



In this issue:

A District Court Holds IRS’s Assessment of a Reportable Transaction Penalty was Untimely under Section 6501(c)(10) as IRS Had Been Furnished the Required Information More Than One Year before Assessment	1
Recent Cases Discussing Privilege: The Tax Court Finds No Attorney-Client Privilege for Emails Listed in Privilege Log, While a District Court Concludes that Both the Attorney-Client Privilege and the Work Product Doctrine Protect Two Memoranda	3
IRS Releases Guidance on FBAR Penalties Containing Procedures for the Determination, Calculation, and Assessment of FBAR Penalties	5
Tax Court Concludes that Taxpayer Did Not Satisfy the Requirements for Automatic Consent but Nonetheless Changed its Method of Accounting and Could Not Revert to the Previous Method of Accounting by Filing Amended Returns	7

A District Court Holds IRS’s Assessment of a Reportable Transaction Penalty was Untimely under Section 6501(c)(10) as IRS Had Been Furnished the Required Information More Than One Year before Assessment

The IRS generally has three years from when a taxpayer files its tax return to assess taxes under section 6501(a). However, several exceptions to the general rule can extend that period. One of those exceptions is found in section 6501(c)(10), which provides that if a taxpayer fails to disclose a listed transaction as required under section 6011, then the assessment statute with respect to the listed transaction is extended until one year after the date on which the taxpayer furnishes the information required under section 6011. On March 31, 2015, section 6501(c)(10) final regulations were issued that set forth the requirements for a taxpayer that did not properly disclose a listed transaction to make a disclosure for purposes of section 6501(c)(10).

On June 23, 2015, a District Court disagreed with the IRS’s interpretation of section 6501(c)(10) and found that the IRS’s assessment of a reportable transaction penalty was untimely as the IRS was furnished all required information about the listed transaction more

than one year before the assessment.¹ The District Court, however, did not specifically address the final section 6501(c)(10) regulations in reaching its conclusion.

Under section 6501(c)(10), if a taxpayer fails to properly disclose a listed transaction on its tax return, the assessment statute of limitations remains open with respect to that transaction until one year after the information is disclosed. The statute provides that the information is considered disclosed on the earlier of:

1. The date on which the Secretary is furnished the information so required, or
2. The date that a material advisor meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to [a listed] transaction with respect to such taxpayer.²

The recently published final regulations prescribe how taxpayers and material advisors should disclose listed transactions that were not properly disclosed under section 6011 in order to start the one-year period under section 6501(c)(10). Under the regulations, taxpayers must:

- Complete the most recent version of Form 8886, *Reportable Transaction Disclosure Statement*,
- Indicate that the Form 8886 is being filed for purposes of section 6501(c)(10) and list the tax return(s) and year(s) for which the taxpayer is making the disclosure,
- Include a cover letter, containing a signed statement that the disclosure is made under penalties of perjury, and
- If the disclosure was prepared by a paid preparer, include a statement signed by the preparer that the disclosure is made under penalties of perjury.³

The final regulations make clear that failing to meet any one of these requirements means that the assessment statute of limitations remains open under section 6501(c)(10).⁴

A District Court recently considered the extended assessment statute of limitations under section 6501(c)(10), and came to a different conclusion regarding the requirements for furnishing the information.⁵ In that case, the taxpayer failed to disclose participation in a listed transaction on his 2004 tax return. On March 10, 2010, the IRS sent the taxpayer a notice that he would be assessed a penalty under section 6707A for failing to disclose the listed transaction. However, the IRS waited until February 6, 2012, to assess the penalty. At no point did the taxpayer file a Form 8886 to disclose the transaction.

The taxpayer paid the penalty and sued for a refund. The taxpayer argued that the extended assessment statute of limitations under section 6501(c)(10) had started to run in March 2010 when the IRS had all the information it needed to make the assessment and, therefore, by the

¹ *May v. United States*, 2015 US Dist. LEXIS 76962, No. 2:14-cv-00910-NVW (D. Ariz., June 23, 2015).

² IRC § 6501(c)(10).

³ Treas. Reg. §301.6501(c)-1(g)(5).

⁴ See Example 7, Treas. Reg. §301.6501(c)-1(g)(8).

⁵ *May*, 2015 US Dist. LEXIS 76962.

time the assessment was made in February 2012, the assessment statute had expired. The United States argued that in order to start the assessment statute of limitations under section 6501(c)(10)(A), the information must be provided on a Form 8886. Because the taxpayer never submitted a Form 8886, the United States argued, the assessment statute of limitations under section 6501(c)(10) had not begun to run.

The District Court, however, interpreted the statute differently. It focused its analysis on the language used by Congress to describe what was required to be provided: *information*. The court looked at the other related statutes – sections 6011 and 6707A – and noted a distinction between *forms* and information. The court held that because the IRS had received the information it needed, regardless of whether it had been submitted on the correct form, the requirements of section 6501(c)(10)(A), which provides only that “the Secretary is furnished the information so required,” had been met. In its analysis, the court determined that no consideration of the IRS regulations or guidance was necessary: “When Congress has directly addressed the precise question at issue, as it has here, courts do not consider whether an agency’s regulation is a permissible interpretation of the statut[e].”⁶ As a result, the court concluded that section 6501(c)(10) extended assessment statute of limitations began to run in March 2010, and expired before the IRS assessed the penalty in February 2012.

The final regulations under section 6501(c)(10) were not in effect for the year at issue in *May*, however, under the District Court’s reasoning, the language of the statute is unambiguous in its meaning, and therefore courts would not have to look at the regulations in order to determine whether or not the terms of the statute had been met. If other courts adopt the same interpretation of section 6501(c)(10)(A), the IRS may find itself unable to enforce the requirements set forth in the final regulations, and taxpayers may be able to satisfy the terms of the statute by means other than those provided in the regulations.

Recent Cases Discussing Privilege: The Tax Court Finds No Attorney-Client Privilege for Emails Listed in Privilege Log, While a District Court Concludes that Both the Attorney-Client Privilege and the Work Product Doctrine Protect Two Memoranda

In *Pac. Mgmt. Group v. Comm’r*,⁷ the Tax Court considered whether the petitioners had met their burden to establish that the attorney-client privilege applied to documents withheld by an attorney in response to a subpoena from the IRS. In this case, the IRS sought several documents from the attorney who had provided legal, corporate, and business advice to the petitioners. The attorney declined to produce approximately 2,000 emails, citing the attorney-client privilege, and supplied a privilege log that identified the sender of each email, the recipients, and the date and time that each email was sent.

⁶ *May*, quoting *Mayo Found. for Med. Educ. v. United States*, 562 US 44, 51-52 (2011) (alteration in original) (internal quotation marks omitted).

⁷ T.C. Memo 2015-97.

The burden of establishing that the attorney-client privilege applies to particular documents rests with the party asserting the privilege. While an attorney preparing a privilege log must balance the need to show that specific communications are privileged against the risk of inadvertently waiving the privilege by disclosing too much information, a privilege log must, at a minimum, identify the authors, dates of preparation, and subject matter of the documents. Additionally, a blanket assertion of the attorney-client privilege will not suffice, and a privilege log must set forth the facts that establish, as to each document, each element of the privilege.

In *Pac. Mgmt. Group*, the Tax Court determined that the submitted privilege log was inadequate because it did not provide the subject of each email; a description of the contents of each email; whether there were attachments to the email and the contents of any attachments; or the purpose for which the email or attached document was created. Based on the lack of information provided in the privilege log, the Tax Court found that it was impossible to determine whether any of the communications to and from the attorney contained legal advice, as opposed to general business advice. Consequently, the Tax Court concluded that the petitioners failed to establish that the attorney-client privilege properly applied to the documents listed in the privilege log, and granted the IRS's motion to compel production of the emails.

In *United States v. Sanmina Corp.*,⁸ the US District Court for the Northern District of California denied enforcement of an IRS summons seeking two memoranda in connection with the IRS's examination of a worthless stock deduction by Sanmina, finding that the memoranda at issue were privileged. In an effort to substantiate its worthless stock deduction, Sanmina had submitted a valuation report ("Report") prepared by outside counsel to the IRS. A footnote to the Report referenced two memoranda that had been relied upon. One memorandum discussed the legal analysis supporting the execution of certain agreements, including the reason for the agreements, their legal enforceability, and their tax treatment. The other analyzed the tax effect of the liquidation of Sanmina's subsidiary. The IRS issued a summons to Sanmina to produce the memoranda and, when Sanmina refused, the United States petitioned the district court to enforce the summons.

Sanmina objected to the production of the memoranda, asserting they were protected under the attorney-client privilege and the work product doctrine. The United States argued that the attorney-client privilege did not apply because Sanmina had neither established that the memoranda were prepared for legal, as opposed to business, purposes, nor that the communication related to legal advice, as opposed to merely the preparation of tax returns or number crunching, noting that the attorneys who drafted the memoranda were not in Sanmina's general counsel department and the memoranda were shared with two tax employees. In addition, the United States took the position that the tax practitioner privilege did not apply because Sanmina could not demonstrate that it was soliciting protected tax advice when it transmitted the memoranda to its tax return preparer, independent auditor, and valuation service provider. The United States further argued that, even if a privilege applied, Sanmina had waived it when it produced the Report to the IRS and when it transmitted the memoranda to its outside counsel, who was engaged to perform non-legal valuation services.

⁸ 2015 US Dist. LEXIS 66123, No. 5:15-cv-00092-PSG (N.D. Cal., May 20, 2015).

With respect to the work product doctrine, the United States asserted that it did not apply because Sanmina could not definitively establish that the memoranda had been created in anticipation of litigation when no audit or lawsuit was pending at the time they were drafted. Additionally, the United States argued that Sanmina had waived the work product doctrine when it turned the Report over to the IRS, a potential adversary.

The District Court declined to conduct an *in camera* review of the memoranda, and held that Sanmina had demonstrated that the attorney-client privilege applied because it had shown that the memos constituted tax advice from lawyers to Sanmina, and that Sanmina had not waived the privilege by providing the memoranda to its outside counsel. In addition, the District Court determined that the work product doctrine was applicable because the memoranda included an analysis of complex business and legal issues, and Sanmina could have reasonably anticipated that the IRS would scrutinize the tax treatment of the worthless stock deduction due to its size. Additionally, the District Court found that there was no waiver of Sanmina's work product claims when Sanmina produced the Report to the IRS because the Report merely referenced the memoranda in a footnote, and such disclosure was consistent with maintaining secrecy against an adversary.

IRS Releases Guidance on FBAR Penalties Containing Procedures for the Determination, Calculation, and Assessment of FBAR Penalties

The IRS recently issued guidance to its examiners for determining, calculating, and assessing Foreign Bank and Financial Accounts (FBAR) penalties, along with a civil FBAR penalty case file checklist.⁹ The IRS explained that the FBAR penalty procedures were developed to ensure consistency and effectiveness in the administration of FBAR penalties, ensure that FBAR penalty determinations are adequately supported, and penalties are asserted in a fair and consistent manner. The guidance was released one month after a District Court found that the IRS lacked an administrative record that established an adequate basis for the assessment of FBAR penalties.¹⁰

The memorandum contains a discussion on determining the penalties for willful and non-willful FBAR violations. For willful violations, the guidance explains that examiners should consider the facts and circumstances of the case in determining the amount of the penalty. However, the guidance does not address how willfulness is determined or what evidence is required to make that finding. As a result, it appears the willfulness guidelines in IRM sections 4.26.16.4.5.3 and 4.26.16.4.5.4 have not been modified. The guidance emphasizes that for each year for which it is determined that there was a willful FBAR violation, examiners must fully develop and adequately document in the examination work papers their analysis regarding willfulness.

⁹ SBSE-04-0515-0025. The guidance is effective from May 13, 2015 through May 13, 2016, and applies to all open cases where the FBAR penalty is considered.

¹⁰ *Moore v. United States*, 2015 US Dist. LEXIS 43979, No. C13-2063RAJ (W.D. Wash., Apr. 1, 2015).

For non-willful violations, the guidance advises the examiners to first determine if the mitigation threshold conditions contained in the IRM apply so as to automatically reduce the amount of the penalty based on the aggregate balance of the accounts. There are no other guidelines for reducing the amount of the \$10,000 penalty. However, the guidance notes that when handling non-willful FBAR violations for multiple years, an examiner has the discretion to impose a penalty for a single year or impose a penalty for each year at issue. If there are multiple accounts involved, an examiner has the option of imposing one penalty per year, regardless of the number of accounts involved, or of imposing a separate penalty for each account.

The IRS guidance was released one month after a decision in a District Court case in which a taxpayer, James Moore, filed a suit after being assessed \$40,000 in FBAR penalties for the years 2005-2008.¹¹ In that case, Moore objected to both the total amount of the penalty, which he claimed violated the Eighth Amendment's Excessive Fines Clause, and the IRS's decision to impose the maximum amount of the penalty for each year, a decision he claimed was arbitrary and capricious and in violation of the Administrative Procedure Act.

The court concluded that Moore committed nonwillful FBAR violations; however, the court determine reasonable cause did not exist for failing to file FBARs because Moore had no objective basis for his belief that he did not have to report his bank account and he continued to ignore notice of his duty to report it.

Next, the court looked at the administrative record the IRS had provided and found that it was insufficient to establish whether the IRS had acted arbitrarily or capriciously¹² in determining the amount of the penalties it assessed. The court explained that the record contained no administrative explanation of the IRS's decision to impose the penalties because the only document before the court did not illuminate what the IRS considered or why it determined that the maximum \$10,000 penalty would apply for each year. The court gave the IRS an opportunity to supplement the record to include contemporaneous evidence for the penalty determination or any other evidence from which the court could conclude that the IRS did not act arbitrarily or capriciously. Finally, the court ruled that the assessment of the penalties did not violate the Eighth Amendment because the penalties were about 10% of the value of the bank accounts that had not been reported, and were therefore not grossly disproportional to the gravity of the offense.

It remains to be seen whether the District Court will find that the IRS acted arbitrarily and capriciously once it has reviewed the supplemented administrative record, and whether the new guidance will have an effect on the way in which the IRS handles the determination, calculation, and assessment of FBAR penalties.

¹¹ *Moore*, 2015 US Dist. LEXIS 43979.

¹² The court determined that the IRS's actions were not subject to stricter de novo review because there was no evidence of inadequate fact-finding procedures.

Tax Court Concludes that Taxpayer Did Not Satisfy the Requirements for Automatic Consent but Nonetheless Changed its Method of Accounting and Could Not Revert to the Previous Method of Accounting by Filing Amended Returns

Recently, in *Hawse v. Comm'r*,¹³ the Tax Court considered the requirements for automatic consent to change accounting methods under the then-applicable revenue procedure, Rev. Proc. 99-49, and analyzed what constitutes a change in accounting method. In 1985, JHH Motor Cars, Inc. (“JHH”) elected to use the last-in, first-out (“LIFO”) method of accounting for its vehicles inventory. In 2001, JHH attempted to follow the automatic consent procedure in Rev. Proc. 97-37¹⁴ by filing an application for automatic consent to revoke its LIFO election in favor of the specific identification method. In order to accomplish this, JHH attached Form 3115, *Application for Change in Accounting Method*, to a timely filed Form 1120S, *US Income Tax Return for an S Corporation*. The Form 3115 stated that, beginning with the 2001 year, JHH would use the specific identification method and value inventory at the lower of cost or market. The Form 3115 also provided that JHH would make the necessary section 481(a) adjustment by recapturing its LIFO reserve over four years.

Consistent with its affirmations on the Form 3115, JHH used the specific identification method of accounting for its inventory on its 2001 through 2007 tax returns, and reported the recapture of its LIFO reserve on its 2001 through 2004 tax returns. However, contrary to its representations on the Form 3115 that it would value its inventory at the lower of cost or market, JHH in fact used different valuation approaches for its various inventories. In 2009, JHH filed amended returns for 2002 and 2003,¹⁵ which reversed the section 481(a) adjustment and claimed deductions for additional LIFO reserve amounts.¹⁶

JHH argued that it never received automatic consent for the revocation of its LIFO election because it did not follow through on the representations that it made on Form 3115, that its application was fatally defective, and, consequently, that it had retained its historic LIFO method. The IRS argued that JHH substantially complied with the automatic consent procedure requirements such that JHH obtained automatic consent to revoke its LIFO election and to change to the specific identification method.

¹³ T.C. Memo 2015-99.

¹⁴ Whereas the parties were under the impression that Rev. Proc. 97-37 was applicable to JHH’s 2001 Form 3115 filing, the Tax Court noted that this revenue procedure was superseded by Rev. Proc. 98-60, which was superseded by Rev. Proc. 99-49. The Tax Court concluded that when JHH sought to change its method of accounting for the tax year ended December 31, 2001, Rev. Proc. 99-49 provided the applicable procedure; accordingly, the Tax Court analyzed the procedures under Rev. Proc. 99-49 in its opinion.

¹⁵ JHH filed amended returns for the years 2002 through 2007, however, because 2002 and 2003 were the only years for which the IRS had proposed a deficiency, they were the only years for which the Tax Court had jurisdiction. JHH did not file an amended return for 2001 because the refund statute of limitations for that year had expired.

¹⁶ Because JHH could not file an amended return for 2001, it included the 481(a) adjustment for 2001 on its 2002 amended return.

The Tax Court analyzed the requirements for automatic consent and the actions taken by JHH. In this case, JHH filed a copy of the Form 3115 with the IRS National Office and stated that the Form 3115 was filed pursuant to automatic consent procedures under the revenue procedure. Additionally, the court noted that JHH did not cite the applicable revenue procedure's appendix on the Form 3115, and it failed to attach a separate statement describing how its new methods of identifying and valuing its inventory conformed to the requirements of the revenue procedure. The Tax Court found that JHH satisfied the eligibility requirements for automatic consent. However, the court also stated that strict compliance with the revenue procedure's applicable provisions is required for an automatic method change and found that, because JHH did not comply with all of the terms and conditions of the revenue procedure, its application for automatic consent failed.

Notwithstanding its failure to secure automatic consent, the Tax Court concluded that JHH had changed its method of accounting because it deviated from its previously established LIFO method on seven consecutively filed tax returns, from 2001 through 2007, before seeking to amend its returns, and it consistently used the specific identification method for its vehicles inventory for a seven-year period. The court further determined that the IRS had accepted the method change because the IRS acknowledged it in the notice of deficiency it issued for 2002 and 2003.

Analyzing the definition of "change in accounting method," the Tax Court found that JHH's attempt to revert to the LIFO method by filing amended returns constituted a second attempted change in accounting method, for which the Commissioner's consent was required. Therefore, it was permissible for the Commissioner to refuse consent and reject JHH's amended returns.

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