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Tax Controversy Services

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The Tax Court Holds that Raising the Reasonable Cause and Good Faith Defense to the Accuracy-Related Penalty May Cause a Waiver of Privilege

On April 14, 2004, Eaton Corporation ("Eaton") and the IRS entered into Advance Pricing Agreements ("APAs") covering 2001-2005. In 2011, the IRS cancelled the APAs after concluding that Eaton did not comply with the terms and conditions of the agreement, and issued a statutory notice of deficiency adjust Eaton's income for the transactions. The IRS also determined an accuracy-related penalty under section 6662 with respect to the deficiency. Eaton filed a petition in Tax Court and argued that it had complied with the requirements of the APAs. In defense of the section 6662 penalty, Eaton invoked the reasonable cause and good faith defense under section 6664. During the course of the Tax Court litigation, the IRS requested certain documents from the period leading up to the execution of the APAs, including internal emails, memos, and data compilations exchanged between Eaton and its outside tax counsel and tax practitioners. Eaton refused to turn over the documents, claiming that the documents were privileged under a combination of the attorney-client privilege, the federal tax practitioner privilege, and the work product doctrine. The IRS filed a motion to compel production, and the documents were turned over to the court for a ruling on the privilege claim.

First, the court noted that in order for the work product doctrine to apply, the documents must have been prepared "because of" anticipated litigation.[1] The court considered the nature of the APA process as well as Eaton's history of transfer pricing disputes with the IRS, and concluded that Eaton subjectively believed that litigation was a real possibility, and that that belief was objectively reasonable. As a result, the court concluded that the documents for which Eaton had claimed protection under the work product doctrine met the requirements of that doctrine.

Second, with respect to the documents for which Eaton had claimed attorney-client or federal tax practitioner privilege, the court noted that the documents memorialized Eaton's outside tax counsel and tax practitioners providing advice with respect to how to present and defend Eaton's proposed transfer pricing methodology. In addition, the record showed that those communications were intended to be confidential. As a result, the documents for which Eaton had claimed attorney-client and/or federal tax practitioner privilege met the requirements of those privileges.

Finally, the court turned to the waiver doctrine, and described how, depending on the context in which the privilege is asserted, an otherwise-privileged document might have to be disclosed. In this case, Eaton had raised reasonable cause and good faith as a defense to the accuracy-related penalty of section 6662. The reasonable cause and good faith defense, found in section 6664(c), allows taxpayers to avoid the section 6662 penalty if they can show that there was reasonable cause for the understatement and the taxpayer acted in good faith. The IRS argued that because Eaton put its state of mind at issue in the case, it was unable to claim privilege for documents that would provide evidence of that state of mind. The IRS relied heavily on *AD Investment 2000 Fund LLC v. Commissioner*,[2] a Tax Court case in which another taxpayer was deemed to have had waived privilege by invoking the reasonable cause and good faith defense.

Eaton tried to distinguish *AD Investment*, arguing that because the transaction in that case had been a tax shelter, Treas. Reg. section 1.6662-4(g)(1)(i)(B), which allows non-corporate taxpayers to have their tax shelter reporting be deemed properly reported if they had substantial authority for their position and reasonably believed that their treatment of the item was more likely than not proper, had put the taxpayer's reasonable belief at issue. As a result, Eaton argued, *AD Investment* did not apply here. Eaton also argued that it did not rely on legal or tax advice from it attorneys and tax practitioners in its reasonable cause and good faith defense.

After reviewing the documents at issue, the court determined that Eaton had relied heavily on its outside attorneys and tax practitioners. The evaluation of reasonable cause and good faith under section 6664 requires an evaluation of all facts and circumstances in order to ascertain Eaton's knowledge and understanding. Several aspects of Eaton's communications with its advisors are relevant: whether Eaton provided complete and accurate information and whether Eaton followed its advisors' advice. The court noted that the privileged communications at issue may be the only probative evidence of the state of mind of those acting on Eaton's behalf. As a result, the court ruled that Eaton, by claiming reasonable cause and good faith in

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[1] *United States v. Deloitte LLP*, 610 F.3d 129, 137 (D.C. Cir. 2010).
[2] 142 T.C. 248 (2014).

its APA negotiations, was deemed to have waived its privilege on the documents requested by the IRS.

Tax Court Rejects Taxpayers' Statute of Limitations Defense and Related Judicial and Equitable Estoppel Grounds for Summary Judgment and Concludes that the Duty of Consistency Doctrine is Not Applicable

Dr. LeCompte was the sole shareholder of a corporate medical practice (the "Corporation"). In 1990, the Corporation adopted a multiemployer plan alleged to constitute a qualified welfare benefit fund or "10-or-more employer plan" under Internal Revenue Code ("IRC") § 419A(f)(6) (the "Original Plan"). In 2003, 2004, or 2005, the Corporation terminated its participation in the Original Plan and adopted a single-employer plan (the "Successor Plan"). The IRS issued a notice of deficiency on the grounds that the Taxpayers had unreported income resulting from Dr. LeCompte's participation in the Original and Successor Plans in excess of $2 million. The IRS also assessed accuracy-related penalties under IRC § 6662A or, alternatively, under IRC § 6662.

The Taxpayers moved for summary judgment, arguing that the assessment statute of limitations had expired for the 1990 tax year, the year in which the Taxpayers would have had additional income if the Original Plan were an illegal tax shelter, as the IRS alleged. Specifically, the Taxpayers contended that, for the 1990 tax year, both the three-year limitations period under IRC § 6501(a) and the six-year limitations period under IRC § 6501(e)(1)(A) expired prior to the IRS's issuance of the notice of deficiency. The IRS argued that the statute of limitations had not expired for 2004-2007, the years for which the IRS assessed a deficiency in tax and the years now before the Tax Court.

The Tax Court agreed with the IRS that the Taxpayers' affirmative defense based on the expiration of the statute of limitations could not succeed, and denied the Taxpayers' summary judgment motion. The court also held that, to the extent the Taxpayers intended to raise an equitable doctrine, i.e. judicial or equitable estoppel, these doctrines would not apply to estop the IRS from assessing a deficiency in the 2004-2007 years because the Taxpayers could not establish that all of the required elements were met. Specifically, judicial estoppel prevents parties in subsequent judicial proceedings from asserting positions contradictory to those previously proffered to a court. In this case, the IRS had not previously persuaded a court that Dr. LeCompte realized gross income for 1990 as a result of the Corporation's contributions to the Original Plan. In addition, the Tax Court noted that the doctrine of equitable estoppel requires a false representation or wrongful misleading silence; here, the IRS had simply failed to charge the Taxpayers with additional income for 1990.

In its answer to the Taxpayers' motion, the IRS requested that the Tax Court apply the duty of consistency doctrine to prevent the Taxpayers from taking the position that the Original Plan was taxable in 1990. The Taxpayers argued that the duty of consistency doctrine was not applicable. In its opinion, the court analyzed the duty of consistency doctrine, which prevents taxpayers from taking a position in one year and a contrary position in a later year after the assessment statute has run on the earlier year. In this way, taxpayers will not be permitted to benefit from their own prior errors or omissions. The elements that the government must meet in order to invoke the doctrine of duty of consistency include: (1) the taxpayer has made a representation or reported an item for tax purposes in one year; (2) the Commissioner has acquiesced in or relied on the that fact for that year; and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessment bars adjustments for the initial year. The Tax Court determined that, in this case, the Taxpayers have consistently taken the position that the acquisition of the life insurance policy by the Original Plan and the payment of premiums did not cause the Taxpayers to recognize income. Accordingly, the court found that there was no inconsistency that the Taxpayers would be duty-bound to forgo unless and until the Taxpayers take a contrary position. Therefore, in its opinion rejecting Taxpayers' partial summary judgment request, the court rejected the IRS's argument as to the applicability of the doctrine of duty of consistency and concluded that the duty of consistency doctrine did not apply.

The IRS Explains the Scope of the Statute of Limitations Extension under IRC § 6501(c)(8)

Under the general rule set forth in IRC § 6501(a), the IRS has three years from the date on which a taxpayer files a return to make an assessment. However, IRC § 6501(c)(8) provides that, with respect to any information required to be reported under certain specified foreign information reporting provisions, the three-year assessment statute of limitations does not begin to run until such information is submitted to the IRS.[3] The extended assessment statute applies to "any tax return, event, or period to which such information relates."[4]

On March 17, 2015, the IRS Office of Chief Counsel released a memorandum, dated October 3, 2014, containing guidance on the application of IRC § 6501(c)(8).[5] The memo dealt with a taxpayer who owned foreign financial assets required to be reported under IRC § 6038D. The taxpayer had died, and an executor had filed a Form 1040, *US Individual Income Tax Return*, on behalf of the taxpayer, and two forms on behalf of his estate: Form 1041, *US Income Tax Return for Estates and Trusts*, and Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* (collectively, the "estate returns"). The executor failed to file the required Form 8938, *Statement of Specified Foreign Financial Assets*, with the Form 1040 to report the foreign financial assets, and also failed to report those assets on the Forms 1041 and 706.

The question presented in the memo was whether IRC § 6501(c)(8) would extend the assessment statute of limitations with respect to the estate returns. The IRS noted that the language in IRC § 6501(c)(8), which extends the statute of limitations for assessment "of any tax imposed by this title with respect to any tax return, event, or period to which such information relates," is very broad. The "information" at issue here was the foreign financial

[3] The information reporting requirements covered are in IRC §§ 1295(b), 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A, and 6048.
[4] IRC § 6501(c)(8)(A). However, please note that, if reasonable cause exists for the failure to furnish the required information, then the scope of the statute extension is narrowed.
[5] Office of Chief Counsel Memorandum POSTN-120589-14 (dated October 3, 2014).

asset information, which was not provided on either of the estate returns. Because both estate returns should have included this information, the IRS concluded that both were "tax return[s]…to which such information relates," and were, therefore, returns for which IRC § 6501(c)(8) provided an extended assessment statute of limitations.

Previously, in 2012, the IRS had released guidance on IRC § 6501(c)(8), in which it focused on a different part of the statute.[6] This memo addressed an S Corporation that failed to file Forms 5471, *Information Returns of US Person with Respect to Certain Foreign Corporations*, to report activities of its controlled foreign corporations ("CFCs"). The S Corporation had two categories of shareholders: majority shareholders, who had the requisite ownership interest in the S Corporation to have their own Form 5471 filing requirements with respect to the CFCs; and minority shareholders, who did not.

The question presented in the memo was whether the failure to file Forms 5471 would extend the assessment statutes of limitations with respect to the individual returns of the S Corporation's shareholders, in addition to the assessment statute of limitations applicable to the S Corporation. The conclusion was mixed: the IRS found that the failure to file did extend the statutes of limitations for the S Corporation and the majority shareholders, but it did not extend the period of assessment for the minority shareholders. In reaching its determination, the IRS noted that "return" is defined in IRC § 6501(a) as "the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit)." The IRS determined that the S Corporation and majority shareholders' failure to file Forms 5471 extended the assessment statute of limitations under IRC § 6501(c)(8); however, because they had no Form 5471 filing requirement, the minority shareholders were not subject to an extended assessment statute.

Both memos analyzed IRC § 6501(c)(8) in different ways, and the more recent memo indicates that the IRS may be interpreting the statute more broadly than it has in the past. As a result, taxpayers and practitioners should be aware that the failure to furnish information required to be reported under certain foreign information reporting provisions could result in an extended assessment statute of limitations for more than just a single return.

IRS Releases FY 2014 Statistics on Enforcement and Business Examinations, IRS Examination Staffing, and the IRS Budget, and the Commissioner Discusses the Impact of the FY 2015 Budget Cuts on the IRS and Taxpayers and Advocates for Increased Funding in the FY 2016 Budget

In March 2015, the Commissioner John A. Koskinen released a brief statement containing statistics on IRS enforcement and business examinations as well as staffing and budget ("Report").[7] A few key areas of the Report are discussed below.

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[6] Office of Chief Counsel Memorandum POSTF-124243-11, Number 201206014 (released February 10, 2012).
[7] *Commissioner's Statement and IRS Statistics on Enforcement and Business Examinations*, published by Tax Analysts, Doc 2015-5148, 2015 TNT 41-21 (March 2015).

The IRS examined 57,211 business tax returns in FY 2014, including large corporate returns, small corporate returns, Subchapter S returns, and partnership returns. The number of business returns examined in FY 2014 decreased by 6.2%, as compared to FY 2013, while the number of business returns filed increased 1% over the same period. Audits of large corporations with assets of more than $10 million are at the lowest rate in a decade. In FY 2014, there was a 20.4% decrease in the total number of large corporate returns examined, as compared to FY 2013.[8] Whereas the number of partnership audits increased by 6.1% in FY 2014, Subchapter S audits decreased by 12.6% in FY 2014, and the number of small corporate returns examined decreased by approximately 2%.[9]

In his introductory message to the Report, the Commissioner stated that the documented declines in IRS examination activity coincide with a decrease in the IRS budget and enforcement staffing. Overall, the IRS has lost 30,000 full-time employees since 1992, and staffing is at the lowest level since the early 1980s; likewise, the number of compliance employees who conduct audits has steadily declined during the past five years, from 13,888 in FY 2010 to 11,629 in FY 2014.[10] In addition, the IRS budget for FY 2015 represents a decrease of $1.2 billion, as compared to FY 2010. The IRS funding level for FY 2015 is lower than it has been since FY 2007. According to the Commissioner, the budget reduction from FY 2014 to FY 2015 approaches $600 million, after accounting for nearly $250 million in mandatory costs and inflation.[11]

Recently, the Commissioner has been vocal about the impact of the FY 2015 budget cuts on the IRS and taxpayers. In January 2015, the Commissioner issued a message to alert the agency and taxpayers to the implications of the FY 2015 budget cuts on the IRS.[12] Recognizing that the IRS has "no choice but to do less with less," the Commissioner announced the following anticipated impacts: delays to critical information technology investments of more than $200 million; enforcement cuts of more than $160 million; cuts in overtime and temporary staff hours of more than $180 million; and extension of the IRS hiring freeze through FY 2015, which ends September 30, 2015. As a result of the budget cuts and corresponding hiring freeze, the IRS expects to lose approximately 1,800 enforcement personnel through attrition during FY 2015, and, in total, between 3,000 and 4,000 full-time employees throughout the agency. The IRS estimates the total reduction in full-time staffing between FY 2010 and FY 2015 to be between 16,000 and 17,000 employees.

In a February 2, 2015 statement on the Fiscal Year 2016 Budget, the Commissioner stated that the "Administration's 2016 budget request provides an important path forward to restoring taxpayer services, improving tax enforcement and providing critical needs for the nation's tax

[8] *Id.*
[9] *Id.*
[10] *Id.*; *Prepared Remarks of Commissioner John A. Koskinen Before the Urban-Brookings Tax Policy Center*, published by Tax Analysts, Doc 2015-8476, 2015 TNT 69-8 (April 8, 2015).
[11] *Commissioner's Statement and IRS Statistics on Enforcement and Business Examinations*, published by Tax Analysts, Doc 2015-5148, 2015 TNT 41-21 (March 2015).
[12] *IRS Commissioner's Corner: A message from IRS Commissioner John A. Koskinen*, published by Tax Analysts, Doc 2015-890, 2015 TNT9-18 (Jan. 14, 2015).

system."[13] The Commissioner further indicated that, for every one dollar invested in enforcement efforts, there can be returns ranging from 6-to-1 and up to 20-1 in some initiatives. The Commissioner provided similar testimony to the Senate Appropriations Committee's Subcommittee on Financial Services and General Government on March 3, 2015.[14] The Commissioner tacitly expressed support for the Administration's FY 2016 budget, which would provide $12.93 billion for the IRS, translating to an increase of $1.3 billion over FY 2015. The Commissioner identified strategic investments that the IRS would make if it were to receive this additional funding in FY 2016, including, but not limited to: increased hiring to improve taxpayer service; new technologies to improve the online filing experience and create new digital capabilities; expanded identity theft-related programs; infrastructure to ensure compliance with the provisions of the Affordable Care Act ("ACA"); technology to improve the implementation of the Foreign Account Tax Compliance Act ("FATCA"); and information technology infrastructure.[15]

Absent a significant increase in the IRS's FY 2016 budget, the Commissioner expressed concerns about the functioning of the agency and the operations of the entire tax system; according to the Commissioner, "the serious ramifications of five years of budget cuts are becoming increasingly visible, and will worsen if action isn't taken soon."[16] In remarks delivered to the Tax Policy Center on April 8, 2015, the Commissioner specifically addressed the question of how the IRS budget cuts affect taxpayers and the tax system. The IRS has estimated that the drop in audit and collection case closures in FY 2015 will translate into a loss for the government of no less than $2 billion in revenue that otherwise would have been collected. In addition to enforcement, taxpayer service has declined as a consequence of insufficient staffing and outdated technology. Meanwhile, just as it has reduced funding for the IRS, Congress has added to the IRS's responsibilities by requiring the agency to implement solutions for ACA and FATCA compliance, and new programs in connection with the Achieving a Better Life Experience Act and the certification requirement for professional employer organizations. The Commissioner urged Congress to adequately fund the IRS to provide the agency with the necessary tools for it to fulfill its mission and build for the future. As the Commissioner explained, the "risk to our tax system posed by underfunding goes deeper than uncollected dollars, unanswered phones or unpublished guidance," recognizing that voluntary compliance, a cornerstone of the tax system, will suffer if taxpayers think they will not get caught if they "cheat" due to diminished enforcement activity, and if taxpayers are unable to get the assistance that they need from the IRS to file their tax returns accurately due to inadequate taxpayer service.[17]

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[13] *Statement of IRS Commissioner John Koskinen*, published by Tax Analysts, Doc 2015-2536, 2015 TNT 22-28 (Feb. 2, 2015).
[14] *Written Testimony of John A. Koskinen, Commissioner, Internal Revenue Service, Before the Senate Appropriations Committee, Subcommittee on Financial Services and General Government on the IRS Budget*, published by Tax Analysts, Doc 2015-5267, 2015 TNT 42-46 (March 3, 2015).
[15] *Id*.
[16] *Prepared Remarks of Commissioner John A. Koskinen Before the Urban-Brookings Tax Policy Center*, published by Tax Analysts, Doc 2015-8476, 2015 TNT 69-8 (April 8, 2015).
[17] *Id*.

New IRS Audit Technique Guide: Real Estate Property Foreclosure and Cancellation of Debt

The IRS maintains Audit Technique Guides ("ATGs") on a variety of issues to assist IRS examiners during audits by providing guidance on specific issues and accounting methods unique to specific industries. ATGs are intended to provide industry-specific examination techniques and include common, as well as unique, industry issues, business practices, and terminology. Guidance is also provided on the examination of income, interview techniques, and evaluation of evidence. ATGs can also be useful to practitioners and taxpayers as primers on particular topics, roadmaps of how examinations might be conducted, and tools for identifying and defending problem areas.

Recently, the IRS issued the "Real Estate Property Foreclosure and Cancellation of Debt Audit Technique Guide" ("Guide"). In addition to foreclosures, the Guide addresses short sales, deeds in lieu of foreclosure, and abandonments. The Guide also discusses different types of debt and the possible implications of a reduction of such debt. Additionally, the Guide covers exclusions from cancellation of debt income, when lenders must report cancellation of debt income on Form 1099-C, *Cancellation of Debt*, and when Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, is required to make an exclusion election.

As to cancellation of debt issues, the Guide advises that the determination of whether debt has been forgiven requires consideration of the surrounding facts and circumstances. For example, IRS examiners are advised that the issuance of Form 1099-C to report cancellation of indebtedness income is not determinative as to whether a taxpayer should recognize cancellation of debt income.

Examiners are also alerted to certain tactics that taxpayers may use when a foreclosure is imminent. For example, the Guide instructs examiners that taxpayers sometimes attempt to convert their homes to rental properties prior to foreclosure in order to deduct expenses and passive losses that would otherwise be disallowed. The Guide lists several avenues of inquiry for examiners when they encounter these situations, including: an evaluation of the extent to which taxpayers advertise their properties, the taxpayers' willingness to accept low rents, the reason(s) why taxpayers converted the properties to rental properties, and whether the conversions were temporary or permanent.

Because the Guide is intended to assist IRS examiners with their duties, it includes sample issues for inclusion in Information Document Requests, sample interview questions, and suggestions as to which items of support should be obtained for exam files. As a result, taxpayers can use the Guide to prepare for IRS examinations dealing with the above-described areas.

Have a question?
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