



*Better Documentation Is Needed  
to Support Office of Appeals'  
Decisions on International Cases*

**September 28, 2017**

**Reference Number: 2017-10-068**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

---

Phone Number / 202-622-6500

E-mail Address / [TIGTACommunications@tigta.treas.gov](mailto:TIGTACommunications@tigta.treas.gov)

Website / <http://www.treasury.gov/tigta>



**To report fraud, waste, or abuse, call our toll-free hotline at:**

**1-800-366-4484**

**By Web:**

**[www.treasury.gov/tigta/](http://www.treasury.gov/tigta/)**

**Or Write:**

Treasury Inspector General for Tax Administration  
P.O. Box 589  
Ben Franklin Station  
Washington, D.C. 20044-0589

Information you provide is confidential and you may remain anonymous.



## HIGHLIGHTS

### **BETTER DOCUMENTATION IS NEEDED TO SUPPORT OFFICE OF APPEALS' DECISIONS ON INTERNATIONAL CASES**

## Highlights

**Final Report issued on September 28, 2017**

Highlights of Reference Number: 2017-10-068 to the Internal Revenue Service Chief, Appeals.

### **IMPACT ON TAXPAYERS**

The Office of Appeals (Appeals) is an independent function within the IRS whose mission is to resolve disputes on a fair and impartial basis without litigation. Appeals is the only IRS function that is authorized to consider the hazards of litigation in attempting to reach a settlement.

In Fiscal Year 2015, the Appeals International Teams did not sustain about \$407 million (94 percent) of \$435 million in proposed deficiencies from IRS examinations that were appealed. It is important that Appeals apply and document a consistent methodology to ensure that taxpayers and the Government receive fair and impartial resolutions.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated because international tax issues are a major area of concern for the IRS. The overall objective was to determine whether controls over international appeals cases are designed to ensure that cases are processed according to IRS criteria and whether Appeals decisions to concede assessments were adequately supported.

### **WHAT TIGTA FOUND**

TIGTA determined that Appeals Officers adequately documented their conclusions for 12 of 39 cases in TIGTA's judgmental sample. The 39 cases included \$348 million of the \$407 million not sustained by the International Appeals Teams in Fiscal Year 2015. The 12 cases (involving \$272 million in proposed deficiencies) were adequately documented or

were resolved without considering the hazards of litigation.

For 27 of the 39 cases in our sample, Appeals did not sustain \$76 million of the Examination function's proposed deficiency; however, it was not apparent, based on the documentation in the case file, how the Appeals Officers arrived at their decision to concede in favor of the taxpayer. Although most case files contained an extensive analysis of facts and tax issues, there was not always a clear connection between the Appeals Officer's analysis and the final decision to concede the Government's position. Because Appeals did not fully document the basis for its decision to concede the proposed deficiencies, TIGTA could not establish if Appeals settled these cases on a basis that was fair and impartial to the taxpayer and the Government.

Further, the IRS could not timely locate nine cases selected for our review and thus could not support Appeals actions in reducing proposed assessments of \$49 million. This is of significant concern due to IRS requirements to retain Federal records.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the Chief, Appeals, reinforce internal guidance to Appeals personnel focusing on how cases settled under the hazards of litigation should be documented to include the weighted hazards for the taxpayer's and the Government's positions and show how settlement amounts or percentages were determined. TIGTA also recommended that the IRS should attempt to secure the unlocated case files, determine the reason(s) the files were not locatable, and implement controls to ensure accessibility of case files.

In their response, IRS management generally agreed with the recommendations and stated that they plan to continue to take steps to reinforce the importance of fully documenting settlement rationales and they plan to review their policies and procedures regarding case routing. They also stated that they plan to continue to participate in IRS-wide efforts to improve record retention processes.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 28, 2017

**MEMORANDUM FOR CHIEF, APPEALS**

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases  
(Audit # 201610022)

This report presents the result of our review on how better documentation is needed to support Office of Appeals decisions on international cases. The overall objective of this review was to determine whether controls over international appeals cases are designed to ensure that cases are processed according to Internal Revenue Service criteria and whether Appeals' decisions to concede assessments on international cases were adequately supported. This audit is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Providing Quality Taxpayer Service Operations.

Management's complete response to the draft report is included as Appendix V. We have concerns about the accuracy of certain statements in the Internal Revenue Service's response to our report. We have noted these concerns in Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations).



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## *Table of Contents*

<a href="#"><u>Background</u></a> .....	Page 1
<a href="#"><u>Results of Review</u></a> .....	Page 5
<a href="#"><u>Appeals Analyzed International Issues but Did Not Always Document the Basis for Decisions to Concede the Government's Position</u></a> .....	Page 5
<a href="#"><u>Recommendation 1:</u></a> .....	Page 10
<a href="#"><u>The IRS Could Not Timely Locate Nine of the 48 Cases We Selected for Review</u></a> .....	Page 10
<a href="#"><u>Recommendation 2:</u></a> .....	Page 11
Appendices	
<a href="#"><u>Appendix I – Detailed Objective, Scope, and Methodology</u></a> .....	Page 12
<a href="#"><u>Appendix II – Major Contributors to This Report</u></a> .....	Page 14
<a href="#"><u>Appendix III – Report Distribution List</u></a> .....	Page 15
<a href="#"><u>Appendix IV – Outcome Measure</u></a> .....	Page 16
<a href="#"><u>Appendix V – Management's Response to the Draft Report</u></a> .....	Page 17
<a href="#"><u>Appendix VI – Office of Audit Comments on Management's Response</u></a> ....	Page 21



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

*Abbreviations*

ACM	Appeals Case Memo
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
SB/SE	Small Business/Self-Employed



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## *Background*

The Office of Appeals (hereafter referred to as Appeals) is an independent function within the Internal Revenue Service (IRS) whose mission is to resolve (settle) tax disputes in a fair and impartial basis without litigation. A settlement is a determination of tax liability, agreed to by the taxpayer, which should fairly and impartially reflect the merits of the issues in the case.

***International tax issues are a major area of concern for the IRS because billions of dollars are involved. The scope, complexity, and magnitude of international financial transactions continue to present significant enforcement challenges for the IRS***

Appeals is the only IRS organization that is authorized to consider the hazards of litigation in attempting to reach a settlement with the taxpayer or the taxpayer's representative. A hazards settlement is an intermediate resolution of an issue based upon the fact that there is substantial uncertainty in the event of litigation as to how the courts would interpret and apply the law or as to what facts the courts would find. Generally, this means that Appeals will settle an issue for a reduced amount, on a basis less than a 100 percent concession or sustention. A settlement may or may not take litigating hazards into account. For example, a case may be settled based solely on the documentation provided by the taxpayer.

Appeals' guidance stresses that a judicial attitude should be used that reasonably appraises the facts, law, and litigating prospects; uses sound judgment and ability to see both sides of a question; and is objective and impartial.<sup>1</sup> Appeals employees consider many types of problems and disputes, including those that arise from international issues.

As of March 2017, Appeals had 46 employees in five teams assigned to its International Operation.<sup>2</sup> These employees are given special training to help them work international cases. Appeals' procedures currently require that cases containing international issues be referred to the Appeals International Teams.

International tax issues are a major area of concern for the IRS because billions of dollars are involved. The scope, complexity, and magnitude of international financial transactions continue to present significant enforcement challenges for the IRS. As the IRS noted in its strategic plan,<sup>3</sup> the evolution and proliferation of virtual commerce has expanded the exchange of goods, services, and currencies (real and virtual) across jurisdictions, further complicating tax

---

<sup>1</sup> Internal Revenue Manual 8.6.4.1.4 (10-26-2007). This manual is the primary official source of IRS instructions to staff relating to the organization, administration, and operation of the IRS. It details the policies, delegations of authorities, procedures, instructions, and guidelines for daily operations for all divisions and functions of the IRS.

<sup>2</sup> International employees account for 3.2 percent of Appeals' total staff.

<sup>3</sup> IRS Strategic Plan Fiscal Years 2014–2017.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

administration. In addition, businesses with U.S. tax obligations are increasingly adopting more complex structures, including increased use of flow-through entities such as partnerships and S corporations.<sup>4</sup>

International tax issues arise from overseas and cross-border activities of U.S. businesses and individuals as well as U.S. activities of foreign businesses and individuals. The tax treatment of these activities is governed primarily by the international sections of the U.S. Tax Code.

Examples include:

- In-bound and out-bound transfers of assets (cross-border reorganizations, liquidations, *etc.*).
- U.S. persons conducting business overseas, either directly or indirectly, through Controlled Foreign Corporations, partnerships, foreign trusts, Passive Foreign Investment Companies, or Foreign Personal Holding Companies.
- Foreign persons conducting business in the United States, either directly or indirectly.
- Foreign persons disposing of U.S. real estate.
- U.S. citizens or residents deriving income abroad, either directly or indirectly, through any entity (foreign bank accounts, foreign trusts, Controlled Foreign Corporations, Passive Foreign Investment Companies, Foreign Personal Holding Companies, or partnerships).
- U.S. citizens residing abroad.
- Withholding on U.S. persons paying U.S.-source passive income (dividends, interest, *etc.*) to foreign persons.
- Any issue that arises under an income tax treaty to which the United States is a party.
- Reporting on Foreign Bank and Financial Accounts (FBAR)<sup>5</sup>

The majority of cases worked by the Appeals International Teams involve individual taxpayers, but the largest dollar value cases involve businesses. Typically, these cases were worked by examiners in the Large Business and International (LB&I) or Small Business/Self-Employed

---

<sup>4</sup> A Subchapter S (S Corporation) is a form of corporation that meets specific Internal Revenue Code requirements, giving a corporation with 100 shareholders or less the benefit of incorporation while being taxed to the shareholders of the corporation.

<sup>5</sup> The Bank Secrecy Act (Pub. L. No. 91-508, 84 Stat. 1114-4 (1970) (codified as amended in scattered sections of 12 U.S.C., 18 U.S.C., and 31 U.S.C.)), regulations for the Bank Secrecy Act and other related statutes (31 C.F.R. §§ 103.11-103.77) may require persons with a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, exceeding certain thresholds to report the account yearly to the Department of the Treasury by electronically filing a Financial Crimes Enforcement Network (FinCEN) 114, *Report of Foreign Bank and Financial Accounts* (FBAR).



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

(SB/SE) Divisions. Cases are assigned to either the LB&I or the SB/SE depending on the taxpayers' sources of income, types of returns involved, business structure, gross assets, *etc.*

According to the IRS, the volume of proposed deficiencies made by its examination functions is larger than the volume of proposed deficiencies that are appealed. The IRS stated that, in Fiscal Year (FY)<sup>6</sup> 2015, the LB&I and SB/SE Divisions proposed approximately \$3.7 billion in deficiencies attributable to more than 42,000 income tax returns that involved at least one international tax issue. According to Appeals, data from its systems show that Appeals received approximately 3,940 returns in FY 2015 from LB&I and SB/SE Division examination functions with at least one international issue associated with the case, and the proposed deficiencies associated with the cases totaled approximately \$2.4 billion.<sup>7</sup> Appeals noted that a small percentage of cases are normally appealed, but large-dollar cases tend to be appealed at a higher rate.

Appeals data show that it closed more than 1,900<sup>8</sup> cases in FY 2015 with at least one international issue associated with the case, and the proposed deficiencies associated with the cases totaled approximately \$6.1 billion. Appeals noted that the \$6.1 billion in cases closed in FY 2015 included several large-dollar cases that were received by Appeals in prior fiscal years but were not closed until FY 2015. Further, not all exam cases with international issues are assigned to the Appeals International Team. Generally, audits of large corporations (which could involve international issues) are assigned to the Appeals Team Case Leader Operations, where multiple Appeals Officers are assigned to a case.

Appeals tracks the number, type, and dollar amounts of cases it works. For the amounts associated with proposed assessments from the examination functions, the Appeals Centralized Database System contains the total proposed deficiency and the total revised deficiency for each case. Based on these two fields, it can be determined how much of the proposed deficiency was reduced during the Appeals process.<sup>9</sup> Figure 1 shows the Appeals International Team's inventory of closed international cases from FY 2012 through FY 2015.

---

<sup>6</sup> Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

<sup>7</sup> This background information was provided by the IRS. We did not validate the information provided.

<sup>8</sup> Cases closed by Appeals in FY 2015 could be associated with proposed deficiencies made by examination functions in prior fiscal years.

<sup>9</sup> The difference between the proposed and revised deficiency is not always the amount conceded due to other factors that affect the tax assessment, such net operating losses and foreign tax credit carryovers.



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

**Figure 1: Summary of Examination Cases Closed by the Appeals International Teams From FY 2012 Through FY 2015**

<b>Fiscal Year</b>	<b>Number of Cases</b>	<b>Proposed Deficiency by Examination by Function<sup>10</sup></b>	<b>Reduction in Proposed Deficiency by Appeals</b>	<b>Revised Deficiency After Appeal</b>
2012	609	\$232,528,657	\$190,559,327 (82%)	\$41,969,330 (18%)
2013	937	\$186,797,662	\$152,044,965 (81%)	\$34,752,697 (19%)
2014	823	\$446,765,752	\$414,259,658 (93%)	\$32,506,094 (07%)
2015	753	\$434,722,947	\$406,944,536 (94%)	\$27,778,411 (06%)
<b>Average</b>	<b>781</b>	<b>\$325,203,755</b>	<b>\$290,952,122 (89%)</b>	<b>\$34,251,633 (11%)</b>

Source: Our analysis of data from the Appeals Centralized Database System.<sup>11</sup>

We determined that Appeals personnel did not sustain 94 percent of the proposed examination assessments on international cases worked by the Appeals International Teams closed in FY 2015. In addition, according to Appeals, when considering International Appeals work by case instead of dollar outcome, over the four-year period, 32 percent of cases were fully sustained, 36 percent of cases were partially sustained, and 32 percent of cases were fully conceded.

This review was performed at the Greensboro, North Carolina, Appeals office and with information obtained from the IRS National Headquarters in Washington, D.C., and other Appeals offices during the period July 2016 through June 2017. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

<sup>10</sup> Proposed deficiencies by examination do not include closed cases involving penalty appeals, innocent spouse, and other cases.

<sup>11</sup> The Appeals Centralized Database System is used by Appeals Officers, Settlement Officers, managers, and technical analysts to track case receipts, record case time, document case actions, and monitor the progress of the Appeals workload.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## *Results of Review*

### **Appeals Analyzed International Issues but Did Not Always Document the Basis for Decisions to Concede the Government's Position**

We found that the Appeals International Teams did not always document decisions to concede the Government's position as required by IRS criteria. Appeals International Team personnel generally conducted a thorough analysis of highly complex tax issues involving high-income individual and business taxpayers. These cases involve a variety of factors that require specialized training and expertise to resolve issues arising from tax treaties, foreign-owned subsidiaries and trusts, foreign tax credits, *etc.* For the 39 judgmental sample<sup>12</sup> cases we reviewed, most included an extensive analysis of the complex tax issues. However, for 27 of the 39 cases, Appeals did not weigh the relative strengths and weaknesses of both the taxpayer's and the Government's position as required by IRS guidance.

### **Appeals international case files generally included an extensive analysis of facts and tax issues affecting each case**

Our review of 39 cases closed by the Appeals International Teams in FY 2015 found that most cases included an extensive analysis of the tax issues involved in each appeal. These cases originated in the LB&I and the SB/SE Divisions within the IRS. These cases included some of the most complex issues in the U.S. Tax Code. The treatment of foreign entities, trusts, and subsidiaries are included in these cases, along with complex decisions on foreign tax treaty implications and the application of foreign tax credits. For 12 of the cases reviewed, which included approximately \$272 million in proposed deficiencies, Appeals Officers provided adequate documentation to support their conclusions.<sup>13</sup>

The Appeals Internal Revenue Manual (IRM)<sup>14</sup> establishes that the Appeals Case Memo (ACM) is the report used to describe the Appeals Officer's basis for settlement. The ACM should discuss the various factors that were considered in arriving at a settlement, if applicable. In

---

<sup>12</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population. For FY 2015, the Appeals International Teams closed 753 exam cases. Of those cases, 451 involved a concession of part or all of the assessments proposed by the Examination function. We selected our judgmental sample from the 48 largest dollar cases of the 451 with concessions. The 48 cases accounted for \$396,283,671 (97.2 percent) of the \$407,716,102 conceded in part or in full of the 451 records. Appeals was unable to timely locate nine of the 48 cases we selected. The 39 cases we were able to test accounted for \$347,746,124 of the \$407,716,102 not sustained by the International Appeals Teams in Fiscal Year 2015.

<sup>13</sup> Some cases did not involve the hazards of litigation.

<sup>14</sup> IRM 8.6.2.1, *Introduction to Appeals Case Memos (ACMs)* (March 16, 2015).



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

addition, the reader of the ACM should understand why the settlement is appropriate. Thorough documentation is important in cases processed by the Appeals International Teams because numerous tax issues can be included in one case file.

Most of the cases we reviewed included a detailed analysis of the numerous factors involved in the Appeals Officer's decisionmaking process. This includes instances in which the Examination function did not provide adequate documentation to support its proposed deficiency and the ACM described why the Government's position could not be fully sustained. \*\*1\*\*

\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*

**Decisions to concede the Government's position based on the hazards of litigation were not always supported as required by the IRM**

Our review found that Appeals Officers did not adequately document how they arrived at their decision to concede the Government's position for 27 of the 39 cases in our judgmental sample. Although Appeals has guidance that directs Appeals Officers to weigh the factors used to determine the relative strengths and weaknesses of opposing positions, this analysis was not documented in 27 cases we reviewed. Therefore, we could not determine how the Appeals Officers converted their analysis into the final settlement percentage or numeric determination.

The Appeals Officers' decisions on these 27 cases reduced the proposed audit assessments of about \$86 million to about \$10 million. The \$76 million in assessments not sustained on these cases amount to 18.7 percent of all proposed audit dollars not sustained by the International Appeals Teams in FY 2015. Hazards of litigation was the primary reason assessments were not sustained in these 27 cases. In addition, the ACMs lacked a clear link between the opposing legal positions involved in each case and the numeric percentage conceded.

The Appeals IRM establishes that the ACM should discuss the various factors that were considered in arriving at the settlement, and the reader should understand why the settlement is appropriate. Further, if an issue was resolved based on the hazards of litigation, the ACM should explain the steps taken in the evaluation process as follows:

- a. Summarize the hazards identified in the discussion and analysis.
- b. Weigh their strengths and weaknesses.
- c. Determine the relative strengths of opposing positions.
- d. Convert the evaluation to a percentage or numerical determination.

Although the case files contained extensive narratives about the various tax issues and litigation hazards, there was not always a clear connection between the analysis and the final decision to concede the Government's position. The lack of a clear connection to the final settlement was





*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

As a result of the lack of documentation, both the taxpayer and the Government cannot be assured that cases were appropriately settled. Appeals management did not agree with our conclusions on 24 of the 27 cases and indicated that, in their opinion, there was adequate information in the case files to establish how the decision to concede was determined and that the amounts conceded were appropriate based upon the case documentation. Appeals management did not agree that documentation weighing the strengths and weaknesses of the hazards identified should have included a percentage or numeric value, despite IRS criteria which requires that documentation to be included.

While we acknowledge that Appeals Officers must exercise independent judgement and are not bound by the Examination functions' findings, Appeals criteria clearly requires Appeals Officers to weigh the strengths and weaknesses of the hazards identified to determine the relative strengths of opposing positions before converting the evaluation into a percentage or numerical determination for an appropriate settlement. Since Appeals did not fully document its decision to concede all or a portion of the proposed deficiencies, we could not establish if Appeals settled these cases on a basis that was fair and impartial to both the taxpayer and the Government. The following are examples of other observations made as part of our review:

**Fifteen cases were fully conceded based on the hazards of litigation**

We found that Appeals conceded 100 percent of the Examination function's proposed deficiency based on the hazards of litigation for 15 of the 27 cases, totaling \$38,073,014 in proposed audit assessments. This decision shows that Appeals believed the Government's position was so weak that the taxpayer faced virtually no hazards if litigation were pursued. For example, 10 cases in our sample involved former employees of the same Swiss employer who received lucrative post-employment benefits that IRS examiners determined to be deferred compensation and subject to U.S. income tax. As part of the audit process, the Examination function obtained a Counsel opinion that supported its position; however, that opinion was not referenced or given any weight in the Appeals Officer's ACM.

**Concessions by Appeals sometimes involved interactions with IRS Chief Counsel's office**

Appeals management advised us that IRS Chief Counsel will sometimes recommend that they settle an issue rather than risk a negative precedent should the Government not prevail in court. In two cases, we confirmed that Chief Counsel suggested that Appeals accept the taxpayer's claimed residency status (one of several issues in the cases), which enabled the taxpayers to receive tax treaty benefits.

\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*



*Better Documentation Is Needed to Support Office of Appeals' Decisions on International Cases*

\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*

**Appeals conceded four cases when the taxpayer made an offer, but Appeals did not document how the concession compared to the relative strengths and weaknesses of opposing positions**

We observed four instances in which settlement offers made by the taxpayer were deemed reasonable by Appeals although these decisions were not documented to establish why the taxpayer's settlement offer amount was appropriate. \*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*

**Appeals made efforts to settle similar cases at similar rates, but it did not document how differences in case facts affected the settlement amount**

We observed two instances in which Appeals made efforts to resolve cases with taxpayers with similar issues at the same concession rate, but the cases included noted differences that could have affected the appropriate range of concessions. \*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*

**Appeals accepted unsupported claims on two cases**

In two instances, the Appeals Officer accepted the unsupported claims made by taxpayers' representatives after they failed to provide written support when it was requested during the examination. \*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*  
\*\*\*\*\* 1 \*\*\*\*\*

Appeals management advised us that it is within their authority to accept verbal testimony and unsupported claims, and they may do so if they have confidence in the integrity of the taxpayer's representative. However, Examination function personnel expressed concern that representatives purposely do not provide supporting documentation during the examination with the expectation that they can provide it later to Appeals, where it will receive less scrutiny.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## ***Recommendation***

**Recommendation 1:** The Chief, Appeals, should reinforce to Appeals personnel that ACMs for cases settled under the hazards of litigation should be documented to include the weighted hazards of both the taxpayer's and the Government's positions and show how settlement amounts or percentages were determined, as required by IRS guidance.<sup>16</sup>

**Management's Response:** Appeals agreed with this recommendation and stated that it will continue to take steps to reinforce the importance of fully documenting settlement rationales, including the relative merits of each side's position, through hazards of litigation training and annual continuing professional education workshops for Appeals Technical Employees who work international cases.

## **The IRS Could Not Timely Locate Nine of the 48 Cases We Selected for Review**

When we began our review in August 2016, we requested the 48 international cases with the highest dollar amounts not sustained by the Appeals International Teams in FY 2015; however, after an extensive search, the IRS was able to provide us with only 36 cases.<sup>17</sup> In October 2016, we asked Appeals management to assist us with the search, and they located five additional cases; however, two cases were received on February 23, 2017, which was too late in the audit process to be included in our review. As a result, we were only able to review 39 cases.

We are unsure why the IRS could not provide the closed Appeals files because they should have been locatable under a specific document locator number<sup>18</sup> that is identified on the Integrated Data Retrieval System.<sup>19</sup> Appeals management advised us that after Appeals closes a case, it sends the file back to various campus locations<sup>20</sup> for storage. Because more than a year had passed, Appeals management stated that they no longer retained Forms 3210, *Document Transmittal*, and therefore could not provide verification that the campus locations received the case files after they were closed.

For these nine cases, Appeals did not sustain \$48,697,633 (97 percent) of the \$50,169,744 in deficiencies proposed by the Examination function. However, because neither our auditors nor Appeals could locate the files, we could not review 19 percent of the cases in our judgmental sample. Subsequent to the completion of our review of the sample cases, and more than

---

<sup>16</sup> IRM 8.6.2.5.4.2, *Resolved Based on Hazards of Litigation* (October 18, 2007).

<sup>17</sup> Case files included some electronically stored documents as well as paper documents that, in some cases, numbered more than 100 pages.

<sup>18</sup> A unique number assigned to every tax return to assist in controlling, identifying, and locating the return.

<sup>19</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

<sup>20</sup> A campus is the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

four months after we initially requested the files, Appeals represented that it was able to locate two of the nine files.

We also requested all available electronic files from Appeals for these nine cases; however, the information we received was incomplete, and key documentation (such as the taxpayer's statement of disagreement with the adjustments proposed by the Examination function) was missing. The unavailability of nine of the 48 cases with the largest reductions in proposed deficiencies is of significant concern due to IRS requirements to retain Federal records.

### ***Recommendation***

**Recommendation 2:** The Chief, Appeals, in coordination with other IRS offices involved in the storage of Appeals case files, should attempt to secure the unlocated case files, determine the reason(s) the files were not locatable, and implement controls to ensure accessibility of case files.

**Management's Response:** Appeals agreed with this recommendation in part. It will review its policies and procedures regarding case routing; however, it indicated that gaps in locating case files is an IRS-wide issue. Accordingly, Appeals will continue to participate in IRS-wide efforts to improve record retention processes to the extent possible given limited resources.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective was to determine whether controls over international appeals cases are designed to ensure that cases are processed according to IRS criteria and whether Appeals' decisions to concede assessments on international cases were adequately supported. To accomplish our objective, we:

- I. Determined what guidance has been provided to Appeals and IRS employees regarding the processing of international cases.
- II. Evaluated Appeals' controls for processing international examination cases for which the proposed assessment was not fully sustained.
  - A. Selected a judgmental sample<sup>1</sup> of FY<sup>2</sup> 2015 cases appealed based on proposed assessments from the IRS Examination functions and identified the highest risk cases based on the total reductions by Appeals to proposed assessments. By selecting a judgmental sample of 48 cases, this audit reviewed more than 90 percent of the dollars reduced during the Appeals process. Case-specific errors were not to be projected to the total population.
  - B. Reviewed the sampled case files to determine whether Appeals personnel followed IRS policies when reducing the proposed assessments during the appeals process.
    1. If Appeals reduced the Government's position based on the hazards of litigation, determined if the Appeals Officer fully documented his or her decision.
    2. Determined if Appeals management approved the Appeals Officer's determination to not fully sustain the Government's position.

#### **Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: Appeals and IRS policies, procedures, and practices for processing Appeals international cases. We evaluated these controls by reviewing a judgmental sample of 39 Appeals international cases closed in FY 2015,

---

<sup>1</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

<sup>2</sup> Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

evaluating Appeals' guidance, and interviewing Appeals management. The 39 cases included \$348 million of the \$407 million not sustained by the International Appeals Teams in FY 2015.



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

**Appendix II**

*Major Contributors to This Report*

Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations)

Jonathan T. Meyer, Director

Janice M. Pryor, Audit Manager

Mary F. Herberger, Lead Auditor

Joseph P. Smith, Senior Auditor

Ahmed M. Tobaa, Senior Auditor



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

**Appendix III**

*Report Distribution List*

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Services and Enforcement  
Commissioner, Large Business and International Division  
Commissioner, Small Business/Self-Employed Division  
Deputy Chief, Appeals  
Director, Office of Audit Coordination



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## Appendix IV

### Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Revenue Protection – Potential; 15 taxpayers and \$38,073,014 in proposed audit assessments conceded by Appeals for which the Appeals case file did not adequately support the decision to concede 100 percent of the proposed deficiencies. As a result, these concessions could have resulted in as much as \$38,073,014 of future tax revenue<sup>1</sup> (see page 5).

#### **Methodology Used to Measure the Reported Benefit:**

For 15 of the 39 sampled FY<sup>2</sup> 2015 closed international cases reviewed, the Appeals case files did not support the decision to concede 100 percent of the Examination function's proposed assessment (\$38,073,014). We originally selected a judgmental sample of 48 cases (40 taxpayers) from a population of 451 international cases closed in FY 2015.<sup>3</sup> These cases had the highest dollars in proposed examination assessments that were either fully or partially conceded by Appeals personnel and included the following types of cases: Industry<sup>4</sup> and Examination cases.<sup>5</sup> We were unable to timely secure nine of the 48 cases, so our review was limited to the 39 available cases.

---

<sup>1</sup> This figure assumes that taxpayer appeals of the proposed examination assessments on all Appeals case files that did not adequately support the decision to abate would have been rejected and that the IRS would have been able to collect all assessments from taxpayers involved in the 14 cases.

<sup>2</sup> Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

<sup>3</sup> The population of international cases closed in FY 2015 was 1,361 cases. We filtered our sample to exclude penalty, collection due process, innocent spouse, and "other" cases to arrive at a population of 451 cases. The 451 fully or partially conceded cases of the total 1,361 cases accounted for 81 percent of the deficiencies proposed by the Examination function: \$425,528,396 of the \$526,927,054 in FY 2015. These 451 records also accounted for 94 percent of the dollars Appeals conceded: \$407,716,102 of the \$434,178,100.

<sup>4</sup> LB&I Division cases fall into two categories: Coordinated Industry Cases or Industry Cases. Any case within the LB&I Division that has not been defined as a Coordinated Industry Case is considered an Industry Case. Point criteria are used to determine if a case falls into the Coordinated Industry Case category.

<sup>5</sup> This category includes Examination cases generated from the SB/SE and the Tax Exempt & Government Entity Divisions.



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

**Appendix V**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

August 31, 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Donna C. Hansberry  
Chief, Appeals

SUBJECT: Draft Audit Report – Better Documentation is  
Needed to Support Office of Appeals' Decisions on  
International Cases (Audit # 201610022)

Thank you for the opportunity to review and provide comments on the subject draft audit report and its recommendations. We appreciate your recognition that most of the selected Appeals International case files included an extensive analysis of the facts and tax issues involved in each appeal. We also note that TIGTA concluded the vast majority (78%) of the conceded amounts reviewed in connection with the judgmental sample were adequately explained and documented or resolved without considering hazards of litigation. We agree in general with the recommendations.

Sustention Data

While we generally agree with your recommendations, we disagree with your inclusion in the report of dollar-based sustention data (Figure 1: "Summary of Examination Cases Closed by the Appeals International Teams from FY 2012 through FY 2015"). Appeals' mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer. A fair and impartial settlement reflects the probable result in the event of litigation or mutual concessions based on the relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation. See IRM 8.6.4.1. Dollar-based sustention rates give no indication whether Appeals' determinations reasonably reflect the hazards of litigation, the standard by which our work should be measured.

Dollar-based sustention data also does not reflect the fact that most taxpayers, including those with international issues, resolve their cases at the Compliance level without an appeal. In fact, in fiscal year 2015, the Large Business and International (LB&I) and Small Business/Self-Employed (SBSE) divisions proposed deficiencies for more than 42,000 income tax returns involving at least one international issue, while Appeals received only 3,940 of those returns.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

Cases that come to Appeals, as evidenced in the judgmental sample selected for this audit, often include issues of legal uncertainty or greater litigating risks for the Government due to taxpayer-favorable judicial precedent. Figure 1 of your report does not provide this important context.

Furthermore, the data in Figure 1 is misleading, because it is heavily influenced by a small number of cases. The vast majority of Appeals International work is comprised of smaller cases that originate from the SBSE and Wage and Investment divisions or LB&I's Individual International Compliance function. As a result, a very small number of large LB&I coordinated industry cases causes a significant outlier effect on the dollar-based data in the report. When viewed instead by the number of cases (rather than by the amounts sustained), the data show that Appeals International fully sustained (32%) and fully conceded (32%) roughly the same number of cases worked during this period, while partially sustaining (36%) the remaining cases.

Case Documentation

Appeals takes seriously its responsibility to provide impartial, high-quality case resolutions to the maximum extent possible. See Policy Statement 8-47. We agree that it is important to adequately document and explain case settlements and, as a result, we continually seek to improve the quality of Appeals Case Memorandums (ACMs). With that said, we think the report misinterprets the documentation requirements of Internal Revenue Manual (IRM) 8.6.2.5.4.2. The IRM instructs Appeals Officers to weigh the relative strengths and weaknesses of opposing positions: it does not specify the form this analysis should take. The report states that Appeals management did not ensure that the hazards noted were weighed and converted into percentages or a numerical determination before the settlement amounts were approved. The IRM is not intended to require Appeals Officers to convert each hazard or every relevant factor into a numerical value for tallying.

The report also states that it is important that Appeals apply and document a consistent methodology to ensure that taxpayers and the Government receive fair and impartial resolutions. We agree it is important to treat similarly-situated taxpayers similarly and to adequately document settlement rationales. However, we note that the IRM is not intended to impose a "one size fits all" approach to ACMs. IRM 8.6.2.5.4.2 provides guidance for all Appeals cases with settlements based on hazards of litigation. Hazards settlements are reached in complex Appeals Team Case Leader (ATCL) cases that often have ACMs spanning tens of pages, as well as in less complex Campus cases that may have ACMs from a few paragraphs to a few pages long. The type of analysis that satisfies the IRM can vary greatly depending on the type of case and the issue(s) involved.



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

Accordingly, from our perspective, 24 of the 27 case files that TIGTA concluded lacked sufficient documentation did, in fact, contain adequate information for the manager—who is expected to possess a level of technical expertise equivalent to the Appeals Officer—to establish how the decisions were made and that the settlements were appropriate.

Records

We fully recognize the importance of complying with records retention requirements and being able to locate case files when needed. Since Appeals does not control the entire IRS records retention process, we will need to collaborate with other IRS stakeholders to develop controls to improve our ability to access case files.

Outcome Measure

You contend that 15 sample cases with \$38 million at issue lacked adequate documentation. Based on these cases, the report concludes that the measurable impact on tax administration of improving Appeals' documentation of hazards-based settlements is potential revenue protection of up to \$38 million. This outcome measure is based on your assumption that all 15 of the identified appeals lacking adequate documentation of the settlement should have been rejected in their entirety. We find no basis in the report for calculating the potential revenue impact of the recommended corrective actions. TIGTA's position that there was inadequate documentation does not necessarily mean that all 15 of the identified cases were wrongly decided in Appeals. Further, as we discussed during the audit, your estimated potential for up to \$38 million in revenue protection does not take into account the effect of offsetting positions and other considerations documented in the case files.

Attached is our detailed response outlining our planned corrective actions to address your recommendations.

If you have any questions, please contact me, or a member of your staff may contact Anita Hill, Director Case and Operations Support at (901) 546-041.

Attachment



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

**RECOMMENDATION 1:**

The Chief, Appeals, should reinforce to Appeals personnel that ACMs for cases settled under the hazards of litigation should be documented to include the weighted hazards of both the taxpayer's and the Government's positions and show how settlement amounts or percentages were determined, as required by IRS guidance.

**PROPOSED CORRECTIVE ACTION**

Appeals agrees with this recommendation. We will continue to take steps to reinforce the importance of fully documenting settlement rationales, including the relative merits of each side's position, through hazards of litigation training and annual continuing professional education workshops for Appeals Technical Employees who work International cases.

**IMPLEMENTATION DATE**

August 15, 2018

**RESPONSIBLE OFFICIAL**

Director, Case and Operations Support

**RECOMMENDATION 2**

The Chief, Appeals, in coordination with other IRS offices involved in the storage of Appeals case files, should attempt to secure the unlocated case files, determine the reason(s) the files were not locatable and implement controls to ensure accessibility of case files.

**PROPOSED CORRECTIVE ACTION**

Appeals agrees with this recommendation in part. We will review our policies and procedures regarding case routing; however, gaps in locating case files is an IRS-wide issue. Accordingly, we will continue to participate in IRS-wide efforts to improve record retention processes to the extent possible given our limited resources.

**IMPLEMENTATION DATE**

Review of Appeals' policies and procedures regarding case routing – March 15, 2018

**RESPONSIBLE OFFICIAL**

Director, Case and Operations Support



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

## Appendix VI

### *Office of Audit Comments on Management's Response*

In response to our draft report, the Chief, Appeals, generally agreed with our recommendations but indicated disagreement with some facts and conclusions presented in the report. We believe those statements by the Chief, Appeals, warrant additional comment. We have included management's response and our related comments below.

**Management's Response:** *While we generally agree with your recommendations, we disagree with your inclusion in the report of dollar-based sustention data (Figure 1: "Summary of Examination Cases Closed by the Appeals International Teams from FY 2012 through FY 2015"). .... Dollar-based sustention rates give no indication whether Appeals' determinations reasonably reflect the hazards of litigation, the standard by which our work should be measured. Dollar-based sustention data also does not reflect the fact that most taxpayers, including those with international issues, resolve their cases at the Compliance level without an appeal. ... Furthermore, the data in Figure 1 is misleading, because it is heavily influenced by a small number of cases. The vast majority of Appeals International work is comprised of smaller cases that originate from the SB/SE and Wage and Investment divisions or LB&I's Individual International Compliance function. As a result, a very small number of large LB&I coordinated industry cases causes a significant outlier effect on the dollar-based data in the report.*

**Office of Audit Comment:** We included Figure 1 to provide perspective into the Appeals International Program over a four-year period. The information in Figure 1 was derived directly from the Appeals' database, Appeals Centralized Database System. In the report, we do not make any value judgment about the information in Figure 1; however, the figure accurately provides summary information on the dollars associated with the final disposition of Appeals international cases. While we agree that the Appeals International Program does process small- and large-dollar cases, the information in Figure 1 accurately shows the percentage of proposed deficiency dollars that were reduced by Appeals with respect to the cases summarized in Figure 1. Finally, given that 89 percent of the dollars (\$1.16 billion of \$1.30 billion) over the four-year period were conceded in favor of the taxpayer, a case-based summary showing a relatively even distribution between conceded and sustained cases would not accurately reflect the magnitude of decisions made by Appeals on these international cases.

**Management's Response:** *Appeals takes seriously its responsibility to provide impartial, high-quality case resolutions to the maximum extent possible. ... With that said, we think the report misinterprets the documentation requirements of Internal Revenue Manual*



---

*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

*(IRM) 8.6.2.5.4.2. The IRM instructs Appeals Officers to weigh the relative strengths and weaknesses of opposing positions: it does not specify the form this analysis should take. The report states that Appeals management did not ensure that the hazards noted were weighed and converted into percentages or a numerical determination before the settlement amounts were approved. The IRM is not intended to require Appeals Officers to convert each hazard or every relevant factor into a numerical value for tallying. ... Accordingly, from our perspective, 24 of the 27 case files that TIGTA [Treasury Inspector General for Tax Administration] concluded lacked sufficient documentation did, in fact, contain adequate information for the manager—who is expected to possess a level of technical expertise equivalent to the Appeals Officer—to establish how the decisions were made and that the settlements were appropriate.*

**Office of Audit Comment:** We stand by our determination that case files lacked sufficient written documentation to justify the full or partial concession of proposed audit deficiencies. Appeals management points out that its IRM instructs Appeals Officers to weigh the relative strengths and weaknesses of opposing positions and that the IRM does not specify what form this analysis should take. However, Appeals left out the fact that the IRM also states “The reader should understand why your settlement is appropriate.” As noted in our report in Figure 2, Appeals cases frequently noted numerous litigation hazards with no discussion of relative strengths and weaknesses. Without some weight or value placed on the various legal hazards, a reader cannot reasonably understand how the Appeals Officer arrived at a settlement percentage and cannot ensure that the arguments of the taxpayer and IRS were appropriately evaluated. Documentation of Appeal’s rationale on cases is particularly important given that 94 percent of the dollars (\$407 million of \$435 million) in our sample were conceded in favor of the taxpayer. Since we could not see how these settlements were appropriate, we continue to strongly disagree with Appeals supposition that Appeals Officers do not have to document their analysis in the case file. Otherwise, the IRS has no assurance that Appeals settlements are appropriate and reasonable.

**Management’s Response:** *You contend that 15 sample cases with \$38 million at issue lacked adequate documentation. Based on these cases, the report concludes that the measurable impact on tax administration of improving Appeals' documentation of hazards-based settlements is potential revenue protection of up to \$38 million. This outcome measure is based on your assumption that all 15 of the identified appeals lacking adequate documentation of the settlement should have been rejected in their entirety. We find no basis in the report for calculating the potential revenue impact of the recommended corrective actions. TIGTA’s position that there was inadequate documentation does not necessarily mean that all 15 of the identified cases were wrongly decided in Appeals. Further, as we discussed during the audit, your estimated potential for up to \$38 million in revenue protection does not take into account the effect of offsetting positions and other considerations documented in the case files.*

**Office of Audit Comment:** We disagree with Appeals’ contention that there is no basis for our outcome measure of \$38,073,014 in potential revenue protection for



*Better Documentation Is Needed to Support  
Office of Appeals' Decisions on International Cases*

---

15 cases in our judgmental sample. For these cases, we determined that Appeals conceded 100 percent of the Examination function's proposed deficiencies based on hazards of litigation, which means that Appeals determined that the Government's position (specifically that of the IRS's own Examination function) had no merit. However, during our review, we found that Appeals Officers did not recognize factors in favor of the Government such as an IRS Counsel Opinion obtained by the Examination function which supported the Government's position. The case files were also not clearly documented to explain why the taxpayer was entitled to full concessions given that the IRS's own Chief Counsel opinion supported the assessment. Finally, the "offsetting positions and other considerations" raised by Appeals were not fully developed in the case files we reviewed. We recognize that the outcome measure is only a potential outcome, but without adequate documentation from Appeals, we could not determine what percentage of the proposed deficiencies should have been sustained and what percentage should have been conceded.