Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Disclosure, Examination, and Notice Issues Regarding Information Matching Program

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether the Service may disclose to investors in a flow-through entity that the entity is subject to an information matching program.

2. Whether subjecting a flow-through entity to an information matching program and making resulting "general adjustments" (as defined in IRM 21.3.1.2) constitutes an examination for purposes of section 7605(b).

3. Whether, where a flow-through entity provides some information to explain the mismatch detected by the information matching program, requesting additional information from the flow-through entity is an examination for purposes of section 7605(b).

4. Whether, if an entity does not agree with or fails to respond to an information matching program notice, the Service may make a general adjustment to the entity's return rather than issuing a notice of deficiency.

5. Whether an adjustment to the entity's Schedule K-1 constitutes an examination for purposes of section 7605(b).

6. Whether, at the time a notice of final adjustment is sent to the entity, notice should be sent to the investors regarding the need to adjust their individual returns.

7. When the Service has adjusted an investor's individual return based on an adjustment to the flow-through entity in which the investor has invested, whether making additional adjustments based on matching information received regarding a different entity for the same taxable year constitutes a second examination for purposes of section 7605(b).

8. Whether an investor who received an adjustment notice from the AUR may be sent a Schedule K-1 adjustment notice for the same taxable year if the AUR notice involved a different issue regarding the investor's income tax liability.

9. Whether issuing a final adjustment notice would impact the ability to assess partner of a 1065 entity where the Service only later learns that entity is a TEFRA entity.

CONCLUSIONS

1. When the investors' individual returns could be impacted by adjustments to the entity's return, the Service may disclose that the entity is subject to an information matching program.

2. Subjecting a flow-through entity to an information matching program and making resulting general adjustments does not constitute an examination for purposes of section 7605(b).

3. When the flow-through entity voluntarily provides information to explain the mismatch or provides further information in response to Service contacts seeking to verify the mismatch, the contact does not rise to the level of an examination for purposes of section 7605(b).

4. In an entity does not agree with or fails to respond to an information matching program notice, the Service should not make a general adjustment. Instead it should follow the appropriate deficiency or TEFRA partnership procedures.

5. When the Service adjusts an entity's Schedule K-1 as a result of an information matching program, such an adjustment is not an examination for purposes of section 7605(b).

6. The Service may contact the investors at the time it issues a final notice to the entity informing the investors of the need to adjust their individual returns, either through an amended return or through an AAR.

7. When the Service has adjusted an investor's individual return based on an adjustment to the flow-through entity in which the investor has invested, making

additional adjustments based on matching information received regarding a different entity for the same taxable year does not constitute an examination for purposes of section 7605(b) because the adjustments are made pursuant to an information matching program.

8. The Service may send the investor an adjustment notice unless the AUR sent the taxpayer a notice of deficiency and the taxpayer timely petitioned the Tax Court from that notice.

9. Issuing a final adjustment notice would not impact the ability to assess partners of a 1065 entity, even if the Service later learns that the entity is a TEFRA entity.

FACTS

Beginning on January 1, 2011, merchant transactions in which either a payment card or third party network is used as the form of payment must be reported to the Service by the payment settlement entity on new Form 1099-K, "Merchant Card and Third Party Payments." The Service would like to compare the information it receives on these forms to the amount of income reported by flow-through entities on Forms 1065 and 1120S. The Service would then issue a notice[1] to entities with significant mismatches. This notice would provide the entity with instructions regarding how to respond to the alleged mismatch. If the entity agrees that it left income off of its return, it will be instructed to file an amended return, which may include an amended Schedule K-1. Where an entity must file an amended Schedule K-1, the entity will be instructed to provide copies to the impacted owners, partners, or shareholders,[2] so that those individuals may amend their individual returns as appropriate.

This memorandum examines questions regarding whether this program would be considered an examination for purposes of section 7605(b), as well as a number of questions relating to who may receive what types of notices under this program.

LAW AND ANALYSIS

I. Disclosure to Investors that the Entity is Subject to the Matching Program

Where the matching program, discussed above, detects a significant mismatch, the Service plans to send notice of that mismatch to the entity in question. However, a change in the entity's return could impact the individual returns of the investors of the entity. Thus, the Service would like to provide the investors with a copy of the notice sent to the entity.

[1] This notice would be a new notice created for this program. Unless otherwise specified, when this memorandum uses the term "notice" it refers to this new notice and not a notice of deficiency.
[2] This memorandum will, hereinafter, refer to owners, partners, and shareholders as "investors," except where clarity dictates otherwise.

The Service must protect the confidentiality of returns and return information unless disclosure is authorized by Title 26 of the United States Code. I.R.C. § 6103(a). As the matching program notice may contain information regarding income or payments of the entity, the notice contains return information. I.R.C. § 6103(b)(2)(A). One exception to this confidentiality rule allows disclosure of returns and return information to those with a material interest in the return information. Specifically, sections 6103 (e)(1)(C), (e)(1)(D)(iv), and (e)(7) allow the Service to disclose the return information of a taxpayer to the partners of a partnership or shareholders of an S corporation. See Solargistic Corp. v. United States, 921 F.2d 729, 731 (7th Cir. 1991) (holding that the interplay between section 6103(e)(7) and (e)(1) allows the Service to disclose to investors in an entity that the entity is being audited where the investors individual returns could be affected by changes to the entity's return). In this case, either the partners in a partnership subject to the matching program or the shareholders of an S corporation subject to the matching program may need to amend their individual returns because of changes to the entity's returns. Therefore, the Service may disclose that the entity they have invested in is being subjected to the matching program.

II. Matching Program and Examinations Under Section 7605(b)

Section 7605(b) protects a taxpayer from unnecessary examinations or investigations and prevents the Service from inspecting a taxpayer's books of account more than once for any one taxable year. Neither the Code nor the Treasury Regulations define what constitutes an examination of the taxpayer. Nevertheless, in Revenue Procedure 2005-32, the Service issued guidance finding that certain actions do not constitute examinations or inspections of books of account. Relevant to this memorandum, "matching information on a tax return with . . . other records or information items that are already in the Service's possession" does not constitute an examination or an inspection of a taxpayer's books of account. Rev. Proc. 2005-32 at 4.03(1)(b). Moreover, considering records the taxpayer voluntarily provides to the Service, requesting that the taxpayer perfect a return, contacting the taxpayer to verify the discrepancy between the return and the third-party information, and making adjustments as a result of an information matching program also do not constitute an examination or an inspection of a taxpayer's books of account. Rev. Proc. 2005-32 at 4.03(1)(c), 4.03(1)(d)(ii)(B) & (C), 4.03(1)(d)(iii)(C). Thus, subjecting an entity to the matching program does not constitute an examination or inspection of the entity because this type of contact is specifically excluded from the definition of either examination or inspection. This remains true even if the entity files an amended return, or voluntarily provides the Service with additional information purporting to explain the mismatch, either on the taxpayer's own initiative or in response to a request from the Service, or if the Service makes adjustments to the entity's return, including Schedule K-1, based on information from the matching program.

It is difficult to determine with precision the exact point at which such contacts would rise to the level of an examination or an inspection of the taxpayer's books of account. As a minimum threshold, courts have looked to whether the Service had access to and

physically viewed the taxpayer's books and records to determine whether a particular examination falls under section 7605(b)'s restrictions. Hough v. Commissioner, 882 F.2d 1271, 1275 (7th Cir. 1989); Grossman v. Commissioner, 74 T.C. 1147, 1156 (1980); Benjamin v. Commissioner, 66 T.C. 1084, 1098 (1976), aff'd on other grounds, 592 F.2d 1259 (5th Cir. 1979). However, courts have held that an examination does not occur where returns were merely checked for form, execution, mathematical accuracy, or surveyed for classification. Pleasanton Gravel Co. v. Commissioner, 64 T.C. 510, 528-29 (1975). Similarly, courts have held that interviewing third parties, checking public records, and checking bank accounts do not constitute an inspection for purposes of section 7605(b). See, e.g., United States v. Dawson, 400 F.2d 194, 200 (2d Cir. 1968). With regards to the matching program, contact with the taxpayer rises to the level of an examination or inspection if the Service demands access to and physically views the taxpayer's books of account. However, if the taxpayer voluntarily provides the Service his books of account in order to explain the discrepancy between the return and the third-party information in the Service's possession, then the contact would not be considered an examination or inspection. Rev. Proc. 2005-32 at 4.03(1)(c).

As this memorandum concludes that the information matching program and the types of contacts discussed above do not constitute an examination or inspection, section 7605(b)'s restriction against multiple inspections does not apply to this program. Thus, if an investor has invested in multiple entities subject to the information matching program, in theory the Service could make an adjustment as it finds each of the entities without regards to the restriction found in section 7605(b). Issuing a notice of deficiency to an investor would not transform a program that is not an examination for purposes of section 7605(b) into an examination. However, as discussed below, issuing a notice of deficiency may preclude determining any additional deficiency for the same tax for the same taxable year, which, as a practical matter, may limit the Service from adjusting the same investor's return repeatedly.

III. Issues Regarding Notices Sent in Conjunction with the Information Matching Program

A general adjustment is a change made at the request of the taxpayer. IRM 21.5.1.2. Thus, in cases where the entity does not agree with the mismatch notice or fails to respond to the notice, it would be inappropriate to make a general adjustment. Instead, the Service should issue a notice of deficiency or follow the unified partnership audit and litigation procedures of I.R.C. §§ 6221-6234 (TEFRA partnership procedures), issuing a notice of final partnership administrative adjustment (FPAA), as appropriate. As discussed above in section I, the Service may contact the investors in the entity regarding the information match being conducted on the entity. In the case of an entity subject to the TEFRA partnership procedures, the partnership or partners may file a request for administrative adjustment (AAR) rather than an amended return. The Service may inform the investors of the need to make adjustments to their individual returns.

IV. AUR Notice and Information Matching Program

The Automated Underreporter program (AUR) is an information matching program that matches information on an individual's return to information obtained from sources such as Forms W-2, 1099-INT, and 1099-DIV. IRM 4.19.3. While the information matching program described in this memorandum would affect different issues, it is possible that a taxpayer could receive an AUR notice and a notice for the information matching program described in this memorandum for the same tax year. If the investor in the entity received only an adjustment notice from the AUR, the Code would not bar the Service from issuing a subsequent adjustment based on the information matching program. See supra Section II (concluding that a matching program does not constitute an examination triggering section 7605(b)'s restrictions on subsequent examinations). However, if the AUR issued a notice of deficiency, the result could be different. Section 6212(c) states that where the Service has mailed a notice of deficiency to a taxpayer and that taxpayer has timely petitioned the Tax Court, the Service may not determine any additional deficiency of the same tax for the same taxable year except in the case of fraud, redeterminations of the deficiency by the Tax Court pursuant to section 6214, a mathematical or clerical error, or except as provided in sections 6851, 6852, and 6861(c). In this case, both the AUR and information matching program would presumably result in adjustments to the investor's income tax. As this would be the same tax in the same taxable year, absent any of the above exceptions in section 6212(c), the Service would be barred from issuing this second notice of deficiency.

V. TEFRA Issues

If the Service issues a final adjustment notice to a partner of a 1065 entity, the Service's ability to assess that partner is not impacted if the Service later learns that the entity is subject to the TEFRA partnership procedures. As discussed in section III of this memorandum, supra, whether an entity is subject to the TEFRA partnership procedures only matters with regards to whether the Service would issue a notice of deficiency or an FPAA.

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Please call (202) 622-4570 if you have any further questions.