DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
May 11, 2001

OFFICE OF
CHIEF COUNSEL

Number: **20043003**
Release Date: 10/26/2001
TL-N-293-01
C:PA:APJP:B3:DAAbernathy
UILC: 1311.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Richard G. Goldman
Chief, Branch 3, Office of Assistant Chief Counsel
(Administrative Provisions and Judicial Practice)
CC:PA:APJP:B3

SUBJECT: Proposed Correction of Error Under I.R.C. § 1311

This Field Service Advice responds to your memorandum dated February 8, 2001. In accordance with I.R.C. § 6110(k)(3), this Field Service Advice should not be cited as precedent.

LEGEND

X =

A =

B =
C =

Year 1 =	\$a =	\$d =
Year 2 =	\$b =	y% =
Year 3 =	\$c =	z% =

ISSUE

A taxpayer overstated its life insurance reserves for a tax year that is now closed. In a subsequent tax year, another taxpayer, with whom the first taxpayer had merged, reduced its life insurance reserves by the amount of the overstatement, but did not take the amount of the overstatement into gross income. Assuming the latter position is sustained by a determination under I.R.C. § 1313(a), do the mitigation provisions of I.R.C. §§ 1311 through 1314 authorize the Internal Revenue Service ("Service") to adjust the error in the closed tax year?

CONCLUSIONS

The Service may not correct the error in the closed tax year, because the mitigation provisions do not authorize an adjustment in these circumstances.

FACTS

In Year 1, X purchased the stock of A and its subsidiaries, B and C. In Year 2, X and A merged and A became a subsidiary of X.

For its Year 2 tax year, A filed two short-period tax returns, one under A's Employer Identification Number ("EIN") for the period beginning on the first day of Year 2 and ending on the day before the merger, and the other as a consolidated return with X for the period beginning on the day of the merger and ending on the last day of Year 2. A ratably allocated its Year 2 revenue and deduction items to each return. In computing its life insurance reserves for Year 2, A overstated the reserves by $a, thereby overstating its deduction in that amount. A allocated y% of the overstatement to the return it filed for the short tax year ending on the day before the merger date. A allocated z% of the overstatement, $b, to the consolidated return filed with X for the short tax year ending on the last day of Year 2. X reported ending life insurance reserves in the total amount of $c on this return.

In preparing its return for Year 3, X realized that its Year 2 reserves were overstated by $a. Instead of amending the tax returns filed for Year 2, or including the amount of the overstatement into income for Year 3, X reported reserves at the beginning of Year 3 in the amount of $d, which was $a less than $c. In other words, X decreased the amount of its life insurance reserves for Year 3 without a corresponding adjustment to gross income.

X now asserts that it should have corrected the overstatement of reserves by filing an amended return for its short tax year ending on the last day of Year 2 and having A amend its return for its short tax year ending on the day before the merger date. The period of limitations for making an assessment remains open for X's short tax year ending on the last day of Year 2 and for X's Year 3 tax year. But the period of limitations is closed for A's short tax year ending on the day before the merger.

LAW AND ANALYSIS

In certain circumstances, the mitigation provisions of I.R.C. §§ 1311 through 1314 lift the bar of the period of limitations on assessing taxes. See Bolten v. Commissioner, 95 T.C. 397, 400 (1990). Congress, however, has strictly limited the use of these provisions. 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, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See I.R.C. § 1311(a).

- Second, there must be a "determination" for an open tax year. As defined in I.R.C. § 1313(a), a "determination" is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treas. Reg. § 1.1313(a)-4.

- Third, the determination must result in a circumstance under which an adjustment is authorized by I.R.C. § 1312. The seven circumstances under which an adjustment is authorized involve double inclusion of an item of gross income (I.R.C. § 1312(1)); double allowance of a deduction or credit (I.R.C. § 1312(2)); double exclusion of an item of gross income (I.R.C. § 1312(3)); double disallowance of a deduction or credit (I.R.C. § 1312(4)); correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (I.R.C. § 1312(5)); correlative deductions and credits for certain related corporations (I.R.C. § 1312(6)); and basis of property after erroneous treatment of a prior transaction (I.R.C. § 1312(7)).

- Fourth, depending on which circumstance of adjustment applies, either an inconsistent position must be maintained by the party against whom mitigation will operate, I.R.C. § 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. I.R.C. § 1311(b)(2).

The first of the four conditions has been met in this case. A erroneously overstated its ending life insurance reserves for its short tax year ending on the day before the merger. 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 condition has yet to be met because there has not been a determination, as defined by I.R.C. § 1313(a), for the open year, Year 3. But even if a determination were to sustain X's position for Year 3, the Service would be authorized to correct the error A made in the closed short tax year only if both the third and fourth conditions were met.

The third condition would be met if a determination for X's Year 3 tax year resulted in one of the circumstances under which an adjustment is authorized by I.R.C. § 1312. A determination that X has properly reported its life insurance reserves for Year 3 will not have this effect, even though it will provide a windfall to X.

Benefit to one party is not the standard by which an adjustment is authorized under the mitigation provisions, as the case law illustrates. In Scwartz v. United States, 67 F.3d 838 (9th Cir. 1995), the taxpayers reported an ordinary loss from an options straddle in an earlier year. In a later year, the taxpayers reported a capital gain from that straddle. The Tax Court determined that the taxpayers were not entitled to the loss claimed in the earlier year, and the taxpayers filed a claim for refund of the tax paid on the capital gain reported in the later year. Because the later year was barred, the taxpayers based their claim, in part, on the application of the mitigation provisions. The court of appeals decided that the loss claimed by the taxpayers in the earlier year was not an item included in gross income, as that term is defined by the Internal Revenue Code. Instead, the loss was an item that was deducted from gross income to determine tax liability. Thus, the taxpayers' situation did not fall within one of the circumstances of adjustment set forth in I.R.C. § 1312 and the period of limitations barred a refund. Id. at 840-41.

In B.C. Cook & Sons v. Commissioner, 65 T.C. 422 (1975), aff'd, 584 F.2d 53 (5th Cir. 1978), non acq., 1977-2 C.B. 2, the Tax Court strictly construed the definition of the term "deduction" in determining that, under I.R.C. § 1312(2), the mitigation provisions apply only when both years at issue involve a "deduction." In B.C. Cook & Sons, the taxpayer, a fruit distributor, discovered that a bookkeeper in its employ had embezzled a substantial sum of money by writing checks for fictitious fruit purchases. These checks were reflected on the taxpayer's books as part of cost of goods sold, and reduced the taxpayer's gross income during each year the embezzlement occurred. For the year in which it discovered the theft, the taxpayer claimed a deduction for unrecovered losses. The United States Tax Court held that the deduction was allowable, and further held that the mitigation provisions did not authorize an adjustment in the earlier tax years, which were closed. The court reasoned that the reductions in gross income in the closed years were not deductions within the meaning of I.R.C. § 1312(2). B.C. Cook & Sons v. Commissioner, 65 T.C. at 428.

The Service has not acquiesced in the Tax Court's decision in B.C. Cook & Sons. See A.O.D. 1977-77 (April 4, 1977). In the action on decision, the Service stated that "[t]he decision of the Tax Court applies an overly-literal interpretation of the word 'deduction' as used in Code § 1312(2). The term 'deduction' in Code § 1312(2) should be interpreted to refer to items which reduce gross income whether included in the cost of goods sold or deducted from gross income in the technical sense."

The facts presented in the instant case are distinguishable from the facts in the action on decision. In the case at hand, the taxpayer took an erroneous deduction in a closed tax year and did not include in gross income in an open tax year an amount corresponding to the erroneous deduction. In contrast, in B.C. Cook & Sons the taxpayer erroneously reduced gross income in a closed year and took a deduction in a corresponding amount in an open tax year. The reasoning of the action on decision does not apply to the facts of this case.

If X's position for its Year 3 tax year is sustained in a determination, it will secure a benefit. But the error in A's short tax year ending on the day before the merger is not one for which an adjustment is authorized under the mitigation provisions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Although the issue was not raised and the facts may not be developed at this point, we recommend that you consider the possibility of arguing the duty of consistency. The duty of consistency doctrine requires the presence of three elements: (1) a representation by the taxpayer; (2) reliance on the representation by respondent; and (3) an attempt by the taxpayer, after the statute of limitations has run, to change the representation. See Unvert v. Commissioner, 72 T.C. 807 (1979); Hollen v. Commissioner, T.C. Memo. 2000-99. At this point, we are not certain whether the duty of consistency applies, but we want to raise this as a potential consideration. We will provide any assistance necessary in developing this issue.

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.

Please call if you have any further questions.