INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-119153-04

Director of Field Operations, Manhattan
L:F:DFO:M

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Agreement =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Date 1 =

Date 2 =

<u>a</u> =

<u>b</u> =

<u>c</u> =

ISSUES:

1. Are Taxpayer's dollar rolled mortgage backed securities (MBS) acquired in the ordinary course of trade or business for services rendered within the meaning of § 1221(a)(4) of the Internal Revenue Code?

2. To what extent does the Agreement apply to the Taxpayer's gains and losses on MBS in taxable years Year 1 through Year 2?

CONCLUSIONS:

1. Taxpayer's dollar rolled MBS are not acquired in the ordinary course of trade or business for services rendered within the meaning of § 1221(a)(4).

2. The Agreement determines tax matters relating to Year 3, Year 4, and Year 5 and has no bearing on transactions undertaken in taxable years Year 1 through Year 2.

FACTS:

<u>Issue 1. Section 1221(a)(4)</u>

A. <u>Taxpayer's Creation, Purpose,</u>

[1]

[1]

Taxpayer has not pointed to any particular rules or regulations that define the extent to which it is . Only a small portion of its investments are not MBS .

B. <u>Taxpayer's General Operation</u>

Taxpayer generally conducts its business in two different ways.

1.

2.

The way in which Taxpayer operates and the secondary mortgage market have dramatically changed since the .

In the , Taxpayer conducted nearly all its business by

(There is some question as to when Taxpayer began to actually .)

Several factors have dramatically reduced the . Those factors include (a) the enormous growth in mortgage securitization, (b) the development of a forward market (called the to-be-announced or TBA market) for MBS and (c) the authorization and acceptance of REMICs in the secondary mortgage market.

Rapid Spread of Securitization

, the late saw a dramatic increase in the securitization of mortgage pools. From , the dollar amount of outstanding MBS grew from $ to over $ (a fold increase). The market for those mortgages (that trade as securities) is very deep and liquid. Although Taxpayer owned about in Year 2, it accounted for a of the daily trading in such securities. Thus, for these securitized mortgages (that are treated as equitable interests in mortgages under the tax law), dealers and others account for much of the day-to-day liquidity and efficiency in the market. Consistent

with Taxpayer's
, securitization has resulted in Taxpayer being today just one of thousands of investors that purchase these highly liquid mortgages.[2]

Though Taxpayer held only about
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Taxpayer's . In Year 2, its investment in had grown over 900 fold from the mid-1980's and investments represented slightly more than 60% of its . The marked change in Taxpayer's might be best appreciated by considering that for every dollar that it had invested in the
. By Year 2, the ratio had entirely flipped so that for every dollar that it had
. Thus, by Year 2, Taxpayer had dramatically shifted away from investing and was investing in highly liquid securitized mortgages.[3]

<u>TBA Market Development</u>

Congress enacted legislation in 1984 (the Secondary Mortgage Market Enhancement Act of 1984) to further encourage private parties to invest in securitized mortgages. This legislation fostered the development of a delayed delivery or forward market in securitized mortgages. As this market developed through the 1980's and 1990's, lenders began to change the way in which they managed their pipeline loan risks. Instead of simply obtaining
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lenders saw that they could increase the size of the market for those mortgages by securitizing them and selling the loans in advance of closing into the TBA market. Today, the TBA market is the most liquid market for MBS. The market has numerous bidders and is characterized by "tremendous liquidity" and thin bid/ask spreads. Consequently, by routinely securitizing whole mortgages, lenders have entirely altered the way in which they replenish the funds they need to make new loans.

2
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3

Other Developments

Congress' enactment of the REMIC rules in 1986 further increased the demand for mortgages by private investors. The REMIC rules provide a mechanism for tranching mortgage cashflows so that investors in REMIC regular interests can acquire interests that more closely suit their investment needs. This has stimulated further demand for whole and securitized mortgages, further diminishing the need for .

3. Dollar Roll Transactions in the Retained Portfolio

Taxpayer uses a small portion of the MBS in its investment portfolio for "dollar roll" transactions. In this type of transaction, Taxpayer sells MBS to a dealer and simultaneously agrees to later purchase similar but not identical MBS from the dealer. Taxpayer treats these transactions as separate sales and purchases for tax, but not accounting, purposes.

Taxpayer reported ordinary losses on these transactions in the amounts of $a, $b, and $c for the tax years Year 1 through Year 2 respectively. Relying on , Taxpayer contends that are ordinary assets under § 1221(a)(4). Exam disallowed these losses by treating the as capital assets.

Issue 2. Closing Agreement

In Year 6 Taxpayer and the Service negotiated an agreement to settle the treatment of gains and losses from Taxpayer's sale of mortgages. The pertinent operative portion of the Agreement is the second determination clause, which provided:

> Gain or loss from sales of mortgages by taxpayer during taxable year Year 3 (calendar year Year 3) and all subsequent taxable years or periods shall be taxed as ordinary income or loss and shall not be entitled or subject to capital gain or loss treatment under Section 1221 of the Internal Revenue Code.

The parties memorialized their agreement in a Form 906 Closing Agreement (the Agreement). The Vice President and Controller of the Taxpayer signed the Agreement on Date 1. The representative for the Service, the Acting Chief of the Washington Appellate Branch Office, signed the Agreement on Date 2. After the Acting Chief signed the agreement, he sent a copy of the executed agreement to the Taxpayer. Accompanying the copy of the Agreement was a letter from the Acting Chief that read in part, "I have approved and signed the closing agreement you submitted pertaining to your income tax liability for the periods shown above." Above this text was typed, "Years: ."

On the same day that the Taxpayer executed the Agreement, Date 1, the same representative of the Taxpayer signed a form 870-C, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. This Form 870-C covered the years Year 3, Year 4, and Year 5.

At the time the Agreement was executed, all representatives acting on behalf of the Service were bound by Internal Revenue Service Delegation Order No. 97 (Rev. 12), that had become effective January 16, 1975. Paragraph 4 of the delegation order read as follows:

> Regional Commissioners; Assistant Regional Commissioners (Appellate); Assistant Regional Commissioners (Audit); District Directors; Director of International Operations; Chiefs and Assistant Chiefs of Appellate Branch Offices, are hereby authorized in cases under their jurisdiction (but excluding cases docketed before the United States Tax Court) to enter into and approve a written agreement with any person relating to the Internal Revenue tax liability of such person (or of the person or estate for whom he acts) for a taxable period or periods ended prior to the date of the agreement and related specific items affecting other taxable periods.

That revision of the delegation order contained no other authorizations for Chiefs and Assistant Chiefs of Appellate Branch Offices, except in cases docketed before the Tax Court. In addition, that delegation order was (and its successors continue to be) the only source of authority permitting Service representatives to execute closing agreements.

The Taxpayer did not own MBS at the time the Agreement was executed in Year 7. In fact, Taxpayer only began to
In the
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Taxpayer itself recognized how dramatically its business had changed in the years following the closing agreement. It stated:

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When the Agreement was executed, it was consistent with the law. At the time, Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), was given an expansive interpretation. Under the Corn Products doctrine, assets held as an integral part of the trade or business of a taxpayer were treated as ordinary assets, which in turn dictated that Taxpayer's mortgages be treated as ordinary assets. The United States

Supreme Court, in Arkansas Best Corp. v. Commissioner 485 U.S. 212 (1988), subsequently cut back the Corn Products doctrine. The Court interpreted Corn Products as "standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of section 1221." Id. at 222.

After Arkansas Best was decided, the Service examined the Taxpayer's

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Taxpayer claims that, by its terms and by the authority of the Acting Chief who signed it, the Agreement continues to be effective in its Year 1 through Year 2 tax years and causes whole mortgages and MBS to be ordinary assets.

LAW AND ANALYSIS:

Issue 1. Section 1221(a)(4)

A. Section 1221(a)(4) Language, Legislative History and Regulations

Like other financial instruments, debt instruments purchased by non-dealers generally have been treated as capital assets. Section 1221 defines a capital asset as all property held by a taxpayer unless specifically excepted by that provision. Section 1221(a)(4) treats accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in § 1221(a)(1) as ordinary assets.

According to the legislative history, Congress enacted § 1221(a)(4) in 1954 to correct a character mismatch problem. Before enactment, the value of accounts or notes receivable acquired for rendering services or selling inventory was ordinary income. Gain or loss on a later disposition of the receivables, however, was capital. Section 1221(a)(4) corrected this mismatch by treating the receivables as ordinary assets.

Congress was focusing only on accounts and notes receivable that could lead to the character mismatch described above. The legislative history confirms this limited focus by referring explicitly to accounts and notes receivable acquired "in payment for" inventory or services rendered by the holder. The specific problem was set forth most clearly in the House Report:

> Paragraph (4) is a new provision which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1), that is, stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. This will change present law treatment, for example, as follows: If a taxpayer acquires a note or account receivable in payment for inventory or services rendered, reports it as income and sells it at a discount, then this amendment will provide ordinary loss treatment. Under present law such loss treatment is only allowed if the taxpayer is also, in effect, a dealer in such accounts or notes. Alternatively, the taxpayer may sell the account or note for something more than the discounted value that was originally reported. Under present law this difference would be capital gain unless the taxpayer is such a dealer. The amendment will cause such gain to be ordinary income.

H.R. Rep. No. 1337, 83d Cong., 2d Sess., A273-74 (1954).

The longstanding regulation interpreting § 1221(a)(4) also confirms this limited focus. Section 1.1221-1(a) states that the term “capital assets” includes all classes of property not specifically excluded by § 1221. Section 1.1221-1(d), which sets forth the § 1221(a)(4) exclusion, simply repeats the statutory language of § 1221(a)(4) and then interprets it to apply as follows:

> Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

Consequently, the statute, legislative history and regulations all demonstrate that § 1221(a)(4) was intended to apply only to notes receivable acquired in payment for services rendered or inventory. There is no indication that § 1221(a)(4) was intended to apply to notes receivable acquired for cash.

B. Expansion of § 1221(a)(4)

1. Burbank

Notwithstanding the intended narrow focus of section 1221(a)(4), the reach of that provision was materially expanded beyond its literal language following the Tax Court’s decision in Burbank Liquidating Corp. v. Commissioner, 39 T.C. 999 (1963), acq., 1965-1 C.B. 5, aff’d in part and rev’d in part on other grounds, 335 F.2d 125 (9th Cir. 1964) (Burbank). In Burbank, the Tax Court held that mortgage loans made by a savings and loan association in the ordinary course of its business were, in the hands of that association, ordinary assets under § 1221(a)(4) because they were notes receivable acquired for the service of making loans. The Service not only acquiesced to that decision, it also relied upon Burbank in a series of revenue rulings that treat loans made by commercial lenders (including banks and REITs) as ordinary assets under § 1221(a)(4) when held by the original lender. Rev. Rul. 72-238, 1972-1 C.B. 65; Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul. 80-57, 1980-1 C.B. 157.

Until the , the Service and the courts strictly limited § 1221(a)(4) to originated loans of taxpayers that were in the business of regularly making loans. Thus, in Ardela, Inc. v. Commissioner, 28 T.C.M. 470 (1969), the Tax Court determined that loans made by the investment companies in that case had to treated as capital assets. The Ardela court's reluctance to expand the reach of section 1221(a)(4) was in substantial part shaped by that court's explicit recognition that the taxpayers' loans fell beyond the language and legislative rationale of § 1221(a)(4). After quoting the relevant legislative history discussing the need for inclusion of the note's value into income, the court observed that the taxpayers that made the loans took nothing into income.

2.

3. Bielfeldt

Courts have not . Recently, an appellate court rejected out of hand a trader's contention that its purchase of government debt that enhanced liquidity in that market was covered by § 1221(a)(4). Bielfeldt v. Commissioner, 231 F.3d 1035 (7th Cir. 2000), aff'g 76 T.C.M. 776 (1998), cert. denied, 534 U.S. 813 (2001). Bielfeldt's principal argument was that government debt he acquired was ordinary because of his status as a dealer. The court determined that Bielfeldt was a trader and not a dealer absent an obligation to maintain an orderly market in such debt. Nevertheless, the court did accept the notion that Bielfeldt's trading activity provided a benefit (increased liquidity and tightened spreads) for the government debt market. In the same breath, however, the court observed that Bielfeldt was not separately paid for these services. Consequently, the court easily disposed of the taxpayer's alternative argument that the debt constituted notes receivable acquired for services rendered within the meaning of section 1221(a)(4). In two brief sentences, the Seventh Circuit called the taxpayer's argument "frivolous" and observed that no debt would be capital if the taxpayer's argument was accepted.

C. Service

See also Section 1221(a)(4)

Capital Asset Exclusion for Accounts and Notes Receivable, 71 Fed. Reg. 44,600 (Aug. 7, 2006).

D. and Secondary Mortgage Market Have Dramatically Changed

The secondary market has evolved considerably since the mid-1980's. Today, the secondary mortgage market is extremely liquid with thousands of investors, traders and dealers competing for mortgages. The development of that liquidity was fostered by, among other things, the rampant growth of securitization, the emergence of the to-be-announced (TBA) market for MBS and the enactment of laws to foster the creation of REMICs. As a result, the actual operations of Taxpayer and lenders are quite different today.

Rather than addressing these changed circumstances, Taxpayer dismisses their relevance.

That read is simply not supportable.

Because of the dramatic transformation of the secondary mortgage market,

Lenders today have more attractive options for disposing of their mortgages that simply did not exist prior to 1986. Among other things, the enormous growth in securitization and the to-be-announced forward market for MBS has changed how lenders operate. Today, lenders by and large seek to sell their mortgages in the form of securities into the TBA market in advance of their creation. In that market, thousands of purchasers competitively bid on MBS, enabling lenders to hedge their pipeline of originated mortgages so as to fund the making of new loans. As a result, Taxpayer now must compete in this highly liquid marketplace with numerous other players to purchase MBS for its portfolio. In addition, Taxpayer is much less apt, in this highly liquid market, for its .

[4]

Thus, even if the Service , the substantial transformation of the secondary mortgage market and that it acquired notes receivable for services rendered. Consequently, Taxpayer's MBS are capital assets; the dollar roll of those MBS in the year Year 1 through Year 2 produced capital losses under § 1221.

Issue 2. Closing Agreement

The Agreement does not apply to taxable years Year 1 through Year 2, but instead covers only the limited issue of the treatment of mortgage transactions made by the Taxpayer in the years Year 3, Year 4, and Year 5. That conclusion is supported by (1) the terms of the Agreement and by evidence extrinsic to it, including

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contemporaneous associated documents and the parties' course of conduct after the Agreement was executed and (2) the limited scope of authority of the Acting Chief of the Appellate Branch Office at the time the Agreement was signed.

A. Interpretation of the terms of the Agreement, review of contemporaneous documents, and the subsequent conduct of the Service pursuant to the Agreement does not support application of the Agreement to tax years Year 1 through Year 2.

Under § 7121, the Secretary of the Treasury, and by delegation, the Commissioner of the Internal Revenue Service, may enter into written agreements with persons concerning their tax liabilities. I.R.C. § 7121; Treasury Order 150-07. Closing agreements are final and conclusive. I.R.C. § 7121(b). Closing agreements are not strictly subject to the common law of contracts because they are legislatively authorized agreements that require no consideration for formation. Closing agreements are nevertheless interpreted using basic contractual principles. Rink v. Commissioner 47 F.3d 168, 171 (6th Cir. 1995); Smith v. United States, 850 F.2d 242, 245 (5th Cir. 1988); Silverman v. Commissioner, 105 T.C. 157, 161 (1995); I.R.M. 8.13.1.1.1(1). One such fundamental principle is that, where the terms of a document are clear and unambiguous, the parties should not look beyond its four corners to determine its meaning. See Rink, 47 F.3d at 171.

In contract interpretation, the principle that the parties must look solely to the four corners of the document where the terms are unambiguous has a converse side: the parties may look to extrinsic evidence where there is ambiguity in the terms of the contract. United States v. Donovan, 348 F.3d 509 (6th Cir. 2003); Bethlehem Steel Corp. v. United States, 270 F.3d 135 (3d Cir. 2001); Rink, 47 F.3d at 171. If an agreement is not clear on its face, information outside its four corners must be considered. This can include the conduct of the parties after an agreement is executed. See Heder v. City of Two Rivers, 149 F. Supp. 2d 677, 687 (E.D. Wis. 2001), vacated on other grounds, 295 F.3d 777 (7th Cir. 2002). If, however, a court regards the agreement as clear, it may minimize or even ignore whatever interpretation the parties have given it through their subsequent conduct. The extrinsic evidence in the present situation includes both contemporaneous documents and the course of conduct of the Service following the execution of the Agreement.

1. The terms of the Agreement restrict its application to the Year 3, Year 4, and Year 5 tax years.

In interpreting the words of the parties to an agreement, a court should put itself in the position the parties occupied at the time the agreement was made. See Restatement (Second) of Contracts §202 cmt. b. Uncertainties regarding the meaning of the parties' words can ordinarily be deduced by putting the words in context, taking into account the circumstances of the agreement. See id. at §201 cmt. b. & §202 cmt. h. An interpretation that gives a reasonable, lawful, and effective meaning to the terms of an agreement is better than one that leaves a part of the agreement unreasonable or unlawful. See Rink, 47 F.3d at 171; Restatement (Second) of Contracts §203(a).

The words chosen by the parties are an especially important signal as to the meaning of an agreement, since they are found within its four corners. The meaning of words commonly depends on their context. Phrases are commonly -- though not invariably -- used in the same manner in the course of a single closing agreement.

The "Whereas" clauses in a closing agreement serve to introduce the subject matter of the agreement and state the premises upon which it is based. See Rev. Proc. 68-16, 1968-1 C.B. at 779. These clauses provide context for the determinations that follow. They cannot be divorced from these determinations, even though they serve a different purpose.

The Taxpayer argues that the parties to a closing agreement are not bound by the recitals in "Whereas" clauses. But this is not the complete teaching of Zaentz v. Commissioner, 90 T.C. 753 (1988), which the taxpayer cites as authority for its argument. Zaentz concluded that the recitals in a closing agreement do not bind the parties "for purposes of resolving an issue concerning a matter other than the matter agreed upon." Id. at 762. In understanding the scope of an agreement, Zaentz instructs that the "Whereas" clauses are an important interpretative guide. See id.

The Agreement uses the phrase "in the taxable year Year 3 (calendar year Year 3) and all subsequent years" in both "Whereas" clauses and in both determination clauses. In the first "Whereas" clause, the phrase identifies the years in which the Taxpayer treated "P and M fees" as reductions in mortgage proceeds and amortized such fees over the remaining lives of the mortgages to which they related. In the second "Whereas" clause, the phrase identifies the years in which the Taxpayer treated sales of mortgages as capital assets.

In both "Whereas" clauses, the phrase "in the taxable year Year 3 (calendar year Year 3) and all subsequent years" refers to years preceding the signing of the Agreement. This is evident from another word in the two "Whereas" clauses -- "treated." It makes no sense to describe events that have yet to occur as having been "treated" in a certain way; "treated" is a past tense word. Thus, in context, the phrase "in the taxable year Year 3 (calendar year Year 3) and all subsequent years" refers to certain years before Year 6, the year the Agreement was signed by both parties.

In the first determination clause, the phrase "in the taxable year Year 3 (calendar year Year 3) and all subsequent years" is used as a limitation. It specifies that "Purchase and Marketing fees (P and M fees)" imposed for certain taxable years -- elsewhere specified in the determination clause as Year 3, Year 4, and Year 5 -- are to be included in income according to a schedule. Although the words "subsequent taxable years or periods" within the phrase suggest a more far-reaching determination, there is no language within the first determination clause that establishes that the parties intended to resolve the treatment of P and M fees for years other than Year 3, Year 4, and Year 5. While the determination clause refers to years other than Year 3, Year 4, and Year 5, the other years, which are are not years in which a determination is being made. Rather, these other years are those in which the effects of determinations made in Year 3, Year 4, and Year 5 must be calculated. The additional years are also prior to the Year 6 execution of the Agreement and do not support the extension of the Agreement to any future years.

In the second determination clause, the contextual clues evident in the first determination clause are missing; there is no helpful schedule pinning the years resolved as Year 3, Year 4, and Year 5. Nevertheless, the use of the phrase “during the taxable year Year 3 (calendar year Year 3) and all subsequent years or periods” appears significant. The repetition of this phrase suggests it has the same meaning it had in the first determination clause. This interpretation is reinforced by the second “Whereas” clause, which describes how the Taxpayer “treated” -- past tense – sales of mortgages during a period similarly identified.

In the two “Whereas” clauses and the first determination clause, the words “subsequent years” and “subsequent taxable years” refer to years that follow Year 3 and precede Year 6, when the Agreement was signed. The first determination clause, which determines the treatment of P and M fees imposed in three specific years, Year 3, Year 4, and Year 5, suggests that “subsequent taxable years” refers only to Year 4 and Year 5. Isolated, the phrase appearing in the second determination clause, “during the taxable year Year 3 (calendar year Year 3) and all subsequent years or periods” could be interpreted as referring to any subsequent years. In context, however, it appears to refer to certain subsequent years, years that have already passed. To interpret the phrase otherwise ignores the rest of the document in which the phrase appears.

The use of the word “shall” in the second determination clause (“gain or loss from sales of mortgages during taxable year Year 3 (calendar year Year 3) and all subsequent taxable years shall be taxed as ordinary income or loss and shall not be entitled to capital gain or loss treatment”) does not demand that the Agreement be given indefinite future duration. Both determination clauses directed that certain tax consequences “shall” eventuate. Although “shall” can refer to future events (e.g., “I shall return”), it can also refer to explicit obligations arising from past actions. The Agreement uses “shall” in the latter manner in the first determination clause, which provided that the P and M fees for each of Year 3, Year 4, and Year 5 “shall be included in income” over specified 4-year periods, the last of which ended in . “Shall” has this same sense in the second determination clause. It refers to how gain or loss from the sale of mortgages during Year 3, Year 4, and Year 5 should be treated.

2. Documents contemporaneous to the Agreement provide additional support to the conclusion that the Agreement applies only to tax years Year 3, Year 4, and Year 5.

Viewing the Agreement as determining only the Taxpayer's Year 3, Year 4, and Year 5 years is consistent with documents prepared contemporaneous to the Agreement itself. On the very same day the Taxpayer's representative signed the Agreement, that same individual signed a Form 870-C, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, on behalf of the Taxpayer. This document explicitly covers only the Taxpayer's Year 3, Year 4, and Year 5 tax years. As this document was executed in conjunction with the Agreement, it is reasonable to conclude that the Agreement was similarly restricted. Additionally, in the Date 2 letter transmitting the signed Agreement, the Acting Chief of the Washington Appellate Branch Office wrote, "I have approved and signed the closing agreement you submitted pertaining to your income tax liability for the periods shown above." Above this text was typed, "Years: , and ." These two associated documents convey the intention of the Taxpayer and the Service to cover only the specified years.

3. The conduct of the Service following the execution of the Agreement does not support application of the Agreement to tax years Year 1 through Year 2.

Extrinsic evidence of the meaning of an agreement can also come from the parties' course of conduct after the agreement is executed. See Real Estate Data, Inc. v. Sidwell Co., 809 F.2d 366, 374 (7th Cir. 1987); United States for Use and Benefit of Union Bldg. Materials Corp. v. Hass & Haynie Corp., 577 F.2d 568, 574 (9th Cir. 1978). The Restatement of Contracts (Second) at §202(4) provides the following rule:

> Where an agreement involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objections to it by the other, any course of performance accepted or acquiesced in without objections is given great weight in the interpretation of the agreement.

This rule is not conclusive, however. A course of performance at odds with the language of a contract may simply reflect a mistake that should be corrected. See id. at cmt g. Compare the following two illustrations:

> A discloses to B a secret formula for an antiseptic liquid and B agrees to pay monthly royalties based on amounts sold. Fifty years later the formula has been published in medical journals. After continuing to pay royalties for 25 years more, B contends that the duty to pay royalties ended when the formula ceased to be secret. B's conduct strongly negates the contention.

> Several railroads agree in writing to share working expenses and taxes of X, another railroad, on a "wheelage basis." For several years they pay shares in proportion to their stock ownership in the other railroad. Then all but one agree that they have been mistaken and that future payments will be made on a basis of use of X's physical

> properties. Stock ownership is so plainly unrelated to any possible meaning of "wheelage" that the course of performance does not support an interpretation of "wheelage basis" as requiring payments in proportion to stock ownership.

Id. at cmt. g., illus. 12 &13. In the second illustration, the interpretation of the contract supported by subsequent conduct crosses the vague boundaries of reason and common sense so it is disregarded. See In re Chicago & E.I. Ry. Co., 94 F.2d 296, 299 (7th Cir. 1938) ("The conduct of the parties may fix a meaning to words of doubtful import. It may not change the terms of the contract.")

The conduct of the Service over the many years that have passed since the Agreement was executed thus is evidence of uncertain value. The Taxpayer nevertheless argues that the Service's conduct since the Agreement was executed proves that the agreement was intended to cover not just Year 3, Year 4, and Year 5, but all future years. Specifically, the Taxpayer points to the Service's

The Taxpayer argues that the law has not changed since , so the closing agreement must continue to apply to sales of mortgage-backed securities.

This view is incorrect. The Service's conduct in this instance is evidence of a mistake, in accordance with comment g. of the Restatement of Contracts (Second) at §202(4). The conclusion of the

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The courts have long held that the Service may correct mistakes of law in the application of the tax laws to particular transactions, even retroactively. See Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Dixon v. United States, 381 U.S. 68, 73 (1965); Zuanich v. Commissioner, 77 T.C. 428, 432-33 (1981); Frische v. Commissioner, T.C. Memo. 2000-237. The Service may make such corrections even where a taxpayer may have relied to its detriment on the mistake. Dixon, 381 U.S. at 73; Zuanich, 77 T.C. at 433. This allows the Service to now accurately determine the proper treatment of Taxpayer's tax years Year 1 through Year 2 without regard to prior mistakes. The Taxpayer may not bind the Service to past erroneous positions by pleading reliance on the .

The Taxpayer similarly may not

B. The scope of authority of the Acting Chief of the Appellate Branch Office invalidates any interpretation of the Agreement that exceeds such authority.

One indisputable fact in this matter is that the Acting Chief of the Washington Appellate Branch Office, at the time he signed the Agreement on behalf of the Service, only had the delegated authority to make an agreement with a taxpayer regarding "a taxable period or periods ended prior to the date of the agreement and related specific items affecting other taxable periods." Delegation Order No. 97 (Rev. 12), ¶ 4. Such language is still in effect today. See Delegation Order No. 97 (Rev. 34). It is a standard principle that the government cannot be bound by the ultra vires acts of its representatives. Heckler v. Community Health Serv., Inc., 467 U.S. 51, 63 n.17 (1984) ("anyone entering into an agreement with the Government takes the risk of having accurately ascertained that he who purports to act for the Government stays within the bounds of his authority. . . . And this is so even [where] the agent himself may have been unaware of the limitations upon his authority."); Utah Power and Light Co. v. United States, 243 U.S. 389, 409 (1917) ("[T]he United States is neither bound nor estopped by acts of its officers or agents in entering into an arrangement or agreement to do or cause to be done what the law does not sanction or permit."); Dorl v. Commissioner, 507 F.2d 406, 407 (2d Cir. 1974), affg. T.C. Memo. 1973-145; Stiskin v. Commisioner, T.C. Memo. 1996-306; Webb v. Commissioner, T.C. Memo. 1994-549.

The Taxpayer argues that the Acting Chief of the Washington Appellate Branch Office did have authority to execute an agreement for future years because the treatment of gains and losses from the sale of mortgages and mortgage-backed securites was a "related specific item affecting other taxable periods." The Taxpayer essentially argues that "related specific items" must include the treatment of mortgage-backed securities by Taxpayer because that there have been instances where closing agreements have been entered into to cover future recurring transactions and the sale of mortgage backed securities and mortgages is recurring. Therefore, the Taxpayer argues that under the language of Delegation Order No. 97, the Acting Chief did in fact possess sufficient authority to execute a valid closing agreement covering future years.

The Taxpayer's analysis is flawed on two counts. Even if the language "related specific items" permits closing agreements to cover future recurring transactions, the Taxpayer fails to satisfy even its own construct of those words. It defies logic to think that the Appeals officer executing the closing agreement was contemplating covering recurring sales of mortgage-backed securities. As previously mentioned, the Taxpayer did not , buy or sell mortgage-backed securities during the audit years or at the time of the agreement. Because the mortgage-backed securities transactions were not undertaken by the Taxpayer, they were not recurring. In short, because the transactions were not even thought of at the time of the closing agreement, there is simply no reasonable means of viewing them as related or specific items about which the parties could even contemplate the future treatment.

This interpretation is contrary to the manner in which the Service has operated in accordance with the "related specific items affecting other taxable periods" language of Delegation Order No. 97. Both the Service and the courts view each tax year as a separate source of liability and new cause of action. See Commissioner v. Sunnen, 333 U.S. 591, 598 (1948). While Sunnen concerned the application of res judicata to tax issues, the principle enunciated by the Supreme Court is a useful analogy. It means that, where a type of transaction is separately recurring in several taxable years, the transactions in each taxable year are independently evaluated pursuant to information pertaining to that taxable year. In the context of a closing agreement, this means that any agreement reached will only be binding on the years specified in the agreement. Where there are identical transactions that occur in years outside the closing agreement, the Service and the taxpayer may seek to use the closing agreement as information or evidence to support a resolution similar to that reached in the closing agreement, but the closing agreement cannot bind the taxpayer or the Service in any way for that year.

Instead, the phrase "related specific items affecting other taxable periods" is used by the Service to accommodate those cases where the nature of the transaction resolved in a closing agreement for one year necessitates a binding affect on that taxpayer's liability in another year. The regulation for section 7121 states that "[c]losing agreements with respect to taxable periods ending subsequent to the date of the agreement may relate to one or more separate items affecting the tax liability of the taxpayer." Treas. Reg. §301.7121-1(b)(3). In the regulations, there is the following illustration of this concept:

> A owns 500 shares of stock in the XYZ Corporation which he purchased prior to March 1, 1913. A is considering selling 200 shares of such stock but is uncertain as to the basis of the stock for the purpose of computing gain. Either prior or subsequent to the sale, a closing agreement may be entered into determining the market value of such stock as of March 1, 1913, which represents the basis for determining gain if it exceeds the adjusted basis otherwise determined as of such date. Not only may the closing agreement determine the basis for computing gain on the sale of the 200 shares of stock, but such an agreement may also determine the basis (unless or until the law is changed to require the use of some other factor to determine basis) of the remaining 300 shares of stock upon which gain will be computed in a subsequent sale.

Treas. Reg. §301.7121-1(b)(4). This regulation was last amended on October 24, 1960, and was therefore in effect at the time of the execution of the Agreement. The significant feature of this example is that it is the determination of the tax consequences of a *past* basis-determining transaction, the acquisition of the shares, (which could represent multiple transactions, although that is irrelevant) that has effect in future years. Essentially, the binding determination made by the Service and the taxpayer, due to the nature of the past transaction, must be applied to future years to ensure accurate determination of the taxpayer's tax liability in those years. In fact, in the example above, the tax liability of those future years would be impossible to determine accurately without reference back to the determination made in the year covered by the closing agreement.

This is markedly different from the interpretation urged by the Taxpayer, in which it seeks to have the treatment of a transaction in a certain year applied to a *different* transaction in a future year. While the treatment of a transaction in one year may provide a good indication of the proper treatment of a transaction of the same type in a future year, the treatment in the earlier year cannot affect the later year in such a way to bind the Service with the finality of a closing agreement. The Service is free, using the analogy to Sunnen, to examine the later transaction independently of the prior transaction. Accordingly, the recurring transactions in which the Taxpayer was engaged in during and subsequent to the years covered by the Agreement do not fit the meaning of "related specific items affecting other taxable periods."

As the Taxpayer's transactions are not in the nature of related specific items, and the Acting Chief of the Appellate Branch office clearly lacked the authority to expressly bind the Service for future years, the Agreement was binding on the Service only for tax years ending prior to Date 2.

ADMINISTRATIVE RELIEF AND OTHER ACTIONS

Notwithstanding the above, the Service has determined in accordance with § 7805(b)(8) that it will not apply the position in this TAM to the tax years at issue. This relief has been granted based on the totality of the circumstances including but not limited to equitable considerations with regard to the closing agreement and administrative difficulties with determining the precise point that the marketplace and

[5] No inferences are intended by the grant of this relief under § 7805(b)(8).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[5] The Service has recently issued proposed regulations clarifying the intended scope of § 1221(a)(4). Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable, 71 Fed. Reg. 44,600 (Aug. 7, 2006). Those regulations propose a prospective effective date tied to the issuance of the final regulations.