OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
August 6, 2001

Number: **200148016**
Release Date: 11/30/2001
TL-N-1354-01/CC:CORP:2
UILC: 482.03-00, 6511.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Associate Area Counsel - Nashville, Small Business/Self-Employed: Area 3 CC:SB:3:NAS:2

FROM: Associate Chief Counsel (CORP) CC:CORP:2 and Assistant Chief Counsel (Administrative Procedures and Judicial Practice) CC:PA:APJP

SUBJECT: Field Service Advice -- TL-N-1354-01

This Chief Counsel Advice responds to your memorandum dated April 6, 2001, concerning whether the recipient of a correlative adjustment under § 482 of the Internal Revenue Code of 1986 ("Code") can be denied the benefit of a refund of paid income tax due to the expiration of the refund statute of limitations. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Husband =

Wife =

C =

D =

Corporation L =

Corporation M =

Business A =

TL-N-1354-01

Business B =

Date A =

Date B =

Year 1 =

Year 6 =

Year 11 =

Year 12 =

Year 13 =

Year 14 =

Year 15 =

Year 16 =

Year 20 =

2x =

3x =

11x =

40x =

90x =

150x =

200x =

300x =

ISSUES

(1) Whether a correlative adjustment[1] pursuant to Treas. Reg. § 1.482-1(g) should be made in the instant case, and if so, what is the correlative adjustment to be made?

(2) How would notice of the correlative adjustment be communicated, and who would execute the document for the Service (considering the fact that the position of "District Director" referenced in the regulation no longer exists)?

(3) If a refund for "the other taxpayer" would be produced by the correlative adjustment, can the statute of limitations for filing a claim defeat that benefit?

CONCLUSIONS

(1) A correlative adjustment should be made to reduce Corporation L's income by $90x for Year 12, $150x for Year 13, and $200x for Year 14.

(2) The notice of the correlative adjustment should be communicated in a letter signed by the appropriate Area Director.

(3) Although the Tax Court suggested in Collins Electrical Co. v. Commissioner, 67 T.C. 911 (1977), that § 482 may contemplate a suspension of the running of the statute of limitations on claims for refund of overpayment attributable to the correlative adjustment or may impose a positive duty on the Service, without regard to the statute of limitation on refund claims, to refund such overpayment, there is no express statutory language supporting that analysis. Additionally, the Supreme Court has ruled that there are no equitable exceptions to the limitations period imposed by § 6511. Accordingly, we believe that § 482 does not provide an exception to the ordinary running of the limitations period under § 6511.

FACTS

Corporation L, incorporated in Year 1, operated Business A and Business B. All of the Corporation L stock was jointly owned by Husband and Wife. In Year 6, Husband and Wife, along with family members C and D, incorporated Corporation M which was also to be engaged in Businesses A and B. Both Corporation L and Corporation M are calendar year taxpayers.

---

[1] Whenever the term "correlative adjustment" is used in this memorandum, it specifically means "correlative allocation." See § 1.482-1(g)(2).

In Year 11, Corporation L sold substantially all of its operating assets to an unrelated buyer and discontinued Business A. Corporation M expanded its Business A into the geographical area that Corporation L had served. Furthermore, in Year 11, Husband, as president of Corporation L, and C, as Vice-President of Corporation M, executed a management services contract.

Ostensibly, in exchange for management services provided to Corporation M, Corporation L received $90x in Year 12, $150x in Year 13 and $200x in Year 14. During Years 12, 13 and 14, Husband provided significant management services to Corporation M, but received only officers' compensation of $2x (Year 12), $11x (Year 13) and $3x (Year 14) from Corporation M.

During Years 12, 13 and 14, in addition to the income received under the management services contract, Corporation L reported only small amounts of income due to sales and passive income. Corporation L utilized loss carryovers to eliminate all of its taxable income for each of these years.

On Date B, the Commissioner issued a notice of deficiency to Husband and Wife. In the explanation of adjustments, the Commissioner stated that for taxable Years 12, 13 and 14, Husband rather than Corporation L provided management services to Corporation M. Therefore, under §§ 61 and 482, the payments Corporation M made to Corporation L for management services were included in Husband's taxable income.

Husband and Wife had filed joint returns for Years 12, 13 and 14. They filed a petition with the Tax Court, and the case was settled with Husband and Wife agreeing with the Commissioner's determination to treat the management fees as taxable income paid to Husband. A stipulated decision was entered in the court on Date A, Year 20. In the Counsel Settlement Memorandum, the Commissioner contended that the management service contract was a device to allow Corporation L to use its net operating losses ("NOLs") and Corporation M to avoid employment tax for Husband. Accordingly, the Commissioner determined that the management fees that Corporation M paid to Corporation L were actually paid for the services of Husband. Relying on § 482 and its clear reflection of income principles, the Commissioner determined that the management fees should be attributable to Husband for federal income tax purposes.

Several months after this agreement, Husband and Wife (as officers of Corporation L) requested a "correlative adjustment" for Corporation L pursuant to § 1.482-1(g). They requested the elimination of the taxable income due to management fees reported by Corporation L for Years 12, 13 and 14. Counsel for Husband and Wife and Corporation L believes Corporation L should be able to

decrease its taxable income as a single reduction to income in Year 20, the year in which the § 482 adjustment became final.

Corporation L paid income tax in the amounts of $40x and $300x for Years 15 and 16, respectively. Corporation L did not execute any waivers to extend the period for assessment with respect to Years 15 and 16.

LAW AND ANALYSIS

Issue 1: Section 482 of the Code authorizes the Service to allocate income and deductions among two or more "controlled" trades or businesses to prevent evasion of taxes or clearly to reflect income of the trades or businesses.

When the Service makes an allocation under § 482 (the "primary allocation"), § 1.482-1(g)(2)(i)[2] generally requires an appropriate correlative allocation with respect to any other member of the group affected by the primary allocation. Thus, if the Service makes an allocation of income with respect to a transaction, it will not only increase the income of one taxpayer, but correspondingly decrease the income of the other taxpayer.

Section 1.482-1(g)(2)(iii) states that a primary allocation will not be considered as having been made until the date of a final determination with respect to the allocation under § 482. Accordingly, the correlative adjustment is not required to be made until the date of such a final § 482 allocation. § 1.482-1(d)(2); Collins Electrical Co., supra 67 T.C. at 923.

Example 1 of § 1.482-1(g)(2)(iv), illustrating the application of the rules regarding correlative adjustments, demonstrates that once the primary allocation is made, the correlative adjustment is made on a tax-year by tax-year basis. In this example, in 1998, the Service determines that Corporation Y did not pay an arm's length rental charge to Corporation X in 1996. In 1998, the Service makes an assessment to increase X's income. The adjustment made to X's income requires

---

[2] Section 482 was amended by the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2561, et. seq. On January 31, 1993, temporary regulations under § 482 were published in the Federal Register. (58 FR 5263). A notice of proposed rulemaking (INTL-401-88) cross-referencing the temporary regulations was published in the Federal Register on that same day. On July 8, 1994, the proposed regulations under § 482 were adopted as revised, and the temporary regulations were removed. For the purposes of this memorandum, we assume that the final regulations apply to the facts of the instant case. In any event, the rules of the prior regulations under § 1.482-1(g) are substantially the same as those in the final regulations.

a correlative adjustment to Y's income. Because Y had NOLs in 1993, 1994, 1995, 1996 and 1997, a correlative adjustment to Y's 1996 taxable year would not have an effect on Y's income tax liability for 1996. However, the adjustment increasing Y's NOL for *1996* is made for the purposes of determining Y's U.S. income tax liability for 1998 or a later taxable year to which the increased NOLs could be carried.

Example 3 of § 1.482-1(g)(2)(iv) also clearly illustrates that the correlative adjustment is made on a tax-year by tax-year basis, even if the correlative adjustment has no effect on the correlative taxpayer's income tax liability for the tax-year in which the correlative adjustment is made. In Example 3, X (a U.S. corporation) makes a loan to its foreign subsidiary, Y, in 1995. In 1997, upon determining that X did not charge Y interest that would reflect arm's length dealing, the Commissioner proposes to adjust X's income to reflect an arm's length rate. X consents to the assessment in 1997. A correlative adjustment is made with respect to Y. The correlative adjustment must be reflected in the documentation of Y that is maintained for U.S. tax purposes, even though the correlative adjustment has no effect on Y's U.S. income tax liability. Thus, Y's earnings and profits for its 1995 taxable year (and subsequent years) must reflect the correlative adjustment.

Corporation L's counsel interprets § 1.482-1(g)(2) as applying the aggregate correlative adjustment to Corporation L's income for the year in which the primary allocation is settled (Year 20). If we were to apply this construct to Example 1 of § 1.482-1(g)(2)(iii), Y would be treated as making higher rental payments in 1998 (year the primary allocation is settled). Such an interpretation does not comport with Example 1 in which Y's NOL for 1996 is increased because Y is treated as making higher rental payments in 1996. Moreover, this interpretation does not comport with the result in Example 3. Notably, in Example 3, even though the amount of the adjustment is initially determined in 1997, the correlative adjustment is applied to Y's 1995 taxable year (the year of the loan).

The examples under § 1.482-1(g)(2) clearly indicate that the correlative adjustments are meant to affect the taxpayer's income tax liability on a tax-year by tax-year basis. Accordingly, in the instant case, such deemed correlative adjustments would reduce the income of Corporation L for Years 12, 13, and 14 by the amount of the management fees attributed to Husband for the years at issue: $90x for Year 12; $150x for Year 13, and $200x for Year 14. The impact of such adjustments to Corporation L's income would be to decrease the amount of NOL carryovers absorbed in each of those three years. A correlative adjustment that has the effect of decreasing the amount of Corporation L's NOL carryovers absorbed in Years 12, 13, and 14 would allow larger NOL carryovers to Year 15,

or later taxable years to which the increased unabsorbed NOLs may be carried. See Example 1 of § 1.482-1(g)(2)(iv).

A tax-year by tax-year correlative adjustment is consistent with the rules of § 172. Section 172(c) defines "net operating loss" as the amount by which the deductions allowed by chapter 1 of the Code exceed gross income. Section 172(a) allows a deduction for an amount equal to the aggregate of the NOL carryovers to the taxable year, plus the NOL carrybacks to such year.[3]

Section 172(b)(2) requires that a net operating loss for a loss year be carried back to the earliest taxable year specified in § 172(b)(1) and limits the amount of the NOL that may be carried to other years to the amount by which the loss exceeds the taxable income for any prior year to which the loss may be carried. For this purpose, the taxable income of any year to which a NOL may be carried is determined without regard to the deduction for that NOL or any NOL arising after it.

In the instant case, the correlative adjustment serves to decrease Corporation L's taxable income in Years 12, 13, and 14, thereby increasing the amount of unabsorbed NOLs that may be carried to subsequent taxable years. In Year 15, it is necessary to offset the NOL carryovers against Corporation L's income of $40x, even though, as discussed under Issue 3, due to the expiration of the statute of limitations, Corporation L cannot obtain a refund for the taxes it paid in Year 15. If there are remaining NOLs carried over to Year 16, such NOLs would be offset against $300x of L's income. Again, Corporation L cannot receive a refund for taxes paid in Year 16, due to the expiration of the statute of limitations. Corporation L may continue to carry forward its remaining NOLs in this fashion, each year setting the NOLs off against taxable income. Corporation L may apply for a refund if there are NOLs available to carry forward to an open taxable year.

Issue 2: Section 1.482-1(g)(2)(ii) states that the

---

[3] Under the general NOL rules, for tax years beginning after Aug. 5, 1997, NOLs can be carried back by a corporation to the 2 years immediately preceding the year the loss was sustained and carried forward 20 years. For tax years beginning before Aug. 6, 1997, the carryback period is three years and the carryforward period is 15 years. § 172(b)(1)(A).

> district director will furnish to the taxpayer with respect to which the primary allocation is made a written statement of the amount and nature of the correlative allocation... .

Because the position of "district director" referenced in the regulations no longer exists, the deemed correlative adjustment should be communicated in a letter executed by the new Area Director. Such a letter would have the same force and effect as correspondence executed by the appropriate district director prior to the restructuring of the Internal Revenue Service in October 2000.

H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 193, 194 (1998), notes that the IRS Commissioner is directed to restructure the IRS. "The legality of IRS actions will not be affected pending further appropriate statutory changes relating to such a reorganization (e.g., eliminating statutory references to obsolete positions.)"

Issue 3: IRC § 482 prevents the artificial shifting of income among commonly controlled taxpayers; i.e., it ensures they deal at arm's length. Generally, whenever the Service acts under § 482 to allocate income to one commonly controlled taxpayer, the Service makes a correlative adjustment in the income of another. See § 1.482-1(g)(2)(i).

In Collins Electrical Co., supra 67 T.C. at 923, the Tax Court recognized the problem that might arise with claiming a refund as a result of a correlative adjustment. In many cases, a correlative adjustment will result in an overpayment by the correlative taxpayer. In a non-section 482 situation, an overpayment of taxes ordinarily will be refunded only if a timely claim therefor has been filed. Yet a primary adjustment under § 482 is not considered to have been made (and therefore a correlative adjustment is not required to be made) until the correctness of the adjustment has been settled by agreement, by payment of the deficiency, or by some other form of final determination. See § 1.482-1(g)(2)(iii). The occurrence of any one such event may take place after the normal limitation period for refund claims has expired.

One method of avoiding this problem is for the correlative taxpayer to file a protective claim for refund before the primary adjustment is made. In fact, directions for notifying the related party about the correlative allocation during the examination involving the primary allocation are provided in IRM 4.3.1.1, International Procedures Handbook.[4] In addition, at the end of the examination in

---

[4] Subsection 8.3.2, Examination Procedures (2/26/99), of the Handbook provides: (1) If the examination of the primary taxpayer results in adjustments per IRC

an agreed case, a special 30 day letter is issued to the correlative taxpayer regarding the correlative allocation.[5] While notification to the correlative taxpayer about the possible need to file a protective refund claim may affect the equities in applying the normal statute of limitations on a refund claim, the Tax Court rejected reliance on the Service's internal operating procedures as determinative of whether a related party is barred from making a refund claim.[6] Collins Electrical

---

482, conduct the examination of the correlative U.S. taxpayer concurrently.

a. Notify the correlative U.S. taxpayer in writing as early as possible that proposed adjustments affect the tax liability of the correlative taxpayer.
b. Advise the correlative taxpayer of the period of limitations under IRC 6511.
c. Solicit Form 1040X or Form 1120X from the correlative taxpayer, if the period for filing a claim for refund expires in less than 180 days.

[5] Subsection 8.3.2.1, Processing Agreed Cases (2/26/99), of the Handbook provides: (1) After review and approval of the examination reports for the primary and correlative taxpayers, the reviewer issues instructions regarding a special preliminary (30-day) letter to the correlative taxpayer. The letter advises the correlative taxpayer of the following:

a. Nature of the adjustment(s)
b. Reason the overpayment cannot be made at this time.
c. Possible need to protect the statute of limitations from expiring.

See, subsection 8.3.2.2, Processing Unagreed Cases (2/26/99), regarding issuing an appropriate 30-day letter for an unagreed case.

[6] In the instant case, the Service did not provide any notification concerning a correlative allocation. However, it does not appear that Corporation L was in need of notification. Corporation L raised the issue of the application of IRC § 482 and correlative allocations itself. Moreover, Corporation L was owned entirely by Husband (in joint ownership with Wife). Husband was the subject of the primary allocation and also controlled Corporation M. Thus, Corporation L was aware of the potential for the Service to reallocate income from the start of the Husband's examination. Moreover, the subject case concerns a shifting of income, and not simply an adjustment in the price of a transaction, and in such a case Corporation L was aware of the potential for reallocation by the very nature of the transaction, as evidenced by the steps taken to shift the income in the first place. Therefore, Corporation L should have been aware of the need to protect the refund period of limitations before it expired. Husband, as an officer of Corporation L, could have signed a Form 872 on Corporation L's behalf, thereby extending the statute of limitations for Corporation L's taxable Years 12, 13 and 14.

Co., 67 T.C. supra, at 924 n. 6 ("[w]e think the right to a correlative adjustment cannot depend on which side is to blame for procedural errors").

The Fifth Circuit has also expressed the view, albeit in dicta, that the right to claim a refund resulting from a correlative adjustment does not turn upon notification from the Service.

> Nor do the regulations require the Commissioner to presume that a correlative adjustment will affect the tax liability of a related corporation for a pending taxable year. A taxpayer seeking a refund bears the burden of notifying the Commissioner that a refund is sought and of indicating the basis for the claim. [Citations omitted]. The regulations promulgated under § 482 do not shift this burden to the Commissioner.

Continental Equities, Inc. v. Commissioner, 551 F.2d 74, 81 (5th Cir. 1977).

In Collins Electrical Co., as a suggestion to resolve the problem, the Tax Court, made the following comment:

> Section 482 may contemplate a suspension of the running of the statute of limitation on claims for refund of the overpayment attributable to the correlative adjustment or, as the first sentence of § 1.482-1(d)(2), Income Tax Regs., . . . seems to suggest, may impose a positive duty on the Commissioner, without regard to the statute of limitation on refund claims, to refund such overpayment.

67 T.C. at 924. Without more, we do not believe that the foregoing suggestion provides sufficient authority for the Service to adopt the Tax Court's analysis. In fact, the weight of authority appears to the contrary.

It is a fundamental tenet of administrative law that statutes control over regulations. Thus, to the extent that the regulations under § 482 conflict with IRC § 6511, the limitations periods specified in § 6511 must control.

The Tax Court suggests, however, that it is not merely a regulation, but § 482 itself, that creates an exception to the provisions of § 6511. On that point, we note that there is no mention of limitations periods at all in the express language of § 482. Even if one were inclined to adopt the Tax Court's suggestion, § 482 provides no guidance on what event would trigger the suspension of the limitations period, when it would start again, and whether any time would be added in the limitations period after the suspension ends, in a manner similar to the provisions

of § 6503(a). Thus, the Tax Court's tolling suggestion does not appear to be workable as a practical matter.

Furthermore, the suggestion that § 482 sub silento imposes a positive duty upon the Commissioner to refund an overpayment notwithstanding the statute of limitations on refund claims flies in the face of a detailed statutory scheme for obtaining a refund. The motivation for the Tax Court's willingness to make this suggestion arises from equitable concerns, namely its intent to avoid being seen as sanctioning a double tax on the same income. Collins Electrical Co., supra 67 T.C. at 922. The Supreme Court, however, has clearly rejected equitable tolling of the statute of limitation on refund claims. In United States v. Brockamp, 519 U.S. 347, 352 (1996), the Supreme Court stated that to read an equitable tolling provision into § 6511 would work a kind of linguistic havoc. Instead, the Court states that "[s]ection 6511's detail, its technical language, the iteration of the limitations in both procedural and substantive forms, and the explicit listing of exceptions, taken together, indicate . . . that Congress did not intend courts to read other unmentioned, open-ended, 'equitable' exceptions into the statute that it wrote." For the same reasons, we believe that the Service is not authorized to read unmentioned exceptions to § 6511 in other provisions of the Code, including § 482.

Your memorandum briefly mentions the mitigation provisions in IRC §§ 1311-1314. We note that the definition of a related party under IRC § 1313(c) does not list a corporation and a shareholder and, therefore, the mitigation provisions would not apply to the facts presented.

Additional Consideration:

You did not request advice concerning an adjustment to conform accounts to reflect allocations made under § 482, as provided for by § 1.482-1(g)(3). In this case, such an adjustment would be appropriate to conform the accounts of Corporation L to reflect the fact that the management fees it received from Corporation M were allocated to Husband for federal income tax purposes but that the payments actually remain in Corporation L. In these circumstances, the appropriate § 1.482-1(g)(3) adjustment appears to be to treat the funds that actually remain with Corporation L as a capital contribution by Husband to Corporation L. Such an adjustment would increase the amount of Corporation L's paid-in capital and of Husband's basis in his Corporation L stock.

Case Development, Hazards and Other Considerations

[redacted] Collins Electrical Co., supra, 67 T.C. at 922-24, (stating that § 482 may contemplate a suspension of the running of the statute of limitation on claims for refund of an overpayment attributable to a correlative adjustment, or may impose a positive duty on the Commissioner to refund such an overpayment). However, the issue was not before the court in the Collins Electrical Co. case, nor was it before the Tax Court in Union Carbide Corporation and Subsidiaries v. Commissioner, supra, 110 T.C. at 390-391, when, in connection with a hypothetical situation posed by the petitioner in that case, it referred to its statements in the Collins Electrical Co. case regarding the possibility that § 482 may contemplate a suspension of the statute of limitation or a duty to refund an overpayment. Moreover, we think it is far from clear that the Tax Court would have authority to provide relief from the requirements of § 6511 in the circumstances in this case. See United States v. Brockamp, supra, 519 U.S. at 352-53 (no equitable exceptions to the limitations of § 6511).

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.

If you have any questions regarding the correlative adjustment under § 1.482, please contact Branch 2 of CC:CORP on (202) 622-7770. If you have any questions regarding the refund period of limitations, please contact Branch 2 of CC:PA:APJP on (202) 622-4940. If you have any questions regarding mitigation, please contact Branch 3 of CC:PA:APJP on (202) 622-7940.

Sincerely,
Jasper L. Cummings
Associate Chief Counsel, Corporate

By: _____
Gerald B. Fleming
Senior Technician Reviewer, Branch 2