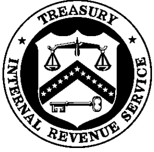

OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR EDSEL FORD HOLMAN, JR.
SENIOR ATTORNEY
CC:SB:3:NAS:2

FROM: James Gibbons
Branch Chief
Administrative Provisions & Judicial Practice CC:PA:APJP:1

SUBJECT: Increased distribution deductions on amended trust returns (Forms 1041) and beneficiaries' income tax returns (Forms 1040)

This Chief Counsel Advice responds to your memorandum dated June 4, 2002. Specifically, you ask advice on the proper handling of amended income tax returns filed by trustees (Form 1041) when the claimed distribution deductions do not match the income reported by the trust beneficiaries. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1) Whether the Service may disallow a claim for refund made by a trustee on an amended Form 1041 solely because the trust beneficiaries have not reported the income distribution amounts that are deducted on the trust's amended return.

2) Whether the Service may treat the trustee's claim for refund as non-processible, under section 301.6402-2(b)(1) of the Regulations on Procedure and Administration ("regulations"), in order to assure compliance by the trust beneficiaries.

3) Whether the Service may either delay the processing of a trustee's claim for refund, disallow the claim for refund, or take any actions regarding the trust beneficiaries' income tax returns in an effort to insure compliance by the trust's beneficiaries.

4) Whether a trust beneficiary may be subjected to the fraud penalty, extending the assessment period of limitations against the beneficiary, if the beneficiary knowingly and willfully fails to report the income distributed by a trust.

5) Whether the Service can collect an income tax deficiency owed by a trust beneficiary if the assessment period of limitations regarding the beneficiary's Form 1040 has expired and a case for assertion of the fraud penalty against the beneficiary cannot reasonably be made.

CONCLUSIONS

1) The Service may not disallow a claim for refund, based on an increased distribution deduction, solely because the trust beneficiaries fail to report the income distribution amounts that are deducted on the trust's amended return.

2) The Form 1041 or amended Form 1041, with attached Schedules K-1 of the beneficiaries, constitutes a valid return for purposes of the statute of limitations on assessment under section 6501 of the Internal Revenue Code ("Code"), constitutes a valid claim for refund for purposes of section 6402 of the Code, and constitutes a processible return for purposes of accrual of overpayment interest under section 6611 of the Code. Therefore, the Service should not invoke section 301.6402-1(b)(1) of the regulations to argue that the trustee's refund claim is non-processible for failure to state the grounds for the claim.

3) The Service may not delay the processing of a trustee's claim for refund or disallow the claim for refund without subjecting itself to overpayment interest on the overpayment amount. However, the Service may contact the beneficiaries and disclose the increased distribution deduction taken by the trust and disclose any other return information of the trust necessary to inform the beneficiaries of the increased deductions. In addition, the Service may send statutory notices of deficiency to the trust beneficiaries that fail to report the income distribution amounts.

4) A trust beneficiary may be subjected to the fraud penalty under section 6663, extending the assessment period of limitations against the beneficiary, if the beneficiary knowingly and willfully fails to report the income distributed by the trust at the time the beneficiary files the original return. However, if the beneficiaries lacked fraudulent intent in filing their original returns, there is no basis to argue that sections 6501(c)(1) or (c)(2) of the Code extend the statute of limitations.

5) In cases in which a determination has been made under section 1313 of the Code, the mitigation provisions of sections 1311 through 1314 of the Code justify the issuance of a statutory notice of deficiency against the trust beneficiaries who

have failed to report the additional distribution income even though the assessment period of limitations for their income tax returns has expired.

FACTS

Issues 1, 2, and 3

Many trusts fail to report distributions on line 18 of Forms 1041 (i.e., the line intended for reporting distribution deductions that are available under sections 651 and 661 of the Code for simple and complex trusts). This error is resolved either by the Service treating the error as a math error, or by the trustee filing an amended return correcting the error. In some situations, the Service adjusts the Form 1041 to reflect the amount of income distribution that was intended to appear on the original return. In other situations, trustees submit an amended Form 1041 to reflect a claimed increase to the amount of income distribution for which a deduction is sought. In either event, the Form 1041 serves as a claim for refund.

Service Center personnel do not routinely disallow refund claims of trusts except in situations where the trustee has requested that a notice of claim disallowance be issued (permitting the trustee to immediately file a refund suit in the District Court). In an effort to insure that the trust beneficiaries are reporting the total amounts being deducted by the trust as income distributions, Service personnel review the individual income tax returns (or the computer records made from the returns) that have been filed by the beneficiaries. Currently, if the income distributions claimed by the trustee do not have corresponding reports of income by the beneficiaries, the trustee is advised by correspondence that the refund request cannot be processed due to the failure of the beneficiaries to report the allegedly distributed income. The authority used for this action is section 301.6402-2(b)(1) of the regulations (i.e., the provision that treats a claim for refund as non-processible if the claim fails to state the basis on which the claim is made).

Issues 4 and 5

For purposes of issues 4 and 5, the following facts apply: A trustee files an amended Form 1041 for the year ending December 31, 199X, in March of 200X. The last date for filing a timely claim is April 15, 200X. The trustee seeks a refund for the 199X tax year of $100,000.00, based on a claimed increase in the income distribution deduction. Nine trust beneficiaries shared this distributed income equally. Four beneficiaries voluntarily filed amended Forms 1040 to report their increased income. After contact with the trustee or the trustee’s attorney, two other beneficiaries filed amended Forms 1040 and paid additional tax. One beneficiary did not file a tax return. The assessment period of limitations has expired with respect to the relevant Forms 1040 filed by the remaining two beneficiaries who did

not report the increased income because the “25% omission rule” of section 6501(e) of the Code is inapplicable.

LAW AND ANALYSIS

Issue 1

The Service lacks the authority to treat the claim for refund filed by the trustee as non-processible or to disallow the claim merely because the trust beneficiaries fail to report the distributed income amount as income. Section 651(a) of the Code, which addresses ”simple trusts” that are required to distribute all of the trust’s income, allows “as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently.” The same rule applies for complex trusts, pursuant to section 661(a)(1) of the Code, even though the trust instrument is not required to distribute all of the income. A determination of the amount of income required to be distributed by the trustee may be required to verify the deductibility of the amount appearing on line 18 of the 2001 version of Form 1041. This determination may involve a review of the trust instrument and substantiation of the income claimed to have been earned by the trust. However, the Service has no statutory authority to reduce or disallow the deduction claimed for the trust’s distribution amount based on the failure of the beneficiaries to report the distributed income.

In addition, double taxation of the same income will result if the Service disallows the trust’s deduction because the beneficiaries fail to report the income. Pursuant to sections 652(a) and 662(a)(1) of the Code, beneficiaries are taxable on the amount of income required to be distributed regardless of whether or not the income is actually distributed. Therefore, regardless of whether the trustee distributes the income required to be distributed, and regardless of whether the trust is taxed on the portion of the income for which a trustee fails to take a distribution deduction, the beneficiaries are liable for income tax based on this amount of the trust’s income. The Service does not have authority to tax the trust on the income instead of taxing the beneficiaries on that income.

However, in some circumstances, the trust may be barred from claiming additional deductions under sections 651(a) or 661(a) by the “duty of consistency.” This rule applies when: 1) the taxpayer has made a representation or reported an item for tax purposes in one year; 2) the Commissioner has acquiesced in or relied on that fact for that year; and 3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year. Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988). The duty of consistency bars a trust from filing for a refund under section 651(a) or 661(a) to the extent that its beneficiaries fail to include the full amount required to be distributed into income if the statute of limitations on

assessment bars adjustments to the beneficiaries' returns. To avoid having its refund claims barred by the duty of consistency, the trust must file its claims so as to give the Service enough time to review the matter before the assessment statute of limitations expires on the beneficiaries' returns.

Assuming the statute of limitations has expired regarding the beneficiaries returns, the duty of consistency bars the trustee from filing for a refund with respect to amounts required to be, but not shown on those returns. The three-part test articulated in Herrington applies to these facts as follows: 1) the beneficiaries and the trustee made representations in one year by reporting an amount that was distributed by the trust; 2) the Commissioner relied on the beneficiaries' and trustee's reporting of those amounts for that year; and, 3) after the statute of limitations expired on the beneficiaries' returns, the trustee later attempted to change the representations by deducting a distribution amount greater than the amount that was originally reported. As a result, the trustee cannot receive the increased distribution deductions, because the beneficiaries failed to report those increased distributions.

Issue 2

Valid Return

Section 6011 of the Code provides that any person made liable for any tax imposed by the Internal Revenue Code, or with respect to the collection thereof, shall make a return or statement according to the forms and the regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

Section 1.6011-1(b) of the Income Tax Regulations provides that each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein. Returns which have not been so prepared will not be accepted as meeting the requirements of the Code.

Although Congress has granted the Commissioner broad authority to determine what information should be submitted with a tax return, the issue of what constitutes a valid tax return is frequently litigated. In an early case addressing the issue, the Supreme Court indicated that "[p]erfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such, and evinces an honest and genuine endeavor to satisfy the law." Zellerbach Paper Co. v. Helvering, 293 U.S. 172, 180 (1934) (citations omitted).

Courts have subsequently stated the criteria for a valid return as such: "First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the

requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury." Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986). This statement of the criteria, generally known as the Beard formulation, derives from a line of Supreme Court cases. See Zellerbach Paper Co. v. Helvering, 293 U.S. 172, 180 (1934); Florsheim Bros. Drygoods Co. v. United States, 280 U.S. 453 (1930). The Beard formulation is generally known as the "substantial compliance" standard. If an income tax return meets the "substantial compliance" standard, the return is a valid return for purposes of the statute of limitations on assessment.

The Form 1041, or amended Form 1041, with copies of the Schedules K-1 furnished the beneficiaries meets all of the criteria to satisfy the "substantial compliance" standard. No further information is needed, including any information from the beneficiaries returns, to meet the "substantial compliance" standard criteria. As such, the Form 1041, or amended Form 1041, with attached Schedules K-1 constitutes a valid return for purposes of the statute of limitations on assessment under section 6501 of the Code.

Valid Claim for Refund

Section 6402(a) provides that in the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to certain offsets, refund any balance to such person.

Section 301.6402-2(a)(1) of the regulations provides that credits or refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitation properly applicable unless, before the expiration of such period, a claim therefor has been filed by the taxpayer.

Section 301.6402-2(b) provides, as a general rule, that all claims for credit or refund must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof.

Section 301.6402-3 provides special rules for refund claims of income tax. Section 301.6402-3(a)(5) provides, in relevant part, that a properly executed fiduciary original income tax return or an amended return shall constitute a claim for refund or credit for the amount of the overpayment disclosed by such return. To constitute a sufficient claim for refund, the income tax return must set forth the amount determined as an overpayment and advise the Service whether such amount shall be refunded to the taxpayer or shall be applied as a credit against the taxpayer's estimated income tax for the succeeding taxable year.

The purpose of the general rule of section 301.6402-2(b) of the regulations, which requires taxpayers to set forth in detail each ground upon which a refund is claimed, is to adequately notify the Service of the grounds for the taxpayer's claim, allowing the Service to properly investigate the claim. See Angelus Milling Co. v. Commissioner, 325 U.S. 293 (1945). Section 301.6402-3(a)(5) of the regulations provides a simplified procedure to notify the Service of the grounds for the claim where the trustee makes the trust's refund claim on the original or amended income tax return for the taxable year. In such a case, the trustee must simply set forth the amount of the overpayment and request that it be refunded or credited. If the return meets the Beard "substantial compliance" standard, and the requirements of section 301.6402-3(a)(5), it will generally meet the requirements of section 301.6402-2(b). See generally Fearis v. United States, 548 F.Supp. 408 (N.D. Tex. 1982); United States v. Ryan, 64 F.3d 1516 (11th Cir. 1995); Sumrall v. United States, 98-2 U.S.T.C. (CCH) ¶50,689 (D. Colo. 1998).

In the present case, the Form 1041 meets the Beard "substantial compliance" standard, sets forth the amount and source of the overpayment, and advises the Service that the overpayment shall be refunded to the trustee. Therefore, the Form 1041, or amended Form 1041, with attached Schedules K-1 constitutes a valid claim for refund. As such, the Service is required to issue the refund under section 6402 following any necessary verification or investigation. If the Service does not issue the refund, the trustee may file a suit for refund once the Service renders a decision on the claim provided the applicable period of limitations has not expired. See sections 6532(a)(1) and 7422(a). If the Service does not render a decision, the trustee may file a suit for refund beginning 6 months after the date the claim for refund is filed. As noted above, however, the "duty of consistency" would justify rejection of the refund claims in certain circumstances.

Processible Return

Section 6611(a) provides that interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at the overpayment rate established under section 6621.

Section 6611(b)(3) provides that in the case of a return filed after the last date prescribed for filing the return (determined with regard to extensions), no interest shall be allowed or paid for any day before the date on which the return is filed.

Section 6611(e)(1) provides that if any overpayment of tax is refunded within 45 days after the last day prescribed for filing the return of such tax (determined without regard to any extension of time for filing the return) or, in the case of a return filed after such last date, is refunded within 45 days after the date the return is filed, no interest shall be allowed under section 6611(a) on such overpayment.

Section 6611(g)(1) provides that for purposes of sections 6611(b)(3) and 6611(e), a return shall not be treated as filed until it is filed in processible form. A return is in processible form for purposes of section 6611(g)(1) if: (1) it is filed on a permitted form; and (2) it contains the taxpayer's name, address, identifying number, the required signature, and sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of tax liability shown on the return. See Section 6611(g)(2).

According to the court in The Columbia Gas System, Inc. v. United States, "[m]athematical verifiability requires sufficient information to permit IRS to recalculate and corroborate the mathematics and data reported by the taxpayer. Thus, under section 6611, a taxpayer must submit, in good faith, all the required forms with the required signatures and enough underlying data for IRS to verify the tax liability shown on the return. The information must be sufficient to enable IRS to calculate the tax liability without undue burden." The Columbia Gas System, Inc. v. United States, 70 F.3d 1244, 1246 (Fed. Cir. 1995).

A Form 1041, or an amended Form 1041, with the attached Schedules K-1 for each beneficiary meets the mathematical verification test because these forms provide sufficient information to allow the Service to corroborate the mathematics and data reported by the trustee. As a result, under the facts presented, the return is a processible return for purposes of section 6611(g). If the Service issues the refund within 45 days from the date the claim for refund is filed, the Service will not owe overpayment interest on the refund amount. If the Service issues the refund after 45 days from the date the return is filed, the Service will owe overpayment interest on the refund amount from the date the return is in processible form. See section 6611(e).

Issue 3

Section 301.6402-2(a)(2) requires that a claim for refund be accompanied by "appropriate supporting evidence." If there is not appropriate supporting evidence of the distribution deductions taken by the trustee, the Service may contact the trustee requesting such supporting evidence. Under the facts you have presented to us, the trustee's claim for refund is a sufficient claim for refund and is a processible return regardless of whether the beneficiaries report the income distributions they receive. As such, the Service will owe the trustee overpayment interest on the overpayment amount stated in the claim for refund, to the extent such overpayment exists, if that amount is not refunded within 45 days from the date the claim for refund is filed. Therefore, the Service may not delay the processing of the trustee's claim for refund or disallow the claim for refund without subjecting itself to overpayment interest.

The Service may contact the trustee and the beneficiaries to resolve the tax reporting discrepancies, subject to the disclosure limitations described below. Under these circumstances, disclosure of the beneficiaries' tax return information to the trustee and disclosure of the trust's return information to the beneficiaries may help resolve the reporting discrepancies. However, as described in further detail below, the Code appears to bar the Service from disclosing the beneficiaries' tax return information to the trustee.

Sections 6103(h)(4)(B) and (C) are the only provisions which could permit disclosure of the beneficiaries return information to the trustee. In order for these provisions to apply, there must be a "proceeding pertaining to tax administration" as described in section 6103(h)(4). An audit is such a proceeding. First Western Government Securities v. United States, 796 F.2d 356 (10th Cir. 1986), but see Mallas v. United States, 993 F.2d 1111 (4th Cir. 1993).

Under these facts, it does not appear that a "proceeding pertaining to tax administration" has been initiated. However, assuming it has, the return information of the beneficiaries may be disclosed to the trustee only if such return information "is directly related to the resolution of an issue in the proceeding," or if such "return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding." See sections 6103(h)(4)(B) and (C). Under these circumstances, neither possibility applies because the tax liability of the trustee can be determined regardless of whether the beneficiaries reported the corresponding distributions in income. The Service can resolve the trust return tax liability by requesting substantiation of the trust's entitlement to the distribution deductions from the trustee. Therefore, under these circumstances, the Service may not disclose the beneficiaries' return information to the trustee.

Pursuant to section 6103(e)(1)(F)(ii), returns of a trust may, upon written request, be disclosed to beneficiaries having a "material interest which will be affected by information contained therein." Pursuant to IRM 11.3.2.4.8(2), a "material interest is an important interest and is generally financial in nature," and applies to the interest of a tax liability of a beneficiary arising as a result of a trust distribution. Pursuant to section 6103(e)(7), return information of a trust may be disclosed to beneficiaries (without written request) if the Secretary determines that such disclosure would not "seriously impair Federal tax administration." Therefore, even absent a tax administration proceeding, return information of the trust may be disclosed to the beneficiaries under certain circumstances.

If the period of limitations on assessment under section 6501 is not near its expiration, the Service should send correspondence to the beneficiaries that failed to report the income distribution amounts to state that the trustee claimed these income distribution deductions and the beneficiary failed to report the distributions.

If the period of limitations on assessment has almost expired, or the beneficiaries fail to respond to the correspondence regarding the income distribution deductions taken by the trustee, the Service should issue statutory notices of deficiency to the beneficiaries that fail to report the increased distribution amounts.

Issue 4

Section 6501(a) provides for a three year statute of limitations on assessment from the date the return is filed.

Section 6501(c)(1) provides that in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

Section 6501(c)(2) provides generally that in the case of a willful attempt to defeat or evade tax imposed by the Code, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

Section 6501(c)(3) provides that where no return is filed, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

Under section 7454(a), the Commissioner has the burden of proving the fraud penalty by clear and convincing evidence. To meet the burden, it must be established that (1) there was an underpayment of tax for each taxable year at issue and (2) at least some portion was due to fraud.

Under section 6501(c)(3), there is no statute of limitations on assessment for the nonfiling beneficiary. However, the facts do not suggest that the other two trust beneficiaries that failed to file amended returns showing the increased distribution had fraudulent intent when filing their original returns. To show fraudulent intent requires the government to prove that the taxpayers had knowledge of the distribution, had knowledge that the distributed trust income was taxable to them, and willfully omitted the income from their original returns. Without fraud in the original filing of the returns, there is no basis to argue that sections 6501(c)(1) or (c)(2) extend the statute of limitations. See Badaracco v. Commissioner, 464 U.S. 386 (1984) (statute of limitations on assessment for purposes of Section 6501 runs from the filing of the original return, not an amended return). Therefore, the three year statute of limitations under section 6501(a) applies to these two beneficiaries. Similarly, absent fraudulent intent in the filing of the original returns, the Service cannot assert the section 6663 fraud penalty against these two beneficiaries.

Issue 5

In certain circumstances, the mitigation provisions of sections 1311 through 1314 lift the bar of the statute of limitations on assessing taxes. See Bolten v. Commissioner, 95 T.C. 397, 400 (1990). These provisions, however, do not provide a broad exception to the statute of limitations. Id. at 402-03; B.C. Cook & Sons, Inc. v. Commissioner, 65 T.C. 422, 427-28 (1995), aff'd. 584 F.2d 53 (5th Cir. 1978), non acq., 1977-2 C.B. 2. In Bolten, the Tax Court explained that the "mitigation provisions are written with great specificity and are not formulated to provide general equitable relief to taxpayers and the Government or to cover every situation involving a double tax benefit or detriment arising out of inconsistent treatment." Id. at 403. The party seeking to utilize the mitigation provisions has the burden of proving that they apply. Id.; Yagoda v. Commisioner, 39 T.C. 170, 178 (1962), aff'd, 331 F.2d 485 (2d Cir. 1964).

For an adjustment to be authorized under the mitigation provisions, four conditions must be met: first, as provided in section 1311(a), an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law; second, there must be a "determination" for an open tax year, which is defined in section 1313(a) as a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement pursuant to section 1.1313(a)-4 of the Income Tax Regulations; third, the determination must result in a circumstance under which an adjustment is authorized by section 1312 (the seven circumstances under which an adjustment is authorized involve double inclusion of an item of gross income (§ 1312(1)); double allowance of a deduction or credit (§ 1312(2)); double exclusion of an item of gross income (§ 1312(3)); double disallowance of a deduction or credit (§ 1312(4)); correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (§ 1312(5)); correlative deductions and credits for certain related corporations (§ 1312(6)); and basis of property after erroneous treatment of a prior transaction (§ 1312(7))); and fourth, depending on which circumstance of adjustment applies, either the party against whom mitigation will operate must maintain an inconsistent position, pursuant to section 1311(b)(1), or the correction of the error must not have been barred at the time the party for whom mitigation will operate first maintained its position, pursuant to section 1311(b)(2).

The first of the four conditions has been met in this hypothetical scenario. The two beneficiaries whose statute of limitations has expired erroneously failed to file amended Forms 1040 and report their increase share of distributed income. The period of limitations on assessment for this year has expired. Thus, an error has occurred in a closed tax year that cannot otherwise be corrected by operation of law.

The second of the four conditions has not been met in this scenario, but could possibly be met upon a final disposition by the Secretary of the trustee's claim for refund (amended Form 1041). As to items which are allowed, the action becomes final on the date the refund is allowed or on the date of a notice of disallowance

(where there are offsetting items) of the claim for refund is mailed. See section 1313(a)(3). As to items with respect to which the claim is disallowed in whole or in part, the action becomes final when the time for instituting suit with respect to that item expires. Service Center personnel do not disallow refund claims of the trusts, except where the trustee has requested that a notice of disallowance be issued which would permit the trustee to file a refund suit. Instead, the trust refund claims remain unprocessed because of the failure of the beneficiaries to report the allegedly distributed income. Thus, it appears unlikely that there would be a determination under section 1313(a)(3), but this circumstance could change assuming the Service decides to process more of these claims.

A determination also could result from final action of a court, closing agreement or agreement pursuant to section 1.1313(a)-4 of the Income Tax Regulations. See section 1313(a)(1), (a)(2) and (a)(4). Based on these facts, it is not clear whether a determination would exist under any of these subsections. Unless a refund suit is instituted, either a closing agreement or an agreement under section 1.1313(a)-4 of the Income Tax Regulations seem to be the most likely sources of a determination. Absent a determination, however, mitigation would not apply.

Assuming that there is a determination, there must be a proper circumstance justifying adjustment under section 1312. On these facts, this third condition is met by way of section 1312(5) which applies to distributions by trust and estates to their beneficiaries. Section 1312(5) provides for a proper circumstance of adjustment where the determination allows or disallows any of the additional deductions allowable in computing the taxable income of estates or trusts, or requires or denies any of the inclusions in the computation of taxable income of beneficiaries, heirs, or legatees and the correlative inclusion or deduction has been erroneously excluded, omitted, or included (or disallowed, omitted, or allowed as the case may be) with respect to the related taxpayer. Section 1313(c)(4) defines a related taxpayer as a taxpayer who stood in a fiduciary and beneficiary relationship with the taxpayer to whom a determination is made in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance occurred. In the instant case, the trustee and beneficiaries are related taxpayers. An adjustment is authorized if the determination requires the allowance to the trust of the deduction provided for by sections 651 or 661 of the Code when such amounts have been erroneously omitted from the income of the beneficiaries. See Reg. § 1.1312-5(a), (b).

The fourth and final condition that must be met for the mitigation provisions to apply is described in section 1311(b). Generally, section 1311(b)(1) requires that an inconsistent position must be maintained by the party against whom mitigation will operate. The only exceptions to this rule are cases in which the determination relates to a circumstance of adjustment described in section 1312(3)(B) (certain exclusions from income) or section 1312(4) (disallowance of certain deductions and

credits). See section 1311(b)(2). Further, where the Service is seeking an adjustment with respect to a related taxpayer, the adjustment cannot be made unless the related taxpayer "stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position" or at the time of the determination. See section 1311(b)(3).

These facts involve the circumstance for adjustment under section 1312(5); thus the general rule under section 1311(b)(1) applies. The beneficiaries who fail to report the additional distribution income on amended Forms 1040 have maintained a position inconsistent with the trustee's inclusion of a distribution deduction on the Form 1041. As noted above, the trustee and beneficiaries are related taxpayers under section 1313(c)(4), and presumably were in such a relationship at the time the beneficiaries failed to report the additional distribution income. Therefore, the additional condition under section 1311(b)(3) has been satisfied.

Therefore, in cases in which a determination exists under section 1313, mitigation would justify the issuance of a statutory notice of deficiency against the trust beneficiaries that have failed to report the additional distribution income. As such, this would justify treating the beneficiaries as having one year remaining in the assessment period pursuant to section 1314(b). If no determination exists, however, mitigation would not apply.

Please call if you have any further questions.