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Documents Prepared By Accounting Firm Protected By Tax-Practitioner Privilege/Work Product Immunity

Schaeffler, CA-2, November 10, 2015

The Court of Appeals for the Second Circuit has found that the taxpayers did not waive the attorney-client privilege by sharing privileged documents with a consortium of banks with which they had a common legal interest. In addition, the materials summoned were protected by the work-product doctrine because they were prepared in anticipation of litigation, the court found.

- ***Take Away.*** "This is one of the most favorable cases applying the work-product doctrine to communications by accounting firms to come down in years," Lawrence Hill, attorney, Shearman & Sterling LLP, told Wolters Kluwer. "It broadens common interest doctrine protection for communications involving accountants and lawyers who have a common tax/legal interest in planning transactions. It also is a strong reaffirmation of the *Adlman, CA-2, 98-1* USTC *¶50,230,* work product decision and represents a liberal interpretation of what constitutes 'anticipation of litigation' in the work product context. The decision supports application of the work product doctrine where the size and complexity and ambiguity of the tax treatment of the transaction in the transaction planning stage governs the likelihood of IRS scrutiny of the transaction," he added.

Background

The taxpayers were an individual and the automotive and industrial parts supplier of which he was the 80-percent owner. They participated in a foreign commercial transaction with the intention of acquiring a minority interest in a German company. An ill-timed stock market collapse resulted in the taxpayers holding 89.9 percent of the German company, which threatened the taxpayers with insolvency. The taxpayers engaged in refinancing and restructuring transactions with the help of a bank consortium, actions that created tax consequences likely to invite an IRS examination. The taxpayers retained the services of an accounting firm and a law firm to advise them on the federal tax implications of their transactions and any possible future litigation with the IRS.

The IRS initiated an audit and issued a summons for all documents created by the accounting firm relating to the restructuring. The taxpayers sought to quash the demand for legal opinions produced by the accounting firm. In particular they sought to withhold a tax memorandum identifying potential U.S. tax consequences of their refinancing and restructuring and analyzing the IRS's possible arguments.

The district court denied the taxpayer's petition to quash, finding that they had waived their attorney-client privilege by sharing the documents subject to the summons with the bank consortium involved in the refinancing transaction. The district court found that the consortium

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IRS Expands Assistance To Identity Theft Victims, Makes Copies Of Fraudulent Returns Available

www.irs.gov

The IRS has announced that victims of identity theft and refund fraud may obtain copies of bogus returns filed under their names. Victims or their authorized representatives may request copies of fraudulent Forms 1040, 1040A, 1040EZ, 1040NR, or 1040NR-EZ.

- ***Take Away.*** Taxpayers need to be very proactive against identity theft, Sheila Brandenberg, Sheila Brandenberg, CPA, New York, told Wolters Kluwer. Among the steps individuals can take are regular checks of their credit reports, update the antivirus programs on their home computers, and make passwords more complex. Brandenberg, who serves on the Family Office Committee and the Personal Finance Committee of the New York State Society of CPAs, noted that some higher income individuals have had their personal computers hijacked by cybercriminals and held for ransom payments.

Background

Tax-related identity theft occurs when a criminal uses an individual's Social Security number (SSN) to file a tax return claiming a fraudulent refund. Generally, criminals file fraudulent returns early in the filing season. As a result, the taxpayer may be unaware that he or she is a victim of identity theft and refund fraud until they attempt to file a legitimate return.

- ***Comment.*** Identity thieves are aggressive with telephone scams, Brandenberg told Wolters Kluwer. "I tell my clients to never engage these individuals in conversation. The IRS never makes threats (such as imprisonment or deportation) to collect taxes," Brandenberg said.

Requests

A victim of identity theft or a person authorized to obtain the identity theft victim's tax information may request a redacted copy of a fraudulent return that was filed and accepted by the IRS using the identity theft victim's name and SSN, the IRS explained on its website. The victim's name and SSN must be listed as either the primary or secondary taxpayer on the fraudulent return. The IRS explained that it will not disclose return information to any person listed only as a dependent because of privacy rules.

Requests for copies of fraudulent returns must be made in writing and include the name of the taxpayer and his or her SSN, mailing address, tax year(s) of the fraudulent returns being requested, and a statement declaring that the individual is the affected taxpayer. Along with the letter, taxpayers must include a copy of government-issued identification. A taxpayer's authorized representative may also request copies of fraudulent returns.

Reference: TRC IRS: 66,305.

Privilege

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did not have a common legal interest with the taxpayers. The district court also found that the documents in question were not protected by the work product doctrine because the accounting firm had not prepared the documents in anticipation of litigation.

Privilege and work product

The attorney-client privilege protects communications between a client and its attorney intended solely for obtaining or providing legal advice and that are intended to be, and in fact are, kept confidential. The privilege is generally waived if a party shares confidential communications with an outsider. The privilege is not waived by disclosure to a party that is engaged in a "common legal enterprise" with the privilege holder.

- ***Comment.*** Code Sec. 7525(a)(1) extends to communications between taxpayers and federally authorized tax practitioners the same protections of confidentiality provided to communications between clients and their attorneys.

The work-product doctrine is a separate privilege that protects documents prepared in anticipation of litigation from discovery.

Court's analysis

The taxpayers did not waive their attorney-client privilege, the Second Circuit found. They shared a common legal interest with the bank consortium sufficient to prevent a privilege waiver through the sharing of the documents. The fact that two parties shared a large financial interest did not preclude a court from finding they shared a legal interest, the Second Circuit found.

Moreover, the documents in question were immune from discovery under the work product doctrine. The documents prepared by the accounting firm were geared to an anticipated audit and litigation, which were highly likely to occur.

- ***Comment.*** The Second Circuit stated the district court's reasoning implied

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REFERENCE KEY

FED references are to ***Standard Federal Tax Reporter***
USTC references are to ***U.S. Tax Cases***
Dec references are to ***Tax Court Reports***
TRC references are to ***Tax Research Consultant***

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Agencies Finalize Regs For ACA's Market Reforms

TD 9744

The IRS, and the U.S. Departments of Health and Human Services (HHS) and Labor (DOL), have issued final regs on health insurance market reforms under the *Affordable Care Act* (ACA). The final regs address grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, appeal and review processes, and patient protections.

- ***Take Away.*** "Group health plans and health insurers generally seem happy that the new and long-awaited final market reform rules do not apply until plan years beginning on or after January 1, 2017," Tamara Killion, principal, Groom Law Group, Chartered, Washington, D.C., told Wolters Kluwer. "At the same time, there is a sense of relief that the rules do not generally add new or onerous requirements and provide welcome clarity in several areas."

Grandfather status

The final regs provide that the determination of grandfather status applies separately with respect to each benefit package and incorporate the clarifications previously issued by the agencies. To maintain this status a health plan, a group health plan, or health insurance coverage, must include a statement that the plan or health insurance coverage believes it is a grandfathered health plan in any summary of benefits provided under the plan. The final regs also clarify anti-abuse rules and application of the grandfather provisions to multi-employer plans.

Limits/integrated arrangements

The ACA generally prohibits annual and lifetime limits on essential health benefits. The final regs clarify how certain plans may select benchmark plans for determining which benefits are not subject to annual and lifetime dollar limits.

The final regulations also clarify the scope of arrangements that can be integrated with other group health plan coverage by defining and referring to "account-based plans." Account-based plans are employer-provided group health plans that provide reimbursements of medical expenses other than individual market policy premiums, with the reimbursement subject to a maximum fixed dollar amount for a period.

Rescissions

Under the ACA, a group health plan or health insurance issuer offering group or individual health insurance coverage cannot rescind coverage unless a covered individual commits fraud or makes an intentional misrepresentation of material fact. This standard applies to all rescissions, whether in the group or individual insurance market, or self-insured coverage. The final regs reiterate that the ban on rescissions is not limited to rescissions based on prior medical history.

Dependents

A group health plan or a health insurance issuer offering group or individual health insurance coverage that makes available dependent coverage of children must make the coverage available for children until attainment of 26 years of age. Beginning in 2014, children up to age 26 have the ability to remain on their parent's employer plan even if they have another offer of coverage through an employer.

Appeals and reviews

The ACA provides standards for plans and issuers regarding both internal claims and appeals and external review. The final regs clarify, among other provisions, notifications of benefit determinations and what constitutes full and fair review.

References: FED ¶47,041; TRC HEALTH: 18,108.

Privilege

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that tax analyses and opinions created to assist in large, complex transactions with uncertain tax consequences can never have work-product protection from IRS subpoenas. This approach, the Second Circuit observed, would be contrary to its decision in *Adlman.* There the Second Circuit had found that work product immunity was appropriate for a document if "in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation."

References: 2015-2 USTC ¶50,555; TRC IRS: 21,400.

IRS Launches 2016 PTIN Renewal Season

The IRS's online preparer tax identification number (PTIN) website is accepting renewals for 2016, the agency has announced. All current PTINs will expire after December 31, 2015.

- ***Comment.*** On social media, Carol Campbell, director of the IRS Return Preparer Office, urged practitioners to avoid a last minute rush to renew their PTINs. "It's easy to let this slip as the holiday season approaches." The IRS Return Preparer Office also reminded preparers of the reduced PTIN fee structure (*see the November 5, 2015 issue of this newsletter for details*).

PTINs. All tax return preparers who are compensated for preparing, or assisting in the preparation of, all or substantially all of any U.S. federal tax return, claim for refund, or other tax form submitted to the IRS must obtain a PTIN, subject to limited exceptions.

The IRS encouraged preparers to renew their PTINs online. Alternatively, preparers may submit Form W-12, IRS Paid Preparer Tax Identification Number Application and Renewal.

IR-2015-125; TRC IRS: 6,106.05.

IRS Provides Transition Relief For Interest Crediting Rates Used By Hybrid Plans

TD 9743

The IRS has issued final hybrid plan rules that allow a plan with a noncompliant interest crediting rate to be amended for benefits that have already accrued so that its interest crediting rate complies with the market rate of return rules. The amendment must be adopted prior to, and be effective no later than, the applicability date of the regulatory market rate of returns rules. This is generally the first day of the plan year that begins on or after January 1, 2017.

- ***Take Away.*** The IRS issued these regs to address a conflict between the anti-cutback rules in Code Sec. 411(d)(6) and the interest crediting requirement in Code Sec. 411(b)(5)(B)(i). The latter provision requires that the plan not provide an effective rate of return that exceeds a market rate of return. The IRS noted that it has authority to provide for the elimination or reduction of protected benefits that have already accrued, if necessary to permit compliance with other qualified plan requirements.

Background

A hybrid plan is a defined benefit plan that uses a lump-sum based formula, including cash balance plans and pension equity plans. The IRS issued final hybrid plan regs in October 2010 (TD 9505) and September 2014 (TD 9693) (together, the "final hybrid plan regs"). For plan years beginning on or after January 1, 2016, the final hybrid plan regs provide a list of interest crediting rates and rate combinations that satisfy the requirement to provide an effective rate no greater than a market rate of return.

- ***Comment.*** These rates can be investment-based rates or non-investment based rates, such as fixed rates or bond-based rates.

Proposed regs also issued in 2014 would permit amendments to change the interest crediting rate to satisfy this requirement, for plan years that begin on or after January 1, 2016.

New regs

Commenters asked for more time for plans to be amended to change its interest crediting rate. The final regs (TD 9743) delay the applicability dates of certain provisions in the final hybrid plan regs, including the requirements for interest rates that do not exceed a market rate of return, until plan years that begin on or after January 1, 2017.

Prior to this date, a plan that uses an impermissible interest crediting rate must be amended to change to a permissible rate. The regs permit amendments that change the specific feature of the interest crediting rate that is noncompliant, without changing other features of the existing rate.

The final regs generally apply to plan amendments made on or after September 18, 2014 (or an earlier date elected by the taxpayer). They do not apply to amendments made on or after the first day of the first plan year that begins on or after January 1, 2017. For collectively-bargained plans, the regs continue to apply for amendments made for plan years starting on or after January 1, 2019.

References: FED ¶47,040; TRC RETIRE: 39,058.20.

IRS Clarifies Rules For Qualified Student Loan Bonds

Notice 2015-78

The IRS has issued guidance to update and clarify various requirements regarding qualified student loan bonds under Code Sec. 144(b). The guidance addresses eligible borrowers, the student nexus requirement, the loan size limitation, and the types of loans eligible for refinancing.

- ***Take Away.*** Tax-exempt private activity bonds may be issued to provide funds for both direct and indirect student loans to pay the costs of post-secondary education. State Supplemental Loan (SSL) programs are programs of general application approved by a state, provided that no loan exceeds the difference between the total cost of attendance and other forms of student aid for which the borrower may be eligible.

Background

Student loan bonds could be initially used for the Federal Family Education Loan Program (FFELP), authorized in 1965, which provided indirect loan guarantees from the federal government. In some cases, parents of undergraduate students could obtain loans. The guarantee program applies only to loans originated before July 1, 2010.

SSL requirements

Eligible borrowers. An eligible borrower of an original loan under an SSL program is a student or is a parent borrowing for a child who is a student. An eligible borrower of a refinancing loan is the student or parent borrower of the original loan. The guidance thus confirms that a parent may borrow for a child's education.

Student nexus requirement. Both loan programs have a student nexus requirement. The student must either be a resident of the state from which the loan's volume cap under Code Sec. 146 was derived, or must be enrolled at a school located in the state issuing the bonds.

The student nexus requirement applies to the loan's student beneficiary, even if the parent is the borrower. The requirement for an original loan applies when the original loan is made. The requirement for a refinancing loan applies when either the

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Generic Drug Manufacturer Required To Capitalize Legal Fees Incurred To Obtain FDA Approval

FAA 20154502F

The IRS has determined in field attorney advice (FAA) that a generic drug manufacturer, who filed an abbreviated new drug application (ANDA) with a ¶IV certification, was required to capitalize legal fees related to its application to the Food and Drug Administration (FDA) for an FDA-approved ANDA. The legal fees required to be capitalized under Code Sec. 263A were incurred to defend patent infringement and also for related filings and proceedings before the FDA.

- ***Take Away.*** Generally, legal costs incurred by a taxpayer to defend against a claim of patent infringement are deductible as business expenses. However, otherwise deductible costs, when incurred in a capital transaction, must be capitalized. Here, the taxpayer's legal costs were incurred for the purpose of creating capital assets.

Background

The taxpayer was a manufacturer of generic drugs subject to the FDA's regulations. These regulations provide that after developing a generic drug, the manufacturer must submit to the FDA an ANDA to obtain the FDA's approval to sell the drug within the U.S. The ANDA applicant must certify that its generic drug will not infringe on the patents disclosed by the NDA holder. There are four types of certifications, and the one at issue in this FAA (¶IV certification) required the generic drug maker to incur expenses both for development of the drug and legal fees for evaluation of the patents relative to their validity and the scope of the claims in the patents. The IRS was asked whether these legal fees could be deducted or should be capitalized.

IRS analysis

The legal fees could not be deducted. Using the "origin of the claim test," the IRS determined that the origin of the claim as to the legal fees incurred to make the ¶IV certification, and to defend the patent litigation, was the ANDA with the ¶IV certification. All of the legal fees at issue had a sufficiently direct connection with the creation of intangible assets, the IRS reasoned. Therefore, the character of the legal fees was capital in nature, and the fees must be capitalized.

- ***Comment.*** Under the origin of the claim test, the character of a particular expenditure is determined by the transaction or activity from which the taxable event proximately resulted. The inquiry is whether the claims in the litigation had their origin in the conduct of the taxpayer's ordinary and necessary business activities or whether the claims were rooted in a capital transaction.

The IRS also determined that FDA-approved ANDAs were Code Sec. 197 intangibles, amortizable ratably over a 15-year period, beginning the first day of the month that the FDA approved the ANDA, provided that all applicable exclusionary periods had expired and provided that the trade or business requirement was met. The annual cost recovery of the capitalized legal fees also must be capitalized under Code Sec. 263A.

The proposed capitalization was also a change to the drug manufacturer's accounting method because the manufacturer had previously deducted the costs. Therefore, a Code Sec. 481(a) adjustment, measured by the aggregate amount of all legal fees expended to create the ANDA with a ¶IV certification deducted in prior years, was required.

Reference: TRC BUSEXP: 12,304.05.

Bonds

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original or refinancing loan was originated.

Loan size limitation. The amount of an SSL may not exceed the difference between the total cost of attendance and other forms of assistance for which the student is eligible. For an original loan, an issuer may rely on a certificate of amounts from the student's school. For a refinancing loan, the original loan must have met the loan size limit, and the stated principal amount of the loan cannot exceed the loan's outstanding principal and any accrued but unpaid stated interest.

Loans eligible for refinancing. SSLs may refinance an original loan that was an SSL or another type of original loan, including FFELP loans and loans by a private lender.

References: FED ¶46,446;
TRC SALES: 51,406.

Three States, One Territory Face FUTA Credit Reductions For 2015

The U.S. Department of Labor (DOL) recently announced the *Federal Unemployment Tax Act* (FUTA) credit reduction for three states and the U.S. Virgin Islands for 2015. Employers in these affected jurisdictions must adjust their FUTA credit for the reduction when they file 2015 Form 940, Employer's Annual Federal Unemployment Tax (FUTA) Return, DOL explained.

Background. Employers may receive a FUTA credit of 5.4 percent for payment of state unemployment insurance tax. However, the credit may be reduced where states have made loans from the Federal Unemployment Trust Fund and have outstanding loan balances on January 1 for two consecutive years, and do not repay the full amount of the loans by November 10 of the second year.

Credit reduction. For 2015, DOL reported that California, Connecticut, Ohio, and the U.S. Virgin Islands face a FUTA credit reduction. The final FUTA tax rates for 2015 are 2.1 percent for Connecticut, and 1.5 percent for California, Ohio, and the U.S. Virgin Islands.

www.dol.gov; TRC PAYROLL: 9,104.

IRS Using International Practice Units To Instruct Auditors

www.irs.gov, International Practice Units

The Large Business and International (LB&I) division, and its International office, have been issuing international practice units (IPUs) to provide information and guidance to its auditors and other employees. IPUs are an important tool in LB&I International's knowledge management efforts.

- ***Take Away.*** "For IRS agents, these are basic educational tools," George Hani, member, Miller & Chevalier Chartered, Washington, D.C., told Wolters Kluwer. "They discuss a fact pattern and issues and provide a framework" for agents to determine whether there are issues to examine, Hani said. "Some IPUs discuss concepts—issues that may arise—while others are more aggressive [and] may be used as audit tools to ferret out transactions." IPUs can also be used by taxpayers to determine what transactions interest the IRS and to prepare for potential questions, he said.

Background

LB&I employees previously determined audit priorities through the tiered issue process, which was eliminated in 2012. This process was inflexible and could hamstring exam teams in developing audits. The newer audit process has been lauded for giving agents and exam teams more flexibility on how to resolve issues.

- ***Comment.*** "IPUs discuss common everyday transactions used by taxpayers. This is not a "gotcha" approach that identifies problem transactions and instructs auditors to look for bad actors," Hani said.

IPUs

The IRS website has a description of IPUs and provides links to all the IPUs released by LB&I International. International has issued 80 units as of November 13, 2015. The first were issued December 15, 2014; the latest are being released currently. IPUs can run from 10 to 50 pages or more. Since the beginning of November this year, International has issued five IPUs, addressing royalty income, licensing of intangible property, CFC (controlled foreign corporation) status, Form 5471 penalties, and Subpart F income.

According to the IRS, IPUs serve as both job aids and training materials on international issues. IPUs can provide explanations of general international tax concepts as well as information about a specific type of transaction. They are a mechanism for IRS employees to share knowledge and collaborate. IPUs "will continue to evolve" and will be updated periodically as the IRS learns more about the subject matter and "as the compliance environment changes." The IRS cautions that IPUs are not official pronouncements of law, and cannot be used, cited, or relied upon as an official pronouncement.

Types of IPUs

Process units. IPUs include process units, transaction units, and concept units. The latest IPU, released November 13, 2015, is a process unit for an audit, entitled Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty. A process unit includes process overview, summary of process steps, and other considerations and impacts to audit. One of the initial process units on the website is entitled First Year Election Under IRC §7701(b)(4), released December 15, 2014

Transaction units. A recent transaction unit is entitled the License of Intangible Property from U.S. Parent to a Foreign Subsidiary. It was released November 4, 2015. A transaction unit includes an issue and transaction overview, a summary of potential issues, and audit steps. One of the steps recommended in this unit is that the examiner consult with APMA (LB&I's Advance Pricing and Mutual Agreement Program) if the case involves a valuation adjustment.

Concept units. Concept units are general explanations of an area of the tax law. They do not provide instructions for audits, unlike other types of IPUs. An example of a concept unit is entitled an Overview of FDAP, issued December 15, 2014.

Reference:TRC IRS: 3,106.

IRS Makes Progress In Curbing Business Tax Identity Theft, TIGTA Reports

TIGTA, Ref. No. 2015-40-082

The Treasury Inspector General for Tax Administration (TIGTA) has applauded the IRS for increasing awareness about business tax-related identity theft. At the same time, TIGTA urged the agency to increase its efforts and its outreach to businesses.

- ***Take Away.*** "Identity theft continues to be a serious and evolving issue which has a significant impact on tax administration," J. Russell George, Treasury Inspector General for Tax Administration, said in a statement. "It is incumbent upon the IRS to use all tools to detect and prevent business identity theft from occurring."

IRS actions

TIGTA reported that the IRS has taken a number of steps to curb business-related identity theft and refund fraud. In addition to defining business identity theft, the IRS has created procedures for employees to follow when they are made aware of a potential business identity theft situation. The IRS also created Form 14039-B, Business Identity Theft Affidavit, to gather information used to determine whether a business's identity has been stolen and conducted a business Identity Theft Project to detect potential business identity theft relating to the filing of Forms 1120 reporting overpayments and claiming refundable credits.

Reference: TRC IRS: 66,305.

District Court Finds *IES Industries* Distinguishable In Dispute Over Foreign Tax Credits And STARS Transactions

Wells Fargo & Co., DC-Minn., November 10, 2015

A federal district court rejected a taxpayer's argument that application of foreign tax credits to a structured trust advantaged repackaged securities (STARS) transaction was akin to the transaction in *IES Industries, Inc., 2001-2* USTC *¶50,471 (CA-8).* The court found the two transactions were distinguishable.

- ***Take Away.*** In *Bank of New York Mellon Corp., 2015-2* USTC *¶50,473 (CA-2)* and *Salem Financial, Inc., 2015-2* USTC *¶50,304 (CA-FC),* the appellate courts found that the STARS transactions were shams and the banks were not entitled to take foreign tax credits in connection with those transactions. The taxpayers have petitioned for Supreme Court review.

Background

The taxpayer engaged in a complex STARS transaction with a bank in the U.K. The taxpayer transferred assets to a trust, which made the assets subject to taxation in the U.K. The taxpayer received distributions of the trust's income, reduced by an amount to pay the U.K. taxes and a management fee. The U.K. bank also made an additional monthly payment to the taxpayer. The IRS disallowed the taxpayer's claim of foreign tax credits.

Court's analysis

The court first noted that under the sham transaction doctrine, a court must disregard a transaction that a taxpayer enters into without a valid business purpose to claim tax benefits not contemplated by a reasonable application of the language and the purpose of the Internal Revenue Code or its regs. A court must ask if a taxpayer's claim to foreign tax credits is tied to true business abroad resulting in actual out of pocket tax payments, or whether its claim to a tax credit derives from sham transactions devoid of a business purpose beyond exploiting differences among foreign tax codes.

The court distinguished the taxpayer's case from *IES Industries.* In *IES Industries,* the taxpayer had purchased the right to dividend payments from foreign companies and claimed a foreign tax credit for the amount of the dividend that was withheld and paid over to the foreign government as tax. The Eighth Circuit allowed the tax credits, finding that this was no different than an employer withholding a portion of its employees' wages to pay over to the government as income tax, the district court observed.

- ***Comment.*** The court also rejected the taxpayer's motion for summary judgment that it was motivated by a non-tax business purpose in entering into the STARS transaction.

References: 2015-2 USTC *¶50,558;*
TRC SALES: 3,154.

TAX BRIEFS

Internal Revenue Service

The IRS has issued a fact sheet on the importance of keeping well-organized tax records. The fact sheet discussed basic recordkeeping tips, including what records are needed to prepare a return and how to keep them. The IRS has also recommended that taxpayers keep a duplicate set of records in a separate location in case of emergency.

FS-2015-26, FED ¶46,447;
TRC ACCTNG: 3,052.05

Liens and Levies

The government was entitled to foreclose federal tax liens against a couple's home and sell it to satisfy their delinquent tax obligations from the 10 tax years at issue. The liens were valid and attached to the property, and the couple failed to show that any third-party would be harmed if the property was sold in the judicial sale. The couple claimed that they would be prejudiced by a forced sale considering their age, retirement, health issues and that they lived in the home for many years; however, the court found there are virtually no circumstances in which it would be permissible to refuse to authorize a sale simply to protect the interests of the delinquent taxpayer.

Nichols, DC Wash., 2015-2 USTC *¶50,554;*
TRC IRS: 45,160

Refund Claims

An individual's claim that an IRS Appeals officer incorrectly determined that he owed the IRS money and sustained a proposed levy was properly dismissed. The individual had received a double refund for the tax year at issue, once in the form of a check and again in the form of a credit against the tax liability on his subsequent year's tax return. The IRS first attempted to collect the erroneous refund by creating a new assessment for the tax year at issue, but later abated the assessment, refunded the set-off amount, and abandoned its levy. However, the IRS kept the two voluntary payments the individual made after he discovered the erroneous refund. The individual argued that the Tax Court could order the IRS to refund the voluntary payments. The Tax Court dismissed his claim because neither an unpaid liability nor a pending levy action remained for the Tax Court to review. The individual had received all of the relief available to him under Code Sec. 6330, and his Tax Court claim was moot.

Willson, CA-D.C., 2015-2 USTC *¶50,548;*
TRC LITIG: 6,136.25

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Passive Losses

A married couple was not entitled to a refund because they could not use disallowed partnership losses that were suspended for future use to offset nonpartnership income. Since the couple had elected to offset their partnership passive activity income with passive losses from other sources, they could not take a deduction pursuant to Code Sec. 469 and at the same time use income from the Code Sec. 469 calculation to access losses suspended pursuant to Code Sec. 465. However, the couple was entitled to refunds attributable to their pre-TEFRA carryover credits and based on their partnership investment credits. Since the IRS's disallowance of the plaintiffs' pre-TEFRA carryover credits was not a computational adjustment, the IRS's disallowance of the credits was unlawful in the absence of a notice of deficiency.

Mandich, FedCl, 2015-2 USTC ¶50,552; TRC PART: 60,058

False Tax Returns

An accountant was not entitled to judgment of acquittal or new trial after his conviction for preparing false tax returns. Evidence that the accountant falsified an undercover officer's tax return was properly admitted and the jury was properly instructed. The evidence showed that the accountant had inflated the undercover agent's charitable contribution and employment expense deductions and did not tell the agent that he did, nor did he ask her to, review them. Therefore, the return and evidence of the undercover meeting were highly probative of the accountant's knowledge, intent and lack of mistake in preparing similar false returns for his clients.

E. Campbell, DC N.Y., 2015-2 USTC ¶50,550; TRC IRS: 66,204

Tax Crimes

An individual was properly convicted of endeavoring to obstruct the administration of the internal revenue laws. The evidence clearly established that the individual filed false liens against various IRS agents and officers intending to secure an unlawful benefit, which satisfied the requirement that the obstruction be undertaken corruptly. Moreover, the individual waived counsel despite the court's warning that this was unwise.

Molen, CA-9, 2015-2 USTC ¶50,557; TRC IRS: 66,356

An individual was properly convicted of tax evasion and willful failure to file income tax returns; therefore, he was not entitled to a new trial. Although the individual claimed that the handwriting report the government relied on was actually written by the government's expert witness, he failed to produce any evidence to support his claim. Moreover, the evidence showed that the individual was responsible for filing Forms 990 for an exempt organization, that he knew he was required to file the returns and that he willfully failed to do so.

Paul, CA-11, 2015-2 USTC ¶50,556; TRC IRS: 66,152.25

IRS Reminds Taxpayers Of Advantages Of Health FSAs

As 2015 draws to a close, the IRS has reminded taxpayers to take advantage of health flexible spending arrangements (FSAs), if eligible. Health FSA dollars may be used to pay qualified medical expenses.

Contributions. For the 2016 plan year, an individual may contribute up to $2,550. Amounts contributed are not subject to federal income tax, Social Security tax or Medicare tax. If the plan allows, the employer may also contribute to an employee's FSA.

Expenditures. Qualified medical expenses include co-pays, deductibles and a variety of medical products and services ranging from dental and vision care to eyeglasses and hearing aids. The "use or lose" provision generally requires participants to incur eligible expenses by the end of the plan year, or forfeit any unspent amounts. A carryover option, if available, allows participants to carry over up to $500 of unused funds to the following plan year. Under the grace period option, an employee has until 2 1/2 months after the end of the plan year to incur eligible expenses.

- ***Comment.*** Employers can offer either the health FSA carryover option or the grace period option, but not both options, or they can offer neither option.

IR-2015-126; TRC HEALTH: 18,150.

IRS Advises Field Attorneys On Reasonableness Of Compensation For Research Or Experimental Expenditures

In Field Attorney Advice, the IRS has provided direction to an outside expert on the standards for determining and evaluating the reasonableness of compensation under Code Secs. 162 and 174(a). The IRS confirmed that there were different standards for determining the reasonableness of compensation under Code Sec. 162 for a deduction as an ordinary and necessary business expense from those under Code Sec. 174 for treatment as a research or experimental expenditure.

The IRS stated that, while the reasonableness of compensation under Code Sec. 162 looked at all of the activities performed by an employee, the determination under Code Sec. 174 was limited to the employee's research or experimental activities. Furthermore, the compensation for research and experimental services was reasonable if the amount would ordinarily be paid for activities by similar enterprises under similar circumstances. Therefore, industry standards were important in determining whether compensation was reasonable.

The IRS also confirmed that when evaluating the reasonableness of compensation, total compensation was the relevant measure. This included all salary, bonuses, deferred compensation, fringe benefits and other taxable and non-taxable payments. In addition, the IRS advised that the expert should include in his or her report various services performed and the percentage of the expert's time devoted to each activity.

FAA 20154501F.

PRACTITIONERS' CORNER

New Partnership Audit Rules Shift Tax Liabilities Between Partnerships And Partners

The *Bipartisan Budget Act of 2015* (signed into law by President Obama on November 2, 2015) repealed the TEFRA rules for auditing partnerships, as well as the rules applicable to electing large partnerships (ELPs). In their place it created a new, streamlined set of rules for auditing partnerships and their partners at the partnership level. Although generally effective for partnership tax years beginning after December 31, 2017, a partnership may elect to come under the new audit regime for any tax year starting after November 2, 2015.

- ***Comment.*** There is growing consensus among practitioners that the new partnership audit rules as they were enacted will need to be supplemented by IRS regulations and, perhaps, technical corrections before they can be operational. In fact, that was one of the purposes of the delayed, 2018 effective date. To that end, Curtis Wilson, IRS Associate Chief Counsel (Passthroughs & Special Industries), commented recently that he expects parts of the new rules will require IRS guidance—or Congressional clarification—to make them fully workable. In the meantime, partnerships and their partners should consider amendments to partnership agreements—as well as indemnity agreements in situations of the sale/acquisition of partnership interests—that may accommodate the IRS's new ability to pursue current partners for deficiencies caused by prior year returns.

Wolters Kluwer's 2015 Tax Legislation, Law, Explanation and Analysis, ¶154, Partnership Audit Rules (now available on IntelliConnect) takes some first steps in explaining the new rules, which are spread over more than 50 Tax Code amendments. The following article is based in large part on that examination, with particular focus on how the new audit regime may shift tax liabilities between a partnership and its partners.

Reviewed/adjustment-year approach

There have been three different regimes for auditing partnerships:

- Partnerships with 10 or fewer partners (small partnerships);
- Partnerships with more than 10 partners (TEFRA) partnerships); and
- partnerships with 100 or more partners that elect to be treated as electing large partnerships (ELPs).

"The new partnership audit rules as they were enacted will need to be supplemented by IRS regulations and, perhaps, technical corrections."

New rules. Under the new audit rules, the IRS will examine the partnership's items of income, gain, loss, deduction, or credit, and any partners' distributive shares of the items, for a particular year of the partnership (the so-called "reviewed year"). Any adjustments to partnership items will be determined at the partnership level and taken into account by the partnership and not the individual partners. These adjustments will be made in the year that the audit or any judicial review is completed (the so-called "adjustment year") and will be collected at the partnership level (unless the partnership elects to pass the adjustment through to its partners). For this purpose, any adjustment will include any tax attributable to the adjustment that is assessed and collected, and any related penalty, addition to tax, or additional amount.

Election to opt out

Partnerships with 100 or fewer qualifying partners may opt out of the new audit regime. Partnerships that opt out will be audited under the general rules applicable to individual taxpayers. The opt-out is available provided that each partner is an individual, C corporation, foreign entity that would be a C corporation under U.S. law, an S corporation, or the estate of a deceased partner. Thus, for example, it appears that lower-tiered partners eliminate a partnership's ability to opt out, irrespective of the number of partnerships.

Duty of consistency

Under the new audit rules, a partner must generally treat on the partner's return a partnership item of income, gain, loss, deduction, or credit attributable to a partnership in a manner consistent with the treatment of that item on the partnership return. Any underpayment of tax attributable to a partner's failure to comply with the consistency requirement is treated as if the underpayment were due to a mathematical or clerical error (that is, an underpayment that is immediately collectible without issuance of a notice of deficiency). A partner, however, may escape liability by timely filing with the IRS a notification identifying the inconsistency.

Partnership adjustments

In the event that the IRS adjusts any item of a partnership's income, gain, loss, deduction, or credit, or partners' distributive shares of such items, the partnership will be required to pay any imputed underpayment with respect to the adjustment in the adjustment year (Code Sec. 6225(a)). If a partnership ceases to exist before a partnership adjustment takes effect, the adjustment is taken into account by the former partners of the partnership

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WASHINGTON REPORT *by the Wolters Kluwer Washington News Bureau*

Conference agreement on highway bill could come soon

At press time, House and Senate negotiators are ironing-out a multi-year federal highway and transportation bill. The House and Senate have both included tax-related offsets in their respective highway bills. One provision would authorize the IRS to engage the services of private collection agencies to collect some tax debts. Another provision would revoke or deny U.S. passports to individuals with seriously delinquent tax debts. Congressional aides have indicated that a conference agreement could be reached and a final bill passed by Congress before the Thanksgiving recess. *For more details on the movement of the highway bill in Conference, see Tax Day on IntelliConnect.*

Former IRS leaders describe impact of budget cuts

Seven former IRS commissioners, in a letter to the chairs and ranking members of the House and Senate Appropriations Committees, have expressed their concerns regarding the IRS's budget for fiscal year (FY) 2016. House and Senate appropriators have approved different funding levels for the IRS for FY 2016. House appropriators have approved an $838 million reduction in the Service's budget for FY 2016. Senate appropriators approved legislation that would cut the IRS's budget by $470 million for FY 2016.

"The appropriations reductions for the IRS over the past five years total $1.2 billion. None of us ever experienced, nor are we aware of, any reductions of this magnitude over such a prolonged period of time," the former commissioners wrote. The former commissioners added that "reductions in IRS appropriations are difficult to understand as Congress repeatedly has passed major tax legislation to substantially increase the IRS workload, most recently, the *Foreign Account Tax Compliance Act* (FATCA) and the *Affordable Care Act* (ACA), two major new programs, each of which significantly expands the IRS's tax administration burdens."

Additionally, the former IRS commissioners mentioned that customer service has suffered because of the budget cuts. "Because of insufficient IRS resources in FY 2015, an average of more than 60 percent of the taxpayers who called the IRS for assistance in preparing their returns could not reach an IRS assistor."

Portman urges lawmakers to take up international tax reform

The U.S. is facing an international tax crisis that will only get worse if Congress fails to act, according to Finance Committee member Rob Portman, R-Ohio, speaking at the Bipartisan Policy Center in Washington, D.C., on November 10. Portman said if the U.S does not make changes to its tax system it will continue to hurt workers and investment, and contribute to a lackluster economy. "Companies are using the Tax Code to do their best to avoid their taxes. They are doing it in the context of a Tax Code that is so extraordinarily noncompetitive," Portman said.

Portman also discussed the Base Erosion and Profit Shifting (BEPS) project by the Organisation for Economic Co-operation and Development (OECD). Portman said that the BEPS project is leading more and more U.S. companies to question if their current status of being able to do business overseas and pay relatively low taxes can continue.

TE/GE deputy commissioner outlines challenges and goals

Although confronted with budgetary challenges, the IRS Tax Exempt/Government Entities (TE/GE) Division is committed to five key focus areas, Donna Hansberry, TE/GE Deputy Commissioner, told practitioners in Washington, D.C. on November 12. Hansberry spoke at an event sponsored by ALI-CLE. Hansberry identified five key focus areas to guide what TE/GE plans to accomplish in FY 2016 and beyond: continuous improvement, knowledge management, risk management, data driven decision making, and employee engagement.

One challenge to TE/GE, and all of the IRS, is budgetary pressure, Hansberry said. The IRS is operating under budget constraints, Hansberry said. The budget cuts have resulted in the loss of some 15,000 employees through attrition over the past five years, Hansberry reported. "Without employee engagement, we will have a difficult time meeting our goals."

The IRS launched Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, 16 months ago, Hansberry reported. "The form now accounts for more than half of all applications received." It takes the IRS approximately 15 days to process Form 1023-EZ if there are no questions and approximately 45 days if there are questions, Hansberry said.

Three countries sign FATCA accords with U.S.

Angola has signed an intergovernmental agreement (IGA) with the U.S. to implement the provisions of the Foreign Account Tax Compliance Act (FATCA). The agreement with Angola is a Model 1 IGA. Azerbaijan and San Marino have also signed FATCA agreements with the U.S. The agreement with Azerbaijan is a Model 1 IGA. The agreement with San Marino is a Model 2 IGA. "The signing marks a significant step forward in our efforts to work collaboratively to combat offshore tax evasion, an objective that mutually benefits both," John Phillips, U.S. ambassador to San Marino, said in a statement.

TIGTA reviews IRS computer security interconnections

Many of the computer system interconnections the IRS uses do not have proper authorization or security agreements, according to the Treasury Inspector General for Tax Administration (TIGTA). Because taxpayer and other sensitive data must be protected, the IRS is required to ensure that external system interconnections satisfy technical and security requirements. However, TIGTA found that the IRS office established to provide oversight and guidance for the development of security agreements is not responsible for managing or monitoring agreements for all external interconnections. TIGTA also found that improvements are needed to ensure that existing agreements contain all required elements.

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"under regulations prescribed by the IRS" (Code Sec. 6241(7)).

Any imputed underpayment with respect to any partnership adjustment for any reviewed year will generally be determined by:

(1) netting all item adjustments and multiplying the net amount by the highest rate of tax in effect for the reviewed year under Code Sec. 1 (income tax) or Code Sec. 11 (alternative minimum tax), including adjustments for increases and decreases resulting from any adjustments to items of credit, and

(2) treating any net increase or decrease in loss under (1) as a corresponding decrease or increase in income (Code Sec. 6225(b)(1)).

If any adjustment for any reviewed year results in the reallocation of distributive shares from one partner to another, the adjustment will be taken into account for purposes of the determination of an imputed underpayment for a reviewed year by disregarding any decrease in any item of income or gain and any increase in any item of deduction, loss, or credit.

Modifications of imputed underpayments

The IRS is directed to establish procedures whereby the partnership's imputed payment may be modified under a number of different situations (see Code Sec. 6225(c)(1)). If one or more partners files amended returns for the reviewed year in which all partnership adjustments are taken into account and pays any resulting tax due with the amended return, then the adjustments reflected in the amended returns will be subtracted for purposes of determining the imputed underpayment. However, if any adjustment reallocates distributive share from one partner to another, the adjustments will only be disregarded in determining the imputed underpayment if all affected partners also file amended returns.

The IRS is also directed to make other allowances "for modifications of imputed underpayments it deems necessary and appropriate" (Code Sec. 6225(c)(5)).

Alternative to payment by partnership

A partnership may make an election within 45 days of the date of the notice of final partnership adjustment to not apply the adjustment rules at the partnership level under Code Sec. 6225, but rather at the partner level (Code Sec. 6226(a)). The election must be made in the manner to be provided by the IRS and the partnership must also furnish to each partner of the partnership for the reviewed year a statement of the partner's share of any adjustment to income, gain, loss, deduction or credit.

- ***Comment.*** This option allows the adjustment to be shared by those taxpayers who were partners during the earlier reviewed year, which in many cases would be the more equitable and more favorable result (especially for those partners taxed at other than the highest rate and those with available offsets).

Regardless of the operation of this election, any penalties, additions to tax, or other amounts are determined at the partnership level (Code Sec. 6226(c)). However, interest on an imputed underpayment passed through to a partner as a result of an election under Code Sec. 6226 is computed at the partner level, from the date of the due date for the tax year to which the increase in the imputed payment is attributable, at the federal short-term rate plus five percentage points.

Assessment, collection, and payment

Any imputed underpayment with respect to any partnership adjustment for any reviewed year as provided under Code Sec. 6225 will be treated for assessment and collection purposes as if it were a tax imposed (Code Sec. 6232(a)). Normal assessment and collection proceedings will be followed, except in the case of an imputed underpayment resulting from an administrative adjustment request under Code Sec. 6227, in which case the underpayment shall be paid when the request is filed.

No assessment of a deficiency will be made before the close of the 90th day after the day on which a notice of final partnership adjustment was mailed and before a decision of a court has become final where the partnership petitioned for judicial review of an adjustment under Code Sec. 6234. Any violation of these restrictions may be enjoined by the proper court, including the Tax Court (Code Sec. 6232(c)). However, the Tax Court will not have jurisdiction to enjoin in the absence of a petition for judicial review under Code Sec. 6234, and then only with respect to the adjustments subject to the petition.

The partnership may waive these restrictions on the making of any adjustment (Code Sec. 6232(d)(2)). If no proceeding for judicial review of an adjustment is begun during the 90-day period after the date of the notice of final partnership adjustment, the amount for which the partnership is liable cannot be larger than the amount determined in accordance with the final notice.

Interest and penalties

In the case of a partnership adjustment for a reviewed year, interest and penalties are imposed at the partnership level, except where Code Sec. 6226(c) operates to make partners liable for interest on an imputed underpayment for which they are liable under a Code Sec. 6226 election (Code Sec. 6233(a)).

Judicial review

Within 90 days after the date on which a notice of final partnership adjustment is mailed, the partnership may petition for readjustment with the Tax Court, the U.S. District Court for the district in which the partnership's principal place of business is located, or the Federal Claims Court (Code Sec. 6234). Similar to any judicial proceeding, a petition with the U.S. District Court or Federal Claims Court is only allowed once the amount of imputed underpayment is deposited with the IRS.

COMPLIANCE CALENDAR

November 20

Employers deposit Social Security, Medicare, and withheld income tax for November 14, 15, 16, and 17.

November 25

Employers deposit Social Security, Medicare, and withheld income tax for November 18, 19, and 20.

November 30

Employers deposit Social Security, Medicare, and withheld income tax for November 21, 22, 23, and 24.

December 2

Employers deposit Social Security, Medicare, and withheld income tax for November 25, 26, and 27.

December 4

Employers deposit Social Security, Medicare, and withheld income tax for November 28, 29, 30, and December 1.

December 9

Employers deposit Social Security, Medicare, and withheld income tax for December 2, 3, and 4.

TRC TEXT REFERENCE TABLE

The cross references at the end of the articles in Wolters Kluwer Federal Tax Weekly (FTW) are text references to Tax Research Consultant (TRC). The following is a table of TRC text references to developments reported in FTW since the last release of New Developments.

ACCTNG 33,152.05	528	HEALTH 3,300	519	IRS 66,305	550
ACCTNG 36,162.05	517	HEALTH 18,000	556	IRS 66,305	554
BUSEXP 3,050	518	HEALTH 18,108	551	IRS 66,360	505
BUSEXP 6,106.15	542	INDIV 33,354	541	PART 3,504	506
BUSEXP 9,104.20	529	INDIV 39,052	541	PART 60,054	496
BUSEXP 12,304.05	553	INDIV 63,052	503	PART 60,552	506
COMPEN 15,208	504	INTL 33,050	538	PAYROLL 9,104	553
COMPEN 27,252.10	513	IRS 3,052	539	REORG 100	517
ESTGIFT 3,158	529	IRS 3,106	554	RETIRE 39,058.20	552
ESTGIFT 45,252.45	542	IRS 3,200	527	RETIRE 66,750	537
EXCISE 9,102.05	530	IRS 3,208.05	543	SALES 3,154	555
FILEBUS 9,108	501	IRS 6,106.05	526	SALES 6,156	507
FILEBUS 9,158	540	IRS 6,106.05	551	SALES 51,100	527
FILEBUS 9,322	494	IRS 9,400	528	SALES 51,406	552
FILEBUS 9,458.10	531	IRS 21,400	549	SCORP 304.10	540
FILEIND 15,204.05	514	IRS 24,106	504		
HEALTH 3,250	503	IRS 60,102	495		

FROM THE HELPLINE

The following questions have been answered recently by our "Wolters Kluwer Tax Research Consultant" Helpline (1-800-344-3734).

Q What is the recovery period for computers under the Modified Accelerated Cost Recovery System (MACRS) depreciation system?

A Code Sec. 168(g)(3)(C) assigns a recovery period of five years to "any qualified technological equipment," which includes computers. *See TRC DEPR: 3,458 for more information.*

Q Are the costs incurred by a blind worker to maintain his seeing-eye dog that he uses in the conduct of his daily business deductible as a business or medical expense?

A Rev. Ruls. 57-461 and 55-261 have addressed this issue by explaining that the cost of a "seeing-eye" dog and its maintenance are expenses paid primarily for the alleviation of the physical defect of blindess. They are, therefore, generally deductible as a medical expense. Medical expenses, unlike deductible business expenses, are subject to an independent adjusted-gross-income floor before they can be deducted. *See TRC INDIV: 36,318 for more information.*