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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DAVID J. MUNGO
ASSOCIATE AREA COUNSEL CC:LM:NR:DEN
ATTN: Michael J. Cooper
Special Litigation Assistant

FROM: John M. Breen
Senior Technical Reviewer, CC:INTL:6

SUBJECT:
( ) — Taxable Year

This Chief Counsel Advice responds to your memorandum dated October 22, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Activity 1 =

Activity 2 =

Amount A =
Amount B =
Amount C =

Country A =

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Foreign Co 1	=
Foreign Co 2	=
Foreign Co 3	=
Foreign Parent	=
Holding Co	=
Taxable Year 0	=
Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=
USCo1	=
USCo2	=
X	=

ISSUE:

Whether the amount of a section 482 conforming adjustment pursuant to Rev. Proc. 65-17, 1965-1 C.B. 833, is considered an omission from gross income reported on USCo1's Taxable Year 2 Form 1042 ("Annual Withholding Tax Return for U.S. Source Income of Foreign Persons"), in determining whether there was a greater-than-25-percent omission from the gross income stated in USCo1's Taxable Year 2 Form 1042 for purposes of section 6501(e)(1)(A).

CONCLUSION:

In this case, the closing agreement executed pursuant to Rev. Proc. 65-17 provided for a section 482 conforming adjustment that treated the amount of the primary section 482 allocation as an interest-bearing account receivable in USCo2's hands, deemed to arise as of the last day of the taxable year in which the primary allocation was made (Taxable Year 2). The conforming adjustment did not give rise to an item of income in Taxable Year 2 required to be reported on USCo1's Taxable Year 2 Form 1042. Accordingly, the amount of the conforming adjustment is not considered in determining whether there was a greater-than-25-percent omission

from gross income on USCo1's Taxable Year 2 Form 1042, for purposes of section 6501(e)(1)(A).

FACTS:

USCo1 is a United States subsidiary of Foreign Parent, a Country A corporation. Foreign Parent owns USCo1 indirectly through Holding Co, a Country A corporation. In Taxable Year 2, USCo1 performed services comprising Activity 1 and Activity 2 for non-United States companies owned by Foreign Parent (Foreign Co 1, Foreign Co 2, and Foreign Co 3, collectively referred to as "the Foreign Companies"). USCo1 performed these activities through USCo2, a wholly-owned United States subsidiary of USCo1. USCo1 and USCo2 are members of a group that files a consolidated United States income tax return (Form 1120).

On Date 1, USCo1 filed its Taxable Year 2 Form 1042 ("Annual Withholding Tax Return for U.S. Source Income of Foreign Persons") as withholding agent for United States source income paid to Foreign Parent. In its Taxable Year 2 Form 1042, USCo1 reported:
$ Amount A of gross income paid to Foreign Parent; total tax payments of zero with respect to gross income paid to Foreign Parent; and total net tax liability of zero with respect to gross income paid to Foreign Parent.[1] Absent an extension of the statute of limitations by agreement, or an exception to the three-year period of limitations in section 6501(a), the statute of limitations for USCo1's Taxable Year 2 Form 1042 would expire on Date 3.

The Service made a section 482 allocation to USCo2's income for Taxable Year 2, allocating additional Activity 1 income of $ Amount B to USCo2 ("the Activity 1 Allocation"). The Service also made a second, distinct section 482 allocation to USCo2's income for Taxable Year 2, allocating additional Activity 2 income of $ Amount C to USCo2 ("the Activity 2 Allocation").

The Activity 1 Allocation was the subject of a Date 2 closing agreement between the Service and USCo1 that provided for Rev. Proc. 65-17 treatment with respect to that allocation.[2] The Date 2 closing agreement provided in relevant part:

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[1] The gross income reported on USCo1's Taxable Year 2 Form 1042 was exempt from withholding under the Country A-United States tax treaty.

[2] The Date 2 closing agreement provides for Rev. Proc. 65-17 treatment with respect to section 482 allocations to USCo2's Activity 1 income for multiple taxable years, which include Taxable Year 2. This advice concerns solely the Taxable Year 2 section 482 allocation to USCo2's Activity 1 income.

Secondary Adjustments:

4. . . . [USCo2] shall make appropriate adjustments to conform [its] accounts to reflect the primary adjustment allocation made under section 482 pursuant to Treas. Reg. § 1.482-1(g)(3) (the secondary adjustment) as follows: An account receivable will be created on the books of [USCo2] as of [Date 4] due from [the Foreign Companies] in an aggregate amount equal to (1) the primary adjustment for [Taxable Year 2 through Taxable Year 3], inclusive, as set forth in Exhibit B to this Agreement, and (2) interest on the primary adjustment determined at an arm's length rate in the manner provided in Treas. Reg. § 1.482[-2](a)(2) from the day after the date the account is deemed to have been created to the date of payment. Any such interest will be accrued and included in [USCo2's] U.S. taxable income on the accrual method of accounting for federal income tax purposes annually. If this account receivable is paid within ninety days of the date of this Agreement is signed on behalf of the Commissioner pursuant to Rev. Proc. 65-17 and Rev. Proc. 99-32, there will be no federal income tax consequences to the taxpayer [(USCo1 and subsidiaries)] or [USCo2] in the Covered Years [(Taxable Year 0 through Taxable Year 3, inclusive)].

5. In the event the account receivable described in paragraph 4. above is <u>not</u> paid within ninety days of the date this closing agreement is signed on behalf of the Commissioner, then, pursuant to Rev. Proc. 65-17 and Rev. Proc. 99-32, the amount of the primary adjustment for each of [Taxable Year 2 through Taxable Year 3], inclusive, as set forth in Exhibit B to this Agreement, shall be a dividend (to the extent of [USCo2's] earnings and profits) as of the close of the taxable year for which the primary adjustment is made. <u>This dividend is deemed paid to [Country A Holding Co]; and is subject to withholding under I.R.C. §§ 1441 and 1442 at the rate provided in Article [X] of the [Country A]-United States Income Tax Treaty</u>.

6. <u>Except as described in paragraph 5. above, there will be no federal income tax consequences as a result of the secondary adjustment described in paragraph 4. above to [USCo2] or [USCo1 and subsidiaries] in the Covered Years. No secondary adjustment will be made for any other Covered Year.</u>

> General:
>
> . . . . .
>
> 8. Except as provided, this Agreement is final and conclusive for federal income tax purposes for all section 482 issues and issues related to section 482 for the [Activity 1 transactions] for the Covered Years. This Agreement does not preclude the Internal Revenue Service from making any adjustment for federal income tax purposes with respect to the taxpayer's returns for each of the Covered Years to items not part of the [Activity 1 transactions] in the Covered Years and any collateral or consequential adjustments arising from such adjustments.

(Emphasis added.)

USCo1 complied with the terms of the Date 2 closing agreement by setting up an account receivable that was paid by Foreign Parent within 90 days of the execution of the closing agreement.

USCo1 extended the period of limitations for assessment of Taxable Year 2 income tax (Form 1120) liability, so that it will expire on Date 5. USCo1 has not extended the period of limitations for assessment of Taxable Year 2 withholding tax (Form 1042) liability. If section 6501(e)(1)(A) is applicable to the Taxable Year 2 Form 1042, however, the period of limitations for assessment of Taxable Year 2 withholding tax liability expires on Date 6.

The Activity 2 Allocation and the underlying activity (Activity 2) are distinct and separate from the Activity 1 Allocation and the underlying activity (Activity 1) at issue in the Date 2 closing agreement. Your incoming memorandum indicates that the $ Amount C Activity 2 Allocation will be accompanied by a conforming adjustment that would treat the amount of the primary allocation as a deemed distribution from USCo2 to Foreign Parent.[3]

LAW AND ANALYSIS

Period of Limitation for Assessment Purposes

[3] We assume that the deemed distribution would be followed by a deemed capital contribution from Foreign Parent to the companies for which USCo2 performed Activity 2.

Initially, as noted by the U.S. Tax Court, the withholding tax and the income tax (and their respective returns, Forms 1042 and 1120) are separate and distinct. See S-K Liquidating Co. v. Commissioner, 64 T.C. 713 at 716 (1975) ("The different type of return and the different filing locations of the withholding tax return and the withholding agent's own income tax return emphasize the distinct nature of the two taxes and the two returns."). As such, the analysis of the applicable period of limitations on assessment for Form 1120 must be separate from the analysis of the period of limitations on assessment for Form 1042. Thus, for example, the Service requires separate Forms 872 and 872-A to extend the periods of limitation for Forms 1120 and 1042. See IRM 121.2.22.4.3(1).

Section 6501(a) generally provides that the amount of any tax imposed by the Internal Revenue Code shall be assessed within three years after the return was filed. In certain cases, however, exceptions to this general three-year limitations period are applicable. Section 6501(e) provides:

> (1) INCOME TAXES.— In the case of any tax imposed by subtitle A—
> (A) GENERAL RULE.— If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. . . .

The six-year period for assessment of tax provided by section 6501(e)(1)(A) applies when income subject to withholding tax is understated by an amount in excess of 25 percent of the amount of gross income stated in Form 1042. Northern Indiana Public Service Co. v. Commissioner, 101 T.C. 294 (1993).[4] In that case, the Tax Court held:

[4] In the context of the withholding tax, section 6501(e)(1) "gross income" refers to the gross amount of income reported on Form 1042 (i.e., paid to foreign persons). Section 6501(e)(1) "gross income" is not limited to income received by the taxpayer. See 101 T.C. at 298.

> The regulation's [Treas. Reg. § 301.6501(e)-1(a)(1)(i)[5]] scope includes Form 1042, which is "the return of a tax imposed by subtitle A." The withholding agent is the payor of, and is liable for, the tax on that return. An understatement of interest paid to a nonresident alien is an omission from "gross income" that should be reported on Form 1042.

101 T.C. at 299 (footnote omitted).

Thus, if USCo1 made a substantial omission from the gross income required to be reported on its Taxable Year 2 Form 1042, the six-year statute of limitations under section 6501(e)(1) would apply to the assessment of the Taxable Year 2 withholding tax (Form 1042) liability. In the present case it is necessary to determine whether the conforming adjustment made pursuant to Rev. Proc. 65-17 gave rise to an item of income required to reported on USCo1's Taxable Year 2 Form 1042 and, if so, whether such item exceeded the 25-percent-of-gross-income threshold of section 6501(e)(1).

Section 482 and Rev. Proc. 65-17

Section 482 provides the Commissioner broad authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled parties in order to prevent evasion of taxes or to clearly reflect income. When the Service makes an allocation of income under section 482, appropriate collateral adjustments will also be made with respect to other members of the group affected by the allocation. See generally Treas. Reg. § 1.482-1(g). Thus, for example, when the Service makes a primary allocation that increases the income of one member of the group, it must also make a correlative allocation that decreases the income of the other affected member(s). See Treas. Reg. § 1.482-1(g)(2). In addition, as provided by Treas. Reg. § 1.482-1(g)(3), certain other adjustments (referred to as conforming adjustments) must be made to conform taxpayers' accounts to reflect the section 482 allocations:

> Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in

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[5] Treas. Reg. § 301.6501(e)-1(a)(1)(i) provides:

> If the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code an amount properly includible therein which is in excess of 25 percent of the gross income so stated, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

> appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see § 601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

Treas. Reg. § 1.482-1(g)(3)(i). Conforming adjustments "may result in adverse tax consequences to the taxpayer." See Rev. Proc. 99-32, 1999-2 C.B. 296, at 298, § 2 (domestic subsidiary must withhold tax on a deemed distribution to foreign parent).

For taxable years beginning before August 23, 1999,[6] Rev. Proc. 65-17 provides a procedure by which a qualifying United States taxpayer whose taxable income has been increased for a taxable year by reason of a section 482 allocation can receive payment from the entity from which the allocation of income was made of an amount equal to a part or all of the amount allocated, without further United States income tax consequences. See 1965-1 C.B. at 833, § 1. Under Rev. Proc. 65-17, a qualifying taxpayer is permitted to make a conforming adjustment that treats the amount of the section 482 allocation as an interest-bearing account receivable from the entity (or entities) with which it engaged in the transaction or arrangement giving rise to the allocation. The account receivable may be established and paid without tax consequences, provided that payment occurs within 90 days of the date of the closing agreement required for Rev. Proc. 65-17 treatment. See id. at 835, § 4.02.

The operation of Rev. Proc. 65-17 is illustrated by an example in Treas. Reg. § 1.482-1(g)(3)(ii). In the example, USD, a United States corporation, buys Product from its foreign parent, FP. The Service determines that the arm's length price would have increased USD's taxable income by $5 million and accordingly makes a section 482 adjustment to reflect USD's true taxable income. To conform its cash accounts to reflect the section 482 allocation, USD applies for Rev. Proc. 65-17 treatment with respect to the $5 million adjustment. USD treats the amount of the allocation as an interest-bearing account receivable from FP, deemed to arise as of the last day of the taxable year of the Product transaction.

The Service has granted USCo1's request for Rev. Proc. 65-17 treatment with respect to the $ Amount B Activity 1 section 482 adjustment for Taxable Year 2.

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[6] Rev. Proc. 99-32 superseded Rev. Proc. 65-17 for taxable years beginning after August 23, 1999. 1999-2 C.B. at 301, § 6.01. Rev. Proc. 65-17 remained in effect for Taxable Year 2. For taxable years prior to the taxable year including the effective date, Rev. Proc. 99-32 provides that the Service considers an interpretation of Rev. Proc. 65-17 that applies Rev. Proc. 99-32 or its general principles to be a reasonable interpretation of Rev. Proc. 65-17. 1999-2 C.B. at 301, § 6.03.

Thus, the original Taxable Year 2 Activity 1 transaction is treated as if arm's length consideration was paid. Foreign Parent is not considered to receive a dividend in Taxable Year 2 equal to the difference between an arm's length charge for USCo2's Taxable Year 2 Activity 1 services and the amount actually paid to USCo2 (i.e., $ Amount B).

In this case, Rev. Proc. 65-17 applies. USCo1 complied with the closing agreement, as well as Rev. Proc. 65-17, with respect to the Activity 1 section 482 allocation for Taxable Year 2. Accordingly, the Taxable Year 2 conforming adjustment treats the amount of that allocation as an account receivable deemed created as of the last day of Taxable Year 2, not as a deemed distribution by USCo1 in Taxable Year 2. The conforming adjustment (the creation of the deemed account receivable) did not give rise to any income item in Taxable Year 2, and USCo1 was not required to report the amount of the conforming adjustment on its Taxable Year 2 Form 1042. The omission of the conforming adjustment could not be an omission from gross income within the meaning of section 6501(e)(1) because that amount was not "properly includible therein." The $ Amount C Activity 2 Allocation, considered separately, is not large enough to give rise to a greater-than-25-percent omission for purposes of section 6501(e)(1)(A). As a consequence, in determining the withholding tax consequences (if any)[7] of a conforming adjustment with respect to the Service's Activity 2 section 482 allocation for Taxable Year 2, the Service should apply the general the three-year statute of limitations in section 6501(a).

Your incoming memorandum also raised the issue of the potential effect of Schering Corp. v. Commissioner, 69 T.C. 579 (1978), acq. in result, 1981-2 C.B. 2, on the closing agreement and Rev. Proc. 65-17.[8] In light of the discussion above, we do not consider Schering relevant to the issue presented here.

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[7] USCo1 may yet request Rev. Proc. 65-17 treatment with respect to the Service's Activity 2 section 482 allocation for Taxable Year 2.

[8] The issue in that case was whether Schering, a U.S. taxpayer, was entitled under section 901(a) to a foreign tax credit for Swiss withholding tax imposed on amounts repatriated to Schering pursuant to Rev. Proc. 65-17, after a section 482 allocation of income to Schering from two Swiss subsidiaries. The Tax Court found that Rev. Proc. 65-17 was essentially equitable in nature and that the "without tax consequences" language of Rev. Proc. 65-17 should be construed to mean only that Schering was not required to recognize gross income upon payment of the account receivable. Further, this language should not be extended to deny Schering a benefit available to it under other sections of the Code (i.e., a foreign tax credit), without regard to whether it received a taxable distribution of property from its subsidiary. See 69 T.C. at 597-598.

Please call (202) 874-1490 if you have any further questions.

By: _____

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