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

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Introduction

- 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.
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.
Agenda

• IRS Audits
  – Responding to IDRS
  – 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.

<table>
<thead>
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<th>Information Due By</th>
<th>At Next Appointment</th>
<th>Mail:</th>
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<td>x</td>
<td></td>
<td>Lacy Jones, Revenue Agent</td>
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<tr>
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<td></td>
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<td>May 11, XXXX</td>
</tr>
<tr>
<td>Telephone Number</td>
<td></td>
<td></td>
<td>(XXN XXXX XXXX)</td>
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</table>

Description of documents requested:

Please have the following items available for our appointment to allow the examination to be completed as quickly as possible:

1. Copy of the Schedule C and related statements attached to your Form 1040 for the years XXXX and XX, this is being requested to obtain information not electronically available in this area.
2. Form 468 and Forms 4161 filed for the period beginning January 1, XXXX to December 31, XXXX.
3. Forms W-2 and Form W-3 issued for XXXX.
4. Summary of income and expenses presented to your accountant to prepare your return for XXXX.
5. Monthly income and expense ledgers we discussed in our call that is used to document daily transactions.
6. All bank statements, both personal and business, for the period beginning December 1, XXXX to January 31, XXXX, including the check register, deposit slips, and cancelled checks, either duplicate, original return, by bank or the copies attached to the statements.
7. Statements for savings account and investment accounts for the period beginning December 1, XXXX to January 31, XXXX.
8. Documentation of reasonable sources of income received in XXXX such as rents, gifts, or tax exempt interest.
9. The year-end inventory count sheets were prepared on December 31, XXXX and December 31, XXXX.
10. All invoices and cancelled checks to support the Return amount of $43,234 claimed on your XXXX return.
11. A sample of sales transactions to be sampled will be provided during the appointment.
12. If your plan to be represented by your attorney, or other representative, a completed Form 8821, Power of Attorney, signed by you and the representative will be needed.

Note: This document request is not all inclusive and additional items may be requested. If additional items are needed, the reason for the request will be discussed when the item is required.
Information Document Requests (IDR)

- IRS IDRs must be narrowly tailored to issues
- IDRs must be written using clear and concise language.
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?
• 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).
IDRs – Limits on IRS Authority

• 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
Attorney-Client Privilege

- Attorney-client privilege applies to confidential communications between a client and an attorney for the purpose of seeking “legal” advice.

- Key Elements
  - Confidential
  - Communication
  - Between client and attorney
  - Legal Advice
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
3 Step Process:

1. Delinquency Notice;
2. Pre-summons Letter;
and