Office of Chief Counsel
Internal Revenue Service

memorandum

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date: December 16, 1998

to: District Counsel, Brooklyn

from: Assistant Chief Counsel, Income Tax & Accounting

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subject: Significant Service Center Advice
Reliance on State Determinations for Under $5,000 Cases

This responds to your request for advice received on July 20, 1998.

ISSUES:

1. Must a service center receiving a referral from New York State as part of the Federal-State Cooperative Audit Program obtain the state's administrative file before issuing a notice of deficiency of less than $5,000?

2. Must Letter 525(SC) be revised to explicitly notify its recipient that he or she may request an appeals conference?

CONCLUSIONS:

1. A service center receiving such a referral from New York State need not obtain the state's administrative file before issuing a notice of deficiency of less than $5,000. However, if the taxpayer responds to the notice by requesting an appeals conference or by petitioning the Tax Court, the Service should move quickly to obtain and review the state's administrative file and determine whether the proposed deficiency should be conceded in whole or part.

2. It would be advisable to inform a taxpayer receiving a Letter 525(SC) that he or she may request an appeals conference, either by revising Letter 525(SC) to so provide or by including Publication 5 with the letter.

FACTS:

IRM sections 4(13)80 et seq. set forth examination procedures to be used by service centers in connection with the Federal-State Cooperative Audit Program. IRM section 4(13)81 provides that as part of this program "[c]opies of examination reports from State tax agencies are referred to the service centers for association with the Federal income tax return and possible examination of that return by correspondence." The two service centers that receive New York State examination reports are the Andover and Brookhaven Service Centers. We understand that after a New York State examination report is received by one of these service centers and then associated by the service center with the taxpayer's Federal income tax return, the service center takes steps to determine whether the report warrants a service center correspondence examination. These steps may include determining whether the state examination report concerns tax years for which assessments are barred by the Federal statute of limitations on assessments, or issues that affect the taxpayer's New York State tax liability but not his or her Federal tax liability, such as the allocation of income between New York State and another state. Further, in the case of a New York State examination report indicating that the taxpayer has underreported income of a kind that should have been reported to the Service by its payor on a Form 1099, these steps may include a review of IRP to determine whether a payor has filed a corresponding Form 1099.

IRM section 4(13)83 further provides that an examination by correspondence prompted by a state examination report is begun by sending the taxpayer a Letter 525(SC), a Form 1902-B(C) (report of examination changes), and Publications 1 and 1383. Letter 525(SC) (Rev. 7-1992) asks a taxpayer to either agree with the proposed changes and return payment, or to explain why he or she disagrees. Letter 525(SC) does not advise its recipient that he or she may request an appeals conference.

IRM section 4(13)83 directs a service center to obtain a state's administrative file only:

(a) before issuing a statutory notice in the amount of $5,000 or more;

(b) when a taxpayer requests an appeals conference regardless of the amount of the tax; and

(c) when a taxpayer petitions the Tax Court regardless of the amount of the tax.

In the absence of these circumstances, IRM section 4(13)83 allows a service center to issue a statutory notice as a result of an examination prompted by a state examination report without first obtaining the state's administrative file containing the information upon which the state examination report is based.

We understand that as part of the Federal-State Cooperative Audit Program the Andover and Brookhaven Service Centers receive two types of New York State

examination reports. One type relates to a New York tax deficiency that has become fixed as a result of either the taxpayer's agreement to all or part of a proposed New York State deficiency or the taxpayer's failure to timely challenge a proposed New York State deficiency. We understand that the great majority of the examination reports received from New York State are of this type. The second type is an "advance" examination report that notifies the Service of a pending New York State examination that the state believes has Federal tax potential. In accordance with Section II.(E)5. of the Amended Implementing Agreement on Coordination of Tax Administration Between New York State Department of Taxation and Finance and Internal Revenue Service dated November 18, 1997, such advance notification is to be given only in cases of "large" deficiencies. While the term "large" is not defined in the Amended Implementing Agreement, we understand that in practice the advance notifications received from New York State deal with potential Federal deficiencies of at least $5,000. We further understand that many of both types of examination reports received from New York State cannot be used by the Service because they are received after the expiration of the Federal statute of limitations on assessments.

In addition, we understand that some of the notices of deficiency issued by the Andover and Brookhaven Service Centers as a result of examinations prompted by New York State examination reports are issued in reliance on the six-year statute of limitations provided by Code section 6501(e). That statute applies only if a taxpayer omits from gross income an amount properly includible therein in excess of 25 percent of the amount of gross income reported. The Service bears the burden of proving the omission.[1]

DISCUSSION

1. In your advice request you raised two concerns with respect to a determination reflected in a statutory notice issued by a service center as a result of an examination prompted by a New York State examination report when the service center does not obtain and review the state's administrative file prior to issuing the statutory notice. First, that the determination may not be entitled to the presumption of correctness generally accorded a determination by the Commissioner because the determination will have been based on information reviewed by the New York State taxing agency but not by the Service. Second, that the Service may be assessed administrative or litigation costs if the taxpayer successfully challenges the determination in appeals or in court because the Service may be held to have not been substantially justified within the meaning of Code section 7430 in issuing a statutory notice in these circumstances.

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[1] See Estate of Iverson v. Commissioner, 27 T.C. 786, 792 (1957), aff'd, 255 F.2d 1 (8th Cir. 1958), cert. denied, 358 U.S. 893 (1958).

While we believe that these concerns have some merit, we do not believe that they warrant changing the examination procedures set forth in the manual to require that state administrative files be reviewed in all cases prior to issuing statutory notices. First, the Service's action in issuing a statutory notice after reviewing a state examination report and the associated Federal income tax return is a valid determination for purposes of Code section 6212(a). See Portillo v. Commissioner, 932 F.2d 1128, 1130 (5th Cir. 1991) (holding that the Service's matching of a Form 1099 to the taxpayer's return was a determination as required by the Code), on remand, T.C. Memo. 1992-99 (attorney's fees), rev'd, 988 F.2d 27 (5th Cir. 1993). Thus, the holding of Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), will not apply. In Scar, the Ninth Circuit held that the Service had not made a valid determination when the proposed deficiency was based on information concerning a partnership unrelated to the taxpayers or their return. A situation analogous to that in Scar will not occur if the service center associates the correct Federal income tax return with the New York State examination report. However, if the state examination report is based solely on the matching of an information return with the state tax return, a notice of deficiency may be found to be arbitrary under Portillo.

Further, if a deficiency notice is issued after the service center associates the correct Federal income tax return with a New York State examination report, that determination will generally not have been based solely on the state examination report, but will also be based on a review of the taxpayer's Federal income tax return, the taxpayer's response or failure to respond to a Letter 525(SC) and often the service center's review of IRP.[2] Accordingly, the determination should generally be entitled to the same presumption of correctness generally afforded the Commissioner's determinations. See Welch v. Helvering, 290 U.S. 111 (1933). Of course, in cases in which the Service relies on the six-year statute of limitations set forth in Code section 6501(e), the general presumption of correctness will not benefit the Service because it has the burden of proving that the taxpayer omitted sufficient gross income from his return.

Finally, your concern that the Service may be held to have not been substantially justified within the meaning of Code section 7430 when it determines a deficiency as a result of an examination prompted by a New York State examination report, and therefore may be assessed administrative and litigation costs if the taxpayer successfully challenges the deficiency in appeals or in court, can be alleviated in large measure by promptly reviewing the determination in the event the taxpayer seeks its

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[2] We understand that in practice the service centers generally refer New York State examination reports dealing with income and deductions reported or reportable on Schedules C and E of Form 1040 to the appropriate district's examination function for review. Accordingly, the service centers generally only deal with purported omissions of income of the types reported to the Service in Forms 1099s (i.e., interest, dividends, etc.) and purported overstatements of deductions claimed on Form 1040, Schedule A.

review by requesting an appeals conference or filing a Tax Court petition. That prompt review will allow an informed decision to concede the case (in whole or in part) to be made, so as to limit any potential liability for administrative or litigation costs.

2. Courts have held that taxpayers do not have a due process right to an appeals conference before the Service issues a notice of deficiency. See Ballard v. Commissioner, T.C. Memo. 1987-471 and cases cited therein. Nevertheless, the procedural regulations indicate that taxpayers are to have the opportunity to have an appeals conference both prior to and after the issuance of a statutory notice of deficiency. Treas. Reg. §§ 601.105(d), 601.106(a)(1), and 601.106(b). Further, as pointed out in the memo requesting this advice, IRM section 4(13)83 implicitly recognizes that a taxpayer may request an appeals conference in response to a Letter 525(SC) by listing "when a taxpayer requests an appeals conference within the Service" as one of the three situations in which a service center must request the state's administrative file. Additionally, Publication 1383, which the manual directs is to accompany a Letter 525(SC), states that Publication 5 is enclosed with it. Thus, the manual implicitly directs that Publication 5 accompany a Letter 525(SC).

In addition, the Notice CP2000 (30-day letter) and accompanying publications (including Publication 5) sent to a taxpayer as a result of unreported income uncovered through the information return underreporter program advises the taxpayer that he or she may go to appeals. Such a 30-day letter, which involves income uncovered as a result of matching a third party report with the taxpayer's return, is somewhat analogous to a Letter 525(SC) resulting from a service center examination prompted by a state's examination report.

For these reasons, it would be advisable for a taxpayer receiving a Letter 525(SC) to be advised at that time that he or she may go to appeals by including Publication 5 in the Letter 525(SC) package.

Sincerely,
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