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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL - Area 1
(Large and Mid-Size Business)
CC:LM:FSH:HAR

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

SUBJECT: Refunds Attributable to DISC and FSC Redeterminations

This Chief Counsel Advice responds to your memoranda dated September 21, 2001 and November 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice is not to be used or cited as precedent.

LEGEND

Corp X =
Corp X-DISC =
Corp X-FSC =
Corp Y =
Corp Y & Subs =
Corp Y-DISC =

ISSUES

1. A related supplier has filed a timely claim for refund based on an investment tax credit carryforward. The investment tax credit carryforward exists only if the related supplier and its domestic international sales corporation (DISC) redetermine their respective incomes and file amended returns for years in which the statutes of limitations on assessment and refund have expired. May the related supplier and its DISC redetermine their respective incomes and file amended returns for those barred years so that the related supplier can obtain a refund in the later year?

2. A related supplier has filed a timely claim for refund based on an investment tax credit carryforward. The investment tax credit carryforward exists only if the related supplier and its foreign sales corporation (FSC) redetermine their respective incomes and file amended returns for a year in which the statutes of limitations on assessment and refund have expired. May the related supplier and its FSC redetermine their respective incomes and file amended returns for the barred year so that the related supplier can obtain a refund in the later year?

CONCLUSIONS

Issue 1 (DISC)

Due to the complex and novel nature of this issue, Field Service Advice is not the appropriate form of guidance. We suggest that you submit a request for a Technical Advice Memorandum in accordance with the procedures set forth in Rev. Proc. 2001-2, 2001-1 I.R.B. 79.

Issue 2 (FSC)

No. Because the statute of limitations for assessment with respect to Corp X-FSC had already expired when the claim for refund was filed, the Service is precluded from assessing the additional tax due from Corp X-FSC. Moreover, the statutes of limitations on claims for refund for tax year 1985 with respect to Corp X-FSC and Corp X had also expired. The portion of the claim for refund for tax year 1986 relating to the deductions for commission expenses attributable to Corp X-FSC in tax year 1985 should be denied.

FACTS

As a preliminary matter, we note that the present cases involve the validity of refund claims and the ability to file amended returns, not the computation of the commission income and corresponding deductions on the underlying DISC and FSC transactions. We assume for purposes of this memorandum that the transactions giving rise to the claims for refund are eligible for the FSC exemption and DISC deferral, and that the question of timeliness aside, the redeterminations of commission income sought in these cases are otherwise valid.

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Corp Y & Subs and Corp X are domestic corporations. In June 1986, Corp X acquired Corp Y as a wholly-owned subsidiary. Prior to the acquisition, Corp Y & Subs filed consolidated Forms 1120 for tax years 1982 through 1985.

Corp Y-DISC is a wholly-owned subsidiary of Corp Y. During tax years 1982, 1983, and 1984, Corp Y-DISC had an election in effect under I.R.C. § 992(b) to be treated as a DISC and timely filed Forms 1120-DISC for each of those years.

During tax years 1982, 1983, and 1984, Corp Y was a related supplier with respect to Corp Y-DISC within the meaning of Treas. Reg. § 1.994-1(a)(3)(ii). Corp Y-DISC acted as commission agent for export sales of Corp Y, which paid Corp Y-DISC a commission.

On July 17, 1997, acting on behalf of Corp Y & Subs, Corp X filed a claim for refund for Corp Y & Subs's 1984 tax year. The basis for the claim for refund is that during tax years 1982 and 1983, Corp Y and Corp Y-DISC entered into certain transactions that were DISC-eligible (i.e., that the commissions on those transactions payable by Corp Y to Corp Y-DISC could have been included in Corp Y-DISC's income for those years). As a consequence, if Corp Y had claimed commission deductions on those transactions on its consolidated income tax returns for tax years 1982 and 1983, Corp Y & Subs would have had additional investment tax credits available to carry forward to the 1984 tax year, which would have resulted in Corp Y & Subs having an overpayment for tax year 1984; Corp Y & Subs's federal income tax liability (after credits) for tax years 1982 and 1983 would not have been reduced for either year.

As of the date of the filing of the claim for refund, the statute of limitations on assessment and for filing claims for refund had expired for Corp Y & Subs's 1982 and 1983 tax years but remained open for tax year 1984; Corp Y & Subs had extended the statute of limitations on assessment for tax year 1984 through March 31, 1997.

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Corp X-FSC and Corp X-DISC are wholly-owned subsidiaries of Corp X. During tax years 1981 through 1984, Corp X-DISC had an election in effect under I.R.C. § 992(b) to be treated as a DISC. For tax years 1981 through 1984, Corp X-DISC timely filed Forms 1120-DISC. For tax year 1985, Corp X-FSC had an election in effect under I.R.C. §§ 922(a)(2) and 927(f)(1) to be treated as a FSC. Corp X-FSC timely filed Form 1120-FSC for tax year 1985.

During tax years 1981 through 1984, Corp X was a related supplier with respect to Corp X-DISC within the meaning of Treas. Reg. § 1.994-1(a)(3)(ii). Corp X-DISC acted as commission agent for export sales of Corp X, which paid Corp X-DISC a commission. Similarly, during tax year 1985, Corp X was a related supplier with respect to Corp X-FSC within the meaning of Temp. Treas. Reg. § 1.927(d)-2T(a).

Corp X-FSC acted as commission agent for export sales of Corp X, which paid Corp X-FSC a commission.

On April 17, 2000, Corp X filed a claim for refund on Form 1120X for its 1986 tax year. The basis for the claim for refund is that during tax years 1981, 1983, and 1984, Corp X and Corp X-DISC entered into certain transactions that were DISC-eligible (i.e., that the commissions on those transactions payable by Corp X to Corp X-DISC could have been included in Corp X-DISC's income for those years). In addition, during tax year 1985, Corp X and Corp X-FSC entered into certain transactions that were FSC-eligible (i.e., that the commission on those transactions payable by Corp X to Corp X-FSC could have been included in Corp X-FSC's income for tax year 1985). Corp X now seeks to claim additional DISC commission expenses in tax years 1981, 1983, and 1984, and FSC commission expenses for tax year 1985. As a consequence, if Corp X had claimed commission deductions on those transactions on its consolidated income tax returns for tax years 1981, 1983, 1984, and 1985, Corp X would have had additional investment tax credits available to carry forward to its 1986 tax year, which would have resulted in Corp X having an overpayment for tax year 1986; Corp X's federal income tax liability (after credits) for tax years 1981, 1983, 1984, and 1985 would not have been reduced.

As of the date of the filing of the Form 1120X, the statute of limitations on assessment and for filing claims for refund had expired for Corp X's 1981, 1983, 1984, and 1985 tax years but remained open for Corp X's 1986 tax year; Corp X had extended the statute of limitations on assessment for its 1986 tax year. Similarly, the statute of limitations on assessment and for filing claims for refund had expired for Corp X-FSC's 1985 tax year, but remained open for its 1986 tax year.

LAW AND ANALYSIS FOR ISSUE 1 (DISC)

A Technical Advice Memorandum is used to address novel or complex legal issues where Service position has not been previously established and is appropriate during consideration of a claim for refund filed by a taxpayer. I.R.M. 39.7.1.11.1(1). We believe that this issue is sufficiently complex in nature to warrant a Technical Advice Memorandum. Moreover, there is no published precedent for determining the proper resolution of this issue. Therefore, we suggest that you consider submitting a request for a Technical Advice Memorandum in accordance with the procedures set forth in Rev. Proc. 2001-2, 2001-1 I.R.B. 79.

When preparing a request for a Technical Advice Memorandum on this issue, we suggest that you consider whether and to what extent the redetermination is limited by the 60-day payment rule of Treas. Reg. § 1.994-1(e)(3)(i). This regulatory provision requires that a reasonable estimate of the DISC commission must be paid

within 60 days following the close of the DISC's taxable year during which the transaction occurred. The DISC regulations also provide a 50% safe harbor test to determine whether a related supplier has paid a reasonable estimate of commissions. Treas. Reg. § 1.994-1(e)(3)(iv)(a). The 50% safe harbor test has been upheld in numerous cases. See Gehl Co. v. Commissioner, 795 F.2d 1324 (7th Cir. 1986), aff'g T.C. Memo. 1984-667; CWT Farms, Inc. v Commissioner, 755 F.2d 790 (11th Cir. 1985), cert. denied, 477 U.S. 903 (1986); Thomas Int'l Ltd. v. United States, 773 F.2d 300 (Fed. Cir. 1985), cert. denied, 475 U.S. 104 (1986).

Further, in the case of an amended return involving additional DISC sales, the 60-day payment rule is based on the original return, not the amended return. See Stokely-Van Camp, Inc. v. United States, 21 Cl. Ct. 731 (1990), aff'd on another issue, 974 F.2d 1319 (Fed. Cir. 1992). For example, if on the taxpayer's original return the DISC commission is $100, and if a commission of only $50 is paid to the DISC by the related supplier within the 60-day period, the taxpayer cannot include any additional DISC sales on an amended return. When submitting your request for Technical Advice Memorandum, this issue should be developed factually, including the taxpayer's reason for adding new DISC sales not included in its original return.

LAW AND ANALYSIS FOR ISSUE 2 (FSC)

Section 6501(a) of the Internal Revenue Code provides that, except as otherwise provided, tax must be assessed within 3 years after the return was filed, whether or not such return was filed on or after the date prescribed. As an exception, section 6501(c)(4) provides that the Service and a taxpayer may enter into a written agreement to extend the limitations period, provided the agreement is executed before the expiration of the period of limitations prescribed by section 6501(a).

Section 6402(a) of the Internal Revenue Code authorizes the Secretary of the Treasury to make refunds when a taxpayer overpays taxes. The regulations on Procedure and Administration under section 6402 provide that "refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitations properly applicable, unless, before the expiration of such period, a claim therefor has been filed by the taxpayer." Treas. Reg. § 301.6402-2(a)(1).

Section 6511(a) provides that a claim for credit or refund of an overpayment of any tax in respect of which the taxpayer is required to file a return shall be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return is filed by the taxpayer, within two years from the time the tax was paid. Section 6511(b)(1) provides that no credit or refund shall be allowed or made after the expiration of the period of

limitations prescribed in section 6511(a), unless a claim for credit or refund is filed by the taxpayer within such period.

When a taxpayer and the Service agree to extend the time for assessment, the taxpayer is entitled to an equivalent extension of the time within which to file a claim for refund. Section 6511(c)(1) provides that the period within which the taxpayer may file a claim for refund arising from the tax liability covered by the extension agreement is extended for the period of the extension, plus an additional six months. For Corp X's 1986 tax year, the statute of limitations on assessment had been extended beyond the date on which its refund claim for that year was filed. Thus, Corp X's refund claim for tax year 1986, filed on April 17, 2000, was timely.

Generally, a FSC's income is treated as income effectively connected with United States business. However, a portion of a FSC's foreign trade income (gross income attributable to foreign trading gross receipts) is exempt from U.S. corporate income tax. I.R.C. §§ 921; 923(a). The related supplier of a commission FSC pays the FSC commissions with respect to transactions that give rise to foreign trading gross receipts, and the related supplier deducts the commission expense. I.R.C. § 925(b)(1); Temp. Treas. Reg. § 1.925(a)-1T(d)(2). A FSC must file an annual return on or before the 15th day of the third month following the close of the taxable year. I.R.C. § 6072(b). The return shall be made on Form 1120-FSC. Temp. Treas. Reg. § 1.921-1T(b)(3).

The commission paid to a FSC is determined under the transfer pricing rules of section 925. Changes on the part of either taxpayers or the Service to FSC commission income as originally reported on a return are commonly referred to as FSC redeterminations. The rules governing redeterminations of FSC commissions for tax years beginning before January 1, 1998, are as follows:

> The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the Commissioner may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and §1.861-8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the FSC and related supplier if their taxable years are still open under the statute of limitations for making claims for refund under section 6511 if they determine that a different transfer pricing method or grouping of transactions may be

> more beneficial. Also, the FSC and related supplier may redetermine the amount of foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the FSC and the related supplier. The FSC and the related supplier may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa.

Temp. Treas. Reg. § 1.925(a)-1T(e)(4) (emphasis added). The regulation imposes, as a condition precedent to a taxpayer-initiated redetermination of FSC commissions, that the period of limitations for refund under section 6511 must be open with respect to both the FSC and the related supplier. Id. In this regard, the United States Tax Court has held that a related supplier could not claim a refund based on recomputations of commissions payable to its FSC under Temp. Treas. Reg. § 1.925(a)-1T(e)(4) where the statutes of limitations for refund were not open for both the related supplier and its FSC. Union Carbide Corp. v. Commissioner, 110 T.C. 375 (1998). The Tax Court rejected the related supplier's argument that the language of Temp. Treas. Reg. § 1.925(a)-1T(e)(4) requires that only the party in the position of overpayment, often the related supplier, must file its claim for refund within the time period required under section 6511. Union Carbide, 110 T.C. at 384-85. The Tax Court also noted that the regulation mandates that the redetermination must "affect" both the FSC and the related supplier. Id. at 385-86. This ensures that in the case of a taxpayer-initiated FSC redetermination, assuming that the dual-refund statute of limitations requirement is met, the Service is able to assess any additional tax due with respect to the taxpayer that is in a deficiency position as a result of the redetermination of FSC commissions.

The statute of limitations for assessment for Corp X-FSC's 1985 tax year had already expired when Corp X filed a claim for refund for tax year 1986, requesting a redetermination with respect to the FSC commissions payable by Corp X to Corp X-FSC in tax year 1985. Because any FSC redetermination for tax year 1985 could not affect both Corp X-FSC and Corp X, the Service cannot assess the additional tax due from Corp X-FSC. In addition, the requirement that the statute of limitations for making claims for refund be open for both Corp X-FSC and Corp X was not met. Therefore, even though Corp X's claim for refund for tax year 1986 was timely, because it required a redetermination of the commissions payable by Corp X to Corp X-FSC for tax year 1985, the redetermination was not within the time prescribed by Temp. Treas. Reg. § 1.925(a)-1T(e)(4).

The regulation makes clear that taxpayers must make their FSC redeterminations in a timely manner. The Supreme Court has recognized that "[s]tatutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government." Badaracco v. Commissioner, 464 U.S.

386, 391 (1984) (quoting E.I. du Pont de Nemours & Co. v. Davis, 264 U.S. 456, 462 (1924)). Therefore, because Corp X and Corp X-FSC did not redetermine the FSC commission payable to Corp X-FSC before their respective statutes of limitations under section 6511 had expired, the redetermination and consequently the claim for refund based on that redetermination are now barred.

Moreover, neither the Code nor the Treasury Regulations require the Service to accept an amended return for Corp X-FSC's 1985 tax year. In this regard, the Court of Appeals for the Fourth Circuit has held that, "[t]here is simply no statutory provision authorizing the filing of amended tax returns, and while the IRS has, as a matter of internal administration, recognized and accepted such returns for limited purposes, their treatment has not been elevated beyond a matter of internal agency discretion." Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977). Similarly, the Tax Court has indicated that the Service's acceptance of amended returns has been limited to the following factual contexts:

> (1) The amended return was filed prior to the date prescribed for filing a return; (2) the taxpayer's treatment of the contested item in the amended return was not inconsistent with his treatment of that item in his original return; or (3) the taxpayer's treatment of the item in the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return.

Goldstone v. Commissioner, 65 T.C. 113, 116 (1975) (citations omitted). The present situation does not fall squarely within any of these contexts. First, any amended return (filed either by Corp X-FSC or Corp X) would not be filed prior to the due date of the original return. Second, Corp X-FSC now seeks to claim additional income as FSC-eligible income on an amended return for tax year 1985, a treatment clearly inconsistent with the manner in which that income was reported on Corp X-FSC's original return. Similarly, Corp X seeks deductions for the commission expenses on an amended return for tax year 1985, where in its original return, it claimed the commission as income, another treatment wholly inconsistent. Lastly, although Corp X-FSC did not include the commission income in its original return, the omission was not improper, as the income was reported on Corp X's return for tax year 1985. Therefore, the Service should not accept amended returns for tax year 1985 by either Corp X-FSC or Corp X. Consequently, the Service should deny the portion of Corp X's claim for refund for tax year 1986 attributable to a FSC redetermination for tax year 1985.

In reaching the conclusion stated above, we have considered and rejected the application of certain "closed year" authorities. We note that as a general rule, adjustments to a barred year can be made so that the correct tax in a nonbarred year can be determined. In computing a taxpayer's taxable income for a nonbarred

year, it is the Service's "duty to consider and determine all items and elements thereof, including the net loss carried forward from the preceding [barred] year." Forres v. Commissioner, 25 B.T.A. 154, 158 (1932), acq., 1932-1 C.B. 3; see also Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974) (holding that the Service may determine the correct amount of taxable income or net operating loss for a barred year as a preliminary step in determining the correct amount of a net operating loss carryover to a nonbarred year). The Service is not limited by the return from the barred year in determining the correct amount of that loss as it may affect the deficiency for the nonbarred year. Id. In addition, the Service may recompute the amount of an unused investment tax credit carryover from a barred year in order to determine the tax due for a nonbarred year. Mennuto v. Commissioner, 56 T.C. 910 (1971), acq., 1973-2 C.B. 2; see also Rev. Rul. 69-543, 1969-2 C.B. 1. However, the concept of making adjustments in a barred year for purposes of determining the existence of an overpayment or a deficiency in a nonbarred year is not applicable when the Code or regulations specifically require a timely act as a condition to allowing a particular tax treatment in a barred year. The regulations under section 925 are an example of such a situation. Temporary Treasury Regulation § 1.925(a)–1T(e)(4) defines the scope of the right of redetermination and makes clear that timeliness is a concern. Thus, none of these so-called "closed year" authorities which allow for adjustments in a barred year are relevant to the instant case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The doctrine of equitable recoupment is a method used by courts to afford equitable relief from the harsh effects of the statute of limitations provisions. It is possible that the doctrine of equitable recoupment may permit Corp X to avoid the bar of the statute of limitations with respect to the portion of the [redacted] refund claim attributable to the Corp X-FSC redetermination. The Tax Court has set forth the following elements that are necessary to sustain a claim for equitable recoupment:

> (1) The refund or deficiency for which recoupment is sought by way of offset be barred by time; (2) the time-barred offset arise out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event have been inconsistently subjected to two taxes; and (4) if the subject transaction, item, or taxable event involves two or more taxpayers, there be sufficient identity of interest between the taxpayers subject to the two taxes so that the taxpayers should be treated as one.

Estate of Orenstein v. Commissioner, T.C. Memo. 2000-150.

Applying these four elements to Corp X's [redacted] refund claim, there is a possibility that a court could utilize the doctrine of equitable recoupment to mitigate the effect of the statutes of limitations and grant Corp X a refund for the portion of the [redacted] overpayment attributable to allowing Corp X-FSC to redetermine its [redacted] income. The first element is satisfied in the present situation; in order to grant the [redacted] refund, the Service would need to assess a deficiency for tax year [redacted], a year which is barred. Moreover, the time-barred deficiency that would be offset by the refund arises from the same redetermination of FSC commission income. With regard to the third element, it is true that equitable recoupment most commonly involves two different taxes; however, there are rare cases in which equitable recoupment has been applied when the same type of tax was involved. See Stone v. White, 301 U.S. 532 (1937) (involving income tax); see also Kolom v. United States, 791 F.2d 762 (9th Cir. 1986) (involving minimum tax); Estate of Vitt, 706 F.2d 871 (8th Cir. 1983), aff'g 536 F. Supp. 403 (E.D. Mo. 1982) (involving estate tax). Thus, there is at least the possibility that a court would find the third element has been satisfied in the present situation. Lastly, because Corp X-FSC is a wholly-owned subsidiary of Corp X, there is likely a sufficient identity of interest between the two.

Given the concerns and court cases noted above, there is at least some possibility that a court might conclude that equitable recoupment is an appropriate remedy with respect to the portion of the [redacted] refund claim attributable to Corp X-FSC's redetermination. In the event Corp X raises an equitable recoupment argument, we suggest that you contact CC:PA:APJP:B03 at (202) 622-7940 for further guidance.

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. If you have questions, please contact (202) 622-4940.

CURT G. WILSON

By: _____

Judith M. Wall
Chief, Branch 2