



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Application of suspension of interest provisions under I.R.C.
§ 6404(g) where the taxpayer has made an election under
I.R.C. § 183(d), deferring determination of tax liability until
profit motive can be presumed.

This Chief Counsel Advice responds to your memorandum dated June 1, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

T =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
a =

ISSUES

1. Whether the I.R.C. § 183(e) election prevents the start or the continuation of the suspension of interest provisions of I.R.C. § 6404(g) until the end of the statute extension provided in I.R.C. § 183(e)(4).

2. Whether the submission of Form 5213, Election to Postpone Determination with Respect to the Presumption that an Activity is Engaged in for Profit, by the taxpayer constitutes the notice required under I.R.C. § 6404.

CONCLUSIONS

1. I.R.C. § 6404(g)(2) excepts out several situations from the notice requirements of section 6404(g)(1)(A). The exceptions cover those situations where the taxpayer is clearly blameworthy, e.g., in the case of fraud, criminal penalties, or failure to file a return, or has already admitted liability by showing the liability on the return, and as such notice of liability is not required. The I.R.C. § 183(e) election is not covered by these exceptions, and, therefore, does not prevent the start or the continuation of the suspension of interest provisions of I.R.C. § 6404(g).

2. The submission of Form 5213 by the taxpayer does not constitute the notice required under I.R.C. § 6404(g). The notice must contain liability amounts and the basis therefor, and the burden is upon the Service to provide such notice.

FACTS

Beginning in Year 1, T was engaged in the activity of a. This activity produced losses which were claimed on T's Year 1 and Year 2 federal income tax returns.

The Service commenced an examination of the taxpayer's Year 1 and Year 2 Federal income tax returns and challenged various expenses claimed in connection with the activity. One proposed adjustment resulted from the application of I.R.C. § 183(a), the disallowance of losses for activities not engaged in for profit. In light of this pending determination, the taxpayer elected to defer the determination as to whether the presumption of profit applied to the activity as provided by I.R.C. § 183(d). On September 4, 1997, the taxpayer signed and filed Form 5213, Election to Postpone Determination as to Whether the Presumption that an Activity is Engaged in for Profit Applies. This election postponed the Service's consideration of the profit motive of the activity until the close of the fourth taxable year after the first year of operation, i.e., from taxable year Year 1 to the close of taxable year Year 4.

The taxpayer reached a partial agreement with respect to other issues that had been raised in the examination. Years Year 1 and Year 2 were placed in audit suspense and further work on the returns ceased. As each succeeding tax year covered by the Form 5213 was filed, it took its place in suspense alongside the Year 1 and Year 2 taxable years. Finally, during the year Year 5, five taxable periods were released from suspense for consideration with respect to the I.R.C. § 183 issues.

LAW AND ANALYSIS

The Effect of I.R.C. § 183(e) Election on I.R.C. § 6404(g) Suspension Provisions

I.R.C. § 183(a) disallows losses for activities not engaged in for profit. However, section 183(d) contains a presumption that an activity is engaged in for profit if its gross income exceeds its deductions for at least three of five taxable years, unless the Secretary establishes to the contrary. Under I.R.C. § 183(e)(1), the taxpayer may elect to delay determination of whether the presumption under section 183(d) applies until the close of the fourth year following the first taxable year in which the taxpayer engaged in the activity. Where the taxpayer files an election, under I.R.C. § 183(e)(4), the statutory period for the assessment of any deficiency attributable to the activity will not expire before the expiration of 2 years after the date prescribed by law (determined without extensions) for filing the income tax return for the last taxable year of the 5 years making up the period for evaluation.

§ 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 IRS does not give the taxpayer proper notice of certain liabilities within a statutorily defined period. As amended, I.R.C. § 6404(g) requires that, where 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 (as applicable here, 18 months), 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). The suspension does not apply to any penalty under I.R.C. § 6651, any interest, penalty, addition to tax, or additional amount in a fraud case or with respect to any tax liability shown on the return, or any criminal penalty. I.R.C. § 6404(g) applies only to taxable years ending after July 22, 1998. Under the effective date, in this case, the requirements of I.R.C. § 6404(g) only apply to the returns filed by the taxpayer for taxable years Year 3 and Year 4. Under I.R.C. § 6404(g), without taking any other circumstances into account, the appropriate notices for Year 3 and Year 4 should have been sent by Date 1 and Date 2, respectively.

In enacting I.R.C. § 6404(g), the primary intent of Congress was to prevent large amounts of interest from accruing on liabilities owed by a taxpayer who was not aware such liabilities existed. S. Rep. No. 105-174 (1998). Congress felt that where a taxpayer could not be notified of his or her liability within a statutory period, it would be unfair to allow interest and certain penalties to continue to accrue until he or she was notified and given a brief period to address the outstanding amounts. Id. However, Congress also felt that there were certain circumstances where either the taxpayer is clearly blameworthy, e.g., in the case of fraud, criminal penalties, or failure to file a return, or has already admitted liability by showing the liability on the return. To that end, Congress has set out very specific instances to which the suspension provisions do not apply, and has not, to date, provided any legislative

direction requiring the Service or granting the Service discretion to suspend interest and penalties outside those limited circumstances.

I.R.C. § 6404(g)(2), which enumerates the limited circumstances which are excepted from suspension under section 6404(g)(1)(A), does not include a provision which would cover an election under section 183(e)(4) or any analogous code sections which provide for a delay in determination and extension of the applicable period of limitations. A tax liability relating to a determination of profit motive under I.R.C. § 183 does not relate to failure to file or failure to pay, does not relate to fraud provisions, is not a criminal penalty, and is not a liability shown on the return or otherwise admitted by the taxpayer. A taxpayer making a I.R.C. § 183(e)(4) election is not necessarily blameworthy and has not admitted liability. While the taxpayer may be aware that losses from the activity are being examined with respect to the five-year period, the taxpayer generally would not have reason to know his or her specific liability and the basis therefore unless a notice was properly sent in compliance with I.R.C. § 6404(g). It would appear that this is precisely the sort of situation Congress had in mind when it enacted section 6404(g). Similarly, the fact that the statutory period of assessment remains open is irrelevant both with respect to the notice period and the exceptions thereto.

Taxpayer's Form 5213 as Notice Under I.R.C. § 6404(g)

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." To address Congress' concerns, I.R.C. § 6404(g) places the burden of timely informing of the taxpayer of his or her liability and the basis therefor on the Service. The fact that a taxpayer has been made aware that the losses claimed on his or her return are under review under I.R.C. § 183 and, consequently, has filed a request for delay of determination, does not meet the Service's burden to provide that information. While a taxpayer may be aware that items are under review, there is no indication that the taxpayer has received notice of his or her full liability and the basis therefor sufficient to meet the requirements of I.R.C. § 6404(g).

In addition, 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). In light of the fact that Congress intended the Service to carry the burden of notifying the taxpayer, that writing should be from the Service to the taxpayer. As a general rule, it is always less hazardous to have all communications with taxpayers reduced to writing in case there are subsequent disagreements. The Form 5213 filed by T will most likely not contain sufficient

evidence of liability and basis or that liability and basis were timely conveyed to the taxpayer in some manner. We believe section 6404(g) requires a notice specifically addressing the provisions of section 6404. The Form 5213 does not perform this task or satisfy section 6404(g).

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Curt G. Wilson
Assistant Chief Counsel
(Admin. Provisions and Judicial Practice)
By: BLAISE G. DUSENBERRY
Asst. to Branch Chief
CC:PA:APJP:B3