DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES & HEALTHCARE) CC:LM:FSH:BRK
ATTN: Halvor Adams

FROM: ASSISTANT CHIEF COUNSEL (ADMINISTRATIVE PROVISIONS & JUDICIAL PRACTICE) CC:PA:APJP

SUBJECT: Closing Examinations of Related Entities
TL-N-1045-01

This Chief Counsel Advice responds to your memorandum dated March 27, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

How should examination teams close examinations of parties to lease stripping transactions other than the party claiming the main loss that the Service is considering disallowing?

CONCLUSION

If it is necessary to close cases of the related parties in lease stripping transactions, examiners should consider closing them as “unagreed,” or “excepted agreed,” as applicable, in order to best preserve the lease stripping issue for further consideration after the audit of the primary entity has been completed.

FACTS

Lease stripping transactions are multiple party tax shelters that purport to direct income from leased property to one party (typically a party not subject to U.S. tax or a partnership that is majority owned by a partner not subject to U.S. tax) while directing most of the deductions to another party (typically a party subject to U.S. tax). Although the theories that the Service uses to attack lease stripping transactions may vary depending on the facts of each case, the Service commonly

takes the position that the transactions are shams and that, alternatively, section 482 of the Code should be applied to match the income and the deductions relating to the income.

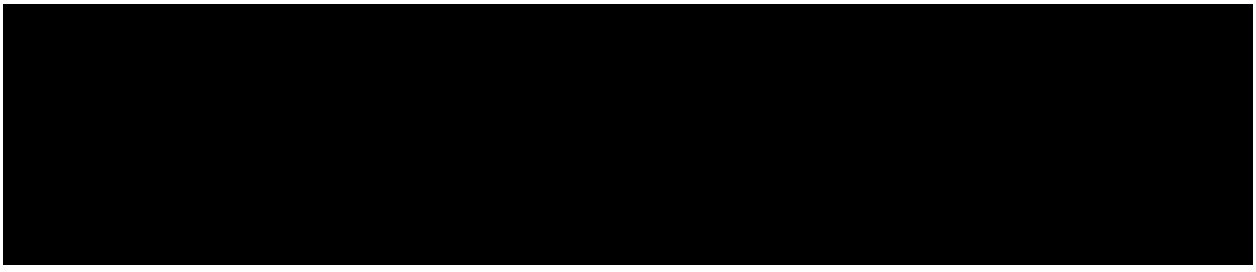
Section 482 provides generally that in the case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly reflect the income of any of such organizations, trades, or businesses.

Lease stripping transactions typically involve one party that claims the bulk of the deductions from the transactions (the “deducting taxpayer”) and are typically examined by the examination team assigned to that taxpayer. In examining the allowability of the deductions, some examination teams also open examinations of the returns of other parties (the “related parties”) involved in the transaction (such as the promoters and the entities that reported income or claimed minor deductions from the transactions). Those examination teams sometimes encounter the need to close out the examinations of the returns of the related parties before the issue of the allowability of the main deductions is resolved. Examples of the situations in which examination teams sometimes encounter the need to close out the returns of the related parties before the issue of the allowability of the main deductions is resolved include the following:

(1) the statute of limitations on one or more of the related parties’ returns may expire before the statute of limitations on the returns of the deducting taxpayer, or before the main deductions from the lease stripping transaction are claimed and the related parties may be unwilling to extend the statute;

(2) the Service may desire for administrative purposes to close out the examinations of the related parties’ returns; or

(3) exam may have disallowed the main deductions but the deducting taxpayer may be contesting that determination in Appeals or the courts.



[redacted]

In your request for advice, you propose two alternatives:

(1) if the related party has reported income from a lease stripping transaction and one or more of the theories being asserted against or considered to challenge the deductions from the transaction would result in adjustments to that income, the examination should be closed by the issuance of a report stating that the Service has decided to close the examination for tax administration purposes and that no final determination has been made on the merits of the transaction. The report should also state that the related party may wish to file protective claims for refunds (or an administrative adjustment request in the case of a TEFRA entity) for any years that it reported income from the transaction.

(2) if a related party claimed deductions from a lease stripping transaction and one or more of the theories being asserted against or considered to challenge the transaction would result in adjustments to the deductions, the examination team should weigh the merits of closing the examination by disallowing the deductions against the merits of closing the examination with a report stating that the Service has decided to close the examination for tax administration purposes and no final determination has been made on the merits of the transaction.

LAW AND ANALYSIS

We are concerned that the alternatives you propose do not adequately take into account restrictions on reopening examinations that may arise under section 7605(b).

Section 7605(b) of the Internal Revenue Code provides that “[n]o taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer’s books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.”

Section 7605(b) first appeared as section 1309 of the Revenue Act of 1921. 42 Stat. 310. Congress designed the section in response to taxpayer complaints that revenue agents were subjecting them to onerous and unnecessarily frequent examinations and investigations. See H.R. Rep. No. 67-350 at 16 (1921). The purpose of the section is to relieve taxpayers from unnecessary annoyance. 61 Cong. Rec. 5855 (Statement of Sen. Penrose) (1921).

If an Examination team determines that it is necessary to obtain information from a related party, it is important to be clear about what does and does not constitute an "examination" for purposes of the closing and reopening procedures. In many cases, information can be obtained without the necessity of a formal "examination," and a later audit of that taxpayer, if necessary, would pose no problems.

Rev. Proc. 94-68, 1994-2 C.B. 803 outlines circumstances that would not amount to an "examination" for purposes of section 7605(b). Those circumstances are:

(1) A contact with the taxpayer to correct mathematical or clerical errors is not an examination, inspection, or reopening.

(2) A contact with a taxpayer to verify or adjust a discrepancy between the taxpayer's tax return and an information return is not an examination, inspection, or reopening. For this purpose, an information return includes a return and an amended return filed by a partnership, fiduciary, or small business corporation.

(3) A contact with a taxpayer to verify or adjust a discrepancy disclosed by an information return matching program may include inspection of the taxpayer's books of account, to the extent necessary to resolve the discrepancy, without being considered an examination, inspection, or reopening within the meaning of section 7605(b). A contact to verify an item of income shown on an information return to a tax return is not a verification of a discrepancy where such item of income is not required to be shown as a specific line item on a tax return.

(4) A contact with an investor to verify the accuracy of, or the need for, a Tax Shelter Registration number is not an examination within the meaning of section 7605(b). To the extent that the contact is to determine the need for a Tax Shelter Registration number, the information sought would be limited to obtaining the name and address of the promoter.

(5) The adjustment of an unallowable item, or an adjustment resulting from other types of service center correction programs, is not considered to be an examination. Therefore, a subsequent examination does not constitute a reopening of a case closed after examination.

(6) Reconsideration of a case is not considered a reopening and, therefore, requires no approval or issuance of a form letter (DO/IO/SC) for:

(a) cases involving section 1311;

(b) cases involving the year of deduction of a net operating loss carryback or similar type of carryback under other provisions of the Code;

(c) cases in which there have been involuntary conversions and the taxpayer has not recomputed his/her tax liability when he/she did not replace property within the time provided by section 1033; or

(d) cases involving an overpayment in excess of $1,000,000, subject to review by the Joint Committee on Taxation under section 6405.

(7) A contact with a CEP taxpayer requesting the written statements provided for in Rev. Proc. 94-69, or notifying a taxpayer that it no longer qualifies for the Coordinated Examination Program, is not considered an examination. Therefore, any subsequent examination does not constitute a reopening.

(8) In the case of a CEP taxpayer, the Service may inspect the taxpayer's books of account with respect to tax periods not currently under examination in order to verify the accuracy of adjustments to an item or items for those periods (a) in which the taxpayer made an "accelerated issue resolution" request, or (b) in accordance with an "accelerated issue resolution agreement between the Service and the taxpayer. See Rev. Proc. 94-67. An inspection made pursuant to this paragraph relating to any tax period will not be considered an inspection or an examination and will not preclude a subsequent inspection or examination of that tax period under section 7605(b) provided the taxpayer so agrees in writing prior to the inspection made pursuant to this paragraph.

(9) A contact by the Service with a taxpayer pursuant to an APA prefiling conference, or the evaluation and processing of an APA request, annual report, or renewal request under Rev. Proc. 91-22, 1991-1 C.B. 526, is not an examination, inspection, or reopening.

(10) An adjustment to a taxpayer's income tax return arising from a discrepancy disclosed during Employee Plans and Exempt Organizations compliance activities as described in I.R.M. 7(10) 12, "Returns within the Jurisdiction of Examination Division," does not constitute an examination, inspection, or reopening if the adjustment is not made in conjunction with an examination of the taxpayer's income tax return. A contact to verify a discrepancy

between the income tax return and the books and records of an employee plan or an exempt organization may include inspection of the taxpayer's income tax records to the extent necessary to verify the accuracy of the discrepancy without being considered an examination, inspection, or reopening within the meaning of section 7605.

(11) A contact with a taxpayer to evaluate the taxpayer's data processing and accounting systems in order to determine whether the taxpayer may limit its retention of machine-sensible records, for purposes of Rev. Proc. 91-59, 1991-2 C.B. 841, is not an examination, inspection, or reopening.

Thus, in certain circumstances, the Examination team may obtain information from a related party without the inquiry rising to the level of an "examination." [redacted]

Although we do not have specific facts before us, it appears that an inspection of a related party's taxable year such as you describe may qualify as an examination and, therefore, be subject to the provisions of section 7605(b).

Examinations has four methods to close cases: (1) no change; (2) agreed; (3) unagreed; and (4) excepted agreed (partially agreed). A no change closing results when the tax liability shown on the return is accepted as filed, and the taxpayer is so notified. (See I.R.M. 8.2). If the examiner proposes adjustments to the taxpayer's liability, the taxpayer may consent to these adjustments. If this is the case, it will be closed on an agreed basis, the taxpayer will sign a consent to assessment, and pay any deficiency. (See I.R.M. 8.3). Conversely, a case will be closed "unagreed" if the examiner proposes adjustments to the taxpayer's tax liability and the taxpayer does not consent to the assessments. (See I.R.M. 8.8.6).

The manual, provides for situations in which the taxpayer agrees to proposed adjustments, but the "examination results are subject to review or additional processing or some other condition." (See I.R.M. 8.4). In such situations, the taxpayer may waive the statutory restriction upon assessment and collection of the deficiency of tax. I.R.M. 8.4 goes further to say that the effect of signing such a waiver will be to "...(a) stop[ ] the running of interest 30 days from the date of receipt...[and] (b) does not preclude assertion of a further deficiency by the Commissioner or a request for further consideration of the issues by the taxpayer. That is, the case is 'excepted' from application of the case reopening criteria."

The manual provides examples of situations in which an excepted agreed case is appropriate. They are:

(1) Partially agreed corporate and individual cases.

(2) Claims allowed in full or in part in a partially agreed case if there are agreed adjustments in addition to the claim;

(3) When an overassessment on one return and a deficiency proposed on a related return is the result of the shifting of income or expenses (whipsaw issues);

(4) “Excepted agreed” fiduciary cases.

(5) Form 1120S, U.S. Income Tax Return, for an S corporation case where small business corporation provisions of the Internal Revenue Code (subchapter S) are not applicable.

We believe that subsections (1) and (3) may pertain to certain lease stripping transaction cases in which other adjustments are made to the related party’s return. Such cases could be closed partially agreed, preserving the future lease stripping issue for consideration without the need of following the reopening procedures. However, neither this procedure, nor any other method of closing an examination will protect an expiring statute of limitations without a waiver duly signed by the taxpayer.

In the event that a case has been opened and subsequently closed, Rev. Proc. 94-68, provides that the Service will not reopen any case to make an adjustment unfavorable to the taxpayer unless:

(1) there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact;

(2) the prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or,

(3) other circumstances exist that indicate failure to reopen would be a serious administrative omission.

While the Service takes a strict position on reopening cases once they have been closed, it appears that the courts read section 7605(b) more liberally.

In construing the language of this section, courts have held that the prohibition against a second “inspection,” must be read in pari materia with the opening clause of the section, which prohibits unnecessary examination of taxpayer records. As the Fifth Circuit Court of Appeals noted in United States v. Schwartz, 469 F.2d 977,

983 (5th Cir.1972), the first clause appears to be the original purpose for which the statute was enacted. See also United States v. Kendrick, 518 F.2d 842, 846 (7th Cir. 1975). In applying the restrictions of section 7605(b), courts have been reluctant to restrict legitimate investigations by the Service where the Service has demonstrated that the second inspection was necessary to promote a vital public interest. Indeed, the Ninth Circuit Court of Appeals stated in DeMasters v. Arend, 313 F.2d 79, 87 (9th Cir. 1963), that the grants of power in section 7601 (power to canvass districts) and section 7602 (power to examine books, records, etc.) "are to be liberally construed in recognition of the vital public purposes which they serve; the exception stated in § 7605(b) is not to be read so broadly as to defeat them."

This precedent suggests that, if litigated, a court might permit reopening of a case such as this in order to make the related party's treatment consistent with the treatment of an item on the deducting taxpayer's return. Nevertheless, we recommend a more conservative approach, consistent with our published procedures. Accordingly, we do not recommend the premature closing of related party cases once an examination of the related party's taxable year has been opened unless it is unavoidable. If a case must be closed, Exam should consider the criteria under Rev. Proc. 94-68 and the existing procedures before reopening the matter.

You have indicated a potential problem if the Service is unsuccessful in defending the merits of an adjustment to a related party's return in an Appeals or court proceeding and then later tries to assert a deficiency arising from the same transaction against the deducting taxpayer. Specifically, you discuss the possibility of the Service being precluded from asserting deficiencies under the doctrines of res judicata or collateral estoppel. As a preliminary matter, the Service would not be precluded under either doctrine from litigating matters determined in any administrative proceeding in Appeals because both doctrines require a prior decision by a court of competent jurisdiction.

Res Judicata

Under the doctrine of res judicata, a judgment on the merits for a particular tax year bars any subsequent proceedings involving the same claim and the same tax year. Commissioner v. Sunnen, 333 U.S. 591 (1948); Cooper v. United States, 217 Ct. Cl. 697 (1978).

Res judicata insures the finality of judgments, conserves judicial resources, and protects litigants from multiple law suits. Res judicata applies if four conditions are met: (1) the parties in both actions are identical or at least the parties in the later suit are in privity with the parties in the earlier suit; (2) a court of competent jurisdiction rendered the judgment in the earlier suit; (3) the earlier suit was

concluded with a final judgment on the merits; and, (4) both suits involve the same claim or the same cause of action. Shaheen v. Commissioner, 62 T.C. 359 (1974).

When these four conditions are satisfied, res judicata prevents either party from raising any claim or defense in support of, or in opposition to, the cause of action that was asserted in the earlier suit. See United States v. Shanbaum, 10 F.3d 305 (5th Cir. 1994); Romano v. Commissioner, 101 T. C. 530 (1993). Res judicata also bars subsequent litigation of all compulsory counterclaims and any permissive counterclaims actually litigated. See Fed. R. Civ. P. 13(a). Thus, once a court has made a decision concerning a particular tax for a tax year and that decision has become final, the tax liability is finally fixed (with some statutory exceptions).

In these cases, we do not believe the deducting taxpayer's cause of action would be considered the same as the cause of action of any related party. Accordingly, it is unlikely that the doctrine of res judicata would apply here.

Collateral Estoppel

The doctrine of collateral estoppel declares that once a court has decided an issue of fact or law necessary to its judgment, that decision is conclusive in a subsequent suit to bind a party to the prior litigation. Restatement (Second) of Judgments § 27 (1982). The Tax Court has stated the requirements necessary for collateral estoppel to apply in a case. First, the issue in the second case must be identical to the one decided in the first case. Second, there must be a final judgment by a court of competent jurisdiction. Third, the parties to the second suit must be the same or in privity with the ones in the first suit. Fourth, the parties must have actually litigated the issue and its resolution must have been essential to the prior decision. Finally, the controlling facts and applicable legal rules must remain unchanged from those in the prior litigation. Peck v. Commissioner, 90 T.C. 162, 166-67 (1988), aff'd, 904 F.2d 525 (9th Cir. 1990).

Even if the disputed issue arises from a continuing transaction, each taxable year is distinct and constitutes a new cause of action for purposes of applying res judicata or collateral estoppel. Sunnen, 333 U.S. at 597; Peck, 90 T.C. at 165. Unlike the doctrine of res judicata, however, collateral estoppel may apply to a different cause of action. Gammill v. Commissioner, 62 T.C. 607 (1974). Thus, under the doctrine of collateral estoppel, a matter actually and necessary determined by a court of competent jurisdiction is conclusive in a subsequent suit involving the same parties. Montana v. United States, 440 U.S. 147 (1979); Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979).

Where collateral estoppel applies, the same factual or legal issue cannot be relitigated by either the taxpayer or the IRS even though the applicable statute of limitations remains open. Collateral estoppel can be utilized in connection with

matters of law, matters of fact, and mixed matters of law and fact. See Meier v. Commissioner, 91 T. C. 273, 283 (1988).

As with res judicata, assertion of the doctrine of collateral estoppel requires privity between the parties to both proceedings. "Privity is a short-hand way of establishing that an individual is not a 'stranger' to an action and is affected by a decision in such action." Gammill v. Commissioner, 62 T.C. 607, 614 (1974). In United States v. California Bridge Co., 245 U.S. 337, 341 (1917), the Supreme Court said:

> The doctrine of estoppel by judgment, or res judicata, as a practical matter, proceeds upon the principle that one person shall not a second time litigate, with the same person or with another so identified in interest with such person that he represents the same legal right.

Privity, in the sense of "identity of interests" has been broadly construed and applied. In Tait v. Western Md. Ry. Co., 289 U.S. 620 (1933), the United States was found to have an identity of interest with the Commissioner of Internal Revenue acting in his official representative capacity, so as to create an estoppel of judgment between a taxpayer and the Commissioner based on a prior adjudication between the same taxpayer and the United States. In Kroh v. Commissioner, 98 T.C. 383 (1992), however, a taxpayer was not allowed to use collateral estoppel offensively against the Government based, in part, on the fact that the taxpayer was not a party to, or a privy of her husband in, an earlier bankruptcy proceeding.

We do not have sufficient facts before us to determine whether a related party might be considered a privy of the deducting taxpayer. Therefore, we have not addressed this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In general, we recommend that the examination teams work closely with counsel on conducting and managing audit of these types of transactions, to ensure uniform and consistent treatment of items.

[redacted]

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Please call if you have any further questions.

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