

Risk and tax controversy
Never let them see you sweat



For many tax executives, managing risk and tax controversy consumes substantial time and resources. Anticipating examinations when performing day-to-day activities is one way to reduce that effort and free up resources for higher-value activities.

Deloitte hosted a [Dbriefs](#) webcast on June 18, 2009, to discuss examination readiness, including steps that companies can take to respond efficiently — and effectively — to Internal Revenue Service (IRS) requests. Nearly 2,500 participants shared their own views through responses to polling questions.

Recent examination activity and areas of focus

IRS examination activity over the past two years suggests a broadening of focus — with smaller and mid-sized companies increasingly in the spotlight. In 2006, only three percent of the 2006 corporate returns reported assets of \$10 million or more, yet this group accounted for 40 percent of examinations. Two years later, the company size distribution was about the same, but the examination distribution had shifted more in favor of smaller and mid-sized companies, as illustrated in the exhibit. By conducting fewer large-company audits, which can require teams of agents, the IRS has freed up the resources to conduct more smaller-scale audits. At the same time, the IRS is conducting more limited-issue examinations, which take less time — again making more examiners available to audit a greater number of companies.

Smaller and mid-sized companies increasingly in the spotlight

Corporate income tax returns	2006 return distribution	2006 exam distribution	2008 return distribution	2008 exam distribution
Balance sheet assets over \$0 and under \$10 million	97%	60%	97%	66%
Balance sheet assets over \$10 million	3%	40%	3%	34%

One way the IRS is focusing its efforts is by identifying high-risk areas through its Issue Tiering System, which groups issues in three categories:

- **Tier I** issues pose the highest compliance risk across multiple industries and generally include large numbers of taxpayers, significant dollar risk, substantial compliance risk, or are high visibility. Examples include listed transactions, foreign withholding, and the Section 199 deduction.
- **Tier II** issues reflect areas of potential high non-compliance or significant compliance risk, inclusive of emerging issues with fairly well-established law that need further development, clarification, direction, and guidance on IRS's position. Examples include casualty losses, treatment of gift cards, and non-performing loans.

Foreign withholding implications

Foreign withholding is an area with rigorous documentation requirements and is a Tier I issue. Most examining agents will be required to include this topic as part of their examination plans. Manual form validation processes and exception processing have historically made compliance in this area very difficult. In addition, remediation of documentation errors can be costly and time consuming — and often cannot be completed within the 15-30 day period you might have to respond to an IRS information request. Companies with foreign withholding obligations can better prepare for an eventual foreign withholding tax examination by reviewing their internal processes and documentation validation standards before the IRS starts an examination. Those companies should immediately start any necessary remediation processes and may be able to benefit from implementing certain IRS-approved automated form submission and validation procedures that allow for remote filing of the forms through the internet and provide a means of centralized electronic storage. Not only can implementation of such a system reduce the potential risk of non-compliance, it also can reduce paper and related storage costs.

- **Tier III** issues are high-risk areas that may apply only to certain industries or may require unique treatment depending on the industry. Examples include delay rentals in the natural resources industry; amortization of intangibles for the communications, technology, and media industries; or cost segregation studies for the retail, pharmaceutical, and health care industries.

From recent activity, it is clear that the IRS, the Treasury, and President Obama's administration view international tax as an area with a potential high degree of non-compliance. In May 2009, President Obama unveiled a plan to raise almost \$200 billion by overhauling the international corporate taxation rules. Last year, IRS commissioner Shulman testified at Senate hearings regarding increased efforts to enforce international tax issues. And, the head of IRS's large and mid-sized business group has stated publicly the goal to achieve 100-percent audit coverage for all Forms 1042 — the foreign withholding tax reporting form. The IRS already has separate programs in place to use statistical or matching efforts to identify potential non-filers or incorrect filers of the Forms 1042. In addition, the area of transfer pricing has also been targeted and the IRS has formed a 12-member Transfer Pricing Council to evaluate the optimal allocation of field examination resources within this area.

Examination readiness

Taxpayers have access to various sources of information that can help them understand key areas of scrutiny and understand how the IRS may audit a particular issue. One important source is the IRS Audit Techniques Guide—a roadmap for IRS examiners who conduct audits. The IRS typically issues two types of Audit Techniques Guides: industry specific and special topics. For example, there are guides for the oil and gas and retail industries as well as for topics that touch multiple industries, such as executive compensation or passive-activity losses. The guides provide an examiner with:

- A description of the industry or topic
- A listing of relevant issues
- Definitions and explanations of important rules
- A list of questions to ask or documents to request
- Points to look for once the examiner has received the documentation or response

The IRS typically requests information from a taxpayer using an Information Document Request (IDR). Some small exams may have only two or three IDRs, while others can have hundreds. A typical IDR will request responses within a short period of time — often 10 to 14 days — although this may be negotiable depending on circumstances. Even if you can negotiate a longer response period, some items such as transfer pricing and foreign withholding documentation may be difficult to produce in this timeframe; thus, advance preparation will be critical.

Common IDRs include:

- **Computer Audit Specialist (CAS) IDR.** This request typically seeks books and records, including electronic trial balances or electronic copies of general ledger detail broken down to the transactional level. For many large companies, this basic request is often hard to answer due to complications such as a new accounting system, acquisitions of companies that ran or continue to run on separate accounting systems, corporate structural changes, or top-side accounting and tax entries.
- **Listed transactions IDR.** This is a mandatory, six-page form that asks whether you have participated in any transactions that the IRS has listed as being potentially abusive.
- **Transfer pricing/Section 482 IDR.** This is a standardized request for contemporaneous pricing documentation required by Treasury Reg. 1.6662-6.
- **Tiered issue IDR.** These requests may also include standardized sets of questions. For example, Section 199 does not have a standard IDR, but it does have an eight-page list of minimum checks that an examining IRS agent will review. With respect to foreign withholding, the IRS has drafted sample IDRs for field agents to use, including one for financial companies and one for non-financial companies.

Other common examination topics include legal and professional fees, officers' compensation, other deductions, inventory issues and Section 263 capitalization, and foreign taxes.

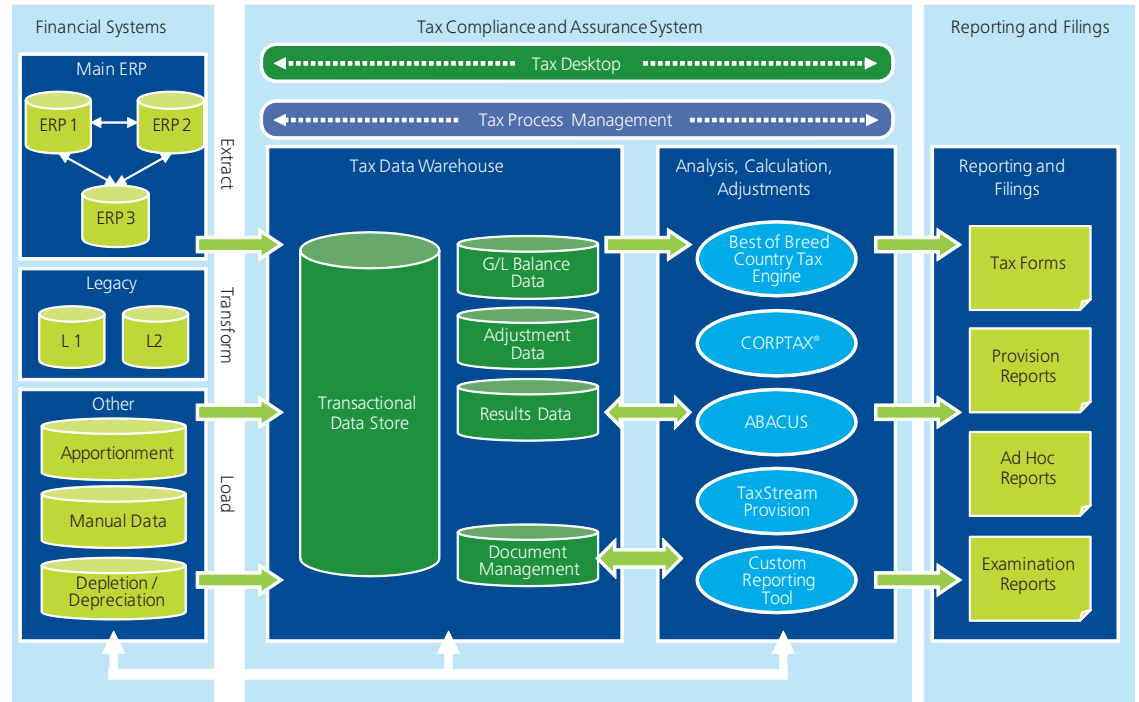
Transfer pricing implications

There are 10 principal documents required to fulfill contemporaneous documentation requirements for transfer pricing-focused examinations:

- Overview of taxpayer's business
- Description of organizational structure
- Documentation explicitly required under Section 482 (such as license agreements)
- Description of method selected and reason for selection
- Description of alternative methods not used and reason for not using them
- Description of controlled transactions and internal data
- Description of comparables and adjustments (if any)
- Explanation of economic analysis and projections used
- Description of data obtained after tax year and before filing return
- General index of documents

In an examination situation, the IRS will provide only 30 days to produce this documentation; otherwise, a company may be exposed to substantial penalties. It is very important, therefore, to gather these documents at the time of the study. Once the project is completed, your team should make sure that everything required for the study is available in the format required by the IRS.

A vision for the future: Record to report to examination



An important element of examination readiness is having a process in place to manage IDRs, including responsibilities and a schedule for specific activities. In most cases, it is a good idea to establish a single point of contact on both sides — but particularly on the taxpayer side in order to control the flow of information and understand exactly what information has been provided to the IRS. Similarly, the company should consider how it will assign IDR responsibilities, and it should establish a response timeline that provides sufficient cushion for reviews and quality control for information before it is provided to the IRS. Finally, it is important to establish responsibilities for maintaining IDR tracking logs, as well as an official IRS correspondence file that houses exact copies of all information submitted.

A key issue during examinations is making sure the response team has access to data — including data from the original books and records — when needed. To determine proper data access, compliance teams should verify that they are capturing and retaining required data, including top-side entries and post-closing adjustments. In addition, they will need to confirm access to old legacy systems as they are retired. Adopting a record-to-report view can help taxpayers plan ahead for addressing examination data requirements (see diagram above).

One way taxpayers can evaluate examination risks is by performing a mock examination — a step that can help identify applicable industry or tiered issues, determine documentation deficiencies, and assess the need for additional

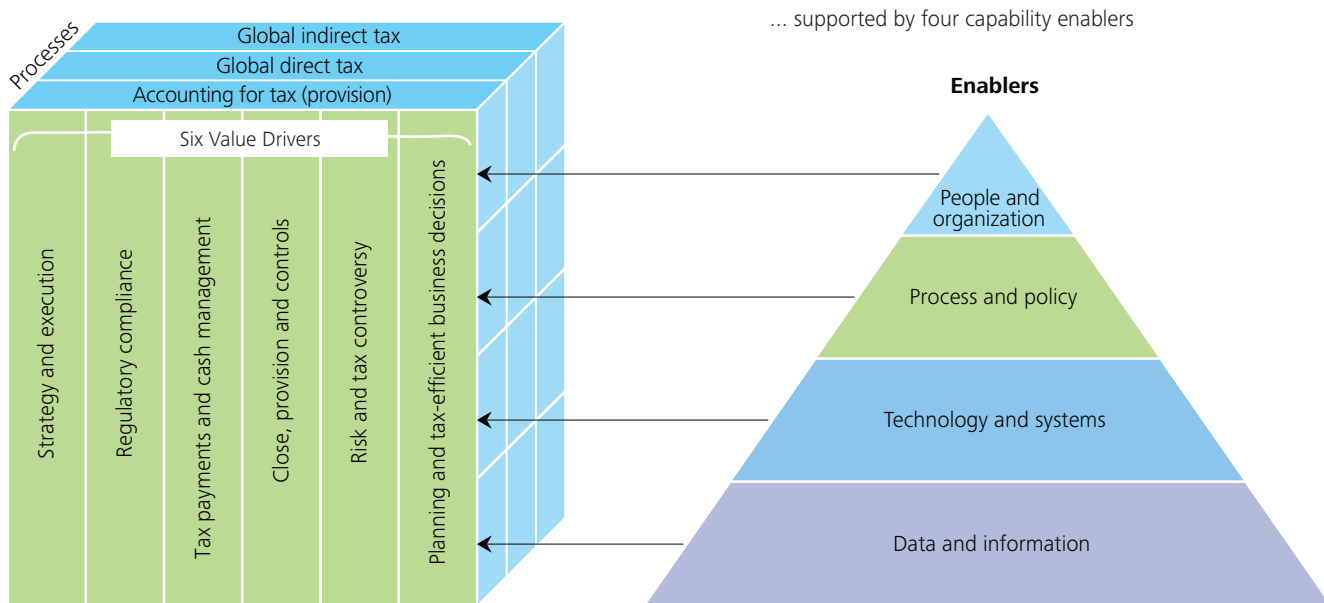
resources or guidance from tax specialists. For actual audits, depending on a company's resources and needs, it may choose to outsource management of the exam, or it could have internal staff handle data gathering but use outside professionals to manage the process and handle IRS contact. Or, if the company has an experienced tax controversy staff, it may choose to use outside resources only for special issues.

A framework for innovation

A framework that incorporates the tax department's key processes and enablers can help in managing and directing resources appropriately for an examination — while improving tax operations over the long term. Deloitte uses a framework (see following page) that considers specific tax processes (top of the cube on the left) and six tax value drivers (front of the cube on the left), as well as four enablers that affect the tax value drivers (elements of the pyramid on the right). Data and information are critical to everything the tax department does; therefore, it is the foundation of this framework for organizing resources.

One key to being prepared for an examination is determining that people in the organization not only focus on their specific value driver, but that they also consider the impact of their work on other areas. For example, compliance professionals should constantly consider how their work affects the controversy or exam process through the decisions they make and the level of detail and documentation that they incorporate in their work papers.

Assessment framework that incorporates the tax department's key processes and enablers



This framework also enables you to evaluate and explore ways to strengthen each of the enablers.

Data and information. One of the most important steps a company can take is to prepare data for an examination during the compliance season. This may include training your compliance team to understand potential examination data needs and potential issues, as well as reviewing data and information prior to boxing it for storage to confirm that everything that may be required to support an audit is available and in the format needed. For example, has the tax function documented post-close adjustments? If necessary, this is a good time to develop or confirm your organization's data archival strategy and needs with the IT department to determine whether data retrieval is available as required for examinations. And, if your organization conducts a mock audit, you may want to run some trials to see if you can recover financial system data as expected, and to test the recovery of "manual" data to confirm it is available on shared drives rather than individuals' hard drives.

Technology and systems. Technology can make the examination process easier. It is important to have in place a technology plan that addresses examination-specific needs. Then, look for available resources within your enterprise and commercially available products such as spreadsheets or project management tools that can fill any gaps in the plan. Compliance providers have certain tools that your organization may already license, for example, CORPTAX's® Workspace product or Thomson's® workflow and document management tools. While performing tax controversy services for clients, Deloitte will generally employ its dedicated tool, Tax Controversy Manager.

Processes and policies. An important first step is to evaluate, standardize, and simplify examination-related activities and confirm that they are well integrated with the function's core processes. For example, include examination-specific items in the compliance checklist so that your team is completing compliance work with an eye toward information that will be required down the road. Also, consider having someone familiar with the examination process provide an independent review of documentation after the compliance cycle is closed. Where possible, you may want to leverage other established processes — both inside and outside of the tax function — to make sure that you have the information you need, when you need it.

A key avenue for process improvement is a post-audit debrief. What went well? What can you fix in the current compliance cycle to determine that it is not an issue in the future? This also provides good opportunities to enhance training and to address any underlying data quality issues.

People and organization. Ideally, your examination leader and single point of contact should be a seasoned professional who has the experience to work with the IRS in a collegial manner and the ability to manage conflict without creating more of it. Yet, this individual should be capable of representing the company's interests — possessing a sound understanding of the organization's true risks and exposure, as well as nuances of the business and industry. At the same time, an audit is a great learning experience for your junior staff, so it is important to involve them appropriately in the process and provide them an opportunity to develop the experience to play more substantial roles in the future.

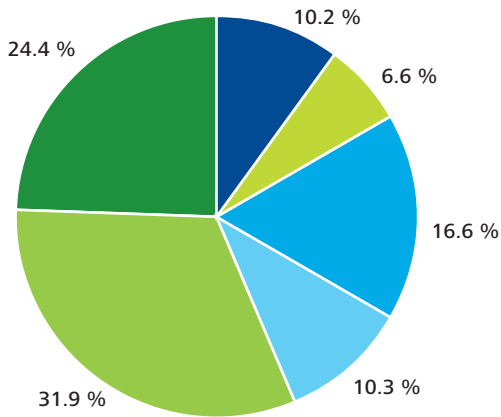
Tax executives' views

Deloitte hosted a [Dbriefs](#) webcast on June 18, 2009, to discuss examination readiness, including steps that companies can take to respond efficiently — and effectively — to IRS requests. Nearly 2,500 participants shared their own views through responses to polling questions.

Recent activity suggests an increase in income tax examination activity. Indeed, 32 percent of webcast participants indicated that their organizations currently are under examination, and another 10 percent said they have been audited within the last year. Only 17 percent said that it has been at least five years since their companies have been subject to an IRS examination.

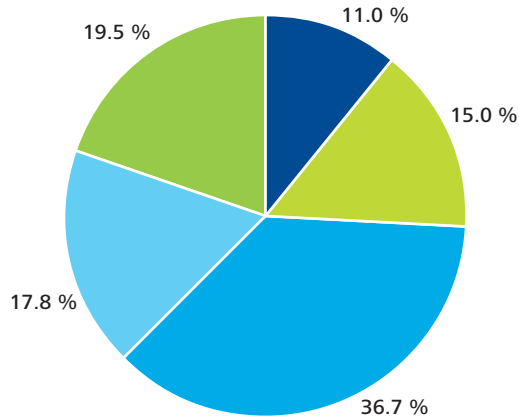
There are a number of steps that companies can take to prepare for an IRS examination — from reviewing IRS Audit Techniques Guides to establishing plans for responding to IDRs to conducting mock audits. More than half of the webcast participants said that they “believe” or “know” their companies are prepared today for an IRS audit. Another 15 percent said they feel “close” to being prepared. Only 11 percent said their organizations are not well prepared for an IRS examination.

When was your company's last federal income tax examination?



- Never or more than 10 years ago
- 5 to 10 years ago
- 1 to 5 years ago
- Less than 1 year ago
- Under examination now
- Unsure/not applicable

Are you prepared today for an IRS examination?



- No
- We are close
- Yes, I believe we are
- Yes, I know we are
- Unsure/not applicable

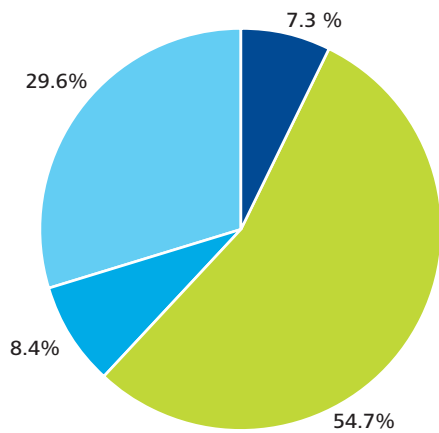
Source: Deloitte's Tax Operations Dbriefs webcast, "Risk and Tax Controversy: Never Let Them See You Sweat" held on June 18, 2009. Polling results presented herein are solely the thoughts and opinions of survey participants and are not necessarily representative of the total population of private companies.

An effective data management approach is critical to preparing for an IRS examination. In fact, it could be the key to a successful outcome. Overwhelmingly, tax executives indicated that they use electronic spreadsheet packages, such as Microsoft Excel®, to track and manage their examinations. Eight percent indicated that they use commercially available tax controversy or project management software, while seven percent still use pen and paper to manage examination details.

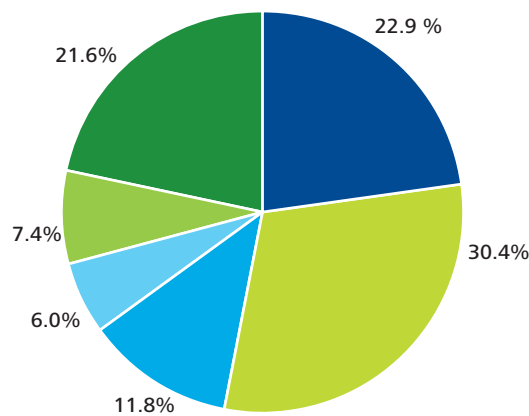
Given the level of examination activity — and the likelihood that it will continue to increase — most webcast participants indicated that their organizations have dedicated examination resources. More than 30 percent said they have an individual dedicated to examinations, while another 23 percent said they have a team of resources established to handle these matters. Only six percent said they contract with outside resources to manage the examination process, while another seven percent assign examination responsibilities depending on availability.

What do you utilize to track your examinations?

What resource within the organization manages the examination?



- Pen and paper
- An electronic spreadsheet package like Microsoft Excel®
- An electronic project management software or system
- Unsure/not applicable



- We have a team of resources dedicated to examinations
- We have an individual dedicated to examinations
- Whoever has the time
- We contract with outside help
- We have not been audited in a long time
- Unsure/not applicable

Source: Deloitte’s Tax Operations Dbriefs webcast, “Risk and Tax Controversy: Never Let Them See You Sweat” held on June 18, 2009.

Additional resources

For more resources that can help address the challenges tax departments face today, visit www.deloitte.com/us/movetaxforward.

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