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Tax Controversy Services

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Tax Controversy Updates: Large Business & International Directive on New Policy for Information Document Requests and Updated Enforcement Process

As discussed in the July edition of IRS Insights, on June 18, 2013 the Internal Revenue Service ("IRS") Large Business & International Division ("LB&I") issued a directive ("Directive")[1] announcing its new policy with respect to Forms 4564, *Information Document Requests* ("IDRs"), issued after June 30, 2013. The stated purpose of this policy is to ensure that the IDR process will be more efficient, and as a result, there will be less need to enforce IDRs through summonses. This policy impacts all LB&I taxpayers under examination. The Directive details practices the examiners should follow to gather information during an examination, which include:

- All IDRs must be issue focused, meaning the examiner must identify and state the issue that has led the examiner to request the information included in the IDR;
- The examiner must discuss the IDR with the taxpayer prior to issuance; and
- The examiner and taxpayer should discuss and determine the appropriate deadline for the request(s).

In the fall of 2013, the IRS started discussing the new enforcement procedures ("Enforcement Process"), which were previously referenced in the Directive. These enforcement procedures were originally effective on October 1, 2013; however, the IRS has recently stated that these procedures will not be effective until January 2, 2014.[2]

The new Enforcement Process provide a mandatory three-step process for LB&I examiners to follow when a taxpayer does not provide information by an IDR due date. These three steps are: (1) delinquency notice, (2) pre-summons letter and (3) summons. The Enforcement Process clarifies that once the IDR due date is set it cannot be altered by the Agent, regardless of taxpayer explanations or later requests for additional time.

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[1] LB&I Control No: LB&I-04-0613-004.
[2] IRS Large Business & International Memorandum, Large Business & International Directive on Information Document Requests Enforcement Process, November 4, 2013 (LB&I -04-1113-009).

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Delinquency Notice (Letter 5077)

The first step under the Enforcement Process is the issuance of a Delinquency Notice, which occurs immediately after an IDR is deemed delinquent (i.e. after the due date of the IDR). Once the due date for the IDR has expired without a response or the response is deemed to be incomplete, an IDR will be considered delinquent. A meeting is required to be held between the exam team and taxpayer to discuss and document the reasons for the delay in providing the material. The mandatory IRS training conducted for all of its Agents provides that this meeting would ideally take place the day after the delinquency; however, should not take place more than 10 days later.

The Delinquency Notice may provide up to 15 additional calendar days for the taxpayer to respond. This extension of time is at the discretion of the examination team, and may only be extended beyond 15 days with approval from the IRS Territory Manager. Accordingly, the exam team may determine that it will not provide the taxpayer with 15 days to respond to the delinquent IDR. Prior taxpayer compliance is an item for the exam team to consider when determining a grant of additional time.

It should be emphasized that the Enforcement Process also requires the issuance of a Delinquency Notice for IDRs that have been partially completed. The Delinquency Notice will detail the information that is still required to be provided and reference the IDR number. Further, at the time of the issuance of the Delinquency Letter, IRS agents are instructed to inform IRS Counsel of the issuance of the letter and to provide them with a copy of the IDR(s) that are the subject of the letter.

Pre-Summons Letter (Letter 5078)

If the Taxpayer does not provide the information sought within the time frame provided by the Delinquency Notice, then the IRS will issue a Pre-Summons Letter. This is the final notice to respond to the IDR prior to issuance of a summons and will be prepared with the assistance of IRS Counsel. Similar to the Delinquency Notice, this letter will include a summary of outstanding information. The taxpayer is then given 10 calendar days from issuance to respond to the Pre-Summons letter, before the IRS will move forward in its enforcement process.

The Enforcement Process directs that the Pre-Summons letter will be issued by the Territory Manager and discussed with the taxpayer. However, it will not be issued to the taxpayer’s primary contact for the examination team but will be issued to, and discussed with, the next level of taxpayer’s management. The IRS states that the purpose of involving the taxpayer’s next level of management is to make management aware that the IDR has not been answered, and ensures the delay has risen to the appropriate level within the corporate taxpayer.

Summons

If the taxpayer fails to respond, or the response is deemed to be incomplete, to the Pre-Summons notice with the requested information, the IRS will move forward with issuing a summons. IRS Counsel will also be involved in the preparation and issuance of the summons. The Enforcement Process training material discusses that the IDR process is designed to ensure that the IRS will follow through with the summons process, if necessary, to complete the examination.

Conclusion

The IRS has updated its procedures related to IDRs and taxpayers should be aware of these changes to the content of the IDRs and the strict process set forth with respect to potential enforcement activity. As noted above, the content procedures are in effect for all IDRs issued after June 30, 2013, while the Enforcement Procedures will not be implemented until January 1, 2013.

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Tax Controversy Updates:
Seventh Circuit Adopts Majority View that Valuation Misstatement Penalty is Applicable when Transaction Lacks Economic Substance

The Seventh Circuit recently adopted the majority view of the U.S. Courts of Appeals and the Tax Court, holding that the valuation misstatement penalty is proper in instances where the transaction that involved the overvalued asset was disregarded because it lacked economic substance. As discussed in the May 2013 and March 2013 editions of "IRS Insights," the Circuits are split as to whether the valuation misstatement penalty is applicable when the Internal Revenue Service ("IRS") has disallowed the underlying deduction or credit on grounds unrelated to the valuation. This opinion reflects the majority view, holding that a taxpayer who overstates basis and participates in sham transactions should be subjected to the valuation misstatement penalty of IRC § 6662.

Superior Trading, LLC v. Comm'r, 2013 U.S. App. LEXIS 17814 (7th Cir. Aug. 26, 2013)

The U.S. Court of Appeals for the Seventh Circuit in *Superior Trading, LLC v. Comm'r,* 2013 U.S. App. LEXIS 17814 (7th Cir. Aug. 26, 2013) considered Taxpayer's appeal from the U.S. Tax Court. On appeal, Taxpayer challenged the Tax Court's decision to uphold the IRS's disallowance of losses claimed by Taxpayer, for the benefit of tax shelter investors, and the Service's imposition of a 40-percent "gross valuation misstatement" penalty under IRC § 6662.

Under IRC § 6662(a), an accuracy-related penalty may be imposed in an amount equal to 20 percent of the portion of the underpayment of tax required to be shown on a return if the underpayment is attributable to one or more of the grounds identified in IRC § 6662(b). In accordance with IRC § 6662(b)(3), "any substantial valuation misstatement under chapter 1" is provided as a basis for the imposition of an accuracy-related underpayment penalty. Section 6662(e) states that a substantial valuation misstatement exists if the value of any property (or the adjusted basis of any property) claimed on any tax return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis. Section 6662(h) provides that the accuracy-related penalty is increased to 40 percent in the case where the underpayment is attributable to a "gross valuation misstatement," which occurs when the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct value or adjusted basis.

In connection with Taxpayer's sham transaction (i.e., distressed asset/debt tax shelter), the aggregate basis of the receivables transferred to Warwick Trading, LLC (the "partnership") was close to zero, where there was no intention to collect on the promissory notes; however, these assets had been valued at roughly $30 million. Accordingly, the Seventh Circuit found that the valuation misstatement in this case was, in fact, "gross," in accordance with IRC § 6662(h). The Seventh Circuit further concluded that Taxpayer had not established that there was "reasonable cause" for Taxpayer's built-in loss deduction. Therefore, the Seventh Circuit affirmed the 40-percent penalty imposed by the Tax Court, concluding that the valuation misstatement was "gross" and that Taxpayer had not proved that it had "reasonable cause" to deduct the built-in losses.

The Seventh Circuit acknowledged the existing disagreement among the Courts of Appeals, and noted that the Supreme Court has granted certiorari to resolve the conflict among the circuits. The Supreme Court will review the U.S. Court of Appeals for the Fifth Circuit's decision in *Woods v. United States*, 471 Fed. Appx. 320 (5th Cir. Tex. 2012). Currently, the First, Third, Seventh and Eleventh Circuits, along with the Tax Court, have found that the valuation misstatement penalty to be applicable, even where the underlying transaction is disregarded. The Fifth and Ninth Circuits, however, have declined to impose the valuation misstatement penalty in cases where the deductions and credits containing the misstatement were disallowed. The U.S. Court of Appeals for the Federal Circuit has also weighed in, overturning a Federal Court of Claims decision and concluding that a valuation misstatement penalty may be applied when the IRS asserts both a valuation misstatement ground and a non-valuation-misstatement ground for the same adjustment.

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Tax Controversy Updates:
Supreme Court Rejects Petition to Review Ninth Circuit's Decision Denying Reasonable Cause Relief Where Taxpayer Relied on Advisor to Determine Due Date of Estate Tax Return

In *Knappe v. United States*, 2013 U.S. App. LEXIS 6809 (9th Cir. 2013), the U.S. Court of Appeals for the Ninth Circuit affirmed a federal district court's determination that an estate was liable for a failure to file penalty as a result of filing the estate tax return three months late, even though the executor had followed the advice of his accountant regarding the due date of the return. In July 2013, the executor Peter Knappe ("Knappe") filed a petition for writ of certiorari ("Petition") with the U.S. Supreme Court; however, this petition was recently denied.

As discussed in the May 2013 edition of "IRS Insights," the U.S. Court of Appeals for the Ninth Circuit affirmed a California district court's ruling that denied executor Peter Knappe ("Knappe") reasonable cause relief. The Ninth Circuit relied on prior reasoning from the U.S. Supreme Court in *United States v. Boyle*, 469 U.S. 241 (1985) and its own recent decision in *Baccei v. United States*, 632 F. 3d 1140 (9th Cir. 2011) for the proposition that reliance on an advisor may establish reasonable cause if the advice is deemed "substantive" tax advice. The Ninth Circuit then stated that, after a close reading of those cases, the question of when the estate tax return was due was "nonsubstantive" tax advice; "the question of how long an extension was available was not a 'debatable' one.'' The Ninth Circuit pointed out that the instructions to the Form 4768 and the relevant section of the Code were unambiguous in that only a six-month extension of time to file was provided. Additionally, the Ninth Circuit stated that "[a]scertaining a deadline is within the ambit of an executor's nondelegable duties, because a deadline is a nonsubstantive matter," and, according to the Ninth Circuit, Knappe was "derelict" in this duty because he did nothing to confirm that Francis Burns, the Certified Public Accountant hired by Knappe, had properly requested a one-year extension to file the Form 706. As a result, the Ninth Circuit concluded that Knappe's reliance on Burns' erroneous advice did not establish reasonable cause for the failure to timely file a return.

As noted above, the executor filed a petition for writ of certiorari urging the Supreme Court to address the issue of whether a taxpayer demonstrates reasonable cause when taxpayer relies on tax advisor's erroneous advice about the applicable filing deadline, and files its return after the due date but within the time that advisor counseled the taxpayer was available.[3] In the Petition, Knappe had urged the Supreme Court to revisit the rule of *Boyle*, which has been applied and interpreted inconsistently. The Petition emphasized that *Boyle* expressly did not address "whether a taxpayer demonstrates 'reasonable cause' when, in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available," citing *Boyle* at 251, n.9. Additionally, the Petition pointed out that the courts are split on the question of whether reliance on erroneous advice for the necessity of filing a tax return or its due date can constitute reasonable cause for failing to timely file the return.

In October 2013, the Supreme Court declined to grant certiorari in the *Knappe* case. Accordingly, taxpayers with this type of situation should continue to be aware of the potential application of the *Boyle* standard, which evaluates the type of advice in determining whether reasonable cause relief is available.

Tax Controversy Updates:
IRS Announces Delay in the Start of 2014 Filing Season (2013 Tax Year), Filing Deadlines are Not Impacted

In IR-2013-82 ("Notice"), published on October 22, 2013, the Internal Revenue Service ("IRS" or "Service") announced a delay of approximately one to two weeks to the start of the 2014 filing season. According to the IRS, the final date will be set in December. This delay will impact the filing of individual returns and the issuance of related refunds. The Notice states that the delay is necessary to allow for adequate time for the IRS to program and test 2014 tax processing systems for the 2013 calendar tax year filings, due to the time lost during the 16-day federal government closure. The Notice states that programming, testing and deployment of more than 50 IRS systems is needed to handle the processing of 150 million tax returns, and the majority of this work is done in the fall of each year. In addition to electronic filings, the IRS will also not process paper returns before the start date.

[3] *Knappe v. United States*, 2013 U.S. Briefs 34 (U.S. July 3, 2013).

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Taxpayers should be aware that the delay of the start of the filing season will not impact filing deadlines. An individual taxpayer is generally required to file his/her 2013 tax return by April 15, 2014, however, six month automatic extensions are available to extend the requisite filing time. Taxpayers other than individuals, such as corporations, may be able to utilize the 2012 form if required to file a 2013 tax return prior to the issuance of the new forms.

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