



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.31.5

APRIL 21, 2025

EFFECTIVE DATE

(04-21-2025)

PURPOSE

- (1) This transmits a revision of IRM 4.31.5, Pass-Through Entities, Investor Level Statute Control (ILSC) Examinations - Field Office Procedures.

MATERIAL CHANGES

- (1) The chapter title of the IRM was changed from Pass-Through Entity Handbook to Pass-Through Entities.
- (2) IRM 4.31.5.1 - Program Scope and Objectives:
 - a. Paragraph (6) - Updated Policy Owner to reflect LB&I's new ownership of IRM 4.31.5.
 - b. Paragraph (7) - Updated Program Owner to reflect LB&I's new ownership of IRM 4.31.5.
 - c. Paragraph (10) - Clarified contact information.
- (3) IRM 4.31.5.1.3 - Roles and Responsibilities:
 - a. Paragraph (1) - Replaced Director, SB/SE Headquarters Examination, Field and Campus Policy to Director, PTE PA to correspond with LB&I's new ownership and responsibilities of IRM 4.31.5.
 - b. Paragraph (2) - Replaced Program Manager, SB/SE, Examination Field and Campus Policy, Campus Exam and Field Support to Deputy Director, PTE Field Support to correspond with LB&I's new ownership and responsibilities of IRM 4.31.5.
- (4) Throughout:
 - a. The IRC citations listed in the table below have been modified to include "of 2002" after each citation, when applicable. This was added to the relevant citations because those subsections of the law have since been removed or changed:

Affected Citation References	IRC Year Version Added
IRC 6231(a)(1)(B)	2002
IRC 6231(a)(1)(B)(i)	2002
IRC 6231(a)(1)(B)(ii)	2002
IRC 6231(g)	2002

- b. Hyperlinked all relevant citations and forms.
- c. Corrected citation references.
- d. Updated website links.
- e. Stylistic editorial, grammar, formatting and spelling changes.

EFFECT ON OTHER DOCUMENTS

IRM 4.31.5, Pass-Through Entities, Investor Level Statute Control (ILSC) Examinations - Field Office Procedures, dated 05-07-2022 is superseded.

AUDIENCE

Field and Technical Services personnel working pass-through entities that are not subject to TEFRA or have a valid election out of BBA or their investors.

Ronald H. Hodge, II
Assistant Deputy Commissioner Compliance Integration
Large Business and International Division

4.31.5

Investor Level Statute Control (ILSC) Examinations - Field Office Procedures

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4.31.5.1
(04-21-2025)
Program Scope and Objectives

- (1) This Internal Revenue Manual (IRM) section provides guidance on field office procedures related to examinations of Investor Level Statute Control (ILSC) pass-through entities that elect out of the Bipartisan Budget Act of 2015 (BBA), partnership not subject to provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, and S corporations.
- (2) The purpose of this section is to define ILSC pass-through entities and to outline and explain how to use the IRS's available resources to process these types of cases. Technical issues will not be found in this part of the IRM. Audit techniques for partnerships and S corporations are found in IRM 4.10, Examination of Returns.
- (3) The Internal Revenue Code (IRC) references in this IRM are reflective of the TEFRA law, and not the BBA law passed in 2015 that used the same code sections (IRC 6221 through IRC 6248) unless proceeded by BBA. BBA examination procedures are in IRM 4.31.9, Centralized Partnership Audit Regime (BBA) Field Examination Procedures.
- (4) **Purpose:** This IRM describes:
 - Investor Level Statute Control (ILSC) Pass-Through Entity Defined
 - Researching ILSC Entities
 - ILSC Risk Analysis
 - Specialist Referral System (SRS)
 - Examination Returns Control Systems (ERCS) TEFRA Indicator
 - Entity Statutes and Amended Return Statutes
 - Entity Examination Procedures
 - Pass-through Control System (PCS) (formerly Partnership Control System)
 - Linking the Key Case and Investors on PCS
 - Investor Considerations
 - Report Writing Procedures for Entity and Key Cases
 - Pass-Through Disposition
 - Investor Disposition; and
 - Technical Services Pass-through Coordinator Duties for ILSC Entities-Linked Return Processing.
- (5) **Audience:** Field examination revenue agents (RAs) and campus RAs, tax compliance officers (TCOs), tax examiners (TEs) and clerks working pass-through entities and/or their investors linked on the PCS.
- (6) **Policy Owner:** LB&I Policy under the Strategy, Policy and Governance (SPG) office in the Assistant Deputy Commissioner Compliance Integration (ADCCI) organization, Director, Pass-Through Entities (PTE) own the field examination policies. The SB/SE Director, Examination Field and Campus Policy, who reports to the Director, Examination Headquarters, owns the Technical Services policies in this IRM.
- (7) **Program Owner:** Director, Pass-Through Entities (PTE), except for IRM 4.31.5.17, which is owned by Field Examination General Processes (FEGP), which is under the SB/SE Director, Examination Field and Campus Policy.
- (8) **Primary Stakeholders:** SB/SE, Large Business and International (LB&I), and Appeals.

- (9) **Program Goals:** Establish an electronic linkage between the pass-through entities being examined and their underlying investors in order to generate notices, monitor and control statutes, and gather closing information.
- (10) **Contact Information:** To recommend changes or make any other suggestions related to this IRM section, contact the IRM author or see SPDER's IMD Contacts list by referencing guidelines provided in IRM 1.11.6.5, Providing Feedback About an IRM Section-Outside of Clearance. A request or inquiry can also be made using the *LB&I Policy Gateway*.

4.31.5.1.1
(05-17-2022)
Background

- (1) Election of Subchapter S status allows a business the advantages of the corporate structure of organization without being subject to the potential tax disadvantages of C corporations. Examples of these advantages include exclusion from the double taxation on distributions and liquidations and the ability for the shareholders to use corporate losses. IRC 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an election under IRC 1362(a) is in effect.
- (2) TEFRA was passed in 1982 to allow examinations and statutes to be controlled at the partnership level. TEFRA was replaced by the centralized partnership audit regime in the BBA for tax years beginning after December 31, 2017. Certain small partnerships and S corporations are not subject to TEFRA. The period to assess investors of entities not subject to TEFRA or BBA is determined at the investor level.
- (3) BBA applies to all partnerships, but allows some eligible partnerships to elect out. Partnerships that elect out of BBA require investor level statute control. Partnership returns beginning after November 2, 2015 and before January 1, 2018 may elect into BBA. BBA does not impact S corporation entity examinations.
- (4) There are four possible partnership regimes:
 - a. BBA partnerships for tax years beginning after December 31, 2017, or who made a valid early election into the BBA for tax years beginning after November 2, 2015 and before January 1, 2018.
 - b. Partnerships that make a valid election out of BBA for tax years beginning after December 31, 2017.
 - c. TEFRA for partnerships for tax years beginning before January 1, 2018 and which did not make an early election into the BBA.
 - d. Non-TEFRA for partnership tax years beginning before January 1, 2018 that are not statutorily TEFRA, or did not elect into TEFRA.
- (5) PCS is a database that was created to establish an electronic linkage between pass-through entities and their underlying investors. This helps ensure that all investors are noticed and adjusted in a timely manner. PCS linkage allows business operation divisions (BODs) to recognize when a taxpayer is subject to a pass-through examination. If an examiner chooses not to control investors returns, it allows the campus to work those investors so the examiner can focus on examining the pass-through entity. PCS also allows the campus to systemically generate notices, control statutes, and gather closing information.

4.31.5.1.2
(04-05-2019)
Authority

- (1) Linkage policy was established in response to the partnership provisions of the TEFRA. Similar policies exist for S corporations and those partnerships that elect out of BBA.

4.31.5.1.3
(04-21-2025)
Roles and Responsibilities

- (1) The Director, Pass-Through Entities (PTE) Practice Area (PA) is responsible for the policies and procedures in this IRM section.
- (2) The Deputy Director, Pass-Through Entities Field Support, has responsibility for oversight of territories, led by program managers, comprised of groups of employees who provide servicewide technical and procedural support for examinations of pass-through entities.
- (3) Field territory managers, field area directors, Director over LB&I Ogden and Director, Examination - Brookhaven, are responsible for ensuring that linked pass-through policies and procedures are followed.
- (4) Field examination managers and campus field support operations managers are responsible for:
 - a. Maintaining an updated copy of IRM 4.29, Pass-Through Control System (PCS) Handbook, in their respective functions;
 - b. Ensuring the training of technical and clerical employees in linked pass-through procedures; and
 - c. Establishing PCS records and acting on PCS reports in a timely manner to assure an accurate PCS database.
- (5) Following are specific Campus Pass-Through Function (CPF) ILSC Coordinator responsibilities:
 - a. Coordinate with campus, Technical Services and Appeals pass-through coordinators on case processing issues;
 - b. Coordinate with Examination Field and Campus Policy (EFCP) on any legal issues that need to be addressed by Chief Counsel;
 - c. Review closing packages for completeness;
 - d. Provide technical support to employees.
 - e. Work with other campus functional areas to ensure timely processing of linked pass-through related returns.
- (6) The campus PCS Coordinator is charged with:
 - a. Identifying and resolving technical problems
 - b. Identifying and coordinating the resolution of PCS systemic problems

4.31.5.1.4
(05-17-2022)
Program Management and Review

- (1) **Program Reports:** Each year an exam plan is created for pass-through examinations.
- (2) **Program Effectiveness:** The exam plan is monitored to ensure the linked pass-through examination objectives are met. Open partnership examinations are monitored to ensure the correct audit regime is recorded on ERCS.

4.31.5.1.5
(05-17-2022)
Program Controls

- (1) The Audit Inventory Management System (AIMS) provides a statute report, AIMS Table 4.0, that the field monitors to ensure field controlled investor cases are worked timely. See IRM 4.4.27.5, AIMS Reports Generated at the Campuses.

4.31.5.1.6
(05-17-2022)

**Terms/Definitions/
Acronyms**

- (1) There are several terms unique to PCS linked returns. Examples of these words:

Defined Terms and Acronyms

Word	Definition
AIMS	Audit Information Management System (AIMS) provides inventory and activity controls of active Examination cases. It uses linkage to Integrated Data Retrieval System (IDRS) to input status changes, adjustments, and case closing actions.
BBA	Bipartisan Budget Act of 2015. The centralized partnership audit regime affects all partnerships filed with tax years beginning after December 31, 2017.
BEO	BBA Elect Out. Partnerships that elect out of the centralized partnership audit regime (BBA).
CPF ILSC Coordinator	Campus Pass-through Function Investor Level Statute Control Coordinator acts as a liaison between the CPF and the field offices, Appeals and Counsel for ILSC cases. The CPF ILSC Coordinator also provides technical support for the CPF.
CC	Command Code
CCP	Centralized Case Processing (CCP) processes assessments and abatements and closes or transfers cases from the area to the campus or to files. Memphis supports SB/SE and Ogden supports LB&I.
CPF (Formally CTF)	The Campus Pass-Through Function (CPF) is the suspense unit for investor returns located in the Brookhaven campus and Pass-through Entities (PTE) Ogden. The two CPFs will be maintained to obtain and control, through the AIMS and PCS, investor returns related to PCS linked key cases within their jurisdiction. For details see Campus Pass-through Function IRM 4.31.3 and IRM 4.31.6.
EIN	Employer Identification Number
ILSC	Investor Level Statute Control are pass-through entities (Form 1120-S or Form 1065) where the assessment periods are controlled at the investor level. Proceedings involve investors in S corporations and partnerships that are not subject to TEFRA or elect out of BBA.
IRC	Internal Revenue Code

Investor	Partner, Shareholder, or Beneficiary - An investor return that reflects pass-through items from a pass-through entity return, which is controlled (via PCS and AIMS). Examples of investor returns for ILSC purposes generally includes, Form 1040, Form 1041(1120-S only), Form 1120 (BEO only), and Form 1120-S (BEO only).
Key Case	The examined ILSC pass-through entity, a Form 1065, U. S. Return of Partnership Income or a Form 1120-S, U. S. Income Tax Return for an S corporation, that results in pass-through items to investors.
LB&I	Large Business and International serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million.
LIN	LB&I Imaging Network (LIN) is a system used by LB&I to store images of returns.
Linkage	The process by which the IRS in its electronic systems associates an investor to a pass-through entity.
Non-TEFRA	Partnership returns that are statutorily excluded from TEFRA procedures. Impacts partnership returns with tax years beginning September 3, 1982 and before January 1, 2018.
PCS	Pass-through Control System (PCS) is a database used to establish an electronic linkage between a key case pass-through entity and its underlying investors. The database is used to manage inventory, systemically generate notices, and control statutes.
PICF	Partnership Investor Control File (PICF) Indicator. The Partnership Investor Control File (PICF) indicator prevents an AIMS account from closing until all linkage record freezes are released. The PICF indicator is automatically set on the AIMS record by establishing the record on the PCS. The PICF indicator appears on an AIMS AMDISA display by the literal PICF Code on page 1.
RA	Revenue Agent (RA)
Record	Information stored on the PCS database for a key case or an investor.
SB/SE	Small Business and Self-Employed. Serves taxpayers who file Form 1040, Schedules C, E, F or Form 2106, as well as small businesses with assets under \$10 million.

TCO	Tax Compliance Officer (TCO)
TE	Tax Examiner (TE)
TS	Technical Services (TS) is the field review staff.
TSPC	The Technical Services Pass-Through Coordinator (TSPC) in TS acts as a liaison between the area and the CPFs for PCS linked cases. The field examiner can locate their TSPC by using the using the Technical Services Pass-through Coordinator (TSPC) listing on the <i>Partnership Knowledge Base</i> .
TEFRA	Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. The act unified audit and litigation procedures for partnerships. We use TEFRA to refer to these procedures, and the affected returns. Partnerships are subject to TEFRA procedures by statute, or those excluded by statute may elect into TEFRA. Impacts partnership returns with tax years beginning September 3, 1982 and before January 1, 2018.
Tier	A pass-through entity that is an investor of a pass-through entity. For example, an S corporation could be a tier partner of a BEO partnership or an estate of a decedent individual could be an investor in an S corporation or BEO.

4.31.5.1.7
(05-17-2022)

Related Resources

- (1) The following IRM cross-references may be helpful:
 - a. Management of Interrelated and Related Cases: IRM 4.31, Pass-Through Entities
 - b. AIMS: IRM 4.4, Audit Information Management System (AIMS) - Validity and Consistency
 - c. PCS: IRM 4.29, Pass-Through Control System
 - d. Statutes IRM 25.6.23, Examination Process-Assessment Statute of Limitations Controls
 - e. *Partnership Knowledge Base*
 - f. *S Corporations Knowledge Base*

4.31.5.1.7.1
(05-17-2022)

Contact with Potentially Dangerous Taxpayers (PDT) or Caution Upon Contact (CAU) Taxpayers

- (1) If the examiner needs to contact a taxpayer designated as Potentially Dangerous Taxpayers (PDT) or Caution Upon Contact (CAU), please refer to IRM 25.4, Employee Protection, for the most current guidance.

4.31.5.2
(05-17-2022)
**ILSC Pass-through
Entity Defined**

- (1) Form 15260, Determination of Pass-through Audit Regime, must be completed to ensure the correct audit procedures are used. The completed Form 15260 will be included in the audit file to document that the partnership is or is not subject to the TEFRA or BBA procedures. SB/SE examiners will file Form 15260 and other work papers together with Form 15261, Investor Level Statute Control (ILSC) Procedures Check Sheet, under a separate line item in Section 600 on the Form 4318, Examination Workpapers Index. LB&I Industry Case examiners will file the check sheets and work papers under SAIN number 724 on Issue Management System (IMS) and Form 4764-B, LB&I Examination Plan, Part III - Examination Procedures Section. The examiner's manager is to review Form 15260 and work papers to ensure that the correct audit regime is used. The manager's signature on the Form 15260 indicates that the various audit regimes were reviewed and correctly considered.
- (2) An ILSC pass-through entity is any S corporation, or partnership that does not fall under the provisions of TEFRA or elects out of the BBA provisions. They are usually the types of entities described below. The completion of Form 15261, Investor Level Statute Control (ILSC) Procedures Check Sheet, is mandatory for every ILSC pass-through entity examined. SB/SE examiners will file Form 15261 and other work papers together with Form 15260 under a separate line item in Section 600 on the Form 4318, Examination Workpapers Index. LB&I Industry Case examiners will file the check sheets and work papers under SAIN number 724 on Issue Management System (IMS) and Form 4764-B, LB&I Examination Plan, Issue Worksheet. The examiner's manager is to review the ILSC Procedures Check Sheet and work papers. The manager's signature on the Form 15261 indicates that the ILSC pass-through procedures were followed.
- (3) An ILSC pass-through entity:
 - a. In general, has no tax liability for itself, but passes the tax consequences to its shareholders, partners, or beneficiaries. An S corporation is a pass-through entity but can also pay tax at the entity level.
 - b. There is no unified proceeding as in TEFRA or a partnership level determination of an Imputed Underpayment as in BBA. Deficiency proceedings (30 and 90 Day letters) are used. However, there are similar letters that are used to keep taxpayers informed and similar procedures for linking cases on PCS.

4.31.5.2.1
(05-17-2022)
S Corporation - Defined

- (1) S corporations are not subject to TEFRA or BBA. All S corporations are ILSC examinations, however the S corporation may also be a partner in a partnership under examination and subject to those regimes as a partner.
- (2) IRC 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an election under IRC 1362(a) is in effect. A corporation elects S corporation status by properly completing Form 2553, Election by a Small Business Corporation. When an election is filed and accepted by the campus, transaction code (TC) 090 is assigned on BMFOLE and the entity's "1120 filing requirement" changes from "01" (indicating an 1120 return is due) to "02", (indicating that it has an S corporation filing requirement).

Note: The campus accepting the S election does not automatically verify that the corporation qualifies to elect S corporation status. As such, this must be confirmed during the examination.

- (3) Generally, an S election can be made at any time during the prior year or on or before the 15th day of the third month of the taxable year. A corporation may qualify for late election relief under Rev. Proc. 2013-30. Examiners do not have the authority to grant a late election. So, if the corporation qualifies for late election relief, contact the S corporation specialist by sending an email to **SBSE.S-Corp Elections*. The S corporation specialist will work with the campus to consider the request and (if granted) establish the effective date of the S election. If the corporation does not qualify for late election relief their only recourse is to request a Private Letter Ruling. See S corporation S Election Identification and Late Election Relief Issue Guide for additional information.
- (4) For more information on S corporation issues, issue guides and audit tools visit the *S Corporation Knowledge Base*. This site provides extensive resources to help examiners with their examinations. Some of the resources include S Corporation issues guides that address many issues identified in S corporation examinations.

4.31.5.2.1.1
(05-17-2022)
**S Corporation Filed –
Campus Processed as a
C Corporation**

- (1) When the corporation files a Form 1120-S but does not have a valid S election on file, the return is rejected in normal processing. The Submission Processing Campus will assign audit code “4” and will attempt to correspond with the corporation to request a copy of the approved Form 2553. If the corporation does not respond back or is unable to substantiate a valid S election, the Submission Processing Campus will notify the corporation that they should file a Form 1120 since there is no S election on file. The Submission Processing Campus will also convert the Form 1120-S to a Form 1120, but will not assess tax.
- (2) If no response is received, the Submission Processing Campus processes the return as a C corporation. Although the Submission Processing Campus processes the return as a Form 1120, the Campus generally does not assess any tax on the Form 1120 or transcribe the data for BRTF purposes. A TRDBV generally provides the detail for the return filed. In addition, an electronically filed MeF return can be pulled from the Employee User Portal (EUP).

Note: Refer to IRM 4.31.5.14.1.1, Conversion of S Corporation to C Corporation for report writing procedures.

4.31.5.2.2
(05-17-2022)
Partnerships

- (1) Subchapter K governs the formation, operation and termination of partnerships. Due to the flexibility afforded by Subchapter K, the partnership entity often becomes the vehicle of choice for abusive transactions.
- (2) For more information on partnership issues, resources and training materials, visit the *Partnership Knowledge Database*.

4.31.5.2.2.1
(04-05-2019)
**BBA Elect Out (BEO)
Partnerships**

- (1) All partnership tax years beginning on or after January 1, 2018 are subject to BBA unless an election is made with the timely filed partnership return.
- (2) Identification of returns as BBA as opposed to BBA Elect Out (BEO) is necessary in order to have a valid assessment of tax. If the IRS applies the wrong procedures, e.g., erroneously proceeds as BBA at the partnership level

rather than deficiency procedures at the investor or partner level, or vice versa, barred deficiencies and/or refunds can result.

- (3) To be eligible to elect out of BBA, the partnership must file 100 or fewer statements for the taxable year, determined by counting the number of Schedules K-1 required to be furnished under BBA IRC 6031(b) with respect to its partners. If the partnership has an S corporation as a partner, the Schedules K-1 required to be furnished to the shareholders of the S corporation count as Schedule K-1 required to be furnished by the partnership for purposes of the 100 partner limit. A listing of Schedules K-1 can be found on the Form 1065, Schedule B-2.
- (4) The agent needs to review the partnership agreement to confirm there are no ineligible partners at any time during the year, or there are no additional partners to consider. The agent needs to ensure all partners during the year received a Schedule K-1. The partnership agreement may provide information about partners that sold their interests, and may not have received a final Schedule K-1 or may not be listed on the Schedule B-2.
- (5) Agents need to do more than compare the Schedule B-2 to the Schedules K-1. Agents need to verify the Federal Tax Classification using IDRS research. Agents cannot rely solely on the forms provided by the partnership to make their determination. For example, a partnership may identify a partner as a C corporation, when they are really an S corporation with enough shareholders to make them ineligible to elect out of BBA.
- (6) Each of the partners of such partnership must be an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner.
- (7) The partnership must make its election each year with a timely filed partnership return, including extensions. The election must include a disclosure of the name, taxpayer ID number, Federal tax classification, and an affirmative statement that each partner is an eligible partner as well as any other information required by forms, instructions, and other guidance for each partner. If the partnership has any S corporation partners, the election must also include the name, taxpayer ID number, Federal tax classification, and any other information required by forms, instructions, and other guidance for each S corporation shareholder.
- (8) If the election is invalid, the partnership must be examined as a BBA partnership.

4.31.5.2.2.1.1
(05-17-2022)
Identification of Partnerships Electing Out of BBA

- (1) The following examples show how to determine if an election is valid.
- (2) Example 1: a partnership has two partners, an individual and an S corporation. The S corporation has 90 shareholders. The total number of partners for the taxable year would be 92 which is the total of the number of Schedules K-1 required to be furnished by the partnership to its two partners (the S corporation and the individual) plus the 90 Schedules K-1 required to be furnished by its S corporation partner.
- (3) Example 2: a partnership has two partners, both S corporations. One S corporation has 90 partners, and the other has 10. The total number of Schedules

K-1 required to be furnished by the partnership is 102. The two Schedules K-1 issued to the S corporations, plus the 100 Schedules K-1 issued to the S corporations' shareholders put the partnership over the limit and it is not eligible to elect out of BBA.

- (4) Example 3: a partnership has two partners, an individual and an S corporation. The S corporation has 90 shareholders. One of the S corporation shareholders is a trust with one beneficiary. The total number of Schedules K-1 required to be furnished by the partnership for purposes of determining the number of partners the partnership has for purposes of its eligibility to elect out of BBA is 92. Any Schedules K-1 issued by shareholders of an S corporation partner are not counted towards the 100 partner limit.

Note: Family attribution rules do not apply with regard to the 100 partner limit. BBA requires that all Schedules K-1 required to be issued by the partnership and any S corporation partner be counted. Although family attribution rules allow a shareholder and up to six generations of family members to be counted as one shareholder, the S corporation is required to issue each a Schedule K-1. Because the S corporation is required to issue a Schedule K-1 to each family member, BBA requires those Schedules K-1 to be counted.

- (5) Example 4: a partnership has an investor that is a foreign entity. A partner that is a foreign entity generally will be considered an eligible partner if the foreign entity would be treated as a C corporation if it were a domestic entity. The agent needs to make the determination and make it clear to the CPF that the foreign entity qualifies as a domestic C corporation, and therefore making the election valid.

4.31.5.2.2.2
(04-05-2019)
**Non-TEFRA
Partnerships**

- (1) A partnership or an LLC (limited liability company)*, which meets the small partnership exception to TEFRA partnership rules and has not elected to be included under TEFRA rules as provided in IRC 6231(a)(1)(B) of 2002. TEFRA covers partnerships returns with tax years beginning on or after September 3, 1982 through December 31, 2017.

Note: * An LLC, which has more than one member and has not elected to be classified as a corporation under 26 CFR 301.7701-3(effective January 1, 1997), will have filed Form 1065.

Note: An LLC that has only one member and has not elected to be classified as a corporation will be treated as a disregarded entity for income tax purposes.

4.31.5.2.2.2.1
(05-31-2005)
**Non-TEFRA
Determination**

- (1) Except for a transfer of interest by a partner, if at any time during the taxable year the number of partners exceeds the small partnership exception of ten partners, the return will fall under the TEFRA provisions. A partnership may have more than 10 partners during the year, but still fall within the small partnership exception, because it never had more than 10 partners at any point in time (as when sales of partnership interests cause more than 10 Schedules K-1 to be filed).
- (2) The small partnership exception does not apply to a partnership for the taxable year if any partner in the partnership during the taxable year is a pass-through partner. See 26 CFR 301.6231(a)(1)-1(a)(2). For example, a partnership con-

sisting of three partners; two individuals plus a partnership, an S corporation or trust will not meet the small partnership exception.

- (3) IRC 6231(a)(1)(B)(i) of 2002 provides that for the purposes of the small partnership exception “a husband and wife (and their estates) will be treated as one partner”. This provision is unqualified and thus should apply to a husband and wife regardless of the manner in which they hold their interests or file their returns.
- (4) A partner must have a proprietary interest in profits or capital. Therefore, if a Schedule K-1 indicates no ownership interest, no distribution of any partnership items, and no capital account balance, the person in question may not be a partner for the taxable year involved. Consult Area Counsel, Federal law controls.

4.31.5.2.2.2.2

(04-05-2019)

Election by a Small Partnership to be Included Under the TEFRA Provisions

- (1) This section is only valid for partnerships with tax years beginning before January 1, 2018.
- (2) A partnership eligible to be excluded under the rules outlined above may elect to be included under the TEFRA provisions. See IRC 6231(a)(1)(B)(ii) of 2002. The election is binding for the year for which it is made and all subsequent years unless revoked with IRS consent. Since the TEFRA election is binding for the year for which it is made, as well as all subsequent years, examiners should inquire about prior year elections. The Form 8893, Election of Partnership Level Tax Treatment, or an equivalent statement should be attached to the partnership return in the year the election is made.
- (3) Per the regulations, a partnership shall make the election by attaching a statement to the partnership return for the first taxable year that the election is to be effective. The statement shall be identified as an election under IRC 6231(a)(1)(B)(ii) of 2002, shall be signed by all persons who were partners of that partnership at any time during the taxable year to which the return relates, and shall be filed at the time (determined with regard to any extension of time for filing) and place prescribed for filing the partnership return. The partnership may make this election on Form 8893. (Under certain circumstances they may file retroactively. Contact the Technical Services Pass-Through Coordinator if the issue is raised.) See 26 CFR 301.6231(a)(1)-1(b)(2).
- (4) The Command Code (CC) MFTRA, and CFOL CC BMFOL 'E' indicate whether the partnership return may be a TEFRA return. However, the facts and circumstances, as to whether or not the partnership elected to be covered by the TEFRA procedures, are controlling.
- (5) If the examiner determines that a valid election has been filed, the procedures for TEFRA will be followed.

Note: Simply checking a box on the Form 1065 and/or completing the line for the tax matters partner on the return is not a proper election. The agent must determine if the partnership has actually filed the proper election.

4.31.5.2.3
(05-17-2022)
**Identification of ILSC
Key Case Returns**

- (1) The Form 15260, Determination of Pass-through Audit Regime, is required to be used for the identification of returns as TEFRA vs. ILSC. It is necessary in order to have a valid assessment of tax because the TEFRA and BBA partnership rules and the deficiency procedures that ILSC entities fall under are different. If the IRS applies the wrong procedures, e.g., erroneously proceeds as TEFRA at the partnership level rather than deficiency procedures at the investor level, or vice versa, barred deficiencies and/or refunds can result.
- (2) Form 1120-S returns are not subject to TEFRA by statute.
- (3) For Form 1065, the examiner must determine, for each taxable year, whether TEFRA, BBA, or ILSC procedures apply. Comments on Form 4318, Examination Workpapers Index, are required from the examiner as to whether the pass-through return is TEFRA or ILSC, and the reasons supporting this conclusion. The Form 15260, Determination of Pass-through Audit Regime, which is required to be completed will assist the examiner in making the determination.
- (4) The small partnership exception applies to partnerships or LLCs treated as a partnership, consisting of 10 or fewer partners or members, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.

Note: A partner that is a trust (including grantor trusts) or a single member LLC that it is treated as a disregarded entity, does not meet the definition “each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner”. Thus, a Form 1065 with a trust or a single member LLC as a partner/member cannot be ILSC, except possibly when the pass-through partner is not identified on the partnership return. See IRC 6231(g) of 2002.

- (5) Generally, most S corporation income is allocated to individual shareholders. It is possible for an LLC, owned by a single individual member, and certain trusts to be a shareholder in an S corporation. The Schedule K-1 may reflect the LLC or trust name and identification number rather than the individual to which the income is reported. In order to properly link the case, it is extremely important that the true shareholder is identified; the individual, trust (in the case of an Electing Small Business Trust) or estate to which the income should be reported. If the examiner cannot look at the Schedule K-1 and determine who is reporting the pass-through items, the Campus will not be able to determine it either. See also IRM 4.31.5.10.1, True/Taxable Investor Statutes (Trusts and Disregarded Entities).

Note: The S corporation is required to file Schedule B-1, Information on Certain Shareholders of an S Corporation, with Form 1120-S if at any time during the tax year a shareholder was a disregarded entity, a trust, an estate, or a nominee.

4.31.5.3
(05-17-2022)
Research

- (1) Research should be performed on the pass-through entity to identify any amended returns, secure any missing Schedules K-1, and analyze the partnership structure.

4.31.5.3.1
(05-17-2022)
IDRS

- (1) There are a variety of command codes that can assist with pass-through examinations.

Command Code	Description
AMDIS	Displays a summary of the Audit Information Management System (AIMS) File.
AMDISA	Displays a summary of the Audit Information Management System (AIMS) File for a specific year.
BMFOLE	<ul style="list-style-type: none"> Command code BMFOLE provides entity information. It will reflect whether an S election, TC 090, is on the module and its effective date. It will reflect whether an entity classification election, TC 076, is on the module and its effective date. In addition, it will provide the entity's current filing requirements. For example, Form 1120 filing requirements include 01 for a C corporation or 02 for an S corporation. BMFOLE also has a LLC indicator (LLC IND:_) that will reflect either an "S" for single member or "M" for multi member LLCs. In addition, it can provide details on who owns the S or M LLC.
BMFOLI	Command code BMFOLI provides a summary of the entity's filing history. Sometimes when a corporation is told that it does not have a valid S corporation election, the corporation simply files a Form 1065 in later years. In order for the entity to file a Form 1065, the corporation must first liquidate. The liquidation is a taxable event. When working an invalid S corporation election case, check the BMFOLI to verify the history of tax return filings for the entity.
BMFOLT	Though it may sound obvious, examiners should always pull a transcript for the year of audit to see what has been posted for the year. For example, the examiner should check for possible amended returns. Command code BMFOLT provides a transcript for any requested tax year which can be used to ascertain all items which were posted to the entity's account (tax return extensions, amended returns, etc.).
BRTVU	Displays Business Master File (BMF) return information
RTVUE	Displays Individual Master File (IMF) return information

Command Code	Description
IMFOLR	<ul style="list-style-type: none"> Provides some skeletal tax information for old and current years. This may allow the examiner to compare income for multiple years. Includes wages, interest income, taxable income, itemized deductions, total positive income, total tax, self employment tax and adjusted gross income.
BMFOLR	<ul style="list-style-type: none"> Includes net receipts, total income, ordinary income, total deductions and total assets. This command code can prove helpful to examiners in establishing the corporation's earnings and profits, shareholder's basis, or determining if financial status issues exist.
INOLE	<p>Command code INOLE provides useful cross reference data. The following definers can provide valuable information.</p> <ul style="list-style-type: none"> G - Displays name line information available for any account associated with the Taxpayer Identification Number (TIN). T - Displays name line and address information for all accounts with the same TIN. S - Displays specific data for the account's most current address. X - Displays Social Security Administration (SSA) name controls, cross-reference, and merge transaction information.

4.31.5.3.2
(05-17-2022)
Audit Codes

- (1) Audit codes exist for each return type. They are specific codes to help identify specific characteristics of a tax return. They are available for use in filtering returns for classification.
- (2) Audit codes can be found on a BRTVU or BMFOLR print. Examiners may want to review these codes on the year(s) under exam as well as prior and subsequent years to identify potential issues and gauge audit risk.
- (3) Audit codes currently assigned to S corporations can be found in IRM 3.11.217.13.1; for partnerships, they are located in IRM 3.11.15.19.1.
- (4) Audit code 4 is an indicator that the entity filed an improper return based upon its filing requirement. In order for there to be an S corporation filing requirement, an S election must be on file. See IRM 4.31.5.2.1.1, S Corporation Filed – Campus Processed as a C Corporation.
 - a. Form 1120 Audit Code 4 - Entity filed an S corporation return but it was processed as a C corporation, consistent with its filing requirement.
 - b. Form 1120-S Audit Code 4 - Entity filed a C corporation return but the return was processed as an S corporation, consistent with its filing requirement.

4.31.5.3.3
(04-05-2019)
**Special Considerations
for Limited Liability
Companies (LLCs)**

- (1) If the type of entity on the investor's Schedule K-1 is "Limited Liability Company", the agent should always check for MFT 02 on a BMFOL or check on INOLET to see if the type of return required is Form 1120, as it would be if the LLC partner has elected to be treated as a C corporation. If it has elected to be treated as a C corporation for Federal tax purposes, it will be treated as a C corporation for purposes of making an election out of BBA, and for the small partnership exception under TEFRA partnership rules.

4.31.5.3.4
(05-17-2022)
Missing Schedules K-1

- (1) To secure missing Schedules K-1 the examiner needs to ascertain whether the return was filed via paper or electronically. Use IDRS command code **TRDBV**. In the upper right-hand corner of the document, it states by form type and tax year one of the following:
 - a. **Paper** – The return was filed via paper.
 - b. **Modernized E-File (MeF)** - Applies to Form 1120-S returns that were filed electronically beginning with tax year 2003. It would also apply to Form 1065 returns beginning with tax year 2006.

4.31.5.3.4.1
(05-17-2022)
Paper Returns

- (1) **For LB&I only**, if the examiner receives a LIN image of a paper filed return that does not contain the Schedules K-1, refer to the *LB&I Image Network (LIN)* web site which provides instructions on how to access the system.
- (2) **For SB/SE**, if examiners have a paper filed return, they can send an email to **SBSE S-Corp Elections*, who can confirm if the document is available on the K-1 Image Net (KIN) system. Or examiners can request an ESTAB through their local clerical support staff who will submit the request to the examiner's area AIMS/ERCS staff. Some areas require Form 2275, Records Request, Charge and Recharge, whereas others do not, so local procedures will prevail. If Form 2275 is required, the examiner must obtain the manager's and territory manager's signature. The remarks section of Form 2275 should state, "PLEASE PULL ALL SCHEDULES K-1".

4.31.5.3.4.2
(05-17-2022)
Electronic Returns

- (1) For an electronically filed return, all the Schedules K-1 that were filed are associated with the return. Any potential Schedules K-1 that are missing were not filed with the original return and therefore, any attempts to retrieve additional Schedules K-1 may not be productive. However, if the examiner does not have the return or any Schedules K-1, they should use the Command Code TRPRT or utilize the Transcript Delivery System (TDS). The TRPRT provides all return information, including the Schedules K-1. TDS allows the examiner to specify the entire return or just Schedules K-1.

4.31.5.3.4.2.1
(05-17-2022)
Modernized e-File (MeF)

- (1) The return can be pulled from the *Employee User Portal (EUP)* - Return Request and Display (EUP-RRD).
Note: For LB&I LIN imaged MeF returns: If there are 500 or more Schedules K-1 the LIN image of the MeF return will not contain any Schedules K-1; they must be viewed/printed from the EUP-RRD.
- (2) If the local clerical support staff has any questions or problems securing the Schedules K-1, they should review IRM 2.3.73-17 and contact a member of their area AIMS/ERCS staff.

4.31.5.3.4.2.2
(05-17-2022)

**Employee User Portal
(EUP)**

- (1) *Employee User Portal (EUP)* is used to access Return Request and Display (RRD) application. The RRD application displays specific tax return and status information for tax returns processed by the Modernized e-File (MeF) application. Access through EUP is based on portal defined permissions for the following user roles:
 - a. Help Desk User
 - b. Tax Return User
 - c. IRS Employee
 - d. Error Resolution System (ERS) User

4.31.5.3.5
(05-17-2022)

yK1 Analysis

- (1) *yK1* is a valuable tool for larger entities. It allows the user to evaluate the size of the partnership structure. It can help the examiner determine the impact of an adjustment on the underlying partners.
- (2) The *yK1* tool is an Interactive Software Tool and Database which uses Schedule K-1 data from pass-through returns to visually depict relationships and income/loss allocations from pass-through entities to their owners. The data provided helps users visualize complex corporate and pass-through structures.
- (3) The *yK1* Program is a useful tool in planning the scope of the audit. The graphs help the examiner identify related entities and returns of interest. In addition, looking beneath the graph to the entity's return transaction file (RTF) and Schedule K-1 data may help determine if there are potential issues worth pursuing. There are 10 years of data available.
- (4) To gain access, submit a *BEARS* (Business Entitlement Access Request System) requesting the following program:

Sub Application	Description	Reports	Suggested Use	Application name
<i>yK1</i> Most users will need access to only yK1	a. Displays network graph of connected entities. b. Can interactively manipulate, expand and explore the graph. c. Primarily K-1 linkages but user can also add address and preparer linkages	a. Can print graph to printer or pdf file b. Labels can be turned off for sanitized graphs c. Can generate detailed tax data comparison (RTF) across years for a selected single entity or linkage	a. Small to medium partnership structures b. Need drill down capabilities for a specific entity. <ul style="list-style-type: none"> • K1, BRTF, IRTF, Parent Subsidiary, Address, Preparer details c. Interactive exploration of partnership structure.	a. PROD USER YK1 YK1SUITE (YK1SUITE)

Sub Application	Description	Reports	Suggested Use	Application name
Tier Structuring Tool (TST) Only users with large, complex partnerships need TST	<p>a. Trace ownership structure through tiers to ultimate partners.</p> <p>b. Trace stops when percent of allocation drops below user specified level or allocated adjustment drops below IRM tolerance.</p>	<p>a. Generates 3 Excel reports of partnership data with varying levels of detail</p> <ul style="list-style-type: none"> • Complete tree of ownership structure. • List of terminal owners. • Summary counts by investor type. 	<p>a. Partnership has 3 or more tiers of investors AND/OR Partnership has over 1000 direct and indirect investors</p>	<p>a. PROD USER YK1 YK1SUITE (YK1SUITE)</p> <p>b. PROD USER TST YK1SUITE (YK1SUITE)</p> <p>Note: Most users will not need access to TST. If you are not sure, please write to the yK1 help desk. (ras.yk1.helpdesk@irs.gov)</p>

Managerial approval is required.

- (5) Once the BEARS request is approved, the examiner may access the *yK1 Application*. The examiner will have access to user guides and other assistance once they enter the system.

4.31.5.3.5.1
(05-17-2022)
Disclosure Warning

- (1) The *yK1* program accesses taxpayer data. The IRS' ability to protect the confidentiality and privacy of taxpayer information is essential for our nation's tax system.
- (2) The output from the *yK1* Link Analysis Tool (electronic or hardcopy) contains tax return information of multiple taxpayers. Since there is a possibility of multiple taxpayers identified on the *yK1* graph, examiners are prohibited from providing the *yK1* graph to the taxpayer or the representative as that would be a disclosure violation. It cannot be disclosed pursuant to IRC 6103, IRC 7213, IRC 7213A and IRC 7431. Contact the local Disclosure Officer with any questions.

4.31.5.3.5.2
(05-17-2022)
Unauthorized Access of Taxpayer Accounts

- (1) Unauthorized Access of Taxpayer Accounts (UNAX) applies to any IRS employee, contractor, or contractor employee who handles tax information. The *yK1*-Link Analysis Tool is an interactive tool that allows the examiner to obtain information on tax entities and their relationships. It queries tax entities and their related links to provide information that is detailed and used for entities of interest.

- (2) A UNAX violation pertains to any person who has access to IRS taxpayer information and accesses this information without a tax administration reason. This includes paper records and all other information systems, which contain taxpayer information.
- (3) Access and inspection of paper and electronic taxpayer records is allowed when the information is needed to carry out assigned tax administration duties. This policy reflects the law on access to taxpayer records as set forth in Taxpayer Browsing Protection Act, USC 26, IRC 7213A(a). The provisions and applicable criminal penalties under the Taxpayer Browsing Act also apply to all contractors, and contractor employees.

Note: The yK1 System has the same UNAX rules as IDRS. **Unauthorized access is not permitted.**

4.31.5.3.5.3
(05-17-2022)

The yK1 Home Screen

- (1) Once signed into the yK1 program the Graph Input screen will appear, which is the home screen. At the top, there are two tabs: File and Tools.

4.31.5.3.5.3.1
(05-17-2022)

File

- (1) The file tab pulls down a menu which includes:
 - a. About yK1 – provides detail on the latest version.
 - b. Legend – provides the current yK1 Legend.
 - c. Enterprise – allows the user to enter an Employer Identification Number (EIN) or Social Security Number (SSN) (both referred to as Taxpayer Identification Number (TIN)) and it provides all the entities that are linked to that TIN where the TIN owns directly or indirectly more than 50 percent.
 - d. Open – allows access a file that were previously opened.
 - e. Logout – allows the user to logout of the program.

4.31.5.3.5.3.2
(05-17-2022)

Tools

- (1) The tools tab allows users to change their password.

4.31.5.3.5.4
(05-17-2022)

The yK1 Legend

- (1) The yK1 Legend provides a description of each shape used in the graph:
- (2) Although most items on the Legend are somewhat self-explanatory, a few need more explanation.

4.31.5.3.5.4.1
(05-17-2022)

Unknown

- (1) For purposes of yK1, "Unknown" means for that given year, yK1 does not recognize the entity as a filing entity. Examples of entities reflected as Unknown, include:
 - a. **Disregarded entities** that do not have a separate filing requirement than its owner. With an unknown entity, additional research is necessary to determine the owner. Check IDRS if there is a valid TIN. Pull up a BMFOLE/IMFOLE to determine the entity's filing requirement. INOLE may also provide information which could reflect the owner if it is a single member LLC.
 - b. **Non-filer or late filed returns.** Consider pulling a BMFOLI/IMFOLI to see if the **return** was filed late. Late filed returns may not be reflected in yK1.

- c. **Bad TINs.** Occasionally the system assigns a node a fake TIN. The fake TIN starts with an "X". It is assigned to ensure that all bad TINs do not inappropriately link to each other.

4.31.5.3.5.4.2 (05-17-2022) **Bold Border**

- (1) The requested TINs are identified as a node with a bold border. If the default search is used, the *yK1* graph reflects two tiers and up to 10 nodes. Knowing whether the default setting is being use can be helpful. For example:
- If an S corporation TIN is entered and *yK1* only reflects one shareholder, it indicates that *yK1* recognized only one Schedule K-1 being issued by the S corporation.
 - On the other hand, if the S corporation's (bold border) 1040 shareholder is also a partner in a partnership; the partnership may look as if it only has one partner. However, since the default search has only requested two tiers, it stopped before listing all of the partners of the partnership. The default setting needs to be changed to show the other partners.

4.31.5.3.5.4.3 (05-17-2022) **Black and Red and Lines**

- (1) Help identify the amount of income/(loss) which an entity is allocating to its owners. There is generally one line, which can have both a positive and a negative number. The line color depends on if there are more positive than negative (black) or more negative than positive (red). In addition, the line gets thicker when allocations are larger. Do not assume that all income is ordinary. How to obtain the detail is discussed below. In addition, note that most, but not all, lines on the Schedule K-1 are transcribed.
- (2) The following lines are transcribed:

Partnerships (Form 1065)	S Corporation (Form 1120-S)	Trusts (Form 1041)
<ul style="list-style-type: none"> Dividends Interest Royalties Ordinary Income Real Estate Other Rental Guaranteed Payments IRC 179 Expense Short Term Cap Inc Long Term Cap Inc 	<ul style="list-style-type: none"> Dividends Interest Tax Withheld Royalties Ordinary Income Real Estate Other Rental IRC 179Expense Short Term Cap Inc Long Term Cap Inc Credits 	<ul style="list-style-type: none"> Dividends Interest Tax Withheld Business Income Passive Income Short Term Cap Inc Long Term Cap Inc Other Portfolio & Non Business Inc. Other Info

- (3) Not all lines on the Schedule K-1 are transcribed. The main items which are not transcribed are IRC 1231 gains or losses (Form 4797, Sales of Business Property) and Other Income/Loss. These can be a significant amount on some returns, especially on tax shelter cases. Nondeductible expenses are also not transcribed.

4.31.5.3.5.5
(05-17-2022)
Graph Input

- (1) The graph input screen provides several options.
 - a. **No TIN Type** versus **Use TIN Type**. In the **No TIN Type**, users can enter TINs they wish to search. There are times where the same TIN is associated with both an SSN and an EIN. The **Use TIN Type** allows the user to distinguish the TIN as either an EIN or SSN to ensure the right taxpayer information is obtained.
 - b. **Years**. Check the box or boxes to select the years to search. It is recommended that more than one year is searched to identify changes in taxpayer ownerships.
 - c. **Identify the View**. This field is used to pull a single window graph (most commonly used) which puts the nodes and links related to all TINs into one graph.
 - d. **Number / Tiers and Number Nodes**. The defaults setting is two tiers and maximum 10 nodes, which keeps the graph from becoming too busy, but can be changed by the user as needed.

4.31.5.3.5.6
(05-17-2022)
Drawing Graphs

- (1) A Graph menu shows up on the home screen once a graph is drawn. When more than one graph is drawn, it allows the user to go from graph to graph, minimize all windows, close all graphs or display the graphs tiled in grid, horizontally, vertically or stagger the graphs.
- (2) On a small graph, viewing it in grid helps the user identify ownership changes or other items that may warrant questioning.

4.31.5.3.5.7
(05-17-2022)
Graph Menu

- (1) Each graph has its own menu. Some of the options are self-explanatory but some features are discussed below.

K-1 Graph Menu Items	
File	<ul style="list-style-type: none"> • Save – allows the graph to be saved. • Create payee list – when a node is selected it creates a payee list. • Print • Close
Edit	<ul style="list-style-type: none"> • Find by TIN • Find by Name • Delete Selection - if a node is selected and the user clicks delete, the node is deleted from the graph.
View	<ul style="list-style-type: none"> • Fit in Window • Zoom Out • Zoom in • Zoom Selected • Magnifier Properties • Show Common Address Nodes • Show Common Preparer Nodes • Show All Preparer Nodes • Show All / Hide All

K-1 Graph Menu Items
Layout <ul style="list-style-type: none"> • Hierarchic • Circular • Organic • Orthogonal

4.31.5.3.5.8
(05-17-2022)
Detail Beneath the Graph

- (1) The graph tells the user a lot about a taxpayer and depicts the links between the entities. Further, the details beneath the graph provide even more information.
- (2) By right clicking on the nodes, the RTF provides up to 10 years of data. And right clicking on any line link, provides a summary of the Schedules K-1 issued from an entity to the owners.
- (3) These details beneath the graph can provide trend information. For example, did the S corporation have just one bad year, or has it lost money for several years.

4.31.5.4
(05-17-2022)

#

4.31.5.4.1
(05-17-2022)
Compliance Checks and Non Pass-Through Issues

- (1) Whether an individual taxpayer, a corporate taxpayer or a pass-through entity is assigned, it is important to ask questions concerning related entities. The examination scope should be modified to establish if what is reflected on the return is accurate and complete.
- (2) If the taxpayer has transactions with related entities in which they can exercise control, it is important that the examiner understand the transactions fully. It is not suggested that when the examiner initiates an examination that all related entities be automatically placed under examination. During the initial interview, ask the taxpayer about ownership in related entities and about transactions occurring between entities. All entities should be reviewed to gain an understanding of what transactions occur between them. If material transactions involving related entities are discovered, ask questions to help establish the facts about these transactions. Also, analyze the transactions. A yK1 printout can be secured to see the big picture when looking at related returns. External websites can also assist in determining information about the taxpayer.

- (3) With related party transactions, it is important to look at the whole picture to determine the proper tax treatment of the transaction(s). In general, documents can be requested from another entity that pertain to a related transaction if it supports a deduction being claimed on the taxpayer's return without placing the other entity under examination.
- (4) Compliance checks require inspection of related returns including required filing checks. See IRM 4.10.5, Required Filing Checks. During inspection of the investor's returns, it is important to remember the impact of loss limitations:
 - a. Stock basis and debt basis limitations are applied at the investor level, not at the S corporation or partnership level.
 - b. At-risk limitations are applied at the investor level, not at the entity level.
 - c. Passive activity loss limitations are applied at the individual investor level, not at the entity level.
 - d. Gain on corporate loan repayments is determined at the shareholder level, not at the S corporation level.
 - e. A distribution in excess of basis is determined at the investor level, not at the S corporation or partnership level.
 - f. The issue of an activity not engaged in for profit (IRC 183) is determined at the entity level, not the individual level.
- (5) Employment tax returns should be reviewed to establish that they were properly filed and that amounts reflected agree with the pass-through entity's return. In addition, consideration should be made as to whether the S corporation shareholders have been properly compensated.

4.31.5.4.1.1
(05-17-2022)
Nonfilers

- (1) If an investor has not filed a return and minimum income probes indicate a material omission of income and/or the investor received a Schedule K-1 reporting material items, substitute for return (SFR) procedures must be followed. The agent must control the investor and follow the procedures outlined in IRM 4.12.1, Nonfiled Returns and IRM 4.4.9, Delinquent and Substitute for Return Processing.
- (2) Other modules should be checked to see if the taxpayer filed their return, or if that return went unpostable or got processed to an incorrect module. An unprocessed or unpostable return may have a statute.

4.31.5.4.1.2
(05-17-2022)
Estate Shareholder

- (1) It is important to link the key case when the S corporation has an estate as a shareholder. This is because the beneficiaries cannot simply report the estate's increased income. There must be an actual distribution of cash or property by the estate to the beneficiaries during the tax year for an estate to allocate its income to the beneficiaries.
- (2) The estate's income distribution deduction is the lesser of the estate income or the actual distribution to the beneficiary. The distribution by the estate must be made during the tax year. In other words, it cannot be made in a subsequent year and applied to a prior year. There is an election to extend the distribution date into the first 65 days of the next year.
- (3) For example, if the estate earns \$60 of income and distributes \$100 of cash to its beneficiary during the tax year, the estate must allocate \$60 of income to its beneficiaries. The beneficiaries will report the income on their respective returns and the estate will be allowed a \$60 income distribution deduction.

- (4) If the estate is subsequently audited, and its total income is raised to \$130, then \$40 (\$100 distribution less \$60 previously allocated) of the \$70 income increase can be allocated to the beneficiary. This results in the estate being taxed on \$30 of the \$130 total income (\$130 less \$100 allocated to the beneficiary).
- (5) An example of how it works is listed below:
 - a. The increased S corporation income resulting from the audit increases the income of the estate.
 - b. An IRC 661 deduction is allowed to the estate in order to offset this increased gross income --- assuming the actual distribution exceeds the S corporation income. This results in zero additional tax to the estate.
 - c. An IRC 662 inclusion into the gross income of the beneficiary is equal to the IRC 661 deduction allowed to the estate.
- (6) Therefore, an adjustment cannot be made to simply have the beneficiary report the estate's increased income. An adjustment is first made to the estate. As such, the key case should be linked to pass the adjustment through the estate.
- (7) It should be noted that all affected parties could agree to have the beneficiary directly report the S corporation gross income, but that would require the individual and estate to be controlled and audited.

4.31.5.4.2 (05-17-2022) **Determine if Investors Are on AIMS or Linked on PCS**

- (1) PCS was created to monitor and control pass-through entity investors. Pass-through entities can have many investors and many levels of tiering. Tiering occurs when an investor in a pass-through entity is also a pass-through entity. This complexity can make it difficult to keep track of statutes and monitor all the investors. PCS establishes an electronic link between the entity and its investors. When the link is established a PICF Code will appear on its AIMS record.
- (2) An AMDISA should be secured for each investor to determine if the investors are controlled by another area. A PICF code indicates linkage has been established with at least one key case, though it will not state the key case. The AMDISA will also show the investor's statute. Since an AMDISA only shows the PICF Code, requesting a CC TSUMYI will show the entities to which the investor is linked. There may be more than one linkage. See IRM 4.31.5.12.2 – Pass-Through Control System (PCS)
- (3) It is important to know if investors are subject to adjustments from more than one pass-through examination due to ILSC statute considerations. ILSC adjustments require deficiency procedures. It is best that only one statutory notice of deficiency be issued per investors to avoid barring statutes.

4.31.5.4.3 (05-17-2022) **ILSC Entity Linked as Investor in a Different Exam**

- (1) For tax years prior to 2018, ILSC entities can be an investor in a TEFRA partnership, thereby causing the S corporation or partnership to also be subject to TEFRA proceedings. For tax years 2018 and subsequent, S corporations can be investors in partnerships that elect out of BBA. Examiners should check PCS to see if their entity is linked to any open TEFRA key case. Request IDRS command code TSUMY. TSUMY with definer code "I" (PCS investor case) will show the cases to which the ILSC entity is linked.

- (2) TSINQ command code provides complete PCS information and partial AIMS information for all of the various types of linkages; that is key cases, investors and tiers. Definer P shows the entity information and Definer I shows the individual information.
- (3) When an investor is linked to an entity on PCS, a Form 5546, Examination Return Charge-Out Sheet, will be generated and sent to the area controlling the investor return. The Form 5546 will show the TIN, MFT and tax period of the entity to which the investor was linked. This may be the entity being examined or may be a pass-through investor.
- (4) If the ILSC entity is linked to another entity, contact the CPF ILSC Coordinator for assistance.

4.31.5.5
(05-17-2022)
**Technical Assistance
Request**

- (1) If the examiner needs additional assistance, after they have conducted preliminary research and reviewed information on the appropriate Knowledge Base, the examiner may contact a Senior Flow-through Specialist or Practice Network Team Member. The procedures from making such requests can be found on the appropriate Knowledge Management site under "Contact an Expert".

4.31.5.6
(05-17-2022)
**Specialist Referral
System (SRS)**

- (1) If an S corporation return has a retirement plan or charitable organization as a shareholder, these shareholders cannot be linked by the CPF, nor can income tax examiners control these shareholders on AIMS. When the return is linked, indicate in the linkage package that the shareholder is a Tax Exempt & Government Entities (TE/GE) taxpayer. In addition, consider making a referral to Employee Plans or Exempt Organizations using the Specialist Referral System (SRS) if there are any potential concerns.

4.31.5.7
(05-17-2022)
**Examination Returns
Control System (ERCS)
Indicators**

- (1) There are ERCS indicators that are required for BBA and TEFRA partnerships.

4.31.5.7.1
(05-17-2022)
Elect Out of BBA Code

- (1) The Elect Out of BBA Code is required on all partnership tax years beginning after December 31, 2017, with MFT Code 06 or a NMFT of 35. The Field Values are as follows:
 - a. 0 = BBA (no elect out)
 - b. 1 = Elect out
 - c. 2 = Revocation of elect out (Whether taxpayer revokes or we determined they were never eligible to elect out.)

4.31.5.7.2
(05-17-2022)
TEFRA Indicator

- (1) There is a TEFRA indicator on ERCS that must be entered for **any** Form 1065 for tax years prior to 201812. The return cannot be updated beyond status 12 until the TEFRA indicator is entered. The TEFRA Indicator should be considered "Not Applicable" for all partnership records with a tax period of 201812 and later.
- (2) The TEFRA indicator should be entered on the system as soon as the TEFRA determination is made, but no later than 60 days after the case is updated to status 12.

- (3) The RA should request that the manager and/or secretary set the TEFRA indicator through the “correct and display” screen on ERCS. The TEFRA indicator can be set or changed on this screen. See IRM 4.7, Examination Returns Control System (ERCS), for further information.
- (4) The TEFRA indicator is required on all partnership tax years beginning before January 1, 2018 with a Master File Transaction (MFT) Code of 06 or a Non Master File Transaction (NMFT) Code of 35. The Field Values are as follows:
 - a. Y (Yes) = Subject to TEFRA procedures; (See IRM 4.31.2, Pass-Through Entity Handbook for field TEFRA procedures.)
 - b. N (No) = Not subject to TEFRA procedures; and
 - c. S (Survey) = Surveyed without determining if subject to TEFRA procedures.

Note: An “S” may be used on status 12 cases surveyed after assignment, without making a TEFRA determination, even though the RA may have charged some time. Survey should not be used after notices are issued.

4.31.5.8 (05-17-2022) Entity Statutes

- (1) As with any taxpayer, the statute of limitations should be verified. The Audit Information Management Systems (AIMS) Database generally reflects a statute based on three years from the date the entity return was filed. See IRM 25.6.22.6.3, Subchapter S corporations (Investor Level Statute Control) and IRM 25.6.22.6.5, Partnership (Investor Level Statute Control) and IRM 25.6.23, Examination Process – Assessment Statute of Limitations Controls. For partnerships that have a valid election out of BBA, there is no entity level assessment statute.

4.31.5.8.1 (05-17-2022) S Corporations

- (1) As with any taxpayer, the statute of limitations should be verified. The AIMS database will generally reflect a statute based on 3 years from the date the S corporation’s return was filed. S corporation examinations are not subject to the TEFRA or BBA audit regimes, so statutes are generally controlled at the shareholder level.
- (2) Generally, when auditing an S corporation, it is the examiner’s responsibility to protect the entity statute and all shareholders’ statutes. If adjustments result from the S corporation examination, the examiner will need to control the shareholder(s) return(s) or link the shareholders on PCS to the corporate return. When linked on PCS, any shareholder returns not currently on AIMS will be established on AIMS and controlled to the CPF. The CPF is responsible for protecting the statutes of the shareholders they control.

Note: The examiner needs to have a year on the statute for the corporation and all shareholders to submit PCS linkage. See IRM 4.31.5.12.2.1, Rules and Guidelines for Linking ILSC Entities on PCS, and IRM 4.31.5.10.2, Form 15041 and Statute Protection, for linkage procedures.

- (3) In *Bufferd v Commissioner* 506 U.S. 523, 113 S.Ct. 927(1993) the Supreme Court held that the limitation period for assessing the tax liability of a Subchapter S corporation shareholder who claimed pass-through items, began to run from the filing date of the individual return and not the filing date of the corporate return.

- (4) In determining whether the corporate statute needs to be protected, in addition to the shareholder level statutes, examiners should first determine whether the entity is a C corporation or is a taxable S corporation. The S corporation may be a taxable entity and have its own statute which needs to be protected. An example of when an S corporation would be a taxable entity is when it is subject to the Built-in Gains Tax of IRC 1374 or the Excess Net Passive Income Tax of IRC 1375. Form 14769, S Corporation - Statute Analysis Tool can be used to assist with determining the correct statute.
- (5) If there is any chance that there is a corporate level tax or there is an invalid S corporation election, protect the corporate statute. Form 872, Consent to Extend the Time to Assess Tax, is used to control the corporate statute – whether it is an S corporation or C corporation.
- (6) Often the entity will have a different statute from its investors. If the investor statutes are shorter than the entity statute, steps should be taken to ensure the investor statutes are protected. Investor statutes must be protected by the examiner (establish group control on AIMS) whether linked on PCS or not.

4.31.5.8.2
(06-07-2013)
**S Corporation or
Partnership Penalties**

- (1) The entity level statute may also need to be protected to assert entity level penalties. Applicable entity level penalties include IRC 6707, Failure to furnish information regarding reportable transactions, IRC 6698, Failure to file partnership return, and IRC 6699, Failure to file S corporation return. The campus normally assesses the failure to file penalty but occasionally it will need to be assessed by an examiner. See IRM 4.31.5.14.1.4.4.7, Who Asserts the Penalty.

4.31.5.8.3
(05-17-2022)
Entity Statute Extension

- (1) Protect the entity statute if the entity has the **potential** of being a taxable entity or may be subject to entity level penalties. Secure a consent from the S corporation or partnership for entity level taxes or penalties, on Form 872, Consent to Extend the Time to Assess Tax. Please note if the IRC 6707A penalty is applicable, there may be special language required. IRM 25.6.22.6, Preparation of Consents for Specific Entities and Taxes.
- (2) Form 872 is used to extend the ILSC entity statute – whether it is an S corporation, a partnership with a valid election out of BBA or a non-TEFRA partnership.
- (3) The “Kind of tax” line on Form 872 for a corporation will be “income” if one or more of the following situations apply to the entity:
 - a. it is taxed as a C corporation (the S election is not valid or it terminated),
 - b. it is subject to the Built-in Gains Tax,
 - c. it is subject to the Excessive Net Passive Investment Income Tax,
 - d. it is subject to the LIFO Recapture Tax,
 - e. it is claiming the income tax credit for fuels, or
 - f. it is recapturing prior C corporation credits.
- (4) If the entity is subject to a penalty, then the applicable penalty will be specified on the “Kind of tax” line. IRM 25.6.22.5.4, Kind of Tax. Additionally, the phrase “tax due” after the “Kind of tax” space must be changed to reflect the phrase “penalty due”.

4.31.5.8.4
(05-17-2022)
Alpha Statute “GG”

- (1) Alpha code “GG” is a two-digit code designating that the ILSC entity statute is controlled by the individual investors. Alpha Code GG can be used to update the entity statute on AIMS if it is determined that the entity does not come within the BBA or TEFRA provisions or there is not an entity level statute (i.e., the entity is not taxable). For BBA, see IRM 4.31.9, Centralized Partnership Audit Regime (BBA) Field Examination Procedures. For TEFRA, see IRM 4.31.2, TEFRA Examinations - Field Office Procedures.

Note: Alpha Code GG cannot be used on MFT 35. The earliest investor statute will have to be used.

- (2) Alpha statute “GG” should be used only if **all** of the following items are confirmed:
- The entity is not liable for entity level tax or penalties. For S corporations that includes the Built-in Gains Tax (IRC 1374), Excess Net Passive Investment Income Tax (IRC 1375), LIFO Recapture Tax (IRC 1363(d)), recapture of prior C corporation credits or tax paid on fuels. For S corporations and partnerships, it can also include application of penalties under IRC 6707A, IRC 6698 and IRC 6699.
 - The S corporation election is valid and has not had a terminating event, including, but not limited to, an invalid shareholder, three years of excessive net passive investment income or a revocation.
 - A final determination has been made that the partnership does not come within the BBA or TEFRA provisions.
 - **All** investor statutes are protected. This means that all investor statutes are either controlled on AIMS by the examiner or PCS linked at the campus, or the agent completed Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor - Statute Protection. See IRM 4.31.5.10, Investor Statutes.

Note: In certain circumstances, once the items above are resolved, it may be appropriate to update the statute to GG. For example, assume the entity return was late filed and assessed the failure to file penalty. Also assume the penalty was properly assessed and that no additional penalty applies. If the entity meets all other requirements, the alpha code GG statute could be used.

- (3) Generally, Form 5348, AIMS/ERCS Update, is used to update the statute date to alpha code GG. For example, if the three-year corporate statute would normally expire March 15, 20XX, the statute date on the Form 5348 would be updated to 03GG20XX.
- (4) Document the determination of the statute before updating the statute to GG on Form 895. Notice of Statute Expiration.
- (5) Always exercise caution in updating the statute to any alpha code. Once an alpha code is input, the statute will not be reflected as imminent on Statute Expiration Reports. Improper use of an alpha code may result in a barred statute. Any time a case is received with an alpha statute, steps should be taken to verify that it is correct.
- (6) Remember, the ILSC pass-through alpha code “GG” should only be used when all investor statutes are protected.

4.31.5.8.5
(05-17-2022)
**Alpha Statute “GG” –
Carryover Deductions**

- (1) As indicated above, alpha code “GG” is a two-digit code designating that the ILSC entity statute is controlled by the individual investor statutes. Generally, when the entity statute is updated to alpha code GG, it relates to the same entity year of its investors. However, when a carryover deduction (e.g. NOL, capital loss, passive activity loss, charitable contribution, credit) is involved, it is possible for the GG date to relate to a closed statute year of its investors. This is because the statute with respect to the carryover deduction is the year the deduction is claimed, but may require an adjustment to an item on the entity’s Schedule K-1 (such as the amount or character of a loss) in the year the deduction was created.
- (2) PLR 9504032 stated that when an NOL deduction is made up entirely of carryovers from prior loss years, the relevant year for statute of limitation purposes is the year in which the deduction is eventually taken, not the loss years. The fact that the loss year is closed for statute of limitations purposes is irrelevant since the relevant limitations periods are, or will be, those years to which the losses are carried and used as NOL deductions.
- (3) **State Farming Co., Inc. v. Comm’r**, 40 TC 774 (1963) held that the Commissioner may disallow net operating loss carryforwards by adjusting income in years prior to those covered in statutory notices of deficiency even though the relevant prior years are barred for deficiency purposes by the statute of limitations.
- (4) The statute of an ILSC entity resides with that of the investors. Even when the entity and investor statutes have expired (based upon the entity filing and the investor filing), there is an open statute with respect to the deduction carryover claimed by the investor. The table below provides an example for a statute of a carryover:

Example – Statute of a Carryover

Example - Statute of a carryover
<p>The examiner is assigned the 2016 Form 1040 of John. The 2016 return claims a deduction for a charitable contribution which was carried over from his 2013 Form 1040. The charitable contribution in 2013 was allocated from an S corporation of which John is the sole shareholder. The statute for the Form 1040 for 2013 has expired and three years have passed since the S corporation return was filed.</p> <p>Although there is no open statute for the 2013 year, the 2016 carryover charitable contribution has a statute. The examiner can audit the 2013 Form 1120-S as it relates to the 2016 deduction claimed on John’s Form 1040.</p> <p>Therefore, if an audit of the deduction reported on the S corporation return is warranted, place the S corporation for 2013 on AIMS using alpha code “GG”. Indicate on Form 895 that the examiner is relying on the statute of John’s Form 1040 as it relates to the 2016 carryover deduction.</p> <p>Do not place the 2013 Form 1040 on AIMS.</p>

4.31.5.9

(05-17-2022)

Entity Amended Return Statutes

- (1) Generally, ILSC pass-through entities are non-taxable. If an amended return Form 1120-S or Form 1065 is filed, it does not extend the statute of the non-taxable entity or its investors. On occasion, an amended ILSC entity return statute is improperly updated to "AA" indicating a claim statute. When the entity is a non-taxable entity, it cannot be a claim.
- (2) The individual investors should have timely filed amended returns relating to the amended entity return. Review CC IMFOL or BMFOL for each investor the examiner controls to see if the amended returns were filed and whether the claims were paid. Also, verify the investors' statutes.
 - If the investor's amended return is taxable, the examiner needs to verify that the assessment was made on the account. Check for a TC 290 with the amount shown on the amended return. If there is no assessment, the amended return changes will need to be included along with any examination changes on the Form 4549, Report of Income Tax Examination Changes.
 - If an investor's claim has not been paid, even though the regular statute has expired, both the investor claim and the amended entity return can be audited and an assessment can be made up to the amount of tax requested in the investor claim. In other words, the tax refund requested in the claim can be offset by other audit adjustments. The investor statute should be updated to "AA" indicating the statute is available up to the claim amount.
 - If one, or more, of the investor claims have been paid and the regular statute has expired, there is no statute with respect to that investor. One exception to this is if the refund is an erroneous refund, which is rare. The determination of whether an erroneous refund exists would need to be made by Counsel.
- (3) The following references provide additional assistance with claims:
 - IRM 4.46.3.7, LB&I Claims Process
 - *Claims, Abatements and Audit Reconsiderations Knowledge Base*

4.31.5.10

(05-17-2022)

Investor Statutes

- (1) ILSC entity statutes are generally controlled at the investor level. One hundred percent (100%) of the investor statutes should be reviewed **and protected**. In *Bufford v. Comm'r*, 506 U.S. 523 (1993), the Supreme Court of the United States held that the limitation period for assessing the tax liability of a shareholder in an S corporation that claimed pass-through items began to run from the filing date of the individual return, not the filing date of the corporate return. *Fehlhaber v. Comm'r*, 94 T.C. 863 (1990) stated "as here, the S corporation is not subject to income taxation, the return it files is merely an 'information' return which does not compute a corporate income tax liability."
- (2) It is the examiner's responsibility to protect all statutes. This includes all investors' statutes. No tax assessment can be made on an investor's return for pass-through adjustments from an ILSC entity once the investor's statute has expired, regardless of the entity level statute. When assigned an ILSC entity return, the AIMS database reflects the entity statute date based on three years from the date the entity return was filed. However, the entity often has a different statute from its investors. If the investor's statutes are shorter than the entity statute, examiners should take steps to ensure the investor statutes are protected. The entity level statute on AIMS cannot be relied upon to hold open

the investors' statutes with respect to pass-through adjustments from the ILSC entity. The examiner should solicit a statute extension if less than 210 days remain on the statute.

- (3) The investor statutes are protected and monitored by either:
- The examiner establishing group controls on AIMS / Examination Returns Control System (ERCS) databases, or
 - Linkage through the Pass-through Control System (PCS).

If an examiner establishes group control of the investor returns on AIMS, they will be responsible for protecting the investor statutes. If the ILSC entity is linked on PCS, then the campus will protect the investor statutes not controlled by the examiner.

- (4) It should be noted the use of PCS linkage does not preclude the examiner from controlling one or more of the investors in the exam group. If the examiner establishes controls of an investor return, then they are responsible for controlling the statute for that investor. PCS simply identifies the return is linked to the pass-through entity. PCS linkage alerts others the entity and related investors are under examination, so they don't issue a statutory notice prematurely.
- (5) A delinquent or amended ILSC entity return will **not** extend the investor statute(s) with respect to a pass-through item. If assigned a delinquent ILSC entity return, the first step should be to verify **all** statutes, including the entity and all investors. If all investor return statutes have expired, no tax assessment can be made for pass-through adjustments. A delinquent or amended ILSC entity return may be examined based upon an investor's amended return. See IRM 4.31.5.13.4, Investor Amended Returns.
- (6) At the time PCS linkage is requested, all investor returns should have 12 months remaining on the statute if the campus will be controlling any of the investors. By the time the entity first shows up on the Statute Expiration Report, it will generally be too late to have the campus control the investors via PCS linkage. Statute extensions would need to be secured for all investor returns. Once the statutes are extended, the linked returns can be transferred to the campus. See the PCS Controls and Linking a Return discussion below.
- (7) If a statute extension is needed for an Electing Small Business Trust (ESBT) shareholder, but the ESBT has since been dissolved, contact an S Corporation Specialist for assistance. The table provides an example to protect investor statutes:

Example – Protect Investor Statutes

Example - Protect investor statutes
<p>The examiner is assigned an S corporation that late-filed its calendar year 2020 Form 1120-S on July 14, 2022. The statute on AIMS is reflected as July 14, 2025. The S corporation has two shareholders, John, who is a 40 percent shareholder, and Patricia, who is a 60 percent shareholder. John and Patricia filed their 2020 Form 1040 on April 15, 2021, and September 15, 2021, respectively.</p> <p>On March 15, 2024, the examiner concludes the audit of the S corporation and proposes \$200,000 of adjustments. To pass the adjustments through to the shareholders, the examiner needs to establish AIMS control or secure PCS linkage on John's and Patricia's Form 1040. Keep in mind that the campus will link the investors, but will not control them unless there is at least a year on the investors statute when the linkage request is submitted.</p> <p>The examiner reviews the shareholder returns and realizes the statute expiration date for John's 2020 Form 1040 is April 15, 2024. This is less than 30 days away. No assessment can be made for the Form 1120-S pass-through adjustments to John unless the examiner can secure an agreement, extend John's statute date, or issue a statutory notice of deficiency before April 15, 2024. This will also be true for Patricia. An assessment cannot be made to Patricia unless the examiner secures an agreement, extends Patricia's statute date, or issues a statutory notice of deficiency before September 15, 2024; her statute expiration date.</p> <p>This example illustrates the importance of reviewing all investor statutes when an ILSC entity is assigned. It also highlights the need to decide early in the ILSC examination about establishing AIMS controls or PCS linkage for the investor returns. The examination statute control system will not alert the examiner to an imminent statute if the investor returns are not controlled at the group level on AIMS or controlled by the CPF through PCS linkage.</p>

4.31.5.10.1
(05-17-2022)
**True/Taxable Investor
Statutes (Trusts and
Disregarded Entities)**

- (1) The true/taxable investors are the individuals or entities who are responsible for reporting the items of income, loss, deduction and credit passing through from the ILSC entity return. It is important that their statutes be protected.
- (2) A non-TEFRA partnership investor must be a natural person, C corporation, or an estate of a deceased partner. Thus, there should be no issue in identifying the true/taxable investor of a non-TEFRA partnership.
- (3) BEO partnerships may only have individuals, and estate of decedent, and S corporations as direct partners. They cannot have direct partners that are trusts or disregarded entities.
- (4) For S corporations, most shareholders are individuals. However, it is possible for a LLC, owned by a single individual member, and certain trusts to be S cor-

poration shareholders. The Schedule K-1 may erroneously reflect the LLC or trust name and identification number, rather than an individual who is responsible for reporting the Schedule K-1 amounts.

- (5) It is important to protect the true/taxable investor statute. Generally, **only** the true/taxable investor statute, versus the trust or disregarded entity, must be protected –
 - Grantor trust – the grantor. IRM 25.6.22.6.6, Trusts.
 - Qualified Subchapter S Trust (QSST) – the beneficiary. Although the trust files a return, the S corporation income, loss, deduction and credits are reported on a schedule and pass through to the beneficiary.
 - Disregarded Entity – the owner.
- (6) If the examiner cannot determine the true/taxable investor by looking at the Schedule K-1, ask the representative or S corporation to clarify who is reporting the pass-through items from the S corporation. It is the responsibility of the S corporation to substantiate that all shareholders are qualifying shareholders, as an invalid shareholder will terminate the S election.

Note: If the type of trust is not clear, obtain a copy of the trust instrument. 26 CFR 1.6012-3 requires the filing of a copy of the will or trust instrument with the IRS upon request. This does not constitute placing the trust under examination; it is considered “perfecting” the trust. Letter 3407, Letter Requesting Copy of Trust Instruments under 26 CFR 1.6012-3, should be used to request the trust instrument.

4.31.5.10.2
(05-17-2022)
**Form 15041 and Statute
Protection**

- (1) Generally, all ILSC pass-through investors must have their statutes secured. However, there are times when it is clear that not all investors will be affected by an adjustment. When this occurs, Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor - Statute Protection, may be used to secure approval to let an investor statute expire. Investors will not be linked on PCS if their statutes are allowed to expire.
- (2) The examining agent or the campus may identify investors that may not be subject to adjustment and may not require statute protection. When this occurs, Form 15041 will be used to:
 - a. identify the investor return(s) where the statute will not be protected,
 - b. the reason(s) for not protecting the statute, and
 - c. for manager approval.

Note: If an investor’s statute has already expired prior to the start of the pass-through entity examination, it is not necessary to obtain approval on Form 15041 for the expired statute.

- (3) Approval must be secured prior to the expiration of the investor’s statute, and ideally at least 12 months prior. See IRM 25.6.23.4.5.1, Inconsistent Application of Investor Returns - ILSC.
- (4) The initiator of the Form 15041 must not only have their manager sign in agreement with the decision to not protect the statute, but must also have their Department Manager or Territory Manager sign the agreement as well. The higher level of approval is necessary since the statute will be allowed to expire.

- (5) Allowing an investor's statute to expire may make sense if it is highly likely the investor will not be adjusted. This will save resources and reduce taxpayer burden. Protecting such an investor will result in unnecessarily contacting them, and potentially requesting statute extensions or other communication.

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- (6) The campus may contact the examining agent to gain their concurrence if they think an investor's statute doesn't need to be protected. The examining agent may have other information that would require the statute of an investor to be protected that not might not otherwise appear to need protecting.

4.31.5.10.3
(05-17-2022)
Failure to Protect All Investors

- (1) If an investor's statute expires while the S corporation and partnership is under examination, the statute of the pass-through entity is deemed as having not been properly protected, unless the decision to allow the investor statute to expire is properly document [with Form 15041] prior to its expiration. See IRM 25.6.23.4.5 Responsibility for Investor Returns - Investor Level Statute Control. When the investor statute is not properly protected the IRS is prevented from making adjustments to the investor's return based on items reported on the return of the S corporation or ILSC partnership. If an investor's ASSED does expire and an assessment cannot be made, examiners should refer to IRM 25.6.1.13, Barred Assessments/Barred Statute Cases, (or other procedures required by their organization) for procedures to prepare and submit Form 3999, Statute Expiration Report.
- (2) The examiner needs to file a Form 3999, Statute Expiration Report, if any investor's statute, not linked and controlled in the campus, expires during the entity examination; regardless of whether the investor was controlled on AIMS. Investors whose statutes are allowed to expire by using a properly approved Form 15041 are not considered to be barred.
- (3) To ensure all investor statutes are protected, the case must either be linked (see IRM 4.31.5.12.2.4, When to Link the ILSC Key Case on PCS) or the investors must be controlled by the examiner. Whether to link or control a case should be considered early in the examination.

4.31.5.10.4
(05-17-2022)
Not All Investor Statutes are Open

- (1) All open investor statutes should be protected. Generally, the examiner should treat all investors consistently and make the appropriate pass-through entity adjustments to the investors' returns. However, there are times when one investor statute has expired prior to the start of the pass-through entity examination and another investor statute has not. There is nothing preventing an examiner from making adjustments to the investor whose statute is open when another investor statute has expired. When placing the entity on AIMS, the Form 895, Notice of Statute Expiration, should indicate any investors' statutes that expired before the pass-through entity examination began. The table below provides an example:

Example – Unable to Protect All Investor Statutes**Example - Unable to protect all investor statutes**

John files his Form 1040 for year X. The return is delinquent and includes a Schedule K-1 from an S corporation for which John is a 60 percent shareholder. Tom, the 40 percent shareholder, filed his Form 1040 timely for year X and his statute has expired. It is determined the S corporation warrants examination. The S corporation and John's return can be placed under examination and the resulting adjustment can be applied to John even though Tom's return cannot be adjusted.

4.31.5.10.5
(05-17-2022)
**Intent Not to Pursue
Investor**

- (1) Approval may be obtained to allow an open investor statute to expire through use of Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor – Statute Protection. Approval is sought by obtaining the concurrence of the examiner's territory manager or campus department manager. Approval **must** be obtained prior to the expiration of the investor's statute and, whenever possible, should be secured at least 12 months prior to the expiration of any investor's statute. See IRM 25.6.23.4.5.1, Inconsistent Application for Investor Returns - ILSC.

4.31.5.11
(05-17-2022)
**Extension of Investor
Statutes for ILSC Items**

- (1) The examiner charged with the investor return is responsible for the IRC 6501 statute for all ILSC issues on the investor return. All regular statute extension request procedures must be followed when soliciting Form 872, Consent to Extend the Time to Assess Tax, including requests for restricted consents. If the examiner receives a return letter with a signed consent that places conditions on the extension, the examiner should include these terms in a revised Form 872, after the conditions are reviewed by Counsel, and re-mail to the taxpayer for signature.
- (2) The case file must be documented that managerial approval has been obtained to solicit a consent to extend the statute of limitations from the taxpayer at a minimum of 210 days prior to the statute expiration date. The additional time requested should not be longer than necessary, however, if the investor protests, then there should be a minimum of 13 months on the statute when the closed case is received in Technical Services. For information on minimum timeframes, see IRM 25.6.23.7, Cases with Imminent ASERDs.
- (3) All investor statutes should be listed and attached to the Form 895. The attachment should indicate that the statutes are being controlled at the investor level. A statement should be included that indicates if any entity level penalties exist. The Form 895 should be initialed and dated by both the examiner and the manager.
- (4) IRC 6501(c)(4)(B) imposed provisions that must be followed in soliciting a consent to extend the statute of limitations. The provision requires the IRS to provide the taxpayer(s) or their authorized representative(s) with an explanation of their rights to decline to extend the assessment statute of limitations, or to request that any extension be limited to a specific period of time or to specific examination issues.
- (5) The IRS has established the following procedures whenever an extension to the statute of limitations is solicited:

- a. Letter 907, Request to Extend Assessment Statute and Publication 1035, Extending the Tax Assessment Period, must be provided to both the taxpayer and any authorized representative. In the case of a joint return, both spouses must be separately notified. A copy of Letter 907 must be attached to the Form 872 in the file, and its mailing documented in the case activity record.
 - b. Examiners should ensure that the proper extension form is transmitted to the taxpayer and representative.
 - c. Upon receipt of the executed copy from the taxpayer or authorized representative, the consent should be date stamped received and processed to the manager for execution. All requests for restricted consents must be considered. If the examiner receives a return letter with a signed consent that places conditions on the extension, the examiner should include these terms in a revised Form 872, after the conditions are reviewed by Counsel, and re-mail to the taxpayer for signature. A copy of the executed consent must be returned to the taxpayer and/or authorized representative(s) with the original attached to the tax return. The team should ensure that both the AIMS and ERCS databases are properly updated to reflect the new statute of limitations date.
- (6) If the taxpayer or authorized representative does not wish to execute a consent, they should be notified that the case will be evaluated to determine whether a statutory notice of deficiency (SNOD) should be issued.
 - (7) Further guidance on the control of statutes can be found at IRM 25.6, Statute of Limitations.
 - (8) If any investor statute of limitations expires, the responsible agent will follow the statute expiration procedures as outlined in IRM 25.6.1.13, Barred Assessments/Barred Statute Cases.
 - (9) Form 872 may be accepted by fax if contact has been made with taxpayer by phone or in-person and the taxpayer history file is documented with the date of contact and notation is made that the taxpayer wishes to send via fax

4.31.5.11.1
(05-17-2022)
Restricted Consents

- (1) Generally, restricted consents are not recommended on a pass-through entity and investors that are subject to a pass-through entity examination as it can present some hazards. If a request for a restricted consent is received the examiner should obtain Area Counsel approval. See IRM 25.6.22.8.6, Area Counsel Approval. If the examiner proceeds with the restricted consent, they should, include the language provided in IRM 25.6.22.8, Restricted Consents, and obtain group manager approval.

Note: For years subject to TEFRA, it should be noted that using the standard language included in IRM 25.6.22.8.12, Basic Restrictive Statement, in effect removes the TEFRA language from the Form 872. A statement must be added that the applicable TEFRA paragraphs are still valid. Without that language, the TEFRA issues may be lost.

- (2) Research the investor for other linkages. If other linkages exist, a restricted consent should not be considered as it may limit the ability to make other pass-through adjustments.

- (3) There is a restricted consent indicator on AIMS that signifies if a restricted consent is secured. An "R" will follow the Statute Date if a restricted consent was secured. If an extension was secured with no restriction, an "X" will follow the Statute Date.
- (4) No other restricted issues may be added after the original IRC 6501 statute has passed.

Note: The original statute may be, for example, the six-year period for a return with a substantial omission under IRC 6501(e).

4.31.5.11.2
(06-07-2013)
**25 Percent Omission of
Income**

- (1) If it can be shown that a taxpayer understated their gross income by 25 percent, a special 6-year statute applies per IRC 6501(e). On a non-taxable, ILSC entity return, the computation of the substantial understatement will be made at the investor level.
- (2) The general rule is the investor's gross income includes the investor's pro rata share of the pass-through entity's gross income. 26 CFR 1.1366-1(c)(1). Gross income for a business is the total amount of sales received or accrued prior to the reduction for cost of goods sold.
- (3) In determining whether an individual has a substantial understatement of income, the examiner would total the gross income reported on the individual tax return and compare it to the correct total of gross income.

Note: Separately stated income from the pass-through entity should be included on the proper line of the Form 1040 – interest, dividends, capital gains, etc.

- (4) The following items would be totaled in arriving at the investor's gross income:

Gross Income Determination	
•	Wages, Salaries, Tips, etc.
•	Interest Income (not including tax exempt interest)
•	Dividends
•	Gross Income from Business or Farm (before cost of sales)
•	Net Gains from the Sales of Property (not the gross sales price)
•	Proportionate Share of Gross S corporation and Partnership Income
•	Gross Receipts (before cost of sales)
•	Gross Rents
•	Net Gain from Form 4797
•	Other Income Included in Total Income
•	Gross Income from Farm Included in Total Income
•	Gross Rents
•	Other Income

- (5) In establishing a 25 percent omission of income case, the burden is on the government. An item other than an overstatement of basis is not considered omitted from gross income if the taxpayer adequately disclosed the item on the return or on an attached statement. The disclosure must adequately apprise the IRS of the nature and approximate amount of the item; the actual dollar

amount of the omission need not be disclosed. An understatement of gross income caused by an overstatement of basis is an omission from gross income for the tax period for which the assessment statute was open on July 31, 2015 and for returns filed after July 31, 2015.

- (6) Due to the requirement to use the proportionate share of gross receipts, it may be difficult to trigger the 25 percent omission rule where the individual investor reports the distributive share of income or loss of the S corporation or partnership ownership interests.
- (7) On the other hand, this gross income test could actually trigger the 6-year statute if the investor failed to report his entire share of the entities pass-through income.
- (8) Based on 26 CFR 1.1366-1(c)(2), the amount of gross income reported by the investor depends on whether the investor reports all of their pro-rata share of pass-through income. If all of the pass-through income is not reported, then all of the gross income for the 25 percent omission test has not been reported. The table below shows an example:

Example of Six Year Statute

Example - Six-year statute	
•	Ann owns 25 percent of S, Inc., an S corporation with gross income of \$200,000 and ordinary income of \$20,000.
•	This means that Ann's gross income from the S corporation is \$50,000. Also, her share of the ordinary income is \$5,000.
•	If Ann only reports \$3,000 of ordinary income, and failed to report \$2,000 of ordinary income, she will also fail to report \$20,000 of gross income (2,000/5,000 of \$50,000).
•	Assume Ann's only other income is \$25,000 of W-2 income. Her total gross income is \$75,000 (\$25,000 W-2 income plus \$50,000 S corp. income).
•	She has omitted \$20,000 of the \$75,000 of income which is a 26.67 percent omission. This triggers the 6-year statute.

- (9) Be careful when computing substantial understatement of income, especially relating to pass-through entities. The pass-through entity's gross income versus pass-through taxable income should be used in the calculation. Situations where an individual fails to include their entire share of S corporation or partnership income can result in a 25 percent omission of income. It is recommended that Counsel approve computations prior to expiration of the normal three-year assessment statute if any uncertainty exists.

Note: Be sure not to double count gross income on the investors return. If the examiner has a 25 percent shareholder, the shareholder should be allocated 25 percent of the gross receipts. Do not include the ordinary income reflected on the shareholder's Form 1040.

- (10) CCA 201333008 addressed items disclosed on an amended return. It concluded that the determination of whether the six-year statute applies is made at the time the original return is filed. Information discovered or provided by the taxpayer after that return is filed (for example, during an audit, on

amended returns, or on subsequent information returns), regardless of whether such information would ordinarily be considered disclosed, is only includable if it is filed with, or prior to, the return of the taxpayer.

4.31.5.11.2.1
(05-17-2022)
**Six-Year Statute of
Limitations Based on an
Overstatement of an
Asset's Basis**

- (1) An overstatement of basis in property sold by a taxpayer can trigger the extended six-year statute for assessment under IRC 6501(e)(1)(B), signed into law on July 31, 2015. The revised provision states that "an understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income".
- (2) This provision overrides the Supreme Court's decision in **U.S. vs. Home Concrete & Supply, LLC**, 132 S. Ct. 1836 (2012), where it held that an overstatement of basis does not trigger the six-year limitations period of IRC 6501(e). Prior to "Home Concrete", the Supreme Court had previously ruled in **Colony, Inc. v. Commissioner**, 78 S. Ct. 1033 (1958), that the statute's scope was limited to situations in which specific receipts are left out of the computation of gross income; thus, the six-year statute did not apply to misstatements that overstate the basis in property.
- (3) The relevant portions of IRC 6501(e)(1)(B) now read as follows:
 - a. In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services;
 - b. An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income; and
 - c. In determining the amount omitted from gross income (other than in the case of an overstatement of unrecovered cost or other basis), there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.
- (4) There is no legislative history on subparagraph (ii). For assistance interpreting how the provision should be applied to specific facts, please follow the exam group's existing procedures for obtaining technical advice.
- (5) A significant change under the revised provision of IRC 6501(e) relates to disclosure exceptions. Under the revised statute, the six-year statute of limitations can apply to a basis overstatement even if the taxpayer fully discloses the underlying tax issue on its return. This is a change from the previous language which provided that omitted amounts of income that are disclosed are not taken into account.

4.31.5.12
(05-17-2022)
**ILSC Entity Examination
Procedures**

- (1) The following subsections cover the ILSC entity examination process.

4.31.5.12.1
(05-17-2022)

Starting the ILSC Entity Examination

- (1) The examiner will issue a regular appointment letter confirming the initiation of an examination with an accompanying Form 4564, Information Document Request (IDR). If, within 120 days, the examiner and their manager have determined that PCS linkage will not be used, the examiner will request exam controls for any investor returns that are not already controlled by the examiner.
- (2) If an investor return is being controlled by another examiner outside of the exam group the ILSC entity must have PCS linkage. The CPF will use Form 6657, Related ILSC Pass-through Examination, to send a Schedule K-1 to the examiner outside of the exam group. It is also recommended the agent examining the pass-through entity reach out to the agent controlling the investor.
- (3) The entity return cannot be surveyed once the examination has started and time has been applied on the case and the entity is notified of the examination. The investors should be sent notification of the examination by the examining agent, or by the CPF when they are linked.

4.31.5.12.1.1
(05-17-2022)

Entity Initial Contact Letter

- (1) Letter 2205, Initial Contact, is a standard letter, which may be used by examiners to request the taxpayer to call the examiner to schedule an initial appointment for the examination. It is appropriate for individual, corporate or other return types examined by SB/SE.
- (2) Letter 2205-D, Initial Contact to Schedule Appointment - Partnership Returns. This letter is used by LB&I and SB/SE examiners to request that taxpayer call back to schedule an initial appointment for the examination of partnership income tax returns. The letter also provides notice of selection for examination to any partnership, whether subject to the unified rules under TEFRA (Tax Equity and Fiscal Responsibility Act of 1982), the centralized audit regime under BBA (Bipartisan Budget Act of 2015), or separate deficiency proceedings (ILSC procedures). Examiners must select the appropriate paragraph on the first page (paragraph 1 for SB/SE or paragraph 2 for LB&I).
- (3) Letter 2205-L, LB&I Initial Contact Letter, is a standard letter, which may be used by LB&I examiners for all corporate return types, and certain other return types. It is not appropriate for examinations of partnerships or individuals. Letter 2205-L was created specifically for LB&I and provides information for obtaining an electronic copy of Pub 1, Your Rights as a Taxpayer, and Notice 609, Privacy Act, from [irs.gov](https://www.irs.gov).

4.31.5.12.1.2
(05-17-2022)

Entity POA

- (1) IRM 4.11.55.2.5, Individual Authorized to Sign POA, provides that any corporate officer, e.g., president, vice-president, treasurer, chief accounting officer, etc., duly authorized by the corporation to bind the corporation in accordance with applicable state law may sign the Form 2848, Power of Attorney and Declaration of Representative. Generally, S corporations are non-taxable entities, with any tax being paid by the individual shareholders. 26 CFR 601.503(c)(1) states that for tax liabilities involving individual taxpayers, the individual taxpayer must sign the Form 2848.
- (2) During nearly all examinations, a Form 2848 is requested and provided. However, it is not always clear who can sign on behalf of the corporation. Two fact patterns listed below describes situations an examiner might see. The fact

patterns will help the examiner identify the appropriate person to execute a Form 2848 on behalf of the S corporation.

- (3) The two fact patterns below provide guidance on the appropriate person to execute Form 2848:
- a. **Fact Pattern 1:** Year under Exam - None of the shareholders are current shareholders, or
 - b. **Fact Pattern 2:** Subsequent to the year under exam, corporation was acquired by another entity and ceases to be an S corporation.
 - c. In these 2 fact patterns, any resulting tax liability is generally paid by the shareholders for the year under exam. As such, any of the former shareholders who were officers during the year under exam can and must sign the Form 2848; it should not be signed by any current officer or shareholder.

Note: Examiners with a taxable S corporation please contact an S corporation subject matter expert for assistance. IRM 4.31.5.5 – Technical Assistance Request.

- (4) A third fact pattern is presented below to address a situation involving signature authority on the tax return.

- a. **Fact Pattern 3:** Subsequent to year end, but before the tax return is filed, corporation is acquired by another entity and ceases to be an S corporation.

Note: IRC 6062 states that a corporate return shall ...**be signed by the president, vice-president, treasurer, assistant treasurer, chief accounting officer or any other officer duly authorized so to act.** As such, it would be appropriate for one of the officers of the S corporation to sign the S corporation return even if, at the time of signing, they are not an officer of the acquiring entity. However, if the situation arises where the new owners are claiming that the former owners should not have signed the S corporation return, consult with a local Counsel attorney.

- (5) It is becoming more common for an entity to be formed as an LLC. If an LLC has more than one member, it can elect to be taxed as either a partnership or a corporation. If the LLC only has one member, it can be taxed as either a disregarded entity or a corporation. So, an S corporation can own an LLC. In addition, an LLC that would otherwise qualify, can elect to be taxed as an S corporation. In that case the LLC has a deemed corporation election effective just prior to the S election.
- (6) The type of taxable entity is important in determining who may sign the Power of Attorney (POA) Form 2848. To assist examiners in determining who may sign the POA of an LLC, the Privacy, Governmental Liaison, and Disclosure (PGLD) created a job aid entitled *POAs for LLCs: IF/Then Quick Guide* which is found on their knowledge base. The POA can be signed by any manager authorized to act in the name of the entity (based on state law that LLC manager has the authority to bind the entity); the entity uses its EIN. Alternatively, a POA can be secured separately from each investor.
- (7) 26 CFR 601.503(c)(5) - In the case of a partnership, a power of attorney must be executed by all partners, or if executed in the name of the partnership, by

the partner or partners duly authorized to act for the partnership, who must certify that he/she has such authority. The statutory authority allows a single partner to represent a partnership in tax matters.

4.31.5.12.1.3
(05-17-2022)
Notice to Investors of Examination of Key Case Entity

- (1) When the examiner has secured the investor returns but is not examining issues other than the pass-through, the examiner should use the Letter 3457, Pass Through Audit Notification, to inform the investors of the examination. This assures that the investors first contact is not a request for a statute extension, a 30-day letter or a notice of deficiency. Separate notices should be considered for taxpayers filing joint returns.
- (2) If it is clear the investors are aware of the pass-through audit, it is not necessary to issue the above letter. If the entity is linked, the CPF will issue the letters to notify the investors of the examination. If there is a reason for the CPF not to notify the investors, the agent should clearly state the reason why the letters should not be issued on the linkage package.
- (3) Do not contact the taxpayer if there is "Z" Freeze or a TC 914 on the taxpayer account. If there is a "Z" Freeze or a TC 914 on the taxpayer account, give the ILSC entity and investor information to the CPF ILSC Coordinator for immediate, appropriate action.

4.31.5.12.2
(05-17-2022)
Pass-through Control System (PCS)

- (1) The PCS was created to establish an electronic linkage between pass-through entities and their underlying investors. This helps ensure that all investors are issued notices and adjusted in a timely manner. PCS linkage allows business operation divisions (BODs) to recognize when a taxpayer is involved in a pass-through examination. If an examiner chooses not to control the investors, PCS linkage can be established. It allows the campus to work those investors so the examiner can focus on the pass-through entity examination. PCS also allows the campus to systemically generate notices. PCS linkage assists with statute control and gathering pass-through entity business results.
- (2) PCS does not replace AIMS inventory control, but it provides the additional information needed to control investor and pass-through returns. It interfaces with AIMS to establish returns, access information, and provide mass updates to AIMS.
- (3) PCS allows an unlimited number of investors to be linked to each key case or tier and allows an investor to be linked to an unlimited number of pass-through entities. The linkage charges the returns to the appropriate area office or CPF. In addition, it places the pass-through entity Partnership Investor Control File (PICF) Code 2 on the key case on AIMS and ERCS databases. It also places an investor PICF Code of 6 on AIMS and ERCS databases so that any other part of the service can see that an entity related to the investor return is under examination. The PICF code appears on AMDISA. This prevents premature closure of an investor return until all key case issues are resolved. It should also prevent improperly restricted statute extensions. See IRM 4.31.5.11.1 – Restricted Consents.
- (4) The campus will input an H freeze on the pass-through entity as part of the linkage process. The H freeze will appear on the key case AIMS transcript when PCS is established. This prevents premature closure of the ILSC key case until investors are addressed.

- (5) The PCS is described in the text of IRM 4.29, Pass-through Control System (PCS) Handbook.

Note: Refer to IRM 4.29 for in-depth information on special features, the various user reports, letters, input documents, and indicators. See IRM 4.29.3-2, PICF Indicator Codes and Conditions.

4.31.5.12.2.1
(05-17-2022)

Rules and Guidelines for Linking ILSC Entities on PCS

- (1) The decision to use or not to use PCS must be made as early in the examination as possible. In some cases, the use of PCS is recommended, in other cases it is required. The number of investors and/or their geographic location will be the factors to consider for required linkage. For entities with less than 5 investors, efficient use of the IRS's resources is the important factor. Regardless of linkage, the examiner should understand that using PCS will not restrict them from following package audit requirements nor prevent them from examining any related investor. If as a result of the package audit the examiner determines that an investor(s) should be examined and others should not, the examiner should place on AIMS the appropriate investor(s) prior to linking the case.
- (2) Linking does not mean the campus must take control of the investors. An examiner may establish the ILSC pass-through return on PCS but retain control of some or all of the investors that are linked. Linkage helps others see the returns under exam and allows us to gather productivity statistics.
- (3) During the compliance checks examiners should review related returns, including investors. If it is determined that one or more of the investors has issues including basis, passive activity losses or other issues on the investor returns not related to the examination of the pass-through return which warrant examination, they should place the investor return under examination. Examiners should not link a return in lieu of their responsibilities to do compliance checks or to place related returns under examination which have large, unusual and questionable items. If the investor is in another geographical area and warrants examination, the examiner should discuss with the manager. Consideration should be made as to whether the examiner should place the investor under examination or work with the other area to have the return examined.

4.31.5.12.2.2
(05-17-2022)

Advantages of Using PCS

- (1) PCS allows all users to research and see the return under exam and all investors involved. This is important information when an investor is involved in multiple pass-through examinations.
- (2) Linkage does not require the campus to control the investors. Examiners can still control all or some of the investor returns. Those investors the agent controls need to be established on AIMS before the ILSC entity is linked.
- (3) Linkage provides awareness of ongoing exams and prevents the inadvertent issuance of a statutory notice of deficiency that could bar assessments from another exam.
- (4) When the key case is linked on PCS Form 14092, Investor Level Statute Control (ILSC) Linkage Check Sheet (SBSE), or Form 14093, Investor Level Statute Control (ILSC) Linkage Check Sheet (LB&I)), it establishes the investor returns on AIMS, and generates Form 5546, Examination Return Charge-Out Sheet, for their tax returns. If an investor return is not already in an audit

status, the investor returns are sent directly to the CPF. The CPF becomes responsible for protecting the statute on the investor returns, except for investor returns already in audit status. For investor returns already in audit status, the examiner with control of the investor return has the statute responsibility. The CPF will also secure agreements, assess tax and send notices of deficiency, when necessary, on the returns they control.

- (5) If during the linkage process the tax identifying number of the investor is incorrectly reported on the Schedule K-1, the CPF unit will identify the problem and take appropriate action. This will include determination of the correct information so that the proper tax return can be secured or notifying the examining agent that additional information is needed. The CPF will contact the examining agent for assistance when they are unable to determine the correct investor.
- (6) The CPF is responsible for inspecting the investor returns to determine if the taxpayer reported all pass-through items. If there are differences, the CPF determines the reason. After the determination is made, the CPF will contact the key case examiner, who will decide the action that should be taken. Unlike TEFRA cases, the investor return cannot be conformed to the key case return using a computational adjustment. Statutory Notice procedures must be used.
- (7) When the investor returns are received in the CPF, cases with potential non pass-through audit issues are identified and referred to the examining agent.
- (8) The PCS system places a PICF Code of "6", or PICF "4" if the investor is also linked to a TEFRA or BBA C2/C2A examination, on the AIMS record for the investor. The PICF code appears on AMDISA. The PICF code alerts personnel to the existence of an ongoing examination of the key case return and prevents its premature closure. For example, an examiner in Peoria may be auditing Investor A's individual income tax return when an examiner in Boston begins the examination of an S corporation in which Investor A is a shareholder. If Investor A asks for a restricted consent, the Peoria examiner can check the PICF Code and determine whether the restricted consent should include any pass-through entities. Investor A's examination cannot be closed without addressing the PCS linkage.

4.31.5.12.2.3
(05-17-2022)
**Investor Returns
Controlled by the Agent**

- (1) If the key case return is not linked, the key case examiner assumes total responsibility for statute control for all of the investor returns. The CPF has no responsibility for any statute protection for any investor unless that investor is in the CPF because of a TEFRA or other ILSC linkage. Once the linkage is resolved, the CPF will no longer have responsibility for the statute.
- (2) If a decision is made not to link the return, the key case examiner is responsible for:
 - a. Establishing AIMS controls, on all investors returns.
Note: If a return is open in another field group or campus the key case must be linked on PCS.
 - b. Preparing individual examination reports for all investors open in their group.

- (3) The key case examiner must reconcile the items reported on the investor Schedule K-1 to the amounts reported on the investor return, and the reason for any differences must be determined. The key case examiner must inspect the investor returns to determine whether non-pass-through issues should be examined.
- (4) If the key case is not linked on PCS, there is no Form 5546, Examination Return Charge-Out Sheet, to be associated with the investor case, and there is no PICF code on AIMS. A person, other than the key case examiner, holding the investor return may be unaware of the need to include the ILSC pass through in any proposed adjustments, statute extensions, or statutory notices of deficiency. If the key case is not linked, the person holding the investor return (CPF, examiner, appeals officer, etc.) is not responsible for statute control on unlinked issues for which there is no notification. For example, if the investor requests a restricted consent, the person holding the investor return will not know to include the non-linked entity in the consent.
- (5) If the key case is linked, the agent is responsible for the protection of any investors they control. They are not responsible for any investors controlled in the CPF.

4.31.5.12.2.4

(05-17-2022)

When to Link the ILSC Key Case on PCS

- (1) The decision to use the PCS should be considered and made as early in the examination as possible. If the examiner waits until there is less than one year on investor statutes, they may not be able to use PCS and have the CPF control the investor returns. The examiner should make the decision within 120 days of the initial interview.
- (2) Linkage is mandatory when:
 - a. There is an investor controlled outside the examining group.
 - b. An ILSC pass-through entity is linked to another ILSC entity already under examination. In that case, a ILSC linkage package **must** be sent to the campus. Even though the investors may already be linked on PCS, the ILSC linkage package is needed to change the designation of the investor returns. This ensures the campus knows that they have to protect the investor's individual statute for the ILSC exam. If a linkage package is not submitted, the campus will not protect the individual statute which could result in barred statutes. Barred statutes in such instances will be returned to the field for failing to notify the campus.
 - c. One of the investors in the ILSC entity has another open linkage. Submitting the ILSC linkage package is needed to change the designation of the investor on PCS from TEFRA to dual status. Adding the ILSC link will alert the campus that the individual investor statute must be protected. With TEFRA, the statute is controlled at the partnership level and not at the partner level. Failing to submit the ILSC linkage package may result in barred statutes. Barred statutes in such instances will be returned to the field for failing to notify the campus.
- (3) It is strongly recommended the area/territory link all ILSC key cases that have more than five investors or there is an investor that is a pass-through entity.
- (4) If the key case is not linked on PCS, Appeals will only accept protesting investors cases if both of the following are met:
 - a. The entity has five or fewer investors, **and**
 - b. None of the investors is a pass-through entity.

- (5) The number of relevant investors in a key case may be less than the number of Schedules K-1 attached to the return. For example, a pass-through entity has 10 investors that are not pass-through entities, but the adjustments are only material to four of them. The agent secures a Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor - Statute Protection, to allow the other 6 investor statutes to expire. Because only 4 relevant investors remain,

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Note: As a general rule, the key case and one protesting investor will be sent to Appeals. However, Appeals will accept protesting investors with different representatives, protesting investors without representation and protesting investors with unagreed non-pass-through issues. The key case examiner must either link the key case on PCS or hold the investor returns until the key case entity issues are resolved in Appeals.

4.31.5.12.3
(05-17-2022)
**Linking the Key Case
and Investors on PCS**

- (1) If the examiner has not determined that the examination will result in a no-change within 120 days of the initial interview they should prepare a linkage package and submit it to their manager. The group manager will review the package for timeliness and accuracy. The group manager will indicate approval by signing the Form 14092 or Form 14093.
- (2) The examiner should make every effort to have the linkage package in the hands of the campus at least 12 months before the expiration of the shortest investor statute in order to be controlled by the CPF.

Note: It is a best practice to request linkage as soon as adjustments are known, but no longer than 120 days. Delays in linkage create a bigger burden for the campus. This impacts the campuses' ability to secure investor returns and have them ready for report writing. It also can leave them with little time to secure statute extensions.

- (3) It is important to remember that when a key case is linked, all material investors will be linked no matter where they are controlled. Establishing the pass-through entity on PCS does not require the investor returns be controlled in the campus.
- (4) The linkage package should alert the CPF if any material partners have not filed or have processing problem with their return.

4.31.5.12.3.1
(05-17-2022)
**Initiating Timely PCS
Controls on ILSC
Pass-Through Entities**

- (1) ILSC linkage package must be received by the CPF with at least 12 months on all investor statutes the CPF will control.
- (2) If less than 12 months remain on an investor statute, examiners must coordinate with the Technical Services Pass-Through Coordinator and/or the CPF ILSC Coordinator. The campus may accept a package if there is less than 12 months, but more than 9 months, if their workload allows.
- (3) If the ILSC pass-through entity is already linked as an investor on PCS to a TEFRA case, ILSC linkage **must** be established as well. If the agent does not establish ILSC linkage, the campus controlling the investor returns will not know to protect the partner level statute. The campus does not control the partner level statute when there is only a TEFRA linkage. Not establishing the ILSC linkage may result in barred statutes.

- (4) If an S corporation is already linked as an investor on PCS to a BEO key case, ILSC linkage **must** be established for the S corporation examination as well. If the agent does not establish linkage, the campus controlling the investor returns will not know to protect the investor level statute. This could result on the campus issuing a statutory notice without including the S corporation adjustments. Not establishing the S corporation linkage may result in barred statutes. The S corporation must be linked as both an ILSC key case and as an investor.
- (5) When there is less than one year remaining on the statutory period of limitations for assessment of the tax for any investor the campus will control, the key case agent is responsible for securing extensions. The statutes must be extended before the campus will link the investors. When extensions cannot be secured, the agent must control AIMS and is responsible for all 30-day letters or notices of deficiency. The CPF will link once the statute has been extended or the examiner controls AIMS.
- (6) It is a best practice to reject a request for a restricted consent when the taxpayer is invested in more than one pass-through entity. Local counsel should review any restricted consent. The agent is responsible for securing the necessary information from any investor areas regarding any other pass-through entities in which the investor may have an interest if a restricted consent is considered.
- (7) When a return is properly linked, the campus has the responsibility to make adjustments from the ILSC pass-through entity audit to the individual investor returns for all investors the campus controls. This does not negate the examiner's responsibility to conduct the compliance examination and evaluate related returns during the examination process.
- (8) In auditing an S corporation, there are several issues which are related to the S corporation but are not pass-through issues. These issues include basis, at-risk, passive activity losses, gain on loan repayment and taxable distributions which can all be identified and developed as part of the corporate audit. In addition, there could be investor issues identified from an inspection of the shareholder's returns which need to be addressed. These non-S corporation issues will generally require the examiner to place the individual shareholder under examination regardless of the S corporation examination results.
- (9) The campus cannot control investors that are placed under examination due to 1040 issues. The campus will only make adjustments for pass-through adjustments. The examiner should first control those returns which have non pass-through issues and then link the key case return which will protect all other investors. See IRM 4.31.5.12.3.2, Field Control of Investors.

4.31.5.12.3.2
(05-17-2022)
**Field Control of
Investors**

- (1) The examiner is responsible for reviewing the investor returns related to ILSC pass-through audits. If it is determined that the investor return warrants further examination, then AIMS controls should be requested.

Note: If not linking, all investor returns must be controlled or there must be an approved Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor - Statute Protection. See IRM 4.31.5.10.2, Form 15041 and Statute Protection.

- (2) If PCS linkage is either required or desired, the examiner may retain control of the investor returns. Linkage does not require campus control of the returns. AIMS needs to be established on all investors the examiner will control before requesting linkage. The CPF is there to support the examiner with the examination and will process none, some or all investors at the examiner's discretion.
- (3) A Form 5546, Examination Charge-Out Sheet, will be issued to the agent controlling an investor return when that return is linked on PCS. The Form 5546 will show the "Flow Through Acknowledgement" and then there is an X-ref with the name and TIN of the entity to which it was linked. A statement stating "NO RTN REQSTD RELATED INVESTOR NOTIFICATION" will appear on the Form 5546.
- (4) The linked investor's will have a TC 424 on their module that will reflect the x-ref TIN and tax year of the entity to which it is linked. See IRM 4.31.5.13.3.2, Investor PCS Linkage.

4.31.5.12.3.2.1 (05-17-2022)

Transferring Controls to the CPF After Linkage

- (1) If the examiner wants to transfer an investor return to the CPF, they must contact the CPF Pass-Through Coordinator.
- (2) If AIMS controls exist on any investor prior to linking the pass-through entity on PCS then it is important that the investor returns remain in the group until linkage is fully established. The investor return can be closed after PCS linkage is established when the non pass-through entity adjustments are resolved before the pass-through entity examination is complete. A TSUMYP secured through AIMS will indicate if PCS linkage does exist along with a listing of investors linked.

Note: Returns that are LCC corporation, Joint Committee, or other corporate specialty cases (Form 1120 with letters after the 1120 other than A, S, or X) must be held in the field. Generally, these returns are updated to status 14 and will remain there until closed.

- (3) **Do not** close the investor returns off ERCS if a key case linkage package is being submitted. This creates added work for the campus as they have to reopen returns before a linkage can be established.
- (4) Once linkage has established, investor returns can be transferred to the CPF through Technical Services and updated to Status 21. In addition to the normal case information, the Form 3198, Special Handling Notice for Examination Case Processing, should be completed as follows:
 - a. On page one, in the Special Features Box, check the other box on page 1 and write "Suspense case with unresolved pass-through issues, non pass-through issues are being surveyed/no changed/ agreed/ unagreed."
 - b. Check Forward to Technical Services.

4.31.5.12.3.3 (05-17-2022)

ILSC Linkage Package

- (1) To initiate a linkage, the agent must complete Form 14092 (for an SB/SE key case) or Form 14093 (for an LB&I key case) and submit the linkage package to the CPF within 120 days of the initial interview.

- (2) The examiner should make every effort to have the linkage package to the CPF before the last 12 months of the shortest investor statute is to expire for any investors the CPF will control.

Note: It is a best practice to request linkage as soon as possible. Delays in linkage create a bigger burden for the campus. This impacts the campuses' ability to secure investor returns and have them ready for report writing. It also can leave them with little time to secure statute extensions.

- (3) For LB&I key cases, the agent must also include the LIN link.
- (4) If the return is not imaged, the return can be scanned or faxed.
- (5) If faxed, the check sheet and attachments should be sent via secure E-mail at the same time. Attachments include:
 - a. A spreadsheet with a reconciliation of the Schedules K-1. All attempts should be made to secure any missing Schedules K-1. The CPF will contact the examiner if they are unable to determine the taxable investor from the reconciliation. See IRM 4.31.5.10.1, True/Taxable Investor Statutes (Trusts and Disregarded Entities).
 - b. The agent must answer the questions on the check sheet.
- (6) The copying of tax returns and Schedules K-1 are no longer required at the field level when the return is imaged or scanned.
- (7) Schedules K-1 filed electronically can be accessed via the Employee User Portal (EUP) or via a TRPRT print.
- (8) The group manager must review the package and electronically sign the Form 14092 or Form 14093 before submission to the CPF. Once signed, the agent can forward the package via secured E-mail to the CPF. The E-mail address is provided on the appropriate form. The manager's signature on the ILSC Linkage Check Sheet indicates that the linkage package has been reviewed, is accurate and complete.
- (9) A copy of the electronic check sheet must be included in the audit file.
- (10) The packages are sent directly to the CPF via secure E-mail.
- (11) If the return is too big to email or fax, the information can be uploaded to a shared drive. If the information cannot be sent electronically, coordinate the mailing of the return with the CPF ILSC Coordinator. All information should be sent electronically except for that which must be mailed.
- (12) The CPF will acknowledge the acceptance or rejection of the package within 3 business days.

4.31.5.12.3.3.1
(06-07-2013)

**Transferring Work to the
Campus Using a Shared
Drive**

- (1) Large files cannot be emailed. As a result, a shared drive was created to allow these large files to be transferred electronically.
- (2) In order to transfer files via the shared drive, a network pathway must be established.
- (3) To map to the drive:
 - a. Right click the My Network Places icon on the desktop.

- b. Left click Map Network Drive.
 - c. A window will open with two fill in boxes. One for Drive and one for folder.
 - d. The Drive box displays the first available drive letter for the connection. You can click on the arrow and scroll down until you see the drive letter that you want to use or you can use the drive letter listed.
 - f. Also, make sure to check the box "Reconnect at Login". This will ensure your computer reconnects to the drive each time you log on.
- (4) Check to see if the mapping was successful. Right click on the "Start" button on the lower left-hand corner of your computer. Left click on "Explore". The newly mapped drive will appear in the list. You should see the specified drive, followed by EX TEFRA Elect Notice followed by the drive name.
- (5) Left click on that drive and there will be two folders. One folder titled LB&I OSC Notices and the other titled SBSE BSC Notices.

Note: All ILSC related documents need to be loaded in the SBSE BSC Notices.

- (6) Once you have mapped the drive, you will then be able to double click to the folders that you have access to. You can also create a shortcut to put on your desktop.
- (7) A new folder needs to be created to send to the campus. To create a new folder in your case folder, left click on the appropriate folder. Left click on "File" in the top menu. Left click on "New" in the drop-down menu, and then on "Folder". A new folder icon with highlighted name "New Folder" will appear in your data folder.
- (8) With the name of the folder highlighted, left click on the folder and enter a name. If the name of the folder is no longer highlighted, then right click on the folder and left click on "Rename".
- (9) The folder should be named:

Folder Name
XXXX = Type of Package-FL. (Where XXXX = Last four digits of the Taxpayer Identification Number (TIN) Type of Package = e.g., NBAP, and FL = First and last name of sender)

- (10) Save all taxpayer files to be sent to the campus in the file folder named above.
- (11) To add the folder to the shared drive, right click on the folder being sent. Bring the cursor to the WinZip option and left click on "Add to foldername.zip" in the submenu. This will create a WinZip folder.
- (12) Right click on the .zip folder and left click on cut. Left click on the short cut folder on your desktop for the campus, or go through the network drive (long way).

- (13) Left click to open the campus folder where the package will be attached.
- (14) Right click on paste to attach the folder. When you click paste, an error message will appear to alert you that encrypted data cannot be copied or moved. Click ignore all.
- (15) The folder will be posted to the campus folder. No password is needed because special access is required for the shared drive.
- (16) Each TEFRA campus will have an employee assigned to monitor the shared drive who will copy and save the package externally and then delete it from the shared drive. The campus will acknowledge the package within 24 hours via email stating "your linkage package has been received for XXXX (last four digits) on MMDDYY".
- (17) The agent should also monitor the shared drive to confirm that the package was deleted.

4.31.5.12.3.4 (05-17-2022)

Verification of Investor Linkage

- (1) The examiner should verify linkages using a TSUMYP print 30 days after the package is accepted. If the examiner notices any discrepancies between the TSUMYP print and the Schedules K-1, the CPF ILSC Coordinator should be contacted. The CPF ILSC Coordinator will help rectify any linkage problems. The campus may not have linked all investors if they determine some will not have a material adjustment. A Form 15041, ILSC Pass-Through Entity Intent Not to Pursue Investor - Statute Protection, will be provide for investors not linked when that occurs.

Note: Investors may appear not to be linked in some situations. For example, where spouses are both investors and file a joint return. There will be only one linkage, but both are included on the same return. If a grantor trust is a shareholder in an S corporation, the campus may opt to link the beneficiary only. Generally, tax exempt investors are also not linked.

- (2) Additionally, an AMDISA can be secured for each investor. The PICF code 6 or 4 indicates linkage to at least one ILSC key case. The AMDISA will also show the investor's statute. If the case is in status 33, it is controlled by the ILSC unit in the Campus. Be aware there may be more than one ILSC key case or TEFRA key case linkage and an AMDISA will not show the key case. TSUMYI will list the pass-through entity to which an investor is linked. TSUMYP lists investors in a specific key case. Keep a copy of the TSUMYP in the key case file.
- (3) Once the key case has been properly linked, the campus is responsible for protecting investor statutes on cases they control and making pass-through adjustments as a result of the examination.

4.31.5.12.4 (05-17-2022)

Inconsistent Treatment

- (1) The requirement for consistency or notification of inconsistent treatment is contained in IRC 6037(c) for S corporations and IRC 6222(a) for TEFRA and BBA partnerships. They require that the investor's return be consistent with the entity return – or that the Secretary be notified of any inconsistencies. IRC 6222(a) does not apply to partnerships not subject to TEFRA or BBA.
- (2) Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), must be filed by S corporation shareholder to take an inconsistent position. See Form 8082 Instructions for more information.

- (3) An S corporation shareholder is required to report the items of income, loss, deductions, and credits as reflected on the Schedule K-1. These items cannot be changed or re-classified by the investor unless the Secretary is notified of any inconsistencies. In a similar vein, the IRS cannot change an item on the Schedule K-1 unless the IRS examines the entity. The table below provide an example:

Example – Changing What is Reported on Schedule K-1

Example - Changing what is reported on Schedule K-1
<p>The examiner is examining the 100 percent shareholder of an S corporation. Through the interview, the examiner establishes that the S corporation improperly included a rental loss in the ordinary business income (loss) reported on Schedule K-1, Box 1. The rental loss should be a passive activity loss on the shareholder's personal return, however the shareholder reported the loss on Schedule E, Part II as an ordinary loss.</p> <p>Before making an adjustment on the shareholder's return, adjust the S corporation return. The categorization of an activity as ordinary or rental is an entity level determination. As such, the entity should be examined. The examiner should not change the shareholder's return without first making the adjustment to the S corporation's return and Schedule K-1.</p>

4.31.5.12.5
(10-01-2010)
**Items Requiring Key
Case and Investor Level
Determinations**

- (1) The key case examiner may need to examine both the entity and investors for some issues such as passive loss, at-risk, and basis issues. Determinations at the key case level and the investor level are required to develop the issue factually. Adjustments are made as part of the same report to the investor. If the investor level arguments below are made, the investor's return must be controlled by the agent on AIMS. See IRM 4.10.5.4.2, Examination of Related and Spin-Off Returns.
- (2) Pass-through level components for basis:
- Amount of the initial capital contribution to the pass-through.
 - Amount of each distribution from the pass-through.
 - Amount of all subsequent capital contributions to the pass-through.
 - Amount of investor's share of taxable income, non-taxable income, losses and deductions.
 - Amount of liabilities used to secure or improve an asset at the pass-through level.
- (3) A partner level component for basis is: "Did the partner buy his interest from another partner without the partnership making a IRC 754 election?" In this situation the partnership does not have to know the purchase price because the partnership cannot adjust the basis of partnership without IRC 754 election in effect for the taxable year. In addition, the partnership does not have to take the purchase price into account for its taxable year.
- (4) An at-risk issue requires certain determinations at the key case level. In situations where loans or notes appear on the books of an entity, it must be

determined in the entity level examination whether the loans or notes are recourse or nonrecourse to the entity. In determining the amount for which an investor is at-risk, several items must be addressed, including situations where:

- a. The loans or notes appear to be recourse, but the pass-through is protected from loss.
- b. The loans or notes are nonrecourse in substance.
- c. The loans or notes are nonrecourse.
- d. The investors cannot use their proportionate share of income, gain, loss, deduction, or credit from the pass-through in determining their at-risk amount for deducting losses.

Note: Not all nonrecourse notes or loans follow the general rule that the investors can use their proportionate share in determining their at-risk amount for deducting losses.

(5) Pass-through level components for at-risk are:

- a. Was a particular loan or note recourse or nonrecourse?
- b. What was the amount of the loan or note?
- c. Whether a partner is a limited or a general partner.
- d. Whether the lender has an interest other than as a creditor.

(6) Investor level components for at-risk are:

- a. Are there third-party side agreements (guarantees, stop-loss or assumption agreements)?
- b. Did a partner contribute money borrowed from another partner to the partnership?
- c. Did an investor bear the ultimate economic risk of loss with respect to a particular pass-through liability?

Note: In these situations, the pass-through does not have to know, nor does it have to take into account for its taxable year, any of these components because these are investor level components.

(7) A passive activity loss issue requires certain determinations at the entity and investor level as to type(s) of activity.

(8) Pass-through level components for passive loss are:

- a. Whether the pass-through is engaged in a rental activity.
- b. Whether the pass-through is engaged in a trade or business for purposes of IRC 162.
- c. Whether a partner is a limited or a general partner.
- d. Whether income is portfolio income.

(9) An investor level determination for passive activity loss is: "Did the investor materially participate in the business?" In this situation the pass-through may know if the investor materially participates.

4.31.5.12.6
(05-17-2022)
**IRC 7602 (c), Third Party
Contacts**

(1) For ILSC partnerships or S corporations, reasonable advance notice is provided (by issuing any one of Letters 3164-A through V, as appropriate, to the entity when the examination is being conducted at the entity level. When the examination of the entity is being made as part of the examination of a particular partner/member or shareholder's return, a Letter 3164 should be

issued to both the entity and the particular investor. If an entity level examination is being conducted, contacts with the partners/members or shareholders of the entity are not considered IRC 7602(c) contacts. On the other hand, if the examination of the entity is being done as part of the examination of a particular partner or shareholder's return, then contact with any other partner or shareholder (other than the partner or shareholder under exam) should be treated as a third-party contact. See IRM 4.11.57, Third-Party Contacts.

Note: Letter 3164-E, Third-Party Contact, will most likely be used for investor cases.

4.31.5.13
(05-17-2022)

Investor Considerations

- (1) The following sub-sections outline investor related actions.

4.31.5.13.1
(05-17-2022)

Power of Attorney (POA) for Investor Level Statute Control (ILSC) Investors

- (1) Only those representatives with a valid Power of Attorney (POA) on file for the taxable year(s) under discussion are permitted to receive information about the ILSC entity examination.

- a. A new POA for an investor does not need to specifically name the entity before the IRS can discuss pass-through issues. However, it does need to meet specific requirements.
- b. Under section 3, on one line, under the heading "Description of Matter", the investor should insert "Income, Including pass-through Items".
- c. Under the heading "Tax Form Number", the investor should enter the form number of the investor's return and "Form 1065" or "Form 1120-S".
- d. Under "Year(s) or Period(s)" the investor should enter the covered tax year(s).

Note: Each tax period should be reflected on the POA form.

Note: If the Form 2848 is not completed as above, the campus CAF unit will reject it.

- e. If an existing POA does not have the proper language, a new POA, with the above statement included in section 3, should be secured.
 - f. Though not required, under Part 5 of Form 2848, it is a best practice to list each act the investor authorizes the POA to perform. These would be acts other than the normal authorization to work with the examiner and exchange confidential information. Care should be taken to identify any restrictions to the POA's authority to act for the investor.
- (2) A hard copy of the POA should be secured and maintained in the case file. The only way to determine if the POA was completed correctly for entity issues is to have a copy. It is best not to rely on the Centralized Authorization File (CAF) due to the special language required.

4.31.5.13.2
(05-17-2022)

Communicating with Divorced/Separated Taxpayers

- (1) Returns and return information for individuals filing income tax returns jointly may be disclosed to either of the individuals identified on the return. This only applies to the joint return itself, including attachments to such a return (the MFT 30 module). IRC 6103(e) provides that certain limited collection information regarding one spouse must be disclosed to the other spouse relative to tax deficiencies with respect to a jointly filed return where the individuals filing

such return are no longer married or no longer reside in the same household. A written or verbal request can be accepted. This also applies when the modules are split.

- (2) Information from the split module that must be disclosed to either spouse, if requested, includes:
 - a. Whether the IRS has attempted to collect the deficiency from the other spouse;
 - b. The amount collected, if any, and how it was collected (such as refund offset, payment (which can be identified by the designated payment code (DPC)), etc.);
 - c. The current collection status (i.e., installment agreement, Currently Not Collectible (CNC), etc.);
 - d. If the module is CNC, the reason (i.e., unable to locate, hardship, etc.).
- (3) Information which will not be disclosed includes:
 - a. The other spouse's location;
 - b. The other spouse's name change;
 - c. The other spouse's telephone number;
 - d. Information about the other spouse's employment, income or assets;
 - e. The income level at which a CNC module will be reactivated;
 - f. The bankruptcy chapter filed by the other spouse.
- (4) Exercise caution when spouses do not have the same power of attorney (POA) to ensure the information of one spouse is not inadvertently disclosed to the POA of the other spouse.
- (5) For additional disclosure information, see IRM 21.1.3.2, General Disclosure Guidelines, and IRM 11.3.2.4, Persons Who May Have Access to Returns and Return Information Pursuant to IRC 6103(e).

Note: Employees with questions about disclosure can refer to the Disclosure website.

4.31.5.13.3
(05-17-2022)
**Control of Investor
Returns Related to Key
Case Entities**

- (1) When examining agent decides to examine investor returns, those returns should be checked to see if they are already controlled on AIMS. They should also be checked to see if they are already linked on PCS to another pass-through examination.
- (2) If the investor return is already controlled on AIMS, the examiner will need to contact the controlling area to either request controls or a copy of the return. If requesting control of a return held in the CPF, use Form 15277, AIMS Database Transfer Request Campus Pass-Through Function (CPF), to request the AIMS transfer. Manager's signature is required.
- (3) If the investor return is already controlled on PCS, the examining agent will now be required to establish their entity on PCS. If the investor is not linked on PCS, but is involved in multiple pass-through examinations, both agents will need to establish their pass-through entities on PCS.

4.31.5.13.3.1
(05-17-2022)
**Re-Opening for
Pass-Through
Adjustments**

- (1) IRC 7605(b) provides in part that no taxpayer shall be subjected to unnecessary examination or investigations. Only one inspection of a taxpayer's books of account shall be made for each taxable year unless:
 - a. The taxpayer requests otherwise, or
 - b. The Secretary, after investigation, notifies the taxpayer in writing that another inspection is necessary.
- (2) If an investor has been examined previously, and the examiner is making a pass-through adjustment from an ILSC entity, it does not require re-opening procedures. Any adjustments made on Form 4605, Examination Changes - Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Sales Corporations, that change an investor's share can be made on the individual's Form 1040 since it is not considered an examination or reopening. Policy Statement 4-3 in IRM 1.2.1.5.1 states: Certain contacts not considered as examinations or reopenings: Contacts with a taxpayer to verify or adjust a discrepancy between the taxpayer's tax return and information returns, including late or amended returns, are not examinations or reopenings. For this purpose, information returns include returns and amended returns filed by partnerships, fiduciaries and small business corporations.
- (3) The examination changes to a pass-through entity may result in changes to the amounts reported on the information returns (Schedule K-1) filed by the S corporation or partnership. Therefore, the group clerk may need to work with the local AIMS coordinator to establish the case on AIMS if the investor return was in status 90.
- (4) As stated above, adjusting an investor's return previously examined to properly reflect adjustments from the pass-through entity examination does not constitute an examination of the investor return; therefore, re-opening procedures do not need to be followed. However, if other adjustments to the investor are necessary, approval to re-open the return is required and written notice to the investor must be provided. Adjustments due to stock and debt basis, at-risk or passive activity loss issues are investor level issues and therefore, require re-opening procedures.

4.31.5.13.3.2
(05-17-2022)
Investor PCS Linkage

- (1) When the examiner establishes a pass-through entity on PCS, the investors will be linked to the entity return. When investors are linked, the area controlling the investor on AIMS will be sent a Form 5546, Examination Charge-Out Sheet. The examiner will receive a Form 5546 for any investors they control.
- (2) When someone links an entity return and the examiner already has controls on the investor return, the examiner will receive a Form 5546. The Form 5546 will show the TIN and tax year of the entity to which it is linked. There will also be a TC 424 on the module with the x-ref information. When an examiner is notified of a linkage that they did not initiate, it is important the area that initiated the linkage be contacted. The examiner needs to understand the type of entity that was linked. The different types of pass-through audit regimes create different statute considerations. If the examiner is auditing both the investor return and the related pass-through entity, and that entity is not linked, it will now require linkage.
- (3) Linkage is required when an investor is related to multiple pass-through examinations. Involvement in more than one pass-through examination creates

statute considerations. Whether the investor is involved in the entities of the same audit regime or different ones, care must be taken. When an investor is involved in entities whose pass-through adjustments will be subject to deficiency procedures it is a best practice for only one statutory notice of deficiency to be issued which include adjustments from all the ILSC and /or BBA Chapter 2/2A pass-through entities. If a statutory notice does not include all the adjustments, and it is petitioned, then no subsequent statutory notices will be issued. Any subsequent pass-through adjustment to the investor return would be barred.

4.31.5.13.4
(05-17-2022)
**Investor Amended
Returns**

- (1) The agent should review and process all amended returns and claims received per IRM 4.10.8.10, Claims.
- (2) Many amended returns can be found on the Correspondence Imaging System (CIS). If they were scanned into the CIS there will be a CIS Indicator of 1 on TXMOD, BMFOL or IMFOL. See IRM 21.5.1.5.1, CII General Guidelines.
- (3) The individual investor's Form 1040 should have timely filed amended returns relating to the amended S corporation or partnership return. AIMS should be reviewed for each investor before beginning to write reports to see if any new amended returns were filed and whether the claims were paid.
 - a. If an investor's claim has not been paid, even though the regular statute has expired, both the investor claim and amended entity return can be audited and an assessment can be made up to the amount of tax requested in the investor claim. In other words, the tax refund requested in the investor claim can be offset by ILSC pass-through entity audit adjustments.
 - b. If one, or more, of the investor claims have been paid and the regular statute has expired, there is no statute with respect to that investor. One exception to this is if the refund is an erroneous refund, which is rare. The determination of whether or not an erroneous refund exists would need to be made by the local Counsel attorney.
 - c. If investor claims were paid, and the regular statute has not expired, the investor may be examined and assessed.
- (4) Claims and taxable amended returns received for any investor controlled by the examiner should be reviewed for potential examination or statute issues.
- (5) If an amended return is received directly from the ILSC pass-through entity or investor, the examiner should verify if it is a copy or an original. If it's an original, make a copy and forward the original to the Service Center where the original tax return was filed.

4.31.5.14
(05-17-2022)
**Report Writing
Procedures**

- (1) The following sub-sections outline actions report writing procedures.

4.31.5.14.1
(05-17-2022)
Entity Reports

- (1) The audit report for a pass-through entity is similar to an information return. The pass-through entity report, Form 4605, Examination Changes - Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Sales Corporations, is used to reflect adjustments made during the examination.

- (2) Line 1, Adjustments to ordinary, distributable net or taxable income, should reflect the audit adjustments that impact the ordinary business income (loss), from the front page of the entity return.
- (3) Line 5, Other adjustments, should reflect the per return and corrected amounts of Schedule K or Schedule K-1 items that were changed. If there are no changes to any separately stated item for the entity or investor, leave Line 5 blank.
- (4) Remarks can be used to notify the entity of other information or determinations made as a result of the audit. Examples include:
 - The correct balances of accounts such as Accumulated Adjustment Account (AAA) or retained earnings.
 - Whether the amount of the Net Unrealized Built-In Gain (NUBIG) has been established.
 - Changes to non-income items such as a reclassification on the balance sheet.
- (5) It can also be used to explain the impact of the adjustments to shareholders' basis.
- (6) IRM 4.10.8.4.2.1, Form 4605, contains detailed instructions on how to complete the forms.
- (7) A signed Form 4605 is generally an indication of an agreement to the entity's examination adjustments and if linked can assist with determining if the entity return should be forwarded to the CPF.
- (8) A signature on Form 4605 does not bind any of the investors. The investor(s) must agree to the entity level findings by signing their individual Form 4549, Report of Income Tax Examination Changes, which incorporates the pass-through entity's adjustments.
- (9) Use Form 4605-A, Examination Changes – Partnership, Fiduciaries, S Corporations, and interest Charge Domestic International Sales Corporations, when the entity is no-changed. Use Form 4605 when the entity has adjustments, whether it is agreed or unagreed. If the S corporation is subject to tax, use Form 4549 in addition to Form 4605 with a notation to refer back.
- (10) Form 4605 reflects the corrected amounts made to the entity's ordinary income/loss and separately stated items of income, loss, deduction and credit. Form 886-X, Shareholders' Shares of Income, Deductions, and Credits and Form 886-S, Partners' Share of Income, Deduction and Credits, are forms used to reflect changes to the shareholders or partners Schedule K-1. Form 886-X and Form 886-S should clearly reflect corrected items of income, separately stated items, and distributions to be adjusted at the investor level. The Letter 921, Report Transmittal from ILSC Partnership, Fiduciary and S Corporation, is a report transmittal letter for ILSC entity cases.
- (11) The pass-through examination results should then be reflected on each investor's examination report (i.e., Form 4549). The Form 4605, and respective Form 886 (sanitized as necessary), is generally attached to the individual investor's report.

Note: Do not use or secure a signature on Form 870-PT, Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts, or Form 870-LT, Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts and Agreement for Affected Items (or Form 870-S which is obsolete). These forms are only used for TEFRA returns.

4.31.5.14.1.1
(05-17-2022)

**Conversion of
S Corporation to C
Corporation**

- (1) When auditing a corporation return with no S election on file, the examiner must treat the return as a taxable C corporation. Therefore, the examiner must remove the pass-through income from the shareholders' returns and place it on C corporation's return. Prepare a Form 4549 to correct the C corporation's taxable income and assess the tax (similar to an SFR). Remember to consider dividend distributions as any distributions paid by the corporation during the year are dividend distributions. In RGS, each income and expense item should be individually entered to correct the C corporation's taxable income. Note: The corporate statute starts on the date Form 1120-S is filed.
- (2) An S corporation can terminate its S status per IRC 1362(d):
 - a. Voluntarily;
 - b. Involuntarily by the corporation ceasing to be a small business corporation; or
 - c. When passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits.
- (3) If during the examination of an S corporation it is established that the election has terminated, either in a prior year or during the year, the examiner should do the following:
 - a. Prepare Form 4605 showing that the proper pass-through income is \$0 as the corporation was processed as an S corporation and no longer qualifies. See IRM 4.31.5.14.1.2.1, Conversions and RGS
 - b. Prepare Form 4549, reflecting the return as a C corporation after the termination date and assess any tax. See IRM 4.31.5.14.1.2.1, Conversions and RGS.
 - c. Prepare Form 886-A, Explanation of Items or lead sheet, to discuss the termination issue and attach it to both the C and S corporation reports.
 - d. Control or link the shareholder returns to remove the pass-through S corporation items consistent with the change in entity status.
- (4) Issue both reports to the corporation with one transmittal letter. For unagreed cases use the corporate 30-day letter (Letter 950). Attach Form 4605 to Form 4549 or Form 4549-A, Report of Income Tax Examination Changes (Without Taxpayer Signature), along with Form 886-A discussing the facts, law and argument.
- (5) If the S election termination issue is unagreed, two Form 4605 should be including in the closing case file.
 - a. One Form 4605 showing that the proper pass-through income is \$0. Throughout the document write "Pending resolution that the corporation is a C corporation". In the Remarks section include "If the S election has terminated, the entity is a taxable C corporation".

- b. A second Form 4605 showing the proper pass-through income as if the corporation is an S corporation. Throughout the document write "Pending resolution that the corporation is properly classified as an S corporation."
- (6) The closing file should also include:
 - a. Form 3198, Special Handling Notice for Examination Case Processing, indicating that the Form 1120-S is being converted to a Form 1120.
 - b. Form 5349, Examination Correction Request, to correct the activity code, as indicated on Form 3198.
 - c. Form 2363, Master File Entity Change, to input TC 091, to change the filing requirement to a C corporation and provide the proper effective date.
 - d. Form 1725, Routing Slip, addressed to the Campus Entity Control function with a Form 1120-S converted to a Form 1120 by Examination with taxpayer's name, address and EIN. Include the effective date of the termination and the reason for the termination.
 - e. Copy of Form 2553, if available.

Note: If the case is agreed, send the Form 2363, Form 1725, and a copy of Form 2553 to the appropriate entity unit to input TC 091, changing the filing requirements to those of a C corporation and to update the S corporation entity information. Maintain copies of the documents in the case file indicating they have been sent to the entity unit. The following is the address and fax information for the entity units:

Campuses	Send forms to:
Cincinnati Campus	Cincinnati IRS Center Cincinnati, OH 45999 Fax 859-669-5748
Ogden Campus	Ogden IRS Center Ogden, UT 84201 Fax 801-620-7116

- (7) If the case is unagreed, the changes will not be made to the module until final resolution is determined.

4.31.5.14.1.2 (05-17-2022) Conversion from C Corporation to S Corporation

- (1) As indicated above, the Campus processes the return based upon whether the taxpayer has an S corporation election on file. If the taxpayer files an S corporation return, and no election is on file, the Campus attempts to correspond with the taxpayer to obtain the election. If nothing is obtained, they process the return as a C corporation even though a Form 1120-S was filed.
- (2) When examining a return, the Campus converted from an S corporation to a C corporation, request a copy of the corporation's signed Form 2553. If it can be established that the corporation had a timely, valid election then:
 - a. Prepare Form 4605 showing the proper ordinary income/loss, separately stated items, and the related Form 886-X, Shareholders Shares of Income, Deductions, and Credits. See IRM 4.31.5.14.1.2.1, Conversions & RGS.

- b. Prepare Form 4549 zeroing out the taxable income/loss reported as a C corporation. See IRM 4.31.5.14.1.2.1, Conversions & RGS.
- c. Determine whether the shareholder returns need to be secured or linked to be consistent with the change in entity status.
- d. Prepare Form 886-A, Explanation of Items, or lead sheet to discuss the conversion of the return and attach it to both reports.

The closing file should include:

- a. Form 3198, Special Handling Notice for Examination Processing, indicating that the Form 1120 is being converted to a Form 1120-S.
- b. Form 5349, Examination Correction Request, to correct the activity code, as indicated on Form 3198.
- c. Form 2363, Master File Entity Change, to input TC 090, to change the filing requirements to an S corporation and to report the proper effective date.
- d. Form 1725, Routing Slip, addressed to the Campus Entity Control function with a Form 1120 converted to a Form 1120-S by Examination with taxpayer's name, address and EIN. Include the effective date of the conversion and the reason for the conversion.
- e. Copy of Form 2553, if available.

Note: If the case is agreed, send the Form 2363, Form 1725, and a copy of Form 2553 to the appropriate entity unit so that the S corporation entity information can be updated. Maintain copies of the documents in the case file indicating they have been sent to the entity unit. The following is the address and fax information for the entity units:

Campuses	Send forms to:
Cincinnati Campus	Cincinnati IRS Center Cincinnati, OH 45999 Fax 859-669-5748
Ogden Campus	Ogden IRS Center Ogden, UT 84201 Fax 801-620-7116

- (3) If the case is unagreed, the changes will not be made to the module until final resolution is determined.
- (4) It is important to note that this procedure should be used only if the taxpayer has an S election that was approved by the IRS after the return was posted incorrectly. **The examiner does not have the authority to grant late elections.**

4.31.5.14.1.2.1
(05-17-2022)

Conversions and RGS

- (1) If the entity is converted, prepare both a Form 4549 and a Form 4605 for each entity. Whipsaw positions may be required.
- (2) Adjustments should be made to both entity types (Form 1120 and Form 1120-S). In RGS, each income and expense item should be individually entered to correct the corporation's taxable income. Assign reason code 23 (Change due to adjustment in another year, financial and tax accounting differences, or entity types – not intentional) to the entries.

- (3) For the initial case assigned, create the case in RGS with work unit code "00" and make the adjustments on the appropriate report (Form 4549 or Form 4605). Then, create a second case with work unit code 75. This allows RGS to handle the same EIN and tax year and allows the case to be forwarded to the server. If you need additional assistance, please contact your local RGS FAS staff.
- (4) The Form 3198, Special Handling Notice for Examination Case Processing, should state that the examination resulted in an entity conversion and includes both S corporation and C corporation reports. This alerts CCP that they need to close both the S corporation and C corporation files for agreed cases. If the case is unagreed, the Special Handling Notice should state whether the positions are whipsaws so Appeals can address the entity conversion issue.

4.31.5.14.1.3
(05-17-2022)

Entity Amended Returns

- (1) When conducting a pass-through examination, the examiner should ask if any amended returns have been filed as with any examination. The examiner should also verify that by checking a BMFOLT and see if a TC 290 has posted to the account. The TC 290 does not mean a claim was processed.
- (2) ILSC partnership amended returns have no statute of limitations and are information returns like their originally filed Form 1065. An examination of the amended ILSC partnership is conducted in the same manner as any other ILSC partnership examination. ILSC examinations can be linked on PCS, see IRM 4.31.5.12.2, Pass-through Control System (PCS). Since the partnership is ILSC, all statutes are controlled by the partners' IRC 6501 statutes.
- (3) Generally S corporation returns are non-taxable entities. If an amended return is filed, it does not extend the statute of the non-taxable corporation or the shareholders. On occasion an amended S corporation return statute is improperly updated to "AA" indicating a claim statute. When the S corporation is a non-taxable entity, it cannot be a claim.
- (4) Examiners can examine the pass-through entities when some investors file claims and others don't. See the examples in IRM 25.6.23.4.5.1, Inconsistent Application for Investor Returns - ILSC.
- (5) If the investor's amended return is taxable, the examiner needs to verify that the assessment was made on the account. Check for a TC 290 with the amount shown on the amended return. If there is no assessment, the amended return changes will need to be included along with any examination changes on the Form 4549.

4.31.5.14.1.4
(05-17-2022)

Penalties

- (1) Penalties, including accuracy related and fraud, apply to audit issues and are assessed on the tax deficiencies that result.

4.31.5.14.1.4.1
(05-17-2022)

Application of Penalties

- (1) When proposing audit adjustments to an ILSC pass-through entity, penalties should always be considered and documented. The documentation should discuss the application of penalties to each specific adjustment. The penalty is first developed at the entity level and then again for each investor. The entity level determination should address the actions taken by the entity and its officers as well as discuss whether the entity acted with reasonable cause and

in good faith with respect to the underpayment. The investor level determination should address the actions taken by the individual investor and whether the investor acted with reasonable cause and in good faith. Generally, the penalty is applied at the shareholder level unless the ILSC entity is a taxable S corporation (e.g., subject to built-in gains tax, excessive passive investment tax, etc.).

- (2) It is important that penalty development at both the entity level and shareholder level is timely documented in each case file. In *Chai v. Comm'r*, 851 F.3d 190 (2nd Cir. 2017), the court found that “IRC 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.”
- (3) In order to satisfy the requirements of IRC 6751(b)(1), the immediate supervisor of the examiner making the penalty determination must personally approve in writing the assertion of the penalty prior to issuing any written communication of penalties that offers the taxpayer an opportunity to sign a consent to proposal of a penalty, or sign an agreement or consent to assessment of a penalty, and the approval must be documented in the case file: :
 - SB/SE Field Exam uses Lead Sheet 300, Civil Penalty Approval Form.
 - LB&I uses SAIN Lead Sheet 011.
- (4) It is always important to develop the facts to establish if penalties may be applicable. Actions taken (or not taken) by the entity and the investors should be specifically addressed. Penalty development should not be boilerplate. 26 CFR 1.6664-4(e) states:
 - Pass-through items. The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made based on all pertinent facts and circumstances, including the taxpayer’s own actions, as well as the actions of the pass-through entity. The table below provides an example:

Example – Penalty Application

Example - Penalty Application
<p>An S corporation is owned by two 50/50 shareholders, Richard and Tom. Richard runs the business and Tom handles the accounting. Tom created fake vendor invoices to divert funds to himself and his family. Richard claimed he did not have knowledge of Toms actions.</p> <p>In development of penalties, the actions taken by and not taken by Richard and Tom should be specifically addressed. Questions should be asked to determine whether Richard should have known or could have known of Tom’s actions. Facts regarding the fake invoices and showing the diversion of money need to be developed at the corporate level. In addition, penalties need to be developed at the shareholder level. If it is determined that the penalty applies to both shareholders, it should be clear what role the specific shareholder had in the diverted income so it can be supported on the individual’s return.</p>

- (5) If penalties apply, the applicable penalty and which adjustment it applies to should be reflected in the remarks section of the entity's audit report, Form 4605, and attached Form 886-A. However, the penalty amount is generally computed on the deficiency at the investor level. Therefore, no penalty dollar amount is reflected on the Form 4605 unless there is entity level tax. If a Form 4549 is needed for an entity level tax, the appropriate penalties and amounts should be reflected on the report and explained in the attached Form 886-A.
- (6) For additional guidance on penalties please refer to the *Penalties Knowledge Base*.

Note: If the key case is linked, the Campus will assess the penalties on all investors as dictated in the entity's Form 4605 and Form 886-A. Each investor will then be able to argue the penalty and provide their position as to why the penalty may not apply.

4.31.5.14.1.4.2
(05-17-2022)
Penalty Refresher

- (1) In developing a penalty, the examiner needs to determine what efforts the taxpayer made to determine the correctness of the return position. The examiner's objective is to determine accountability for the return position and determine whether the paper trail corroborates the taxpayer's position. For more details, refer to IRM 20.1.5, Penalty Handbook - Return Related Penalties. In addition, refer to the *Penalties Knowledge Base* for guidance on penalties.

4.31.5.14.1.4.3
(05-17-2022)
**Shareholder Fraud When
Fraudulent S
Corporation Return Filed**

- (1) In *Jenkins vs. Comm'r*, T.C. Memo. 2012-283, the Tax Court issued a summary judgment in favor of the government holding that the shareholder personally committed fraud by understating his S corporation's gross receipts and overstating his S corporation's expenses.
- (2) A summary judgment can be issued by a court when there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law.
- (3) This case is important in that it shows if a shareholder fraudulently files an S corporation return and reports that incorrect S corporation income/loss on his Form 1040, then the shareholder has personally committed fraud.

4.31.5.14.1.4.4
(05-17-2022)
**Assessment of Penalties
on Late or Incomplete
Partnership or S
Corporation Returns**

- (1) IRC 6698 imposes a failure to file penalty on a partnership that fails to file a timely return or provide the information required on Form 1065. IRM 20.1.2.4, Failure to File a Partnership Return- IRC 6698. IRC 6699 imposes a failure to file penalty on an S corporation that fails to file a timely return or provide the information required on Form 1120-S. IRM 20.1.2.6, Failure to File S Corporation Return- IRC 6699. A deficiency does not need to exist to impose these penalties.
- (2) Examiners should consider the failure to file penalty during their partnership or S corporation examinations if it is found that the ILSC pass-through entity failed to file the return, filed the return late or the return filed was incomplete or was missing schedules.

Note: Although most S corporations are not taxable entities, if the return is delinquent and it is a taxable entity, a separate lead sheet should be prepared for

the delinquency penalty under IRC 6651(a) which imposes a penalty for failure to file on balance due returns. Both penalties should be considered when there is a taxable entity; however, only the larger of the two penalties should be asserted. See IRM 20.1.2.6(3) and Program Manager Technical Advice (PMTA) 2013-15 - Section 6651 – Failure to File Tax Return or to Pay Tax.

- (3) In addition, IRC 6722 imposes a failure to furnish correct payee statements including Schedules K-1 to its investors. The penalty applies even if the entity return, Form 1120-S or Form 1065, was filed but the Schedules K-1 were not provided to the investors.
- (4) Therefore, both penalties, IRC 6699 (or IRC 6698) and IRC 6722 may apply when Schedules K-1 were not provided to the investors because the entity failed to file a return.

4.31.5.14.1.4.4.1
(05-17-2022)

**IRC 6698, Failure to File
Partnership Return**

- (1) IRC 6698, failure to file partnership return, provides for an addition to the penalty imposed by IRC 7203 (relating to willful failure to file return, supply information, or pay tax), if any partnership required to file a return under IRC 6031 for any taxable year--
 - a. Fails to file such return at the time prescribed therefore (determined with regard to any extension of time for filing), or
 - b. Files a return which fails to show the information required under IRC 6031.
- (2) The partnership shall be liable for a penalty calculated for each partner* for each month (or part of a month) the return is late or incomplete, not to exceed 12 months. Penalty rates are adjusted for inflation and published at least annually via Internal Revenue Bulletin and in return instructions.
- (3) The amount of the penalty is:
 - For returns due between January 1, 2021 and December 31, 2022 (without regard to extensions) the base penalty rate is \$210.
 - For returns due between January 1, 2020 and December 31, 2021 (without regard to extensions) the base penalty rate is \$205.
 - For returns due between January 1, 2018 and December 31, 2019 (without regard to extensions) the base penalty rate is \$200.
 - For tax years beginning after December 31, 2014 or before December 31, 2017, the penalty is calculated at a rate of \$195 plus an adjustment for inflation. IRC 6698(e).
 - For tax years beginning after December 31, 2009 but which begin before January 1, 2015, the penalty is calculated at a rate of \$195.
 - For tax years required to be filed after December 31, 2008 but which begin before January 1, 2010, the penalty is calculated at a rate of \$89.
 - For returns required to be filed for tax periods that begin in 2008, that are required to be filed before January 1, 2009 the penalty rate is \$86.
 - For returns required to be filed after December 20, 2007 but before January 1, 2009, the penalty is calculated at a rate of \$85.
 - For tax years beginning after December 31, 1978 and required to be filed before December 21, 2007 the penalty is \$50.

*A person is a partner for penalty calculation purposes if the person was a partner for any portion of the tax year.

4.31.5.14.1.4.4.2
(05-17-2022)

IRC 6699, Failure to File S Corporation Return

- (1) IRC 6699, failure to file S corporation return, provides for an addition to the penalty imposed by IRC 7203 (relating to willful failure to file return, supply information, or pay tax), if any S corporation required to file a return under IRC 6037 for any taxable year--
 - a. Fails to file such return at the time prescribed therefore (determined with regard to any extension of time for filing), or
 - b. Files a return which fails to show the information required under IRC 6037,
- (2) The S corporation shall be liable for a penalty calculated for each shareholder** for each month (or part of a month) the failure continues, for up to 12 months.
- (3) The amount of the penalty is:
 - For returns due between January 1, 2021 and December 31, 2022 the base penalty rate is \$210.
 - For returns due between January 1, 2019 and December 31, 2020 (without regard to extensions) the base penalty rate is \$205.
 - For returns due between January 1, 2018 and December 31, 2019 (without regard to extensions) the base penalty rate is \$200.
 - For tax years beginning after December 31, 2014 or before December 31, 2017 the penalty is calculated at a rate of \$195.
 - For tax years beginning after December 31, 2009 but which begin before January 1, 2015, the penalty is calculated at a rate of \$195 plus an adjustment for inflation.
 - For tax years beginning after December 31, 2009 the penalty is calculated at a rate of \$195 and subject to inflation adjustment for.
 - For tax years required to be filed after December 31, 2008 but begin before January 1, 2010 the penalty is calculated at a rate of \$89.
 - For returns required to be filed after December 20, 2007 but before January 1, 2009, the penalty is calculated at a rate of \$85.

For S corporation returns for periods prior to 2008¹², see IRM 20.1.2.5(2).

**A person is a shareholder for penalty calculation purposes if the person was a shareholder for any portion of the tax year.

4.31.5.14.1.4.4.3
(05-17-2022)

Incomplete Returns

- (1) The table below provides that a partnership or S corporation return is incomplete if it is missing schedules or forms such as:

Incomplete Return Schedules	
<ul style="list-style-type: none"> Schedules K-1 (be careful as these may have been removed by the Campus when transcribing return information for returns not secured by Exam). Missing TINs on Schedule K-1 (five or more). Partnership: Schedule L Balance Sheet, if required. 	<p>Note: No balance sheet is required if the partnership satisfies all four of the conditions: (i) Partnership's total receipts for the tax year were less than \$250,000; (ii) Partnership's total assets at the end of the tax year were less than \$1 million (2007 and prior \$600,000); (iii) Schedule K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and (iv) Partnership is not required to file Schedule M-3.</p> <ul style="list-style-type: none"> S corporation: Schedule L Balance Sheet, if required. <p>Note: No balance sheet is required if the corporation's total receipts (see Form 1120-S instructions) for the tax year and its total assets at the end of the tax year are less than \$250,000.</p>

- (2) See IRM 20.1.1.3.3.2.1, First Time Abate (FTA) for penalty relief questions.

4.31.5.14.1.4.4.4
(05-17-2022)

Reasonable Cause

- (1) Examiners should request documentation to consider and determine whether the ILSC pass-through entity can establish reasonable cause. If reasonable cause can be established, the penalty is not applicable.

Note: These penalties have post-assessment appeal rights. The ILSC pass-through entity will have the opportunity to establish reasonable cause after assessment.

4.31.5.14.1.4.4.5
(05-17-2022)

Small Partnership Provisions, Rev. Proc. 84-35

- (1) Under Rev. Proc. 84-35, a domestic partnership consisting of ten or fewer partners and coming within the exceptions outlined in IRC 6231(a)(1)(B) of 2002 will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by IRC 6698 for the failure to file a complete or timely partnership return, provided that the partnership, or any of the partners, establishes, if so requested by the IRS, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.
- (2) Requirements: Non-TEFRA partnership and all partners reported their share of income, deductions, and credits on a timely filed return. Each partner is either an individual (excluding nonresident aliens), or the estate of a deceased partner and each partner's items of income, deductions, and credits are allocated in the same proportion as all other items of income, deductions, and credits.

Note: This provision does not apply to an S corporation.

4.31.5.14.1.4.4.6
(05-17-2022)

First-Time Abate Administrative Waiver

- (1) In accordance with IRM 20.1.1.3.6.1, the first-time abate (FTA), based on a history of compliance, can be considered for the failure to file or failure to pay penalties on all forms. This includes IRC 6698 and IRC 6699 penalties.
- (2) However, FTA does **not** apply if the penalty is assessed because the ILSC pass-through entity filed a return that failed to show the information required under
 - IRC 6031 (in the case of IRC 6698), or
 - IRC 6037 (in the case of IRC 6699).

Note: Although IRC 6699 was not applicable prior to Dec. 21, 2007, the 3-year history includes any S corporation. FTA relief does not apply if any return required to be filed was not filed by the return due date (generally Mar. 15th) or extended due date (generally Sept.15th).

4.31.5.14.1.4.4.7
(05-17-2022)

Who Asserts the Penalty

- (1) Generally, the campus will assert the penalty when the delinquent return is processed.
- (2) The examiner should review BMFOLT to see if these were previously asserted.
- (3) Examiners have responsibility for asserting IRC 6698 and IRC 6699 penalties when:
 - An SFR has been input on the system, or
 - There are adjustments necessary to increase or decrease the penalty assessed by the Campus.

4.31.5.14.1.4.4.8
(05-17-2022)

Asserting the IRC 6699 Penalty

- (1) The penalty will be assessed against the entity.
- (2) The penalty is generally assessed during pipeline processing of the return, and a notice explaining that assessment (CP 162) is sent to the ILSC pass-through entity. This process meets the taxpayer notification requirements contained in IRC 6751.
- (3) When these penalties apply, and they were not assessed during pipeline processing (or the assessed amount was less than the amount required by law), the tax must be manually assessed. In order for manual assessments of these penalties to meet the taxpayer notification requirements contained in IRC 6751, the following procedure must be followed by ALL employees assessing either penalty for a tax period where TC 150 is already posted. (If TC 150 is not posted, the penalty should be assessed through normal pipeline processing whenever possible.)
- (4) Examiners are responsible for considering and asserting or adjusting the penalty when –
 - An SFR has been placed on the system, or
 - The field identifies that the Campus assessment of the penalty should be adjusted.
- (5) No examination report or waiver needs to be prepared and the signature for the ILSC pass-through entity will not be solicited. The penalties are not subject to deficiency procedures, IRC 6698(d) and IRC 6699(d). Accordingly, they

should not be part of any system that can result in deficiency procedures in respect to the assessment or collection of these penalties. The penalty will not be part of the examination report or on Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties.

- (6) Examiners should consider the penalty during an examination if it is found that the ILSC pass-through entity failed to file the return, filed the return late or the return filed was incomplete or was missing schedules. Facts and circumstances should be developed to determine whether the penalties apply.
- (7) Determine if the entity return was late or incomplete. It is incomplete if it is missing schedules or forms such as:
 - Schedules K-1 (be careful as these may have been removed by the Campus when transcribing return information).
 - Missing TINs on Schedule K-1 (five or more).
 - Schedule L Balance Sheet, if required. (Note: If gross receipts and total assets at the end of the tax year are less than \$250,000 no Schedule L is required for S corporations).

4.31.5.14.1.4.4.9
(05-17-2022)
Statute of Limitations

- (1) The statute of limitations will be three years from the date the return is filed or, for SFR inputs, when an agreement is reached at the corporate level. If the case is unagreed and no return was filed, then use alpha statute code "EE."

4.31.5.14.1.4.4.10
(05-17-2022)
POA Covering Penalties

- (1) If a representative is to be included in correspondence or discussions of the IRC 6698 or IRC 6699 penalties, Form 2848, Power of Attorney and Declaration of Representative, will be needed that states "Civil Penalties" in addition to other tax considerations. See IRM 20.1.7.4, Power of Attorney for Civil Penalties. Please ensure that: (1) the applicable "Year(s) or Period(s)" section is complete (e.g., "Dec. 31, 2016" or "12/31/2016," and not merely "2016" or "16") and, (2) there is evidence that the form has been sent to the campus.

4.31.5.14.1.4.5
(05-17-2022)
Field Examination Procedures

- (1) When warranted, the penalty case files should be established separately from the audit of the partnership or S corporation. (Note: If it is established that the ILSC pass-through entity has reasonable cause, notate it in the entity examination; there is no need to establish the penalty). The penalty case should be established on ERCS by requesting controls on Form 5345-D, Examination Request-ERCS Users, or Form 5345-B, Examination Request Non-ERCS User, selecting the "Control Penalty Investigation box" and including the taxpayer's name and TIN, source code 99, **tracking code 6413**, activity code 506, and MFT PY on the examiner's ERCS Monthly Time Worksheet.

Note: If it is established that the ILSC pass-through entity has reasonable cause prior to setting up the penalty file, notate the determination in the entity examination; there is no need to establish the penalty file.

- (2) See IRM 20.1.7, Penalty Handbook - Information Return Penalties, and *Partnership Knowledge Base* for more information.
- (3) The case file should contain:
 - A complete copy of the entity delinquent return(s) labeled in RED at the top "Copy of Delinquent Return - Do Not Process." (Include a copy of

the envelope reflecting the postmark when the return was mailed. Remember that timely mailing is timely filing regardless of when the return is received.)

- A recent BMFOLT print of the tax module for the return.
- Form 3198, Special Handling Notice for Examination Case Processing, under the “Other” instructions indicate failure to file penalty IRC 6698 or IRC 6699.
- Form 886-A, Explanation of Items, or its equivalent.
- Examiner’s Activity Record.
- Form 3244-A, Payment Posting Voucher - Examination.

If advanced payment of the penalty is received, TC 670 with secondary TC 570 will be used to indicate an advance payment of the penalty. In the box titled “Form number/MFT” enter Form 1065 or Form 1120-S as applicable. Do NOT enter “13.” MFT 13 is used only for civil penalties that are not return related.

- No examination report or waiver needs to be prepared and a signature for the ILSC pass-through entity will not be solicited, as deficiency procedures do not apply. See IRM 20.1.7, Penalty Handbook – Information Return Penalties and *Partnership Knowledge Base* for more information. Taxpayers who are not in agreement with the penalty application should be informed that a post assessment appeal procedure allows them to appeal the penalty determination to an appeals officer after assessment of the penalty, but prior to payment.

Note: Taxpayers may also file a claim for refund after full payment of the penalty.

4.31.5.14.1.4.5.1 (05-17-2022) No Change Cases

(1) Form 3870, Request for Adjustment

- a. The examiner will enter the taxpayer information. TC 160 for FTF penalty amount, and TC 240 for missing information penalty amount in item 29. (No penalty reference number is necessary.)
- b. For no-change cases, the TC 160 for FTF penalty or 240 for missing information amount should be input for a zero amount. Manager’s approval (signature) is required in item 14; if it is not signed, the case will be returned to the field from Centralized Case Processing (CCP).

Note: Form 3870 should not be used with TC 160 or 240 with an amount other than zero.

(2) The examiner's workpapers (including a determination of why the penalty does not apply).

4.31.5.14.1.4.5.2 (05-17-2022) Abatement Cases

(1) Abatement cases will need the following:

- a. Form 3870, Request for Adjustment - The examiner will enter the taxpayer information. TC 161 for FTF penalty decrease, and TC 241 for missing information penalty decrease in item 29. (No penalty reference number is necessary). Manager’s approval (signature) is required in item 14; if it is not signed, the case will be returned to the field from CCP.
- b. The examiner’s workpapers (including a determination of why penalty does not apply).

- (2) Abatement cases require input into the “Short Period Early Termination Module”.
 - a. To abate or correct the penalty where the entity has a short period and the penalty was assessed using the incorrect return due date, prepare a Form 3870 to input TC 971 with action code 358 in the short period early termination module. Use the correct return due date as the transaction date. This will manually set the return due date for the module to the transaction date of the TC 971 AC 358. That will cause the computer to automatically abate or correct the penalty. See IRM 21.7.4.4.4.2.1.2, Correcting the Form 1120, Return Due Date.

4.31.5.14.1.4.5.3
(05-17-2022)

Assessment Cases

- (1) Form 2859, Request for Quick or Prompt Assessment.
- (2) Check the “Quick” box and the applicable box for the examiners functional area.
- (3) Prepare the rest of the form using the following instructions:

Preparation of Form 2859:	Instructions:
Step 1:	Complete Part A – Taxpayer Information. However, do not enter an 870 Agreement Date, a Correspondence Received Date, a 2 percent int. date, or an Int. Comp. Date.
Step 2:	Complete Part B – Requester Information. Manager’s approval (signature) is required under IRC 6751. (This may not be delegated to an “acting” employee. For the purpose of this requirement, an employee is “acting” if a delegation order is not on file that delegates all authorities of the manager to that employee. If acting with delegation order on file, please indicate in the case file.)

Preparation of Form 2859:	Instructions:
Step 3:	<p>Complete Part C – Assessment Information.</p> <p>1) Enter form number (1065 or 1120S) in item 1.</p> <p>2) Enter tax period in YYYYMM format in item 2a.</p> <p>3) If assessing a penalty for filing late, enter the penalty amount on line 6.</p> <p>4) If assessing a penalty for filing an incomplete return—</p> <p>4a) Enter “Incomplete Return Penalty” on line 12 in the “Transaction” Column.</p> <p>4b) Enter “240” on e 12 in the “TC” column.</p> <p>4c) Enter the penalty amount on line 12 in the “Transaction Amount” column.</p> <p>5) If assessing a penalty for filing late for Form 1120-S, and the posted return (TC 150) is a SFR return (DLN is all 9s except for the first two digits and the last digit), then interest must be restricted. In item 17—</p> <p>5a) Enter “23C DT” as the “Interest-To-Date”.</p> <p>5b) Enter “340” in the “TC” column.</p> <p>5c) Enter “.00” in the “Transaction Amount” column.</p>
Step 4:	<p>In the “Remarks” area enter “Quick assessment to satisfy IRC 6751”.</p> <p>Do not complete any other parts of Form 2859.</p>

4.31.5.14.1.5
(10-01-2010)
Preparer Penalties

- (1) Under 26 CFR 301.7701-15(b)(3), a preparer of the key case entity return is considered a preparer of the investor’s return if the “pass-through” share of income, credits, deductions, etc. from the key case entity reportable on the investor’s return constitutes a “substantial” portion of the investor’s return.

Note: For purposes of this section, whether an entry, schedule, or other portion of an investor’s return is “substantial” depends on its length, complexity, and the associated tax liability, relative to the return as a whole. A single entry, schedule, or other portion involving amounts of gross income, deduction or basis for computing a credit that is either (i) less than \$10,000, or (ii) less than \$400,000 and also less than 20 percent of gross income (or AGI for an individual), shall not, by itself, be “substantial”. If there are several entries, schedules, or other portions, the preceding amounts (and percentage) are applied to the aggregate. See 26 CFR 301.7701-15(b)(3)(ii)(A) and (B).

- (2) In those situations where a preparer penalty under IRC 6694(a) or IRC 6694(b) may be warranted:

- a. If the return is controlled outside the CPF, the CPF will alert the those with AIMS control by placing a comment on line 5 of Form 6657, stating that a penalty is being considered;
- b. The investor area or CPF should complete their examination; and
- c. Send a memorandum to the key area with a copy of the RAR, and copies of pertinent sections of the investor's income tax return. This allows the key area to decide whether the pass-through items from the key case entity are, in fact, a substantial part of the investor's return, and whether a penalty should be applied.

4.31.5.14.2
(05-17-2022)

Investor Reports

- (1) Examiners are responsible for issuing the investor reports and letters for any investor they control. CPF will prepare and issue reports for investors they control. The report should include the pass-through adjustments from the entity examination. In addition, the investor reports should include other adjustments that do not pertain directly to the entity examination, that can only be addressed at the investor level. These adjustments include stock and debt basis limitations for S corporation shareholders, outside basis limitations for partners in partnerships, at-risk limitations, passive activity limitations, taxable loan repayments, and taxable distributions.
 - (2) Generally, the campus **will not** examine any non-pass-through items on the return. For example, the campus does not audit the investor to determine whether there is sufficient basis to claim the loss. Likewise, they do not audit at-risk, passive activity loss limitations, taxable loan repayment, or the determination of a taxable distribution in excess of basis. The examiner is responsible for the examination of these issues.
 - (3) IRM 4.31.5.10(2), Investor Statutes, states that if less than 210 days remain on the statute the examiner should solicit an extension.
 - (4) If a statutory notice of deficiency is issued, it must contain all adjustments – pass-through and non-pass-through adjustments. (However, it should not include any TEFRA adjustments.) Generally, unagreed non-docketed cases sent to Appeals must include both pass-through and non-pass-through issues (an exception may be made under the Early Referral Program, see Rev. Proc. 99-28).
- Note:** Investors may be subject to ILSC and BBA Chapter 2/2A adjustments which are both subject to deficiency procedures. BBA Chapter 2/2A investors are required to be linked on PCS. When BBA Chapter 2/2A investors are controlled in the CPF they will be held in EGC 57XX.
- (5) Form 4549, or Form 4549-A along with Form 870, Waiver of Restrictions on Assessment & Collection of Deficiency in Tax and Acceptance of Overassessment, are the forms that are used to reflect the appropriate adjustments. Each shareholder must sign a separate Form 4549 as part of their examination. The only difference between Form 4549 and Form 4549-A, Income Tax Examination Changes, is that the Form 4549 has a signature line and Form 4549-A does not.
 - (6) Form 4549, Form 870 can be accepted by fax from the taxpayer if contact has been made with the taxpayer by phone or in-person and the taxpayer history file is documented with the date of contact and notation is made that the taxpayer wishes to send the form by fax.

4.31.5.14.2.1
(05-17-2022)
Investor Amended Returns - Report Writing

(1) The agent should review and process all amended returns and claims received per IRM 4.10.8.14.6.3, Examination of Return or IRM 4.10.8.10, Claims for Refund and Overassessments.

4.31.5.14.2.2
(06-07-2013)
Capital Loss or Net Operating Loss Carryforward Adjustments

(1) A capital loss or net operating loss carryforward is governed by the investor's IRC 6501 statute for the carryforward year. IRC 6501(h) would extend the investor's statute based on the loss year only for carrybacks. If a carryforward adjustment is possible, the investor's statute will need to be protected on all carryforward years.

4.31.5.14.3
(05-17-2022)
Tax Computation Specialist (LB&I Only)

(1) Upon completion of the examination of the pass-through entity, various reports and letters to the entity and its investors' will be necessary (unless they are PCS linked).

(2) Examiners in LB&I utilize the services of a tax computation specialist (TCS) during this process. However, ultimately it is the examiner's responsibility to ensure the accuracy of the information prepared by the TCS. As such, it is imperative that examiners understand what reports and letters are used for the various types of case closures (i.e., agreed, unagreed, and no-change).

Note: A request for TCS services is made through the SRS program.

- (3) Once the TCS has been assigned to a case, the examiner will communicate directly with that TCS for all the services listed below:
- Pre-Computation or Input – This referral should be made very early in the examination process. The return information is input by the TCS into BNA/RGS to reconcile the tax computations on the return or identify any variances.
 - Mid-Cycle or Tentative Computation – This referral can be made at any point during the examination process. The TCS will prepare a tentative RAR based on the current proposed adjustments.
 - Final Tax or RAR Computation – This referral will be made at the conclusion of the examination. The TCS will prepare a final RAR based on all the adjustments having been identified as either agreed or unagreed.

The priority order for working the referrals by the TCS is the (1) RAR Computation, (2) Input Computation and (3) Tentative Computation. In addition, the referrals will be worked according to the earliest estimated completion date (ECD).

- (4) The TCS is a team member; as such, the examiner needs to keep in contact with them on a regular basis. This is particularly important on large and complex cases.
- (5) With an S corporation, ensure the adjustments are clear on the impact of the adjustment to ordinary income or separately stated items. It is best practice to list the schedule and line number affect (e.g. Page 1, Line 19 Other Deductions or Schedule K, Line 4 Interest Income). Remember that an adjustment may have an impact on more than one item (i.e., IRC 199).

- (6) Be sure to identify all adjustments recommended for penalties. This includes penalties for late filing, late payment, accuracy related, etc.
- (7) The accuracy of the reports issued by the TCS is the responsibility of the examiner who is assigned the case. Please review the reports carefully.
- (8) For questions about the TCS referral process, please see the Procedure Guide - Tax Computation Specialist.

4.31.5.15
(05-17-2022)
**Pass-Through Entity
Case Closing
Procedures**

- (1) An examination that results in no changes to the entity is closed **no change**.
- (2) The entity return is closed **agreed** when changes are made to the entity and all the investors agree to the entity pass-through adjustments on their Form 4549.
- (3) If the case is linked, the entity return should be closed **agreed** if the entity's Form 4605 is signed by a person authorized to sign. A signature indicates agreement for a linked case if the examiner is not aware of any investors who are not in agreement. The signature does not bind any investors and any controlled by the CPF will receive 30-day letter.
- (4) The entity return should be closed **unagreed** if any investor does not agree to all of the adjustments.
- (5) A partial agreement should be secured during the investor examination if some of the pass-through adjustments are agreed and others are not. However, a partial agreement should not be secured at the entity level, instead close the entity as **unagreed**.
- (6) The type of closure and the appropriate reports, letters and disposal codes are discussed separately below. See Exhibit 4.31.5-1 , Entity Closing Chart and Exhibit 4.31.5-2, Disposal Codes.

4.31.5.15.1
(05-17-2022)
No-Change Cases

- (1) The entity examination results in a no-change if there are no adjustments made to ordinary income/loss or any separately stated items of income/loss, deduction, credit or distributions. However, if a change is made to the **allocation** of any ordinary income/loss or separately stated items, the examination is no longer considered a no-change.
- (2) If the taxpayer raises affirmative issues during the examination, consider them as part of the examination. If adjustments are made in the entity's favor, make the adjustments on the entity's and on the investors' returns. It is no longer considered a no-change.
- (3) If it is determined that the affirmative issues are not allowable, issue a no-change report. The fact that the issues were considered but not allowed will be noted in the remarks section of the Form 4605-A and explained on Form 886-A. This report should be associated with the relevant investors' files for future reference. There is no procedure similar to the Administrative Adjustment Request (AAR) procedure under TEFRA for non-TEFRA partnerships. Investors must file a claim for any further consideration.

4.31.5.15.1.1
(05-17-2022)
No Change Forms

- (1) When no changes have been made to the entity, prepare a no-change report using Form 4605-A with Letter 3401-S, Pass-Through Entity No Change Transmittal (ILSC). At the top of Form 4605-A or in the Remarks section at the bottom write "NO-CHANGE SUBJECT TO [AREA DIRECTOR (for SB/SE cases) or DIRECTOR, FIELD OPERATIONS (for LB&I cases)] APPROVAL". It is not necessary to secure the entity's signature since no changes have been made. Also, see *FAQ* "How can I print a "no-change" report with RGS for an 1120, 1065 or 1120-S case?"
- (2) When changes have been made to the entity but not to the ordinary income/loss or any separately stated items of income/loss, deduction, credit or distributions, do not use Letter 3401-S. The Letter 3401-S states "... I am proposing no change to your tax return". Examiners should use the agreed letters and reports; Form 4605, with Letter 921, Report Transmittal for ILSC Partnership, Fiduciary, and S Corporation. An example would include a reclassification of a balance sheet item.
- (3) The LB&I Streamline Process eliminates the requirement for examiners to issue a No Change Revenue Agent Report (RAR) for Disposal Code 02 examination closures. See the full requirements at IRM 4.46.6.3.1, No-Change Examination (Disposal Code 02) Procedures.

Note: This streamlined process does not apply to returns closed using Disposal Code 01, No Change with Adjustments (or any examination with adjustments in one or more years which net to zero), returns subject to Joint Committee review, Offshore Voluntary Disclosure Initiative (OVDI) cases, TEFRA examinations, or ILSC returns which are linked. In addition, the streamlined process does not eliminate the requirement to submit an SRS referral for a TCS when an examination is initiated. The assigned TCS will continue to complete the initial input of all returns to verify the accuracy of the per return tax computations.

4.31.5.15.1.2
(05-17-2022)
No-Change Letters

- (1) When no changes have been made to the entity, Report Transmittal Letter 3401-S is issued to the entity along with Form 4605-A. This letter explains that the examination of the entity has been completed and no changes are being proposed to the return. LB&I examiners, see IRM 4.31.5.15.1.1(3), No Change Forms, for Streamline Process Information.
- (2) Prepare the case closing Letter 992, No-Change, and include it in the closed case file. The letter states that the examination of the entity return has been completed and the return has been accepted as filed. Indicate on the Form 3198 that the letter should be issued. Centralized Case Processing (CCP) will issue the letter after the case is closed.
- (3) When changes have been made to the entity but not to the ordinary income/loss or any separately stated items of income/loss, deduction, credit or distributions, do not use Letter 3401-S. The Letter 3401-S states "... I am proposing no change to your tax return." Examiners should use the agreed letters and reports; Form 4605, with Letter 921. An example would include a reclassification of a balance sheet item.

Note: No-change with adjustment reports and letters apply to taxable entities that have adjustments made to an item of income, loss, deduction and/or credit

but results in no tax. If changes are made to the entity return which result in a DC 01, use agreed reports and letters to communicate these changes.
Example: Reclassification of a balance sheet item resulting in no changes to the investors' Schedule K-1.

4.31.5.15.1.3
(05-17-2022)
**No Change Disposal
Codes**

- (1) Use DC 01 (No Change with Adjustments).
 - a. No changes are made to the entity's reported items of income, loss, deduction, credit or distribution as reflected on the return, **and**
 - b. A delinquent return is secured by examination and accepted as filed. If the TC 424 posted prior to the posting of the delinquent return, enter the amount of the ordinary income/loss and separately stated income/loss items per the delinquent return, in Form 5344, Examination Closing Record, Item 414. (If an SFR has posted, the amounts from the secured return must be input through RGS; therefore, DC 01 does not apply), **or**
 - c. There is an adjustment made to a balance sheet item, **or**
 - d. When no changes are made to the entity's ordinary income or loss or separately stated items reflected on the return or Schedule K-1 and an owner's return is adjusted as a result of the flow through examination. This would include (i) adjustments to basis, at risk, or passive activity rules; (ii) taxable distributions or taxable loan repayments; and (iii) adjustments made to include the amount(s) reported on the investor's Schedule K-1.
- (2) Use DC 02 when no examination changes are made to the entity's reported items of income, loss, deduction, credit or distribution as reflected on the return **and** no adjustments were made to any related returns as a result of the entity examination.

4.31.5.15.2
(05-17-2022)
Agreed Cases

- (1) For a non-taxable entity, the entity examination is agreed when, all investors agree to the findings impacting their individual return. Individual investors will receive a report incorporating the entity pass-through adjustments when it results in an income tax liability to their return. If the case is linked, the entity return should be closed agreed if the Form 4605 is signed by a person authorized to sign agreements and the examiner is not aware of any investor who disagrees.
- (2) For a taxable S corporation, the entity examination is agreed when an authorized corporate officer signs Form 4549 and all investors agree to the findings impacting their individual returns.
- (3) The case is unagreed if one or more of the investors do not agree.

4.31.5.15.2.1
(05-17-2022)
Agreed Report Forms

- (1) Form 4605 is normally used when the entity audit results in examination adjustments. Form 886-X (for S corporation) or Form 886-S (for partnership) allocates the entity's corrected pass-through items to the investor(s).
- (2) If the S corporation is subject to an entity level tax, use Form 4549 to reflect an adjustment to the tax. Form 4549 should be signed by a corporate officer authorized to sign binding agreements.
- (3) A signature on Form 4605 does not bind any of the investors, it is an indicator of potential agreement. Each investor must sign a separate Form 4549 as part of their examination. If the examiner controls all investors, the entity case can

be closed agreed without a signature on Form 4605 if all the investors individually agree to the adjustments relating to the entity adjustments on their Form 4549. If this is the situation, note on Form 4605, "Agreement secured at investor level".

- (4) When the examiner controls one or more of the investor cases on AIMS, state on Form 3198, Special Handling Notice for Examination Case Processing, that the entity and investor cases are related and should remain together. When the corporation has been PCS linked, check the box for TEFRA or Non-TEFRA Key Case.

4.31.5.15.2.2 (05-17-2022)

Agreed Letters

- (1) Report transmittal, Letter 921, is issued to the entity upon completion of an examination resulting in adjustments with a copy of the final examination report.
- (2) This letter explains that the examination report, Form 4605, is enclosed and provides directions to the entity on what to do if it agrees or disagrees with the examination report. The letter states, "The investors of the entity must protest the findings; the protest is not made at the entity level because it is not a taxable entity." It goes on to state "We'll also send a separate examination report to each partner, shareholder, grantor, fiduciary, or beneficiaries (investor) whose income tax liability the proposed adjustments may affect. After the investor receives their separate examination report, the investor may appeal adjustments they disagree with by requesting an appeals conference. The investors' separate examination reports will fully explain their appeal rights."
- (3) The examiner prepares final closing Letter 1002, Notification Letter for Agreed Audit Changes for Partnerships and S Corporation (non-TEFRA) Cases, which states that the report, previously discussed and provided, was reviewed and accepted. The letter is included in the closed case file and is issued by Centralized Case Processing (CCP) after the case is closed. Indicate on Form 3198 that the letter should be issued.
- (4) If the corporation is subject to an entity level tax, both reports (Form 4605 and Form 4549) should be transmitted with the letters used for a C corporation examination. Letter 4121, Agreed Examination Report Transmittal, and final closing Letter 987, Agreed Income Tax Change.

4.31.5.15.2.3 (05-17-2022)

Agreed Disposal Codes

- (1) Use disposal code (DC) 03 or 04 for Form 1120-S and Form 1065 cases that are closed agreed. These disposal codes apply when all investors agree to the examination findings. Linked cases are agreed if the entity indicates agreement to the adjustments by signing Form 4605 and there is no indication that any investors are not in agreement with the findings.

4.31.5.15.3 (05-17-2022)

Unagreed Cases

- (1) The entity examination is unagreed when one or more of the investors does not agree to the findings impacting their individual return. If the return is linked, an entity is considered unagreed if the entity does not sign in agreement with the entity level adjustments. Although an entity agreement is not binding, it has been found that when an entity "agrees" to the adjustments, the investors usually agree. The linked entity examination is also considered unagreed when the entity "agrees" but the examiner is aware that one or more of the investors does not agree to the findings impacting their individual return. Individual

investors will receive a report incorporating the entity pass-through adjustments when it results in an income tax liability to their return. The investor has the opportunity to protest the findings. The protest is not made at the entity level since it is not a taxable entity.

- (2) If the S corporation is a taxable entity, in addition to the pass-through adjustments, the entity is able to protest the entity level tax adjustments.
- (3) The entity examination is considered to be unagreed if the case consists of both agreed and unagreed investors.

4.31.5.15.3.1
(05-17-2022)

Unagreed Report Forms

- (1) Form 4605 is normally used when the audit results in examination adjustments to the items reported on the entity return. Form 886-X (for S corporation) or Form 886-S (for partnership) allocates the entity's corrected pass-through items to the investor(s).
- (2) In addition to the above forms, use Form 4549-A along with Form 870 if the S corporation is subject to an adjustment to the entity level tax. Form 870 should be signed by any corporate officer authorized to sign binding agreements.

4.31.5.15.3.2
(05-17-2022)

Unagreed Letters

- (1) Report transmittal, Letter 921, is issued to the entity upon completion of an examination resulting in adjustments with a copy of the final examination report.
- (2) This letter explains that the examination report, Form 4605, is enclosed and provides directions to the entity on what to do if it agrees or disagrees with the examination report. The letter states, "We'll also send a separate examination report to each partner, shareholder, grantor, fiduciary, or beneficiary (investor) whose income tax liability the proposed adjustment may affect. After the investor receives their separate examination report, the investor may appeal adjustments they disagree with by requesting an appeals conference. The investors' separate examination reports will fully explain their appeal rights."
- (3) For taxable S corporations, Letter 950, 30 Day Letter - Straight Deficiency, is issued to the entity with Form 4549-A and Form 870. The Letter 950 explains that the examination report, Form 4549-A, is enclosed and provides directions to the entity on what to do if it agrees or disagrees with the examination report.
- (4) If investors are controlled by the examiner, the examiner should follow normal case processing. Reports will be issued to each investor. The investor's report should show pass-through issues and any other issues that have been addressed during the audit. If the entity level case is unagreed, the examiner will need to issue the individual 30-day letter and report to each investor.
- (5) When the case is linked and the campus controls investors, the campus will issue the 30-day letters to the investors they control and forward protesting investors to Appeals per their procedures.

4.31.5.15.3.3
(06-07-2013)

Fast Track Settlement

- (1) Fast Track Settlement (FTS) is a service offered by the IRS designed to expedite case resolution. It involves an Appeals Officer who has been trained in mediation techniques acting as a mediator between the taxpayer and Compliance (Examination/Collection). The purpose is to facilitate communication and to help the parties resolve the issue(s). This service is available for unagreed issues on ILSC key cases and should be considered by the

examiner before reports are issued to investors. At the conclusion of an examination determination, if the ILSC pass-through entity do not agree to the proposed changes, the examiner will determine whether the case qualifies for FTS using the case criteria set forth in FTS Eligibility. If the case qualifies for FTS, see IRM 4.10.7.5.6, SB/SE Fast Track Settlement, or IRM 4.46.5.4.2.6, Fast Track Settlement (FTS) (LB&I). If the case does not qualify for FTS, standard procedures for unagreed cases should be followed.

4.31.5.15.3.4
(05-17-2022)

Unagreed Cases with No Immediate Tax Consequences

- (1) As a rule, there is nothing to appeal if there is no deficiency at the investor level. The table below provides an example:

Example – No Immediate Tax Consequences

Example - No Immediate Tax Consequences	
The S corporation reflects a (\$400,000) loss. The sole shareholder is only able to claim (\$100,000) because of stock and debt basis limitations; the remaining loss (\$300,000) is suspended and carried over.	
An audit changes the (\$400,000) loss to a (\$275,000) loss. The \$125,000 S corporation audit adjustment will not result in a deficiency at the shareholder level as the suspended loss carryover has merely been reduced from (\$300,000) to (\$175,000). As such, there is no deficiency to appeal.	
Note: Carryover year should be adjusted, or a Form 5346, Examination Information Report, should be completed for future years.	

- (2) As part of the IRS's dispute resolution process, Appeals may still grant consideration of these cases when requested by the taxpayer. Taxpayers requesting an Appeals conference under the provisions of this section must file a protest addressing the proposed adjustment with the examiner. The examiner will then forward the case to Appeals as unagreed. The IRS cannot request the appeal of a case with no tax consequences; only the taxpayer can request an appeal.
- (3) Letter 950-F, 30-Day Letter - No Deficiency, along with Form 13683, Statement of Disputed Issues, is sent on unagreed change/no change cases where the taxpayer wants to go to Appeals.
- (4) Close the case unagreed upon receiving a timely protest using Disposal Code "07". If no protest is received, close the case change/no-change using Disposal Code "01".

4.31.5.15.3.5
(05-17-2022)

Unagreed Disposal Codes

- (1) Use DC 07 (Appealed) or 08 (did not agree and did not request an Appeal) to close the entity case when one or more investors do not agree.

4.31.5.15.3.5.1
(05-17-2022)

Transferring to Technical Services

- (1) Generally, the key case and all investors should be forwarded to Technical Services with at least one unagreed or protesting investor. If the key case is not linked on PCS, Appeals will only accept protesting cases if the entity has five or fewer investors and none of the investors is a pass-through entity. See IRM 4.31.5.12.2.4, When to Link the ILSC Key Case on PCS.

- (2) If an entity files a protest and no investors are controlled by the agent, the case should be closed to Technical Services with a DC 08, Other, and Form 3198 marked as ILSC key case.
- 4.31.5.15.4
(05-17-2022)
Taxable S Corporation
- (1) If the S corporation is subject to an entity level tax (including Built-in Gains per IRC 1374, Excess Net Passive Investment Income Tax per IRC 1375, LIFO Recapture Tax per IRC 1363(d), recapture of prior years' investment credit, or tax paid on fuels), use Form 4549 to reflect the tax. The form should be signed by a responsible person authorized to sign binding agreements.
- (2) If an S corporation is subject to tax, the examiner will set up the issue in RGS by selecting "Income Tax Computation and Credits" and then choose the appropriate Standard Audit Index Number (SAIN). After that select "Taxes" and the appropriate issue. A pop-up box will appear on RGS. After the examiner completes the pop-up box, RGS will compute the tax. Form 4549 will reflect the tax on Line 10; no entries are reflected on Lines 1-4.
- (3) If it is determined that the corporation is not an S corporation but rather a C corporation, a Form 4549 or Form 4549-A will also be used to make the corporate level adjustments. See IRM 4.31.5.14.1.1, Conversion of S Corporation to C Corporation.
- (4) If the corporation is a taxable entity, follow the same case closing procedures as for a C corporation. Additionally, a Form 4605 needs to be prepared to reflect adjustments to the pass-through items.
- (5) If the case is unagreed, the examiner will send the Form 4549-A, Form 870, and Letter 950 to the corporation in addition to the Letter 921. Follow regular corporation 30-day letter procedures. If the issue is whether the S corporation election is valid, please see "Conversion of S corporation to C Corporation" discussion below.
- (6) If converting the S corporation to a C corporation, the Form 4605 will zero out the income/loss, deduction, and credits previously reflected on the originally filed S corporation return.
- (7) In addition, the return's activity code must be updated to 202 for the assessment to be made. The examiner should change the activity code using Form 5348, AIMS/ERCS Update. If the return was subject to tax upon filing, its activity code will have been updated to 202.
- 4.31.5.15.4.1
(05-17-2022)
Form 5344 – Examination Closing Record
- (1) As with any case, it is important that the examiner verify that the amounts on Form 5344, Examination Closing Record, are accurate and complete. See *Form 5344 Entries – Area of Responsibility*. To capture examination results for a pass-through entity, RGS reflects an amount on Item 34, Adjustment Amount, based upon the adjustments that affect taxable income and credits as outlined below in IRM 4.31.5.15.4.1.1, Item 34 - Adjustment Amount and IRM 4.31.5.15.4.1.1.1, Adjustment to Credits.
- 4.31.5.15.4.1.1
(05-17-2022)
Item 34 – Adjustment Amount
- (1) For an S corporation, the adjustment should be the difference between per return and corrected Schedule K, Line 18, Income/loss reconciliation. Schedule K, Line 18 includes adjustments made to following line items:

Schedule K-1 Items to be Included in Line 34, Form 5344

Schedule K-1 Items	Line number (1065)	Line number (1120-S)
Ordinary business income (loss)	1	1
Net rental estate income (loss)	2	2
Other net rental income (loss)	3	3
Total guaranteed payments	4c	N/A
Interest Income	5	4
Ordinary dividends	6a	5a
Royalties	7	6
Net short-term capital gain (loss)	8	7
Net long-term capital gain (loss)	9a	8a
Net section 1231 gain (loss)	10	9
Other income (loss)	11	10
Section 179 deduction	12	11
Investment Interest expense	13H	12H
Section 59(e)(2) expenditures	13J	12J
Total foreign taxes paid	16P	14P
Total foreign taxes accrued	16Q	14Q

4.31.5.15.4.1.1.1
(05-17-2022)

Adjustments to Credits

- (1) Item 34 is increased or decreased when credits are adjusted. The increase or decrease should be the total credit adjustment divided by 30 percent (credit amount / 30 percent = credit adjustment amount). This grosses up the credit adjustment amount to more closely reflect the change to ordinary income/expense items.
- (2) For example, if there are adjustments that increase the entity's ordinary income by \$4,000 and \$10,000 of credits are being disallowed, the adjustment amount on Item 34 should reflect \$37,333 (4,000 + 33,333 [10,000/.3]).

4.31.5.15.4.1.1.2
(05-17-2022)

**Offsetting Adjustments
or Only Adjustment is to
Distributions**

- (1) When there are changes to income, loss, deduction, or credit items, the adjustment amount on Line 34 requires an entry other than zero. When adjustments made to the entity net to zero or when only distributions are adjusted, enter \$1. The table below provides an example:

Example – Offsetting Adjustments**Example - Offsetting Adjustments**

An audit finds the entity included in ordinary business income a rental activity loss of (\$10,000). The rental loss should have been separately stated.

The report would reflect two adjustments. Ordinary income would increase by \$10,000 while Rental loss would decrease by \$10,000. This would result in total adjustments of \$0.

The adjustments net to \$0. The case should be closed agreed or unagreed based upon whether investor agreements can be secured.

The Form 5344, Item 34, Adjustment Amount should be shown as \$1.

4.31.5.15.4.1.1.3
(05-17-2022)
**Form 5344 and Taxable
S Corporation**

- (1) If the S corporation is subject to tax, RGS will prepare two reports a Form 4549 (for the built-in gains or excessive net passive income tax) and a Form 4605 for the pass-through adjustments.
- (2) Only one Form 5344 is required for the entity and should include –
 - Item 34 amount based upon the adjustments made to the S corporation taxable income.
 - Item 12, TC 300, Tax Amount, and
 - Item 15 Reference Code 886 reflecting the change to taxable income (e.g., the amount of gain subject to the built-in gains tax).

Note: RGS will input the TC 300 and Item 34 amounts, but they should be verified. The examiner must manually input Item 15.

4.31.5.15.5
(05-17-2022)
Case Closing Guidelines

- (1) Remember that if the examiner establishes AIMS controls for the investor return, that is treated as an audit. Follow normal audit procedures for the investor. The report should include both pass-through and non-pass-through issues.
- (2) Below are some general guidelines for closing the pass-through entity case.

4.31.5.15.5.1
(05-17-2022)
**Adjustments Made to
Income, Loss,
Deduction, Credit or
Distributions**

- (1) The case should be closed either agreed or unagreed.
- (2) Issue a Form 4605 with transmittal Letter 921 to the entity and request that they sign and return the report.
- (3) If the investors are controlled, the examiner will make the pass-through entity adjustments on the investor returns. Remember that this constitutes an examination. Be alert for other non-pass-through issues that need to be addressed.
- (4) If the case is linked and the entity indicates agreement or if the examiner controls all the investors and all investors agree, close the case agreed and use disposal code 03 or 04. Do not use disposal code 01 or 02 if changes have been made to the entity. Prepare closing Letter 1002.

- (5) If the case is linked, the campus will send out the reports to the investors controlled at the Campus. If the examiner controls any of the investors, then the examiner will prepare and issue those reports and try to secure agreement. For unagreed cases, the entity case will be forwarded to Appeals with the first investor who protests.
- (6) If any investor does not agree, close the entity return unagreed using disposal code 07 (Appealed) or 08 (did not agree and did not request an appeal).
- (7) The investors of the entity must protest the findings; the protest is not made at the entity level because it is not a taxable entity. Letter 921 issued with the Form 4605 states "We'll also send a separate examination report to each partner, shareholder, grantor, fiduciary, or beneficiaries (investor) whose income tax liability the proposed adjustments may affect. After the investor receives their separate examination report, the investor may appeal adjustments they disagree with by requesting an appeals conference. The investors' separate examination reports will fully explain their appeal rights." A copy of the investor(s)' protest should be placed in the entity case file if unagreed.
- (8) Generally, the unagreed pass-through and investors (linked or unlinked) should be closed together to Technical Services. However, there may be an occasion where it may be better to close an unlinked agreed investor directly to CCP. For example,
 - The unlinked agreed investor is due a refund and the examiner wants to limit the amount of interest that is due
 - The unlinked agreed investor wants to stop the interest and/or penalties they may be subject to.

Note: Linked investors must close to Technical Services.
- (9) If the case is not linked (i.e., the examiner has all the investors open and is passing through the adjustments to their returns), the following items should be marked on the entity's Form 3198:
 - a. Agreed: "Forward to CCP" and "Agreed - Letter 1002" boxes checked. Complete the Adjustment Amount (same as item 34 on Form 5344).
 - b. Unagreed: In the "Forward to Tech Services" section, check the "Unagreed to Appeals" box. Close with the investor case(s); do not send the case to CCP. The "Related Taxpayers or Key Cases" section should be completed to include all investors. In the "Other" section notate that the pass-through entity is unagreed and that entity and investor cases should be kept together. See IRM 4.31.5.15.3.5.1, Transferring to Technical Services.
- (10) If the case is linked, the "TEFRA or Non-TEFRA Key Case" box should be checked on Form 3198 and the case forwarded to Technical Services.

4.31.5.15.5.2
(05-17-2022)

Adjustment Made to the Entity – No Changes to Schedule K-1 (e.g., a balance sheet adjustment)

- (1) Issue Form 4605 to the entity with the transmittal Letter 921, Report Transmittal for ILSC Partnership, Fiduciary, and S Corporation.
- (2) Close the entity return no-change with adjustments utilizing disposal code 01. Prepare closing Letter 1002, Notification Letter for Agreed Audit Changes for Partnerships and S Corporation (non-TEFRA) Cases.
- (3) If the case is not linked, the entity's Form 3198 should indicate "Forward to CCP" and the "Agreed – Letter 1002" box checked. The adjustment amount should be \$0.
- (4) If the case was linked, the "TEFRA or Non-TEFRA Key Case" box should be checked on the Form 3198 and the case forwarded to Technical Services.

4.31.5.15.5.3
(05-17-2022)

No Entity Level Adjustments but there are Investor Adjustments

- (1) Cases where there are investor issues (such as basis, at-risk, passive activity loss, gain on loan repayments or distributions in excess of basis), but no adjustments are made to the entity:
 - a. Issue Form 4605-A to the entity and prepare Letter 3401-S, Pass-Through Entity No Change Transmittal (ILSC), this letter explains that the examination of the entity has been completed and no changes are being proposed to the entity return.
 - b. Close the entity return No Change with Adjustments utilizing disposal code 01 and prepare case closing Letter 992, No Change, and include it in the closed case file.
 - c. If the case is not linked, the entity's Form 3198 should indicate "Forward to CCP" and the "Letter 992" box checked. The adjustment amount should be \$0.
 - d. If the case was linked, the "TEFRA or Non-TEFRA Key Case" box should be checked on the Form 3198 and the case forwarded to Technical Services.
 - e. When there are investor issues, the examiner should control the investor on AIMS and make the adjustment to the investor's return. If the investor case is unagreed and the entity case has information that should be available for the investor appeal, copy the information for the Form 1040 file or flag the files so that they remain together in Appeals.
 - f. If the entity case is going to Appeals with the unagreed investor case, do not send the case to CCP. The Form 3198 should indicate the case is unagreed. Flag the cases to remain together. See IRM 4.31.5.15.3.5.1, Transferring to Technical Services.

4.31.5.15.6
(05-17-2022)

Closing Linked Entity Cases

- (1) Key cases with PCS linkages must be closed to Technical Service Pass-Through Coordinators for special handling regardless of the audit outcome. This is true even when an in-area investor has requested an Appeals hearing.
- (2) When a pass-through entity return is linked, it must be closed through Technical Services to ensure the results are forwarded to the proper campus and the investor returns closed accordingly. Verify that all the investors are properly linked by requesting a TSUMYP for the key case. The TSUMYP lists all the linked investors. Verify the PICF Code is 2. If other than a 2, see sections below. The PICF Code appears on PCS and AMDISA.
- (3) Check the "TEFRA or ILSC Key Case" box on Form 3198, Special Handling Notice, and forward the case to Technical Services. Indicate how the case is

being closed (No-Change, Change/No-Change, Agreed or Unagreed) and whether any of the investors are being closed with the key case.

- (4) Entity report Form 4605 or Form 4605-A and related forms are used by the campus to pass through the adjustments to the investors. The report should clearly support the IRS's position on each of the issues.

4.31.5.15.6.1
(05-17-2022)
**ILSC Pass-Through
Entity is Linked as a
TEFRA Partner**

- (1) For tax years beginning before January 1, 2018, the examination of an ILSC pass-through entity may be related to a TEFRA examination. This is because the ILSC pass-through entity can be an investor in a TEFRA partnership. When the pass-through investor entity is linked as an investor in a TEFRA package, it must be closed through Technical Services to ensure the results are forwarded to the proper campus and the investor returns are processed. Determine if the entity is linked as a partner in a TEFRA partnership by requesting an AMDISA and identify if there is a PICF Code of 5, which indicates the entity is a partner in a TEFRA examination. The PICF Code appears on PCS and AMDISA.
- (2) On Form 3198, check the "TEFRA or Non-TEFRA Investor" box and follow the TEFRA Investor Instructions. See IRM 4.31.2.6.3, Closing a Non-TEFRA Investor with an Open TEFRA Linkage.
- (3) ILSC issues can be partially assessed on the investor returns and the return can then be sent to the campus for suspense to await the TEFRA results.

Note: It is mandatory to link an ILSC entity that is linked to a TEFRA partnership.

4.31.5.15.6.2
(05-17-2022)
**An S Corporation is
Linked as an Investor in
a BEO Examination**

- (1) For tax years beginning after December 31, 2017, the examination of an S corporation may be related to an examination of a partnership that elected out of BBA. Determine if the entity is linked as an investor in a BEO partnership by requesting an AMDISA and identify if there is a PICF Code of 6, which indicates the entity is a partner in a BEO examination.
- (2) When the S corporation is linked as an investor in a BEO package, it must be closed through Technical Services to ensure the results are forwarded to the proper Campus and the investor returns are processed.

Note: The S-Corporation should already be linked as its own key case to protect the statute for both the S corporation and BEO adjustments. See IRM 4.31.5.12.3.1, Initiating Timely PCS Controls on ILSC Pass-Through Entities.

- (3) If there are indications that the investors will not agree with the examination results, there must be coordination with the examiner of the BEO partnership. If statutory notices of deficiency will be issued, adjustments from both examinations must be included in the report.
- (4) Put in status 21 and update to Technical Services along with shareholder return.
- (5) On the Form 3198, check the TEFRA or ILSC Key Case and TEFRA, ILSC or BBA Chapter 2/2A Investor boxes, along with any other applicable boxes.

4.31.5.15.6.3
(05-17-2022)

**ILSC Pass-Through
Entity is Linked as an
Investor in a BBA
Chapter 2/2A
Examination**

- (6) Add a comment in the Other box to state the S corporation is also an investor in a BEO partnership, and add the BEO key case TIN.

- (1) An examined ILSC pass-through entity may be linked to a BBA Chapter 2/2A examination. All BBA Chapter 2/2A examinations require linkage. Determine if the entity is linked as an investor in a BBA Chapter 2/2A examination by requesting an AMDISA and identify if there is a PICF Code of 6, which indicates the entity is a partner in a BBA Chapter 2/2A examination.
- (2) On the Form 3198, check the TEFRA or ILSC Key Case and TEFRA, ILSC or BBA Chapter 2/2A Investor boxes, along with any other applicable boxes.
- (3) Add a comment in the Other box on Form 3198 to state the ILSC Entity is also an investor in a BBA partnership and subject to Chapter 2/2A issues, and add the BBA key case TIN.

4.31.5.15.6.4
(05-17-2022)

**A Taxable Investor is
linked to a BEO or BBA
Chapter 2/2A
Examination**

- (1) Before closing an ILSC investor examination, the examiner should check AMDISA to see if there is a PICF Code 6 on the module. A PICF Code 6 means the ILSC investor is linked on PCS and is associated with one or more ILSC or Chapter 2/2A examinations. Further research or assistance from the Technical Services Pass-through Coordinator will be needed.

4.31.5.16
(05-17-2022)
**Investor Case
Disposition**

- (1) Please review IRM 4.10.8, Examination of Returns, Report Writing, for the appropriate reports and letters to be issued at the investor level.

4.31.5.16.1
(05-17-2022)

**Pass-Through Reason
Codes for Individual
Returns**

- (1) When examining individual returns with related pass-through entities, it is important that examiners properly record RGS Reason codes. Since pass-through entities are generally not subject to tax, it is hard to determine if the audit of a pass-through entity is productive. Individual returns are often impacted by the pass-through entity audit. To capture this impact, RGS Pass-Through Reason Codes were established.
- (2) These specific codes are important in helping the IRS track adjustments made to partners and shareholders related to ILSC pass-through entities. The RGS Reason code is a two-digit code that identifies the reason for an adjustment and is entered on the Issue Adjustment screen. Do not use the Penalty and No Penalty codes for these adjustments.

Note: These codes apply to Form 1040 taxpayers whether or not the examiner actually has an examination adjustment at the entity level.

- (3) The following codes (34 – 40) are reason codes used for all Form 1040 adjustments related to pass-through limitation issues:

Reason Code	Description for Individual Pass-Through Limitations
34	Adjustment made to Form 1040 due to Basis Limitation related to a Form 1120-S
35	Adjustment made to Form 1040 due to At-Risk Limitation related to a Form 1120-S

Reason Code	Description for Individual Pass-Through Limitations
36	Adjustment made to Form 1040 due to Passive Activity Limitation related to a Form 1120-S
37	Adjustment made to Form 1040 due to Basis Limitation related to a Form 1065
38	Adjustment made to Form 1040 due to At-Risk Limitation related to a Form 1065
39	Adjustment made to Form 1040 due to Passive Activity Limitation related to a Form 1065
40	Adjustment made to Form 1040 due to Passive Activity Limitation related to a Form 1041

- (4) The following codes (24 – 26) should be used for **all** other Form 1040 adjustments related to pass-through entities. Therefore, it includes:

- When the Form 1040 adjustment results from an adjustment to a pass-through entity's ordinary income/(loss).
- Any item of separately stated income, loss, deduction or credit.
- An adjustment related to an item on the Form 1040 related to a pass-through entity.

Reason Code	Description for Individual Pass-Through Adjustments Related to Pass-Through Entities
24	Adjustment made to Form 1120-S shareholder distributive share of income (loss) item.
25	Adjustment made to a Trust/estate owner distributive share of income (loss) item
26	Adjustment made to Form 1065 ILSC partner distributive share of income (loss) item

4.31.5.16.2
(05-17-2022)
**IRC 6404(g), Suspension
of Interest and Certain
Penalties**

- (1) The notice date for the purposes of IRC 6404(g) is the date adequate notice is mailed or provided to the individual investor. For ILSC pass-through purposes, it is not the date a report is given to the entity. All other IRC 6404(g) rules apply. See IRM 4.10.8.14.13, Notice Under IRC 6404(g) , Suspension of Interest, to ensure these procedures are current.
- (2) In the case of an individual who files a return on or before the due date for the return (including extensions), the IRS has a 36-month period (18 months effective for tax years where the 18-month period ended on or before November 25, 2007) beginning on the later of:
- the date on which the return is filed; or
 - the due date of the return without regard to extensions,
- in which to provide notice to the taxpayer specifically stating the taxpayer's liability.
- (3) If notice is not provided to the taxpayer before the close of the 36-month period, then any imposition of interest, penalty, additions to tax or additional

amounts that are calculated in reference to the 36-month time frame (18-months effective for tax years whose 18 months end on or before November 25, 2007) are suspended.

Note: If, as of November 25, 2007, the 18-month period has closed and the IRS has not provided notice to the taxpayer, interest and applicable penalties will be suspended beginning on the day after the close of the 18-month period and ending on the date that is 21 days after the notice is provided. In all other cases, interest and applicable penalties will be suspended beginning on the day after the close of the 36-month period and ending on the date that is 21 days after the notice is provided.

- (4) The exceptions to the 36-month (18 months effective for tax years where the 18 month period ended on or before November 25, 2007) notice requirements:
 - a. Any penalty imposed by IRC 6651
 - b. Any interest, penalty, addition to tax, or additional amount in a case involving fraud
 - c. Any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return
 - d. Any interest, penalty, addition to tax, or additional amounts with respect to any gross misstatement
 - e. any interest, penalty, additions to tax or additional amounts with respect to any reportable transactions with respect to which the requirement of IRC 6664(d)(2)(4) is not met and any listed transaction (as defined in IRC 6707A(c)), or
 - f. Any criminal penalty.
- (5) The term suspension period means the period:
 - a. Beginning on the day after the close of the 36-month period under (1) above, and
 - b. Ending the date which is 21 days after the date on which notice is provided to the taxpayer.
- (6) The IRC 6404(g) date should be included on the back of Form 3198 in the Special/Restricted Interest Features section. If IRC 6404(g) applies, the date should also be entered on RGS when prompted.

4.31.5.16.3
(05-17-2022)

**Changes to the Entity
that Result in No Tax to
the Investor**

- (1) Generally, when the examiner has adjustments to an entity, the investors' returns should be placed under examination or linked to reflect changes to the entity's income, loss, deduction, credit or distribution items.
- (2) In some situations, the adjustments made to the pass-through entity has no current year tax consequences to an investor. In this case, it is appropriate to issue an examination report to the investor since the report may impact subsequent tax returns (e.g., suspended loss carry overs, net operating losses, etc.).
- (3) An investor who received a Letter 3457 should receive a no-change letter if the ILSC entity was closed no change. See Exhibit 4.31.5-1, Entity Closing Chart.
- (4) Carryback or carryover years should be reviewed to determine if there will be a tax impact. If there will be a tax impact to an ILSC investor under audit, the relevant prior or subsequent investor returns should be secured, and reports should be prepared.

4.31.5.17
(05-17-2022)
**Technical Services -
Linked Return
Processing**

- (1) The Technical Services Pass-Through Coordinator is the main contact for LB&I and SB/SE field agents and managers to explain and clarify the ILSC audit procedures for linked returns.
- (2) The Technical Services Pass-Through Coordinator responsibilities include the following:
 - Function as the liaison with the CPF functions for PCS linkage for any related linkage problems.
 - Verifying that the LCC group timely writes the RAR and requests removal of PCS controls and input of the Form 8339, PCS Change, for linked LCC investors.
 - Coordinate with Counsel on key case technical questions involving TEFRA, BBA and ILSC issues.
 - Give advice on the preparation and signing of statute extensions.
 - Provide on-site case visitations/consultations for key cases with procedural problems as necessary.
 - Complete a procedural review of closed ILSC key case entities and related investors.
 - Forward ILSC key case closing packages to the CPF.
 - Forward PCS reports to examination groups within the area.
- (3) The following subsections cover the duties of the Technical Services Pass-Through Coordinator.

4.31.5.17.1
(05-17-2022)
Review the Case File

- (1) Upon receipt in Technical Services of an ILSC key case closed from a group, the Technical Services Pass-Through Coordinator (TSPC) should review the following areas of the case file:
 - a. Form 15260, Determination of Pass-through Audit Regime, to ensure a proper ILSC determination as made.
 - b. If a Power of Attorney (POA) is attached, two areas of the Form 2848 need to be reviewed. For a Form 1120-S: Item #3 - Type of Tax - Income, Including pass-through Items, Tax Form Number - 1120-S. Item #7 - The signature block should be signed by a responsible person including their title. Any corporate officer that can bind the corporation under State law may sign. For a Form 1065: Item #3 - Type of Tax - Income, Including pass-through Items, Tax Form Number - 1065. Item #7 - The signature block should be signed by a responsible person including their title, such as general partner.
 - c. Statute Extensions - If statute extensions are part of the package, review any investor consents to determine if they have been prepared and signed correctly. If there are any errors, and the normal statute is still open, a new consent will be secured. If the normal statute is gone, consult with local Counsel on the validity of the consent. An S corporation can need the IRC 6501 statute protected when corporate level tax issues under IRC 1374, IRC 1375, or IRC 55 are to be raised. The agent would solicit a regular, unrestricted Form 872.
 - d. The examiner's RAR will be reviewed for required content and accuracy. The TSPC will ensure that all forms required for a ILSC examination are included. If any required items are missing or incorrect, the package may be returned to the originating office, or the reviewer may invite the

examining agent to appear at the Technical Services office to complete or correct the case there. Minor errors may be corrected by the coordinator.
e. Review the Form 886-S.

- (2) If a statutory notice of deficiency (SNOD) is needed, TSPC will route to local Technical Services.
- (3) When TP defaults, or agrees, the case is returned to the TSPC.
- (4) If the TP petitions, local TS will forward to Appeals.

4.31.5.17.2
(05-17-2022)
Prepare Package for the Campus

- (1) Prepare Form 14729, Investor Level Statute Control (ILSC) Closing Package Check Sheet.
- (2) Email Form 14729 and required enclosures to the campus and await a response. Campus should respond within 14 days.

4.31.5.17.3
(05-17-2022)
H Freeze Release

- (1) The CPF will release the H freeze for agreed and no change cases once all required information is received.
- (2) If after 14 days the H freeze is not released, contact the CPF ILSC Coordinator.

4.31.5.17.4
(05-17-2022)
Closing Entity Return

- (1) The pass-through entity is linked as a key case and not linked as an investor, and is ready to close:
 - a. Check PCS linkage using TSUMY to see that all its investors are linked.
 - b. Mark the Instructions for CCP section at the top of Form 3198, Page 2.
 - c. The TSPC will close all PCS linked key cases through CCP. If the key case is likely unagreed, the TSPC will mark the Form 3198 to indicate which CPF the return should be forwarded.
- (2) The pass-through entity is linked as a key case and also linked as an investor, and is ready to close:
 - a. Check PCS linkage using TSUMY to see that all its investors are linked.
 - b. Form 8339 will be reviewed and enclosed in the case file to CCP for any agreed or no-changed field-controlled investors in the package that are full closing.
 - c. Mark the Instructions for CCP section at the top of Form 3198, Page 2.
 - d. The TSPC will close all PCS linked key cases through CCP. If the key case is likely unagreed, the TSPC will mark the Form 3198 to indicate which CPF the return should be forwarded.
 - e. If the key case is agreed with an open linkage, the TSPC will mark the Form 3198 to indicate which CPF the return should be forwarded.

4.31.5.17.4.1
(05-17-2022)
Closing Unagreed Entity Return to Appeals

- (1) Examining agent has issued the 30-day letters to investors in their control and received a protest from at least one of the investors. If the returns are linked, notify the CPF that 30-day letters were issued to all investors and if not, which investors did not receive letters.
- (2) When a protest is received, it should be reviewed to determine if it is acceptable.

- (3) If the protest is received in TS, allow the examining agent to review and add comments.
- (4) The pass-through entity is forwarded to Appeals with a protesting investor controlled by the group.
- (5) Protesting investor should have at least 13 months on the statute when sending to Appeals through Technical Services.
- (6) The key case file will contain the documents included in a regular unagreed case, such as the revenue agent report (RAR), tax returns, etc. In addition, the following items should be included:
 - a. Form 886-S for partnerships, or Form 886-X for S corporations.
 - b. Form 4605 Examination Changes - Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Sales Corporations
 - c. Form 886-A Explanation of Items
- (7) The investor case file will contain the documents included in a regular unagreed case, such as the RAR, tax returns, 30-day letter, etc. In addition, the following items should be included:
 - a. Power of Attorney, if applicable
 - b. Protest and rebuttal if prepared
 - c. Form 4549-A
 - d. Form 4700, Examination Workpapers (if the investor case was previously worked by one of the Campus Pass-through Functions (CPF), Brookhaven or Ogden)
 - e. Form 4318, Examination Workpapers (if the investor case was worked by the examiner that handled the examination of the ILSC key case)
- (8) If the CPF has control of any investors, a copy of the RAR **must** be sent to the CPF.
- (9) If the examining agent controlled more than one investor and only one investor has filed a protest, the agent or Technical Services should contact the CPF ILSC Coordinator to see if they are willing to suspense the other investors.
- (10) The CPF will usually accept the other investors if:
 - a. There is more than one year on the investor statute and,
 - b. There are no other non-pass-through issues, or a partial closure was made for all other issues.

4.31.5.17.5
(05-17-2022)

Closing Linked Investor Returns

- (1) All linked investor returns must close to Technical Services in Status 21.
- (2) If an investor 1040 exam is closed agreed or no change without key case pass-through adjustments. TSPC will forward to CCP with instructions to forward to CPF for open linkage. CCP will partial agreed adjustments.
- (3) If an investor 1040 exam is agreed or no change to the key case pass through adjustments and there is no other open linkage, the case can be final closed to CCP. If there are other open linkages TSPC will instruct CCP to forward the investor to CPF.
- (4) If unagreed, with protest, the case is sent to Appeals.

- (5) If unagreed, for statutory notice, TSPC will need to ensure pass-through adjustments are included.
- (6) If the statutory notice is petitioned, forward to Appeals.

Investor Level Statute Control (ILSC) Examinations - Field Office Procedures 4.31.5

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Exhibit 4.31.5-1 (05-17-2022)

Entity Closing Chart

The following chart should assist an examiner in determining what forms and letters are necessary in closing a ILSC examination. These letters and forms are used whether the linked on PCS or not.

Form 1120-S

Closure	Report	Closing Letter	CCP Letters	Disposal Code	Examples (table below)
No Change (N/C to entity return)	Form 4605-A	Letter 3401-S	Letter 992	02	(A)
No Change (w/ changes to entity return)	Form 4605 w/ Form 886-X	Letter 921	Letter 1002	01	(B)
Agreed	Form 4605 w/ Form 886-X	Letter 921	Letter 1002	03 or 04	(C)
Unagreed	Form 4605 w/ Form 886-X	Letter 921	n/a	07 or 08	None

Taxable 1120-S

Closure	Report	Closing Letter	CCP Letters	Disposal Code	Examples (table below)
No Change	Form 4605-A	(D)	(D)	01 or 02	(D)
Agreed (E)(F)	Form 4549	Letter 4121	Letter 987	03 or 04	None
Unagreed (E)(F)	Form 4549-A w/ Form 870	Letter 950	n/a	07 or 08	None

Form 1065

Closure	Report	Closing Letter	CCP Letters	Disposal Code	Examples (table below)
No Change (N/C to entity return)	Form 4605-A	Letter 3401-S	Letter 992	02	(A)
No Change (w/ changes to entity return)	Form 4605 w/ Form 886-S	Letter 921	Letter 1002	01	(B)
Agreed	Form 4605 w/ Form 886-S	Letter 921	Letter 1002	03 or 04	(C)
Unagreed	Form 4605 w/ Form 886-S	Letter 921	n/a	07 or 08	None

Exhibit 4.31.5-1 (Cont. 1) (05-17-2022)
Entity Closing Chart

No.	Examples
(A)	When there are no changes to the entity the case is closed no-change. DC 02 is used when there are no changes made to the entity or any related return. If adjustments are made to a related ILSC investor use DC 01 (No Change with Adjustments). See IRM 4.31.5.15.1.3, No Change Disposal Codes.
(C)	A signed Form 4605 agreement is not binding on the investors. Agreements must be obtained at the investor level.
(D)	A no-change report using Form 4549 to an S corporation is generally not used. However, if a tax issue was worked that results in a no-change, it may be used to formalize the results. If so, use the normal C corporation closing procedures. See IRM 4.10.8.3, No-Change and No Liability Case (SB/SE) and IRM 4.46.6.3.1, No-Change Examination (Disposal Code 02) Procedures (LB&I).
(E)	Adjustments made on a taxable S corporation generally require the preparation of reports used for a non-taxable S corporation. For example, if adjustments are made for the BIG tax, an adjustment is required to allow for the deduction of the deemed tax paid. If there are no adjustments to the S corporation's ordinary income/loss, separately stated items or distributions, only the Form 4549 and related forms are necessary. Issue the letters for a taxable entity and treat the Form 4605 as an information return and attach it to the Form 4549.
(F)	Use taxable entity letter only.

Note: Issues such as basis, gain on loan repayment and distributions in excess of basis are not entity level issues; they are investor level issues. The examiner needs to examine the investor return(s) to address these issues.

CCP Letters will be prepared by examiners to be issued by Centralized Case Processing (CCP).

Exhibit 4.31.5-2 (05-17-2022)

Disposal Codes

Disposal Code	When to Use the Disposal Code
01 – No Change with Adjustments	<p>Should be utilized on a pass-through return when No changes are made to the entity's reported items of income, loss, deduction, credit or distribution as reflected on the return, and</p> <ol style="list-style-type: none"> A delinquent return is secured by examination and accepted as filed. If the TC 424 posted prior to the posting of the delinquent return, enter the amount of the ordinary net income/loss and separately stated income/loss items per the delinquent return, in Form 5344, Item 414. (If an SFR has posted the amounts from the secured return must be input through RGS; therefore, DC 01 does not apply.); or There is an adjustment made to a balance sheet item; or A related return is adjusted as a result of the pass-through examination, including changes such as: <ul style="list-style-type: none"> adjustments to basis, at risk, or passive activity rules; taxable distributions or taxable loan repayments; or adjustments made to non-income / deduction or credit items reported on the investor's Schedule K-1.
02 – No Change	<p>Should be utilized when no examination changes are made to the entity's reported items of income, loss, deduction, credit or distributions as reflected on the return and no adjustments were made to any investor or related return.</p> <p>Note: Delinquent returns secured and accepted by examination or cases where adjustments are made to a related return may result in a disposal code 01. See above.</p> <p>When using disposal codes 01 or 02, the Adjustment Amount, item 34 of the Form 5344 should be blank. If RGS enters an amount on item 34, adjustments are being made to the entity's reported items of income, loss, deduction or credit as reflected on the return.</p>

Exhibit 4.31.5-2 (Cont. 1) (05-17-2022)**Disposal Codes**

Disposal Code	When to Use the Disposal Code
03 – Agreed prior to 30-day or 60-day letter 04 – Agreed after the 30-day or 60-day letter	Entity cases that are closed agreed should be closed with disposal code 03 or 04. To obtain an agreement on an ILSC nontaxable entity, each of the investors need to agree to the adjustments impacting their tax return. If the case is linked, close the case agreed when an authorized party signs Form 4605 indicating agreement to the adjustments. If any investor indicates they are not in agreement, the case should be closed unagreed even if Form 4605 is signed. Note: Use disposal code 03 or 04 any time changes to the entity return are agreed, even if the changes are not made to the owner's return due to materiality or other considerations.
07 – Unagreed – Appeals	Entity cases should be closed DC 07 if one or more owners request an Appeals conference.
08 – Unagreed – Other: Non-Taxable Returns (ILSC)	Entity cases should be closed DC 08 if all investors do not agree, and no investor requests an Appeals conference. In addition, cases that are linked but there is an indication that one of the investors does not agree, should be closed DC 08.