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Tax Controversy Services

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Ninth Circuit Affirms in Part and Reverses in Part District Court Decision, Holding that Internal Revenue Service Timely Assessed Tax on Lower-Tier Partnership for Liability Attributable to Partnership Flow-Through Items of Upper-Tier Partnership where Extension Agreements Referred to Upper-Tier Partnership Only

In *Candyce Martin 1999 Irrevocable Trust v. United States*, 2014 U.S. App. LEXIS 605 (9th Cir.), the Ninth Circuit Court of Appeals affirmed in part and reserved in part the decision of the U.S. District Court for the Northern District of California. A group of heirs to the founders of Chronicle Publishing Company, with interests in two irrevocable trusts who were partners in a partnership, filed a petition for readjustment of partnership items in connection with the sale of a partnership and the resulting tax consequences, arguing that the Internal Revenue Service ("IRS" or "Service") issued a Notice of Final Partnership Administrative Adjustment ("FPAA") after the expiration of the limitations period. The trusts moved for summary judgment, asserting that the FPAA and resulting assessments were time-barred. The district court denied the motion, finding that the statute had been extended by agreement because the extension encompassed the disputed partnership adjustments. On *de novo* review, the Ninth Circuit concluded that the assessment statute was still open and remanded the case to the district court for determination of which adjustments in the FPAA were "directly attributable to partnership flow-through items" of the upper-tier partnership referenced in the extension agreements.

Chronicle Publishing Company ("Chronicle Publishing") was co-founded by Charles and M.H. de Young in the mid-1800s, and incorporated in 1880. In the late 1990s, Chronicle Publishing planned to sell the majority of its assets to Hearst Corporation ("Hearst"). To minimize their tax liability, consequent to the asset sale, and protect themselves from future liability related to their execution of a recontribution agreement, some of the de Young heirs ("the Martin heirs") implemented a "Son of BOSS" tax shelter.[1] Based on tax advice received, the Martin heirs formed a tiered partnership, which included three components: (a) the fourteen Martin Family Trusts (the "Trusts"); (b) an upper partnership tier, which included multiple partnerships; and (c) a single, lower-tier partnership. The upper partnership tier reflected three partnerships, including: First Ship, LLC ("First Ship"); Fourth Ship, LLC ("Fourth Ship"); and LMGA Holdings, Inc. ("LGMA").

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[1] *See* Notice 2000-44, 2000-2 C.B. 255, which alerts taxpayers that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes. Notice 2000-44 addresses Son of BOSS transactions, which the Service asserts promote tax avoidance by using an artificially high basis. These transactions are also discussed in Announcement 2002-2, 2002-2 C.B. 304, and Announcement 2004-46, 2004-21 I.R.B. 964.

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The lower tier was comprised solely of First Ship 2000-A, LLC ("2000-A"); First Ship, Fourth Ship and LMGA were the three partners of 2000-A.

Through this structure, the Martin heirs engaged in a series of transactions that were intended to generate sufficient losses to offset the taxable gain to be realized from the sale of Chronicle Publishing to Hearst. The Trusts purchased long options and sold short options, and then contributed their assets to the upper-tier partnerships. These upper-tier partnerships then contributed the assets to 2000-A. The Trusts and First Ship claimed an increase in their tax bases in the partnerships as a result of these transactions. Ultimately, consistent with the Son of BOSS plan, 2000-A sold of its assets, terminated the options, distributed its remaining holdings back to its partners (namely First Ship), and dissolved. On March 22, 2001, 2000-A filed its Form 1065 partnership tax return; First Ship also filed a Form 1065 on this date, reflecting a $321 million short-term capital loss resulting from the closing out of 2000-A. The Trusts had an inflated basis in First Ship; accordingly, the Trusts reported losses in excess of $320 million. The overall result of the transactions was that the Martin heirs owed no tax on the proceeds from the sale of Chronicle Publishing.

Both 2000-A and First Ship were subject to the uniform audit rules of the Tax Equity and Fiscal Responsibility Act ("TEFRA"), and the relevant assessment limitations periods are contained in Internal Revenue Code ("IRC" or "Code") §§ 6229 and 6501. The IRS initially executed Form 872-I, *Consent to Extend the Time to Assess Tax As Well As Tax Attributable to Items of a Partnership*, with the Trusts to extend the limitations period to April 15, 2005; the parties subsequently extended the limitations period to June 30, 2008 through successive agreements ("Extension Agreements"). The forms included the following restrictive language:

> The amount of any deficiency assessment is to be limited to that *resulting from any adjustment directly or indirectly* (through one or more intermediate entities) *attributable to partnership flow-through items of First Ship LLC* and/or to any adjustment attributable to costs incurred with respect to any transaction engaged in by First Ship LLC, and penalties and additions to tax attributable to any such adjustments, any affected items, and any consequential changes to other items based on any such adjustments. [Emphasis added.]

Prior to the expiration of the time for assessment that the Trusts had agreed to in the Extension Agreements, on June 18, 2008, the Service issued an FPAA to 2000-A for 2000 tax year ("2000-A FPAA"). In the 2000-A FPAA, the IRS concluded that 2000-A's transactions should be disregarded because the partnership was a sham and the transactions lacked economic substance. In addition, the Service found that the short options constituted liabilities that would have reduced First Ship's basis in 2000-A by approximately $315 million, thereby virtually eliminating First Ship's reported $321 million short-term capital loss on its 2000 tax return.

Two of the Trusts, the Candyce Martin 1999 Irrevocable Trust and Constance Goodyear 1997 Irrevocable Trust ("Taxpayers"), challenged the 2000-A FPAA on the grounds that the adjustments were time-barred because the language in the Extension Agreements was restricted to First Ship and did not reference 2000-A by name. The district court denied the Taxpayers' motion for summary judgment, concluding that the Extension Agreements encompassed the IRS adjustments reflected in the 2000-A FPAA because 2000-A and First Ship had a "direct connection," and the 2000-A FPAA involved "an adjustment directly attributable to flow-through items of First Ship."

On *de novo* review, the Ninth Circuit discussed Congress's objective in enacting the TEFRA regime, stating that TEFRA was designed to create a single, unified procedure for determining the tax treatment of all partnership items at the partnership level, thereby reducing the redundancy of assessing the effect of a partnership on a partner's tax returns at the individual partner level. In accordance with the Code and Treasury Regulations, partnership items, such as a partnership's income, gain, loss, deductions and credits, are items that must be taken into account on a partner's federal income tax return and are "more appropriately determined at the partnership level than at the partner level."[2] With respect to the applicable limitations period, the Ninth Circuit looked to both IRC §§ 6501 and 6229. The limitations period and extension alternatives announced in IRC § 6229 are applicable to assessments of tax. However, the Court highlighted that an FPAA may be issued at any time, provided that it only impacts partners with individual returns that remain open, under either IRC §§ 6501 or 6229.

Upon analysis of the 2000-A FPAA and the Extension Agreements, the Ninth Circuit concluded that the Extension Agreements between the Trusts and the Service encompassed some of the adjustments made in the 2000-A FPAA. The

[2] *See* IRC § 6231(a)(3).

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Court interpreted the "attributable to" language in the Extension Agreements to mean "due to, caused by, or generated by." The Court framed the question on appeal as "whether at least some of the adjustments made in the 2000-A FPAA are directly due to, caused by, or generated by partnership items of First Ship that flow through (e.g., items of income or loss) to First Ship's partners, the Trusts." Accordingly, the Ninth Circuit concluded that the $318 million loss, related to First Ship's inflated basis in 2000-A, was a partnership flow-through item of First Ship that led to the adjustment to 2000-A.

The Ninth Circuit factually distinguished the Court of Federal Claims' decision in *Russian Recovery Fund Ltd. v. United States*, 101 Fed. Cl. 498 (2011), from the Taxpayers' case. In *Russian Recovery*, the Court of Federal Claims held that an agreement that specifically cited an upper-tier partnership did not encompass adjustments made to the lower-tiered partnership. However, the Ninth Circuit argued that, unlike in *Russian Recovery*, the upper-tier partnership in this case, First Ship, was largely reporting its own loss, which generated both the loss claimed by the Trusts and the adjustments made by the IRS to 2000-A, thereby bringing it within the confines of the Extension Agreements. By contrast, in *Russian Recovery*, the upper-tier partnership merely reported and passed along its share of the lower-tiered partnership's losses.

The Ninth Circuit concluded that the Extension Agreements: (1) encompassed those adjustments made in the 2000-A FPAA that were directly attributable to partnership flow-through items of First Ship; (2) did not encompass adjustments to items of 2000-A that only flowed up through the minority partners; and (3) did not encompass any adjustments to partnership items of 2000-A of which First Ship merely claimed a share. The Ninth Circuit remanded the case to the district court to determine which adjustments in the 2000-A FPAA were directly attributable to partnership flow-through items of First Ship.

IRS Issues Directive on the Definition of Milestone and Directs Examiners as to When to Challenge Treatment of Eligible Milestone Payments in Connection with the Safe Harbor of Rev. Proc. 2011-29, for LB&I Taxpayers

On January 27, 2014, the Commissioner of the Large Business & International ("LB&I") Division of the Internal Revenue Service ("IRS" or "Service") distributed "Updated Guidance on the Examination of Milestone Payments in the Acquisition of Businesses" in a memorandum addressed to LB&I Employees, LB&I Directive 04-0114-001 ("Directive"). The Directive states that, if a taxpayer meets certain requirements, LB&I examiners should not challenge a taxpayer's treatment of eligible milestone payments made or incurred in the course of a covered transaction, described in Treas. Reg. § 1.263(a)-5(e)(3), for which the taxpayer incurs a success-based fee (i.e., a payment that is contingent upon the successful closing of the covered transaction). The Directive's guidance is only applicable to investment banker fees incurred by either an acquiring corporation or a target corporation, and it only applies to amounts deducted on original timely-filed returns.

Background

On April 8, 2011, IRS issued Revenue Procedure 2011-29, 2011-18 I.R.B. 746, which provides a safe harbor for allocating success-based fees paid or incurred in covered transactions. In lieu of maintaining the documentation required by Treas. Reg. § 1.263(a)-5(f) to support a deduction for a portion of a success-based fee, Rev. Proc. 2011-29 permits an electing taxpayer to treat 70 percent of a success-based fee as an amount that does not facilitate the covered transaction. The remaining 30 percent of the fee must be capitalized as an amount that facilitates the covered transaction.

Covered transactions are transactions described in Treas. Reg. § 1.263(a)-5(e)(3), as follows: (i) a taxable acquisition by the taxpayer of assets constituting a trade or business; (ii) a taxable acquisition of an ownership interest in a business entity if, immediately after acquisition, acquirer and the target are related within the meaning of IRC § 267(b) or IRC § 707(b); and (iii) a reorganization described in IRC § 368(a)(1)(A), (B), or (C), or a reorganization described in IRC § 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction qualifying under IRC § 354 or IRC § 356.

An election under Rev. Proc. 2011-29 applies to all success-based fees paid or incurred by a taxpayer in a covered transaction for which the election is made. Once made, the election is irrevocable. The Revenue Procedure does not provide a safe harbor for milestone payments. "Milestone" is defined as "an event, including the passage of time, occurring in the course of a covered transaction," and a "milestone payment" means a "non-refundable amount that is contingent on the achievement of a milestone." An "eligible milestone payment" is an amount that is "paid for investment banking services that is creditable against a success-based fee."

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Taxable Years Ended on or After April 8, 2011

The Directive provides that, for taxable years ended on or after April 8, 2011, LB&I examiners are directed not to challenge a taxpayer's treatment of eligible milestone payments provided the taxpayer: (1) has qualified for and timely elected the Rev. Proc. 2011-29 safe harbor for the covered transaction; (2) has not deducted more than 70% of any eligible milestone payment incurred in connection with the respective success-based fee on its original tax return; (3) is not contesting its liability for the eligible milestone payment.

For a taxpayer who incurred eligible milestone payments before the taxpayer was able to elect the safe harbor of Rev. Proc. 2011-29 (i.e., in tax years preceding the tax year in which the success-based fee would be paid), taxpayer's treatment of these payments will not be challenged if the taxpayer: (A) has not deducted more than 70% of any eligible milestone payment incurred in connection with the respective success-based fee on its original tax return and is not contesting its liability for the eligible milestone payment; (B) has documented that, in the year in which the eligible milestone payments were made, the taxpayer intended to elect Rev. Proc. 2011-29 with regard to the respective success-based fee; and (C) has made the Rev. Proc. 2011-29 election for the success-based fee that was paid or incurred, if the transaction successfully closed.

Taxable Years Ended Before April 8, 2011

For success-based fees paid or incurred in taxable years ended before April 8, 2011, the taxpayer's return position must satisfy the requirements of LB&I Directive 04-0511-012, and the taxpayer must demonstrate that it has not deducted more than 70% of any eligible milestone payment incurred in connection with the respective success-based fee on its original tax return and establish that it is not contesting its liability for the eligible milestone payment.

IRS Enforcement Statistics for FY 2013

The Internal Revenue Service ("IRS") recently released the Fiscal Year 2013 ("FY 2013") Enforcement and Service Results ("Enforcement Report"). These statistics provide insight about the current level of IRS activities in the following areas: audit, collection and taxpayer service. A few key areas are discussed below.

The Enforcement Report shows a significant increase in enforcement revenue collected by the Collection and Appeals Divisions compared to Fiscal Year 2012 ("FY 2012"). The FY 2013 tables detail total enforcement revenue of $53.35 billion, which is an increase of more than $3 billion from FY 2012. The increase in enforcement revenue was primarily attributable to Appeals with over a $2 billion increase from the prior year and an increase in Collection revenue of approximately $1 billion from FY 2012.

With regards to examinations, the IRS examined 61,020 business tax returns in FY 2013, which include for purposes of the report: large corporate returns, small corporate returns, Subchapter S returns and partnership returns and represents a decrease in the coverage rate (number of examinations conducted/number of returns filed) from FY 2012. As to large corporate returns, defined as returns of corporations with assets of $10 million and greater, the IRS examined 9,876 of the 62,347 returns filed, resulting in a coverage rate of 15.84%.

The Enforcement Report provides more detailed information for the following four asset classes of corporations:

Asset Class	Returns Examined	Coverage
$10 Million < $50 Million	2,240	6.98%
$50 Million < $100 Million	1,206	15.51%
$100 Million < $250 Million	1,589	19.43%
$250 Million and Higher	4,841	33.88%

The only asset class with an increased coverage rate for FY 2013 was corporations with $250 million or higher in assets, while all other assets classes showed decreases in coverage rates.

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The number of returns examined for Subchapter S corporations dropped in coverage rate from 0.48% in FY 2012 to 0.42% in FY 2013. While the coverage rate decreased, it is important to note that the amount of returns examined is one of the highest, with the exception of FY 2012, in the prior ten years and reflects the IRS' increased emphasis on examining Subchapter S returns. Similarly, the number of partnership returns examined decreased from 16,691 to 14,870 in FY 2013, which is a drop of 0.05% in coverage rate. However, similar to the S corporation returns, the number of returns examined for FY 2013 was the second-highest in the prior ten years.

The IRS's examination activity of individual taxpayers shows a continued decline in both correspondence and field audits. In FY 2013, the IRS conducted a total of 1,404,931 examinations of tax returns filed by individuals, which is a 0.96% coverage rate and is the lowest since FY 2005. Similar to recent years the vast majority of these audits, over 75%, occurred as correspondence audits as compared to traditional field examinations. The decrease in coverage rate from FY 2013 was applicable for examinations of individuals at all levels: Income Under $200,000; Income $200,000 and Higher; and Income $1 Million and Higher.

Lastly, it is interesting to note that while enforcement revenue increased, the level of staffing at the IRS continues to decline. The FY 2013 staffing was 19,531, which is the lowest in the prior ten fiscal years with decreases in each of the following areas: revenue officers, revenue agents and special agents. The largest staffing decrease was in revenue agent positions, which decreased from a FY 2012 level of 13,021 to 12,234 in FY 2013, a reduction of 787 revenue agents. Additionally, revenue officers numbered 4,748 in FY 2013 as compared to 5,186 in FY 2012, which is a reduction of 438 revenue officers.

***Loving v. IRS*, 2014 U.S. App. LEXIS 2512 (D.C. Cir. 2014)**

The Court of Appeals for the DC Circuit recently affirmed the District Court's decision in *Loving v. IRS*, 917 F.Supp. 2d 67 (D.D.C. 2013) holding that the Internal Revenue Service was not able to extend Circular 230 provisions to tax return preparers, including currently un-enrolled individuals who prepare all or substantially all of a tax return or claim for refund for compensation. At issue in this case was the final regulations issued by the IRS in 2011 governing practice before the Internal Revenue Service. The final regulations extended Circular 230 provisions to tax return preparers, including currently un-enrolled individuals who prepare all or substantially all of a tax return or claim for refund for compensation. The IRS relied on 31 U.S.C. § 330, which was originally enacted in 1884 and "authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department," as authority for the final regulations.

In *Loving v. IRS*, 917 F.Supp. 2d 67 (D.D.C. 2013), the United States District Court for the District of Columbia issued an order enjoining the IRS from enforcing the final regulations' registration requirement against unenrolled tax return preparers. In reaching its decision, the court concluded that the Treasury Department and the IRS did not have statutory authority to govern those who did not practice before the IRS. The court limited the definition of "practice before the Internal Revenue Service" to those who advise and assist taxpayers, and thus found that a paid preparer did not fit within the boundaries of those roles.

In affirming the lower court's decision, the D.C. Court of Appeals looked to multiple factors in holding that 31 U.S.C. § 330 did not provide the IRS the authority to regulate paid tax return preparers. The court first looked directly at the term "representatives" in 31 U.S.C. § 330 and concluded that paid tax preparers were not "agents," thus were not authorized to act on behalf of the taxpayer. The court also examined the traditional meaning of the "practice" before the Department of Treasury and by extension the Internal Revenue Service. The court held that "practice" ordinarily refers to practice during an investigation, adversarial hearing, or other adjudicative proceeding and that the preparation of a tax return does not fall under this purview. The court noted that until a taxpayer is selected for audit or a taxpayer appeals proposed adjustments that there is not a proceeding, which falls under the purview of "practice" and it is only at that point that a representative may be appointed.

The D.C. Court of Appeals also looked to the context of the statute and related regulations in holding that there was no evidence that 31 U.S.C. §330 was intended to apply to paid tax return preparers. Lastly, the court noted that the IRS had never previously asserted that tax return preparers were representatives who practiced before the IRS such that they would fall under Circular 230.

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Accordingly, the D.C. Court of Appeals held that the grant of authority to regulate representatives under 31 U.S.C. § 330 did not extend to tax return preparers. The court stated, "In our judgment, the traditional tools of statutory interpretation – including the statute's text, history, structure, and context – foreclose and render unreasonable the IRS's interpretation of Section 330." Furthermore, at the end of the opinion, the court cautioned that although the expansion of the rules would potentially be a good policy, any regulation should be done legislatively.

IRS issues LB&I Directive Removing all Coordinated Issue Papers

On January 21, 2014, the IRS issued a Large Business & International ("LB&I) Directive LB&I-04-0114-002 ("Directive") de-coordinating all current Coordinated Issue Papers. Coordinated Issue Papers were technical guidance setting forth the IRS position with respect to certain issues and were binding upon IRS examiners. Effective as of the date of issuance of the Directive, all coordinated issue papers are de-coordinated.

The Directive notes that any technical guidance or tools contained within the Coordinated Issue Papers will be available through the Issue Practice Group ("IPG") and International Practice Networks ("IPN") websites, which are accessible to the examiners. Furthermore, IPGs and IPNs will provide additional guidance and support to the examiners on any issues previously contained in Coordinated Issue Papers. Lastly, the Directive states that the de-coordination of these issues does not impact whether a particular issue will be examined by an LB&I examiner.

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