IRS Insights | A closer look

Failure-to-file penalties apply when certain forms are paper filed

The IRS released a *Chief Memorandum*, POSTN-107995-22 on July 8, 2022, regarding penalties when taxpayers paper file certain forms that are required to be filed electronically.

Electronic filing rule

Last year the Department of the Treasury and the IRS proposed regulations that require filers of certain forms to electronically file those forms if the filer is filing 10 or more of the form. The forms included: Form 5330, *Return of Excises Taxes Related to Employee Benefit Plans;* Form 4720, *Return of Certain Excise Taxes Under Chapter 41 and 42 of the Internal Revenue Code;* Form 5227, *Split-Interest Trust Information Return;* Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations.*

The proposed regulations also have special rules for Form 1042, *Annual Withholding Tax Return of U.S. Source Income of Foreign Persons*. If a filer has to file more than 250 Forms 1042 or is a financial institution, the filer must file Form 1042 electronically.

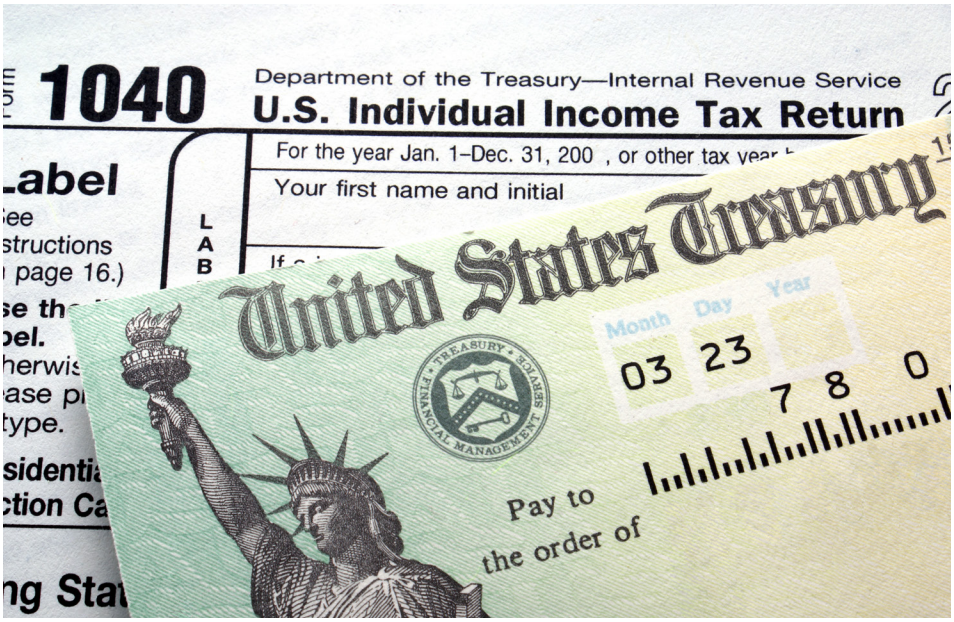
These rules do not go into effect until the regulations are finalized (although Form 4720 has to be electronically filed under Section 6033(n)).

Penalty

In a recent memo, the IRS Chief Counsel took the position that if a taxpayer timely paper files the above forms when IRS rules required the forms be electronically filed, the failure-to-file penalties apply.

Chief Counsel reasoned that under Section 6011(a) the IRS has broad authority to prescribed filing requirements and, under case law, taxpayers must meticulously comply with the IRS's filing requirements. Chief Counsel stated that any taxpayer that fails to comply with the IRS's proposed electronic filing rules has failed to comply with the filing requirements. Therefore, a Section 6651 or 6652 failure-to-file penalty may apply, absent a showing of reasonable cause.

DC Circuit affirms that a partnership that is profitable only after claiming tax incentives is bona fide



The DC Circuit Court of Appeals recently ruled that a partnership formed to conduct activity made profitable only by tax credits engaged in legitimate business activities for US federal income tax purposes. In *Cross Refined Coal, LLC, et al. v. Commissioner*, No. 20-1015, the DC Circuit concluded that all of the partnership's members shared in the profits and losses and had a meaningful stake in the partnership and rejected the Internal Revenue Service's argument that the partnership needed to have a reasonable expectation of pretax profit to be considered bona fide.

Background facts

Shortly after Congress amended the refined-coal tax credit in Section 45, AJG Coal, Inc. began developing coal-refining technology and formed Cross Refined Coal, LLC ("Cross"). Cross began construction on a new refined-coal facility and entered into three agreements to further its business enterprise: (1) a rental agreement with a local utility company to construct a coal-refining facility at a power-generating station; (2) a sub-license agreement with AJG Coal, Inc. to use the coal-refining technology; and (3) a purchase-and-sale agreement with the utility to purchase unrefined coal for refinement and then sell the refined coal back to the utility for $0.75 *less* per ton than the purchase price for unrefined coal.

Given the expenses and the purchase-and-sale agreement with the utility, Cross expected to generate a pretax loss from its operations and to generate a profit only due to the refined-coal tax credit. After the facility was constructed, two new investors invested in Cross and were treated as partners. The new investors could more efficiently utilize the tax credits.

For the tax years at issue (2011 and 2012), the IRS determined that Cross was not a partnership for US federal income tax purposes because it was not formed to carry on a business or for the sharing of profits and losses from the production or sale of refined coal. Accordingly, the IRS denied the two new partners' ability to claim the tax credits. The Tax Court disagreed and concluded that Cross was a bona fide partnership.

DC Circuit analysis

The DC Circuit affirmed the Tax Court's decision and rejected the IRS argument that a partnership will be respected only if there is an expectation of a pretax profit at some point in time.

First, the DC Circuit noted that the three partners intended to jointly carry on a business, and there were legitimate non-tax motives to form Cross and recruit outside investors to the enterprise.

Second, Congress expressly recognized the benefits of refined coal and provided tax incentives precisely to encourage activity that would otherwise be unprofitable. There was nothing "untoward" about seeking capital from investors who could efficiently utilize such tax credits. Congress specified the division of credits when a facility has multiple owners, indicating an expectation that partnerships would be utilized for such investments.

Third, the new investors were legitimate partners that became actively involved in the operations of Cross and shared in the potential for after-tax profit and risk of loss.

Fourth, in light of congressional goals, Cross was engaged in a legitimate business activity and thus constituted a bona fide partnership, notwithstanding that there was no potential for pretax profit. To conclude otherwise would "hamstring" Congress' ability to use tax credits to encourage activity that is socially desirable but unprofitable.

Conclusion

This decision holds that a partnership that is profitable only due to tax incentives can still be respected as a bona fide partnership for US federal income tax purposes. Of course, the analysis of whether a partnership will be respected is fact specific. In *Cross Refined Coal*, the facts related to partners' involvement in the partnership (e.g., degree of active management by the partners; their level of potential risk of loss in the venture) distinguished it from cases where partnerships were not respected.

Taxpayer cannot invalidate closing agreement

In *Smith v. Commissioner*,[1] the Tax Court rejected the taxpayer's attempts to invalidate a closing agreement he entered into with the IRS.

Under Section 7121(a), the IRS is authorized to enter into agreements with taxpayers regarding their tax liability for a specific tax period. These agreements are called "closing agreements."[2] Closing agreements are "final and conclusive." Courts strictly enforce closing agreements because closing agreements are intended to ensure the "finality of liability for both the taxpayer and the IRS."[3] A closing agreement can be invalidated only if there is "fraud," malfeasance, or misrepresentation of material fact."[4]

Background

When petitioner Cory Smith took a job in Australia, he entered into a closing agreement with the IRS waiving his ability to make the Section 911(a) election (i.e., Mr. Smith waived his ability to elect to exclude the Australia income from his US taxable income). Mr. Smith's employer facilitated the execution of the closing agreement. Specifically, the employer obtained blank closing agreements from the IRS, provided the closing agreement to Mr. Smith, and transmitted Mr. Smith's signed closing agreement to the IRS.

The closing agreement covered the 2016–2018 tax years. Consistent with the closing agreement, Mr. Smith's original 2016 and 2017 Forms 1040 did not make the Section 911(a) election. However, Mr. Smith's original 2018 Form 1040 did make the Section 911(a) election, and Mr. Smith filed amended tax returns for 2016 and 2017 making the Section 911(a) election.

The IRS issued a notice of deficiency for taxable years 2016–2018 disallowing the claimed Section 911(a) elections because Mr. Smith waived the election in the closing agreement. Mr. Smith argued the closing agreement did not apply because (1) the closing agreement was not properly approved by the IRS and (2) it was invalid because of malfeasance or misrepresentation. The Tax Court rejected both arguments and held the closing agreement valid.

Tax Court decision

First, the Tax Court ruled the IRS properly approved the closing agreement. The court reviewed the relevant treaty and delegation orders to determine the IRS officer who signed the agreement had the authority to do so.

Second, the Tax Court rejected Mr. Smith's argument that there was malfeasance. Mr. Smith argued there was malfeasance because when his employer facilitated with the closing agreement with the IRS, the IRS disclosed his confidential return information in violation of Section 6103. The Tax Court ruled that the IRS did not violate Section 6103 merely by transmitting a blank closing agreement to the employer because it was not asking Mr. Smith to enter into a closing agreement. Moreover, the blank form agreement—which is similar to the samples on the IRS's website—did not contain any confidential return information. Similarly, there was no disclosure of confidential information when his employer sent the closing agreement signed by Mr. Smith because it was Mr. Smith, not the IRS, who shared the closing agreement he signed. Finally, the court punted on whether the IRS disclosed confidential return information when it sent the final (IRS signed) closing agreement to Mr. Smith through his employer. The court said it did not matter whether that transmission constituted a disclosure because the closing agreement was already in effect when the IRS sent the closing agreement to Mr. Smith's employer. Thus, there was no malfeasance that warranted invalidating the closing agreement.

Third, the Tax Court considered Mr. Smith's argument that the IRS misrepresented facts about the Australian tax regime and the relevant treaty. The court rejected this argument because closing agreements can be set aside only for misrepresentation of material *fact*, not a misrepresentation of *law*.

Conclusion

The Tax Court continued the court's long-standing tradition of upholding closing agreements. Taxpayers entering into closing agreements should consider all aspects of the agreement before signing.

Court allows IRS to assess interest after closing agreement

In *Chesapeake Energy Corporation v. United States,*[5] a district court ruled that the IRS could assess interest for a tax year in which the IRS and taxpayer had entered into a closing agreement.

Background

Chesapeake Energy Corporation and the IRS entered into a closing agreement for tax year 2012. The closing agreement did not address interest. Later, the IRS assessed $12 million of interest on the deficiency for the 2012 tax year. Chesapeake Energy Corporation sued for a refund on the grounds that the IRS could not assess interest because the parties had entered into a closing agreement.

Construing closing agreements

Through Section 7121, Congress allows the IRS to enter into closing agreements with taxpayers. The district court summarized the law on interpreting such closing agreements. It stated that courts strictly construe a closing agreement; that is, the court will read the agreement as narrowly as possible. Courts will regard a tax matter as settled by closing agreement only if the matter is specifically spelled out in the closing agreement. When interpreting a closing agreement, courts will construe the agreement according to the intent of the parties, and the court infers the parties' intent from the four corners of the document unless it is ambiguous. A closing agreement is ambiguous only if the terms are inconsistent on their face or the phraseology can support reasonable differences as to their meanings.

Court's analysis

Here, the closing agreement did not address how interest would be calculated. The district court determined that the omission did not create "ambiguity" because the calculation of taxable income and the assessment of penalties and interest are provided for by law. Because the closing agreement was unambiguous, the court said it would not consider any extrinsic evidence.

The court concluded that nothing in the closing agreement prohibited the IRS from assessing interest under Section 6601(d)(1). Because the IRS did not specifically waive its right to collect that interest, the closing agreement did not bar the IRS from assessing it.

Conclusion

Courts will strictly construe closing agreements so taxpayers should ensure all terms are contained in the agreement.

Endnotes

1 *Smith v. Commissioner,* 159 T.C. No. 3 (2022).

2 Section 7121(b).

3 *Hopkins v. Commissioner*, 120 T.C. 451, 457 (2003).

4 Section 7121(b).

5 *Chesapeake Energy Corporation v. United States,* No. 5:20-cv-00934 (W.D. Okla. September 6, 2022).

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