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

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR TECHNICAL SUPPORT GROUP, COMPLIANCE POLICY
SB/SE, AREA 9

FROM: Assistant Chief Counsel (Administrative Provisions and Judicial Practice)
CC:PA:APJP

SUBJECT: Chief Counsel Advice

This responds to your request for Chief Counsel Advice dated March 13, 2001, in connection with questions received by the Technical Support Group in St. Louis, Missouri regarding the application of I.R.C. § 6404(g).

ISSUES

1. Does the phrase "specifically stating the taxpayer's liability and the basis for liability" in I.R.C. § 6404(g) mean that to satisfy the notice requirements of that provision the Service must provide the amount of the adjustment or the amount of tax related to the adjustment?

2. Does the exception to the suspension of interest under I.R.C. § 6404(g) for the I.R.C. § 6651(a)(1) failure to file penalty have any practical ramifications? Does the exception for the I.R.C. § 6651(a)(2) failure to pay penalty state that regardless of whether or not interest is suspended under I.R.C. § 6404(g), it will not be suspended for that portion of the deficiency that relates to an assessed failure to pay penalty on the additional deficiency?

3. What is meant by I.R.C. § 6404(g)(2)(C)?

4. Is it really necessary to provide a written explanation to taxpayers in agreed cases to satisfy the notice requirement?

5. Where new information acquired by the examiner results in an increase to an adjustment, would it be necessary to provide another notice in order to satisfy the provision? If so, would this result in multiple notices on the same issue and different suspension periods for the respective deficiencies?

6. In examination of flow through entities, given that the notice provided met the legal requirements, is the notice considered to have been provided when given at the entity level or the individual level?

CONCLUSIONS

1. "The taxpayer's liability," as used in I.R.C. § 6404(g), is the amount owed by the taxpayer, including tax, additions to the tax, and interest on the tax. The tax liability generally refers to an income tax deficiency, but may also refer to additional tax assessments that are not based upon a deficiency determination. In addition, because the notice of adjustment must also contain the "basis for the liability," it must also contain the adjustments to income upon which the tax adjustment is based.

2. I.R.C. § 6404(g) has no effect on the I.R.C. § 6651(a)(1) failure to file penalty since that penalty would never be imposed if a return was timely filed, a precondition for I.R.C. § 6404(g) to apply. A failure to pay penalty under I.R.C. § 6651(a)(2) may be indirectly affected by I.R.C. § 6404(g)(2)(A) in that interest on the unpaid tax liability reported on a timely filed return may be suspended, but the failure to pay penalty and the interest thereon will never be suspended.

3. I.R.C. § 6404(g)(2)(C) excepts from suspension any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return filed by the taxpayer. The Congressional intent with respect to the suspension was to ensure that interest did not accrue exponentially before the taxpayer had notice that additional amounts were owed. A taxpayer is presumed to have notice of items reported on the return filed by the taxpayer. Therefore, no suspension is necessary.

4. A writing is necessary even in agreed cases. The written notice prevents prospective problems in situations where the taxpayer may misunderstand the agreement or subsequently assert that he or she did not agree with the terms used by the Service. We understand that standard language has been created which would enable a writing compliant with I.R.C. § 6404(g) to be easily generated.

5. A second notice should be issued whenever new information results in recomputation of an adjustment. The Congressional intent with respect to I.R.C. § 6404(g) was to ensure the taxpayers are informed of their liability within enough time to limit the amount of interest accruing on it. If the Service subsequently

changes the amount of liability, the taxpayer has not yet been properly informed and a second notice should be issued. This is especially true where the adjustment increases the taxpayer's deficiency.

6. Partnership audits provide an exception to the general rules. The TEFRA provisions in I.R.C. §§ 6221 through 6233 direct the Service to provide notice of partnership proceedings to taxpayers who are direct or indirect partners in the partnership via the tax matters partner once the required notice to the partnership is issued. Because individual tax adjustments of the partners are not determined in the partnership proceedings, the Service should provide the required notice by setting forth the proposed adjustments to partnership items and the basis for those adjustments.

FACTS

You have provided the following facts:

1. The Technical Support Group has received questions regarding whether the notice required must contain the amount of the adjustment to income or the amount of tax related to the adjustment. You have raised concerns that if the provision requires that the taxpayer be provided with a deficiency amount instead of an adjustment amount, it would necessitate generating interim examination reports. You felt such a report would be confusing to the taxpayer, and may not, in practice, be calculated during the course of examination.

2. The Technical Support Group has also received questions concerning the application of I.R.C. § 6404(g) to I.R.C. §§ 6651(a)(1) and (2). You commented that since I.R.C. § 6404(g) applies only to timely filed returns, I.R.C. § 6651(a)(1) should never enter into the analysis. You also felt that, with respect to I.R.C. § 6651(a)(2), where I.R.C. § 6404(g) is triggered, with respect to an audit deficiency, the provisions appeared not to apply to that portion of the deficiency related to any failure to pay penalty.

3. You stated that if I.R.C. § 6404(g)(2)(C) is intended to mean that I.R.C. § 6404(g) will not apply to any items reflected on an original, timely filed return, then there would be no need for a notice requirement as it results from having filed the return.

4. The main concern heard and conveyed by the Technical Support Group regarding the notice requirement of I.R.C. § 6404(g) is whether written notice is required in agreed cases. Typically, in agreed field cases, formal written explanations of adjustments are usually not provided, and taxpayers are issued only an examination report. Examination reports with some standard language that would meet the requirements of I.R.C. § 6404(g) are generally issued in unagreed

cases as well as agreed office cases. You stated that it would seem logical to assume that the taxpayers were nonetheless aware of the explanation of adjustments in these scenarios because they had agreed to them. In these instances, it would be necessary to change practice and mandate the addition of some standard language to the examination report which might satisfy any requirement of a writing with regard to the explanations of adjustments.

5. During the course of an audit, an examiner may propose an adjustment which might later be altered as a result of information subsequently discovered. You felt that, in order to comply with the notice requirements of I.R.C. § 6404(g), a second notice would need to be issued, as the new information would lead to adjustment of the amount of the deficiency.

6. You stated that I.R.C. § 6404(g) appears to apply only to individual taxpayers. You also mentioned that where adjustments are proposed at the entity level in the case examination of a flow-through entity, individual partners or shareholders are generally not given notice. However, it has been suggested that notice has been provided for the individual where the requisite information has been conveyed to a duly appointed entity representative.

LAW AND ANALYSIS

I. I.R.C. § 6404(g) REQUIRES NOTIFICATION OF THE AMOUNT OF THE TAXPAYER'S LIABILITY, i.e., THE AMOUNT OF THE ADJUSTMENT.

I.R.C. § 6404(g) requires the Service to provide taxpayers with a notice "specifically stating the taxpayer's liability and the basis for the liability" during the 12 (or 18) month period following the later of the filing of the return and the due date of the return without regard to extensions. "Liability" is not defined by I.R.C. § 6404(g) or the regulations thereunder. Generally, however, "liability" refers to the correct amount of tax to be imposed under the Internal Revenue Code. "Liability" includes deficiency amounts, as well as those items which are immediately assessable or "self-assessed."

If we were to define "liability" as "deficiency," the only document which would meet the requirements of I.R.C. § 6404(g) would be a notice of deficiency. Instead, because "liability" is much more broadly defined than "deficiency," the Service can comply with the requirements of I.R.C. § 6404(g) by issuing math error notices, examination reports, and other documents listing liability and the basis thereof. In issuing these documents, the Service must include a statement of the tax liability, not merely an adjustment to the income from which that liability is computed.

II. APPLICATION OF I.R.C. § 6404(g) TO I.R.C. §§ 6651(a)(1) AND (a)(2)

Section 3305 of the Internal Revenue Service Restructuring and Reform Act of 1998 amended I.R.C. § 6404(g) to suspend the running of interest when the Service does not give the taxpayer proper notice of certain liabilities within a statutorily defined period. As amended, I.R.C. § 6404(g) requires that, when a taxpayer files a federal income tax return on or before the due date (including extensions) and the Service fails to provide a notice to the taxpayer stating the taxpayer's liability and the basis for that liability within a statutorily defined period, the Service must suspend the "interest, penalty, addition to tax, or additional amount with respect to any failure relating to the return which is computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period." I.R.C. § 6404(g)(1)(A). I.R.C. § 6404(g)(2) excepts from the coverage of I.R.C. § 6404(g)(1)(A):

A) any penalty under I.R.C. §6651,

B) any interest, penalty, addition to tax, or additional amount in a fraud case,

C) any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return, or

D) any criminal penalty.

A prerequisite to I.R.C. § 6404(g) treatment is the filing of a timely federal income tax return. As such, a failure to file penalty under I.R.C. § 6651(a)(1) would never be applied in any case eligible for I.R.C. § 6404(g) treatment. Therefore, there will be no penalty under I.R.C. § 6651(a)(1) or interest on such a penalty to be suspended under I.R.C. § 6404(g).

The failure to pay penalty under I.R.C. § 6651(a)(2) is also excepted from suspension by I.R.C. § 6404(g)(2)(A). Thus, although interest on a reported, but unpaid tax liability can be suspended under I.R.C. § 6404(g), the failure to pay penalty imposed on that tax liability under I.R.C. § 6651(a)(2) and interest accumulating on that penalty will continue to accumulate unchecked.

III. I.R.C. § 6404(g)(2)(C) DEFINED

I.R.C. § 6404(g)(2)(C) excepts from suspension "any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return." This provision provides that there will be no suspension of interest on liabilities reported by the taxpayer on his or her return and assessable under I.R.C. § 6201(a)(1) (so called "self-assessments"). I.R.C. § 6404(g) was enacted to prevent excessive amounts of interest from accumulating before a taxpayer knew that he or she owed any deficiency amounts. Where the amounts owed were reported by the taxpayer

on his or her return, the taxpayer should be aware of the amounts owed and that interest may be accruing as long as he or she delays paying the reported tax liability. As such, Congress saw no value in suspending interest from accumulating on items tied to the self-assessed tax liabilities.

IV. I.R.C. § 6404(g) REQUIRES WRITTEN EXPLANATIONS.

It has consistently been the position of the National Office that the notice required by I.R.C. § 6404(g) be a writing. See Office of Chief Counsel Notice N(35)000-172 (March 22, 2000). As stated above, from its inception, the intent of Congress in setting up the provision was to prevent interest from accruing excessively before the taxpayer was aware that any problem existed. The best way to communicate that a problem exists, and to be able to subsequently defend that a proper notice was issued, is through a written document.

When cases are "agreed" following an audit or other examination, the concerns of Congress might be satisfied if the resulting adjustments to the tax liability are not separately reduced to writing since the nature of an agreed case is that the taxpayer is aware of and has agreed to the adjustments that are to be made. Other provisions of the Code, such as I.R.C. § 6213(d), require a written agreement before the assessment can be made. As yet, no court has determined whether oral communication of liabilities and the basis thereof is sufficient for purposes of I.R.C. § 6404(g). Considering the importance of written notices for other statutory purposes and the need to clearly notify taxpayers of potential adjustments, we strongly advise that the notice required by I.R.C. § 6404(g) be written, particularly inasmuch as the inclusion of standard language in the written examination report (already used in office cases) may address any potential problems. As a general rule, it is always less hazardous to have all communications with taxpayers reduced to writing in case there are subsequent disagreements.

V. ADDITIONAL NOTICES ARE NOT REQUIRED WHERE NEW INFORMATION RESULTS IN THE CORRECTION OF PREVIOUSLY EXPLAINED ADJUSTMENTS.

Per I.R.C. § 6404(g)(1)(b), the suspension applies "separately with respect to each item or adjustment." Certainly, when a different issue giving rise to an additional liability arises after one notice has been issued, a second notice would need to be sent with regard to the new issue and additional liability to comply with I.R.C. § 6404(g), and a new suspension date would apply to that item and liability. Also, if the discovery of new information with regard to an issue addressed in a notice results in a chance to the amount of a taxpayer's liability once the notice has been provided, a second notice alerting the taxpayer to the increased liability would be equally important.

It is important that the taxpayer be continually apprized of changes to his or her liability and the basis thereof in successive notices once the 12 (or 18) month period established by I.R.C. § 6404(g) has expired. To protect the Service from the loss of accruing interest, the taxpayer should be promptly notified of any change in his or her potential liability. Since I.R.C. § 6404(g) requires notification of the liability with respect to each adjustment, and Congressional intent was to make sure the taxpayer was notified of his or her liability in a timely fashion, a second notice would be the best course of action (particularly where the new information resulted in a greater deficiency).

VI. I.R.C. § 6404(g) NOTIFICATION REQUIREMENTS ARE MET IN THE EXAMINATION OF A FLOW-THROUGH ENTITY WHERE THE REQUIRED NOTICE IS PROVIDED TO THE TAX MATTERS PARTNER.

I.R.C. § 6404(g) applies only to individual taxpayers. More specifically, it applies to "an individual who files a return of tax imposed by subtitle A", i.e., a return of individual federal income tax. Although partnerships and other flow-through entities are not explicitly mentioned in either I.R,C, § 6404(g) or in its legislative history, many adjustments to the income tax liabilities reported on individual income tax returns result from adjustments to the income and other "partnership items" of such entities during partnership level audits under the TEFRA provisions of I.R.C. §§ 6221 through 6233. For purposes of avoiding the suspension of interest under I.R.C. § 6404(g) if the liability adjustment relates to an adjustment to a partnership item, we believe that the notice requirements of I.R.C. § 6404(g) are met if notice is provided to the taxpayer as a partner under the TEFRA provisions. Because the examination is conducted at the partnership or entity level and the Service is not obligated to compute the resulting tax liability for individuals who may be direct or indirect partners until the determination of the partnership items becomes final, there is no reason to notify partners who may be individuals of their potential liability attributable to partnership items during the partnership proceedings. The TEFRA provisions, notably I.R.C. § 6223, specifically address the notice requirements during partnership audits. It is our position that compliance with these provisions is sufficient for purposes of I.R.C. § 6404(g).

Please call if you have any further questions.

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