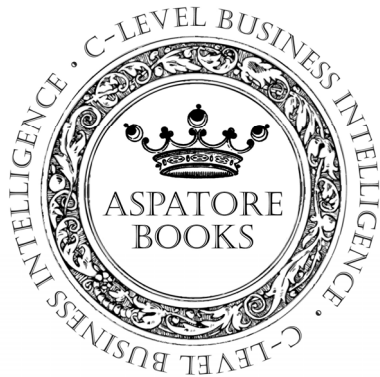


I N S I D E T H E M I N D S

Tax Law Client Strategies

*Leading Lawyers on Understanding and Allocating
Risks, Assessing Settlements and Negotiations, and
Developing Deal Strategies*

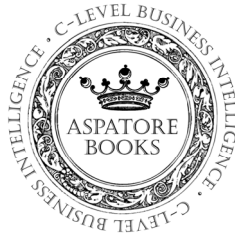


Practical Advice for Handling Tax Disputes

Robert C. Daleo

Partner

Riker, Danzig, Scherer, Hyland & Perretti LLP



Introduction

In my role as a tax attorney, I handle a broad range of issues including partnership tax, corporate tax, and state tax issues. In addition, I have substantial experience representing taxpayers in audits, administrative appeals, and litigation involving the Internal Revenue Service and state taxing authorities. I would like to share some practical advice that can go a long way in facilitating a favorable resolution in disputes with taxing authorities.

Approach in Dealing with Tax Disputes

Preliminary Steps

Prior to communicating with a taxing authority it is essential for the taxpayer and its representative to develop a negotiation and settlement strategy. In order to determine how best to approach a tax dispute I will meet with the client to obtain an overview of the case and target all documents and information that are relevant to the matter. I will also discuss the matter with any other parties who can provide factual background relating to the case and rationale for the positions taken by the client, such as the client's chief financial officer and accountants. This is essential in helping to assess the client's position and to ensure that no surprises arise. For instance, if the facts presented to the taxing authority representatives in support of a taxpayer's position prove to be inaccurate or cannot be substantiated, a client's credibility could be compromised negatively influencing the taxing authority representatives.

After making an assessment of the client's tax exposure I will have a brainstorming session with my client in order to discuss my assessment and develop a negotiation and settlement strategy, which will depend largely on the client's goals; the client's potential tax liability; the costs of pursuing the matter; the client's tolerance of risk; and the amount of the client's time and other resources that will be needed in order to proceed with the matter.

Set the Right Tone

When taking on a tax audit, administrative appeal or litigation, I always try to set the right tone with the taxing authority representatives handling the taxpayer's matter. I believe that it is very important to be cooperative with taxing authority representatives and to promote an environment that is conducive to resolving the matter.

To that end, I believe that it is prudent to be forthright and strive to accurately present the facts relating to a taxpayer's position. It is important that both the taxpayer and its representatives are perceived to be credible by the taxing authority representatives. In short, it is important to be honest and cooperative, while firmly advocating the taxpayer's position. My experience has been that a representative who believes the taxpayer is credible and cooperative will keep an open mind, and be more likely to work to achieve a fair resolution of the matter.

Take Advantage of All Opportunities to Bridge the Gap.

I believe that taxpayers and their representatives should always take full advantage of all the opportunities that are presented at every level of the administrative and judicial process to settle a tax-related matter on favorable terms or reduce the gap between the taxing authority and the taxpayer. At both the audit and administrative appeals levels, I believe that taxpayer representatives should do their best to chip away at the amount in dispute between the taxpayer and the taxing authority. Even if a matter is not fully resolved at the audit or administrative appeals level, there is typically an opportunity at each level to narrow the gap between the amount each party feels should be paid. Therefore, it makes sense to work with auditors in an effort to reduce the liability being asserted and to take full advantage of the right to an administrative appeal by preparing a comprehensive protest that fully sets forth a taxpayer's arguments, rationale, and relevant facts. For example, a taxpayer should typically not forego the right to an administrative appeal, and decide to go directly to court since this is another opportunity to chip away at the difference between the taxing authority and the taxpayer. In addition, an administrative appeal is generally far less costly than litigation and presents a more cost-effective opportunity to resolve the dispute. However, in some limited instances, a taxpayer may consider

bypassing an administrative appeal. For instance, if the taxing authority has consistently taken a position on the issue that is adverse to taxpayers for some time, a taxpayer may consider proceeding directly to litigation, since it would be unlikely that the taxing authority would back off its position.

Simply put, each level of the administrative and litigation process generally presents the opportunity for the taxpayer to get a fresh look at its matter and an opportunity to reach resolution of some or all issues, and my strategy is to pursue resolution to the fullest extent possible at each level. At a minimum, I try to chip away at the gap between the taxing authority and the taxpayer by resolving as many issues as possible in a manner favorable to the taxpayer, even if a favorable resolution of all issues is unavailable.

Presenting the Taxpayer's Position

It is important that the taxpayer and its representatives always present the taxpayer's position in as complete and thorough a manner as possible. This is particularly true with respect to the first communication with taxing authority representatives. I find that first impressions are critical when dealing with taxing authorities. A well-reasoned and complete communication (for instance, a taxpayer's initial response to an auditor on an initial submission in an administrative appeal) will create an impression that the taxpayer is intent on pursuing the matter and prepared for battle. Such a presentation also makes it easier for a taxing authority representative to find a way to resolve a matter in a favorable manner for the taxpayer. Always submit well-reasoned positions that provide taxing authority representatives with rationales that can be used to justify settlement. This is crucial since most taxing authority personnel have a large volume of matters that they need to handle at any given time.

Unfortunately, many taxpayers and their representatives make the mistake of making an incomplete or bare-bones submission. A bare-bones submission which contains only the minimum information required creates a first impression that the taxpayer is unprepared and does not facilitate a resolution of the matter since it does not fully convey the strength of the taxpayer's position or provide taxing authority personnel with a justification to settle the matter.

Provide a Rationale to Justify Settlement.

It is important to find opportunities during the course of negotiations to suggest arguments that the taxing authority representative can use to justify his or her settlement of the matter. Always provide a well-reasoned legal analysis supporting the taxpayer's position. Taxing authority representatives must generally provide the basis of any settlement to a superior for review and approval. Providing a justification or rationale for settlement can make the job of the representative much easier, and go a long way in resolving the matter.

Another effective approach to justify settlement is to highlight any litigation risks that may adversely impact the taxing authority. An unfavorable litigation result for a taxpayer may only impact that taxpayer with respect to the matter in dispute. However, a bad result for a taxing authority could be binding with regard to future taxpayers. It could, for example, restrict the ability of the taxing authority to take the same position on the issue in dispute with future taxpayers, and could even lead to many taxpayers seeking refunds. Therefore, it could be a very effective strategy in settling tax disputes to argue that it is not in the best interest of the taxing authority to pursue your client's matter due to the risk that litigation could create negative precedent that would assist other taxpayers. For instance, this approach could be particularly effective in situations where there is no established precedent with respect to the issue in dispute and you can argue that the facts of the particular matter are favorable to the taxpayer.

To Settle or to Litigate

At each level, whether at audit, administrative appeals or in litigation, a taxpayer and its representatives must assess whether it makes the most sense to settle the matter or pursue it to the next level based largely on the benefit of the proposed settlement versus the cost and risk of pursuing the matter further. The risks of pursuing the matter further could include the possibility of additional issues being raised by the taxing authority or not prevailing in court. The costs associated with pursuing the matter further typically include fees for attorneys, accountants and other experts, any additional interest that would accrue on unpaid amounts that are ultimately due and the use of the taxpayer's resources, such as its employees. When estimating the cost of pursuing the matter further, taxpayers and their

representatives should be particularly sensitive to whether there is a significant dispute between the taxpayer and the taxing authority as to the facts surrounding the matter. The more the facts are in dispute, the more likely costs will mount due to increased investigation and demands by the taxing authority for substantiation and additional information, which results in increased professional fees, use of additional taxpayer resources, and lengthening the administrative and judicial process.

Assume, for example, that the proposed adjustment offered at the audit level is \$200,000, including interest and penalties. This result is not appropriate due to the agent's disallowance of certain deductions that would not be upheld if the matter was litigated. Now assume that the best result that could be achieved by taking the matter to appeals—and, if unresolved, to tax court—is \$150,000. The cost of an administrative appeal and/or litigation and the time that the client would have to spend on this case would in all likelihood outweigh the \$50,000 savings. In addition, unless the client has made a deposit of the amount in controversy, interest will continue to accrue on that sum. Since the appeals and litigation process can be lengthy, this could add a significant additional cost that would weigh in favor of settling at the audit level.

In essence, the decision as to whether to settle the matter or pursue it to the next level is generally a cost-benefit analysis. What is the strength of the client's position versus the time, cost, and effort that is involved in pursuing litigation?

Another consideration that sometimes arises in determining whether to litigate a matter is the benefit of setting a precedent. For instance, the matter in dispute may involve an issue for which there is no precedent but which frequently arises in the context of the taxpayer's business. Of course, the strength of the client's position must be factored in when considering litigation to establish a precedent.

Avoid Common Mistakes

Not Being Responsive in an Audit

One of the biggest mistakes that many taxpayers make in the context of a tax audit is that they fail to respond or provide an incomplete response to

an auditor's request for documents or information. An incomplete response or a failure to respond always negatively influences an auditor, resulting in either added scrutiny directed at the taxpayer or an audit with a less than favorable outcome.

For example, I recently handled an appeal of a tax dispute. During the audit of the taxpayer, the auditor requested additional information regarding a deduction taken by the taxpayer. The taxpayer did properly deduct the item in question, but did not provide the information requested by the auditor. The matter clearly should have been resolved in favor of the taxpayer at audit, but because the taxpayer did not fully respond to the auditor's request, he asserted an assessment of additional tax against the taxpayer. As a result, the taxpayer had to appeal the assessment, and incurred unnecessary cost and aggravation.

In addition, it is not unusual to see a taxpayer respond to an auditor's request by providing information or documents above and beyond what is requested by the auditor. I always advise my clients that they should only provide the information requested—no more and no less. Providing additional information may result in additional issues being raised, or additional tax periods being examined.

Off-the-Cuff Responses

Another common mistake that many taxpayers make is responding too quickly to an auditor's questions or requests. Off-the-cuff responses that are inaccurate will have to be corrected at a later time. At a minimum this diminishes the taxpayer's credibility with the auditor. In addition, a response that has not been fully thought through could lead to additional items being examined in the audit.

If you are having a conversation with an auditor and the auditor raises additional questions or requests information or documents, instead of providing immediate responses, it is prudent to agree with the auditor on a list of follow-up requests and a reasonable amount of time to provide responses. This will allow the taxpayer to carefully consider the questions raised, consult with counsel, and provide complete and accurate responses.

Bare-Bones Submissions

A taxpayer's submission to a taxing authority with regard to its positions should be thorough, setting forth all of the taxpayer's positions, along with all relevant facts, documentation, and authority supporting those positions. Unfortunately, I often see what I call "bare-bones" submissions prepared by either the taxpayer or its representatives. This generally occurs because the taxpayer does not want to spend significant time and incur costs and wants to simply do the minimum possible to have an opportunity to meet with or speak to a taxing authority representation.

I will focus on a taxpayer's initial submission in an administrative appeal since this is where I see the most bare-bones submissions. Making a good first impression on an appeals officer is invaluable, and a well-prepared submission will assure that a taxpayer has a meaningful appeals conference. It will also signal to the appeals officer that the taxpayer is well prepared and serious about pursuing the matter. A well-prepared submission also assists the appeals officer by providing justification that he or she can rely on to settle the matter in favor of the taxpayer; in essence, it gives the taxing authority representative something to hang his or her hat on. Furthermore, the submission will be a part of the file that will be reviewed by taxing authority counsel in the event that the matter is not resolved at the administrative appeals level, and the taxpayer chooses to litigate. If the administrative appeals submission is well prepared, it will have a positive impact on taxing authority counsel.

Unfortunately, many taxpayers and their representatives provide a bare-bones submission to commence the administrative appeals process. For instance, a general form provided by the taxing authority is used and the taxpayer or the taxpayer's representatives simply fill in the blanks with the minimum information required. This is a critical mistake on a number of levels. First, it creates an impression that the taxpayer is not prepared. Second, since the taxpayer did not set forth its position in detail, there may be an impression that the taxpayer's position is unsupported or weak. Next, it is far less likely that an appeals conference will be meaningful, because the appeals officer will not have a complete picture of the taxpayer's position and rationale, and will not be prepared to have a constructive discussion. Lastly, the appeals officer will not have been

provided with a position that he or she could use to justify a settlement beneficial to the taxpayer. The end result is that it will be much more difficult to reach a resolution at the administrative appeals level, or narrow the gap between the taxpayer and the taxing authority.

Refusal to Extend the Statute of Limitations on Assessment

Another major mistake that some taxpayers make is that they refuse an auditor's request to extend the statute of limitations on assessment. In most instances, taxing authorities must assert any additional tax liability within a limited amount of time provided by applicable law. When the time for making an assessment is close to expiring, it is common practice for an auditor to request an extension of time from the taxpayer so that the audit can be completed. Sometimes a taxpayer will refuse to grant an extension. Usually this occurs from the perception that the matter will fly under the radar and the statute of limitations will expire or from a reluctance to prolong the audit further.

However, a taxpayer's refusal to grant an extension virtually always leads to an additional tax assessment being asserted. In addition, since the auditor needs to protect against the expiration of the statute of limitations, the agent will generally assert an assessment that is greater than what would occur if the agent had sufficient time to conclude the audit.

As a result, I believe that it is generally more prudent to agree to an extension of the statute of limitations on assessment but attempt to limit the period of the extension. By providing a limited period of extension a taxpayer affords the auditor additional time to complete the audit but protects against the audit continuing for an unreasonable amount of time. In addition, if possible, the taxpayer may attempt to limit the tax issues that may be considered during the extension. For instance, a taxpayer may attempt to limit the extension only to the tax issues that are then being reviewed by the auditor.

Success in Tax Settlement Negotiations

While there is no one strategy or technique for achieving success in a tax settlement negotiation, I have found that following certain guideposts generally assist taxpayers and their representatives in achieving favorable outcomes. Establish a productive working relationship with the taxing

authority representative. Be fully responsive to requests—but in a manner that protects the rights and interests of the taxpayer. Take a well-reasoned position and provide rationales justifying settlement. Provide a complete, detailed, and polished presentation. Be prepared! Be ready to anticipate all issues and have a preconceived plan as to the endgame of the negotiation that is desired by the taxpayer. Take advantage of all opportunities to narrow the gap. Try to chip away at the difference between the taxpayer and the taxing authority at each of the audit, administrative appeals and litigation levels. At each level there is an opportunity to resolve one or more issues even if a complete resolution is not obtained. Finally, be pragmatic. Seek a resolution to the tax issue that is cost effective taking into account any risks of proceeding and any fees or additional costs that would have to be incurred to resolve the dispute.

A partner with a broad and diverse practice in all areas of general taxation, Robert C. Daleo takes a “value-added” approach in meeting his clients’ needs. “I think that my clients choose me because I can pragmatically come up with solutions that further their business purposes and also protect them on the legal front,” he says. “Clients know that the firm and I can take it to the next level. We are result-oriented.”

Mr. Daleo has a diverse tax practice including partnership tax, corporate tax, and state and local tax. He has substantial experience representing parties in audits, appeals, and litigation with various taxing authorities. Outside the firm, Mr. Daleo is active in Project Acorn, a nonprofit organization that provides preschool tuition for children from families in need of financial assistance in Morris and Somerset counties. He is a trustee and member of the organization's executive committee.

Mr. Daleo received his J.D. from Rutgers University School of Law and his LL.M. in taxation from New York University School.



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