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IRS Memorandum Provides Implementation Guidance for Phase 2 of the Appeals Judicial Approach and Culture (AJAC) Project

On July 2, 2014, the IRS Director for Policy, Quality and Case Support issued a Memorandum for Appeals Employees, AP-08-0714-0004, which discusses the implementation of Phase 2 of the Appeals Judicial Approach and Culture ("AJAC") Project ("Phase 2 Memo"). The Phase 2 Memo is effective September 2, 2014, with the exception of IRM 8.4.1.15.4, which will have an effective date of October 1, 2014. The guidance is effective for all new Appeals case receipts on or after September 2, 2014, and will be incorporated into the IRM by September 2, 2016.

Background on AJAC

Appeals is designed to provide an independent forum for taxpayers and the IRS to resolve disputes, outside of litigation. Its mission is to resolve disputes in a fair and impartial basis to both the Government and taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.[1] In 2013, the IRS announced the AJAC Project, which is intended to return Appeals to a quasi-judicial approach to handling cases. On July 18, 2013, the IRS issued guidance to Appeals personnel on the implementation of the first phase ("Phase 1") of the AJAC Project in Memorandum Control No. AP-08-0713-03 ("Phase 1 Memo").

Focusing on the changes for cases other than collection cases, the Phase 1 Memo and the IRM provisions contained therein directed Appeals Officers to not raise new issues and to concentrate on dispute resolution efforts. Phase 1 also provided that Appeals may still consider alternative or new legal arguments that support the parties' positions for purposes of hazards of litigation analysis, but Appeals may only utilize evidence within the case file to evaluate such theories. Moreover, Phase 1 provided that Appeals will attempt to settle a case based upon the factual hazards when the case is not fully developed by IRS Examination and where the taxpayer has not presented new evidence or information, rather than attempt to more fully develop facts. For a more comprehensive discussion of AJAC – Phase 1, please refer to the September 2013 edition of *IRS Insights*.
URL: http://newsletters.usdbriefs.com/2013/Tax/IRSI/130909_3.html

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[1] IRM 8.1.1.1(1).

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AJAC – Phase 2

The overall objective of the changes to the IRM implemented as part of AJAC Phase 2 is to create a clearer delineation between the roles of Examination and Appeals. Examination is to serve a fact-finding and investigatory function; whereas, Appeals is to serve as the independent arbiter weighing the hazards of litigation, based on the evidence gathered during the examination. The IRM states that Appeals Officers are not investigators or examining officers and may not act as such. Consequently, the IRM instructs Appeals Officers not to take investigative actions or perform analysis of new information or new issues. *See* IRM 8.2.1.8.3(1). Some noteworthy changes to the IRM are discussed in more detail below.

New Information Introduced by Taxpayer at Appeals – In the event that a taxpayer produces new evidence in Appeals related to a disputed issue that was not previously shared with the examiner and the new information merits additional analysis by Examination, Appeals is instructed to release jurisdiction and return the case to Examination to examine the new information and make a determination.

Appeals is to release jurisdiction to Examination if: (1) the new information or evidence is relevant to the proposed deficiency; (2) the new information or evidence is not already referenced in the case file; and (3) the new information or evidence requires investigative action or additional analysis. *See* IRM 8.6.1.6.5(4). There must be at least 210 days remaining on the statute of limitations when Examination receives the case; otherwise, the Appeals Officer is instructed to solicit a consent to extend the statute of limitations from the taxpayer. *See* IRM 8.6.1.6.5.

For Large Business and International ("LB&I") cases, if the taxpayer provides new information in response to a request for clarification or corroboration from Appeals, then Appeals will refer the information to LB&I, allowing at least 45 days for written review and comment. *See* IRM 8.7.11.5.3. For all non-LB&I cases, if a taxpayer provides information in response to a request from Appeals, then such information will not be provided to Examination for review and comment. *See* Note to IRM 8.6.1.6.5(1).

New Issue Raised by Taxpayer at Appeals – If the taxpayer raises a relevant new issue that has not been examined by Examination, then Appeals will release jurisdiction of the case and send it back to Examination to examine the issue. If there are fewer than 210 days remaining on the statute of limitations when Examination would receive the case, then the Appeals Officer is to solicit taxpayer's consent to extend the statute prior to releasing jurisdiction. If a statute extension is not agreed to by the taxpayer, then the Appeals Officer is directed to follow the relevant procedures to protect the assessment statute. *See* IRM 8.6.1.6.4.

New Theory or Alternative Legal Argument Raised at Appeals – If the taxpayer raises a relevant new theory or alternative legal argument at Appeals, then Appeals will retain jurisdiction of the case and share information with Examination. *See* IRM 8.2.1.8.3(4). Appeals is instructed to follow a series of steps outlined in the IRM, including sending the information package and all supporting information back to Examination for written review and comment. Exam will be given at least 45 days to prepare its comments. See IRM 8.6.1.6.6.

Statute of Limitations – The new provisions also emphasize protecting the statute of limitations to ensure that Examination and Appeals have sufficient time to investigate the facts and evaluate the case, respectively. As a general matter, Appeals will not accept a proposed deficiency case if the number of days remaining on the assessment statute of limitations is less than 365 days. *See* IRM 8.21.3.1.1(1); IRM 8.2.1.4(1); IRM 8.7.7.2(1).

In several places, the IRM directs the Appeals Officer to solicit the taxpayer's consent to extend the statute of limitations for assessment. For example, if a case is being returned to Examination because the taxpayer raised a new issue or presented new information, then the Appeals Officer is to solicit a statute extension if there are fewer than 210 days remaining on the statute of limitations when Examination would receive the case. Moreover, when the case is returned to Appeals, there must be 180 days remaining on the statute of limitations when the case is received in Appeals. *See* IRM 8.2.1.4(1).

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IRS Releases Final Regulations for Material Advisor Penalty for Failure to Furnish Information Regarding Reportable Transactions

On July 31, 2014, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued final regulations (T.D. 9686) relating to the assessment of penalties under Internal Revenue Code ("IRC" or "Code") § 6707 against material advisors who fail to timely file a return required under IRC § 6111(a) disclosing a reportable transaction or who file a false or incomplete return ("Final Regulations"). The Final Regulations affect material advisors responsible for disclosing reportable transactions and are effective as of July 31, 2014.

Section 6707 was originally added to the Code by section 141(b) of the Tax Reform Act of 1984. As originally codified, section 6707 imposed a penalty for failing to register a tax shelter or for filing false or incomplete information with respect to the tax shelter registration. Temporary regulations were published shortly after section 6707 became law (T.D. 7964). Section 816 of the American Jobs Creation Act of 2004 (AJCA), enacted on October 22, 2004, amended IRC § 6707 to impose a penalty on a material advisor required to file a return under IRC § 6111(a) with respect to a reportable transaction who fails to file such return or who files the return with false or incomplete information. A reportable transaction is defined as any transaction for which information is required to be included with a return or statement because the IRS has determined that the transaction is of a type that has a potential for tax avoidance or evasion, in accordance with IRC § 6707A(c)(1). The amended IRC § 6707 is effective for returns due after October 22, 2004.

On December 22, 2008, the Treasury published proposed regulations (REG-160872-04) implementing the IRC § 6707 penalty, (the "2008 Proposed Regulations"). The Final Regulations, effective July 31, 2014, adopt the 2008 Proposed Regulations with some substantive changes and remove temporary regulations issued in 1984, when Code § 6707 applied only to tax shelters (former Temp. Reg. § 301.6707-1T).

Substantive Changes in the Final Regulations

The penalty for a material advisor failing to report a reportable transactions is $50,000 for each failure, under IRC § 6707(b)(1). A listed transaction is the same as a reportable transaction, except the IRS has specifically identified it as a tax avoidance transaction, under IRC § 6707A(c)(2). The penalty for a listed transaction is the greater of $200,000 or 50% of the material advisor's gross income from the transaction, pursuant to IRC § 6707(b)(2). Section 6707(c) gives the IRS authority to rescind these penalties.

The 2008 Proposed Regulations set forth the rules for application of the penalty under IRC § 6707, and include examples and relevant definitions, such as the definition of incomplete information, false information, and when a failure is intentional so that the higher penalty with respect to listed transactions will apply. The 2008 Proposed Regulations also adopted the factors described in Rev. Proc. 2007-21 that the IRS will consider when determining whether a request for rescission of a section 6707 penalty with respect to a non-listed reportable transaction will be granted.

As compared with the 2008 Proposed Regulations, the Final Regulations add a new paragraph in Treas. Reg. § 301.6707-1(a)(1)(C). The new paragraph provides clarification that only one IRC § 6707 penalty will be applicable in the case of a transaction that is both a listed transaction and a reportable transaction other than a listed transaction; the penalty that applies in this circumstance will be the higher penalty for listed transactions under Treas. Reg. § 301.6707-1(a)(1)(ii). If there is a failure with respect to more than one reportable or listed transaction, a material advisor will be subject to a separate penalty for each transaction, in accordance with Treas. Reg. § 301.6707-1(a)(1).

To provide further clarification, a section has been added to the description of gross income for purposes of the 50% penalty in the Final Regulations. Treas. Reg. § 301.6707-1(a)(2) describes gross income derived from a transaction for the purpose of determining the penalty in the case of a listed transaction, and provides that only fees from a listed transaction for which the advisor is a material advisor are taken into account to compute the penalty. The Final Regulations added a new Example 4 to illustrate this point under Treas. Reg. § 301.6707-1(d).

The Final Regulations also reflect changes to the language of the 2008 Proposed Regulations that are non-substantive, and provide clarification with respect to some of the examples.

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Effect on Rev. Proc. 2007-21

Sections 4.04, 4.05, and 4.06 of Rev. Proc. 2007-21, relating to the factors for rescission of the IRC § 6707 penalty, are superseded by the provisions under Treas. Reg. § 301.6707-1(e) as of July 31, 2014. The Final Regulations now allow consideration of facts and circumstances relating to whether a material advisor's failure to timely file Form 8918, *Material Advisor Disclosure Statement*, was unintentional.

In addition, the Final Regulations provide that, if a material advisor unintentionally failed to file a Form 8918, but later files a properly completed Form 8918 with the IRS, then that filing will be a factor that weighs in favor of rescission of the IRC § 6707 penalty if the facts suggest that the material advisor did not delay filing the form until after the IRS had taken steps to identify the person as a material advisor with respect to that particular transaction. In accordance with Treas. Reg. § 301.6707-1(e), a late filing of Form 8918 will not weigh in favor of rescission if the facts and circumstances suggest that the material advisor delayed filing the Form 8918 until after the material advisor's client filed its Form 8886, *Reportable Transaction Disclosure Statement*, identifying the material advisor with respect to the particular reportable transaction.

SB/SE Issues Memo Outlining Changes to the Limitations Period for Cases Going to and Coming from IRS Appeals

On July 9, 2014, the IRS Small Business/Self-Employed division ("SB/SE") issued interim guidance (SBSE-04-0714-0024) on changes to the required number of days that must remain on the assessment statute of limitations for cases being forwarded to and being returned from the IRS Office of Appeals. The guidance is effective September 2, 2014.

To effectuate the recommendations that emerged from the Appeals Judicial Approach and Culture ("AJAC") project, Appeals recommended a change in the number of days that must be remaining on the assessment statute of limitations when a case is received in Appeals, as follows:

- When a case is initially received by Appeals, there must be at least 365 days remaining on the assessment statute of limitations (270 days for estate tax cases or section 6206 excessive claim cases).
- If Appeals returns the case to Examination for consideration of new information or new issues raised by the taxpayer, there must be at least 210 days remaining on the assessment statute of limitations when a case is received in Examination.
- If Appeals released jurisdiction of the case and returned it to Examination for additional work, there must be at least 180 days remaining on the assessment statute of limitations when a case is received in Appeals.

The new guidance will also be incorporated into the affected sections of the Internal Revenue Manual by July 9, 2015.

IRS Issues "Rules of Engagement" for International Business Compliance and Transfer Pricing Practice Employees

On September 13, 2013, the IRS issued a memorandum to International Business Compliance ("IBC") employees and Transfer Pricing Operations/Practice ("TPO" or "TPP") employees, providing general guidelines and rules of engagement for IBC and TPP ("Memo"). Even though the Memo was issued almost one year ago, the Memo was only recently made available to the public. The Memo is jointly authored by the Director of IBC and the Director of TPO ("Directors") and is currently in effect for cases having potential transfer pricing issues.

The Memo stresses that IBC and TPP must work collaboratively to identify the best answer from the perspective of the interests of the U.S. government, and emphasizes the value of inclusive and open communication by all IRS personnel. The Memo indicates that IBC and TPP share the responsibility for determining whether a case is meritorious and for making the appropriate staffing decisions. In addition, IBC and TPP have joint responsibility for the national transfer pricing inventory, and are instructed to conduct risk assessment and case reviews and collaboratively assess staffing needs. The Memo notes that, due to resource constraints, the TPP might not have any involvement in the day-to-day management of an issue. The

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Memo states that there is no single person or department that "owns" the transfer pricing issue, and emphasizes the importance of effective communication and collaboration throughout the examination process. In the event of disagreement between IBC and TPP, there should be full discussion and debate of the issues. If the matters are not resolved, the unagreed issues will be elevated to the next level of management. Disagreement as to procedural or substantive issues should be resolved internally, and not in the presence of the taxpayer.

In the Memo, the Directors outline three distinct levels of TPP involvement: extensive, moderate and limited involvement. Extensive involvement means that TPP plays a direct, continuing and significant role in the day-to-day management and execution of the examination. Moderate involvement is characterized by regular interaction between the IBC and TPP members of an examination team. Finally, limited involvement entails only occasional or periodic interaction between the IBC and TPP members of an examination team, where TPP serves in an advisory capacity and the exam team may contact the TPP for assistance on an ad hoc basis.

The Memo directs that the Directors also delineate the responsibilities and participation of IBC and TPP personnel in the following situations: Estimated Completion Date determination, issue management, Information Document Request management process, quarterly/status meetings with the taxpayer, acceptance of settlement offers, international penalties, Compliance Assurance Program cases, Advanced Pricing Agreements and Competent Authority cases, Fast Track cases, closing agreement approval, Appeals matters, and the engagement of outside experts. The Memo also provides guidance on sequencing in specific circumstances, including when the transfer pricing issue is identified at the start of an examination and when transfer pricing issues that require TPP assistance are identified during the examination.

IRS Issues Directive with Respect to Insurance Company Guaranteed Minimum Benefits Hedges on Variable Annuity Contracts

On July 17, 2014, the IRS Large Business and International division ("LB&I") issued a Directive (LB&I-04-0514-0050), which states that examiners are not to challenge the eligibility of an insurance company's guaranteed minimum benefit hedge ("Eligible Hedges") to qualify as hedging transactions under Treas. Reg. § 1.1221-2(b). In addition, the Directive provides that LB&I examiners should not challenge an insurance company's (A) mark-to-market ("MTM") values of Eligible Hedges if they conform to the MTM values reported in the company's Annual Statement[2] (defined below); and (B) should not challenge the method of accounting described in this Directive for income, deductions, gains, and losses relating to Eligible Hedges for variable annuity.

The Directive applies only to the portion of the aggregate Eligible Hedges gain or loss related to the variable annuity contracts issued before December 31, 2009. Eligible Hedge gain or loss related to the variable annuity contracts issued on or after December 31, 2009 are to be accounted for using a method consistent with the matching requirements in Treas. Reg. § 1.446-4(e)(1). Additionally, if an insurance company does not meet the requirements of this Directive, regular audit procedures will apply to guaranteed minimum benefit hedge for all of the company's variable annuity contracts.

The Directive states that it is intended to provide an efficient and uniform method of accounting for the reporting of Eligible Hedge income, deductions, gains and losses from Eligible Hedges, which would allow LB&I and taxpayers to more efficiently manage their resources.

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[2] Insurance companies are required by state law to file Annual Statements using the accounting principles set out in the National Association of Insurance Commissioners (NAIC) Accounting Practices and Procedures Manual, Statement of Statutory Accounting Principles (SSAP), or equivalent accounting standards mandated by insurance regulators. "Annual Statement" means the form that is approved by the NAIC, which is filed by an insurance company for the year with the insurance departments of States, Territories, and the District of Columbia. If the insurance company is not required to file the NAIC annual statement, "Annual Statement" means a pro forma annual statement filed with the company's federal income tax return under Treas. Reg. § 1.6012-2(c)(5) or a certified independently-audited financial statement that is required to be provided to a government agency other than the IRS.

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IRS Releases Details on its Appeals Teleconferencing Program for IRS Campus Appeals

The Internal Revenue Service ("IRS") is offering taxpayers the opportunity to have virtual face-to-face appeals conferences with IRS Campus Appeals at designated sites through the IRS's Virtual Service Delivery ("VSD") program. IRS Campus Appeals typically hears cases involving examination adjustments determined by IRS Campus Compliance units, cases involving the denial of a taxpayer's request for penalty abatement, collection due process cases and other matters. Under the new policy, the IRS is revising the Internal Revenue Manual ("IRM") to provide that taxpayers who qualify for a face-to-face meeting with IRS Campus Appeals and who reside within 100 miles of a VSD site will have the option of traveling there for a virtual meeting. Taxpayers who reside between 100 and 150 miles away from a VSD site may be informed of the program if they express a willingness to travel. Taxpayers who prefer a face-to-face conference can decline to participate in the virtual meeting. In such cases, the updated IRM provisions direct the IRS Campus employee to transfer the case to the field.

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