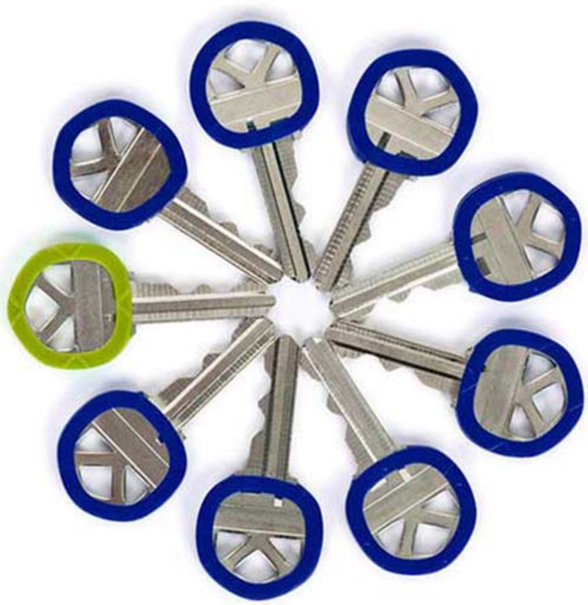

In this issue:

Federal Circuit Affirms FPAA Tolled Statute for Partnership when Losses were "Attributable To" Another Partnership

Affirming the Court of Federal Claims' judgment, in *Russian Recovery Fund Ltd. v. United States*, 851 F.3d 1253 (2017), the Federal Circuit upheld the IRS's position that a Final Partnership Administrative Adjustment ("FPAA") issued to a partnership tolled the statute of limitations for a separate partnership when the losses of the latter partnership were "attributable to" the losses of the former partnership.

In early 1999, Russian Recovery Fund (RRF), a partnership, was formed to invest in Russian credit-linked notes (CLNs), which had become virtually worthless after the default of Russian sovereign debt in August 1998. Tiger Management, LLC (Tiger), a third-party hedge fund manager, held a significant investment in the CLNs prior to the devaluation, but, in May 1999, after subsequent changes to RRF's standard investment terms and conditions, contributed its devalued CLNs to RRF in exchange for RRF interests. However, only a few short weeks after the transaction with RRF, Tiger sold its RRF interests to RRF's owner, FFIP LP (FFIP), a partnership, at a discount. RRF then sold the majority of its CLNs to a third party in late 1999, and the remainder on the open market in early 2000, generating losses for RRF.

RRF's tax return for the 2000 tax year allocated a loss from the CLNs to its owner, FFIP. In turn, FFIP reported the losses from the CLNs on its 2000 and 2001 tax returns. Zimmerman, an individual partner in FFIP and representative of similarly situated indirect partners of RRF, then reported the allocated losses from FFIP on her 2001 tax return.

In October 2005, the IRS issued an FPAA to RRF (2005 RRF FPAA), disallowing losses from the CLNs claimed on its 2000 tax return, and also assessed a 40-percent gross valuation misstatement penalty, under sections 6662(a) and 6662(h)(1). While the IRS failed to issue an FPAA to FFIP for the allocated losses for 2001 and later years, the IRS attempted to collect tax from FFIP partners (indirect partners of RRF) for those years related to the disallowed losses from RRF.

The taxpayer argued that the IRS's attempt to collect tax from FFIP partners in 2001 and later years, based on the FFIP partnership items from RRF, was time-barred because the IRS failed to issue an FPAA to FFIP for those years. Although the taxpayer conceded that the IRS had timely issued the 2005 RRF FPAA and tolled the assessment period for partnership items attributable to tax year 2000, the taxpayer asserted that it failed to toll the assessment period for FFIP's 2001 partnership items. The taxpayer further argued that a single FPAA cannot apply to two partnerships (*i.e.*, RRF and FFIP) or two tax years (*i.e.*, 2000 and 2001). Contrarily, the IRS contended that the 2005 RRF FPAA properly tolled the statute period because FFIP's 2001 losses are "attributable to" RRF's 2000 losses.

Section 6229(a) provides that the period for assessing any tax imposed by subtitle A with respect to any person which is *attributable to* any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is three years after the later of either filing of the partnership's return or the return's due date (emphasis added). However, under section 6229(d), if an FPAA with respect to any taxable year is mailed to the tax matters partner, the limitations period in section 6229(a) is suspended for the period during which an action may be brought under section 6226 and, if a petition is filed under section 6226, until the decision of the court becomes final, and for one year thereafter.

The Federal Circuit upheld the Court of Federal Claims' finding that the 2005 RRF FPAA suspended the limitations period for FFIP's 2001 losses "attributable to" RRF's 2000 losses, because defining "attributable to" to mean "due to, caused by, or generated by" preserves its plain meaning, maintains consistency with that phrase as it is used throughout the Internal Revenue Code, and adheres to the precedent established in *Badaracco v. Comm'r*, 464 U.S. 386 (1984), in granting deference to the IRS's interpretation of the Internal Revenue Code. Additionally, the IRS's application of "attributable to" is consistent with section 6221, where tax treatment of a partnership item generally is determined at the partnership level. As such, the 2005 RRF FPAA also suspended the limitations period for assessing tax against RRF's indirect partners (*i.e.*, Zimmerman) that was "due to, caused by, or generated by" a partnership item on a partner's return.

The court further held that there was no bona fide partnership formed between RRF and Tiger. Applying both Treas. Reg. § 1.704-1(e)(1)(iii) ("a partner is treated as a partner for tax purposes if the 'interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes,'") and *Comm'r v. Culbertson*, 337 U.S. 733 (1949) (a court must evaluate all the facts showing parties' true intent as to "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits or losses or both"), the court affirmed the Court of Federal Claims' finding that, considering all the facts, Tiger had no true intention of becoming a partner in RRF, and RRF had reason to know. RRF's transaction with Tiger lacked economic substance, in part, because RRF was aware that its 1999 transaction to acquire CLNs from Tiger was part of a plan to acquire assets with built-in tax losses. Given the changes to the standard partnership interest agreement that Tiger demanded prior to the transaction, RRF had reason to know of Tiger's lack of intent to become an actual partner in RRF.

Additionally, with respect to the assessment of the gross valuation misstatement penalty, the Federal Circuit affirmed the Court of Federal Claims' holding that the taxpayer's reliance on a tax advisor was insufficient because (1) the reliance was predicated on unreasonable factual or legal assumptions, or alternatively, the advisor unreasonably relied on a "self-interested summary" of the facts by the taxpayer and "did no independent investigation into the factual accuracy of the information" provided to the advisor by the taxpayer and (2) a tax return signed by a purported tax advisor is insufficient to demonstrate that there was any "advice" rendered by the advisor that could have been relied upon by the taxpayer. Finding RFF unable to meet the burden in showing a reasonable cause defense, the Federal Circuit upheld the 40-percent penalty against RRF.

IRS Grants Relief for Partnerships Filing Returns or Extension Requests by the Due Date in Effect before the Enactment of the Surface Transportation Act

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (“the Act”) amended IRC section 6072 and changed the date by which a partnership must file its annual return. Specifically, the due date for filing the annual return of a partnership changed from the fifteenth day of the fourth month following the close of the taxable year (April 15 for calendar-year partnerships) to the fifteenth day of the third month following the close of the taxable year (March 15 for calendar-year partnerships). The new due date applies to the returns of partnerships for taxable years beginning after December 31, 2015.

Partnerships filing Form 1065, *U.S. Return of Partnership Income*, and Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*, are affected by the Act. These partnerships may also file Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, and Form 8805, *Foreign Partner’s Information Statement of Section 1446 Withholding Tax*, which are generally due to the IRS on the same date as the partnership’s Form 1065 or Form 1065-B. Filers of Form 1065 must furnish their partners with Schedules K-1, *Partner’s Share of Income, Deductions, Credits, etc.*, by the due date of the Form 1065, and filers of Form 1065-B must furnish their partners with Schedules K-1 by the first March 15 following the close of the partnership’s taxable year. Filers of Form 8804 that are required to file Forms 8805 must furnish their partners with copies of the Forms 8805 by the due date of the Form 8804. Additionally, some partnerships must file other returns, such as Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, by the due date of the Form 1065 or Form 1065-B.

Partnerships can obtain a six-month extension of time to file Form 1065, Form 1065-B, or Form 8804 by filing Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, by the due date of those returns.

Partnerships that fail to timely file and furnish returns are subject to penalties. The failure to file Form 1065 or Form 1065-B by the due date (including extensions) is subject to penalty under IRC section 6698. The failure to file Form 8804 by the due date (including extensions) is subject to penalty under IRC section 6651. The failure to file Forms 8805 by the due date (including extensions) is subject to penalty under IRC section 6721. The failure to furnish Schedules K-1 or Forms 8805 by the due date (including extensions) is subject to penalty under IRC section 6722. The failure to file Form 5471 by the due date (including extensions) is subject to penalty under IRC sections 6038 or 6679.

Many partnerships have filed the returns discussed above (or Form 7004) for the first taxable year beginning after December 31, 2015, by the date previously required by IRC section 6072. If not for the Act, those returns and requests for extension of time to file would have been timely. As a result, the IRS will grant relief from the penalties described above for any return described above for the first taxable year of any partnership beginning after December 31, 2015 if the following conditions are satisfied:

1. The partnership files the Form 1065, Form 1065-B, Form 8804, Form 8805, Form 5471, or other return required to be filed with the IRS and furnished copies (or Schedules K-1) to the partners by the date that would have been timely under IRC section 6072 before amendment by the Act (April 18, 2017 for calendar-year partnerships, the fifteenth day of the fourth month following the close of the taxable year for other partnerships), or
2. The partnership filed Form 7004 to request an extension of time to file by the date that would have been timely under IRC section 6072 before amendment by the Act and files the return with the IRS and furnishes the copies to the partners by the fifteenth day of the ninth month after the close of the partnership’s taxable year (September 15, 2017 for calendar-year partnerships). If the partnership files Form 1065-B and was required to furnish Schedules K-1 to the partners by March 15, 2017, it must have done so to qualify for relief.

This relief will be granted automatically for penalties for failure to file Form 1065, Form 1065-B, Form 8804, Form 8805, and any other returns, such as Form 5471, for which the due date is tied to the due date of the Form 1065 or Form 1065-B. Partnerships that qualify for relief and have already been assessed penalties can expect to receive a letter within the next several months notifying them that the penalties have been abated. For consideration of a penalty covered by the Notice that has not been abated by February 28, 2018, partnerships may call (800) 829-1040, and state that they are entitled to relief under Notice 2017-47. Partnerships that qualify for relief under this notice will not be treated as having received a first-time abatement under the IRS’s administrative penalty waiver program.

The Tax Court and the Court of Appeals for the Second Circuit Reach Contrary Conclusions as to the Section 6751(b)(1) Written-Approval Requirement for Sustaining an Accuracy-Related Penalty

IRC § 6751 was enacted as part of the IRS Restructuring and Reform Act of 1998 (the "Act"). The Act introduced additional procedures for determining and assessing penalties and IRC § 6751, in particular, was designed to curtail the improper imposition of penalties and prevent IRS agents from using the prospect of penalties as a bargaining chip against taxpayers. In two recent opinions, the Tax Court and the Court of Appeals for the Second Circuit have interpreted the written-approval requirement under IRC § 6751(b)(1), and these courts have reached different conclusions as to when and whether the IRS is required to show that the necessary written approval has been obtained to assess an accuracy-related penalty against a taxpayer.

In *Graev v. Comm'r*,[1] the Tax Court concluded that Lawrence G. Graev and Lorna Graev (the "Graevs"), who claimed deductions for a conservation easement contribution that were disallowed by the Tax Court in 2013, were liable for a 20-percent accuracy-related penalty. In this case, the Tax Court considered whether the IRS was barred from assessing the accuracy-related penalty because the IRS could not demonstrate that the proper written approval for assessment of the penalty had been given, as required by IRC § 6751(b)(1).

The Graevs purchased property in a historic preservation district in New York, New York in 1999. In December of 2004, the Graevs contributed cash and a façade conservation easement to the National Architectural Trust ("NAT"), and claimed charitable contribution deductions for the cash contribution and easement donation on their 2004 and 2005 Forms 1040, *U.S. Individual Income Tax Return*. In September of 2004, the Graevs received a "side letter" from NAT, which provided that, in the event that the IRS were to disallow the charitable contribution deductions that the Graevs intended to claim on their individual tax returns, then NAT would refund their cash contribution and remove the façade conservation easement from the Graevs' property.

In the notice of deficiency, the IRS disallowed the Graevs' charitable contribution deductions taken in connection with the easement donation, asserted a 40-percent accuracy-related penalty and, in the alternative, a 20-percent accuracy-related penalty, under IRC § 6662. There was no managerial approval for the alternative 20-percent accuracy-related penalty recorded in writing. In a prior opinion, the Tax Court determined that the charitable contribution deductions were properly disallowed.[2] Thereafter, the IRS conceded that the IRC § 6662(h) valuation penalty was inapplicable; however, the IRS maintained that the accuracy-related penalty under IRC 6662(a), as asserted in the notice of deficiency, applied.

In contesting the IRS's penalty determinations, the Graevs argued that the IRS had failed to comply with the requirement of IRC § 6751(b)(1), which states that "[n]o penalty shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher office as the Secretary may designate." In this case, there was no evidence that the accuracy-related penalty determination was approved by the immediate supervisor of the IRS agent who made that determination.

After analyzing the Graevs' argument and the IRS's counterarguments, the Tax Court determined that it was premature for the Tax Court to consider whether the IRS had complied with the IRC § 6751(b)(1) requirement because the IRS had not yet assessed the IRC § 6662 penalties at issue. The Tax Court noted that an assessment is the formal recording of a taxpayer's liability on the IRS's records. The Tax Court then pointed to the statutory language and the legislative history to IRC § 6751, and concluded that there is no deadline for obtaining the requisite approval before assessment. The Tax Court ultimately concluded that the Graevs were liable for the 20% accuracy-related penalty, finding that none of the defenses to the penalty that they raised applied.

In dissent, Judge Gustafson and four other judges concluded that consideration of IRC § 6751(b)(1) was not premature in a deficiency case, in light of IRC § 7491(c). The *Graev* dissent observed that the majority's construction

[1] 147 T.C. No. 16 (Nov. 30, 2016) (hereinafter, "*Graev*").
[2] *Graev v. Comm'r*, 140 T.C. 377 (2013).

of the statute would undermine the congressional goal in creating a supervisory approval requirement, expressed in the legislative history to § 6751, for penalties to only be imposed where appropriate and not as a bargaining chip. The five dissenting members would have held that written approval must be obtained prior to the initiation of Tax Court proceedings regarding penalties and that the failure to obtain the supervisory approval required by IRC § 6751(b)(1) bars the assessment of an accuracy-related penalty.

In *Chai v. Comm'r*,[3] Mr. Chai did not pay self-employment tax on a $2 million payment he received in 2003. The IRS issued a notice of deficiency, asserting that Mr. Chai owed the additional amount of self-employment tax, as well as a 20-percent accuracy-related penalty under IRC § 6662. Mr. Chai petitioned the Tax Court for redetermination of the deficiency.

Mr. Chai argued, in his post-trial briefing, that the IRS failed to meet the burden of production under IRC § 7491(c) because the IRS had not provided evidence of compliance with the IRC § 6751(b)(1) written-approval requirement. The Tax Court sustained the self-employment tax deficiency and the associated accuracy-related penalty. However, the Tax Court declined to consider Mr. Chai's IRC § 6751(b)(1) argument because it was raised for the first time in a post-trial briefing.

On appeal to the Second Circuit, the IRS argued that the circuit court should adopt the reasoning of the majority in *Graev* and find that the issue of compliance with the written-approval requirement was not ripe for review in a deficiency proceeding. The appellate court framed its task in *Chai* as: "to decide which side in *Graev* got it right"[4] (*i.e.*, the majority or the dissent).

After reviewing the statutory language and the legislative history to IRC § 6751, the Second Circuit found the *Graev* dissent more persuasive than the majority opinion. The Second Circuit endorsed the *Graev* dissent's view that the IRS was required to obtain written approval of the penalty pre-assessment, and the court concluded that compliance with the written-approval requirement is an element of the IRS's penalty claim. Consequently, in *Chai*, the appellate court held that compliance with IRC § 6751(b) is part of the IRS's burden of production and proof in a deficiency case in which a penalty is asserted. The Second Circuit also determined that the Tax Court abused its discretion by declining to consider Mr. Chai's post-trial claim that the IRS had not complied with the written-approval requirement under IRC § 6751(b)(1), where compliance with IRC § 6751(b)(1) is required before the penalty proceedings begin. Because the IRS failed to show that it complied with the written-approval requirement, the Second Circuit concluded that assessment of the penalty was improper in this case.

IRS Issues Revised Guidance on Key Officer and Executive Tax Return Compliance Checks

Generally, IRS Large Business & International Division (LB&I) examiners must complete a tax return compliance check of key officers and executives concurrently with an examination of a Coordinated Industry Case (CIC) taxpayer or an Industry Case (IC) taxpayer. Typically this officer compliance check involves an inspection of an officer's tax return, to confirm filing, and if warranted, an examination. For purposes of this compliance check, the IRS defines 'key officers' as those "who have control or authority over corporate activities, or whose relationship with any segment of the entity is close enough to significantly influence corporate governance or tax results." For IC taxpayers, key officers are generally shareholders.

On June 13, 2017, LB&I issued a memorandum (LB&I-04-0617-002) providing revised guidance to IRS examiners regarding compliance checks for key officers and executives. Effective upon its issuance, this LB&I memo serves as interim guidance, until the date of revision and publication as Internal Revenue Manual (IRM) 4.46.3-6.

The revised guidance allows examiners "to use their professional judgment, knowledge of the taxpayer's operations, and other available information to determine whether inspection of executive returns is warranted," whereas existing guidance merely references the 'minimum requirements' for IRS inspection of key officers' returns. IRS examiners are

[3] 851 F.3d 190 (2d Cir. 2017).
[4] *Id.* at 216.

permitted to use available automated information systems for the initial inspection of the return, but are advised to request a tax return from the IRS campus or the officer-taxpayer if it is determined that the return warrants further analysis and examination. The revised guidance also specifies that the officer compliance check should verify tax return filing through the most recent filing season, providing new clarification as to which returns are subject to the compliance check.

Guidance concerning SB/SE referrals, "whipsawing" of issues, consents to extend statutes of limitation, and the scope of individual examinations remained the same in the revision.

Internal Revenue Service Releases Frequently Asked Questions on Appeals Team Cases Conferencing Initiative

On May 1, 2017, the IRS Office of Appeals ("Appeals") implemented the Appeals Team Conferencing Initiative ("Initiative") in which some Appeals Team Case Leaders ("ATCLs") will hold Appeals conferences with representatives from IRS Compliance Examination teams ("Compliance") in attendance. On August 8, 2017, Appeals released Frequently Asked Questions ("FAQs"), which provide some insight into the Initiative.

Appeals is designed to be an independent forum within the IRS whose mission is as follows:

> To resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.[5]

In order to accomplish its mission, Appeals considers protested cases, holds conferences and negotiates settlements.[6]

In November 2016, the IRS updated its procedures on other IRS participants, such as individuals from the Compliance or IRS Office of Chief Counsel, attending Appeals conferences.[7] Historically, Appeals officers had the discretion to invite other members of the IRS to a specific conference; however, participation was generally limited. On May 1, 2017, Appeals implemented the Initiative, whereby, some ATCLs will hold Appeals conferences with representatives from Compliance in attendance.

The recently released FAQs provide clarification around various areas of the Initiative, including that participation by Compliance will now be routine for certain types of cases. In these situations, the Compliance personnel directly related to the un-agreed issue will be invited to discuss the IRS' position and answer questions, as well as listen to the taxpayer's position and answers.

According to the FAQs, the new procedures are designed to create an open forum whereby Compliance and the taxpayer will both participate to clarify factual or legal items. According to the FAQs, the process is intended to allow the ATCL to focus on the significant aspects of the dispute and evaluate any hazards of litigation. The FAQ document also states the IRS belief that all parties could benefit from the open discussion into the issues, which in turn could facilitate resolution of the same or similar issues in the future.

According to the FAQ document, the conference attendance changes are not intended to impact the primary function of IRS Appeals to be a fair and impartial forum. The FAQs contrast IRS Appeals to the IRS' Rapid Appeals Program ("Rapid Appeals"), which is a voluntary process, in which the IRS Appeals officer acts as a mediator between the taxpayer and IRS examination team. In IRS Appeals conferences, the taxpayers and Appeals officers continue to be the only parties to the negotiations.

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[5] https://www.irs.gov/individuals/appeals-an-independent-organization
[6] IRM 8.1.1.1(2) (10-01-2016).
[7] IRM 8.6.1.4.1(4) (10-01-2016). For a further discussion, see "IRS Announces Revisions of IRS Office of Appeals Conference Procedures," *IRS Insights*, November 2016.
URL: http://newsletters.usdbriefs.com/2016/Tax/IRSI/161114_2.html

Additionally, the inclusion of Compliance in conferences does not impact the prohibition against either the taxpayer or IRS raising new issues in IRS Appeals. If the taxpayer raises a new issue, then the IRS Appeals officer will return the case to Compliance for further review. These policies had been previously established pursuant to the Appeals Judicial Approach and Culture Project.[8]

For all ATCLs participating in this Initiative, it is mandatory that Compliance be invited to attend Appeals conferences and taxpayers are not entitled to request a conference outside these procedures. Accordingly, Taxpayers should be aware of the Initiative and the FAQs.

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[8] *See* IRS Memorandum AP-08-0713-03 (July 18, 2013); Memorandum for Appeals Employees, AP-08-0714-0004 (September 2, 2014); Internal Revenue Manual Policy Statement 8-2. For additional information on the AJAC process and procedures, please also see "IRS Memorandum Provides Implementation Guidance for Phase 2 of the Appeals Judicial Approach and Culture (AJAC) Project," *IRS Insights*, September 2, 2014.
URL: http://newsletters.usdbriefs.com/2014/Tax/IRSI/140908_1.html