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

OFFICE OF
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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Phyllis Marcus, Chief
CC:INTL:BR2

SUBJECT:

This Field Service Advice responds to a question first informally raised with this office on October 1, 1997. 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:

B	=
C	=
D Corp.	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
X%	=
Country Y	=
Business Z	=

ISSUE:

1. Whether the repetitive examination guideline, under I.R.M. § 4241, compels the Service to terminate its examination on the issue of subpart F income for Year 3

when that same issue was examined in the immediate preceding taxable year without any proposed tax adjustments?

2. For purposes of the duplicate examination provision under section 7605(b) of the Code, is the Service considered to have examined the taxpayers' Year 3 income tax return when it merely requests a copy of that return during its examination of taxpayers' Year 2 return?

CONCLUSION:

1. The repetitive examination guideline under I.R.M. § 4241 does not compel the Service to terminate its examination on the issue of subpart F income for Year 3 when that same issue was examined in the immediate preceding taxable year without any proposed tax adjustments. The Service has discretionary authority to determine whether it should expeditiously conclude the examination of subpart F income in Year 3 when the taxpayers allege repetitive examination.

2. A request for taxpayers' Year 3 income tax return, during the Service's examination of taxpayers' Year 2 return, does not constitute an examination of the Year 3 return, and thus, the Service is not subjecting the taxpayers to duplicate examinations of Year 3 under section 7605(b) of the Code.

FACTS:

Taxpayers, B and C, are U.S. citizens who filed joint income tax returns (Form 1040) for calendar Years 1 through 3. As part of their returns for each of the respective three years, the taxpayers also filed a Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) disclosing B's x% ownership interest in D Corp., a foreign corporation organized under the laws of Country Y. D Corp. is a controlled foreign corporation ("CFC") within the meaning of section 957. As the U.S. shareholder of a CFC, B is required to include as gross income his pro rata share of D Corp.'s subpart F income in accordance with sections 951(a).

On January 5, Year 5, the Service notified the taxpayers that it would be examining their income tax return and books and records of D Corp. for purposes of reviewing the issue of subpart F income. D Corp. maintains its books and records at the corporate office located in Country Y. The Service also requested the taxpayers to submit complete copies of their Forms 1040 for Years 1 through 3.

The taxpayers submitted the income tax returns for the three respective years on

January 15, Year 5, and asked the Service to draft a sample "invitation letter", to be issued by D Corp., that would permit Service officials to visit D Corp.'s office in Country Y. In response to this request, the Service drafted the following sample letter:

> This is to extend an invitation to you, and other IRS officials whom may accompany you, to visit our corporate offices in [Country Y] for the purpose of examining the subpart F Income reported by shareholders [of D Corp.] on their [Year 2] tax returns.
>
> This invitation is effective upon receipt of this letter by you and is terminated on the date of your (final) Revenue Agent's Report.

In connection with this examination, the Service issued Form 4564, Information Document Request ("IDR"), for materials pertaining to the taxpayers and D Corp. for Year 2. The requested items included: (1) annual audited financial statements, (2) D Corp.'s corporate minutes and by-laws, (3) annual statements filed in Country Y, (4) organization chart of D Corp., (5) trial balance and general ledger, (6) copies of contracts, and (7) workpapers on subpart F income calculations. None of the IDRs contained a request for documents, books or records related to Year 3.

Upon examination of Year 2's Form 5471, the Service determined that D Corp. had erroneously characterized its organization as engaging in business Z. At the conclusion of Year 2's examination, the Service issued Forms 4549 (Income Tax Examination Changes) and 886-A (Explanation of Items). No Forms 4549 or 886-A were issued with respect to Year 3. Furthermore, during the course of this examination no inquiry was made as to whether D Corp. was a passive foreign investment company within the definition of section 1297(a).

On July 2, Year 6, the Service issued a letter notifying the taxpayers that their Year 3 income tax return had been selected for examination. Attached to this letter were IDRs for taxpayers' and D Corp.'s documents, books and records related to Year 3. The requested materials included: (1) annual audited financial statements, (2) D Corp.'s corporate minutes and by-laws, (3) annual statements filed in Country Y, (4) trial balance and general ledger, (5) copies of contracts, (6) information regarding U.S. shareholders of D Corp., (7) summary of accounting principles employed by D Corp., and (8) workpapers on subpart F income calculations.

On July 10, Year 6, the taxpayers notified the Service that its IDRs were identical to the ones that were previously issued during the examination of the subpart F issue in Year 2. Specifically, the taxpayers stated that Service concluded Year 2's examination without any proposed adjustments with respect to subpart F income, and thus accepted taxpayers' Year 2 return as filed. Under these circumstances, the taxpayers believe that it is the Service's policy not to re-examine an issue (e.g. subpart F income) in a subsequent year when that same issue had been examined in the immediate preceding year without any proposed adjustments.

Based on this letter, the taxpayers appear to be asserting a claim of repetitive examination under I.R.M. § 4241. On August 19, Year 6, the Service responded, in general, that the guidelines in I.R.M. § 4241 do not apply to the instant matter. The consideration of subpart F income for each taxable year is based on the facts and circumstances of the business, and such facts can change from year to year. The determination made in one year is not binding upon subsequent years.

To clarify their position, on August 28, Year 6, the taxpayers communicated that the Service is attempting to conduct a repetitive examination of the same tax year that was already examined. Specifically, the Service examined Years 1 through 3, and is now seeking to re-examine Year 3 for the second time.

LAW AND ANALYSIS:

The taxpayers assert two arguments for terminating the examination of their Year 3 income tax returns. First, in their letter dated July 10, Year 6, the taxpayers claim that pursuant to the repetitive examination provision in I.R.M. § 4241, it is the Service's policy not to conduct an examination of an issue where that same issue was examined in the immediate preceding year without any proposed tax adjustments. That is, I.R.M. § 4241 provides Service personnel with the procedures to expeditiously conclude an examination of an issue when that same issue was examined in the preceding year without any proposed tax deficiency.

However, by letter dated August 28, Year 6, the taxpayers also claim that the Service is conducting a repetitive examination of a year (Year 3) that had already been examined. Specifically, the examination previously conducted in Year 2 constitutes an examination of Years 1 through 3. This matter is not addressed by I.R.M. § 4241, but governed by section 7605(b) of the Code which seeks to prevent taxpayers from unnecessary or duplicate examinations and inspections of their books and records with respect to a particular taxable year.

The taxpayers appear to be asserting conflicting arguments concerning the examination of their Year 3 income tax return. First, they claim that according to I.R.M. § 4241, the Service should expeditiously conclude the examination of their Year 3 return because the issue of subpart F income was previously examined in Year 2 with no resulting tax adjustments. Hence, the taxpayers infer that the Service has not yet examined their Year 3 returns, with respect to the issue of subpart F income, and that the Service should not do so since that issue has been examined and concluded in Year 2 without any adjustments to their tax liability for that year. On the other hand, the taxpayers claim that their Year 3 return should not be examined because that return has already been inspected, and the Service is thus barred from conducting a duplicate examination pursuant to section 7605(b).

In light of these conflicting positions asserted by the taxpayer, we will address the facts set forth herein with respect to I.R.M. § 4241 and section 7605(b) of the Code.

I. I.R.M. § 4241

The purpose of I.R.M. § 4241 is to ease the administrative burden on the Service and the taxpayers, and to save both parties from having to invest the time to revisit an issue that was examined in either of the two preceding years with little or no tax change. However, the repetitive audit guideline neither precludes nor limits the Service's ability to examine an issue in the current year even if that same issue was examined in either of the two preceding years. It should be noted that effective May 14, 1999, the Service streamlined the guidelines on repetitive examination and redesignated that provision in I.R.M. 4.2, at 2.4.2.

The Tax Court has repeatedly held that the "decision to conclude an examination under [§ 4241] is totally discretionary with [the Service]". Tucker v. Commissioner, T.C. Memo. 1983-210, 45 T.C.M. (CCH) 1347, 1349 (1983), *citing* Chapman v. Commissioner, T.C. Memo. 1982-68, 43 T.C.M. (CCH) 511, 513 (1982); *see also* Greene v. Commissioner, T.C. Memo. 1992-202, 63 T.C.M. (CCH) 2665, 2668-69(1992). I.R.M. § 4241 does not restrict the Service's decision or ability to conduct an examination. Greene v. Commissioner, 63 T.C.M. at 2668-69. Such "general statements of policy and rules governing internal agency operations or 'housekeeping' matters, which do not have the force and effect of law, are not binding on the agency issuing them and do not create substantive rights in the public." Capital Federal Savings & Loan v. Commissioner, 96 T.C. 204, 216 (1991); United States v. Will, 671 F.2d 963, 967 (6th Cir. 1982) (guidelines adopted in the Internal Revenue Manual are for purposes of internal administration, rather than for the benefit or protection of taxpayers).

Based on the facts presented, the Service may exercise its discretion not to terminate the examination of taxpayers' Year 3 income tax return.

II. I.R.C. § 7605(b)

Sections 7602 and 7605 of the Code prescribe the general rules concerning the manner, time and place for examining a taxpayer's return. Section 7602(a) states in pertinent part that:

> for the purpose of ascertaining the correctness of any return, ... determining the liability of any person for any internal revenue tax, ...
>
> or collecting such liability, the Secretary is authorized —
>
> (1) to examine any books, papers, records, or other data which may be relevant or material to such inquiry; ....

Section 7605(b) places certain restrictions on taxpayers' examinations by requiring that:

> no taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless that taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

In Grossman v. Commissioner, 74 T.C. 1147, 1155-56 (1980), the Tax Court explained that this provision was

> designed to protect the taxpayer from 'onerous and unnecessarily frequent examinations and investigations of revenue agents'. The purpose of the section was to free honest taxpayers from the petty annoyances of repeated examinations. There is no indication anywhere in the legislative history that section 7605(b) and its predecessors were intended to restrict the scope of [the Commissioner's] legitimate power to protect the revenue. The grants of power contained in section 7601(power to canvas districts, and section 7602 (power to examine any books, records, etc.) are to be liberally construed in recognition of the vital public interest they serve. By the same token, the limitation in section 7605(b) is not to be construed so as to defeat that legitimate purpose (citations omitted).

The facts in the instant matter do not support the application of section 7605(b). While the taxpayers claim that the Service has already examined their Year 3 return, the facts indicate otherwise. First, the sample invitation letter expressly limited the scope of the Service's examination to taxpayers' Year 2 return. Second, the IDRs issued by the Service were for records pertaining to the disclosures made by the taxpayers in their Year 2 return. Also, no IDRs were issued for documents related to the Year 3 return during Service's examination of taxpayers' Year 2 return. Lastly, upon the conclusion of the Year 2 examination, the Service issued Forms 4549 and 886-A with respect to Year 2 only. That is, no Forms 4549 or 886-A were issued with respect to Year 3. Consequently, there are no facts that remotely suggest that the Service conducted an examination of taxpayers' Year 3 return in Year 5.

Although the Service requested a copy of taxpayers' Year 3 return in Year 5, such conduct is not deemed to be an examination or inspection of that return. For there to be an inspection of taxpayer's "books of account[, it] would require at a minimum that [the Service] have access to and physically view taxpayer's books and records." *See* Grossman v. Commissioner, 74 T.C. at 1156. A "mere examination of the taxpayer's income tax return and accompanying schedules does not comprise a[n] ... inspection of [taxpayer's] books within the meaning of section

7605(b)." Id. A second examination of taxpayer's books and records arises when the Service inspects the "records that had [already] been inspected for the same taxable year." Digby v. Commissioner, 103 T.C. at 449. The limitation imposed by section 7605(b) relates to one inspection of books and records for each taxable year. Even if the same books and records are responsive to IDRs that were issued pursuant to the examination of different tax years (e.g. Years 2 and 3), such repeated inspection of the same books and records for both years does not constitute a duplicate examination under section 7605(b). That is, "Congress did not intend to restrict the [Service] from auditing subsequent years' transactions originating from the same records, even if those records had been inspected in connection with the audit of an earlier year." Id. at 450.

If you have any further questions, please call (202) 622-3840.

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