

Office of Chief Counsel
Internal Revenue Service
Memorandum

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CC:LB&I: :POSTF-123135-12

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to: , Team Manager, LB&I:

from: , Associate Area Counsel, CC:LB&I:

subject: Taxpayer's Request for Mitigation

Taxpayer:

EIN:

Tax Years Ended:

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INTRODUCTION

On May 23, 2012, you requested that we review an Agreement as a Determination Pursuant to Section 1313(a)(4) of the Internal Revenue Code ("Form 2259") to ensure that you prepared it properly. Subsequently, by e-mail dated May 30, 2012, the taxpayer's representative informed you that she no longer believes that a Form 2259 needs to be executed in this matter, since there is a

(" ") and is, therefore, a "determination" under I.R.C. § 1313(a).

We explain below why in our view the mitigation provisions do not apply to enable (" ") to

reopen the closed tax years ended (" ") and
" ") to make the adjustments it is proposing.

ISSUES

1. Whether the mitigation provisions of I.R.C. §§ 1311 - 1314 apply to permit to reduce the "amount of the bad debt section 481(a) originally reported as income" for and by \$ and \$, respectively, to "revers[e] out the double reported income occurring as a result of ."

2. If issue (1) is answered in the affirmative, whether a Form 2259 must be entered to effect a determination under I.R.C. § 1313 and the regulations thereunder.

CONCLUSIONS

1. No, for the reasons explained below, the mitigation provisions do not apply. Therefore, cannot reduce its taxable income by its overstatements of the ratable portion of positive section 481(a) adjustments in the amounts of \$ and for the tax years and , respectively.

2. Because mitigation does not apply, this issue is moot.

FACTS¹

I. Background facts

is the common parent of a consolidated return group. operated during .

A. Change in method of accounting

Before , used a reserve method of accounting for bad debts for both financial and tax accounting purposes.

filed a Form 3115, Application for Change in Accounting

¹ Our understanding of the facts is based on information provided by Exam. If the actual facts are different from the facts known to us, our legal analysis, conclusions and recommendations might be different. Accordingly, if you learn the facts relied upon for purposes of this opinion are incorrect or incomplete in any material respect, you should not rely on the opinions set forth herein, and you should contact our office immediately.

Method, with the Internal Revenue Service ("IRS") requesting permission to change the method of accounting for bad debts of of its subsidiaries: (1)

(" "); (2)
 (" "); and (3)
 (" ").

In , the IRS granted permission for the subsidiaries to change their method of accounting for bad debts for tax purposes from the reserve method to the specific charge-off method. The subsidiaries continued to use the reserve method of accounting for bad debts for financial accounting purposes.

The change was determined to be a change from a Category A method of accounting as defined in section 3.06 of Rev. Proc. 92-20, 1992-1 C.B. 685. The change in accounting method for bad debts from the reserve method to the specific charge-off method required a section 481(a) adjustment for the amount of the reserve for bad debts as of the close of the tax year ended (" ").²

Based on its determination of the balances of the bad debt reserves as of (" -Determined Bad Debt Reserve Balances"), determined it had a net positive section 481(a) adjustment of \$, computed as in Table 1, below:

Table 1

	\$	
	\$	
	\$	
Total	<u>\$</u>	<u>\$</u>

B. Return

When there is a change in method of accounting from a Category A method of accounting that results in a net positive section 481(a) adjustment, the taxpayer must, beginning with the year of change, take the net positive section 481(a) adjustment

² It is assumed throughout this Memorandum that the amounts of the bad debt reserves as of (which is the end of) are the same as the amounts of 's bad debt reserves as of (which is the beginning of).

into account ratably over 3 tax years in computing taxable income.

reported the ratable portion of the claimed section 481(a) adjustment on its consolidated U.S. Corporation Income Tax Return ("Form 1120") for , which was the year of change, as shown in Table 2, below:

Table 2

	\$ /3 = \$	
	\$ /3 = \$	
	\$ /3 = \$	
Total		<u>\$</u>

On its Form 1120, claimed the following current year deductions for bad debts for , , and:

	\$	
	\$	
	<u>\$</u>	
Total		<u>\$</u>

On the Form 1120, Schedule M-1, Line 8, reported the following amounts as "Deductions in Return Not on Books:"

\$
\$
\$

To compute the "Deductions in Return Not on Books" (book-to-tax adjustments) reported on the Form , used the - Determined Bad Debt Reserve Balances and the balance of the bad debt reserves as of the end of , as shown in Table 3, below.

Table 3

<u>Bad Debt Reserve</u>				<u>Total</u>
Balances	\$	\$	\$	
Less:				
-Determined				

Bad Debt Reserve				
Balances	\$	\$	\$	
M-1	(<u>\$</u>)	(<u>\$</u>)	(<u>\$</u>)	(<u>\$</u>)

II. Examination's Findings/Adjustments for

The IRS conducted an examination of 's Form .

During the examination, the IRS determined that as of , the bad debt reserves for , , and \$, respectively ("Redetermined Bad Debt Reserve Balances"), or an aggregate of \$. The IRS did not question 's balances which are shown in Table 3, above, for the bad debt reserves as of , for , and .

A. Ratable Portion of Section 481(a) Adjustment

Using the Redetermined Bad Debt Reserve Balances, the IRS determined that the correct section 481(a) adjustment was \$ and that for the ratable portion of the section 481(a) adjustment was \$, as shown in Table 4, below:

Table 4

	\$	÷ 3 = \$	
	\$	÷ 3 = \$	
	\$	÷ 3 = \$	
Total	<u>\$</u>	<u>\$</u>	<u>\$</u>

Accordingly, for , the IRS determined that the pro rata portion of 's section 481(a) adjustment should be reduced by \$ because included an adjustment in income of \$ (Table 2, above) that should have been \$ (Table 4, above).

B. Bad Debt Deductions

Using the Redetermined Bad Debt Reserve Balances, the IRS determined that should have reported aggregate Schedule M-1 adjustments decreasing taxable income by \$ (\$ +) and a Schedule M-1 adjustment increasing taxable income by \$ ³ (See

Table 5, below), rather than aggregate Schedule M-1 adjustments of \$ (See Table 3, above).

Table 5

Bad Debt Reserve				—
Balances	\$	\$	\$	\$
Less:				
Redetermined Bad Debt Reserve				
Balances	\$	\$	\$	\$
M-1 per IRS	\$	(\$)	(\$)	(\$)

The IRS determined that, as a result of its erroneous Schedule M-1 adjustments, overstated its M-1 adjustments by \$ and accordingly, also overstated its I.R.C. § 166 bad debt deduction for by \$ (See Table 6, below).

Table 6

					<u>Total</u>
M-1 Per Return Table 3, Above	(\$)	(\$)	(\$)	(\$)	
M-1 Per Audit Table 5, Above Adjustment	\$	(\$)	(\$)	(\$)	(\$)

Accordingly, the IRS determined 's I.R.C. § 166 bad debt deduction should be decreased by \$ for .

The IRS did not disallow any part of 's I.R.C. § 166 bad debt deduction for and/or .

C. Net Increase to Taxable Income

The IRS's decrease of 's I.R.C. § 166 bad debt deduction by \$ and its decrease of the pro rata portion of 's positive section 481(a) adjustment by \$ resulted in a net increase to taxable income of \$ (\$ less \$) for .

III. Statutory Notice of Deficiency and

In a statutory notice of deficiency ("SNOD") issued to dated , the IRS determined a deficiency for .

A Form 886-A, Explanation of Adjustments, attached to the SNOD stated as follows:

the IRS's determinations concerning the amounts of the Redetermined Bad Debt Reserve Balances that should be used for purposes of calculating the section 481(a) adjustment and the M-1 adjustments. As a result, both the decrease of 's I.R.C. § 166 bad debt deduction, in the amount of the \$, and the decrease of the pro rata portion of 's section 481(a) adjustment, in the amount of \$, were , resulting in a net increase to taxable income of \$ (\$ - \$).

On

⁵ had no bad debt reserve as of the end of , because it was temporarily closed.

IV. Taxpayer's and Returns and its Proposed Adjustments to Such Returns

Using the Determined Bad Debt Reserve Balances, reported the following amounts on its Forms 1120 for and as the ratable portion of the section 481(a) adjustment:

	\$	\$	\$	\$
		<u>\$</u>	<u>\$</u>	<u>\$</u>
Total		<u><u>\$</u></u>	<u><u>\$</u></u>	<u><u>\$</u></u>

You have determined that using the amounts of the Redetermined Bad Debt Reserve Balances, which were determined by the IRS and , to calculate the section 481(a) adjustment results in the ratable portion of the section 481(a) adjustment being \$ for and , as shown in Table 7, below:

Table 7

	\$	\$	\$	\$
	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>
Total		<u><u>\$</u></u>	<u><u>\$</u></u>	<u><u>\$</u></u>

Accordingly, overstated the pro rata portion of its positive section 481(a) adjustment by \$ (\$ - \$) and \$ (\$ - \$) for and , respectively.

Since the subsidiaries continued to use the reserve method of accounting for book purposes for bad debts for and , but used the specific charge-off method of accounting for bad debts for tax purposes, calculated book-to-tax adjustments ("Schedule M-1 adjustments") to compute its I.R.C. § 166 bad debt deductions for the for such years. To compute the M-1 adjustments for , used the same method as in Tables 3 and 5, above, calculating the difference in the bad debt reserve account balances of the subsidiaries between the beginning

of _____ and the ending of _____. To compute its M-1 adjustments for _____, used this same method, calculating the difference in the bad debt reserve account balances of the _____ subsidiaries between the beginning of _____ and the ending of _____. The IRS did not question the bad debt reserve account balances used to compute the Schedule M-1 adjustments for each of the _____ subsidiaries for _____ and _____. Moreover, it did not propose any adjustments to _____'s bad debt deductions claimed for _____ and/or _____.

_____ contends that the _____ has resulted in a double inclusion of an item of gross income within the meaning of I.R.C. § 1312(1), since the _____ determined that "the bad debt section 481(a) amount of \$ _____ should all be reported in [_____]" and the "amount of the bad debt section 481(a)" was originally reported as income in _____ and _____, in the amounts of \$ _____ and \$ _____, respectively. _____ contends in the alternative that the "resulted in the double disallowance of a deduction or credit within the meaning of IRC Section 1312(4) since the determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the Taxpayer for [_____] and [_____]."

LAW and ANALYSIS

In order for the mitigation provisions to apply, four conditions must be met.

1. Error in Barred Year that Cannot be Corrected by Operation of Law

First, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See I.R.C. § 1311(a). The parties agree that this requirement is met since the statutes of limitations under I.R.C. § 6511 for _____ to file requests for credit or refund for _____ and _____ were expired when the _____.

2. A "Determination" Described in Section 1312 is Required

Second, there must be a "determination" as defined in I.R.C. § 1313(a), for another tax year for the item giving rise to the error. See I.R.C. §§ 1311 and 1312. That there is a "determination" is not in dispute. The _____ qualifies as a "determination" under I.R.C. § 1313(a).

3. Circumstance of Adjustment Authorized by I.R.C. § 1312

Third, the determination must result in a circumstance under which an adjustment is authorized by I.R.C. § 1312. There are seven circumstances under which an adjustment is authorized by I.R.C. § 1312. argues that its situation falls under I.R.C. § 1312(1), which involves double inclusion of an item of gross income. In the alternative, also argues that the resulted in the double disallowance of a deduction or credit within the meaning of I.R.C. § 1312(4).

A. I.R.C. § 1312(1)

I.R.C. § 1312(1) authorizes a correction only when "[t]he determination requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year" The language of I.R.C. § 1312(1) does not suggest that an adjustment is authorized when a deduction is erroneously taken in one year and an item of gross income is erroneously reported in another year.

In Schwartz v. United States, 67 F.3d 838 (9th Cir. 1995), the Ninth Circuit faced the question whether an ordinary loss for which a Tax Court decision disallowed a deduction was an item which was erroneously included in gross income. The Court limited gross income to the type of items listed in I.R.C. § 61, stating:

We conclude that a deduction for an ordinary loss is not an item included in gross income. The Internal Revenue Code defines gross income as "all income from whatever source derived...." 26 U.S.C. § 61(a). The representative list that follows the statutory definition includes only items that add wealth. 26 U.S.C. §61(a)(1)-(15). Under this definition of gross income, the Schwartzes' ordinary loss reported on their 1976 return is not an item included in gross income.

Id. at 840.

Likewise, in holding that failure to take depreciation deductions did not constitute an erroneous inclusion in gross income, the Tenth Circuit stated:

The meaning of an item of gross income is, under Section 61 of the 1954 Code, limited to specific items and does not include everything that results in an increase in

tax. It is restricted to positive items and does not include negative elements such as deductions ... the omission of which results in increased taxes.

Gardiner v. United States, 536 F.2d 903, 906 (10th 1976).⁵

Based on the plain language of the statute and the rationale in Schwartz and Gardiner, I.R.C. § 1312(1) is only applicable if the _____ required to include an item in gross income. But, this is not the case here.

_____ incorrectly asserts that the _____ required it to include an item in income for _____ which was erroneously included in its gross income for _____ and _____. In a letter dated _____, _____'s representative misrepresents the effect of the _____ the IRS's adjustment as including an item in _____'s income for _____ as follows:

The _____ the Service's revised calculation of the Section 481(a) amount and this resulted in an increase to the Taxpayer's income for the tax year ending _____. This same correction to the Section 481(a) calculation resulted in a decrease to the Taxpayer's Section 481(a) income amount that was reported in taxable income for the years _____ [sic], _____ and _____ in the same amount equivalent to the increase that resulted from the having _____ the Service's revised Section 481(a) income. Thus, this income has been reported twice. First, as a result of the _____ the Taxpayer income for the taxable year ended _____ was increased by \$ _____. No corresponding decrease to income that resulted from the Service's revised calculation was made by the Service. The facts clearly show that there has been a double inclusion of an item of gross income within the meaning of IRC § 1312(1).

_____ 's analysis of the effect of the _____ is simply incorrect. The IRS's adjustment reducing the ratable

⁵ But see, M. Fine & Sons Mfg. v. United States, 144 Ct.Cl. 46 (1958) (depreciation allowances were a constituent element in the determination of cost of goods sold, and their disallowance resulted in an erroneous inclusion in gross income).

portion of 's positive section 481(a) adjustment, which was by the , resulted in a decrease, not an increase, to 's taxable income for . The increase in 's taxable income for was not caused by the the IRS's determination that 's ratable portion of its section 481(a) adjustment was overstated by \$, but rather by the the IRS's determination that 's I.R.C. § 166 bad debt deduction was overstated by \$ for .

Since the disallowance of a portion of 's bad debt deduction cannot be characterized as the inclusion of an item in gross income, we conclude that I.R.C. § 1312(1) does not authorize an adjustment under the circumstances of the present case.

B. I.R.C. § 1312(4)

I.R.C. § 1312(4) allows an adjustment for a barred year when, "The determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year . . ." For I.R.C. § 1312(4) to apply, there must be a deduction or credit disallowed by the determination which should have been allowed, but was not allowed, in the barred year(s). Qureshi v. United States, 75 F.3d 494, 498 (9th Cir. 1996); and Curtis Gallery & Library, Inc. v. United States, 388 F.2d 358, 361 (9th Cir. 1968). Here, and throughout the Internal Revenue Code, deductions are "amounts paid or incurred by the taxpayer that may be subtracted from gross income in order to arrive at taxable income." Curtis Gallery & Library, Inc., 388 F.2d at 361.

I.R.C. § 1312(4) does not apply here because, although the determination does disallow a portion of 's bad debt deduction for , has not established that any part of the portion of the bad debt deduction disallowed for should have been allowed, but was not allowed, for and/or . See, e.g., Qureshi v. United States, supra.

4. Maintenance of an Inconsistent Position or Correction Not Barred at Time of Erroneous Action

Fourth, depending on which circumstance of adjustment applies, either an inconsistent position must be maintained by the party against whom mitigation will operate, or the correction of the error must not have been barred at the time the party for whom mitigation will operate first maintained its

position. I.R.C. §§ 1311(b)(1) and (2). In the case of determination described in I.R.C. § 1312(4), a correction shall be made only if credit or refund of the overpayment attributable to the deduction or credit which should have been allowed was not barred at the time the taxpayer first maintained in writing that he or she was entitled to the deduction or credit for the taxable year to which the determination relates. I.R.C. § 1311(b)(2)(B).

Whether this fourth requirement is met is moot, in light of our conclusion that the two circumstances of adjustment which relies on are inapplicable (see, Part 3., above).

If you have any questions concerning the foregoing or require additional assistance, please contact _____ at _____ .