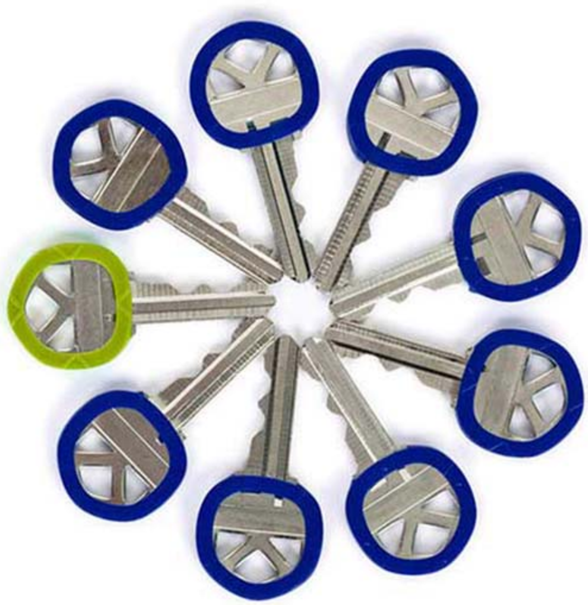

In this issue:

IRS Compliance Assurance Process Program under Review

On August 26, 2016, the IRS formally announced that the Compliance Assurance Process ("CAP") Program is under review, and no new applications into the program will be accepted for the 2017 application season that began in September 2016.[1] The CAP Program is a voluntary program under the IRS's Large Business and International Division ("LB&I") in which large corporate taxpayers[2] work cooperatively with the IRS prior to filing their returns to identify and resolve potential tax issues.

The CAP Program is divided into three phases: Pre-CAP, CAP, and Compliance Maintenance. In the Pre-CAP phase, the IRS examines a taxpayer's returns for all open years, and works with the taxpayer to close those examinations, with

[1] https://www.irs.gov/businesses/corporations/irs-continues-comprehensive-assessment-of-the-cap-program.
[2] To participate in the CAP Program, a taxpayer must have assets of $10 million or more; be a publicly held entity with a legal requirement to prepare and submit certain forms to the SEC or equivalent regulatory body or, if privately held, agree to provide certified, audited financial statements or equivalent documentation on a quarterly basis; and must not be under investigation by, or in litigation with, the IRS or other federal or state agency that would limit the IRS's access to current corporate tax records.

the goal of progressing to the CAP phase. In the CAP phase, a taxpayer identifies transactions and issues within transactions prior to filing, and works with the IRS to resolve those issues. If all issues are resolved, the taxpayer is assured that the IRS will accept the return if filed consistently with the resolutions agreed to by both parties. Finally, in the Compliance Maintenance phase, a taxpayer who has been successful in the CAP phase is afforded an adjusted level of review, based on its unique history and risk.

The IRS announced that taxpayers in the Pre-CAP phase may choose to remain there but cannot apply to move into the CAP phase; taxpayers in the CAP phase may apply to continue participating in that phase, or may apply for the Compliance Maintenance phase; and taxpayers in the Compliance Maintenance phase may apply to continue in that phase.

This announcement maintains the uncertainty that already existed over the fate of the CAP Program. It has been reported previously that the IRS had stopped accepting new CAP applications,[3] and there has been speculation about whether the CAP Program is aligned with LB&I's strategic vision, which uses more targeted, issue-based campaigns for risk identification.[4] The IRS explained that the assessment of the CAP Program is necessary given the IRS's continuing resource and budget constraints.[5]

IRS Announces Revisions of IRS Office of Appeals Conference Procedures

The IRS recently updated several of the IRS Office of Appeals ("IRS Appeals") procedures, including its conference procedures set forth in the Internal Revenue Manual ("IRM") 8.6.1.4 *et seq*. One of the most significant changes is the shift towards conducting IRS Appeals conferences by telephone with only limited exceptions. The new conference procedures became effective October 3, 2016.

As background, IRS Appeals is an independent administrative appeals function within the IRS. The mission of IRS Appeals is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the [IRS]."[6] In order to accomplish its mission, IRS Appeals considers protested cases, holds conferences and negotiates settlements.[7]

Prior to the recent updates, a taxpayer or representative could request a transfer of a case to an IRS field office for a face-to-face IRS Appeals conference, and IRS procedures required an automatic transfer to the office.[8] In October 2016, the IRS changed its policy to primarily conducting IRS Appeals conferences by telephone and only allowing in-person conferences in certain situations. The IRS has stated that the conference changes were implemented to allow IRS Appeals to better allocate resources and to route each case to the correct IRS employee.[9] Furthermore, the IRS noted its belief that the prior transfer process created delays, increased costs and often resulted in a mismatch of case complexity to the skill of the IRS employee, despite the majority of the cases being ultimately decided via telephone.[10]

IRM 8.6.1.4.1(2), updated on 10-01-2016, delineates that the default method for holding an IRS Appeals conference is by telephone. Under the new IRS Appeals procedures, either the taxpayer or an IRS Appeals officer may request an in-person conference; however, the request must be approved by the case manager and will only granted in certain situations.

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[3] 2016 TNT 71-4 (Apr. 13, 2016).
[4] http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/PublicForums/Olson_Statement.pdf. *See also* https://www.irs.gov/uac/newsroom/irs-future-state and https://www.irs.gov/pub/irs-utl/d11809--2016-01-00.pdf.
[5] 2016 TNT 167-31 (Aug. 26, 2016).
[6] IRM 8.1.1.1(1) (10-01-2016).
[7] IRM 8.1.1.1(2) (10-01-2016).
[8] IRS Fact Sheet: Changes to Case Transfer and Conference Procedures (October 3, 2016).
[9] *Id.*
[10] *Id.*

The IRM provides that the following factors may be considered in determining whether an in-person conference should be granted:

- There are substantial books and records requiring review that cannot be easily referenced;
- IRS Appeals cannot determine the credibility of the taxpayer's oral testimony without an in-person conference;
- The taxpayer has special needs, such as a disability, that can only be accommodated with an in-person conference;
- There are numerous conference participants and there are concerns about unauthorized disclosure or breach of confidentiality that can be mitigated by an in-person conference;
- An alternative dispute resolution procedure will be used; or
- Another provision of the IRM, specific to the workstream, calls for an in-person conference.[11]

If an in-person IRS Appeals conference is granted, the case remains with the IRS Appeals officer assigned to the case.[12] In locations where the IRS Appeals officer is allowed to travel to attend conferences ("circuit riding"), the IRS Appeals officer will be allowed to travel to a mutually convenient location if the address of the taxpayer, representative or business is more than 100 miles from a virtual conference site (discussed below) or 150 miles from the nearest IRS Appeals office.[13] Alternatively, the IRS Appeals officer may request assistance from another IRS Appeals officer when the officer's location does not accommodate an in-person conference, is not reasonably convenient for the taxpayer or representative, or does not conduct circuit riding.[14] In this instance, the assisting IRS Appeals officer will attend the in-person conference and confer with the original IRS Appeals officer after the conference.[15]

Virtual Conferences

The new procedures provide that, if the taxpayer requests an in-person conference, IRS Appeals should offer a virtual conference as an alternative via the IRS' Virtual Service Delivery ("VSD") technology.[16] In order to utilize the VSD technology, the taxpayer must travel to a site with the capability and the IRS Appeals officer must be located at a similarly equipped site.

VSD equipment is currently installed at the six campus IRS Appeals locations for the use of IRS Appeals employees and at ten customer-facing sites, whereby, the taxpayer and/or the taxpayer's representative can access the VSD technology.[17] Per IRM Exhibit 8.6.1-1, the ten customer-facing sites are located in the following cities:

- Anchorage, Alaska;
- Boise, Idaho;
- El Paso, Texas;
- Billings, Montana;
- Little Rock, Arkansas;
- Miami, Florida;
- Pensacola, Florida;
- Spokane, Washington;
- Oakridge, Tennessee; and
- Seattle, Washington.

Conference Participants

Updated IRM 8.6.1.4.4 also modifies the procedures regarding the participation of other IRS employees at IRS Appeals conferences. IRS Appeals may invite IRS Chief Counsel and/or the Compliance function to the Appeals conference, assuming that the prohibition against *ex parte* communication is not violated. The *ex parte* rules, contained in Rev.

[11] IRM 8.6.1.4.1(4) (10-01-2016).
[12] IRM 8.6.1.4.1.1 – 2(10-01-2016).
[13] IRM 8.6.1.4.1.2 (10-01-2016).
[14] IRM 8.6.1.4.1.1 (10-01-2016).
[15] *Id.*
[16] IRM 8.6.1.4.1(4) (10-01-2016).
[17] IRM Exhibit 8.6.1-1.

Proc. 2012-18[18], generally provide for certain prohibitions on communications between IRS Appeals and the IRS originating function, without the presence of the taxpayer. These provisions are designed to ensure the independence of IRS Appeals within the IRS organization.

The prior version of these procedures utilized a different standard and allowed for representatives of other IRS divisions or other experts to attend the conference, if the IRS Appeals officer believed that it was advisable to do so. Previously, IRS Chief Counsel was generally not involved, but could be present where criminal prosecution had been recommended and the fraud penalty was contested.

Conclusion

The above changes represent a significant shift in IRS Appeals' processes and procedures. As these procedures are new, it is difficult, at this time, to ascertain the impact that these new procedures will have on taxpayers and representatives seeking a resolution in IRS Appeals. Due to the significant changes, however, taxpayers and representatives should be sensitive to the actions of IRS Appeals and, as appropriate, assert their right to have a conference with IRS Appeals that "is fair and impartial to both the Government and the taxpayer."[19]

Tenth Circuit Concludes a Managing Partner was Not Precluded from Asserting Partner-Level Defenses to Penalties

In *McNeill v. United States*,[20] the Tenth Circuit held that an adverse decision to a partnership's assertion of a reasonable cause and good faith defense in a TEFRA administrative partnership-level proceeding does not preclude a managing (or tax matters) partner from asserting any partner-level defenses to penalties.

Through a series of partnerships, Corbin McNeill ("McNeill") participated in a distressed asset/debt ("DAD") tax shelter[21] designed to generate losses that McNeill could use to offset $18 million of income for the 2002 tax year. Specifically, McNeill and his tax advisors created two partnerships, Dulwich LLC ("Dulwich") and Livrpol LLC ("Livrpol"), to which foreign debt holders contributed their debt instruments and basis, and McNeill made relatively small cash contributions to the partnerships. McNeill owned approximately 98 percent of Dulwich and was designated the tax matters partner ("TMP") of Dulwich by the end of 2002. Dulwich owned 99 percent of Livrpol, the partnership to which the debt was contributed during formation. Upon the partnerships' sale of the debt instruments to third parties, Livrpol reported a loss in excess of $22 million, and 90 percent of this loss was allocated to McNeill.

McNeill and Dulwich both received opinion letters analyzing and supporting their tax positions taken in connection with the DAD tax shelter; namely, the opinion letters confirmed the positions taken with respect to Dulwich's tax basis in the assets and the tax consequences to McNeill upon sale of the assets. McNeill's tax return preparer also reviewed the transactions and signed his 2002 income tax return. The IRS issued a Final Partnership Administrative Adjustment ("FPAA") to Livrpol, in which it concluded the DAD transaction was a sham and lacked economic substance and, therefore, the IRS disallowed the losses resulting from the sale of the debt instruments and asserted an accuracy-related penalty under IRC § 6662.

The TMP of Livrpol did not contest the proposed adjustments in the FPAA. McNeill, as the TMP of Dulwich, filed a Petition for Readjustment of Partnership Items under IRC § 6226 to challenge the FPAA. Two years after filing the petition in federal district court, Livrpol, at McNeill's direction, filed a motion to voluntarily dismiss the case with prejudice. The Livrpol case was dismissed with prejudice and the dismissal Order provided that the FPAA issued to

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[18] 2012-1 C.B. 455.
[19] IRM 8.1.1.1(1) (10-01-2016).
[20] 2016 US App. LEXIS 16343 (10th Cir. Wyo. 2016).
[21] A DAD tax shelter allows a taxpayer to avoid paying taxes by shifting a built-in loss from a tax-indifferent party to a taxpayer who has not incurred the economic loss, but who aims to shelter a large taxable gain. See *Superior Trading, LLC v. Comm'r*, 137 T.C. 70, 72 (2011); see also the IRS's Coordinated Issue Paper – "Distressed Asset/Debt Tax Shelters," LMSB-04-0407-031 (Apr. 18, 2007).

Livrpol was correct, and also stated that the Order “does not adjudicate any partner-level defenses by Corbin… McNeill, such as a reasonable cause/good faith defense” under IRC § 6662 and the Treasury Regulations thereunder.

After paying his share of Livrpol’s liability (including the accuracy-related penalty and interest), McNeill filed a refund suit in the United States District Court for the District of Wyoming, arguing that he should not be liable for the accuracy-related penalty and associated interest because he had reasonable cause and acted in good faith in filing his return. To support his reasonable cause and good faith defense to the accuracy-related penalty, McNeill relied upon the opinion letters and an internal memorandum prepared by his tax return preparer in claiming the benefits of the DAD transaction.

The district court did not evaluate McNeill’s reasonable cause and good faith defense on the merits; instead, the court held that the TEFRA partnership audit rules precluded a managing partner, like McNeill, from pursuing a reasonable cause and good faith defense at the partner level, where the IRS has already rejected the partnership’s assertion of reasonable cause and good faith at the partnership level in administrative proceedings.

On appeal, the Tenth Circuit reviewed the relevant statutory language in IRC § 6230, which states:

> No review of substantive issues. – For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of a court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty…which relates to an adjustment to a partnership item shall also be conclusive. **Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply to or challenge the amount of the computational adjustment.** [Emphasis added.]
>
> IRC § 6230(c)(4).

The Tenth Circuit noted that the statute does not carve out an exception for managing partners or TMPs, and concluded that Congress contemplated a regime in which *any* partner (including a managing partner or the TMP) could assert *any* partner-level defense that may apply. Moreover, the appellate court observed that the Treasury Regulations expressly indicate that the reasonable cause and good faith defense under IRC § 6664(c)(1) is more appropriately determined at the partner level. Citing *United States v. Woods*,[22] the Tenth Circuit noted that the Supreme Court has endorsed the position that, under TEFRA, a partner’s reasonable cause and good faith defense cannot be conclusively determined at the partnership level.

In response to the United States’ argument that its interpretation of the statute, as precluding a managing partner from raising a reasonable cause and good faith defense after the partnership’s reasonable cause and good faith defense was denied at a partnership-level proceeding, would yield a more efficient process, the Tenth Circuit stated: “Neither, of course and far more importantly, can any claim of efficiency substitute for the statute’s text and structure as a basis for discerning statutory meaning.”[23]

While the Tenth Circuit acknowledged that there is often a strong identity of interests between a managing partner (or a TMP) and a partnership, the court found that, where the United States did not argue that a final ruling existed to trigger judicial preclusion principles in this case, the adverse decision in Livrpol’s TEFRA administrative partnership-level proceeding did not prevent McNeill, a managing partner, from pursuing a reasonable cause and good faith defense in his partner-level proceeding. Accordingly, the Tenth Circuit reversed the district court’s judgment and remanded the case for further proceedings to determine the merits of McNeill’s reasonable cause and good faith defense.

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[22] 134 S. Ct. 557, 564 (US 2013).
[23] 2016 US App. LEXIS 16343, *14.

Fifth Circuit Court of Appeals Requires Strict Compliance to TEFRA Procedural Requirements

The Fifth Circuit Court of Appeals, in an unpublished opinion, held that the government was entitled to a refund of amounts paid to David Stewart and Richard Plato (collectively, the "Taxpayers") due to their failure to properly follow the procedural requirements of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") in adjusting a partnership item.[24]

The Taxpayers were partners in Odyssey Energy Capital I, LP ("Odyssey"), a TEFRA partnership, which managed certain oil and gas properties held by Hydrocarbon Capital, LLC. During tax year 2004, the properties were sold, and Odyssey received a twenty-percent interest valued at $20 million ("Fee"). Odyssey reported the Fee as ordinary income on its 2004 Form 1065, *US Partnership Income Tax Return*, and issued Schedules K-1, *Partner's Share of Income, Deduction, Credits, etc.*, to its partners reflecting their respective shares of the Fee as ordinary income. The Taxpayers filed 2004 Forms 1040, *Individual Income Tax Return*, consistent with the Schedules K-1.

Subsequently, Odyssey sought to reclassify the Fee as long-term capital gain. In 2007, Odyssey filed an amended partnership return reflecting this reclassification and issued amended Schedules K-1 to the partners; however, neither Odyssey nor the Taxpayers filed an Administrative Adjustment Request ("AAR") as required under the TEFRA provisions.[25] Rather, the Taxpayers each filed an amended return seeking to change the classification of the Fee on their individual return and claim a refund. In 2008, the IRS issued refunds to the Taxpayers based upon their amended returns.

In 2010, the government filed an erroneous refund suit against the Taxpayers to recover the previously issued refunds asserting that the Taxpayers had failed to follow the proper procedures to reclassify the Fee.[26] The United States District Court for the Southern District of Texas granted summary judgment for the Taxpayers on the grounds that the Fee was properly characterized as capital gains.[27] In reversing the district court, the Fifth Circuit held that the primary issue was whether Odyssey and the Taxpayers utilized the proper procedures to adjust the classification of the Fee from ordinary income to capital gain.[28]

Under IRC § 6227, an AAR must be filed by either the partnership or partner to adjust the classification of a TEFRA partnership item, such as the Fee. The court noted that Form 8082 was the prescribed method for filing an AAR, and neither Odyssey, nor the Taxpayers, filed a Form 8082 for tax year 2004. Furthermore, the court rejected the argument that the Taxpayers' amended returns substantially complied with the AAR requirements. The court pointed towards the similarities of the Taxpayers' situation and the facts in *Rigas v. United States*,[29] which dealt with another partner of Odyssey seeking a refund of the Fee under a similar fact pattern. The court noted that there were significant factual similarities between the taxpayers in *Rigas* and the Taxpayers, and, in the *Rigas* case, the return statement was held to not substantially comply with the AAR requirements because it was sent to the wrong service center and did not contain the requisite level of detail. Accordingly, the Fifth Circuit held that the Taxpayers failed to meet the standards of an AAR, either by filing of a Form 8082 or by substantially complying with the requirements.

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[24] *See United States v. Stewart*, 2016 US App. LEXIS 18446 (5th Cir. 2016).
[25] Under Internal Revenue Code ("IRC") § 6227, in order for a TEFRA partnerships or its partners to properly amend an income tax return, they must file an AAR.
[26] As noted by the *Stewart* court, the government became aware of this case pursuant to an examination of the refund claim submitted by another partner of Odyssey. In that case, the IRS denied the refund claim for lack of a valid AAR and required that the taxpayers treat the Fee consistently with Odyssey's originally filed Form 1065. The taxpayers filed suit seeking the refund on the grounds that their amended return should qualify as an AAR and the IRS was bound to offer consistent settlements among the partners, as the IRS had previously issued refunds to other partners. Ultimately, in *Rigas v. United States*, 486 F. App'x 491 (5th Cir. 2012), the Fifth Circuit concluded that the taxpayers were not entitled to a refund. For additional analysis of the *Rigas* case, please see the November 2012 issue of *IRS Insights*.
[27] *United States v. Stewart*, 123 F. Supp. 3d 921 (S.D. Tex. 2015).
[28] Based upon the Fifth Circuit's holding, it was not required to determine whether the Fee was taxable as ordinary income or as capital gains.
[29] 486 F. App'x 491 (5th Cir. 2012).

The Fifth Circuit concluded that the Fee had not been properly reclassified as capital gain, thus the Taxpayers were bound to treat the Fee consistent with the original treatment. Accordingly, the Taxpayers' 2004 refunds were issued in error. As the government properly filed an erroneous refund suit under IRC § 7405 within the requisite period, the court held the previously issued refunds could be recovered.

The *Rigas* and *Stewart* cases reinforce the principle that taxpayers, which have holdings in partnerships subject to TEFRA provisions, must be very careful in determining the proper course of action relating to any partnership items or affected items as reported on their returns. If a taxpayer mistakenly utilizes an incorrect procedure for requesting a refund, or bringing suit, this may bar an otherwise valid claim.