In this issue:

2 IRS practice and procedure
   • New IDR process announced
   • LB&I issues FY14 Field Focus Guide
   • To Pre-CAP or not to Pre-CAP: that is the question

10 Transfer pricing enforcement trends
   • LB&I issues new “Roadmap” for transfer pricing audits

16 Penalty corner
   • Expansion of the IRS program to systemically assess penalties for Forms 5471 and 5472 filed with late-filed returns, including late-filed Forms 1065, makes it even more imperative that taxpayers file timely returns

18 Courts
   • Court holds that fraudulent items on partnership return do not automatically keep open the statute of limitations for partners
   • Supreme Court update

22 Legislative, regulatory and other guidance
   • The use of statistical sampling for mitigating tax risk

24 TEFRA corner
   • Duties of a tax matters partner under TEFRA procedural rules

29 Ernst & Young LLP adds new controversy talent
IRS practice and procedure

New IDR process announced

By Pat Chaback, Executive Director, Tax Controversy and Risk Management Services, Ernst & Young LLP

L&I issued a third directive regarding the IDR process, providing further clarification of issuance requirements and the enforcement process. On 28 February 2014, the Internal Revenue Service’s (IRS) Large Business and International (LBI) Division issued a new directive (LB&I-04-0214-004, the New Directive) with updated guidance clarifying Information Document Request (IDR) issuance requirements and enforcement procedures. The New Directive incorporates and supersedes LBI’s two prior IDR directives, with changes intended to help examiners and taxpayers understand the new procedures, particularly with regard to the timing of enforcement.

The initial LBI directive attempting to revamp the IDR process was issued on 18 June 2013 (LB&I-04-0613-004, the June Directive), and covered IDR issuance requirements. These included the need for IDRs to be issue-focused (i.e., they must identify the issue that led to the request) and IDRs to be issue-focused (i.e., they must be timely reviewed. If, during the discussion of an IDR, a taxpayer indicates that the requested information will not be provided without a summons, the IDR enforcement procedures do not apply, and the IRS should move directly to the issuance of a summons.

Know and understand the new IDR process to avoid a summons

The New Directive clarifies the IDR process and provides taxpayers with a specific time frame that LB&I examiners and specialists must follow during the enforcement process. This guidance allows examiners and specialists limited discretion in granting extensions for responding to the IDRs. However, taxpayers should not rely on this possibility in discussing and determining the mutually agreed-upon response time during the early stages of the IDR process.

Knowing what is expected in fulfilling the IDR requests and how long it is reasonably expected to take for the taxpayer to respond remains critical. Given that the revised IDR procedures delineate each step’s specific requirements, taxpayers should expect LB&I to follow these rules and appropriately object if the guidelines are not being followed. On their face, these rules are relatively strict. Since this process is new, taxpayers have had little experience in how the examiners and specialists will deal with them. Therefore, taxpayers should closely monitor their IDR activity to avoid finding themselves in the unfortunate position of having to respond to a summons.

New IDR process

The New Directive incorporates and supersedes the IDR enforcement procedures included in the November Directive, providing details of the three-step enforcement process. This new IDR enforcement process, effective beginning 3 March 2014, applies only to IDRs issued in accordance with the requirements of the New Directive.

This new IDR enforcement process, effective beginning 3 March 2014, applies only to IDRs issued in accordance with the requirements of the New Directive.

Step 1: Issuing the Delinquency Notice

The first step, issuing the Delinquency Notice signed by the IRS team manager, should be discussed with the taxpayer to ensure the taxpayer understands the next steps. The Delinquency Notice should be issued to the taxpayer within 10 business days of the application of the enforcement process and should include a response date that is generally no more than 10 business days from the date of the Delinquency Notice. The IRS territory manager must approve any request by the taxpayer to respond to the Delinquency Notice beyond the 10 business days.

Step 2: Sending the Pre-Summons Letter

If the taxpayer does not provide a complete response to the IDR by the Delinquency Notice due date, the examiner or specialist must follow the procedures set forth in the second step of the enforcement process. Specifically, the examiner or specialist must discuss the taxpayer’s failure to provide a complete response to the Delinquency Notice with the examiner or specialist’s management chain and assigned counsel and must then prepare the Pre-Summons Letter for signature by the appropriate territory manager.

The territory manager must discuss the Pre-Summons Letter and the process regarding the issuance of that letter with the taxpayer to ensure understanding of the next steps. The Pre-Summons Letter must be sent within 10 business days from the Delinquency Notice due date and include a response due from the taxpayer that is generally 10 business days from the date of the letter. The director of field operations (DFO) must approve any response date beyond 10 business days. The Pre-Summons Letter is addressed to the taxpayer management official who is above the level of the official that received the Delinquency Notice.

Step 3: Issuing the summons

If the taxpayer does not provide a complete response to the Pre-Summons Letter by the date indicated, then the examiner or specialist must proceed to Step 3 of the enforcement process and obtain the summons for issuance to the taxpayer.

The New Directive gives limited extension authority to examiners and specialists.

The New Directive gives limited extension authority to examiners and specialists, permitting them to grant taxpayers an extension of up to 15 business days before the enforcement process begins. The New Directive provides two scenarios under which an extension can be granted by examiners and specialists: (1) the taxpayer fails to respond to the IDR and (2) taxpayer provides an incomplete response.

The New Directive instructs the examiner or specialist to discuss the cause of the taxpayer’s failure to respond or the cause of the incomplete response with the taxpayer within five business days of the IDR due date. In either case, the examiner or specialist may grant an extension up to 15 business days if warranted by the taxpayer’s explanation. The IDR enforcement process begins as of the extended due date or, if no extension was granted, the date that determination was communicated to the taxpayer.

Important points:

- The New Directive makes it mandatory for the examiner or specialist, when determining the taxpayer’s response date to the IDR, to commit to a date by which the examiner or specialist will review the information and documentation provided by the taxpayer and respond to the taxpayer as to whether the information received satisfies the IDR request. That response date is included on the IDR. This requirement is designed to ensure that if the taxpayer timely responds, then the information provided will be timely reviewed.
- The New Directive gives limited extension authority to examiners and specialists, permitting them to grant taxpayers an extension of up to 15 business days before the enforcement process begins. The New Directive provides two scenarios under which an extension can be granted by examiners and specialists: (1) the taxpayer fails to respond to the IDR and (2) taxpayer provides an incomplete response.
- The New Directive instructs the examiner or specialist to discuss the cause of the taxpayer’s failure to respond or the cause of the incomplete response with the taxpayer within five business days of the IDR due date. In either case, the examiner or specialist may grant an extension up to 15 business days if warranted by the taxpayer’s explanation. The IDR enforcement process begins as of the extended due date or, if no extension was granted, the date that determination was communicated to the taxpayer.
- The New Directive clarifies the June Directive and includes Attachment 1, Requirements for Issuing IDRs. The most important item requires the examiner or specialist, before issuing the IDR, to discuss the issue with the taxpayer and why the requested information is relevant. The taxpayer must receive a draft of the IDR, and generally, the discussion regarding its contents should be completed within the following 10 business days. Additionally, the examiner or specialist, in the interest of clarity, is to prepare one IDR for each issue.
- The New Directive also includes an explicit exception to the “issue-focused” IDR requirement: the requirement does not apply to IDRs issued at the beginning of an enforcement process, to the IRS territory manager must discuss the Pre-Summons Letter and the process regarding the issuance of that letter with the taxpayer to ensure understanding of the next steps. The Pre-Summons Letter must be sent within 10 business days from the Delinquency Notice due date and include a response due from the taxpayer that is generally 10 business days from the date of the letter. The director of field operations (DFO) must approve any response date beyond 10 business days. The Pre-Summons Letter is addressed to the taxpayer management official who is above the level of the official that received the Delinquency Notice.
- This new IDR enforcement process, effective beginning 3 March 2014, applies only to IDRs issued in accordance with the requirements of the New Directive.
- The New Directive gives limited extension authority to examiners and specialists, permitting them to grant taxpayers an extension of up to 15 business days before the enforcement process begins. The New Directive provides two scenarios under which an extension can be granted by examiners and specialists: (1) the taxpayer fails to respond to the IDR and (2) taxpayer provides an incomplete response.
- The New Directive instructs the examiner or specialist to discuss the cause of the taxpayer’s failure to respond or the cause of the incomplete response with the taxpayer within five business days of the IDR due date. In either case, the examiner or specialist may grant an extension up to 15 business days if warranted by the taxpayer’s explanation. The IDR enforcement process begins as of the extended due date or, if no extension was granted, the date that determination was communicated to the taxpayer.
- The New Directive clarifies the June Directive and includes Attachment 1, Requirements for Issuing IDRs. The most important item requires the examiner or specialist, before issuing the IDR, to discuss the issue with the taxpayer and why the requested information is relevant. The taxpayer must receive a draft of the IDR, and generally, the discussion regarding its contents should be completed within the following 10 business days. Additionally, the examiner or specialist, in the interest of clarity, is to prepare one IDR for each issue.
- The New Directive also includes an explicit exception to the “issue-focused” IDR requirement: the requirement does not apply to IDRs issued at the beginning of an examination that requests “basic books and records and general information about a taxpayer’s business.” All other IDRs issued subsequently must be relevant to a specific issue to be examined.
- Importantly, the New Directive makes it mandatory for the examiner or specialist, when determining the taxpayer’s response date to the IDR, to commit to a date by which the examiner or specialist will review the information and documentation provided by the taxpayer and respond to the taxpayer as to whether the information received satisfies the IDR request. That response date is included on the IDR. This requirement is designed to ensure that if the taxpayer timely responds, then the information provided will be timely reviewed.

The New Directive gives limited extension authority to examiners and specialists.
Tax controversy and risk management review

By Pat Chaback, Executive Director, Tax Controversy and Risk Management Services, Ernst & Young LLP

Taxpayers should be familiar with LB&I’s Field Focus Guide and plan accordingly

Every year, the LB&I Division of the IRS outlines its strategic goals and priorities for the fiscal year in its internal Field Focus Guide. Taxpayers should be aware of the current year’s goals and priorities as they plan interactions with LB&I.

Many of this year’s focus areas reflect LB&I’s goal to become more efficient and effective and to deploy strategic thinking around how and where to best apply limited resources. The areas of emphasis include:

- Deploying resources to those areas that have the greatest compliance impact and the highest compliance risk
- Implementing new LB&I exam processes setting forth the road map for an examination that is professionally executed and issue-focused throughout planning, execution and resolution. (To date, LB&I has released only the Transfer Pricing Practice (TPP) part of the road map.)
- Implementing and deploying process changes that LB&I initiated in FY13:
  - Improvements to the industry case (IC) exam process – moving away from the coordinated industry case (CIC) designation toward an issue-driven, risk-based model focused on the nature and complexity of issues regardless of entity type or size
  - Advancements in the knowledge management area, including the Issue Practice Groups (IPGs), encompassing domestic issues and the International Practice Networks (IPNs), which address international tax issues
  - Clarification of the Information Document Request (IDR) process, including stricter IDR management and enforcement (see “New IDR process announced” in this issue)

FY14 LB&I priorities

- Knowledge management – Enhance and leverage LB&I programs and tools designed to capture expertise, identify training needs and opportunities for guidance, disseminate best practices and increase collaboration and knowledge-sharing across the division
- LB&I examination process – Implement the road map for an LB&I examination that is professionally executed and issue-focused throughout the planning, execution and resolution phases of the examination
- Exam re-engineering – Continue using Lean Six Sigma to identify and implement improvements to the current IC examination process, moving away from the CIC designation toward an issue-driven, risk-based model
- Information Document Requests – Implement the new process through IDRs that are issue-focused with clear explanations of the information being requested, agreed-upon time frames for responses and, if time frames are not met, swift enforcement
- Issue focus – Select, audit, provide guidance on and allocate resources to issues that will have the broadest impact on compliance regardless of entity type or size
- Role of specialists – Pilot and test new approaches for maximizing effective deployment of limited specialist resources (e.g., the engineering program, which has experienced a near 20% decline in technical staff from FY13 levels)
- FATCA – Continue leading the design and implementation of the foreign financial institution (FFI) registration and intergovernmental data exchange processes
- Offshore compliance – Continue strategic enforcement efforts and parallel voluntary disclosure programs, which have given US taxpayers with undisclosed offshore assets or income opportunities to comply with the US tax system, pay their fair share and avoid potential criminal charges

New LB&I exam processes will set forth the road map for an issue-focused process.

Tips to taxpayers for maintaining good relationships with LB&I

- Initiate and maintain frequent communication throughout the planning, execution and resolution stages of an examination to ensure a full understanding of:
  - Which issues have been risk assessed and selected for examination?
  - Why were the issues selected for examination?
  - What information and documentation are necessary to ensure a thorough factual development and understanding of the return positions taken?
  - What legal determinations are being applied by the IRS to reach its conclusions?
- Get to know and engage with all the team members assigned to the examination and become familiar with the chain of command and team members’ respective levels of accountability
- Understand the rules of engagement regarding IPGs and IPNs on issues, which will enable a clear line of sight as to who is influencing the issue development and the conclusions being reached
To Pre-CAP or not to Pre-CAP: that is the question

By Pat Chaback, Executive Director, and Ned Connelly, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

Pre-CAP is the gateway to the Compliance Assurance Process (CAP), through which a company could significantly increase the certainty of its tax liability by the due date of its tax returns.

Pre-CAP could be a good move if a company believes that its tax department:

- Is inclined to want to achieve IRS examination currency for given tax years and to minimize the need to file numerous amended state tax returns. Through Pre-CAP and CAP, it is possible to accelerate closing the books on the company’s tax reserves.
- Would like to minimize the issues faced in reporting uncertain tax positions (Schedule UTP). By completing Pre-CAP – prior to acceptance into CAP – the company could resolve those issues sooner and greatly reduce post-filing examination activity.
- Anticipates potential post-filing exam controversy relative to significant federal tax transactions and matters that will undoubtedly be selected for audit. Participation in Pre-CAP as a prelude to CAP could provide the company with quicker guidance on complex tax issues.
- Strives to complement its corporate governance and accountability responsibilities. The various phases of CAP will enhance tax reserve integrity. Consequently, the company benefits from improved financial statement reporting, support for compliance with Sarbanes-Oxley and enhanced public/investor confidence that tax issues are settled. Participating taxpayers can note the benefits achieved through participation in Pre-CAP and CAP in their financial statements.

If these scenarios apply to your company, then the answer to, whether to Pre-CAP or not to Pre-CAP is most likely – yes!

Background

On 31 March 2011, the IRS announced that CAP would become a permanent program available to taxpayers and expanded the program to include Pre-CAP and CAP Compliance Maintenance phases.

Under CAP, participating taxpayers act jointly with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. Ideally, all major potentially controversial tax issues are largely settled prior to filing, thereby subjecting taxpayers to a shorter and narrower post-filing examination.

CAP is a method of contemporaneously identifying and resolving tax issues through open, cooperative and transparent interaction between the IRS and LB&I Division taxpayers prior to filing that year’s return. CAP allows taxpayers to better manage tax reserves, ensure more precise reporting of earnings on financial statements and minimize the need to amend multiple state tax returns.

Pre-CAP provides interested taxpayers with a clear road map for gaining entry into CAP (see Internal Revenue Manual (IRM) 4.51.8.4). The Pre-CAP action plan is jointly developed by the examination team coordinator and the taxpayer and presents a time frame for closing all the transition years required to establish CAP eligibility.

Pre-CAP description:

- Takes place in a traditional post-file environment and is conducted by a team coordinator, not a CAP account coordinator
- Aims to develop an action plan to close all transition years occurring within an agreed (usually accelerated) amount of time, except for one open and one unified year
- Requires taxpayer to meet CAP eligibility criteria (see IRM cited earlier in this article)
- Allows taxpayers to apply for Pre-CAP at any time

Pre-CAP requirements:

- Taxpayer works with the exam team to develop an action plan to prepare for CAP
- Taxpayer signs a Pre-CAP Memorandum of Understanding (MOU)
- Taxpayer and team will work in an open and collaborative environment
- Taxpayer exhibits the transparency and cooperation needed to progress to CAP
- Taxpayer agrees to identify issues within transaction(s) and provide information in a timely manner to resolve outstanding issues
- Taxpayer will be eligible for CAP if all transition years are closed except for one open filed year and one unified year

Pre-CAP takes place in a traditional post-file environment.
Getting into CAP through Pre-CAP

Taxpayers who have ongoing examinations on filed tax returns (other than the most recently filed tax return) can apply for participation in Pre-CAP. Once accepted into Pre-CAP, the IRS and the taxpayer work to resolve ongoing examinations on the intervening filed tax returns so that the taxpayer may become eligible for CAP. Taxpayers who do not have an examination open for any tax year may bypass Pre-CAP and apply directly for CAP.

Pre-CAP eligibility — taxpayers must meet the following criteria:

- Have assets of $10 million or more
- Be a publicly held entity with a legal requirement to prepare and submit Forms 10K, 10Q, 8K or 20F or other disclosure forms to the Securities and Exchange Commission (SEC) or equivalent regulatory body or, if privately held, agree to provide to the IRS certified, audited financial statements on a quarterly basis or equivalent documentation
- Not be under investigation by, or in litigation with, the IRS or other federal or state agency that would limit the IRS’s access to current corporate tax records.

Taxpayers who meet Pre-CAP eligibility requirements must complete Form 14234 and mail or fax the application to:

Internal Revenue Service
Attn: LB&I: PFTG: Pre-CAP
The Mint Building
1111 Constitution Avenue, NW
Washington, DC 20224
Fax: +1 202 283 8313

If a taxpayer meets the eligibility criteria, LB&I Pre-Filing and Technical Guidance (PFTG) forwards the application to the LB&I industry director who has jurisdiction over the taxpayer for an evaluation of the application and to determine the taxpayer’s suitability for Pre-CAP. If the taxpayer’s Pre-CAP application is approved by the IRS, the taxpayer will be notified in writing by the territory manager assigned to the taxpayer.

After approval and prior to acceptance into Pre-CAP, taxpayers must execute a standardized Pre-CAP MOU that outlines the Pre-CAP requirements and establishes an agreement to meet the requirements. The Pre-CAP MOU is effective for the first Pre-CAP year and will continue for all years until one of the following occurs:

- The transition years are closed and the taxpayer fulfills the CAP selection criteria
- The taxpayer terminates from Pre-CAP
- The taxpayer voluntarily withdraws from Pre-CAP

Both parties are held to a higher standard of proactive engagement throughout the process to ensure success.

Under Pre-CAP, the IRS and taxpayer work together to develop an action plan to complete all required examination activity within an established time frame. Taxpayers must identify transactions, material items and steps within the transactions, and other tax return items and positions taken on their filed returns and provide relevant information within the established time frames. The taxpayer’s disclosures described in this paragraph should be in writing. The IRS and the taxpayer will jointly determine the scope of the Pre-CAP examination, including materiality thresholds. However, the ultimate decisions for identifying transactions and issues for examination remain at the discretion of the IRS.

Conclusion

CAP is a valued mechanism for LB&I to achieve exam currency and maximize the use of the division’s extremely limited resources. Additionally, taxpayers accepted into the program are viewed favorably for their willingness to be proactive in their tax administration. There is a heightened level of commitment to succeed in getting a taxpayer prepared and eligible for the CAP program. A successful CAP relationship is founded on the principles of cooperation and transparency with the LB&I examination team, where the battle lines have not yet been drawn. This is a welcome change from the often controversial and antagonistic relationships of the past.

Pre-CAP provides an opportunity for taxpayers to significantly change the dialogue and the dynamics of their working relationship with LB&I. Pre-CAP allows taxpayers to exhibit the transparency and cooperation required to be considered for the CAP program. Since the goal of Pre-CAP is to help taxpayers meet the selection criteria for entry into CAP, both parties are held to a higher standard of proactive engagement throughout the process to ensure success.

The ultimate answer to the “To Pre-CAP or not to Pre-CAP?” question is ... it depends. When taxpayers are deciding whether the benefits of choosing Pre-CAP outweigh the risks, the real question should be, “Why not Pre-CAP?”

Pre-CAP provides an opportunity for taxpayers to significantly change the dialogue and the dynamics of their working relationship with LB&I.
Transfer pricing enforcement trends

LB&I issues new “Roadmap” for transfer pricing audits

By Loren Ponds, Manager, International Tax Services – Transfer Pricing, John Dilorio and Matthew Cooper, Senior Managers, Tax Controversy and Risk Management Services, Ernst & Young LLP

On 14 February 2014, Transfer Pricing Operations (TPO) of the IRS’s LB&I Division issued the long-awaited Transfer Pricing Audit Roadmap (the Roadmap).1 As noted in the Roadmap, it was created to “…provide the transfer pricing practitioner, whether employed in TPO or International Business Compliance (IBC), with the audit techniques and tools to assist with the planning, execution and resolution of transfer pricing examinations.” With the Roadmap’s external publication, the taxpayer is afforded very specific insight as to the TPO’s view of how a transfer pricing audit should be conducted.

The Roadmap provides best practices and helpful reference materials for LB&I employees regarding the administration of transfer pricing audits. It is organized around a 24-month audit timeline — separated into three phases: planning, execution and resolution — under the rubric of the IRS’s Quality Examination Process (QEP) (Figure 1). The Roadmap represents an institutional effort to formalize the continuous involvement of transfer pricing specialists in transfer pricing audits, from inception to completion. Overall, the Roadmap emphasizes coordination within LB&I, including the exam team and transfer pricing specialists and the taxpayer, and it encourages constant communication among all three stakeholder groups. Further, opening with the statement that “Transfer pricing cases are usually won and lost on the facts,” the Roadmap seems to emphasize fact-gathering to build a case not only for exam but for successful litigation. Accordingly, taxpayers are well advised to ensure that their transfer pricing documentation is robust and presents a factual picture consistent with their tax returns and financial statements.

Knowing how the TPO is organized is important to understanding the Roadmap’s more structured approach to transfer pricing audits. TPO is headed by Director Sam Maruca and encompasses both the Advance Pricing and Mutual Agreement (APMA) Program and the Transfer Pricing Practice (TPP). The TPP is a team of transfer pricing specialists — including economists, lawyers, international examiners and other experts — that began assisting the field exam teams with transfer pricing enforcement in the fall of 2012. Specifically, the TPP was designed to maintain certain information on each transfer pricing case: a summary and status of the case, who is working on it and the relevant issues. Not every case will have heightened scrutiny, but with this database, TPP members have a view of what is going on with every transfer pricing case and can choose to become involved if they see a need.

The Roadmap emphasizes coordination within LB&I, including the exam team and transfer pricing specialists and the taxpayer, and it encourages constant communication among all three stakeholder groups.

Planning phase: pre-examination analysis

1. Preliminary assessment

The initial planning phase can last up to six months and starts before the 24-month audit cycle begins. Examiners are instructed to review the taxpayer’s returns with emphasis on Forms 5471, 5472, 8833, 8858, 8865 and 926, as well as Schedules UTP and M-3. Examiners are also encouraged to familiarize themselves with the taxpayer’s business operations (e.g., 10-K) and to perform preliminary economic analyses (e.g., key financial ratio analysis). This phase involves reviewing the information already at the IRS’s disposal, including prior audit cycle results, reports and Appeals Case Memoranda (ACM), as well as the use of IRS tools to conduct industry analyses.

The examiner prepares the mandatory Information Document Request (IDR) for the taxpayer’s transfer pricing documentation and initial examination contact letter, which are issued simultaneously.2 Finally, in the description of this phase, the Roadmap makes the first of many references to TPP involvement throughout the document, noting that a TPP member and/or an economist will participate in the preliminary assessments. The level of involvement of a TPP member can range from advisor to lead examiner.

1 The TPO is national in scope and is divided into three territories: East, Central and West.
3 Taxpayers are required to respond within 30 days from receipt of the initial examination contact letter regarding the transfer pricing documentation.
Airline 456
cases. Airline 456

Trends continues. Airline 456


test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
test-
Conclusion
The Roadmap is a toolkit for conducting transfer pricing audits, from the identification of issues, to the formulation of a working hypothesis, to issue resolution. The process relies heavily on open and active communication between the taxpayer and the exam team. With an emphasis on the involvement of TPP members at every step, taxpayers should be prepared for scrutiny by professionals with sophisticated transfer pricing knowledge. Further, having robust documentation of transfer pricing methodologies is paramount, as the Roadmap itself approaches the audit with the maxim that cases are “won and lost on the facts.” Therefore, it is reasonable to expect that the meticulously detailed steps set forth in the Roadmap could be designed to generate reports, notes and stipulated facts that could form the basis of case development for litigation, if issues are not resolved at the Exam or Appeals levels.

The Roadmap points out that transfer pricing audits can take as long as two to three years; accordingly, it is constructed on a two-year framework. Timeline notwithstanding, the Roadmap seems to emphasize issue development over currency. When approaching a transfer pricing audit, taxpayers can use the Roadmap information to their advantage, especially with regard to the activities the exam team is recommended to undertake and the emphasis on “continuous communication” and cooperation among various groups within LB&I and with the taxpayer. Coupled with LB&I’s new IDR directives, taxpayers should have the opportunity to frame their transfer pricing methodology in a compelling manner, clearly addressing the basis for their business decisions and the resulting financial outcomes and effective tax impact.
Expansion of the IRS program to systematically assess penalties for Forms 5471 and 5472 filed with late-filed returns, including late-filed Forms 1065, makes it even more imperative that taxpayers file timely returns

By Elvin T. Hedgpeth, Executive Director, Tax Controversy and Risk Management Services, Ernst & Young LLP

For several years the IRS has been automatically assessing certain penalties for late filing of returns and certain required international information reporting forms. This process first caught the eye of the tax community when, in 2009, the IRS started this automatic assessment process with the penalty under IRC Section 6038(a) for Forms 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations), which is filed with a delinquent tax return, Section 6038(a) requires that each US taxpayer submit certain specified information regarding each foreign business entity it controls (e.g., controlled foreign corporation (CFC)), Treas. Reg. Section 1.6038-2(f) provides that the following information needs to be included on a Form 5471 filed for each CFC with the taxpayer's Form 1120: certain identifying information, stock, shareholder, earnings and profits, and financial information about the foreign corporation, as well as transactions between the foreign corporation, the filer, certain other shareholders, and entities related to the filer or the foreign corporation. Section 6038(b) prescribes a penalty of $10,000 for each annual accounting period in which there was a failure to submit such information. That penalty increases at a rate of $10,000 per 30 days, where the failure to file continues for more than 90 days after the IRS notifies the taxpayer of its compliance failure.

Similarly, Section 6038A requires a US person to make a separate annual information return for a domestic corporation that is 25% foreign owned. Section 6038C also requires foreign corporations engaged in US business to make an annual information return. Generally, this information is to be provided on a Form 5472, which is to be filed with the corporation’s income tax return by the due date of that return. Sections 6038A(a) and 6038C(c) authorize a $10,000 penalty for each failure to comply with the provisions of Sections 6038A and 6038C. That penalty also increases in the same manner as the Section 6038(b) penalty if the delinquency continues.

Significantly, the penalties in Sections 6038(a), 6038A and 6038C for late-filed Forms 5471 and Forms 5472 apply even if no tax is due on the returns to which they are attached. These penalties for late-filed forms can, however, be waived if the taxpayer can show reasonable cause for the delinquency.

The systemic assessment of late-filed information forms expanded in 2013 to include late-filed Forms 5472, and further expansion is intended

Based primarily on a recommendation in a 2006 TIGTA report10 regarding the penalty-setting process for information returns related to foreign operations and transactions, the IRS established the systemic automatic assessment process to ensure that it is assessing late-filed penalties for delinquent returns and required international information returns and forms. As noted above, the IRS rolled out this program in stages. In January 2009, Forms 5471 that are attached to a late-filed Form 1120 or Form 1120-F were included in this automatic assessment process. At that time there was speculation that the IRS would extend this automatic assessment process to other late-filed information returns.

The goals of this automatic process are to provide revenue enhancement and improve taxpayer filing compliance. According to the 2013 TIGTA report, the process is working, as the IRS is meeting these goals. However, in that same report, TIGTA criticized the IRS for not identifying late-filed Forms 5471 and Forms 5472 with particular diligence with respect to the filing of Forms 1120 or Form 1120-F. We believe this may prove to be an impediment to the systematic automatic assessment of penalties for late-filed Forms 5471 or 5472 may be avoided if the IRS does a better job of identifying late-filed Forms 5471 or 5472.

The IRS agreed with TIGTA’s recommendations and noted in its response to these recommendations that the LB&I Division of the IRS had already begun to take actions to expand the systemic penalties assessments with respect to other types of income tax and international information reporting returns, including Form 1120-S.11

10 With respect to Form 1120-S, the IRS has systemically assessed penalties to late filing of Forms 5471 since 2009.
11 With respect to Form 1040, the IRS is pursuing changes to Form 1040. Schedule B that would require identification of the number of Forms 5471 attached to a late-filed Form 1040.

Penalty corner
Courts

Court holds that fraudulent items on partnership return do not automatically open the statute of limitations for partners

By Matthew Cooper, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

There is now a difference in interpretations of the various courts that have considered this issue.

In October 2013, the US Court of Federal Claims issued a significant opinion dealing with the statute of limitations during which the IRS can assess taxes against the members of a Tax Equity and Fiscal Responsibility Act (TEFRA) partnership. In BASR Partnership v. United States, No. 1:10-cv-00244 (Fed. Cl. 30 September 2013; opinion revised on 29 October 2013), the US Court of Federal Claims addressed, in the context of a partnership subject to the TEFRA procedural rules, whether fraudulent items appearing on a partnership return create an unlimited assessment period when none of the partners in the partnership personally intended to evade tax. The court held that fraud by the outside counsel who structured the fraudulent transaction for the partners was not enough on its own to indefinitely extend the assessment statute under Sections 6229(c)(1) and 6501(c)(1) as against the partners. The court disagreed with prior opinions addressing this issue from the Tax Court and the Court of Appeals for the Second Circuit.

Background

Transaction and examination

An attorney at a law firm advised the tax matters partner (TMP) of a partnership and the TMP's accountant regarding the tax consequences of the sale of a business owned by the TMP, his wife and their sons. The tax advice provided for the sale to take place through the creation of BASR Partnership, which included the contribution by each of BASR's partners. In 2000, the TMP filed the BASR Partnership returns for the tax years ending 12 June 1999 and 12 December 1999; the individual and trust returns for the tax years ending 12 June 1999 and 12 December 1999; and the individual and trust returns for each of the partners also were filed in 2000.

The partnership returns included fraudulent items as a result of the tax plan developed by the attorney. The IRS initiated an audit of the partnership returns in 2006 and issued a Notice of Final Partnership Administrative Adjustment (FPAA) in 2010, well beyond the normal three-year period of limitations for assessment of tax in Section 6501(a), and beyond the period of limitations for the assessment of partnership items and affected items in TEFRA proceedings under Section 6229(a).

The law

Section 6226(a) of the TEFRA rules permits judicial review of an FPAA in the Tax Court, the district court for the district in which the partnership has its principal place of business or the US Court of Federal Claims. The partner filing for such review does not have to pay the adjustments determined in the FPAA before bringing the action, although the partner does have to deposit the amount by which the partner's tax liability would be increased if the proposed adjustments were sustained.

Taking advantage of this TEFRA rule and presumably to avoid the adverse precedent in the Tax Court, the TMP filed a complaint in the US Court of Federal Claims challenging in a motion for summary judgment the issuance of the FPAA as invalid due to the expiration of the relevant assessment statutes. Section 6501(a) generally requires the IRS to assess the amount of any tax at any time within three years after the return was filed, although Section 6501(c)(1) provides that the tax may be assessed at any time in the case of a false or fraudulent return with the intent to evade tax.

For purposes of Section 6501(a) the term “return” means the return required to be filed by the taxpayer and does not include a return of any person from whom the taxpayer received an item of income gain, loss, deduction or credit. Section 6229(a)(1) also provides that any tax attributable to any partnership item (or affected item) for a partnership year needs to be assessed before three years after the date the partnership return was filed.

Under Section 6229(a)(1), however, if any partner has, with the intent to evade tax, signed or participated in preparing a partnership return that includes a false or fraudulent item, the tax attributable to any partnership item (or affected item) may be assessed at any time against partners who signed or participated in preparing the return. In this case, the US Government argued that the fraudulent items included in the partnership returns created an unlimited period under both Sections 6229(c)(1) and 6501(c)(1), even though the Government admitted that the partners themselves did not possess an intent to evade tax. The Government relied heavily on favorable case law in the Tax Court (Allen v. Commissioner, 128 T.C. 37 (2007)) and Second Circuit (City Wide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d. Cir. 2013)) for unlimited assessment periods under Section 6501(c)(1) in instances where the fraud was committed solely by the taxpayers’ preparers acting as their agents.

Holding of Court of Federal Claims

There is one assessment period

The court initially addressed the taxpayer's argument that Section 6229 is a separate period of limitations on assessment that controls in a TEFRA proceeding. The court found, consistent with the prior precedent in the Federal Circuit, that the three-year period of limitations in Sections 6229 and 6501 must be read together in TEFRA proceedings (see AD Global Fund, LLC v. United States, 481 F.3d 1351 (Fed. Cir. 2007)). In other words, for TEFRA partnerships, Section 6229(a) provides a minimum period for assessment of partnership items, although this minimum period may expire before or after the maximum period provided in Section 6501 (Id. at 1354) (see Andantech L.L.C. v. Commissioner, 331 F.2d 972 (D.C. Cir. 2003)).

Fraudulent intent of individual partners required

Notwithstanding this initial finding, the court agreed with the taxpayer's position that the assessment period was closed under both Sections 6229 and 6501. Although the court found that there was no question that the partnership returns contained false or fraudulent items, the unambiguous meaning of the relevant provisions limits these exceptions to instances when the taxpayer personally has the requisite intent to commit fraud. In reaching this conclusion, the court relied upon the definition of “return” in Section 6501(a), which is “the return to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer received an item of income gain, loss, deduction or credit).”

The court determined that because the language of Section 6501(a) is expressly limited to the taxpayer, the fraudulent intent referenced in Section 6501(c) is by implication limited to fraud by the taxpayer despite different prior interpretations by the Tax Court and Second Circuit. The court also concluded that this interpretation was consistent with the plain language in Section 6229(c)(1) requiring that “any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item” to extend the assessment period for tax attributable to partnership items. Thus, notwithstanding any valid policy reasons raised by the Government regarding the practical impediments to the discovery of tax fraud, the court held that the relevant assessment period for all of the partners was already closed, and any adjustments in the FPAA were untimely.

For TEFRA partnerships, Section 6229(a) provides a minimum period for assessment of partnership items, although this minimum period may expire before or after the maximum period provided in Section 6501.
Implications

It remains unclear whether the IRS will be able to examine taxpayers’ returns well beyond the three-year period (or six-year period for substantial omissions of gross income) based on the fraud of the taxpayers’ agents. Although this case arose in the context of a TEFRA partnership, the court’s analysis could apply equally to both TEFRA and non-TEFRA matters, and there is now a difference in interpretations among the various courts that have considered the issue. The Government has filed a notice of appeal, and the taxpayer has cross-appealed. We can only speculate on whether the Circuit Court will affirm the lower court or when an opinion will be issued on the appeal.

It is likely, that the Government will continue to push for unlimited assessment statutes based on fraud of the taxpayers’ agents in future cases. Until more appellate courts or the Supreme Court address this issue, taxpayers should be cautious in assuming that they are no longer subject to examination by the IRS and additional tax liability, even well after the normal three-year limitations period, if there is any potential for the IRS to argue fraud by the taxpayers’ agents, including their preparer, CPA or attorney. For now, taxpayers contesting FPAAs with this issue should consider bringing actions in the Court of Federal Claims or other district courts outside the Second Circuit until the Federal Circuit and other appellate courts address this issue.

Supreme Court update

By Matthew Cooper, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

The US Supreme Court agreed to accept three federal tax cases during its 2013 term, which runs from October 2013 through June 2014. This is a shift from recent times when the Court rarely reviewed more than one federal tax case per term. Here is a brief summary of the cases:

United States v. Woods – The Court heard oral arguments on 9 October 2013, and delivered its opinion on 3 December 2013 (United States v. Woods, 134 S. Ct. 557 [2013]). In a 9-0 Government-favorable decision, the Court held that the 40% accuracy-related penalty for gross valuation misstatements applies to a transaction subsequently disregarded for lack of economic substance. The Court also held that the TEFRA procedural rules confer jurisdiction in a partnership-level proceeding for a court to determine the applicability of the 40% penalty arising from a misstatement of a partner’s outside basis.

United States v. Quality Stores, Inc. – The Court heard oral arguments on 14 January 2014, and delivered its opinion on 25 March 2014 (United States v. Quality Stores, Inc. [Docket No. 12-1408]). In an 8-0 Government-favorable decision, the Court held that supplemental unemployment benefit payments paid to involuntarily terminated employees as a result of a plant closure or reduction in force are subject to FICA taxes.

United States v. Clarke – The Court granted the Government’s petition for writ of certiorari on 10 January 2014, in United States v. Clarke (Docket No. 13-348). The question presented is whether an unsupported allegation that the IRS issued a summons for an improper purpose entitles an opponent of the summons to an evidentiary hearing to question IRS officials about their reasons. The case is to be argued on 23 April 2014.
The use of statistical sampling for mitigating tax risk

By Mary Batcher, Executive Director; Ed Cohen, Senior Manager; and Nicole Miller, Manager, Quantitative Economics and Statistics group (QUEST), Ernst & Young LLP

Statistical sampling can mitigate tax risk for the taxpayer under audit. Given the instability of the global economy and the ever-changing tax environment, companies are more risk averse. Statistical sampling, which can enable companies to take advantage of federal tax credits and deductions that bring much-needed cash, allows companies to prepare a sample to estimate the total amount qualifying for a tax credit and would be close to the IRS's expectation for both parties. Lastly, if the taxpayer is in doubt, working with the IRS directly can provide guidelines and procedures for the examiner and under audit. Statistical sampling can mitigate IRS audit risk in several ways. First, a taxpayer preparing a sample may significantly reduce the chance that the IRS will use an improper or unsanctioned statistical method in the audit. Specifically, the IRS may extract a sample for audit if the taxpayer does not already have one in numerous ways, some of which do not adhere to the sampling procedures outlined in Revenue Procedure 2011-42.

The examination team might use a judgment sample as opposed to a random sample. However, occasionally the examiner might apply the results of the judgment sample to the entire population. Unfortunately, most items in the population have no probability of selection; therefore, the results cannot be applied across the population. If the taxpayer consents to the use of the judgment sample, the potential impact on the exam might not be fully understood. For example, the sample selections might be more heavily weighted toward problematic items. If the IRS extrapolates the sample results to the population, an overly large adjustment could result. It is not statistically appropriate to extrapolate a judgment sample, and it is interesting that, historically, a judgment sample, when used by a taxpayer, carried serious risk of rejection by the IRS under audit.

There are benefits to understanding the process

While taxpayer samples can safeguard against those potential challenges presented when the IRS selects a sample, understanding the general concept of sampling error and how it should be applied can also reduce risk under audit. Sampling error is the degree of inaccuracy of an estimate due to the fact that a sample was reviewed as opposed to every item in a population. The more inaccurate the estimate (usually due to a small sample size or inefficient type of sample), the larger the sampling error.

In a taxpayer sample, a larger sampling error equates to a larger reduction in the deduction or credits the taxpayer can claim. However, if the IRS uses its own sample under audit, the agency does not always suffer the effects of the sampling error as the taxpayer would. Given the IRS's own internal sampling guidance, taxpayers should expect the IRS to follow the same procedures and requirements described in the revenue procedure with only the exceptions noted. However, this might not always be the case. The taxpayer who knows the proper use of statistical sampling and understands the requirements of the IRS's own guidance, can also reduce risk under audit. Sampling error reduction in its adjustment in order to foster agreement with the taxpayer.

Conclusion

Statistical sampling can be a tremendous asset in minimizing the effort to determine a tax position, but it is perhaps even more advantageous in reducing the risk faced under an IRS examination. Statistical sampling by a taxpayer is a proactive way to achieve greater control over an audit and to protect the taxpayer from agreeing to an IRS sample without fully understanding the statistical or financial consequences. When the IRS is in doubt, working with the IRS directly can be mutually beneficial.
Tax controversy and risk management review

TEFRA corner

Duties of a tax matters partner under TEFRA procedural rules

By Alice Harbutte, Executive Director, and Matthew Cooper, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

“TEFRA corner,” a new recurring section of the Tax controversy and risk management review, addresses hot topics in the area of the Tax Equity and Fiscal Responsibility Act (TEFRA). The first installment highlights the general duties and responsibilities imposed by the Internal Revenue Code under TEFRA on a tax matters partner (TMP) who plays a critical role and has substantial responsibilities in TEFRA proceedings.

The unified partnership audit and litigation procedures (otherwise known as the TEFRA procedural rules) can be complex and difficult to understand. Both taxpayers and tax practitioners should be aware of these rules given the increased use of pass-through entities subject to TEFRA and the IRS’s renewed focus on examining these entities.

Moreover, the potential pitfalls relating to TEFRA have resulted in a significant number of cases in litigation being decided based by duplicative audits and to provide consistent treatment of partnership items among the partners in the same partnership, Congress enacted the unified audit and litigation procedures of TEFRA, which are located in Sections 6221 through 6234 of the Code. The TMP is the partner designated as liaison of the partnership in administrative and judicial proceedings. Generally, the TMP is the partner designated as liaison of the partnership in administrative and judicial proceedings. The rules for designating a TMP are set forth in Treas. Reg. Section 301.6231(a)(7)-1. The TMP is usually a general partner (or a member manager if the TEFRA entity is an LLC) of the partnership designated by the partners and identified in Schedule B of Form 1065 (U.S. Return of Partnership Income). The IRS has the authority to designate a TMP if the partnership has not named one. The TMP determination is made separately for each partnership taxable year. If several years are under audit for the same partnership, it is thus possible for the IRS to have to deal with a different TMP for each taxable year being examined.

In connection with its role as a liaison with the IRS, the TEFRA provisions confer on the TMP certain rights and responsibilities. The TMP may extend the period of limitations for items (and affected items) and enter into settlement agreements that bind certain non-notice partners (partners who are not entitled to receive copies of these notices directly from the IRS). In order for the settlement agreement to be binding on a non-notice partner, the agreement must expressly state that the agreement is to bind the non-notice partner, and the non-notice partner must not have filed a statement with the IRS providing that the TMP does not have authority to enter into a settlement agreement on the non-notice partner’s behalf. Under the TEFRA procedures, the TMP is required to provide copies of certain documents issued during the examination of a partnership. Two of the most important documents that the TMP must provide to non-notice partners are copies of the Notice of Beginning of Administrative Proceeding (NBAP) issued by the IRS at the start of a TEFRA examination of the partnership and any Final Partnership Administrative Adjustment (FPAA) issued by the IRS at the end of the TEFRA administrative process. The NBAP must be furnished to non-notice partners within 75 days of the date it was mailed by the IRS, while the FPAA must be furnished to such partners within 60 days of the date it was mailed by the IRS. The regulations under Section 6223 lists a host of other notices or information that the TMP is required to furnish to the other partners, including information regarding the following:

- Closing conference with the examining agent
- Proposed adjustments, rights of appeal and requirements for filing a protest
- Time and place of any Appeals conference
- Acceptance by the IRS of any settlement offer
- Consent to the extension of the period of limitations with respect to all partners
- Filing of a request for administrative adjustment (including a request for substituted return treatment under Treas. Reg. Section 301.6227(c)-1 on behalf of the partnership
- Filing by the TMP or any other partner of any petition for judicial review under Sections 6226 or 6226(a)
- Filing of any appeal with respect to any judicial determination provided for in Sections 6226 or 6226(a)
- Final judicial redetermination

TEFRA background

To eliminate the administrative burden caused by duplicative audits and to provide consistent treatment of partnership items among the partners in the same partnership, Congress enacted the unified audit and litigation procedures of TEFRA, which are located in Sections 6221 through 6234 of the Code. Pursuant to Section 6221, partnership items are determined in a single partnership-level proceeding instead of at the partner level, and any partnership-level determinations are binding on all direct and indirect partners of the partnership. Any resulting tax liability, however, is assessed against the individual partners after the conclusion of the partnership-level proceeding.

Overview of TMP and related duties and responsibilities

Generally, the TMP is the partner designated as liaison of the partnership in administrative and judicial proceedings. The rules for designating a TMP are set forth in Treas. Reg. Section 301.6231(a)(7)-1. The TMP is usually a general partner (or a member manager if the TEFRA entity is an LLC) of the partnership designated by the partners and identified in Schedule B of Form 1065 (U.S. Return of Partnership Income). The IRS has the authority to designate a TMP if the partnership has not named one. The TMP determination is made separately for each partnership taxable year. If several years are under audit for the same partnership, it is thus possible for the IRS to have to deal with a different TMP for each taxable year being examined.

In connection with its role as a liaison with the IRS, the TEFRA provisions confer on the TMP certain rights and responsibilities. The TMP may extend the period of limitations for items (and affected items) and enter into settlement agreements that bind certain non-notice partners (partners who are not entitled to receive copies of these notices directly from the IRS). In order for the settlement agreement to be binding on a non-notice partner, the agreement must expressly state that the agreement is to bind the non-notice partner, and the non-notice partner must not have filed a statement with the IRS providing that the TMP does not have authority to enter into a settlement agreement on the non-notice partner’s behalf. Under the TEFRA procedures, the TMP is required to provide copies of certain documents issued during the examination of a partnership. Two of the most important documents that the TMP must provide to non-notice partners are copies of the Notice of Beginning of Administrative Proceeding (NBAP) issued by the IRS at the start of a TEFRA examination of the partnership and any Final Partnership Administrative Adjustment (FPAA) issued by the IRS at the end of the TEFRA administrative process. The NBAP must be furnished to non-notice partners within 75 days of the date it was mailed by the IRS, while the FPAA must be furnished to such partners within 60 days of the date it was mailed by the IRS. The regulations under Section 6223 lists a host of other notices or information that the TMP is required to furnish to the other partners, including information regarding the following:

- Closing conference with the examining agent
- Proposed adjustments, rights of appeal and requirements for filing a protest
- Time and place of any Appeals conference
- Acceptance by the IRS of any settlement offer
- Consent to the extension of the period of limitations with respect to all partners
- Filing of a request for administrative adjustment (including a request for substituted return treatment under Treas. Reg. Section 301.6227(c)-1 on behalf of the partnership
- Filing by the TMP or any other partner of any petition for judicial review under Sections 6226 or 6226(a)
- Filing of any appeal with respect to any judicial determination provided for in Sections 6226 or 6226(a)
- Final judicial redetermination

The TMP is the partner designated to act as liaison of the partnership in administrative and judicial proceedings.

16 A partnership item is an item required to be taken into account at the partnership level (e.g., items of income, gain, loss or deduction), while an affected item is an item to the extent such item is affected by a partnership item. See Section 6231(a)(3) and (5); Treas. Reg. Section 301.6231(a)(7)-1 and (a)(7)-1.
17 See Sections 6229(b)(1)(B) and 6224(c)(3)(A).
18 See Sections 6229(b)(1)(B) and 6224(c)(3)(A).
19 Treas. Reg. Section 301.6224(c)-1.
20 Section 6223(a). See Treas. Reg. Section 301.6223(g)-1(a).
21 See Treas. Reg. Section 301.6223(g)-1(a)(1) for NBAP. Treas. Reg. Section 301.6223(g)-1(a)(2) for FPAA.
22 Id.
23 Treas. Reg. Section 301.6223(g)-1(a)(3).
The TMP is required to furnish the information with respect to the action or other matter described above within 30 days from the date the action was taken or the information received. Note that Section 6230(f) provides that if the TMP fails to provide actual notice of a judicial proceeding to any partner, the TEFRA proceeding is nevertheless applicable to that partner.

Note that Section 6230(f) provides that if the TMP fails to provide actual notice of a judicial proceeding to any partner, the TEFRA proceeding is nevertheless applicable to that partner.

The TMP also has the authority to file an Administrative Adjustment Request (AAR) on behalf of the partnership under Section 6227(b). An AAR filed by the TMP (partnership-level AAR) is a request by the partnership to the IRS to allow the amendments to the partnership’s tax return that are set forth in the AAR. As referenced above, the regulations under Section 6223 require that within 30 days of filing an AAR, the TMP must provide information to the other partners concerning the filing. In addition to notifying the other partners that a partnership-level AAR was filed, the TMP needs to keep the other partners informed concerning the status of the partnership-level AAR filing.

For example, there is a two-year period of limitations to file suit requesting a court to allow the adjustments in the AAR regardless of whether the IRS allows or disallows the adjustments requested in the AAR. This two-year period to file suit, which may be extended by agreement, starts from the date the partnership-level AAR is filed. Thereafter the IRS has two years to issue a refund to partners who are entitled to a refund based on the adjustments in the partnership-level AAR. If the refund is not paid, the TMP must file suit asking a court to issue the refund. Unlike the procedures applicable for claiming a non-TEFRA refund, the filing of a partnership-level AAR by the TMP does not toll the period of limitations with respect to any claim for refund attributable to the partnership items being adjusted.

There is a two-year period of limitations to file suit requesting a court to allow the adjustments in the AAR regardless of whether the IRS allows or disallows the adjustments requested in the AAR.
It is important for the TMP and the TMP’s tax advisor to understand the basics of the TEFRA procedural rules.

Implications
It is important for the TMP and the TMP’s tax advisor to understand the basics of the TEFRA procedural rules. As the Tax Court has repeatedly observed, the continual presence of a TMP to act on behalf of the other partners is essential to the proper operation of TEFRA because the execution of the TMP’s statutory duties will have a substantial effect upon the rights of all partners in the partnership.16 In other words, actions that are taken by the TMP, as identified above, will impact all of the partners and may have detrimental consequences, including a loss of the right to timely take action, for partners who did not receive proper information or notification. This is especially true considering the language in Section 6230(h) providing for the applicability of the TEFRA rules notwithstanding any failure by the TMP to provide notice to any partner. Consequently, it is critical that partners choose a TMP wisely — one who is reliable and responsive.

Consequently, if two years is allowed to lapse after the AAR is filed and refunds have not been issued, partner-level refunds attributable to the partnership-level AAR are barred unless the TMP files suit in one of three courts: Tax Court, District Court or Court of Federal Claims. As a result, it is extremely important for the TMP to monitor the filing and processing of the partnership-level AAR to prevent barred partner refunds.

In our next issue, we will explore in more detail the TMP’s duties and responsibilities with respect to filing an AAR under TEFRA and the perils if the TMP neglects those duties and responsibilities.

# Tax Controversy and Risk Management Services: Ernst & Young LLP team leadership

<table>
<thead>
<tr>
<th>Name</th>
<th>City</th>
<th>Contact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National leadership</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rob Hanson, EY Americas Director</td>
<td>Washington, DC</td>
<td>+1 202 327 5696</td>
</tr>
<tr>
<td>Tina Boldt, Accounts and Interest Group Leader</td>
<td>Dallas, TX</td>
<td>+1 214 969 8476</td>
</tr>
<tr>
<td>Frank Cannetti</td>
<td>Pittsburgh, PA</td>
<td>+1 412 644 0571</td>
</tr>
<tr>
<td>Pat Chaback</td>
<td>San Francisco, CA</td>
<td>+1 415 894 8231</td>
</tr>
<tr>
<td>Richard Fultz</td>
<td>Washington, DC</td>
<td>+1 202 327 6840</td>
</tr>
<tr>
<td>Alice Harbutte</td>
<td>Denver, CO</td>
<td>+1 303 871 4511</td>
</tr>
<tr>
<td>Elvin Hedgpeth</td>
<td>Washington, DC</td>
<td>+1 202 327 8319</td>
</tr>
<tr>
<td>Tom Meyerer, Employment Tax Controversy Leader</td>
<td>Washington, DC</td>
<td>+1 202 327 8380</td>
</tr>
<tr>
<td>Frank Nig</td>
<td>Washington, DC</td>
<td>+1 202 327 7887</td>
</tr>
<tr>
<td>Alan Summers</td>
<td>Portland, OR</td>
<td>+1 503 414 7967</td>
</tr>
<tr>
<td><strong>US Regional leadership</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ned Connelly</td>
<td>Stamford, CT</td>
<td>+1 203 674 3066</td>
</tr>
<tr>
<td>Steve Diamond</td>
<td>Houston, TX</td>
<td>+1 713 750 8277</td>
</tr>
<tr>
<td>Dolly Park</td>
<td>McLean, VA</td>
<td>+1 703 747 1303</td>
</tr>
<tr>
<td>Sharon Kariya</td>
<td>San Francisco, CA</td>
<td>+1 415 894 8575</td>
</tr>
<tr>
<td>Mark Meader</td>
<td>Atlanta, GA</td>
<td>+1 404 817 5236</td>
</tr>
<tr>
<td>Maureen Nelson</td>
<td>Washington, DC</td>
<td>+1 202 327 6021</td>
</tr>
<tr>
<td>Bill O’Meara</td>
<td>Philadelphia, PA</td>
<td>+1 215 448 5656</td>
</tr>
<tr>
<td>Lee Pouillard</td>
<td>Los Angeles, CA</td>
<td>+1 213 240 7509</td>
</tr>
<tr>
<td>John Risacher</td>
<td>Chicago, IL</td>
<td>+1 312 879 3323</td>
</tr>
<tr>
<td>Trevor Wetherington</td>
<td>Detroit, MI</td>
<td>+1 313 628 8439</td>
</tr>
</tbody>
</table>

An electronic copy of this newsletter can be downloaded on the Tax Controversy and Risk Management page of ey.com:

To be added to the mailing list for electronic distribution of this newsletter, please send an email to chip.faught@ey.com.
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2014 Ernst & Young LLP.
All Rights Reserved.
SCORE no. YY3306
1404-1231986
ED 0115

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com