THE PAST ISN'T DEAD: HOW THE IRS CAN SURPRISE TAXPAYERS

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As William Faulkner observed in *Requiem for a Nun*, "[t]he past is never dead. It's not even past." While not aimed specifically at taxpayers and practitioners, Faulkner's observation is nonetheless relevant to tax procedure.

The Seventh Circuit recently demonstrated this in *United States v. Titan International, Inc.*, 2106 U.S. App. LEXIS 1687 (7th Cir. Feb. 1, 2016), an appeal from a summons enforcement proceeding. The taxpayer had taken an operating loss carry-forward in 2010 and the relevant loss had occurred in 2009. *Titan Int'l*, 2106 U.S. App. LEXIS 1687 at *1. The IRS sought the taxpayer's records for the 2009 tax year, which it had already inspected in auditing its 2009 return. The taxpayer balked, arguing that reinspection of its records violated Section 7605(b) of the Code, which provides that "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." I.R.C. § 7605(b). This argument failed badly. The Seventh Circuit held that Section 7605(b) only limits the IRS to a single examination of the taxpayer's records *per audit*. *Titan Int'l*, 2106 U.S. App. LEXIS 1687 at *5. Since the material was to be reinspected for an audit of a subsequent tax year, Section 7605(b) was not applicable and the summons was enforceable.

The broader point is that the limits on the ability of the IRS to re-examine issues that are seemingly closed are anything but robust. For example, section 7605(b) itself indicates that the IRS can re-examine the taxpayer's books when the Secretary investigates the need to do so, and the taxpayer is notified. I.R.C. § 7605(b). The regulations make clear that this decision can be made by "an authorized internal revenue officer." Treas. Reg. § 301.7605-1(h).

Even a closed exam can be reopened. In its Statement of Procedural Rules, the IRS identifies

situations in which a closed examination will be reopened to make an adjustment in the government's favor. *See* Treas. Reg. § 601.105(j). It's no surprise that fraudulent behavior will suffice, but the other grounds have nothing to do with the taxpayer's behavior: "The prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or . . . [o]ther circumstances exist which indicate failure to reopen would be a serious administrative omission." Treas. Reg. § 601.105(j)(1)(ii), (iii). The "other circumstances" include "cases with items or transactions with a significant potential for abuse for which a limited examination was performed." Rev. Proc. 2005-32, § 5.02, 2005-23 IRB 1206, 1208 (2005). The only real limitation here appears to be that a senior IRS official must bless the re-examination. Treas. Reg. § 601.105(j)(2).

And then there are closed years. The mere fact that the assessment limitations period has expired doesn't mean the past is past, as there are situations in which the IRS can nonetheless deal with the "closed" year.

First, taxpayers are subject to a duty of consistency:

> The duty of consistency arises when the following elements are present: "(1) a representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner."

Eagen v. United States, 80 F.3d 13, 17 (1st Cir. 1996) (quoting *Herrington v. Comm'r*, 854 F.2d 755, 758 (5th Cir. 1988)). The Ninth Circuit applied the duty of consistency in *Estate of Ashman v. Commissioner*, 231 F.3d 541 (9th Cir. 2000). The taxpayer received a distribution from a qualified plan in 1990; she only rolled over a part of it, but she did not report the income associated with the portion of the distribution that was not rolled over. 231 F.3d at 542. Three years later, she received distributions from an investment account that had been funded with the distribution that was not rolled over; since the distributions were less than what she had deposited in the fund, she reported no income associated with them, since they should have been taxed in 1990. *Id.* Her argument was unavailing. The Ninth Circuit applied the duty of consistency and upheld a tax assessment for the income in 1993, reasoning, in part, as follows: "[t]he law should not be such a (sic) idiot that it cannot prevent a taxpayer from changing the historical facts from year to year in order to escape a fair share of the burdens of maintaining our government." *Id.* at 544 (footnote omitted).

Another means of reaching a "closed" tax year arises in cases that involve an accounting change, a concept that is broader than the phrase might suggest.

Generally, taxpayers have some discretion in selecting a method of accounting. If, however, the method selected by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." I.R.C. § 446(b).

Section 481(a) of the Code, in turn, provides the IRS with authority to make adjustments to reflect the correct accounting:

> In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—
> (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
> (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

I.R.C. § 481(a).

The term "method of accounting" is defined broadly in the regulations, and they expressly indicate that a change in the "method of accounting" can involve a single item:

> The term "method of accounting" includes not only the overall method of accounting of the taxpayer *but also the accounting treatment of any item*. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. *These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc.*

Treas. Reg. § 1.446-1(a)(1) (emphasis supplied).

In *Mingo v. Commissioner*, 773 F.3d 629 (5th Cir. 2014), the Fifth Circuit sustained an adjustment made to correct the treatment of unrealized receivables in connection with the sale of a partnership interest; the taxpayer had reported the sale of her partnership interest on the installment method, including the value of the receivables. 773 F.3d at 631. This was problematic because Sections 741 and 751 of the Code dictate that unrealized receivables be treated as ordinary income, and because ordinary income items do not qualify for installment treatment. *Id.* at 633-35.

The taxpayer had commenced the use of the installment agreement in 2002 and had failed to recognize the value of the unrealized receivables at that time. *Id.* at 632. The IRS audited the taxpayer for the 2003 tax year and determined that a portion of her income associated with the sale of her partnership interest did not qualify for installment treatment; it determined that the taxpayer had income from the unrealized receivables that should have been reported in 2002. *Id.* The IRS made an adjustment in 2003 to reflect the income that should have been recognized in 2002 because it could no longer assess additional tax for the 2002 tax year due to the expiration of the assessment limitations period. *Id.* at 632-33.

The adjustment was sustained. As the Fifth Circuit explained, if an accounting change is involved, "[t]he only limitation on [§ 481(a)] adjustments is that no pre-1954 adjustments shall be made." *Id.* at 636 (quoting *Comm'r v. Welch,* 345 F.2d 939, 950 (5th Cir. 1965)); *see* also *Rankin v. Comm'r*, 138 F.3d 1286, (9th Cir. 1998) ("the statute does not apply to § 481") (citations omitted).

Taxpayers and their representatives should thus remember that the past isn't even past.

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