Deloitte.

Tax Controversy Services

IRS Insights

A closer look.

January 2016

In this issue:

Changes Made to Partnership Audits and Adjustments 1
Second Circuit Reverses District Court and Holds that Attorney-Client Privilege Was Not Waived By the Sharing of Documents with Parties Having a Common Legal Interest 3
The IRS Continues to Release International Practice Units... 4
IRS Launches Early Interaction Initiative to Help Employers Meet Their Payroll Tax Obligations 5

Changes Made to Partnership Audits and Adjustments

On November 2, 2015, the Bipartisan Budget Act of 2015 (the "Budget Act") was enacted, which includes, among other items, significant rule changes for partnership audits and adjustments. The Budget Act completely replaces the current Tax Equity and Fiscal Responsibility Act ("TEFRA") procedural rules for partnership audits and adjustments. These provisions are effective for returns filed for partnership taxable years beginning after December 31, 2017, however a partnership may elect to apply the new rules to any partnership return filed for partnership taxable years beginning after the date of enactment and before January 1, 2018. According to the Congressional Budget Office, the partnership audit and adjustment provisions will increase federal receipts by approximately $9 billion over 10 years as a result of improved tax compliance and the use of a streamlined process for auditing complex partnerships.

TEFRA established unified audit rules for partnerships with more than 10 partners, and required that the tax treatment of all partnership items be determined at the entity level for these partnerships. Partnerships with more than 100 partners (an electing large partnership or ELP) were allowed to elect into a simplified reporting regime, which included streamlined audit and adjustment procedures.

The Budget Act repeals the current TEFRA and ELP rules, including the simplified reporting aspects, and replaces them with one set of partnership-level audit rules that will apply to all partnerships, subject to an election out by certain partnerships with 100 or fewer partners. Under these streamlined audit rules, the IRS will examine items of income, gain, loss, deduction, or credit for a particular year (the "reviewed year"), and any adjustments will be

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

taken into account by the partnership at the partnership level in the year the audit or judicial review is completed (the “adjustment year”). This is a significant change from the current TEFRA provisions as it shifts the cost of any adjustment to the partners in the adjustment year rather than flowing the adjustments through to the partners who benefitted in the reviewed years.

Under the Budget Act, the partnership will pay the tax, interest, and penalties on underpayments. The tax due is calculated by multiplying the net of the adjustments as the highest statutory corporate or individual rate in place. Any adjustments not causing underpayments will then flow through to the partners in the year of the adjustment. The amount of the underpayment at the partnership level could be reduced by (i) the tax reported on the underpayment by partners filing amended returns, (ii) the tax attributable to tax-exempt partners, and (iii) the tax rate differential due to a lower corporate tax rate or lower capital gain/dividend rate.

Alternatively, partnerships may elect to issue adjusted information returns to the reviewed-year partners, who would then take the adjustments into account on their individual returns in the adjustment year through a simplified amended return process. Those partners would calculate the additional tax owed for the reviewed year and then pay the tax (and interest and penalties) from that prior year with the tax return for the year when they receive the statement of adjustments. The partnership isn’t required to ensure that each of its reviewed-year partners actually take the adjustments into account and pay any tax due. Once this election is made, it may only be revoked with the consent of the Secretary.

The statute of limitations for assessments is determined based upon when the partnership’s return was filed and considers extensions between the IRS and the partnership, rather than taking into account partners’ individual assessment statutes of limitations. The statute of limitations for filing partnership refund claims is based solely on when the partnership return was filed, and cannot be extended by agreement.

Small partnerships with 100 or fewer qualifying partners are allowed to elect out of the new rules, and those partnerships and partners are subject to the general rules that apply to auditing individual taxpayers. To qualify to elect out, the partners must all be individuals, C corporations, foreign entities that would be treated as C corporations if domestic, S corporations, estates of deceased partners, or others if the Secretary prescribes in guidance. Thus, partnerships with partners that are partnerships or trusts are unable to elect out absent further guidance. The provision also contains several consent and election rules with special rules for certain partners, such as S corporations. The election to opt out is made for a particular year with a timely filed return for that taxable year.

Audits will be handled by a designated partnership representative, who can be a partner or non-partner with a substantial presence in the US. The partnership representative is granted broad authority to resolve any partnership audit and any such resolution would be binding on all partners.

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

Second Circuit Reverses District Court and Holds that Attorney-Client Privilege Was Not Waived By the Sharing of Documents with Parties Having a Common Legal Interest

In *Schaeffler, et al. v. United States*, 806 F.3d 34 (2d Cir. 2015), Plaintiffs Georg Schaeffler and his associated entities (the "Schaeffler Group") took out a loan from a consortium of banks (the "Consortium") to finance the purchase of stock days before the market collapsed in 2008. It seemed unlikely that it would be able to pay back the loan, so the Schaeffler Group decided to refinance the loan and restructure the entities. The Schaeffler Group hired Ernst & Young ("E&Y") to advise on the tax implications of the transactions and possible future litigation because it anticipated that the IRS would scrutinize the refinancing and restructuring.

The IRS began an audit of the Schaeffler Group and issued a summons requesting all documents created by E&Y and shared with third parties. The Schaeffler Group produced some documents and filed a petition to quash with respect to the legal opinions. The District Court for the Southern District of New York denied the petition to quash and held that the Schaeffler Group had waived the attorney client privilege because the legal opinions had been shared with the Consortium, and the work product doctrine did not apply because the legal opinions did not specifically refer to litigation strategies and therefore were not prepared in anticipation of litigation but merely in the ordinary course of business.

The Schaeffler Group appealed, and the Second Circuit reversed the decision of the District Court, finding that the attorney client privilege was not waived and the legal opinions prepared by E&Y were protected by the work product doctrine.

With respect to the attorney-client privilege, the Second Circuit acknowledged that the common interest rule protects the confidentiality of communications passing from one party to the attorney for another party where a joint defense or strategy has been undertaken by the parties, and therefore the attorney-client privilege is not waived by the disclosure of communications to a party that is engaged in a common legal enterprise with the holder of the privilege. Additionally, the court noted that parties have a common legal interest even if they are not parties in ongoing litigation. As a result, the Second Circuit held that the Schaeffler Group and the Consortium had a common interest in the outcome of the Schaeffler Group's legal encounter with the IRS because if the Schaeffler Group became insolvent, it would not be able to pay back the Consortium, but such a scenario could be avoided if the Schaeffler Group and the Consortium cooperated in securing a particular tax treatment for the refinancing and restructuring. The court explained that while there was both a financial component and a legal component to the relationship between the Schaeffler Group and the Consortium, the Consortium's interest was dependent on the resolution of the legal tax issues, and therefore the two parties had a common legal interest in the outcome of the IRS encounter.

With respect to the work product doctrine, which protects documents that are prepared in anticipation of or because of the prospect of litigation, the Second Circuit held that the E&Y legal opinions were protected because they did, in fact, contain a litigation-focused analysis. Specifically, the court found that the tax advice in the legal opinions was aimed at addressing the refinancing and restructuring and was geared to an anticipated audit and subsequent

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

litigation, and that such a level of detail would not have been sought in the ordinary course of business.

As a result, the Second Circuit vacated the District Court's order and remanded the case for a determination as to whether any other documents were protected by the attorney-client privilege or work product doctrine.

The IRS Continues to Release International Practice Units

Between July 2015 and December 2015, the IRS released an additional 42 Large Business & International ("LB&I") International Practice Units ("IPUs") that cover a wide range of international topics including foreign income sourcing, foreign earned income exclusion, overview of Section 482 and failure to file certain international information return. The IRS had previously released a number of IPUs in December 2014.

IPUs provide IRS personnel with explanations of international tax concepts as well as information about a specific type of transaction. Each IPU generally contains a summary of an international issue, recommended action steps, and related guidance. IPUs are not binding and cannot be relied upon by taxpayers.

IPUs are designed to be used as an aid for examination or for training purposes. For example, the IPU entitled "LB&I International Practice Service Process Unit – Audit: Monetary Penalties for Failure to Timely File a Substantially Complete Form 5471 – Category 4 & Category 5 Filers" provides an overview of United States persons ("USPs") that are required to file Form 5471 and the monetary penalties that may imposed when a USP fails to file a Form 5471, files a Form 5471 late, or files a Form 5471 that is substantially incomplete. This IPU also provides a series of steps for examiners to determine if monetary penalties apply:

- **Step 1:** Determine if the return was filed late;
- **Step 2:** Identify whether required Forms 5471 were attached to the return;
- **Step 3:** Review Forms 5471 attached to the return for completeness;
- **Step 4:** Issue a Form 5471 pattern letter;
- **Step 5:** Review Forms 5471 submitted in response to pattern letter;
- **Step 6:** Determine if USP's reasonable cause statement met the regulatory requirements;
- **Step 7:** Review the definition and factors of reasonable cause;
- **Step 8:** Review cases in which reasonable cause was considered;
- **Step 9:** Evaluate USP's request for reasonable cause.

This IPU then contains guidance on each step, which includes factors to evaluate and potential actions.

Although not binding, IPUs may be a valuable tool, particularly for items with limited guidance, from which taxpayers gain insight into IRS methodology and potential positions. For example, in the above IPU, Step 3 discusses factors for an examiner to evaluate if a taxpayer

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

substantially complied with the Form 5471 reporting requirements or whether a Form 5471 should be deemed “substantially incomplete,” thus triggering penalties. This concept is not defined in Section 6038 or the regulations thereunder, and the IRS has issued only limited non-binding guidance on the determination of “substantially incomplete” for international information returns.[1] The IPU provides that examiners should look to specific items on the form for completeness and also notes that if any change in the information as originally reported would impact Exam’s risk analysis of the return, then the Form 5471 may be substantially incomplete.

While not binding, IPUs provide insight into the view of the IRS on a variety of international topics, as well as potential factors for consideration. Practitioners should be conscious of IPUs and give consideration to utilizing IPUs for guidance on procedures and actions the IRS may take during an IRS proceedings, such as an examination. The IPUs are published on the IRS website.
URL: https://www.irs.gov/Businesses/Corporations/International-Practice-Units

---

IRS Launches Early Interaction Initiative to Help Employers Meet Their Payroll Tax Obligations

Recently, the IRS announced the Early Interaction Initiative (“Initiative”), a new initiative that seeks to identify employers falling behind on their payroll or employment tax obligations even before an employment tax return is filed and then assist them in meeting their payment and reporting responsibilities.[2] Specifically, the IRS plans to offer information and guidance to employers identified under this Initiative through written correspondence, automated phone messages, other forms of communication, and, in some cases, a visit from an IRS revenue officer.

Prior to the Initiative, the IRS first contact with an employer having payment difficulties often took place after the employer’s employment return was filed and the employer had an unpaid tax liability. As part of the Initiative, the IRS will monitor deposit patterns and identify employers that have declining deposits and employers that are making payments late. The IRS will then contact those employers identified under this Initiative. Some employers will receive automated phone messages from the IRS, which are intended to provide information and compliance assistance to the employers. Some employers will receive written correspondence from the IRS, which may include an initial letter from the IRS reminding employers of their payroll tax responsibilities and requesting that they contact the IRS to discuss their specific circumstances. In addition, in some cases, an IRS revenue officer may contact an employer at its place of business.

The new Initiative appears to be consistent with recent changes to how the IRS approaches large and international business compliance and enforcement. The Large Business &

---

[1] *See* CCA 200429007; *see also* CCA 200645023.
[2] “New Early Interaction Initiative Will Help Employers Stay Current with Their Payroll Taxes.” IR-2015-136 (Dec. 8, 2015).

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

International division of the IRS (“LB&I”) has stated that it intends to design and deploy multi-faceted campaigns to identify and address key compliance risks, so that it can focus its limited resources in the proper areas to drive a specific compliance issue. This Initiative may be an early example of a campaign, as it is designed to identify and address payroll and employment tax compliance risks, even though the IRS has not specifically referred to the Initiative as a campaign. Pursuant to the Initiative, the IRS is focusing on identifying employer compliance issues earlier in the process by analyzing existing data, including deposit patterns, and the IRS is presenting tailored treatments (*e.g.*, delivering automated phone messages, sending correspondence, visiting an employer at its place of business) to correct identified noncompliance in the specific area of payroll and employment tax.

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.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Disclaimer
This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. None of Deloitte Touche Tohmatsu Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

Copyright © 2016 Deloitte Development LLC
All rights reserved.
Member of Deloitte Touche Tohmatsu Limited