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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL,

FROM: Heather C. Maloy
Associate Chief Counsel (Income Tax & Accounting) CC:ITA

SUBJECT: Request for Field Service Advice on Tax Consequences of Right to and Receipt of Insurance Proceeds and Related Assessment Period

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

LEGEND

X =
Y =
Z =
FY =
year 1 =
year 2 =
year 3 =
year 4 =
year 5 =
date 1 =
date 2 =
date 3 =
date 4 =
date 5 =

date 6 =

date 7 =
date 8 =
date 9 =
date 10 =
date 11 =
date 12 =
date 13 =
$a =
$b =
$c =
$d =
$e =
$f =
$g =
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$i =
$j =
$k =
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$m =
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$o =
$p =
$q =
$r =
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$u =
$v =
$w =

<u>ISSUES</u>

1. What is the proper taxable year for inclusion of gross income of insurance proceeds claimed under a loss and business interruption insurance policy?

2A. Whether a restricted consent (on Form 872) prepared pursuant to I.R.C. § 6501(c)(4) extends the general three year period of limitations under § 6501 to allow the assessment of tax on insurance proceeds? Has the period for assessment of the increase in tax shown on X's amended return for year 1 has expired?

2B and 2C. Has the special period of limitations under §§ 1033(a)(2)(C) and (D) for assessing tax on insurance proceeds expired?

CONCLUSIONS

1. Taxation of the transaction is governed by §§ 1033 and 451. Amounts claimed by X on its proofs of loss in years 1, 2, and 3 are properly includible in its gross income for the year in which the proofs of loss were filed by X and paid by Y. To the extent disputed by Y, amounts claimed by X on its proofs of loss made during years 4 and 5 are not includible in X's gross income until the litigation between the parties is settled and the additional amount to be received by X, if any, is determinable. Further factual development is required to determine whether amounts accrued by X in years 1 and 2 were properly includible in gross income during those years. To the extent the field determines that a dispute existed between X and the insurer regarding these amounts, accrual is improper.

2A. The restricted consent does not extend the general three year period of limitations under § 6501 to allow the assessment of tax on insurance proceeds. Accordingly, the period of limitations for assessment for year 1 has expired.

2B. & C. For year 1, the special period of limitations in § 1033(a)(2)(C) and (D) only remain open for the amounts not reported on Form 1120X. For the amounts reported by the taxpayer on Form 1120X, the period of limitations for assessment has expired. The periods of limitations for assessment for years 2, 3, and 4 are open.

FACTS

X is the parent of a group of subsidiary corporations that file consolidated federal income tax returns for taxable years ending FY. X and its subsidiaries use the accrual method of accounting for federal income tax purposes. One of X's businesses involves manufacture, warehousing, and distribution. On date 1, a destroyed the property located at X's Z manufacturing facility.

Y provided insurance coverage on Z totaling $a. While we have not been furnished a copy of the policy, you state that documents indicate that the policy provides coverage for loss, as well as coverage for lost earnings due to business interruption and reimbursement of expenses incurred to reduce the business interruption losses.

Insurance adjustment activities related to X's loss began on date 2. In the early weeks after the X and Y agreed on an adjustment process that provided for the following activities:

(a) Creating teams of employees and representatives of consultants employed by X and Y;

(b) Collecting information and documents related to X's plans to rebuild the Z facility;

(c) Preparing estimates of costs to replace the

(d) Tracking the actual costs and other data necessary to support X's insurance claim, including the costs of

(e) Identifying and evaluating improvements, betterments, and modifications;

(f) Setting target dates for reaching agreement on major segments of X's loss claim; and

(g) Payment by Y for the agreed and settled categories of loss, subject to an ongoing audit of actual rebuilding costs and business interruption loss.

While X substantially completed rebuilding the facility by date 4, it was not until date 5 that Y and X reached an agreement that the building loss consisted of direct costs of $b. The parties also identified the indirect costs incurred and a formula and methodology to apportion the indirect costs to the rebuilding project.

Under the adjustment process agreed to by X and Y, X submitted eight partial proofs of loss to Y during year 1 seeking recoveries in an amount totaling $c, and Y paid these amounts to X. The proceeds were allocated by X and Y as follows:

$d

$e reimbursement of expenses
$f

X reported the full amount of these proceeds on its income tax return for year 1. In addition, X accrued on its income tax return additional income of $g related to its right to receive proceeds for business interruption expenses incurred.

During year 2, X submitted five partial proofs of loss to Y seeking recoveries in an amount totaling $h, and Y paid these amounts to X. X reported the full amount of these proceeds on its income tax return for year 2. In addition, X accrued on its income tax return additional income of $i related to its right to receive proceeds for business interruption expenses incurred.

During year 3, X submitted one partial proof of loss to Y seeking recovery in the amount of $j, and Y paid this amount to X. X reported the full amount of these proceeds on its income tax return for year 3.

You indicate that the proofs of loss filed in years 2 and 3 do not reflect any allocation of the loss among or business interruption. You further note that the file contains no contemporaneous documents from X or Y reflecting the purpose of the payments to X during these years. A document prepared by Y during year 4 indicates only that the partial payments covered accumulated covered costs and an ongoing assessment of X's business interruption loss. Y placed no restrictions on X's receipt or use of any of the proceeds paid in years 1, 2, and 3. In addition, you note that there is no evidence that X engaged in any conduct merely to delay the computation of the amount of its recoverable claim or the timing of any agreement as to liability and damages.

In Date 6, X filed an amended return for year 2 that reduced its reported income for year 2 by the amount of $k. This amount consists of the accruals of income made on the original income tax returns for tax years 1 and 2 in the amounts of $g and $i, respectively. X explained the reason for the reduction on the amended return as follows:

> Insurance claim receivable recorded on books as income. The receivable was contested by the insurance carrier and is therefore not fixed and determinable at the fiscal year ended year 2 – $k.

No action has been taken on this amended return.

You indicate that, at least as of year 3, a dispute existed between X and Y regarding significant portions of X's insurance claim. Sometime before date 8, X commenced suit against Y with respect to the amount to be paid under the policy. There is apparently no information regarding the details of the dispute involved in that litigation or the exact date the litigation commenced. However, as a result of the litigation, the informal adjustment process discussed above (under which X received payments based on its partial proofs of loss) ended. This litigation is still pending and that a significant disagreement between X and Y involves the method of computing the recovery for business interruption coverage. Specifically, there is disagreement regarding the the business interruption recovery and whether the computation should assume that production was totally suspended at Z.

On Date 8, X filed a proof of loss claiming that its total recoverable loss amounted to $l. In response to this claim, Y determined that X's recoverable loss totaled $m. Because Y had already paid X a total of $n during the previous three tax years, Y computed a net amount due of $o and paid this amount to X on date 10. Exam has not verified whether X included this payment in its income tax return. As with Y's other payments to X, no restrictions were imposed on the receipt or use of this payment. Along with this payment, Y rejected X's date 8 proof of loss. Additionally, Y expressly reserved all rights or defenses under the policy with X, and invoked provisions of the policy calling for the use of disinterested appraisers in the event the parties fail to agree to the amount of the loss. The facts presented indicate that much of the discrepancy between the amount claimed by X in its date 8 claim and the amount determined by Y in its date 10 response is attributable to amounts claimed for business interruption coverage and loss mitigation expense reimbursement.

On date 11, X submitted a revised proof of loss reflecting a total recoverable loss of $p. Taking into account payments previously received from Y, X claimed a net amount due of $q. On date 12, Y rejected X's net claim and expressly reserved all rights or defenses under the insurance policy.

<u>Tax Return Treatment</u>

On Form 1120 for year 1, X reported $r in taxable income, including $g in accrued taxable insurance proceeds and $s in nontaxable insurance proceeds for which it was making an election under § 1033. For year 2, X reported $t in taxable income, including $u in insurance proceeds and the accrual of $i relating to the right to receive proceeds for business interruption expenses. For year 3, X reported $v in taxable income, including $w of the insurance proceeds. It is unknown what the portion allocated to business interruption proceeds and reimbursement of mitigation expenses was for years 2 and 3. .

On date 7, X submitted an amended return on Form 1120X for year 2 that adjusted the taxable insurance proceeds accrued for both year 1 and year 2, alleging that those proceeds were no longer considered fixed and determinable. X delivered the amended returns to the Service official in charge of the examination of the years before year 1 and asked that a refund claimed for an earlier year be netted against the increase on the amended return for year 1. The claim has never been acted on by the Service and X has not taken any further action.

On date 9, X submitted amended returns on Form 1120X for year 1 and year 2 that reallocated the amounts between taxable and nontaxable insurance proceeds. The amended returns reclassified insurance proceeds from amounts for which the 1033 election applied to taxable business interruption insurance proceeds.[1] This claim has never been acted on.

The period of limitations for assessment for year 1 has been extended by a restricted consent. After year 4, X was requested to execute a consent to extend the period of limitations for assessment. X was not willing to provide an unrestricted consent. The consent in question was restricted to the adjustment to income, gain, or loss attributable to an unrelated issue, which was an issue in a prior year. Subsequently, other restricted consents have been executed for year 1.

Unrestricted consents have been signed for years 2, 3, 4, and subsequent years.

LAW AND ANALYSIS

Issue 1

An involuntary conversion resulting from a is generally treated as a sale or exchange. Under § 1001(c), the entire amount of a gain realized from a sale or exchange of property is recognized in the year the gain is received. A taxpayer realizes gain on the loss to the extent that the related insurance proceeds exceed the adjusted basis of the destroyed property. In Central Tablet Manufacturing Co. v. United States, 417 U.S. 674, 676 (1974), a occurred in 1965, but the claims were settled and paid in 1966 and 1967. Accordingly the taxpayer realized gain in the later years.

§ 1033(a)(2) of the Internal Revenue Code provides an exception to the general rule. If property (as a result of its destruction in whole or in part) is compulsorily or involuntarily converted into money, and if the taxpayer, for the purpose of replacing

[1] These proceeds had been used to purchase nonqualifying replacement property and to make improvements.

the property so converted, purchases other property similar or related in service or use to the property so converted, then, at the election of the taxpayer, the gain, if any, shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property.

§ 1.1033(a)-2(c)(7) of the Income Tax Regulations provides that if the taxpayer makes an election under § 1033, the gain upon the conversion is recognized to the extent that the amount realized upon the conversion exceeds the cost of the replacement property, regardless of whether the amount is realized in one or more taxable years.

§ 1.1033(a)-2(c)(8) provides that the proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been. Accordingly, in this case, X cannot claim section 1033 treatment on the business interruption portion of the insurance proceeds.

Under §1033(a)(2)(B), the replacement period begins with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ends (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or (ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer.

X properly elected § 1033 treatment and the replacement property was acquired during the replacement period. The open question is in what year are the insurance proceeds that do not qualify for §1033 taxed.

§ 451(a) provides that the amount of any item of income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.

Under an accrual method of accounting, it is the right to receive an item of income and not the actual receipt that determines the inclusion of the amount in gross income. Spring City Foundry v. Commissioner, 292 U.S. 182, 184 (1934). §1.451-1(a) of the Income Tax Regulations clarifies that, under an accrual method, income is includible in gross income when all the events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy.

Where the right to receive an item is in dispute, income is not properly accruable until the dispute is resolved. North American Oil Consolidated v. Burnet, 286 U.S. 417, 423 (1932); H. Liebes & Co. v. Commissioner, 90 F.2d 932, 938 (9th Cir. 1937). The propriety of an accrual must be judged by the facts which the taxpayer knew or could reasonably be expected to know at the end of its taxable year. Camilla Cotton Oil Co. v. Commissioner, 31 T.C. 560, 567 (1958).

In applying these principles to cases concerning the accrual of insurance proceeds, courts generally consider whether there has been a recognition of liability by the insurer and whether the amount of the proceeds can be reasonably approximated. See, e.g., Maryland Shipbuilding and Drydock Co. v. United States, 409 F.2d 1363, 1369 (Ct. Cl. 1969). Where liability is not disputed by the insurer and the amount of the recovery can be reasonably approximated, income accrues in the year of the loss, despite the fact that the ultimate amount of the recovery is not known at the time of accrual. See, e.g., Cappel House Furnishing Co. v. United States, 244 F.2d 525 (6th Cir. 1957); Worstell Co., Ltd. v. Commissioner, 15 B.T.A. 413, 414 (1929); Kurtz v. Commissioner, 8 B.T.A. 679, 684 (1927). On the other hand, where the insurer disputes its liability or takes a position which makes it quite uncertain whether the bulk of the claim will be recoverable, accrual in the year of loss is improper. See, e.g., Central Tablet Manufacturing Co. v. United States, 417 U.S. 673, 695 (1974) (dissenting opinion); Maryland Shipbuilding and Drydock, 409 F.2d at 1368; Thalhimer Brothers, Inc. v. Commissioner, 27 T.C. 733, 739 (1957).

There is no bright-line standard for determining whether there has been a recognition of liability by the insurer. Rather, cases are decided based on the particular facts and circumstances, taking into consideration the provisions of the insurance policy and other evidence that tends to establish whether and to what extent the insurer acknowledged liability to the insured. See, e.g., Maryland Shipbuilding & Drydock, 409 F.2d at 1369 (insured not required to accrue insurer's settlement offer where acceptance of the offer would have required the insured to surrender its right to seek additional recovery); Cappel House Furnishing, 244 F.2d at 530 (insured required to accrue expected recovery where the evidence demonstrated that the insurer did not dispute the fact of its liability under the policy, but only disputed the measurement of its liability under the policy); Curtis Electro Lighting, Inc. v. Commissioner, 60 T.C. 633 (1973), vacated and remanded in unpublished opinion, 532 F.2d 756 (7th Cir. 1976) (insured not required to accrue amounts where insurer, although it never contested its liability, retained its freedom throughout the adjustment process to deny any and all liability); Rite-Way Products, Inc. v. Commissioner, 12 T.C. 475, 480 (1949) (insured required to accrue expected recovery where insurer never denied its liability under the policy but only disputed the amount of its liability and the method of computing the amount); Georgia Carolina Chemical Co. v. Commissioner, 3 T.C.M. (CCH) 1213 (1944) (insured not required to accrue a recovery negotiated with the insurer's adjuster where the insurer retained the right to impose a co-insurance provision on the insured).

Although there might exist a recognition of liability by the insurer, accrual is improper unless the amount of the recovery is subject to reasonable approximation. In determining whether the amount of a recovery is subject to reasonable approximation, courts have considered whether the taxpayer has in its books and records the data necessary to ascertain the amount of the recovery within reasonable limits. Cappel House Furnishing, 244 F.2d at 530 (insured required to accrue expected insurance recovery for lost earnings where the insurer's liability was fixed and the taxpayer had in its books the necessary earnings information to estimate the amount of the recovery); see also Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 296 (1932) (accrual of an award was required where legislation fixed the taxpayer's right to the award and the amount of the award was based on information contained in taxpayer's own accounting records).

Notwithstanding the principle that it is the right to receive income and not actual receipt that governs inclusion, amounts received by an accrual method taxpayer under a claim of right and without restriction as to disposition or use are includible in gross income in the year of receipt even though at the time of receipt conditions exist that might require the taxpayer to return part or all of the amounts. North American Oil Consolidated, 286 U.S. at 424. Courts have applied this claim of right doctrine in cases involving an accrual method taxpayer's receipt of proceeds resulting from an involuntary conversion. See Estate of Resler v. Commissioner, 17 T.C. 1085 (1952) (condemnation award paid to the taxpayer was includible in the taxpayer's income when received under a claim of right, notwithstanding the fact that a court proceeding brought by the taxpayer challenging the adequacy of the award was not settled until two years later); Georgia Carolina Chemical Co. v. Commissioner, 3 T.C.M. (CCH) 1213 (1944) (taxpayer received insurance proceeds under no restrictions as to their use or enjoyment).

Proofs of Loss in years 1, 2, and 3

X filed proofs of loss during its tax years 1, 2, and 3. Based on the facts presented, we conclude that X properly included the insurance proceeds received upon these proofs of loss in its gross income for each of the years in which it filed its proofs of loss and received payment from Y.

The facts indicate that immediately after the X and Y developed an informal insurance adjustment process under which the parties would assess the extent of X's loss, set targets for reaching agreement on the elements of X's insurance claim, and pay X for the agreed and settled elements of its loss, subject to an ongoing audit of the loss. Under this process, X filed partial proofs of loss and received payment of its claimed losses. We conclude that amounts claimed and recovered by X under this adjustment process are properly includible in gross income for the year X filed its respective proofs of loss and received payment. The facts do not indicate any dispute as to these proofs of loss. Not only did Y pay these amounts upon receipt of the proofs of loss, but it subsequently confirmed, by its date 10 letter to its liability for these amounts. Finally, there is no indication that Y's agreement to these amounts was conditioned on X abandoning or compromising the remainder of its claim. See, e.g., Johnson v. Commissioner, 6 T.C.M. (CCH) 255 (1947) (accrual of uncontested portion of overall claim proper).

Moreover, even if facts are discovered indicating that Y disputed the amounts claimed in these proofs of loss, the amounts received by X are properly includible in gross income in the year of receipt under the claim of right doctrine. The facts indicate that X claimed a right to these amounts under its insurance policy. In addition, X had unrestricted use during years 1, 2, and 3 of insurance proceeds in the respective amounts of $c, $h, and $j. Under the claim of right doctrine, X must include these amounts in gross income in the years received. See North American Oil Consolidated, 286 U.S. at 424.

The facts presented do not establish that amounts claimed on X's proofs of loss in years 1, 2, and 3 should have accrued any earlier than the years in which the proofs of loss were filed. Courts will not permit a taxpayer to defer income by delaying the filing of its claim for insurance proceeds. See Cappel House Furnishing, 244 F.2d at 530 (insured's delay in presenting its claim and in computing its lost earnings will not result in deferral of insurance proceeds to a subsequent taxable year). The facts presented here indicate that X and Y followed an informal adjustment process that called for payment as each segment of X's loss was agreed upon and settled.

Years 4 and 5 Proofs of Loss

On dates 8 and 11, X filed proofs of loss claiming total recoverable losses of $l and $p respectively. On date 10, Y paid only an additional $o in response to the date 8 proof of loss. Y rejected the date 11 proof of loss to the extent it exceeded amounts already paid, and disclaimed further liability. We conclude that, except for the $o received by X on date 10, no amount claimed by X from Y on these proofs of loss is accruable in years 4 and 5.

The facts indicate that at least as early as year 3 a dispute existed between X and Y regarding the extent of the loss. The facts also indicate that X filed suit against Y before date 8, and that the primary area of dispute involved the method of computing X’s business interruption coverage. A comparison of amounts shown on the year 4 and year 5 proofs of loss to amounts shown on Y’s year 4 determination of liability confirms that the discrepancy between the parties is mostly attributable to the computation of business interruption coverage and expense reimbursement.

Where a dispute exists between an insurer and an insured, income is not accruable until the dispute is resolved. Maryland Shipbuilding and Drydock, 409 F.2d at 1368 (insurer’s refusal to pay insured’s claim deprives policy proceeds of the fixed status essential to accrual); Thalhimer Brothers, 27 T.C. at 739 (right to insurance proceeds was not fixed where a dispute existed between the insured and the insurers regarding subrogation). Because the facts indicate the existence of a dispute between X and Y as of the date the proofs of loss were filed, only the additional amount of liability acknowledged by Y in year 4 ($o) is includible in X’s gross income. This amount is includible in gross income for year 4.

Issue 2A

A restricted consent allows the period of limitations to expire for all items on a return except those covered by the restricted language. See IRM 121.2.22.8(1), *Restricted Consents* (01-01-2000). We agree with the conclusions reached on this issue in the draft FSA.

Issue 2B &C

§§ 1033(a)(2)(C) and (D) provide special statutes of limitations for assessment of tax that might arise when a taxpayer makes an election under § 1033(a)(2). § 1033(a)(2)(C) provides that if a taxpayer has made the election in § 1033(a)(2)(A)

> The statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe,) of the replacement of the converted property or of an intention not to replace

§ 1.1033(a)-2(a)(5) of the Income Tax Regulations provides that any deficiency attributable to a gain may be assessed at any time before the expiration of 3 years from the date the district director with whom the return for the year of conversion has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of § 6212(c). If replacement has been made, the notification must contain all of the details in connection with the replacement.

The regulation states that the requisite notification should be made in the return for the year in which the replacement occur and does not explicitly state that the notification can be made on an amended return. However. § 1.1033(a)-2(c)(2) provides, in part:

> If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an "amended return."

The limitations periods under § 1033 are independent of and override the limitation periods provided by other Code provisions, including § 6501. Vaira v. Commisioner, 52 T.C. 986 (1969), acq. 1972-3 C.B. 3, rev'd on other grounds, 444 F.2d 770 (3d Cir. 1971). The first special period for assessment of a deficiency for any year during which any part of the gain in an involuntary conversion is realized does not expire before three years from the date that the taxpayer notifies the Service in accordance with applicable regulations of the taxpayer's (a) replacement of the converted property, (b) intention not to replace the destroyed property, or (c) failure to replace the destroyed property within the replacement period. When a taxpayer fails to satisfy the notice provisions, the special limitations period will not expire. Au Hoy v. Commissioner, 58 T.C. 201 (1972).

The second special limitation period for assessment applies to any deficiency in income tax attributable to any election under § 1033 for any year in which a gain on an involuntary conversion is realized and is the limitation period of the last taxable year during which any part of the gain is realized by the taxpayer. In such a case, when the taxpayer purchases replacement property before the last year during which any part of the gain is realized, any deficiency under § 6211 attributable to the election under § 1033 may be assessed within the limitation period for assessment for the last taxable year during which the taxpayer realizes the gain.

As a general rule, nothing in the Code requires the Service to accept an amended return. While the decision in Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977) is often cited for the proposition that the Service recognizes amended returns as a matter of internal agency discretion, we also want to point out that the Tax Court has indicated that the Service's acceptance of amended returns is 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).

We note that this rationale has been applied to § 1034 elections. See Rager v. Commissioner, T.C. Memo. 1984-563, aff'd on other grounds 775 F.2d 1081 (9th Cir. 1985). Rager holds that the Service is not obligated to assess tax reported on an amended return but can, instead, use the deficiency procedures. However, we do not believe that Rager holds that an amended return could not start the running of the special period of limitations when an amended return is required by regulations.

We believe that, under the facts of this case, the submission of the amended return on date 9 reallocating the insurance proceeds between taxable and nontaxable income started the running of the special period of limitations for assessment. In this case the two portions of the regulations may not be wholly consistent. § 1.1033(a)-2(c)(5) requires that the notification be made on "the return" and while an amended return might not be a return, § 1.1033-2(c)(2) specifically requires that if, after having made an election under section 1033(a)(2), replacement is made at a cost lower than was anticipated at the time of the election, the tax liability for the year or years for which the election was made shall be recomputed on an "amended return." While it could be argued that the Service is free, under the rationale discussed above, to ignore the amended return, we think that this is not the best view.

We also question whether the present situation falls within the third factual context in Koch. In particular, we question whether the taxpayer's reporting of the insurance proceeds on the original return for the year ended year 1 can be characterized as improper; you suggest that the Form 1120X properly reclassified the proceeds. Additionally, as noted above, the regulations required X to notify the Service that it was not reinvesting all the insurance proceeds. Thus, to the extent that this is discretionary, it would appear that this could be a situation in which the Service should use its discretion to accept the amended return.

If X's Form 1120X for year 1 properly reclassified the taxable and nontaxable portions of the insurance proceeds originally reported as being used to replace qualified replacement property, that Form 1120X constituted X's notification to the

Service that X failed to use the taxable insurance proceeds for qualified replacement property within the 2-year replacement period. Accordingly, the period of limitation for assessment of any additional tax expired on date 13.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Year 1 and Year 2 Accruals

[redacted]

[redacted]

[redacted]

Restricted Consent Issue

We question the statement on page 17 that "[t]he Forms 872 did not restrict X's ability to file refund claims on any ground." At this time, we do not believe that the law is clear concerning whether a restricted consent limits a taxpayer's ability to obtain a refund on only those items identified in the restricted consent.

We also considered the question whether there are any other remedies if the applicable period of limitations on assessment (§§ 6501 or 1033) has expired. If the taxpayer claims a refund for year 1 and the statute of limitations is open for a refund claim, then, as provided in the draft FSA, the Service may seek to offset that claim with an underpayment even though any period of limitations for assessment of a deficiency for that underpayment has expired.

For additional guidance on application of §§ 6501 and 6511 to such a situation, please contact CC:PA:APJP:B2.

Mitigation Issue

If the Taxpayer's refund claim for year 2 as submitted on date 9 is denied because it improperly subtracts the amount of the taxable insurance proceeds accrued in year 1 from the following tax year, but the Service, nevertheless, agrees that the amount is properly accrued in a tax year other than year 1, X may seek to apply other remedies to the closed year (e.g., apply the mitigation provisions in §§ 1311–1314) to remove the accrual from year 1 after the Service includes the accrual in the proper (open) tax year and denies a refund for the removal of the accrual from year 2.[2] You may wish to advise the revenue agent who is requesting this advice that if the taxpayer seeks to use the mitigation provisions of §§ 1311–1314, the agent should coordinate with CC:PA:APJP:B3.

If mitigation of the statute of limitations or another remedy was to allow the taxpayer to claim a refund for the accrual for year 1, then the Service could assert that the amount that was not assessed from the amended return submitted on date 6 should offset any overpayment for year 1 under the rationale of Lewis v. Reynolds, 204 U.S. 281 (1932).
For additional guidance on overpayments and the concept of offset, we suggest you contact CC:PA:APJP:B1.

Finally, we note that the citation to Piarulle v. Commissioner should reflect the following: acq., 1984-1 C.B. 1, AOD 1984-009 (Jan. 23, 1984).

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 202-622-4920 if you have any further questions.

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[2] As indicated above, we question the statement on page 17 that "[t]he Forms 872 did not restrict X's ability to file refund claims on any ground."