INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR: Associate Area Counsel, Large and Mid-size Business
CC:LM:HMT:

FROM: Associate Chief Counsel (Income Tax & Accounting)
Branch 2
CC:IT&A:B02

SUBJECT: Timing of taxpayer's deduction of interest on partial payments of proposed tax deficiencies

This Chief Counsel Advice responds to your memorandum dated January 23, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

= Audit Team Coordinator

= Year 1

= Year 2

= Year 3

= Year 4

= Year 5

= Year 6

= Year 7

= Date 1

= Date 2

= Date 3

= Date 4

$ = Amount W

$ = Amount X

$ = Amount Y

$ = Amount Z

ISSUES

1. Whether taxpayer's Year 4 remittances to the Service relating to proposed tax adjustments for its Year 1 and Year 2 tax years should be characterized as payments or deposits in the nature of a cash bond and whether the Service could have assessed these remittances in Year 4.

2. Whether unpaid interest on a portion of taxpayer's proposed income tax deficiencies for tax years Year 1 and Year 2 to which taxpayer allegedly agreed was accruable in Year 4 or in Year 6.

3. Whether taxpayer's request to accrue the interest on a portion of its proposed income tax deficiencies in Year 4, rather than in Year 6, represents an unauthorized change in accounting method.

CONCLUSIONS

1. Taxpayer's Year 4 remittances relating to a portion of its proposed Year 1 and Year 2 income tax deficiencies constituted payments that the Service could have assessed in that year.

2. The unpaid interest relating to a portion of the proposed deficiencies for tax years Year 1 and Year 2 to which taxpayer allegedly agreed was not accruable until Year 6.

3. There are insufficient facts to determine whether taxpayer's request to accrue the interest on a portion of its proposed income tax deficiencies in Year 4, rather than in Year 6, represents an unauthorized change in accounting method.

FACTS

The facts are based on your memorandum requesting advice, the attached exhibits, and telephone conversations with Audit Team Coordinator in the Examination Division [hereinafter "Exam"]. In Year 3, the Service commenced an audit of taxpayer's Year 1 and Year 2 tax years. Exam proposed numerous income tax adjustments for both tax years. During the course of negotiations between taxpayer and Exam regarding these adjustments Exam forwarded Forms 5701, Notices of Proposed Adjustment, to taxpayer when the parties agreed or disagreed on a particular adjustment. In addition to setting forth the substance of the proposed adjustments, on some of the Forms 5701 sent to taxpayer Exam indicated whether an issue was agreed or not by marking "agreed" or "disagreed" in the box located at the bottom of the form, or by including a statement on the form that taxpayer agreed to the adjustment. Audit Team Coordinator also noted that some of the Forms 5701 originally marked as "disagreed" were revised to "agreed" based on information taxpayer sent to Exam. In addition, some of the Forms 5701 indicated that taxpayer's position on an adjustment was unknown. Taxpayer did not sign and mail back to Exam any of the Forms 5701. Taxpayer maintained a log of Forms 5701 that it reviewed and updated with Exam on a regular basis.

On Date 1 Exam sent taxpayer a 30-day letter and revenue agent's report [hereinafter "RAR"] for the Year 1 and Year 2 tax years. The RAR incorporated the above-mentioned Forms 5701. On Date 2, taxpayer sent two checks to the Service in the amounts of Amount W and Amount X for the Year 1 and Year 2 tax years. To arrive at these amounts, taxpayer added up the Year 1 and Year 2 adjustments marked "agreed" in its log of Forms 5701, determined a net adjustment amount for each tax year, and applied its tax rate to the amount. Since taxpayer did not provide any computations with the remittances setting forth the specific proposed adjustments to which it claims it agreed, it was not completely clear to Exam how the taxpayer intended the remittances to be applied to the proposed adjustments.[1] Taxpayer did not provide a computation sheet to Exam until Date 4 in response to an IDR. Taxpayer included with the checks a letter identifying them as payments toward its Year 1 and Year 2 federal income tax audit deficiencies relating to the agreed items and indicated on the checks that the amounts constituted payment toward income tax audit deficiencies for the respective tax years.

Once Exam received the checks, it posted them as deposits in the nature of a cash bond. In Year 5 taxpayer discovered that the checks it mailed to Exam on Date 2 were posted as deposits, rather than as payments. Upon discovering this taxpayer notified Exam and requested that it change the classification of the amounts to payments, as it had requested in its letter and in its notation on the checks. Shortly thereafter, Exam complied with taxpayer's request.

At the time taxpayer sent the checks, Audit Team Coordinator had asked taxpayer to sign

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[1] In computing the remittances, taxpayer did not account for most foreign tax credits (but treated them as unagreed) and did not account for other credits.

Forms 870 "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment," waiving the Service's restrictions on assessment and collection with respect to the amounts it had sent for each of the tax years. Taxpayer chose not to sign partial Form 870 waivers in Year 4. According to Audit Team Coordinator, taxpayer claims it did not sign partial waivers in Year 4 when it sent the checks since doing so would have triggered its obligation to file amended state tax returns. Exam did not assess either of the amounts taxpayer sent by check on Date 2.

Although taxpayer filed a number of protests after receiving the RAR, these protests did not relate to the "agreed" adjustments for which it sent the checks on Date 2. In Year 6, following Appeals' consideration of the case, taxpayer signed a Form 870-AD, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment," relating to the Year 1 and Year 2 tax years for which the final agreed tax liabilities were Amount Y for Year 1 and Amount Z for Year 2. Taxpayer also paid all interest on the final agreed tax liabilities in Year 6. Appeals signed the Form 870-AD in Year 7 and the taxes were subsequently assessed in that year.

On its Year 6 return, taxpayer deducted all deficiency interest, including interest relating to the amounts it paid in Year 4. Taxpayer filed a refund claim in Date 3 in which it sought to deduct in Year 4 interest relating to the remittances sent to the Service that year toward its proposed federal tax liabilities for tax years Year 1 and Year 2. Taxpayer contends that it is entitled to the interest deduction in Year 4, rather than in Year 6, since the all events test was met with respect to the "agreed" tax adjustment items in the earlier year.

Taxpayer maintains that its accounting method for deducting interest on federal tax deficiencies has been to accrue interest at the time its obligation to pay the tax is fixed and determinable and has economically accrued. Exam contends that taxpayer always deducted tax deficiency interest expenses on the tax return of the taxable year in which taxpayer paid such expenses. Based on this contention, Exam asserts that taxpayer adopted the cash method of accounting for tax deficiency interest expenses and, thus, taxpayer's accrual of tax deficiency interest expenses for taxable year Year 4 represents a change in its method of accounting for which it did not request the Commissioner's consent.

LAW AND ANALYSIS

Issue 1

Payment vs. Deposit

Where a taxpayer makes a voluntary remittance to the Service, the taxpayer has the right to direct the application of the remittance to whatever type of liability he chooses. See, e.g., Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983); Estate of Wilson v. Commissioner, T.C. 1999-221. Under Rev. Proc. 84-58 § 4.03(1), 1984-2 C.B. 501:

> A remittance not specifically designated as a deposit in the nature of a cash bond will be treated as a payment of tax if it is made in response to a proposed liability, for example, as proposed in a revenue agent's or examiner's report, and remittance in full of the proposed liability is made.

In addition to the above considerations, in reviewing whether a remittance is a payment or deposit, courts will look to the facts and circumstances of the individual case, applying such factors as:

1. Whether the Service made a formal assessment
2. How the Service treated the remittance upon receipt
3. When the tax liability is defined
4. The taxpayer's intent upon making the remittance

Moran v. United States, 63 F.3d 663, 668 (7th Cir. 1995). Of these factors, it appears both the courts and the Service place the greatest weight upon the final factor, the taxpayer's intent. See, e.g., Moran, 63 F.3d at 669; IRM § 8.1.1.3.1.2 (2) & (3) (a remittance intended to satisfy a tax liability constitutes a payment, unless specifically treated by the taxpayer as a deposit). Where a taxpayer clearly intends a remittance to be a payment, the Service should treat the remittance as a payment. Moran v. United States, 63 F.3d 663 (7th Cir. 1995); Van Canagan v. United States, 231 F.3d 1349 (Fed. Cir. 2000).

With respect to the first factor cited by Moran, the Service did not assess the Year 1 and Year 2 tax liability until Year 7. While an assessment is a prerequisite to collection, there is no requirement that a tax be assessed where the Service already is in possession of the payment. Baral v. United States, 528 U.S. 431, 437 (2000); Rev. Proc. 89-6, 1989-1 C.B. 119. As is discussed in more detail below, the Service has the discretion to assess when it receives an advance payment, and for various reasons may choose to post a remittance to the taxpayer's account as a deposit or as a payment without ever making an assessment. For this reason, we do not believe a court would accord great weight to the Service's choice not to assess.

Regarding the second and third factors cited by Moran, although the Service applied the remittances as deposits in the nature of a cash bond, it appears that the taxpayer protested this denomination as soon as it was discovered. Again, since the taxpayer had no control over the Service's internal processes, and protested the Service's designation, a court is unlikely to accord significant weight to this factor. Finally, the remittance was made by the taxpayer in response to a 30-day notice by the Service. Under Rev. Proc. 84-58, a remittance made in response to a proposed liability will be posted by the Service as a payment of tax, unless specifically instructed otherwise by the taxpayer. IRM § 8.2.1.7.1(1). See also James S. Niblock, "Moran v. United States: You Pay Your Money and You Take Your Chances" 22 Iowa J. Corp. L. 153, 169 (1996).

In reference to the fourth requirement, the taxpayer manifested its intent to have its remittances treated as payments from the time the remittances were made, and the

taxpayer has not varied from its original designation. Both of the checks and the accompanying letter specified that the remittances were to be considered payments for Year 1 and Year 2 tax deficiencies. It could be argued that the taxpayer did not make a "remittance in full" and so the Service had the right to designate the payment as a deposit. However, in its letter of Date 2, the taxpayer directs that the payments be applied to the Year 1 and Year 2 audit deficiencies "relative to agreed items." There does not appear to have been any written response by the Service to the taxpayer that the words "agreed items" were unclear, or that the amount submitted by the taxpayer as payment could not be applied or assessed. We believe the taxpayer could plausibly argue in court that it did, in fact, fully pay what it termed as "agreed items." Based on the holdings in Baral and Moran, and the Service's position in Rev. Proc. 84-58, a court would likely agree with the taxpayer's position on this issue.

Service's Right to Assess

The Service could have assessed the Year 1 and Year 2 taxes and applied the taxpayer's remittances to those assessments, but was not required to do so. I.R.C. § 6213(b)(4) provides in part, "[a]ny amount paid as a tax or in respect of a tax may be assessed upon the receipt of such payment ..." The accompanying Treas. Reg. § 301.6213-1(b)(3) provides, "[i]f any payment is made before the mailing of a notice of deficiency, the district director or the director of the regional service center is not prohibited by section 6213(a) from assessing such amount, and such amount may be assessed if such action is deemed to be appropriate."

Under Rev. Proc. 84-58 § 4.03(3), 1984-2 C.B. 501:

> Remittances treated as payments of tax will be posted against the taxpayer's account upon receipt, or as soon as possible thereafter, and may be assessed . . . In any case, the remittance will be applied against the taxpayer's account as of the date received by the Service.

Although the Service is not required to assess the amount remitted by the taxpayer as an advance payment,[2] section 6213(b)(4) authorizes such assessment upon receipt of payment. Further, IRM § 8.2.1.7.3(2) recommends assessment of advance payments in all docketed cases and in non-docketed cases that are likely to be delayed in closing. Assessment is encouraged for a number of reasons, such as avoiding statute of limitations problems. However, there is nothing in the law or the Service's internal procedures that would require the Service to have made assessments in this instance.

Based on the foregoing, taxpayer's Year 4 remittances to the Service relating to proposed tax adjustments for its Year 1 and Year 2 tax years may be characterized as payments

[2] Under IRM § 3.8.44.11, an advance payment is a payment made for a determined or undetermined deficiency prior to additional tax assessment.

which the Service had a right to assess in Year 4.

Issue 2

Timing of Deficiency Interest Deductions

Pursuant to I.R.C. § 6601(a) interest is required to be paid on any underpayment of tax. Section §163(a) allows taxpayers a deduction for interest paid or accrued within the taxable year on indebtedness, with the exception of personal interest. Indebtedness has been defined as an existing, unconditional, and legally enforceable obligation for the payment of money. Perkins v. Commissioner, 92 T.C. 749, 759 (1989).

Generally, under section 461(a), the amount of a deduction allowed shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 446(c)(2) allows a taxpayer to compute taxable income by an accrual method of accounting. An accrual method taxpayer is entitled to deduct expenses in the year in which they are incurred, regardless of when they are actually paid. United States v. Hughes Properties, Inc., 476 U.S. 593, 599 (1986).

Under the accrual method of accounting, expenses may be deducted only if taxpayer satisfies three criteria. First, all events must have occurred that establish the fact of liability. Treas. Reg. § 1.446-1(c)(1)(ii). A liability is established or fixed when it is based on facts actually known or reasonably knowable at the end of the taxable year. United States v. Hughes Properties, Inc., 476 U.S. 593, 602 (1986). See also United States v. General Dynamics Corp., 481 U.S. 239, 243 (1987) (even though expenses may be deductible before due and payable, liability must first be firmly established for all events test to apply). See also Globe Products Corp. v. Commissioner, 72 T.C. 609, 621, 622 (1979), acq., 1980-2 C.B. 1.

A liability is not fixed if it is contested. If a taxpayer contests a liability no deduction is allowed until the liability has been finally determined since up to that time the liability is contingent and uncertain. Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 (1944) (to truly reflect income all events must occur which fix the amount and fact of taxpayer's liability for items of indebtedness deducted though not paid); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944). A contest is defined as a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amounts of an asserted liability and may include an affirmative act denying the validity or accuracy of an asserted liability to the person who is asserting such liability. Treas. Reg. § 1.461-2(b)(2). It is not necessary that the affirmative act denying the validity of an asserted liability be in writing if, upon examining all the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested. Id. Whether a liability is contested is a question of fact. Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257. If a taxpayer contests some portions of a liability but

agrees to others, the agreed portion of the liability may be deducted. Treas. Reg. § 1.461-1(a)(2)(ii), 1.461-2(a)(4) ex. 1.

Second, the amount of the liability can be determined with reasonable accuracy. Treas. Reg. §1.446-1(c)(1)(ii). Even though the precise amount of a liability incurred is not known, a taxpayer may take a deduction if the amount can be computed with reasonable accuracy within the taxable year. Treas. Reg. § 1.461-1(a)(2)(ii). See also Continental Tie and Lumber Corp. v. United States, 286 U.S. 290, 297-298 (1932) (amount of liability considered determinable with reasonable accuracy when basis for calculation of liability is known or knowable at end of tax year). If an amount is properly accrued based on a computation made with reasonable accuracy and the exact amount of liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account in the later year when the exact amount is determined. Treas. Reg. § 1.461-1(a)(3).

Third, economic performance must have occurred with respect to the liability. I.R.C. § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). With regard to interest, economic performance occurs as the interest cost economically accrues. Treas. Reg. § 1.461-4(e). According to the legislative history of section 461(h), economic performance occurs with respect to interest "with the passage of time (that is, as the borrower uses, and the lender forgoes use
of, the lender's money) rather than as payments are made." H. Rep. No. 861, 98th Cong., 2d Sess., 875 (1984).

For an accrual method taxpayer, interest on a tax deficiency begins to accrue in the year the underlying tax liability is fixed through agreement, by settlement, or by final order of the court, and the amount of the liability is determinable with reasonable accuracy. Southwest Exploration Company v. Riddell, 362 F.2d 833, 837 (9th Cir. 1966); Fifth Avenue Coach Lines, Inc. v. Commissioner, 281 F.2d 556, 558-560 (2nd Cir. 1960), cert. denied, 366 U.S. 964 (1961) (interest on tax deficiencies is not accruable where liabilities remained contested and taxpayer did not relinquish right to appeal deficiency amounts). An accrual basis taxpayer will not be allowed to deduct interest on a tax deficiency until the liability for the deficiency is finally determined. Kolkey v. Commissioner, 27 T.C. 37, 65 (1956); Rev. Rul. 70-560, 1970-2 C.B. 37. In Rev. Rul. 70-560 the Service indicated that if a taxpayer agrees to a tax deficiency when asserted against it, taxpayer may accrue the interest on the deficiency in the tax year of the agreement. Assessment is not necessarily a prerequisite for accrual of tax deficiencies since prior to assessment all events may occur that fix the amount of the tax and determine amount of the tax liability. United States v. Anderson, 269 U.S. 422, 441 (1926); Woodmont Terrace, Inc. v. United States, 261 F. Supp. 789, 791 (M.D. Tenn. 1966).

The Tax Court has recently addressed the issue of when interest on tax deficiencies accrues under section 461 in the cases of Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247, and Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257. In both cases the Tax Court held

that the taxpayers' liability for tax deficiencies was not sufficiently fixed in the year taxpayers proposed to deduct related deficiency interest.

In Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247, the Tax Court denied taxpayer a deduction for interest related to allegedly uncontested tax deficiencies in the tax years to which the underlying deficiencies related based on taxpayer's failure to satisfy the fixed prong of the all events test. Upon commencement of the audits, taxpayer supplied the Service with additional information about items on its returns. The Service proposed adjustments on various items that it identified on Forms 5701, Notices of Proposed Adjustment. The Service sent these forms to the taxpayer and requested that it indicate whether it agreed, agreed in part, or disagreed with each proposed adjustment. Taxpayer did not indicate on these forms or in any other written manner whether it agreed or disagreed with the adjustments. Taxpayer claimed that it informally or orally communicated to the Service its intent not to protest some of the specific adjustments, and argued that the Service should assume that all adjustments it did not specifically protest were agreed. The Court observed that whether a liability is contested and when a contested liability is resolved are questions of fact. The Court concluded that taxpayer could not deduct the interest relating to the deficiencies in the year
to which the tax adjustments related. Rather, interest could not be deducted until the earlier of either the end of the audits (when RAR's were issued and taxpayer executed Forms 870 evidencing its agreement to some of the adjustments at issue) or when the Service made assessments. The Court noted that before either of these events the adjustments were not fixed and definite, since taxpayer provided "insufficient specific communication" to the Service reflecting its agreement to the proposed adjustments. The Court cited the following evidence in support of its holding: first, taxpayer's returns reflected amounts different from the agreed adjustments; second, the adjustments were raised by the Service in writing in Forms 5701; third, the taxpayer did not indicate on the Forms 5701 any agreement to the proposed adjustments; fourth, taxpayer did not provide any written statements of agreement to the adjustments until the Forms 870 were signed; and fifth, taxpayer challenged several of the adjustments to which it allegedly agreed in its Tax Court petition. The Court pointed out that taxpayer's informal and oral communications regarding its intent not to protest the adjustments were not sufficient to constitute an agreement. Rather, as the Court explained, a taxpayer's liability is fixed when agreements regarding the tax adjustments are entered into in a clear and formal manner.

In Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257, the Tax Court similarly denied taxpayer a deduction of deficiency interest in 1975-1978 relating to uncontested tax deficiencies for 1970-1977. Once the Service commenced the audit, it reviewed taxpayer's records and consulted with taxpayer. Thereafter, the Service issued Forms 5701 on which it requested taxpayer to indicate its full agreement, partial agreement, or disagreement with the proposed adjustments by checking the appropriate boxes on the bottom of the form. Taxpayer did not indicate its agreement or disagreement with the adjustments on each of the Forms 5701 but merely

stamped a copy and mailed it to the Service to acknowledge its receipt. The Service issued RARs that it furnished to taxpayer along with 30-day letters. Taxpayer protested certain adjustments in the RARs, orally claimed that it agreed with the adjustments it chose not to protest, and performed no other affirmative act denying the validity of the allegedly agreed adjustments. Taxpayer claimed that in each year in which it chose not to protest the adjustments, all events occurred to determine its liability for interest on the agreed amounts and such amounts could be determined with reasonable accuracy. Although the Court acknowledged that a taxpayer can protest an adjustment at any time within the statute of limitations, a line must be drawn between contested and settled liabilities. The Court noted that the determination of whether an accrual basis taxpayer was in fact contesting a liability must be based on a consideration of all of the relevant facts and circumstances. The Court held that taxpayer's unprotested adjustments were not sufficiently settled to allow taxpayer to accrue deductions for related interest prior to the point at which taxpayer signed Forms 870-AD or Forms 866 ("Agreement as to Final Determination of Tax Liability") both of which gave the Service permission to assess. The Court observed that prior to signing these forms, taxpayer neither explicitly agreed to the proposed adjustments nor explicitly contested them. The Court further stated that taxpayer reserved its right to protest all of the adjustments. Taxpayer's failure to explicitly contest the adjustments should not be construed, in the Court's view, as the equivalent of an implied admission of liability. The Court thus concluded that the adjustments "were sufficiently challenged by taxpayer's nonacquiescence to render them contested."

Fixed Prong of All Events Test

In the present case, taxpayer contends that the following events fixed its liability in Year 4 for interest relating to the proposed tax deficiencies to which it claims it agreed: 1. receipt of Forms 5701 on which Exam indicated taxpayer's agreement to certain adjustments, 2. receipt of a 30-day letter and an RAR incorporating the proposed adjustments on the Forms 5701, and 3. calculation and payment of proposed adjustments marked as "agreed" on the Forms 5701. Taxpayer also points out its lack of protest of any of these adjustments after it sent its payments in Year 4. Based on the standards set forth by the Tax Court in Exxon and Phillips, these events are insufficient to fix taxpayer's liability in Year 4 for the proposed "agreed" tax adjustments and related statutory interest.

As the Tax Court stated in Exxon, particularly in the case of prolonged audits where numerous adjustments are developed and negotiated over a period of years (as was the case here) statutory interest relating to the eventually agreed-upon tax adjustments is not fixed and definite until an agreement between taxpayer and the Service regarding the underlying tax adjustments is entered into in a clear and formal manner. Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247. In contrast to the facts of Exxon and Phillips, there is more evidence of taxpayer's position as to the proposed adjustments in the present case, namely Exam's indication on some of the Forms 5701 of taxpayer's agreement or disagreement to a proposed adjustment, taxpayer's calculation of "agreed" proposed adjustments based on items marked

"agreed" by Exam on the Forms 5701, taxpayer's payment of the "agreed" adjustments based on an RAR incorporating the Forms 5701, and taxpayer's lack of protest of the "agreed" proposed adjustments after payment in Year 4. However, these actions are not sufficient to fix taxpayer's liability for the allegedly agreed tax adjustments in Year 4 for the reasons discussed below.

In examining the facts and circumstances of the present case to determine whether taxpayer agreed to a proposed tax adjustment, we must also examine what acts taxpayer failed to take in Year 4. When taxpayer remitted amounts toward what it termed the "agreed items" in Year 4, Exam requested that it sign a Form 870, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment" with respect to the amounts it remitted to Exam on Date 2. Taxpayer refused to do so on the ground that the execution of the waiver form would trigger its obligation to file amended state tax returns. If taxpayer had signed a partial Form 870 waiver, the "agreed" adjustment amounts would have been fixed for federal tax purposes, and, by extension, for state tax purposes. Taxpayer's refusal to sign this form evidences taxpayer's intention not to fix the tax liabilities relating to the proposed "agreed" adjustments in Year 4, but rather to preserve its rights to protest these adjustments in the future. Although taxpayer did not challenge any of the proposed adjustments for which it remitted the amounts in Year 4, it preserved its right to do so by not signing a partial Form 870 waiver in that year. As the Tax Court indicated in Exxon, a taxpayer need not necessarily engage in an "affirmative act of protest or litigation to a proposed tax adjustment in order for the adjustment to be regarded as unsettled and contested." Exxon, T.C. Memo. 1999-247. Taxpayer left the Service with an ambiguous situation in Year 4 with respect to its position on the "agreed" proposed adjustments, as it had sent remittances to the Service based on the "agreed" Form 5701 adjustments and designated them as payments, but, at the same time it refused to sign partial Form 870 waivers with respect to these "agreed" amounts. As in Phillips, taxpayer in the present case is knowledgeable and sophisticated and was thus well aware of the rights it preserved by not signing partial Form 870 waivers in Year 4. Taxpayer chose to keep its options open with respect to these "agreed" adjustments by not taking sufficient action to evidence its explicit agreement to the proposed adjustments. Had taxpayer wished to fix its liability for the "agreed" amounts in Year 4 it could have done so by executing a partial Form 870 waiver. Based on this evidence, taxpayer did not concede the proposed "agreed" tax adjustments in Year 4. Taxpayer failed to enter into a formal agreement with the Service relating to the proposed "agreed" tax adjustments until Year 6, at which time taxpayer signed Forms 870-AD. Therefore, prior to Year 6, taxpayer's liability for the proposed "agreed" adjustments was not sufficiently fixed and established to permit accrual of any related statutory interest.

Although we agree with your statement that a taxpayer's execution of a Form 870 or 870-AD is not a prerequisite to fixing a tax liability for purposes of the all events test, in the absence of such executed forms, there must be some act or acts on the part of taxpayer that clearly evidence its intent to fix its tax liability. This principle is supported

by Volvo Cars of North America, Inc. v. United States, 97-2 U.S. Tax. Cas. (CCH) ¶ 50,705 (M.D.N.C. 1997), which examined whether taxpayer's underlying tax liabilities were fixed in the year it sought to deduct related interest in the absence of an executed Form 870 or 870-AD.

In Volvo Cars of North America, Inc. v. United States, 97-2 U.S. Tax. Cas. (CCH) ¶ 50,705 (M.D.N.C. 1997) the Court concluded that taxpayer could deduct tax deficiency interest in 1990 even though it did not execute a Form 870-AD until 1991. During an audit of taxpayer, Appeals orally agreed to taxpayer's computations of proposed adjustments in September or October 1990. In October 1990, taxpayer's representative sent Appeals a letter confirming Appeals' agreement to taxpayer's computations. In late December 1990 Appeals sent taxpayer Forms 870-AD reflecting these computations. Taxpayer and Appeals signed Forms 870-AD in 1991. The Court held that taxpayer was entitled to deduct interest on the agreed tax liabilities in 1990 despite the fact that taxpayer and Appeals did not sign the Forms 870-AD until the subsequent year. The Court noted that sufficient evidence existed to show all events necessary for taxpayer to accrue a deduction occurred in 1990, the year in which taxpayer and the Service agreed to the amount of the tax liability. The Court acknowledged that although the agreement was not legally binding until both parties signed the Forms 870-AD, this was not a dispositive factor in determining whether the all events test was satisfied. In the present case, there was insufficient evidence in Year 4 that liabilities relating to the "agreed" proposed adjustments were fixed. Between Year 4 and Year 6, taxpayer and Appeals continued to negotiate proposed adjustments, and taxpayer retained its right to protest all of the proposed adjustments. By Year 6, in contrast, taxpayer and Appeals had reached an agreement as to the amount of tax liabilities for Year 1 and Year 2 and taxpayer had executed a Form 870-AD. Even though the Form 870-AD was not executed by Appeals (and thus not legally binding) until Year 7, all events occurred in Year 6 to fix taxpayer's liability for the tax and the related interest.

Taxpayer contends that the Forms 5701 marked "agreed" unequivocally evidence its agreement in writing to certain of the proposed adjustments. Forms 5701 merely provide a taxpayer notice of proposed adjustments to its tax liabilities and indicate those adjustments to be included in an RAR. An indication that an adjustment is "agreed" on a Form 5701 does not prevent the taxpayer from contesting it and does not grant the Service the rights of assessment and collection (even if taxpayer signs a Form 5701). This point was recently made by the Court of Federal Claims in Sara Lee Corp. & Subs. v. United States, 29 Fed. Cl. 330, 335 (1993). In Sara Lee Corp., the Court noted in *dicta* that Phillips marked the critical point as to whether an adjustment is contested at the execution of Forms 866 ("Agreement as to Final Determination of Tax Liability") or Forms 870-AD. Id. The Court observed that the execution of a Form 5701 by a taxpayer does not have the same effect as the execution of a Form 870-AD since only the latter is dispositive. Id. In the present case the issues marked "agreed" on the Forms 5701 reflected oral negotiations between taxpayer and Exam. The fact that

certain adjustments were marked "agreed" did not preclude the taxpayer from protesting them. Taxpayer was thus not bound by the positions Exam indicated on the Forms 5701 and could contest the proposed adjustments up until Year 6 since it had not entered into a formal written agreement establishing its liabilities for any of the adjustments until that time.

Taxpayer also asserts that by making a payment that Exam had the right to assess in Year 4, the Service was in the same position in Year 4 as it would have been in had taxpayer signed a partial Form 870 waiver in that year. The fact that the Service had a right to assess the amounts remitted in Year 4 by virtue of the fact that they constituted payments (for the reasons set forth in issue 1) does not automatically fix taxpayer's liability for these amounts or for related interest. The right of the Service to assess is not a dispositive factor in determining whether a taxpayer's liability is fixed for purposes of the all events test. Rather, all of the facts and circumstances must be examined to determine whether the liability is fixed and definite. As explained above, taxpayer's failure to enter into a formal written agreement with the Service in Year 4 with respect to the "agreed items" is an important factor in determining whether taxpayer's liability for these amounts was fixed in that year. [3]

Determinable Prong of All Events Test

Taxpayer's liability for interest on the "agreed" tax deficiencies was not reasonably determinable in Year 4 since at that time the amount of taxpayer's underlying tax liability had not been determined. The facts on which the calculation of the final deficiency amounts would be based were not established in Year 4. The audit was a prolonged one in which the calculation of the "agreed" amounts of the proposed tax adjustments changed over the years as a result of several factors including the effect of: other proposed unagreed tax adjustments, foreign tax credits and other credits, carryovers, and taxpayer's ability to raise other affirmative issues not proposed by Exam in the RAR. Although your request points out that many of the "agreed" adjustment amounts did not change when the final computations were made in Year 6, the facts on which the taxpayer's calculation was based were not known or knowable in Year 4 due to the factors mentioned above. Audit Team Coordinator noted that once all of adjustments were agreed to between taxpayer and Appeals in Year 6, the calculation of final deficiency amounts took approximately six to eight months to complete. It was not until Year 6, at which time taxpayer and Appeals computed the final tax liabilities, that the related interest liabilities were determinable with reasonable accuracy.

Economic Performance

[3] If Exam assessed the amounts taxpayer remitted in Year 4, this would have fixed taxpayer's liability for the amounts, and the related interest, in that year.

As noted above, the all events test may not be satisfied at any point earlier than the taxable year in which economic performance occurs. Economic performance occurs with respect to interest with the passage of time, as the borrower uses the lender's money. In the case of deficiency interest, economic performance will have occurred with respect to all of the amounts of deficiency interest for which taxpayer is liable during the years taxpayer allegedly had use of the government's money (i.e. the underpayment amounts). Thus, economic performance will have occurred with respect to interest on the amounts of proposed tax deficiencies paid in Year 4**.**

Based on the foregoing, taxpayer is not entitled to deduct interest relating to the "agreed" amounts of proposed tax deficiencies in Year 4 for failure to meet the fixed and determinable prongs of the all events test. Taxpayer did not take sufficient action in Year 4 to fix its liability for the amounts to which it allegedly agreed. Taxpayer did not communicate in writing to Exam its agreement to certain adjustments that Exam raised by entering into a partial Form 870 waiver agreement or a similar written agreement in Year 4. By refusing to execute such agreements that would clearly and formally fix and establish the fact of taxpayer's liability for these tax adjustment amounts in Year 4, taxpayer cannot now argue that it intended the tax liabilities relating to these amounts to be fixed in Year 4. Rather, the amounts were fixed in Year 6, when taxpayer executed a Form 870-AD. In addition, the amount of interest on the "agreed" tax adjustments was not reasonably determinable until Year 6 when all of the adjustments were agreed to and the foreign tax credits and other applicable credits and carryovers were calculated.

Issue 3

Change in Method of Accounting

A taxpayer may not change its method of accounting retroactively without the Service's consent. Pacific National Co. v. Welch, 304 U.S. 191, 58 S.Ct. 857 (1938). However, a taxpayer may file an amended return to correct an error related to the improper use of its permissible method of accounting. See Standard Oil (Indiana) v. Commissioner, 77 T.C. 349, 379-84 (1981), acq. in result on another issue, 1989-1 C.B. 1 (having elected to deduct intangible drilling costs, taxpayer is permitted to deduct these costs in the years incurred). Finally, a change in the underlying facts may affect the timing of a taxpayer's accrual, but this is not a change in method of accounting. Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2 (taxpayer's right to accrue income changed when the terms of its contracts changed).

Whether taxpayer changed its method of accounting for interest expense attributable to federal tax deficiencies is a question of fact. The critical fact in this case with respect to this issue is whether taxpayer adopted the cash method or the accrual method for this item. Exam agrees that taxpayer's overall method of accounting is the accrual method. Nevertheless, Exam asserts that taxpayer adopted the cash method for tax interest expense and, thus, taxpayer's accrual of tax deficiency interest expenses for

taxable year Year 4 is a change in method of accounting. Exam's assertion is based on the fact that taxpayer always deducted tax deficiency interest expenses on the tax return of the taxable year in which taxpayer paid the expenses. However, this single fact does not resolve the issue. To prove that taxpayer adopted the cash method for tax deficiency interest expense, Exam needs to show that taxpayer paid tax deficiency interest expense in a taxable year that ends before or after the taxable year in which taxpayer signed a Form 870 or Form 870-AD and that taxpayer deducted that amount on the tax return of the year of payment. If these are the facts, we would conclude that taxpayer changed its method of accounting for tax deficiency interest expense from the cash method to the accrual method. On the other hand, if taxpayer always deducted tax deficiency interest expense on the tax return of the taxable year in which taxpayer signed the Form 870 or Form 870-AD and paid the tax deficiency interest expense, this fact supports taxpayer's contention that it adopted the accrual method because the payment of a liability generally is unnecessary for a proper accrual of an expense item under the all events test. Thus, if these are the facts, we would not conclude that taxpayer changed its method of accounting for tax deficiency interest expense.

Under the accrual method, taxpayer may deduct the interest expense on federal tax deficiencies for the taxable year that the all events test is satisfied. As discussed above, this determination requires an analysis of all the facts and circumstances. In our view, the critical issue is whether something other than a taxpayer's execution of a Form 870 or Form 870-AD can satisfy the all events test. Apparently, taxpayer did not initially believe that its actions (i.e., orally agreeing to some of the proposed adjustments which Exam then marked as "agreed" on Forms 5701, issuing checks for the tax deficiencies attributable to these agreed-upon items, and sending a letter identifying these amounts as payments towards its Year 1 and Year 2 tax deficiencies) satisfied the all events test because taxpayer did not accrue the related deficiency interest expense on its original Year 4 return. However, if a court agrees with taxpayer's current position regarding the all events test, a court is likely to hold that taxpayer is permitted to correct an error attributable to the improper application of the accrual method (i.e., file an amended return for Year 4). On the other hand, if a court does not believe that the all events test was satisfied in Year 4 with respect to the partial payments of proposed deficiencies, a court is likely to hold that taxpayer improperly applied the accrual method when filing its refund claim for Year 4 and that taxpayer's erroneous method does not clearly reflect income. Brown v. Helvering, 291 U.S. 193 (1934).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The standards set forth in Phillips and Exxon effectively support the conclusion that taxpayer's liability for the proposed "agreed" adjustments, and therefore the related deficiency interest, was not fixed and determinable in Year 4. [redacted]

[redacted]

In Exxon, the Tax Court cited the following factors on which it based its opinion that taxpayer's tax liabilities were not fixed in the tax years to which they related: first, taxpayer's returns reflected amounts different from the agreed adjustments; second, the adjustments were raised by the Service in writing in Forms 5701; third, the taxpayer did not indicate on the Forms 5701 any agreement to the proposed adjustments; fourth, taxpayer did not provide any written statements of agreement to the adjustments until the Forms 870 were signed; and fifth, taxpayer challenged several of the adjustments to which it allegedly agreed in its Tax Court petition. In the present case, [redacted]

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.

Sincerely,

HEATHER C. MALOY

Associate Chief Counsel (Income Tax & Accounting)

By: _____
THOMAS D. MOFFITT
Chief
Income Tax & Accounting
Branch 2