



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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATED: March 17, 1999

MEMORANDUM FOR:

FROM: Elizabeth G. Beck
Senior Technical Reviewer
CC:INTL:6

SUBJECT:

This Field Service Advice responds to your memorandum dated November 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

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Date G	=
Date H	=
Date I	=
Date J	=
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Date M	=
Date N	=
Date O	=
FSC	=
USCorp.	=
Year 1	=
Year 2	=

ISSUES:

1. Whether the foreign sales corporation (FSC) and the U.S. related supplier must file amended returns within the period of limitation under I.R.C. § 6511 in order to give rise to a valid taxpayer-initiated FSC redetermination within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(e)(4).
2. Whether the six-year period of limitation of section 6501(e)(1)(A) applied to a FSC for one of the tax years.
3. Whether the statute of limitations for assessment began to run from the date of the U.S. related supplier's initial tax return or from the date of a "duplicate" or "substitute original" tax return filed by that party for the same tax year.
4. Whether a Form 872, Consent to Extend the Time to Assess Tax, filed after expiration of the statute of limitations, extended the periods of limitation for assessment under section 6501(c)(4) and for refund under section 6511.
5. Whether FSC redeterminations for the tax years at issue satisfied the requirements of Temp. Treas. Reg. § 1.925(a)-1T(e)(4).

CONCLUSIONS:

1. Although it is not necessary that both the FSC and the U.S. related supplier file amended returns, both parties must take steps within the period specified by sections 6501 and 6511, as applicable, to notify the Service of the actual

amounts of additional tax due or refund claimed as a result of the FSC redetermination.

2. No. Based on the magnitude of the additional income items reported, the original FSC return did not make a “substantial omission” of gross income within the meaning of section 6501(e)(1)(A).
3. The period of limitation for assessment under section 6501(a) began on the filing date of the initial tax return for the tax year in question.
4. The Form 872, filed after the period of limitation for assessment for that year under section 6501(a) had expired, was without effect.
5. For Year 1, because the U.S. related supplier’s amended return was filed several days before the period of limitation for assessment expired for the FSC, the Service did not have a reasonable period of time to assess additional tax against the FSC, and the redetermination therefore could not “affect” the FSC, as required by Temp. Treas. Reg. § 1.925(a)-1T(e)(4). For Year 2, because the period of limitation under section 6511(a) had already expired prior to the filing of the amended return by the U.S. related supplier, the FSC redetermination failed to satisfy the requirement of Temp. Treas. Reg. § 1.925(a)-1T(e)(4) that the periods of limitation for refund be open with respect to both parties.

FACTS:

USCorp. is a U.S. corporation with its principal place of business in City. FSC, a Country corporation, is a wholly-owned subsidiary which elected to be a FSC within the meaning of section 922(a). Both corporations file U.S. income tax returns on a calendar-year basis. This memorandum addresses Year 1 and Year 2. The relevant facts for the individual years are set forth separately.

Year 1

USCorp.

USCorp. filed its income tax return (Form 1120) on Date A. Three years later, on Date C, USCorp. filed an amended return (Form 1120X) to claim additional FSC commission deductions attributable to additional foreign trading gross receipts and changes in transfer pricing methods due to regrouping. USCorp. initially claimed \$a in additional FSC commissions, but reduced this amount to \$b. In response to an IDR concerning the

amended return, USCorp. stated that approximately c% of the FSC redetermination resulted from “chang[es] in product grouping.”

FSC

FSC filed its income tax return (Form 1120FSC) on Date B, five days after Date A. No amended return was filed within the normal period of limitation for assessment, which ended five days after Date C on Date M, nor has any additional tax been paid by FSC.

Year 2

USCorp.

On Date D, one day prior to the due date of Date E, USCorp. filed an Application for Extension of Time to File Corporation Income Tax Return (Form 7004). The Form 7004 extended the due date of the return to Date F. Two days after Date E, on Date G, USCorp. filed its income tax return (Form 1120). On Date F, USCorp. filed what it termed a “Substitute Original Return,” also on Form 1120. The Service posted the latter return under transaction code 976, indicating a duplicate return.

The Service examined USCorp.’s Year 2 based on the return filed on Date F, rather than the original return of Date G. The three-year period of limitation for assessment with respect to USCorp.’s original return expired on Date H. After Date H, on Date I, apparently based on the filing date of the duplicate or “substitute original” return (Date F), the Service and USCorp. executed a consent to extend the time to assess tax (Form 872). The Form 872 purported to extend until Date J the period of limitation for assessment with respect to USCorp. Prior to Date J, on Date K, USCorp. filed an amended tax return (Form 1120X), claiming a refund due to additional FSC commission deductions.

FSC

On Date L, FSC filed its income tax return on Form 1120FSC. On Date K, FSC timely filed an amended income tax return on Form 1120X-FSC, reporting additional tax due, allegedly corresponding to the refund claimed by the U.S. related supplier. No payment of additional tax was made.

LAW AND ANALYSIS:

Section 6501(a) contains the general rule that the Service must assess tax due within three years of the date of filing of the return.

Section 6501(c)(4) permits taxpayers and the Service to enter into an agreement to extend the period of limitation for assessment of tax, provided that the agreement is executed prior to expiration of the period of limitation for assessment which is otherwise applicable.

Section 6501(e)(1)(A) provides that, if the taxpayer makes an omission of more than 25% from gross income, the Service may assess tax within six years of the date of filing of the original return. Section 6501(e)(1)(A)(i) defines “gross income” in the case of a trade or business as “the total of the amounts received or accrued from the sale of goods and services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.” In the case of a commission FSC, the concept of “gross income” corresponds to “gross receipts on the sale, lease, or rental of property upon which the commissions arose,” plus any other income. I.R.C. § 927(b)(2). See also Temp. Treas. Reg. § 1.927(b)-1T(e)(1).

Section 6511(a) contains the general rule that a taxpayer must make a claim for credit or refund of an overpayment of tax prior to the later of: (a) three years after the date on which the (first valid) income tax return was filed, or (b) two years after the date on which the tax was paid.

Section 6511(c)(1) provides that, if the applicable period of limitation for assessment is validly extended by agreement between the Service and the taxpayer, the period of limitation for refund extends for an additional six months after the end of the period of limitation for assessment, as extended by agreement.

The rules governing redeterminations of FSC commissions for tax years beginning before January 1, 1998, are contained in Temp. Treas. Reg. § 1.925(a)-1T(e)(4), which states:

(4) Subsequent determination of transfer price, rental income or commission.

The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the Commissioner may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and § 1.861-8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the FSC and related supplier if their taxable years are still open under the statute of limitations for making claims for refund under section 6511 if they determine

that a different transfer pricing method or grouping of transactions may be more beneficial. Also, the FSC and related supplier may redetermine the amount of foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the FSC and the related supplier. The FSC and the related supplier may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa.

Temp. Treas. Reg. § 1.925(a)-1T(e)(4) (emphasis added).

The regulation only permits redeterminations with respect to transactions between a FSC and its U.S. related supplier, which is by definition a related party, owned or controlled (directly or indirectly) by the same interests as the FSC within the meaning of section 482. Temp. Treas. Reg. § 1.927(d)-2T.

The regulation imposes, as a condition precedent to a taxpayer-initiated redetermination of FSC commissions, that the period of limitation for refund under section 6511 must be open with respect to both the FSC and the related supplier. Temp. Treas. Reg. § 1.925(a)-1T(e)(4); Union Carbide Corp. v. Commissioner, 110 T.C. 375 (1998). In addition, the redetermination must “affect” both the FSC and the related supplier. That is, the Service must be able to assess additional tax due with respect to the taxpayer (in this case the FSC) which is in a deficiency position as a result of the redetermination.

Issue 1: Unilateral Action by U.S. Related Supplier (Year 1)

At the outset, we note that a taxpayer-initiated FSC redetermination generally consists of a claim for additional FSC commission deductions. Such a claim may generate a refund of tax to the U.S. related supplier, due to increased commission deductions, and additional tax due on the part of the FSC, due to increased FSC commission income. The regulation, Temp. Treas. Reg. § 1.925(a)-1T(e)(4), recognizes that taxpayer-initiated FSC redeterminations may have an impact on both taxpayers. The regulation requires that the periods of limitation for refund be open with respect to both the U.S. related supplier and the FSC, and also requires that the FSC redetermination “shall affect” both parties. In this context, the “shall affect” provision requires that the Service be able to assess additional tax against the party in a deficiency position as a result of the redetermination (the FSC).

The regulation does not specifically require that both parties file amended returns to implement a FSC redetermination. However, both parties must communicate the FSC redetermination in a manner which will permit the Service to act upon both the refund and the additional-tax components of the redetermination. In general, a refund claim requires submission of an amended return (Form 1120X). Treas. Reg. § 301.6402-3(a)(5). Thus, in

the present case, USCorp.'s filing of an amended return in its capacity as the U.S. related supplier informed the Service of the nature and amount of the refund claim.

Because the FSC redetermination gave rise to additional tax, the "shall affect" provision required FSC to provide the Service a reasonable opportunity to assess additional tax due against it. Date C was the final day of the three-year period of limitation for refund applicable to USCorp. under section 6511. The final day of the three-year period of limitation for assessment under section 6501 with respect to FSC was five days later, Date M. Hypothetically, if FSC had filed an amended return within the sixty-day period ending on Date M, the Service would have had an additional 60-day period from the date of the amended return to assess tax against FSC. I.R.C. § 6501(c)(7). Alternatively, FSC could have offered to enter into an agreement to extend the period of limitation for assessment, in order to afford the Service a reasonable opportunity to assess additional tax due. FSC instead took no action whatsoever prior to expiration of the period of limitation for assessment with respect to FSC.

The eleventh-hour filing of USCorp.'s amended return – coupled with FSC's failure to file a statement indicating additional tax due – placed the Service in the untenable position of having to issue a notice of deficiency to FSC within five days (four business days) of the date of the refund claim from USCorp. We believe that the "shall affect" provision in the regulation was intended in part to prevent such a result, by placing on the FSC (which is owned or controlled by the U.S. related supplier filing the redetermination claim) the responsibility for affording the Service sufficient time to assess additional tax. As outlined above, several options were available to FSC to comply with this requirement, all of which involved minimal burden to FSC.

With respect to Year 1, the FSC redetermination failed to satisfy the "shall affect" requirement of the regulation, because the filing of an amended return by USCorp. five days (four business days) prior to the end of the period of limitation applicable to FSC, without more, did not afford the Service a reasonable period of time to assess additional tax due from FSC.

Issue 2: Six-Year Period of Limitation on Assessment (Year 1)

Notwithstanding the method used to present the FSC redetermination for Year 1, the Service might have been able to assess additional tax against FSC if the six-year period of limitation applicable to a "substantial omission" of gross income were applicable to FSC. That is, the "shall affect" requirement of the regulation might have been satisfied if additional tax could have been assessed against FSC, despite the imminent expiration of the general, three-year period of limitation on assessment.

Because the FSC redetermination was based in part on additional foreign trading gross receipts, section 6501(e)(1)(A) was potentially applicable. I.R.C. §§ 923(b), 927(b)(2), 6501(e)(1)(A)(i); Temp. Treas. Reg. §§ 1.923-1T(a), 1.927(b)-1T(e). That is, assuming FSC made a “substantial omission” of gross income, *i.e.*, an omission of more than 25%, a six-year assessment period would have been in effect.

The IDR response of Date N, however, indicated that “c% of the FSC redetermination is the result of changing the product grouping.” This statement indicates that additional foreign trading gross receipts in the FSC redetermination could not have constituted a more-than-25% omission of gross income under section 6501(e)(1)(A). Because the six-year period of limitation was inapplicable in this case, the redetermination fails to satisfy the “shall affect” requirement.

Issue 3: Period of Limitation in Case of Multiple Returns (Year 2)

USCorp. filed both an original and a “substitute original” income tax return for Year 2. If more than one tax return is filed for particular tax year, absent fraud on the part of the taxpayer, the statute of limitations begins to run on the filing date of the first valid return. Kaltreider Construction, Inc. v. United States, 303 F.2d 366, 368 (3d Cir. 1962), *cert. denied*, 371 U.S. 877 (1962); Estate of Robinson v. Commissioner, 101 T.C. 499, 515 (1993). *See also* Badaracco v. Commissioner, 464 U.S. 386, 393 n.8 (1984); Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934).

USCorp.’s return dated Date G was a valid return because it was signed by an officer of the taxpayer, contained a full statement of income, deductions, and tax liability, and included a claim for refund of overpayment of tax. The Service treated the return as valid and granted USCorp. a refund of approximately \$d on Date O. Nothing in the return indicated that it was tentative or incomplete. *Cf.*, Zellerbach Paper, 293 U.S. at 177-78. The Date G income tax return thus started the running of the statute of limitations for Year 2 with respect to USCorp. Absent a timely extension of the period of limitation, the periods of limitation for both assessment and refund purposes expired for USCorp. on Date H. I.R.C. §§ 6501(a), 6511(a).

Issue 4: Agreement to Extend Period of Limitation for Assessment (Year 2)

On Date I, USCorp. and the Service executed a Form 872 which purported to extend the period of limitation for assessment for USCorp. to Date J. Section 6501(c)(4) authorizes an extension of the period of limitation for assessment, provided that the agreement is executed prior to expiration of the limitation period then in effect. When a valid extension of the assessment period is executed, section 6511(c)(1) provides for an automatic extension of period of limitation for refunds, to the end of the assessment period (as extended) plus an additional six months. If a period of limitation specified by statute has already expired,

however, it cannot be extended by agreement. Treas. Reg. § 301.6501(c)-1; Rev. Rul. 85-67, 1985-1 C.B. 364. See also United States v. Garbutt Oil Co., 302 U.S. 528, 533-34 (1938) (government official lacks authority to consider a “new” refund claim where the applicable statutory period of limitation for refund has already expired). The alternate period of limitation for refund specified by section 6511(a), *i.e.*, two years from the date the tax was actually paid, had also expired in this case, prior to execution of the Form 872.

The Form 872 in this case, which was executed on Date I, was without effect, as it could not enlarge or re-institute the period of limitation (applicable to both assessment and refunds), which had already expired on Date H. Therefore, pursuant to sections 6501(a) and 6511, the period of limitation for both assessment and refund applicable to USCorp.’s Year 2 expired on Date H, three years after the filing date of the original return (Date G).

We note that an agreement to extend the period of limitation for assessment, although executed by both the Service and the taxpayer, is not a “contract,” but rather, “a voluntary, unilateral waiver of a defense by the taxpayer.” Berry v. Commissioner, 97 T.C. 339, 347 (1991), quoting Stange v. United States, 282 U.S. 270, 276 (1931). Thus, even assuming that the Form 872 in this case was executed pursuant to a mutual mistake of fact regarding the operative date of the Year 2 tax return, that Form 872 could not extend the period of limitation for assessment applicable to USCorp., which was specified by statute. Nor could the Form 872 have any corresponding effect, pursuant to section 6511(c)(1), on the period of limitation for refund applicable to USCorp.

Issue 5: Application of Regulation

With respect to Year 1, USCorp.’s amended return (Date C) was filed within the section 6511 periods of limitation for refund applicable to both USCorp. and FSC. However, FSC filed no amended return and took no other action that might have allowed the Service to assess additional tax due. As discussed earlier, because the Service did not have a reasonable period of time to assess additional tax, the redetermination failed to meet the “shall affect” requirement of the regulation. Thus, the Service should reject the FSC redetermination for Year 1.

With respect to Year 2, the period of limitation for assessment and refund for USCorp. began when the initial tax return was filed on Date G, and expired three years later, on Date H. The Form 872 executed on Date I, after expiration of the period of limitation for assessment, was therefore without effect. When USCorp. and FSC filed amended returns on Date K, the period of limitation for both assessment and refund had already expired with respect to USCorp. As of that date, the regulatory requirement that the period of limitation for refund be open was not satisfied with respect to USCorp. Accordingly, the Service should reject the FSC redetermination for Year 2.

If you have any further questions, please call (202) 874-1490.

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