (cont’d)

• A taxpayer or attorney may invoke the attorney-client privilege if:
  – The taxpayer was a client of the attorney, or sought to become the attorney’s client;
  – The attorney was offering counsel in his capacity as an attorney and was admitted to practice law in the jurisdiction where counsel was given; and
  – The taxpayer and attorney communicated for the purpose of receiving and giving legal counsel. United States v. Lawless, 709 F.2d 485 (7th Cir. 1983).
The attorney may also assert the attorney client privilege to protect himself during questioning. *Fisher v. United States*, 425 U.S. 391 (1976)
Under United States. v. Kovel, 296 F.2d 918 (2d Cir. 1961), the attorney-client privilege may extend to communications made by an attorney’s client to an accountant. - Accountant must be employed by attorney for purposes of providing legal advice.
A Kovel Agreement is where an attorney hires an accountant to assist the attorney in counseling the client. Accountants who perform work subject to a "Kovel Agreement" are also protected by the attorney-client privilege.
Common Interest/Joint Defense Privilege

- This privilege extends the attorney-client privilege to allow attorneys representing different parties with common interests to collaborate without waiving either of their privileges.
- To establish the existence of a joint defense privilege, the party asserting the privilege must show that:
  - the communications were made in a joint defense effort;
  - the statements furthered the effort; and
  - the privilege has not been waived. Matter of Bevill, Bresler & Schulman Asset Management Corp., 805 F.2d 120, 126 (3d Cir. 1986).
Marital Privilege

• Two different privileges:
  – spousal communications privilege;
  – the spousal immunity, or spousal adverse testimonial, privilege.
Spousal Communications Privilege

- The Spousal Communications Privilege protects information privately disclosed between husband and wife in the confidence of the marital relationship.
  - Either spouse may invoke this privilege to prevent the other from testifying about confidential and private communications between the spouses;
  - The spousal communications privilege survives divorce;
  - This privilege applies *only to communications* between the spouses and does not protect observations or other nonverbal conduct; and
  - As with the attorney-client privilege, the spousal communications privilege is waived if the communication is made in the presence of a third party.
Spousal Immunity Privilege

• The Spousal Immunity, or Spousal Adverse Testimonial Privilege protects a witness spouse from giving compelled testimony against the other spouse in a criminal proceeding.
  – The privilege may only be asserted by the spouse being compelled to testify;
  – This privilege does not survive if the marriage ends, but it protects all facts – not just communications;
  – If an ex-spouse is not friendly toward the tax professional's client, outreach should still be made to see if the spouse would invoke the privilege; and
  – Quite often spouses, and even separated spouses, find it beneficial to invoke the spousal immunity privilege. One spouse’s wrongdoings tend to affect the other spouse in unexpected ways.
Work Product Doctrine

• Strongest of Privilege
  – Protects items prepared in “anticipation of litigation”
  – Fact work-product
    • Opponent can discover fact work product if they demonstrate a need and that the information cannot be obtained from other sources without undue hardship
  – Opinion work product
    • Mental impressions, thoughts, legal strategies of the attorney
    • Almost absolute protection against discovery
IRC section 982 prohibits the taxpayer from introducing foreign-based documentation (any document which is outside the United States and may be relevant or material to the tax treatment of an examined item, IRC section 982(d)(1)) into civil proceedings if the Service requested the documentation using a Formal Document Request (FDR) unless the taxpayer does the following:

- Complies substantially with the FDR
- Establishes reasonable cause for failure to comply
Reasonable cause exception

1. In general Subsection (a) shall not apply with respect to any documentation if the taxpayer establishes that the failure to provide the documentation as requested by the Secretary is due to reasonable cause.

2. Foreign non-disclosure law not reasonable cause
   - For purposes of paragraph (1), the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause.
Formal Document Request

- The term “formal document request” means any request (made after the normal request procedures have failed to produce the requested documentation) for the production of foreign-based documentation which is mailed by registered or certified mail to the taxpayer at his last known address and which sets forth—
  - (A) the time and place for the production of the documentation,
  - (B) a statement of the reason the documentation previously produced (if any) is not sufficient,
  - (C) a description of the documentation being sought, and
  - (D) the consequences to the taxpayer of the failure to produce the documentation described in subparagraph (C).
During an exam, when foreign-based documentation requested by an Information Document Request ("IDR") was not sufficiently provided, issuing a formal document request ("FDR") is one means to obtain them. Congress provided for FDRs “to discourage taxpayers from delaying or refusing disclosure of certain foreign-based information to the IRS.”
Example Circumstances Under Which Process Applies

- Following is a nonexclusive list of issues for which FDRs may be valuable:
  - Subpart F
  - Investment of earnings in US property
  - Foreign tax credits
  - Dividend repatriations
  - Debt v. equity
  - Loan v. dividend
  - Limitations on deductions for related-party payments
  - Ownership of foreign bank accounts and assets
  - Ownership of foreign trusts
  - Investments in partnerships, disregarded entities, foreign corporations, and passive foreign investment companies
  - Exchange rate calculations for earnings and profits, foreign taxes, and other transactions
Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR

- The following criteria must be met before issuing a FDR:
  - An IDR issued was not responded to or the response was not sufficient.
  - The requested documents “may be relevant” or material to the tax treatment of an examined item.
  - The documents requested are located outside the US, i.e., foreign-based documentation.
  - The requested foreign-based documentation is held by a foreign entity, whether or not controlled by the U.S. Taxpayer (“UST”).
Foreign-based documentation

• Any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item
Foreign-based Documentation Held by a Foreign Entity

• If UST owns (directly) controlling interest (i.e., greater than 50%) in a foreign affiliate which has custody or control over documents, UST has the power to provide copies of those documents to the Service.
Foreign-based Documentation Held by a Foreign Entity

- When UST owns (directly) less than controlling interest in a foreign affiliate, UST’s power to provide documents held by the foreign affiliate to the Service depends on the facts and circumstances.
Section 982(e) - Suspension of statute of limitations

- If any person takes any action as provided in subsection (c)(2), the running of any period of limitations under section 6501 (relating to the assessment and collection of tax) or under section 6531 (relating to criminal prosecutions) with respect to such person shall be suspended for the period during which the proceeding under such subsection, and appeals therein, are pending.
Section 6038A(e)

• Agreement to treat corporation as agent
  – The rules of paragraph (3) shall apply to any transaction between the reporting corporation and any related party who is a foreign person unless such related party agrees (in such manner and at such time as the Secretary shall prescribe) to authorize the reporting corporation to act as such related party’s limited agent solely for purposes of applying sections 7602, 7603, and 7604 with respect to any request by the Secretary to examine records or produce testimony related to any such transaction or with respect to any summons by the Secretary for such records or testimony. The appearance of persons or production of records by reason of the reporting corporation being such an agent shall not subject such persons or records to legal process for any purpose other than determining the correct treatment under this title of any transaction between the reporting corporation and such related party.
Substantial Compliance with an FDR

- If compliance was substantial, all requested foreign-based documentation is admissible, even those that were not provided. If compliance was not substantial, none of the foreign-based documentation requested is admissible to a court having jurisdiction over a civil proceeding, even those that were provided.
Quashing the FDR

• Within 90 days of the FDR issue, UST can file a petition to quash a FDR with a US District Court having jurisdiction. If the petition is granted, the FDR is voided.
Quashing the FDR

• In any proceeding to quash, the US may counterclaim to enforce the FDR.
• The same requirements for court enforcement of a summons apply to that of a FDR. Those requirements are that:
  – there is a legitimate purpose for the investigation;
  – the material sought is relevant to that purpose;
  – the material sought is not already within the IRS' possession; and
  – those administrative steps which are required by the IRC have been taken.
Petition to Quash

• The petition to quash suspends the running of the 90-day response period for the FDR while any action and any appeals on the petition are pending.

• Also, the petition suspends the statute of limitations on assessment and collection under § 6501 while any action and any appeals on the petition are pending.
Determining Reasonable Cause

• A court’s assessment of UST’s reasonable cause involves consideration of the following:
  – whether the request was reasonable in scope,
  – whether the requested documents were available in the US and, thus, subject to summons,
  – the reasonableness of the requested place of production, and
  – control over the foreign entity in possession of the documents.
Minority Ownership

- Minority ownership by a taxpayer can prevent it from producing certain records held by a foreign entity. However, taxpayers may hide behind that status to avoid producing records. Thus, whether minority status is reasonable cause is based on the facts and circumstances.