

# Tax Practice & Procedures

## CIRCULAR 230 BEST PRACTICES • PASSIVE ACTIVITY GROUPING DISCLOSURE STATEMENTS • NET OPERATING LOSS AND THE IRS • ASSESSMENT PERIOD REMAINS OPEN IN PARTNERSHIP CASE



### Circular 230 Best Practices

Circular 230, Section 10.33, on best practices deals with providing advice and preparing a submission to the IRS. This section affects several aspects of tax practice, including clear client communications, the importance of the conclusions reached, acting fairly and with integrity, and having procedures to ensure best practices. Section 10.33 says about best practices:

- (a) *Best practices.* Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:
- (1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the tax advice and should have a clear understanding with the client of the form and scope of the advice or assistance to be rendered.
  - (2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potential applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
  - (3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
  - (4) Acting fairly and with integrity in practice before the Internal Revenue Service.
- (b) *Procedures to ensure best practices for tax advisors.* Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.
- The steps practitioners should use in providing advice to clients include:
- Establishing the facts;
  - Determining relevancy;
  - Evaluating reasonableness of assumptions or representations;

- Relating applicable law to relevant facts; and
- Arriving at a conclusion supported by the law and the facts.

The IRS has indicated that best practices are “aspirational,” thereby giving CPAs latitude in their practices to implement the necessary procedures to conform with best practices. The comments in the Circular 230 revision state:

These best practices are aspirational. A practitioner who fails to comply with best practices will not be subject to discipline under these regulations. Similarly, the provision relating to steps to ensure that a firm’s procedures are consistent with best practices, now set forth in §10.33(b), is aspirational. Although best practices are solely aspirational, tax professionals are expected to observe these practices to preserve public confidence in the tax system. [T.D. 9165, “Explanation of Provisions.”]

While aspirational, best practices apply to both oral and written advice, and tax practitioners should embrace them as a tool to better operate their practices and assist their clients while still remaining an advocate for their clients. Reasonable steps to conform to this approach are expected and may be a factor if any legal problems arise with an engagement.

Implementation of best practices will require different procedures depending on the size of the firm and its area of expertise. Section 10.33(a) states that practitioners should use best practices in “providing advice and in preparing or assisting in the preparation of a submission to IRS.” This broad language would make this section applicable to all areas of tax practice, including both formal and informal advice, oral and written, given to clients. Section 10.33(a)(1) advocates communicating terms of engagement to clients, which would indicate that engagement letters in some form should be used.

This mandate is all inclusive and creates the responsibility for all CPAs to re-evaluate their procedures for their tax practice. Small firms without established tax departments may have a significant burden in conforming with Section 10.33.

Likewise, time and fee burdens may make it difficult to implement certain provisions of this section.

Practice units will have to consider many matters, including the use of engagement letters, tax return checklists, adequate review of returns prepared, workflow, document retention, tax research materials, client acceptance and retention, and the use of a written memo whenever oral advice is given. CPAs will need to rely on external practice tools, printed material, continuing education, and possibly increases in staff to help them conform with Section 10.33. CPAs will be required to exercise professional judgment as to what is necessary to conform with this section.

Voluntary compliance with this section by CPAs who know the particular needs and technical areas of their practice will result in better “best practices” than a government mandate would. The AICPA’s Tax Division has devoted a significant amount of time and resources to helping members provide the highest quality tax services to the public. Tax advisers should consult the Tax Center website (<http://tax.aicpa.org/>) to review the available information and apply it to their practices. The Tax Center website includes:

- Practice guides and checklists;
- E-alerts;
- Resource pages;
- Sec. 7216 practice guide and information;
- AICPA Statements on Standards for Tax Services;
- Information on Report of Foreign Bank and Financial Accounts (FBAR); and
- Quality control recommendations.

The IRS website also provides information for practitioners, and both the *Journal of Accountancy* and *The Tax Adviser* regularly cover practice topics.

### Practical Considerations

The IRS language for best practices is aspirational. Tax practitioners should embrace this approach as a tool to better operate their practices and be advocates for their clients. The full text of Circular 230 is available at [www.irs.gov/pub/irs-pdf/pcir230.pdf](http://www.irs.gov/pub/irs-pdf/pcir230.pdf).

From Gerard H. Schreiber Jr., CPA, Metairie, LA

## Passive Activity Grouping Disclosure Statements

The passive activity loss and credit limitation rules in Sec. 469 apply to individuals, trusts, estates, personal service corporations, and closely held C corporations. The rules prevent taxpayers subject to them from applying losses or credits generated by rental activities and activities in which they do not materially participate against investment income, compensation, or income from activities in which they do materially participate. In order to be treated as materially participating in an activity, a taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis.

Taxpayers who are involved in multiple separate but related trade or business activities may find it difficult to meet the stringent material participation requirements of Sec. 469 for each activity. In addition, activities that involve property rental are treated as passive activities regardless of whether the taxpayer materially participates. As a result, the application of the passive activity rules could produce harsh results were it not for provisions in Regs. Sec. 1.469-4(c)(1) that allow taxpayers to treat separate activities as a single activity for the purposes of Sec. 469. Generally, a taxpayer may treat multiple trade, business, or rental activities as a single activity if the facts and circumstances indicate that they constitute an appropriate economic unit.

The rules in Regs. Sec. 1.469-4 place limits on which activities may be aggregated and limit the ability of taxpayers to change groupings from year to year. Once a taxpayer has grouped activities for a tax year, changes to groupings are generally not allowed. Changes are required, however, when it is determined that the taxpayer’s original grouping was clearly inappropriate or becomes inappropriate as a result of a material change in the facts and circumstances.

### Grouping Disclosure Statements

Except for a special provision in Regs. Sec. 1.469-9(g) that applies only to certain real estate professionals, taxpayers have not been required to file grouping election forms or disclosure statements. As a result, it is difficult for

the IRS to determine whether groupings are appropriate or whether prohibited changes have been made to groupings.

In 2008, the IRS issued Notice 2008-64, in which it proposed rules to require the filing of written statements with tax returns to disclose the grouping of activities under the passive activity regulations. After considering comments on the proposed rules, the IRS recently issued Rev. Proc. 2010-13, which provides final rules pertaining to the filing of passive activity grouping disclosure statements.

The new rules require written disclosure statements to be filed for activities that are grouped for the first time for tax years that begin on or after January 25, 2010. The statements must:

- Be filed with the tax return;
- Disclose the names, addresses, and EINs of trade, business, or rental activities that are grouped; and
- Include an attestation that the activities together form an appropriate economic unit for the purposes of Sec. 469.

Groupings that were made before the effective date of the revenue procedure are not required to be disclosed. However, when additions or changes are made to groupings, a disclosure statement must be filed with the required information for each activity within the resultant groupings, including the attestation that the grouped activities form an appropriate economic unit. The disclosure must also include an explanation of the justification for the change—specifically, why the taxpayer's original grouping was inappropriate or what material change in the facts and circumstances makes the original grouping inappropriate.

## Partnerships and S Corporations

Rev. Proc. 2010-13 does not require additional disclosures by partnerships and S corporations. Groupings of activities for the purposes of Sec. 469 are already required to be disclosed on statements filed with Forms 1065, U.S. Return of Partnership Income, and 1120S, U.S. Income Tax Return for an S Corporation. The new rules do not require partners and shareholders to make separate disclo-

sure of groupings that were reported by passthrough entities. However, partners and shareholders must separately disclose when:

- They group together activities of an entity that were not grouped together by the entity;
- They group an entity's activities with activities conducted directly by the partners or shareholders; and
- They group an entity's activities with activities conducted by other entities.

## Failure to File a Grouping Disclosure Statement

The failure to file a required disclosure statement with a tax return will generally result in the activities' being treated as separate activities for the application of the passive activity loss and credit limitations unless the taxpayer can establish good cause for the failure to disclose. However, Rev. Proc. 2010-13 includes a relief provision for taxpayers who discover the error before the IRS discovers it, treat the groupings consistently, and file the required disclosure statement with the return for the year in which the error was discovered.

*From John Slatten, CPA, Indianapolis, IN*

## Net Operating Loss and the IRS

Recent legislation has amended Sec. 172(b)(1)(H), which gives taxpayers an ability to carry back a net operating loss (NOL) for a period of three, four, or five years to offset taxable income in those preceding years and obtain refunds of taxes paid. The IRS's ability to make adjustments to the affected returns is an important consideration for taxpayers when deciding whether to make the carryback election and how many years to include. This item focuses on the procedures for filing returns, the IRS examination policy and procedures, and implications to be aware of.

## Seeking a Refund Based on an NOL Carryback

Taxpayers can apply for a refund based on a loss carryback by either filing an amended return or filing an application for tentative refund on the appropri-

ate forms. Generally, a taxpayer must file an application for a tentative refund no later than 12 months after the close of the tax year in which the NOL was incurred. For example, the taxpayer must file the application for a tentative refund for a NOL incurred during a calendar year by December 31 of the following year. The IRS has issued guidance in the form of two revenue procedures that provide rules for filing the appropriate forms under the legislation. Taxpayers filing as an eligible small business (ESB) should review Rev. Proc. 2009-19 (as modified by Rev. Proc. 2009-26), and taxpayers with NOLs arising in tax years ending after December 31, 2007, and beginning before January 1, 2010, should consult Rev. Proc. 2009-52 for rules related to making the election and when to file the application.

The obvious advantage of filing an application for tentative refund, as compared with filing an amended return, is that the IRS must process a tentative refund within 90 days of receipt, provided the application is prepared correctly and contains no material errors. The amount requested in a tentative refund claim is paid prior to an examination, even if the amount of the requested refund is in excess of \$2 million (the statutory amount subject to review by the Joint Committee on Taxation (JCT)). However, amended returns are claims for refund and are therefore subject to IRS scrutiny before payment of the refund. These returns can be examined or accepted as filed but may require JCT review prior to the payment of any refund. The examination process can last for more than a year, depending on the span and scope of examination activity.

## Examination of NOL and Carryback Years

Depending on the taxpayer's filing method, the IRS can recoup the prior tentative refund by assessment, or it can reduce the amount of refund requested either by disallowing a taxpayer's claim for refund through the examination of the loss year or by making adjustments to the carryback year(s).

## The NOL Year

The IRS can examine and adjust the loss year return to determine the correct amount of NOL available for carryback. Assuming a reduced NOL, if the taxpayer filed an application for tentative refund, the IRS can recover the tax refunded and make an assessment to the carryback year(s) even if the normal statute of limitation on assessment has expired. If the taxpayer filed amended returns, the IRS would be able to reduce the amount of the claimed refund to the extent that the NOL carryback is reduced. If the IRS does not make a change to the NOL year, it will then look to the carryback year(s).

## The Carryback Year

If the carryback year was previously examined, the IRS will not reexamine it except in specific circumstances. (To reopen a prior examination year, IRS Policy Statement P-4-3 requires evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact; a clearly defined substantial error based on an established IRS position existing at the time of the previous examination; or other circumstances indicating that failure to reopen would be a serious administrative omission (Internal Revenue Manual §1.2.13.1.1 (12/21/84).) Assuming that reopening criteria are not present, the IRS would further process the case.

If the IRS did not previously examine the carryback year, it is free to examine the issues on the return to determine the correct taxable income of the year before allowance of the carryback. Once determined, the NOL carryback is applied to offset the corrected taxable income, and any excess NOL will be available for carryover to the next carryback year. That year will be subject to the same examination procedures.

For any carryback year in which the statute of limitation on assessment has expired, any resulting tax increases would be limited to the amount of the refund; however, the NOL carryback could be reduced or eliminated by the tax increases, precluding any further carryover to other tax years.

Other implications of the NOL carryback to consider include the suspension of the 90% limitation for computation of the alternative minimum tax, a 50% limitation on the deductibility of the NOL in the fifth preceding year, the effect on allowable and deficiency interest computations, the use or loss of tax credits, and, for some corporate taxpayers, the potential impact on their financial statements.

## Summary

The change to the NOL carryback rules has given taxpayers the opportunity to obtain refunds of taxes paid in earlier years. However, to maximize the overall position, taxpayers must be wary of the rules relating to NOLs and the interaction between the various sections of the law and IRS policy. A taxpayer should make the decision to elect to carry back a NOL to a closed tax year only after a complete analysis and risk assessment.

From William O'Meara, CPA, Philadelphia, PA

*The views expressed herein are those of the author and do not necessarily reflect the views of Ernst & Young LLP.*

## Assessment Period Remains Open in Partnership Case

In *Blak Investments*, 133 T.C. No. 19 (2009), the Tax Court applied Sec. 6501(c)(10) to extend the assessment statute of limitation for a taxpayer with an undisclosed listed transaction on a return due prior to October 22, 2004.

## Background

This case involved a transaction in which two partners (1) borrowed Treasury securities and sold them in the open market (a short sale), (2) contributed the short sale proceeds, as well as the obligation to cover the short sale, to a partnership in exchange for interests in that partnership, and (3) claimed that their bases in the partnership were increased by the short sale proceeds but were not reduced by the obligation to cover the short sale. After the contribution, the partnership redeemed the partners' interests, and the partners claimed significant losses on their federal income tax

returns. Neither the partnership nor the partners had adequately disclosed their participation in the transaction on their federal income tax returns for the 2001 and 2002 tax years, which were filed on October 15, 2002, and October 15, 2003, respectively. The IRS issued a final partnership administrative adjustment (FPAA) on October 13, 2006, disallowing the losses and imposing accuracy-related penalties.

The Tax Court held that the transaction at issue was a listed transaction because it was substantially similar to the son-of-boss transactions described in Notice 2000-44, which determined that those are listed transactions. The more interesting issue in the case, however, was whether the effective date of Sec. 6707A precludes the application of Sec. 6501(c)(10) to the transaction at hand.

## Statute of Limitation Applicable to Partnership and Partner Assessments

Secs. 6501(a) and 6229(a) contain the statute of limitation rules applicable to partnership and partner assessments. Sec. 6501(a) contains the general rule limiting the period in which the IRS can assess tax to three years from the date a return is filed. Sec. 6229(a) guides the timely issuance of an FPAA and provides that an FPAA may be issued within three years from the later of (1) the date on which the partnership return for the tax year was filed or (2) the last day for filing the return for that year, determined without regard to extensions.

Sec. 6501(c)(10) may extend the statute of limitation on assessment under certain circumstances. It provides that if a taxpayer fails to disclose on a return or statement for any tax year information required under Sec. 6011 for a listed transaction, as defined in Sec. 6707A(c)(2), the period of limitation does not expire until one year after the IRS is given this information. Sec. 6501(c)(10) was enacted as part of the American Jobs Creation Act of 2004, P.L. 108-357 (AJCA), on October 22, 2004, and was effective for tax years for which the period for assessing a deficiency had not expired before October 22, 2004.

Sec. 6707A, which imposes penalties for failure to disclose reportable and listed transactions, was also added to the Code by the AJCA and was effective for returns due after October 22, 2004, that were not filed prior to that date. Sec. 6707A(c)(2) defines the term “listed transaction” as “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.”

## The Interplay and Applicability of Secs. 6501(c)(10) and 6707A

The taxpayer in this case argued that because Sec. 6707A is incorporated into Sec. 6501(c)(10), the effective date of Sec. 6707A should control; therefore, Sec. 6501(c)(10) cannot apply to any transaction for which a return or statement was due on or before October 22, 2004.

The Tax Court acknowledged that Sec. 6707A(c) applies to statements and returns due after October 22, 2004, while Sec. 6501(c)(10) applies to tax years for which the period for assessing a deficiency did not expire before October 22, 2004. The court concluded:

Because AJCA makes section 6501(c)(10) applicable for tax years for which the period of limitations remains open as of the date of enactment of the AJCA, section 6501(c)(10) may apply to transactions which are required to be disclosed on returns due well before that date and which therefore would not be subject to a section 6707A penalty if left undisclosed. For that reason, application of the effective date of section 6707A to section 6501(c)(10) would render the express effective date of section 6501(c)(10) meaningless, violating the cardinal principle of statutory construction.

## Conclusion

The Tax Court held that Sec. 6501(c)(10) is effective for tax years for which the period for assessing a deficiency did not expire before October 22, 2004, and that the effective date of Sec. 6707A, defining a listed transaction and incorporated into Sec. 6501(c)(10), had no bearing on

the application of Sec. 6501(c)(10) in this case. This meant that the limitation period for assessment of tax resulting from the adjustment of partnership items for the 2001 tax year was open under Sec. 6501(c)(10). This demonstrates that taxpayers with undisclosed reportable or listed transactions in tax years for which the Sec. 6501(a) statute of limitation was open on October 22, 2004, may have potential exposure.

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