Deloitte.

Tax Controversy Services

IRS Insights

May 2014

In this issue:

IRS Provides for Automatic Determination Under Treas. Reg. § 1.1502-75(b) to Treat a Subsidiary that Failed to File a Form 1122 as Joining in the Making of a Consolidated Return by the Affiliated Group

Overview

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns for the taxable year if certain requirements set forth in the regulations under IRC § 1502 are satisfied and provided that each corporation that has been a member of the group during any part of the taxable year for which the consolidated return is to be filed consents to the regulations (in the manner prescribed in Treas. Reg. § 1.1502-75(b)). A corporation is deemed to have joined in the making of a consolidated return if it files a Form 1122, *Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return*, in the manner specified in Treas. Reg. § 1.1502-75(h)(2).

In a situation where a subsidiary fails to file Form 1122, Revenue Procedure 2014-24 affords relief such that the subsidiary that failed to file a Form 1122 (non-filing subsidiary) is treated as if it filed a Form 1122 and thus joined in the making of a consolidated return if certain conditions are satisfied. This relief is available irrespective of whether the return of the common parent of the affiliated group is currently under examination.

Requirements

Under Rev. Proc. 2014-24, the requirements to obtain an automatic determination under Treas. Reg. § 1.1502-75(b) are as follows: (1) the affiliated group timely filed what purported to be a consolidated return for the taxable year, i.e., either a Form 851, *Affiliations Schedule*, with the affiliated group's return or other clear and unequivocal indication that the return was intended as a consolidated return for the affiliated group; (2) there is no statutory or regulatory prohibition on the non-filing subsidiary that would have prevented it from joining in the filing of the consolidated return; and (3) no separate return was filed by the non-filing subsidiary for any period of time included in the consolidated return or any subsequent taxable year, with two exceptions. *See* Rev. Proc. 2014-24, Section 3.01-3.04.

In addition to the foregoing, one of the following conditions must be satisfied: (1) the consolidated return did not include the Form 1122 for the non-filing subsidiary due to a mistake of law or fact, or inadvertence, and the non-filing subsidiary's income and deductions were included in the consolidated return as if the non-filing subsidiary were a member of the affiliated group; (2) the consolidated return did not include the Form 1122 for the non-filing subsidiary due to a mistake of law or fact, or inadvertence, and the non-filing subsidiary's income and deductions were included in the consolidated return as part of the income and deductions of another member of the group (as where the non-filing subsidiary was treated as a disregarded entity, separate from its owner, or formally ceased to exist pursuant to a merger or liquidation of another member of the group); or (3) the consolidated return did not include the Form 1122 for the non-filing subsidiary because the affiliated group believed that the non-filing subsidiary was taxable as a partnership for Federal income tax purposes. See Rev. Proc. 2014-24, Section 3.05.

Non-Automatic Determination Alternatives

Rev. Proc. 2014-24 amplifies Rev. Proc. 2014-1, which discusses the procedures for requesting and issuing determination letters. To the extent that a non-filing subsidiary is not eligible for automatic determination because it cannot meet the above requirements, the subsidiary is still permitted to request a determination letter pursuant to Rev. Proc. 2014-1. However, an affiliated group is not able to request a determination letter under Treas. Reg. § 1.1502-75(b) if the issue is under examination or in litigation at the time that the request is made, in accordance with Rev. Proc. 2014-1, Section 6.01. However, during an examination, the Commissioner may make a determination that a subsidiary should be treated as if it had filed a Form 1122 if it meets the standards provided in Treas. Reg. § 1.1502-75(b)(2) or § 1.1502-75(b)(3).

Effective Date

Rev. Proc. 2014-24 is generally effective March 24, 2014.

Office of Chief Counsel Releases Generic Legal Advice Memorandum Discussing the Tax Consequences of an Invalid Section 953(d) Election

On February 12, 2014, the Internal Revenue Service ("IRS" or "Service") issued advice to taxpayers regarding the tax consequences of an invalid Internal Revenue Code ("IRC") § 953(d) election, in a Generic Legal Advice Memorandum ("GLAM"). The IRS determined that a controlled foreign corporation ("CFC") had made an invalid election under IRC § 953(d), concluding that CFC would not be treated as a domestic corporation for U.S. tax purposes. CFC had filed Forms 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*. Taxpayer, a U.S. shareholder of CFC, did not file Forms 5471, *Information Return of U.S. Persons With Respect to Foreign Corporations*, because it believed a valid IRC § 953(d) election had been made.

In the GLAM, the IRS determined that, in the case of an invalid election under IRC § 953(d), the CFC remains a foreign corporation subject to U.S. income tax in accordance with IRC §§ 881 and 882. According to the GLAM, if the U.S. shareholders, like Taxpayer, fail to report information required by IRC § 6038, then IRC § 6501(c)(8) is applicable and will extend the period of limitation for assessment.

IRC § 6501(c)(8) was modified by the Hiring Incentives to Restore Employment Act ("HIRE Act"). Under this exception, the limitations period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Secretary by the person required to file the return. Specifically, IRC § 6501(c)(8) reads as follows:

> (8) Failure to notify Secretary of certain foreign transfers.
>
> (A) In general. In the case of any information which is required to be reported to the Secretary pursuant to an election under section 1295(b) or under section 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048, the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section.

(B) Application to failures due to reasonable cause. If the failure to furnish the information referred to in subparagraph (A) is due to reasonable cause and not willful neglect, subparagraph (A) shall apply only to the item or items related to such failure.

The most significant aspect of IRC § 6501(c)(8) is that the taxes that may be assessed during this extended period are not limited to adjustments related to the international information required to be reported by one of the enumerated sections, but rather, the assessment statute remains open to assess additional tax for any adjustment made to the income tax return. The scope of the extension is limited if a failure to provide information on cross-border transactions or foreign assets is shown to be due to reasonable cause and not willful neglect. In cases in which a taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose.

The IRS also concluded that the filing of the Form 1120-PC by CFC does not operate to start the running of the statute of limitations for assessment because IRC § 6038 requires CFC's U.S. shareholders to provide specific information on the Form 5471 and the Form 1120-PC is not a return of CFC's U.S. shareholders.

Large Business & International Division Revises Information Documentation Request Policies

As discussed in the November 2013, and July 2013 editions of *IRS Insights*, on June 18, 2013, the Internal Revenue Service ("IRS" or "Service") Large Business & International Division ("LB&I") issued a directive ("First Directive") announcing its new policy with respect to Forms 4564, *Information Document Requests* ("IDRs"). On November 4, 2013, LB&I issued another directive ("Second Directive"), reiterating the guidance contained in the First Directive and establishing a mandatory three-step IDR Enforcement Process, effective January 2, 2014, for LB&I examiners to follow when a taxpayer does not provide information by an IDR due date. On February 7, 2014, LB&I extended the effective date of its IDR enforcement procedures to March 3, 2014. On February 28, 2014, LB&I issued another directive, LB&I-04-0214-004 ("Third Directive"), revising its IDR policies for the stated purpose of ensuring that the procedures governing IDR issuance and enforcement are clearly understood. On March 25, 2014, LB&I announced that it plans to issue a set of frequently asked questions and answers ("FAQs") addressing taxpayer and revenue agent questions relating to its new IDR enforcement procedures.

Directive LB&I-04-0214-004

Overview and Summary of Changes – The Third Directive emphasizes the importance of meaningful communication between the IRS and taxpayers with respect to the focus of an IDR, the information required to be provided to evaluate relevant issues, the length of time to comply with the requests, and the amount of time that it will take the IRS to review IDR responses and respond to taxpayers. The Third Directive also sets forth the mandatory three-step IDR Enforcement Process. The IDR Enforcement Process became effective on March 3, 2014. Pursuant to the Third Directive, examiners and specialists should not have issued any Delinquency Notices prior to April 3, 2014.

While the three-step enforcement process is the same as in the Second Directive, a significant change is that the Third Directive now grants the examiner or specialist the ability to extend the IDR response time prior to instituting the IDR Enforcement Process. The Third Directive also provides additional time in several steps by establishing response dates based upon "business days" rather than "calendar days."

The Third Directive consists of two primary components: requirements for issuing IDRs and the IDR Enforcement Process.

Requirements for Issuing IDRs – The policies for issuing IDRs announced in the Third Directive are substantially similar to the guidelines provided in the First Directive and Second Directive. The Third Directive requires LB&I examiners and specialists to abide by specific requirements when issuing IDRs, including:

- Discuss the issue to which the IDR relates with the taxpayer;
- Discuss the relationship of the information requested to the issue under consideration and explain why the information is necessary;
- Ensure that the IDR clearly indicates the issue under consideration and that the IDR only requests information relevant to the stated issue;

- Prepare one IDR for each issue;
- Ensure that the IDR is customized to the taxpayer or the taxpayer's industry;
- Provide a draft of the IDR and discuss its contents with the taxpayer;
- Determine a reasonable timeframe for the taxpayer to provide a response to the IDR, based on consultation with the taxpayer; and
- Determine a date by which the examiner or specialist will review and provide a response to the taxpayer as to whether the information received satisfies the IDR.

The most significant changes to the rules on issuing IDRs clarified two specific issues. First, an IDR issued at the beginning of an examination requesting the taxpayer's basic books and records and general information about the taxpayer's business is not subject to the IDR issuance requirements set forth above. This means that examiners and specialists are not required to state a specific issue that the Service is considering, nor must they establish that the IDR only requests information relevant to a stated issue. Second, if a taxpayer indicates that the requested information will not be provided without a Summons, the IDR enforcement procedures do not apply and the IRS is permitted to move directly to the issuance of a Summons.

IDRs issued in accordance with these requirements are subject to the IDR Enforcement Process articulated below.

IDR Enforcement Process – LB&I's mandatory IDR Enforcement Process includes three steps, as follows:

1. A Delinquency Notice;
2. A Pre-Summons Letter; and
3. A Summons.

These steps are described in more detail below. LB&I did not change the three graduated steps of the process; however, the Third Directive gives LB&I examiners and specialists the discretion to provide taxpayers with extensions of up to fifteen business days to complete an IDR response before the examiner or specialist initiates the IDR Enforcement Process. Whereas the prior directives referred to calendar days, in the Third Directive, the deadlines are provided in "business days" (with one exception), thereby extending the response time.

Extension Authority

An examiner or specialist has the authority to grant taxpayers extensions of up to fifteen business days prior to beginning the IDR Enforcement Process. An examiner or specialist is permitted to grant only one extension for each IDR. An extension may be granted when a taxpayer fails to respond or when a taxpayer provides an incomplete response, provided the taxpayer provides an explanation warranting an extension of time to respond to the IDR. In both cases, the examiner or specialist may grant an extension of up to fifteen business days from the date the extension determination is made and communicated to the taxpayer.

Timing of Application of IDR Enforcement Process

If no response is received by the IDR due date and no extension is granted, then the IDR Enforcement Process begins on the date that the extension determination is communicated to the taxpayer. If an extension is granted and no response is received by the due date, then the IDR Enforcement Process begins as of the extended due date.

If a response is received by the due date, the IRS must determine whether the response is complete by the date that the examiner or specialist provided in the IDR. If the response is not complete and an extension is granted, the IDR Enforcement Process begins at the end of the extension period. If additional information is received at the end of the extension period, the information provided should be reviewed for completeness within fifteen business days from the receipt of the response. If the IDR response is determined to be incomplete, the IDR Enforcement Process begins on the date the examiner or specialist notifies the taxpayer that the response remains incomplete.

Three-Step IDR Enforcement Process

Step 1: Delinquency Notice (Letter 5077) – When an IDR is deemed incomplete or the due date for the IDR has expired without a response, the examiner or specialist will issue a Delinquency Notice, which is signed by the Team

Manager, within ten days of the application of the IDR Enforcement Process. Generally, the Delinquency Notice will include a response date that is no more than ten business days from the date that the Delinquency Notice is issued.

Step 2: Pre-Summons Letter (Letter 5078) – If the examiner or specialist determines that the taxpayer has not provided a complete response to an IDR by the Delinquency Notice response date, the examiner or specialist issues a Pre-Summons Letter signed by the Territory Manager as soon as possible and no later than ten business days after the due date of the Delinquency Notice. This Letter will be addressed to the taxpayer management official who is at a level equivalent to the LB&I Territory Manager (i.e., a level above the taxpayer management official who received the Delinquency Notice) and include a response date in the Pre-Summons Letter that is generally ten business days from the date that the Pre-Summons Letter is issued. A response date beyond ten business days requires approval from the Director of Field Operations.

Step 3: Summons – If a taxpayer does not provide a complete response to an IDR by the response date established in the Pre-Summons Letter, the examiner or specialist will coordinate the issuance of the Summons with assigned Counsel and follow Summons procedures provided in Section 25.5 of the Internal Revenue Manual.

Conclusion

The IRS has updated its procedures and policies 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 Enforcement Process is effective as of March 3, 2014, with the earliest Delinquency Notices issued on April 3, 2014. Taxpayers can also expect FAQs to be posted to the IRS website; these FAQs will provide informal guidance in response to taxpayer and revenue agent questions and problems related to the new IDR enforcement procedures.

IRS Publishes Guidance on How Tax Principles Apply to Transactions Using Convertible Virtual Currency: IRS Will Treat Virtual Currency as Property for U.S. Federal Tax Purposes

On March 25, 2014, the IRS issued Notice 2014-21 ("Notice"), which clarifies the Internal Revenue Service ("IRS") position on convertible virtual currency ("virtual currency"). The Notice provides guidance on how existing tax principles would apply to transactions using virtual currency, as set forth in the form of Frequently Asked Questions ("FAQs") in Section 4. The Notice provides that convertible virtual currency is treated as property for federal tax purposes and would be subject to general tax principles applicable to property transactions.

The Notice defines virtual currency as a "[D]igital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value" and virtual currency that has an equivalent value for real currency is "convertible" virtual currency. An example of convertible virtual currency is Bitcoin, which can be digitally traded and purchased or exchanged into U.S. dollars, Euros or other currencies. In Section 3, the applicable treatment of the Notice is limited to convertible virtual currency transactions:

> This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Section 4 refers only to convertible virtual currency.

In Section 4, the Notice discusses potential tax consequences of transactions in, or with, virtual currency, and sets forth guidance on various tax situations including: payment for goods or services, determination of fair market value, gain or loss upon exchange, mining of virtual currency, virtual currency as wages or income, information reporting, backup withholding and penalties.

The Notice states that taxpayers who receive virtual currency as payment for services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received. The basis of the virtual currency that a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in U.S. dollars, as of the date of the receipt of the virtual currency.

Further, the receipt of virtual currency in exchange for services would be considered taxable wages in the case of employee and self-employment income in the case of an independent contractor. In addition, the Notice reiterates that virtual currency payments are subject to information reporting requirements to the same extent as any other payments made in property, such as Forms 1099-MISC, and payments of virtual currency may by subject to withholding or back-up withholding, as appropriate.

A taxpayer that exchanges virtual currency for other property or services may have gain or loss on the transaction, to the extent that the value of the property received is more or less than the taxpayer's basis in the virtual currency. The character of the gain or loss will generally depend on whether the virtual currency is a capital asset in the hands of the taxpayer. For example, stocks, bonds and other investment assets are generally capital assets, whereas, inventory and other property held mainly for sale to customers in a trade or business would not be capital assets.

Last, it is important to note that the Notice does not provide a safe harbor for virtual currency treatment prior to the issuance date of March 25, 2014. Instead FAQ 16 states:

> Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?
>
> A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

Taxpayers with virtual currency transactions should be aware of Notice 2014-21, which provides that virtual currency is to be treated in the same manner as property for U.S. federal tax purposes. Accordingly, Taxpayers should be aware of this guidance and consider potential tax ramifications when utilizing virtual currency.

Tax Court Discusses Attorney-Client Privilege and Waiver in Tax Shelter Penalty Case

In *AD Investment 2000 Fund LLC v. Comm'r*, 142 T.C. No. 13 (2014), the United States Tax Court granted the Internal Revenue Service's ("IRS's") motion to compel production of six opinion letters expressing attorneys' opinions as to whether it was more likely than not that the tax benefits related to the transactions in issue, ultimately claimed by AD Investment 2000 Fund LLC and AD Global 2000 Fund LLC ("Taxpayers") on their 2000 tax returns, would be sustained on the merits.

The IRS has alleged that Taxpayers engaged in "Son-of-BOSS" transactions,[1] which created artificial tax losses to offset income from other transactions. The IRS asserted Internal Revenue Code ("IRC") § 6662 accuracy-related penalties due to any underpayment of tax resulting from the transactions and related tax return positions. Taxpayers raised an affirmative defense, arguing that the Taxpayers reasonably believed that their tax treatment of the items was more likely than not the proper treatment. To establish their reasonable belief, in accordance with Treas. Reg. §1.6662-4(g)(4)(i)(A), Taxpayers asserted that they analyzed the pertinent facts and legal authorities and reasonably concluded that there was a greater than 50-percent likelihood that the tax treatment of the item would be upheld if challenged by the IRS. The Taxpayers also argued that they acted with reasonable cause and in good faith, in accordance with IRC § 6664(c)(1) and Treas. Reg. § 1.6664-4.

Prior to engaging in the transactions at issue, the Taxpayers had obtained several opinion letters from the law firm of Brown & Wood LLP. IRS filed a motion with the Tax Court seeking to compel the production of the tax opinions. The Taxpayers argued that the tax opinions need not be disclosed to the IRS because each tax opinion represented a privileged communication between attorney and client. Moreover, the Taxpayers argue attorney-client privilege had not been waived as Taxpayer had not raised an affirmative defense to penalties, under IRC § 1.6662-4(g)(4)(i)(B), premised upon good faith reliance on a professional tax advisor. Nonetheless, the IRS argued that Taxpayers had placed the opinion letters in issue by relying on reasonable cause, good-faith defenses, and by putting the Taxpayers' beliefs into issue. Therefore, the IRS sought

[1] For a more detailed discussion of the "Son-of-BOSS" transaction *see, e.g.*, Announcement 2004-46; and *Klamath Strategic Investment Fund v. United States*, 472 F. Supp. 885 (E.D. Tex. 2007).

production of the legal opinions, reasoning that Taxpayers had waived the attorney-client privilege, under the common law doctrine of implied waiver, by raising an affirmative defense to the penalties that turned on the Taxpayers' state of mind (i.e., reasonable belief and good faith).

The Tax Court granted the IRS's motion to compel production of the six tax opinions, finding that the Taxpayers' averments in support of their affirmative defenses to the IRS's assertion of accuracy-related penalties put into contention the state of mind of those who acted for Taxpayers and the Taxpayers' good faith efforts to comply with the tax law. The Tax Court concluded that it would be unfair to deprive the IRS of knowledge of the contents of the opinions and the opportunity to put those opinions into evidence. Finally, the Court determined that, if Taxpayers maintain their reasonable belief and reasonable cause defenses to the accuracy-related penalty, then the Taxpayers will thereby waive their attorney-client privilege with respect to the opinion letters' contents.

Have a question?
If you have needs specifically related to this newsletter's content, send us an email at
clientsandmarketsdeloittetax@deloitte.com to have a Deloitte Tax professional contact you.