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**WHAT TO EXPECT IN AN IRS AUDIT OF A BANK**

**TO: Community Bank Clients**

**FROM: Powell Goldstein's Tax Practice**

**Reasons for Recent Concern**

Although there have been relatively few IRS audits of community banks in the past, the IRS recently announced that it will increase its audits of community banks, especially where they have investments in partnerships. This new focus on community banks is the result of the bank taxation background now found in a number of IRS agents assigned to the Financial Services audit area. The two key factors in successfully navigating a bank audit are substantive preparation to support the bank's tax positions and a coordinated managed approach to dealing with the IRS audit team. This memorandum discusses the attorney-client privilege issues, how to prepare for an audit, how the audit process works and common bank audit issues. Because IRS personnel are now relying more heavily on IRS legal counsel early in the audit, banks contacted for an IRS audit have a greater need for legal tax counsel advice to guide them through the audit process.

**Attorney-Client Privilege Issues**

A partial accountant-client privilege now exists for non-criminal tax proceedings before the IRS with respect to the tax advice given. However, this privilege is inadequate and may not be asserted to prevent disclosure of information to any regulatory body (and banks are highly regulated) other than the IRS. In addition, this extension of the confidentiality privilege does not include (i) work product prepared by accountants, (ii) an accountant's opinion on financial statements, (iii) audit workpapers, (iv) private party litigation, and (v) non-tax matters. Furthermore, the law is not entirely clear as to whether disclosure of otherwise confidential tax advice on state tax audits could constitute a waiver of the federal accountant-client tax privilege in states that do not recognize an accountant-client privilege.

Information that is disclosed for purposes of preparing a tax return is never privileged. However, it is not clear whether tax advice merely affecting the tax return is privileged. Intra-firm information disclosed to an incorrect department can result in a waiver of the privilege. Therefore, there should be a clear delineation between the audit and tax department personnel as well as between tax compliance and tax planning/litigation support groups within a tax department.

When an accountant is hired by the client's attorney to work under the attorney's direction and control and the accountant's presence is necessary or highly useful to the attorney, the communications between the client and the accountant, and the accountant's workpapers may be protected by the attorney-client privilege. Where the accountant is acting as an agent of the attorney for purposes of assisting with the provision of legal advice, the attorney-client privilege and the work product doctrine may also apply.

### **The IRS Field Audit**

Before the Audit - Obviously, the best time to work on an IRS audit is before it starts. There are a number of things that can be done to marshal the bank's records and substantiate the bank's position on tax issues. The bank should confirm that it has audit trails and contemporaneous documentation of activities. For example, the bank should be preserving correspondence, memoranda, and opinions of counsel and other advisors, as well as external data and other pertinent documents that support a particular position taken. Senior and mid-level managers should be fully aware of the documents needed. The bank's outside legal counsel should conduct such a review so that the attorney-client and work product privileges will be available with respect to any analysis and reports that are generated. Areas that should be reviewed include:

1. Mortgage servicing departments
2. Any types of leasing activity operations
3. Securities or brokerage department operations for trading stocks and bonds for individual or corporate customers
4. Interest rate or commodity trading activities
5. Ownership or operation of any institutions acquired from the FDIC or RTC
6. Any foreign operations/activities

Initial IRS Contact - The bank will usually receive a letter from the IRS providing it notice and scheduling a time to meet for an audit planning conference. The audit is usually held where the original books and records and pertinent source documents are maintained. Commercial banking is included in the IRS' Industry Specialization Program ("ISP") to ensure uniform and consistent treatment of banking issues nationwide. Thus, the initial letter from the IRS will include a description of the ISP and copies of both banking and savings and loan Coordinated Issue Papers. Currently there are four coordinated banking issues: (i) accrued interest on nonperforming loans, (ii) core deposit intangibles, (iii) gain or loss on foreclosed property, and (iv) gross-up net loans.

There are also four coordinated savings and loan issues: (i) accrued interest on nonperforming loans, (ii) core deposit intangibles, (iii) validity of Treas. Reg. § 1.593-6A(b)(5)(iv) (dealing with bad debt deductions in NOL carryback years), and (iv) interest income on the sale of foreclosed property. The last two issues would only be applicable to a bank if it has a savings and loan subsidiary.

At this time, the bank should identify potential issues and review the IRS' 2001 Market Segment Specialization Program ("MSSP") Audit Technique Guide on Commercial Banking (the "Bank Audit Guidelines"). The Bank Audit Guidelines primarily provide detailed instructions for IRS examining agents who are examining commercial banks. However the Bank Audit Guidelines are also used for the audits of savings and loans, mortgage companies, and finance companies. Keep in mind that the size of the bank's asset base does not necessarily correspond to the complexity of the examination. The guidelines direct the examining agents to review the following eight significant issues, some of which are not necessarily relevant for community banks:

1. Mortgage Servicing Rights - This issue involves the recognition of income on the sale of mortgage pools where the seller separates and retains the mortgage servicing rights, and the allocation of basis to the rights retained.
2. Loan Origination Costs (SFAS 91) - The current inclusion into income of all fees, and the capitalization of all direct expenses related to the origination of a loan.
3. Other Real Estate Owned ("OREO") - This issue involves the recognition of gain or loss on the repossession of OREO property, the discount factor used to determine FMV, the write-down of OREO property after it is repossessed, and the handling of OREO expenses where the property is not being used as rental property.
4. Hedging Gains and Losses - Are taxpayers properly identifying hedging transactions or should Internal Revenue Code section 1256 apply?
5. Foreign Tax Credit - What level of substantiation must the taxpayer provide in order to be allowed a foreign tax credit? Can the taxpayer use "borrower" letters as proof of payment?
6. Brazilian Foreign Tax Credit - Is the Brazilian Foreign Tax Credit a credible foreign tax for U.S. tax purposes and if the tax is credible, is the Brazilian Central Bank exempt from tax?
7. Interest Expense (Form 1120F) - This issue involves adjustments made to conform the taxpayer's balance sheet to U.S. standards.
8. Home Office Allocation (Form 1120F) - What is the proper method for allocating expenses from the parent company to the branch operation?

The IRS Audit Team - An audit team will be assigned to an audit and may consist of the Revenue Agent(s), Banking Industry Specialists, Savings and Loan ISP teams, and a case manager. In addition, other specialists will be called in as needed in such areas as international, employment taxes, employee benefit plans, insurance, partnerships and joint ventures, as well as computer, account-

ing and valuation experts. Often representatives of District Counsel's office are called on for advice on legal issues and the IRS's National Office is often involved in policy and legal issues.

**Setting Up Ground Rules** - The bank should insist on having a preliminary meeting with the IRS before the audit begins to establish a tentative timetable for the conduct of the audit and the audit ground rules. The bank should ask for a list of other members of the team and their areas of responsibility. This meeting should set the tone and momentum for the audit. It is important that the audit be conducted in a business-like and professional manner so that dealing with the IRS personnel is not more difficult than it needs to be. Cooperation lends credibility to the tax positions taken and focuses the positions in the best possible light, thus, materially increasing the speed of the audit and decreasing the bank's costs.

**Team to Manage Audit** - The bank should create an audit team and hold pre-audit internal meetings with appropriate personnel to plan for the audit. A point person should be designated to deal with the IRS. Legal counsel should be present to identify legal issues that may come up. The public relations office, certain staff, and union/employee representatives (if applicable) should be informed of the audit to prevent any chance of misinformation. In addition, the bank should inform the employees and staff that a routine exam is being conducted and request that, if contacted, they notify the point person in charge of the audit.

**Access to Facilities, Personnel and Equipment** - The examining agents should be provided with a room or rooms and the records should be delivered to them there. They should not be allowed access to the organization's file room or to financial records on an indiscriminate basis. If they wish to interview employees, they should submit a written request indicating the name, position, or function of the employee to be interviewed and the types of questions that will be asked. The designated point person and the legal advisor should also be present at the interviews. Interviews will likely be requested with executives, directors, and other employees to confirm information already provided, and to clarify information, as well as to mitigate concerns that agents generally have that information may have been filtered and thus not all obtained. Copy machines, phones, computers, and fax machines should be made available for the examining agents' use.

**Process for Providing Records** - The IRS usually starts an examination with requests for documents and other information. Banks should establish procedures for providing information to the IRS. The IRS should be required to give the bank written Information Document Requests ("IDRs"), which specify the nature of the information and documents being requested. The IRS should be advised that all requests for information or documents are to be made to the bank's designated point person. The bank should be forthcoming about providing all documents requested by examining agents. It is important for the bank to have central control over information that is being provided to the IRS in the course of the audit and to maintain its own audit records. Procedures for contacting third parties should also be agreed upon so that the bank is notified in advance if the IRS proposes to contact third parties regarding transactions with the bank.

**Scope of the Audit** - The examining agents will generally make a pre-contact analysis of the filed returns and operations of the bank to determine which items should be examined and the scope of the examination. As the examination progresses, however, new issues may be raised. The

examining agents will pursue the examination to a point where they can make reasonable conclusions based on all the items necessary for substantially proper determinations. For example, they will evaluate all the internal controls over the receipts and payments, explore all sources of revenues, purchases of assets, loan balances and borrowing, etc. Based on their findings the examining agents may decide to expand the investigation to subsequent and prior years and possibly make a referral to the Criminal Investigation division if they suspect fraud. In addition, the IRS has the authority and may decide to review the income tax returns (Forms 1040) filed by persons employed or affiliated with the bank.

Techniques used by Revenue Agents - Techniques used by the examining agents to make determinations include the following:

- ◆ Scrutinize the returns for anything unusual or questionable;
- ◆ Develop all relevant information using direct and indirect methods;
- ◆ Review financial history, financial statements, and current outlook;
- ◆ Review relationships with other entities;
- ◆ Review transactions with other entities;
- ◆ Develop information about real and personal property owned; and
- ◆ Explore any purchases, sales, transfers, contributions, or exchanges of assets.

Authority of Revenue Agents - Examining agents have broad powers to demand and examine any books, papers, and records, or other data "which may be" relevant or material to the particular inquiry. The Internal Revenue Code requires taxpayer to keep permanent books of accounts or records sufficient to establish reportable items. Thus, records must be kept available at all times for inspection by authorized IRS officers and employees and retained as long as the content may be material in administering the Internal Revenue laws. The IRS can ask a Federal District Court Judge to compel the production of the requested records. However, examining agents will not freely request production of audit workpapers that the accountants prepared during the course of a financial audit. Although the IRS has the authority (even under the expanded confidentiality privilege) to request these documents, the IRS recognizes the chilling effect that such a routine request would have on the accountant-client relationship and, therefore, instructs its examiners to request those documents only in unusual circumstances.

Use of Summons - The IRS may summon any officer, employee, or person with possession, custody or care of the books of account containing entries related to the business, or any other person deemed proper, to appear at a time and place named in the summons and to produce those

books, papers, records or other data and to give such testimony, under oath, as may be relevant or material to the inquiry.

## **Methods of Resolution**

**Examination Conferences** - Most audits are resolved at the Examination level by agreement with the case manager and his staff. However if there is no agreement, a determination can be appealed to the IRS' Appeals Office. As the audit proceeds, the agents will often provide written statements of their positions on particular issues in the form of Notices of Proposed Adjustment ("NOPA") on IRS Form 5701 in hopes that the issues can be disposed of early in the process. Under early referral procedures, a request can be made to transfer a developed, unagreed issue to Appeals while other issues remain under examination.

**Appeals Office Conferences** - If all the issues cannot be resolved at the Examination level, the bank may appeal the unresolved issues to the IRS Appeals Office. Issues can often be resolved at this level because the mission of the Appeals Officer is to resolve tax controversies without litigation, and Appeals Officers have the authority to consider the hazards of litigation. A written submission is prepared by the bank for the Appeals Office and is designed to persuade the reader of the correctness of the bank's position.

**Coordinated Issues** - ISP Coordinated Issue Papers (discussed above under "Initial IRS Contact") are written to ensure uniform treatment on issues unique to an industry. Case managers have the authority to settle coordinated issues only with the concurrence of both the Examination and Appeals ISP coordinators and only if the IRS Appeals Office has a written approved settlement position. If the audit includes an adjustment involving a coordinated issue that does not follow the approved settlement position, the examining agents must obtain the approval of the Industry Specialist.

**Technical Advice Memorandum (T.A.M.)** - The examining agents or the bank itself may request technical advice from the National Office during the examination as issues arise on technical or procedural points. If the technical advice is favorable to the bank, the advice is binding on the IRS. If the technical advice is adverse to the bank, the examining agents must raise the issue, but the Appeals Officer can settle the issue at Appeals.

**Closing Agreements** - Often settlements are reflected in a closing agreement between a bank and the IRS. A closing agreement is binding on the IRS as well as the bank because it is a contract. The language of the agreement should be negotiated with great care and the bank's representa-

tives should be comfortable that it is administrable. Although closing agreements are not subject to public disclosure, the IRS can condition such an agreement on its disclosure to the public.

Litigation - As a last resort, litigation is available in Tax Court, a Federal District Court, or the U.S. Court of Federal Claims.

### **Hot Tax Issues in the Banking Industry**

- ◆ FSLIC Assistance
- ◆ Bad Debts
- ◆ Failed Thrift Institutions Operated by the RTC
- ◆ Fee Income
- ◆ Loan Swaps
- ◆ Discharge of Indebtedness
- ◆ Income Received in Advance
- ◆ Capital Costs Reduction Payments
- ◆ Tax-Exempt Obligations
- ◆ Leveraged Buyout Loans
- ◆ Acquisition Costs
- ◆ Branch Costs
- ◆ Credit Card Start-Up Costs
- ◆ ATM Fees
- ◆ Advertising
- ◆ Regulatory Agency Penalties