



# MANUAL TRANSMITTAL

Department of the Treasury  
Internal Revenue Service

4.10.13

JULY 27, 2023

## EFFECTIVE DATE

(07-27-2023)

## PURPOSE

- (1) This transmits a revision of IRM 4.10.13, Examination of Returns, Certain Technical Issues.

## MATERIAL CHANGES

- (1) Minor editorial changes have been made throughout this IRM. Website addresses, legal references, and IRM references were reviewed and updated as necessary. Updates were made to adhere to the IRM style guide.
- (2) Significant changes to this IRM are listed in the table below:

IRM Reference	Description of Change
IRM 4.10.13.1	Replaced Section Overview with Program Scope and Objectives including background, topics covered, authority, responsibilities, acronyms and abbreviations, and related resources.
IRM 4.10.13.2	Added information on tax rates, accumulated earnings credit and a link to the Virtual Library.
IRM 4.10.13.2.5.1	Added information on the Virtual Library, the Bardahl formula worksheet, and the Apollo case referred to in Exhibit 4.10.13-2.
IRM 4.10.13.3	Clarified the authority under IRC 6901. Changes made throughout subsection to display the references from statutory notice of deficiency to notice of liability with respect to the transferee. Also added relevant references to IRM 4.11.52 and IRM 5.17.14. and the subsections with them.
IRM 4.10.13.3.2	Added context to the definitions of transferees at law and transferees in equity.

IRM Reference	Description of Change
IRM 4.10.13.3.2.1	Added notes regarding consulting Area Counsel and information about burden of proof. Updated paragraph (6)(e)(7) to ensure that the statement is not too broad in light of the differing state or federal laws.
IRM 4.10.13.3.3.1	Added a more recent court case, <i>Starnes v. Commissioner</i> , 680 F. 3d 417 (4th Cir. 2012).
IRM 4.10.13.3.2.2	Added clarification about statutory mergers resulting in liability for the successor corporation.
IRM 4.10.13.3.5	Clarified information on Liability of Transferee for Interest.
IRM 4.10.13.6	Changes made throughout this subsection, Activities Note Engaged for Profit - Hobby Loss (IRC 183), as shown below.
IRM 4.10.13.6.1	Reworded for clarity: must meet the requirements of IRC 162 <b>or</b> IRC 212.
IRM 4.10.13.6.1.4	Added a note regarding temporary tax law changes for miscellaneous itemized deductions under the Tax Cuts and Jobs Act (TCJA).
IRM 4.10.13.7	Added reference for change in accounting methods, as well as other changes in the subsection as listed below.
IRM 4.10.13.7.2	Updated this section to define taxpayers who are allowed to use the cash method of accounting and the rules under the cash method.

IRM Reference	Description of Change
IRM 4.10.13.7.2.1	Added a new paragraph to address a qualifying taxpayer that does not want to account for inventories. Added more information on rules for inventory for tax years beginning before January 1, 2018. Updated automatic consent information for making a voluntary change to cash method of accounting. Added note regarding inventory beginning after December 31, 2017 referring to IRM 4.10.13.7.2.2.
IRM 4.10.13.7.2.2	Added a new subsection titled, Inventory Exceptions That May Allow the Use of the Cash Method for Tax Years Beginning After December 31, 2017.
IRM 4.10.13.7.4	Added a new paragraph (3) to discuss Revenue Procedures 2001-10 and 2018-31 that provide exceptions to certain rules relating to accounting methods. Added new paragraph (4) to discuss small business taxpayer rules for tax years beginning after December 31, 2017.
IRM 4.10.13.7.5	Added a new paragraph (3) to explain the all events test under IRC 461.
IRM 4.10.13.7.7	Updated rules for voluntary changes in accounting methods.
IRM 4.10.13.7.9.3	Updated example to more current years. Added clarification noting a difference when the change is taxpayer initiated.
IRM 4.10.13.7.9.4	Updated example with more current years. Updated table for Section 508 compliance. Noted that net investment income tax is not considered in the IRC 481(b) computation.

IRM Reference	Description of Change
IRM 4.10.13.7.10	Added this new subsection to discuss tax law changes for tax years beginning after December 31, 2017.
IRM 4.10.13.7.11	Updated summary to reflect changes made throughout 4.10.13.7.
IRM 4.10.13.11	Added new subsection to incorporate the information on the Interim Guidance Memorandum, Control number LB&I -04-0422-0014 dated 4/22/22 on Economic Substance Doctrine and Related Penalties
Exhibit 4.10.13-1	Updated table on Bardahl-Apollo Formulas with explanations of calculations for clarity.

#### **EFFECT ON OTHER DOCUMENTS**

This IRM supersedes IRM 4.10.13, dated October 28, 2015.

#### **AUDIENCE**

Examination personnel in SB/SE, LB&I and Specialty Programs

Garrett Gluth  
Director, Examination Quality & Technical Support  
SE:S:DCE:E:HQ:EQ&TS Small Business/Self-Employed

4.10.13

Certain Technical Issues

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4.10.13.1  
(07-27-2023)  
**Program Scope and Objectives**

- (1) Purpose: This IRM Section provides information on various topics as shown in the table of contents.
- (2) Audience: LB&I and SB/SE personnel.
- (3) Policy Owner: SB/SE HQ Director, Examination Quality and Technical Support
- (4) Program Owner: SB/SE EQTS
- (5) Primary Stakeholders: LB&I and SB/SE personnel
- (6) Program Goals: To assist examiners working cases involving a variety of specialized issues.

4.10.13.1.1  
(07-27-2023)  
**Background**

- (1) This IRM provides information for general examination procedures that examiners should understand and apply in the performance of their duties.
- (2) The topics covered, and their subsections are listed below:

IRM Subsection	Topic
IRM 4.10.13.2	Accumulated Earnings Tax (IRC 531)
IRM 4.10.13.3	Transferor-Transferee Liability Cases
IRM 4.10.13.4	Related Party Transactions (IRC 482)
IRM 4.10.13.5	Adjustments Between Correlative Taxpayers (also known as Whipsaw Issues)
IRM 4.10.13.6	Activities Not Engaged in For Profit - Hobby Loss (IRC 183)
IRM 4.10.13.7	Change in Accounting Method
IRM 4.10.13.8	Real Estate Developers: Alternative Treatment of Common Improvements Under Rev. Proc. 92-29
IRM 4.10.13.9	Self-Rented Property and Renewable Options
IRM 4.10.13.10	Personal Holding Company Deficiency Dividends
IRM 4.10.13.11	Economic Substance Doctrine

- (3) Additional information on certain topics in this IRM may be found in the following Examining Officers Guide (EOG) IRMs:
  - IRM 4.11.5, Allocation of Income and Deductions Under IRC 482;
  - IRM 4.11.6, Changes in Accounting Methods; and
  - IRM 4.11.52, Transferee Liability Cases.

4.10.13.1.2  
(07-27-2023)  
**Authority**

- (1) By law, the IRS has the authority to conduct examination under Title 26, Internal Revenue Code, Subtitle F - Procedure and Administration, Chapter 78, Discovery of Liability and Enforcement of Title, Subchapter A, Examination and Inspection.

- (2) The following are some of the Internal Revenue Code sections and published guidance that governs the topics covered.

Reference	Description
IRC 332	Complete Liquidations of subsidiaries
IRC 905(c)	Adjustments To Accrued Taxes
IRC 6501	Limitations on Assessment And Collections
IRC 6532	Periods of Limitation on Suits
IRC 6662	Imposition of Accuracy Related Penalty on Understatements
IRC 6662A	Imposition of Accuracy-Related Penalty on Understatements With respect to Reportable Transactions
IRC 6664	Definitions and Special Rules
IRC 6676	Erroneous Claim for Refund or Credit
IRC 6901	Transferred Assets
IRC 7121	Closing Agreements
IRC 7405	Action for Recovery of Erroneous Refunds
IRC 7430	Awarding of Costs and Certain Fees
IRC 7605	Time and Place of Examination
<i>Notice 2014-58</i>	Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties
Rev. Proc. 64-22	Statement of Some Principles of Internal Revenue Tax Administration
Rev. Proc. 2005-32	Examination of Returns and Claims for Refund, credit, or Abatement; Determination of Correct Tax Liability
Rev. Proc. 2010-11	Forms and Instructions
Rev. Proc. 2012-18	Ex Parte Communications Between Appeals and Other Internal Revenue Service Employee

Reference	Description
Rev. Proc. 2016-22	Appeals Function

4.10.13.1.3  
(07-27-2023)  
**Responsibilities**

- (1) The Director, Headquarters Examination, is the executive responsible for providing policy and guidance for SB/SE Examination employees and ensuring consistent application of policy procedures and tax law to effect tax administration while protecting taxpayer rights. See IRM 1.1.16.5.5, Examination Headquarters, for more information.
- (2) The Director, Examination Quality and Technical Support, reports to the Director, Headquarters Examination, and is responsible for implementing strategies to prevent abusive and offshore tax noncompliance, provide technical guidance and support Field, Campus, and Specialty Exam Quality. See IRM 1.1.16.5.5.4, Exam Quality and Technical Support, for more information.
- (3) The Technical Support Group, which is under the Director, Examination Quality and Technical Support, is the group responsible for promoting fair, consistent, and effective administration of income tax examinations by implementing new tax legislation, supporting communication office, managing tax forms and publications by educating SB/SE examiners, SB/SE taxpayers, and practitioners through education, outreach and enforcement. See IRM 1.1.16.5.5.4.3, Technical Support Group, for more information.
- (4) All examiners must perform their professional responsibilities in a way that supports the IRS Mission. This requires examiners to provide quality service and to apply the law with integrity and fairness to all.
- (5) Income tax examiners and their managers should thoroughly acquaint themselves with the examination procedures and information contained in this IRM, as well as other resources, such as those listed in IRM 4.10.13.1.5 , Related Resources, below.

4.10.13.1.4  
(07-27-2023)  
**Acronyms and Abbreviations**

- (1) The following table lists commonly used acronyms and their definition used throughout this IRM:

Acronym	Definition
AC	Activity
AIMS	Audit Information Management System
ATG	Audit Technique Guide
CCP	Centralized Case Processing
EOG	Examining Officer's Guide
ERCS	Exam Return Control System
FDCP	Federal Debt Collection Procedures

Acronym	Definition
PHC	Personal Holding Company
PSP	Planning and Special Procedures
TCS	Tax Compliance Specialist
TCJA	Tax Cuts and Jobs Act
TEFRA	Tax Equity and Fiscal Responsibility Act
TIN	Taxpayer Identification Number
TS	Technical Services

4.10.13.1.5  
(07-27-2023)

**Related Resources**

- (1) Additional information can be found in the following Examining Officer's Guide (EOG) IRMs:
- IRM 4.11.5, Allocation of Income and Deductions Under IRC 482
  - IRM 4.11.6, Change in Accounting Methods, and
  - IRM 4.11.52, Transferee Liability Cases

4.10.13.2  
(07-27-2023)

**Accumulated Earnings Tax (IRC 531)**

- (1) The purpose of the accumulated earnings tax is to prevent a corporation from accumulating its earnings and profits beyond the reasonable needs of the business for the purpose of avoiding income taxes on its stockholders.
- (2) Liability for the accumulated earnings tax is based on the following two conditions:
- a. The corporation must have retained more earnings and profits than it can justify for the reasonable needs of the business
  - b. There must be an intent on the part of the corporation to avoid the income tax on its stockholders by accumulating earnings and profits instead of distributing them.
- (3) The term **earnings and profits** is not defined in any of the revenue acts. The amount of earnings and profits for a taxable year usually is computed by adjusting taxable income in accordance with 26 CFR 1.312-6.
- (4) Any corporation within a chain of corporations can be subject to the accumulated earnings tax. A subsidiary corporation can be subject to the accumulated earnings tax even though the parent corporation is not subject to the accumulated earnings tax and vice versa.
- (5) The accumulated earnings tax is computed on the corporation's accumulated taxable income (defined in IRC 535(a)) for the taxable year or years in question.
- (6) The accumulated taxable income is the corporation's taxable income with various adjustments, minus the dividends paid deduction and the accumulated earnings credit. These adjustments are made primarily for the purpose of arriving at an amount that corresponds more closely to financial reality and thus, measures more accurately the corporation's dividend paying capacity for the year.

- (7) The tax is 20% of the accumulated taxable income.
- (8) To calculate accumulated taxable income IRC 535(c) allows a minimum accumulated earnings credit. In general, the minimum credit is the amount by which \$250,000 exceeds the accumulated earnings and profits at the close of the preceding year.
  - a. An accumulation in excess of the \$250,000 minimum credit is not an indication of an unreasonable accumulation.
  - b. There is no statutory maximum credit that can be allowed. The maximum credit allowed is the amount of current earnings and profits retained for the reasonable needs of the business (adjusted for net capital gains)
- (9) The Virtual Library has useful information including recent guidance. See Corporate/Business Issues & Credits Knowledge Base.

4.10.13.2.1  
(03-16-2015)  
**Considerations in  
Computing Accumulated  
Earnings and Profits**

- (1) In order for the examiner to make a determination on the corporation's accumulated earnings and profits, the following items should be considered:
  - a. Book "earned surplus" should be analyzed. The book account may have been reduced by the transfers to capital, or other accounts, in the form of stock dividends or reserves.
  - b. Some accounting write-offs of surplus might not qualify as write-downs of earnings and profits for tax purposes.
  - c. It is generally helpful to reconcile the surplus shown in the books to earnings and profits available for tax purposes.
  - d. Life insurance proceeds are a part of earnings and profits and are available for dividend distribution.
  - e. Excess of percentage depletion over cost depletion constitutes a part of earnings and profits.
  - f. At some time during the history of the corporation, surplus may have been reduced by writing down purchased goodwill or other intangible assets. For this reason, the examiner should prepare a careful analysis of the earned surplus account for the year under examination and at least the five preceding years, and the amount and date of any cash dividends paid shortly after the close of the year under examination. If any distribution of dividends in reorganization was made, full details of such distribution should be stated.

4.10.13.2.2  
(03-16-2015)  
**Indicators of Intent**

- (1) A prerequisite to imposition of the IRC 531 tax has been that the corporation be formed or availed of for the purpose of avoiding the income tax on its shareholders. As purpose involves a state of mind or intent, it is necessary to look at the surrounding facts and circumstances in each individual case to determine whether the purpose of the accumulated earnings was to allow the shareholders to avoid the income tax or for some other purpose.
- (2) The following factors should be considered in determining whether the tax avoidance purpose was present (this list is not exclusive and no one factor is determinative of the intent to avoid shareholder tax):
  - a. Dealings between the corporation and its shareholders, including loans to shareholders and expenditures of corporate funds for the personal benefit of the shareholders - note that corporate loans to or expenditures on behalf of shareholders tend to show that the corporation has the capacity to distribute these funds as dividends, particularly if there is a pattern of

these transactions, the loans or expenditures are substitutes for dividends and show that corporate earnings are diverted, and The examiner should include an analysis of amounts, if any, withdrawn by the stockholders in the form of loans or advances and reflected in the asset accounts at the close of the year under examination

- b. Investments of undistributed earnings in assets having no reasonable connection with the corporation's business. An inference may arise if the corporation has invested its funds for purposes which are not reasonably related to the business. Such unrelated investments evidence the liquidity and dividend-paying capacity of the corporation, as well as an inference that the failure to distribute such funds as dividends was for the purpose of avoiding shareholder taxes.
- c. The corporation's dividend history - note that a failure to distribute dividends or minimal payments indicates that earnings may have been accumulated to avoid shareholder taxes, a failure to distribute dividends or minimal payments indicates that earnings may have been accumulated to avoid shareholder taxes, the examiner should include a statement showing the amount of taxes actually avoided by the principal stockholders through the failure of the corporation to distribute all of its earnings for the year under consideration, and even if the corporation has a good dividend record and pays liberal officer-stockholder salaries, this does not in itself serve to rebut the tax avoidance factor.

4.10.13.2.3  
(03-16-2015)  
**Holding or Investment  
Company**

- (1) IRC 532(a) states that the accumulated earnings tax imposed by IRC 531 shall apply to every corporation (other than those described in subsection IRC 532(b) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.
- (2) IRC 532(b), Exceptions, states that the accumulated earnings tax imposed by section 531 shall **not** apply to a personal holding company (as defined in IRC 542 , Definition of personal holding company),
- (3) However, a Personal Holding Company (PHC) tax is a penalty tax which discourages excessive accumulation of passive income. Regulations under IRC 547, Deduction for Deficiency Dividends, provide a method (absent fraud) for a corporation to eliminate its personal holding company tax liability for a prior year by making a distribution of a deficiency dividend. The benefits of IRC 547 are applicable when an examination results in an agreed deficiency in PHC tax. See IRM 4.8.8.4 for additional information.
- (4) The examiner should set forth the basis for concluding why a corporation does not qualify as a personal holding company, and why it is a mere holding company or investment company that was formed or availed of for the purpose of sheltering its shareholders from income taxes.

4.10.13.2.4  
(03-16-2015)  
**Reasonable Needs of  
the Business**

- (1) Examiners should consider that IRC 543 provides that earnings permitted to accumulate beyond the reasonable needs of the business shall be "determinative" of the purpose to avoid shareholder's income taxes unless the corporation shall prove to the contrary by a preponderance of the evidence. By virtue of this provision, most cases have been won or lost on the battleground of reasonable business needs.

4.10.13.2.4.1  
(03-16-2015)  
**Effect of Prior  
Accumulations**

- (1) In determining whether current earnings were accumulated for reasonable business purposes, the examiner must make a determination on whether prior accumulations were, in fact, sufficient to meet the taxpayer's then current and reasonably anticipated future needs. See 26 CFR 1.537-1(a).
- (2) In making this determination, it is necessary to examine the character of the corporation's assets, since earnings used for the expansion of business plant or equipment, inventories, or accounts receivable cannot be readily distributed to the stockholders no matter how large the corporation's earned surplus may be.
- (3) This issue requires a thorough analysis of the corporation's business and financial status for each year, including:
  - a. Balance sheet position - meaning the size, character, and relationship of its various asset, liability, and surplus accounts
  - b. Profit and loss statement
  - c. Liquidity and cash flow position
  - d. Type of business
  - e. Economic conditions prevailing in the taxpayer's business

4.10.13.2.4.2  
(03-16-2015)  
**Factors to be  
Considered in  
Determining Reasonable  
Needs**

- (1) The term "reasonable needs of the business" includes the reasonably anticipated future needs of the business.
- (2) The following items, while not exclusive, may indicate that the earnings and profits are being accumulated for the reasonable needs of the business and should be used as guides:
  - a. Bona fide expansion of business or replacement of plant
  - b. Acquisition of a business enterprise through purchasing stock or assets
  - c. Retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with obligations incurred on issue
  - d. Necessary working capital for the business
  - e. Investments or loans to suppliers or customers
- (3) Apart from the grounds specifically mentioned above, accumulations may be justified by a range of business needs. Among these are the following:
  - a. Redemption of stock held by minority stockholders
  - b. Need to meet competition
  - c. Reserves for various business risks and contingencies such as self-insurance against casualties, potential liability from litigation, and unsettled business conditions
  - d. Need to finance pension or profit-sharing plans for the employer
  - e. Possible loss of principal customer
  - f. The IRC 303 redemption needs of the business. Examiners should thoroughly investigate the facts and circumstances in the case with a view toward determining whether the redemption was for a corporate purpose or was primarily for the benefit of the stockholders in a redemption of the stock of a minority or a majority stockholder
  - g. Need to redeem excess business holdings of shareholders under IRC 4943, Taxes on excess business holdings.



## 4.10.13.2.4.3

(03-16-2015)

**Contingencies**

- (1) Accumulations have been justified as a result of various forms of contingencies including the following:
  - a. An actual or potential lawsuit
  - b. A possible liability arising out of some contractual obligation
  - c. A possible business reversal resulting from the loss of a customer
  - d. Accumulations to guard against competition has been justified in some cases
  - e. An accumulation to provide funds to finance a self-insurance plan. This includes key men/women, as well as the more common types of risk insurance
  - f. Accumulations to provide a retirement plan for employees

## 4.10.13.2.4.4

(03-16-2015)

**Financing of Corporate Operations and Debt Retirement**

- (1) A corporation **cannot** be required to resort to the borrowing of funds under any circumstances. Therefore, the current operations of the business or planned expansion may be financed fully by retained earnings.
- (2) An accumulation to retire a corporate indebtedness has in most cases been determined to be a reasonable need of the business, depending upon the reason the debt was created in the first place.
- (3) The examiner should determine if the debt to be retired by the accumulation was bona fide and was incurred in connection with the trade or business.

## 4.10.13.2.4.5

(03-16-2015)

**Effect of Subsequent Events**

- (1) Events subsequent to the end of the taxable year may not be used to show that retention of earnings and profits was unreasonable at the close of such taxable year if all the events indicated a reasonable accumulation at the close of the taxable year.
- (2) Examiners may consider subsequent events to determine the taxpayer actually intended to carry out or has actually carried out the plans for which the earnings and profits were accumulated.
- (3) The fact that the corporation did not, in fact, use the accumulated funds as originally planned does not necessarily mean that the accumulation was not reasonable when made.
- (4) If the earnings are not used to accomplish the purpose for which they were to be used, this may indicate that the earnings were not to be used for the indicated purpose in the first place and will make any future accumulations more difficult to justify.

## 4.10.13.2.4.6

(03-16-2015)

**Working Capital**

- (1) Working capital is defined as current assets minus current liabilities. Working capital is the liquidity of a business that is used in its day-to day operations.
- (2) The working capital needs of a business are justification of accumulating earnings and profits.

## 4.10.13.2.5

(03-16-2015)

**Operating Cycle Approach**

- (1) The formula for calculating the working capital needs of a manufacturing concern or similar business is set forth in the *Bardahl Manufacturing Corp. v. Commissioner*, T.C. Memo. 1965-200. In that case, the Tax Court permitted the corporation to accumulate enough working capital to cover the normal expenses of one operating cycle plus any anticipated extraordinary operating



expenses. This is known as the operating cycle approach, which uses a mathematical formula to compute working capital needs.

- (2) A normal operating cycle is the period of time required to convert cash into raw materials, raw materials into inventory of finished goods, finished goods inventory into sales and accounts receivable, and accounts receivable into cash.

4.10.13.2.5.1  
(07-27-2023)

**Selection of Appropriate Working Capital Formula**

- (1) Inasmuch as the need for working capital has long been recognized as the main reason for accumulating earnings and profits, the examiner should compute the Bardahl formula as modified by the *Empire Steel Casting, Inc. v. Commissioner*, T.C. Memo. 1974-34, decision, on a preliminary basis by using the figures shown on the return to calculate reasonable working capital needs. If the taxpayer's net working capital exceeds the calculated reasonable working needs, then further analysis should be made following the procedures set forth in Exhibit 4.10.13-1. See also the Virtual Library in the Corporate/Business Issues & Credits Knowledge Base which contains an overview of accumulated earnings tax with links to published guidance and a Bardahl Formula worksheet job aid.
- (2) In an expanding business, the examiner should obtain the necessary financial information to compute the corporation's working capital needs in the years immediately preceding the year or years under examination and the years immediately succeeding the year or years under exam.
- (3) For seasonal business, the Bardahl International formula is considered more appropriate for peak inventory and receivable months. For service business, the formulas should be modified to consider the average length of time required to perform on a contract rather than use the operating inventory turnover concept. The Apollo formula (stemming from a court case: *Apollo Industries v. C.I.R.*, 358 F.2d 867 (1966)) may have application to non-manufacturing businesses. See Exhibit 4.10.13-2.

**Note:** The exhibit does not include computations for accounts payable. Accounts payable may or may not be relevant in the determination of the capital needs, depending on the facts and circumstances.

- (4) As noted above, the Bardahl formula is "one test" and is not necessarily applicable to every IRC 531 case. Examiners who are considering IRC 531 should analyze each case with respect to specific facts before determining the type of operating cycle approach most appropriate.
- (5) The latest criteria relied on in current court decisions should be considered.

4.10.13.2.6  
(03-16-2015)

**Relationship to Other IRC Sections**

- (1) Consideration should be given to the relationship between IRC 531, Imposition of accumulated earnings tax, IRC 541, Imposition of Personal Holding Company Tax and IRC 545, Undistributed Personal Holding Company Income, since these sections consider the problem of tax avoidance through undistributed earnings. An examiner may find that a potential IRC 541 case is actually a good IRC 531 case because the taxpayer does not qualify as a personal holding company.

4.10.13.2.7  
(03-16-2015)

**Data to be Furnished  
When Application of IRC  
531 is Recommended**

- (1) The examiner should weigh all available evidence before proposing to apply IRC 531. When it is determined that IRC 531 should not be applied, the examiner will make a clear, concise statement in his/her report transmittal or workpapers supporting the recommendation.
- (2) If an examiner recommends application of IRC 531, the examiner will include the data, specified in (3) below, in the workpapers or in the report transmittal. Since disclosure of certain information specified below might violate the disclosure provisions, the report will only include information considered vital to the taxpayer's understanding of the case.
- (3) The examiner will include in the report transmittal or workpapers the following data:
  - a. A history of the corporation from the date of its incorporation, fully setting forth the purpose for which it was formed, including comments, if applicable, regarding assets transferred thereto, capital stock issued in exchange for such assets, actual paid-in capital, and whether represented by par or no-par stock, and if no-par stock, the stated value, in any ascribed thereto and kind of business in which engaged.
  - b. Names and addresses of the principal or controlling stockholders and number of shares held by each at the close of the year involved.
  - c. Names and titles of the officers of the corporation, stock ownership (if any) and amount of compensation received if such information is not contained in the corporate return.
  - d. A statement of substantial amounts, if any, withdrawn by the stockholders in the form of loans or advances and reflected in the asset accounts at the close of the year under examination.
  - e. An analysis of the earned surplus account for the year under examination and at least the five preceding years, which will show in particular both taxable and nontaxable income, the amount of cash dividends paid during each of the respective years, and the amount and date of any cash dividends paid shortly after the close of the year under examination. If any distribution of dividends in reorganization was made, full details of such distribution should be stated.
  - f. A statement showing the amount of taxes actually avoided by the principal stockholders through the failure of the corporation to distribute all of its earnings for the year under consideration.
  - g. Review of corporate minutes for a discussion on why the funds are being accumulated (e.g., plans for plant expansion, debt retirement, inventory increases, etc.).
  - h. Comparative balance sheets at the beginning and end of the year or years under examination, and five prior years.
  - i. Whether or not, in the opinion of the examiner, the corporation is a mere holding or investment company and the basis for such conclusion and why it does not qualify as a personal holding company under the applicable revenue law.
  - j. Any other facts and circumstances deemed pertinent by the examiner, including a summary of the material facts upon which the IRC 531 recommendation is based.

4.10.13.2.8  
(03-16-2015)  
**Notification of  
Unreasonable  
Accumulation of  
Earnings**

- (1) In any proceeding before the Tax Court involving the allegation that a corporation has permitted its earnings and profits to accumulate beyond reasonable business needs, the burden of proof is on the Commissioner unless a notification is sent to the taxpayer under IRC 534(b), Notification by Secretary, prior to issuance of a notice of deficiency. However, if such a notification is sent to the taxpayer and the taxpayer timely submits the statement described in IRC 534(c), the burden of proof will be on the Commissioner as to the grounds given in the statement.
- (2) Operating officials who hold delegations or redelegations of authority to sign notices of deficiency pursuant to Servicewide Delegation Order 4-8 are also empowered to sign notifications under IRC 534(b). See IRM 4.8.8.2, Accumulated Earnings Tax, regarding coordination with Technical Services.
- (3) IRC 534(b) requires that taxpayers be notified if a proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by IRC 531 so that the burden of proof initially will be on a taxpayer.
  - a. Exam is responsible for notifying the taxpayer.
  - b. Letter 572 is used for this notification. The letter may be sent to the taxpayer prior to issuance of the 30-day letter or concurrently with the 30-day Letter (in which case the purge date will allow for 60 days rather than the normal 30 days).
  - c. Letter 572 should be mailed concurrently with the 30-day Letter in unagreed cases having less than one year remaining on the statute of limitations.
  - d. If notification is sent to the taxpayer and (1) the taxpayer timely submits the statement of the grounds on which the taxpayer relies to establish that there has been no accumulation of earnings and profits beyond the reasonable needs of the business and, (2) such grounds are supported by facts contained in the statement, then the burden of proof will be on the Commissioner as to the grounds given in the statement. See 26 CFR 1.534-2(a)(2).
  - e. Officials and reviewers delegated to sign notices of deficiency pursuant to Servicewide Delegation Order 4-8 are also empowered to sign Letter 572.
- (4) A notice of deficiency will not be issued before expiration of the period of time granted for filing the statement except when expiration of the period of limitation is imminent or other compelling circumstances require earlier issuance.
- (5) If a jeopardy assessment is made under IRC 6861(a), a separate notification need not be sent before a notice of deficiency is issued. In such instances the notice of deficiency, which must be mailed within 60 days after the date of assessment, constitutes the notification providing it informs the taxpayer that the deficiency includes the tax imposed by IRC 531. The taxpayer's statement then may be included in the petition to the Tax Court.
- (6) Notification under IRC 534(b) will be issued on Letter 572, which must be manually signed, and sent by certified mail (by registered mail if the taxpayer's address is outside the United States). The number and disposition of copies of Letter 572 usually will be the same as for a notice of deficiency.

4.10.13.2.9  
(03-16-2015)  
**Rebuttal Statement by  
Taxpayer**

- (1) Treas. Reg 1.534-2(d), (26 CFR 1.534-2(d)) provides that a taxpayer has 60 days after a notification is mailed in which to file a statement to justify the alleged unreasonable accumulation.
- (2) If the taxpayer, for good cause, cannot submit the statement within the 60-day period, the taxpayer may be granted an extension, not to exceed 30 days. The taxpayer must request the extension before expiration of the 60-day period. SB/SE Delegation Order SB/SE 4-2-1 (IRM 1.2.65.4.40), Extension of Time for Filing Statement of Grounds for Earnings and Profits Accumulation, states that Revenue Agent Reviewers Grade GS-13 in Technical Services are delegated authority to grant an extension of time not to exceed 30 additional days.
- (3) Letter 572 requires the taxpayer to submit an original and two copies of the statement. Upon receipt, the original should be attached to the return of the earliest year in which the issue is raised. One copy should be placed in the administrative file and the other copy should accompany the administrative file for further association with the Area Counsel's legal file.
- (4) After consideration of the taxpayer's rebuttal, the issue will be dropped if it is concluded that earnings and profits have not been accumulated beyond reasonable business needs.

4.10.13.3  
(07-27-2023)  
**Transferor-Transferee  
Liability**

- (1) Transferee liability is a situation where a third party can be held liable for the tax liability of another. The government may seek to collect a taxpayer's unpaid tax, penalty or interest by asserting transferee liability when a taxpayer (transferor) has transferred property to another person or entity (transferee) and a substantive provision of the law provides the ability to assert liability against the recipient based on the transfer.
- (2) IRC 6901 provides the Service an administrative mechanism to assert that a transferee is liable for a transferor's primary liability. For example, a case under IRC 6901 can be used:
  - to collect a transferor-taxpayer's tax liability from the transferee who received the transferor-taxpayer's assets for less than adequate consideration or
  - to collect the liability from the transferee that is legally responsible for paying the transferor-taxpayer's liability
- (3) "Transferee" is defined in IRC 6901(h), and includes a donee, heir, legatee, devisee, and distributee and the person or entity whose tax liability the IRS is seeking to collect is known as the "transferor". See IRM 4.11.52.1.5 for a detailed definition.
- (4) Transferee liability does not create a new liability. Instead, it provides a secondary method to collect the transferor's tax liability.
- (5) IRC 6901 is strictly a procedural statute that does not by itself create any liability. It provides the IRS with an administrative mechanism to assert that a transferee is liable for a transferor's primary liability. IRC 6901(a) states that generally, taxes owed by a transferee shall be assessed, paid, and collected in the same way the IRS would pursue the transferor for those amounts. The substantive elements establishing the existence or extent of a transferee's liability are determined by applicable state or federal law.
- (6) The substantive basis of law for transferee cases is:

- a. The applicable State fraudulent transfer or conveyance statute;
  - b. The Federal fraudulent conveyance statute, effective for transfers made on or after May 29, 1991, subpart D of the Federal Debt Collection Procedures (FDCPA) Act of 1990 (codified at 28 U.S.C. 3301 to 3308), which can be asserted instead of or in the alternative to the applicable State fraudulent conveyance statute
  - c. An express or an implied contract
  - d. A state statute other than the state fraudulent conveyance statute; and
  - e. A federal statute (FDCPA, 28 USC 3001 et seq.)
- (7) IRC 6901 applies to income, estate, and gift taxes incurred by the transferor. It also applies to all other taxes (e.g., employment taxes) incurred by the transferor if the transferee's liability arises as a result of the liquidation of a partnership or corporation, or a reorganization under IRC 368(a).
  - (8) The Area Director having jurisdiction in the initial determination of the income, estate, and gift tax liability of the transferor is responsible for proceeding, under IRC 6901, against transferees or fiduciaries regardless of their location, and is responsible for all administrative action required in management and control of the case.
  - (9) IRM 4.8.9.19.5.1, Transferor-Transferee Liability Cases discusses the notice of liability issued to a transferee and the three parts to that notice.
  - (10) See IRM 5.17.14, Legal Reference Guide for Revenue Officers, Fraudulent Transfers and Transferee and Other Third Party Liability, for a discussion of the different legal theories and methods of collection from third parties, including transferee liability.
  - (11) See IRM 4.11.52, Examining Officers Guide, Transferee Liability Cases, with respect to examination processes. It is important to note the caution in IRM 4.11.52.1.6.

4.10.13.3.1  
(07-27-2023)  
**Origination of Transferee Cases**

- (1) Two sources from which a transferee case can be generated are:
  - a. As a referral from the Collection function, see IRM 5.17.14, Legal Reference Guide for Revenue Officer - Fraudulent Transfers and Transferee and Other Third Party Liability, for additional information and
  - b. As a related pick-up during an examination, see IRM 4.11.52, Examining Officers Guide (EOG) Transferee Liability Cases.

4.10.13.3.1.1  
(03-16-2015)  
**Referral From Collection Function**

- (1) In an attempt to collect a tax liability, the Collection function may refer transferee cases to the Examination function for assistance.
- (2) Collection prepares Form 3031, Report of Investigation of Transferee Liability, to recommend a transferee assessment. The Advisory Section reviews the report to ensure that pertinent factual data and adequate evidence are obtained to sustain assertion of the transferee liability. Once approved, the original report is forwarded to Planning and Special Procedures (PSP) to establish the transferee case on AIMS non-master file and to forward the case to an Examination group. See IRM 5.1.14.2.1, Report of Investigation of Transferee Liability, which describes the preparation and presentation of the report and IRM 4.1.1.6.11.2, Collection Referrals-Form 3031, Report of Investigation of Transferee Liability, which discusses the PSP review.

4.10.13.3.1.2  
(03-16-2015)

**Transferee Case Initiated  
During a Related  
Examination**

- (1) Examiners are required to consider collectibility in every examination. IRM 4.20.1, Examination Collectibility Procedures, provides instructions and guidance to examiners for considering collectibility during the examination process and for soliciting payment at the conclusion of the examination.
- (2) As such, they must be able to identify situations in which the taxpayer has intentionally or inadvertently placed assets out of the legal reach of the IRS. Additionally, they must be able to identify situations in which asset transfers may not be conducted in a normal "business manner" because of the close relationship of the parties involved.
- (3) If the taxpayer gives an indication of insolvency, the examiner should try to learn about the disposition of the taxpayer's assets and/or the transferee's legal responsibility for payment of the transferor's tax liability. The examiner must consider whether the elements of a transferee examination, as described below, have been met.
- (4) A transferee case will be initiated once the examiner determines:
  - a. The taxpayer has, or will have, a tax liability that cannot be collected directly
  - b. The elements of a transferee case have been met (See IRM 4.10.13.3.2.1 , Transferee in Equity, and IRM 4.10.13.3.2.2 , Transferee at Law), and
  - c. All or part of the tax liability could be collected from the transferee see IRM 4.10.13.3.2.1
- (5) Examiners are responsible for the identification and development of potential transferee cases that arise during their examinations. For identification purposes the examiners should fill out Form 2045 Transferee Agreement. Examiners should not assume that Collection will develop a transferee case after the transferor's examination is concluded. By the time a case is routed to a Revenue Officer (RO) for collection, the transferee statute of limitations may prevent adequate consideration.

**Note:** Filling out a Form 2045 does not conclusively establish transferee liability under IRC section 6901.

4.10.13.3.2  
(07-27-2023)

**Types of Transferee  
Liability and Burden of  
Proof**

- (1) There are two basic types of transferee liability. Both can be asserted under IRC 6901; however, the extent of the liability depends on the law underlying the two types of transferee liability, the value of the equity in the transferred assets, and the amount of taxes due from the transferor. The types of transferee liability are:
  - a. Transferee in Equity, and
  - b. Transferee at Law
- (2) Historically, transferees responsible for the tax obligations of another person were described as either 'transferees at law' or 'transferees in equity'. This distinction has become less significant since the adoption of uniform state laws relating to transferee liability, such as the Uniform Voidable Transactions Act (UVTA). The IRS may pursue both transferee liability in equity and transferee liability at law within the administrative structure of IRC 6901; for a more complete description of these two sources of transferee liability see IRM



5.17.14.3.3, Establishing Transferee Liability, and IRM 5.17.14.3.3.2.1, Fraudulent Transfers Under Federal and State Law.

4.10.13.3.2.1  
(07-27-2023)  
**Transferee In Equity**

- (1) Transferee liability in equity is the most common form of transferee liability and is based on equity or fairness principles. A Transferee in equity is a person or entity who receives the transferor's assets for less than adequate consideration, leaving the transferor insolvent and unable to pay the tax liability. Transferee in equity cases are predicated on state or federal fraudulent conveyance statutes. See IRM 4.11.52.2.2, Transferee in Equity, and *Hagaman v. Commissioner*, 100 T.C. 180 (1993) which indicates the specific state statutes must be consulted to determine liability in equity for each particular case.
- (2) The liability of a transferee in equity is generally limited to the value of the property transferred. However, where transferee liability is based on state law, state law determines the extent of the liability, which may also include penalties or interest. *Commissioner v. Stern*, 37 U.S. 39, 44-45 (1940).
- (3) The Government must prove the value of the assets transferred. Where the assets transferred are subject to existing liabilities or assumed by the transferee, the value of the property received may be reduced by the associated liability in determining the limit of transferee liability.
- (4) It should be noted that the mere fact that the transferee uses assets which he receives to pay debts of the transferor will not relieve him of transferee liability. The transferee must also show that the debts paid had priority over the tax liability. A transferee does not cease to be a transferee merely by selling the transferred property. Additionally, the price at which the transferee sells the property is not an accurate measure of the transferee liability. Rather, the liability is measured by the value of the property that was transferred on the date of transfer.
- (5) Even though a taxpayer admits that the taxpayer is a transferee of assets of a dissolved corporation, unless he admits the extent of this liability, the Government must still prove the value of the assets so received in order that a court can determine the amount due from him.
- (6) Although specific elements will vary depending on the substantive law relied upon, the IRS generally must prove numerous things as delineated below.
- (7) Generally, the IRS must prove the transfer of assets from the transferor to the transferee for less than adequate consideration. In this regard, the Government must establish by evidence the value of the assets transferred in order to show that the transfer was for less than full and adequate consideration. Documentation must show:
  - The transferor transferred property to the transferee (i.e., deeds, balance sheets, cancelled checks, title transfers, etc.)
  - The value of the transferred property at the date of transfer
  - The transfer was for less than adequate consideration, and
  - Who received the assets. The documentation must show the current legal title. A transferee is rarely a joint entity

**Example:** If a corporation made one check payable to the shareholder husband and one check to the shareholder wife, there would be two separate transferee cases - one for the husband and one for the wife. One transferee case in the joint names would not exist since the checks were not

made out in joint names. If land was transferred to them jointly (i.e., joint ownership, such as tenancy by the entireties) there would be only one transferee - the husband and wife as joint tenants.

- (8) Generally, the IRS must prove a transfer of assets from the transferor to the transferee for less than adequate consideration. In this regard, the Government must establish by evidence the value of the assets transferred in order to show that the transfer was for less than full and adequate consideration. Documentation must show:

- The transferor transferred property to the transferee (i.e., deeds, balance sheets, cancelled checks, title transfers, etc.)
- The value of the transferred property at the date of transfer
- The transfer was for less than adequate consideration, and
- Who received the assets. The documentation must show the current legal title. A transferee is rarely a joint entity.

**Example:** If a corporation made one check payable to the shareholder husband and one check to the shareholder wife, there would be two separate transferee cases - one for the husband and one for the wife. One transferee case in the joint names would not exist since the checks were not made out in joint names. If land was transferred to them jointly (i.e., joint ownership, such as tenancy by the entireties) there would be only one transferee - the husband and wife as joint tenants.

- (9) Generally, the IRS must prove the transfer of assets must have been made after the liability for taxes accrued. Transferee liability was developed based on the principle that debtors may not transfer assets for less than adequate consideration if they are left unable to pay their liabilities. The chance to satisfy the debt out of the asset(s) transferred never existed where the transfer was made prior to the time the tax liability accrued. Therefore, no transferee liability can ordinarily arise when the transfer is made before the period in which the tax liability is created. However, the tax liability need not have been asserted prior to the transfer. In this connection, the tax liability need only accrue. The examiner should consult with Technical Services and/or Area Counsel in unusual circumstances. Documentation must show:

1. The date the tax liability accrued. The tax liability accrues at least by the last day of the tax period, not the due date of the return. In some cases (such as lottery winnings), a transfer during the tax year may be argued to include an anticipated tax liability since the income was earned prior to the year end and the transfer was obviously fraudulent. There is no requirement that the tax liability be assessed at the time of the transfer.

**Note:** Different courts have reached various conclusions as to when the tax liability of the transferor accrues, so Area Counsel must be consulted when determining the date the liability of the transferor for the tax debt accrued.

2. The date the transfer took place.

- (10) Generally, the IRS must prove the transferor is liable for the tax at the time of the transfer, or the transfer occurred in the year of liability, and the transferor remains liable for the tax. It would appear to be self-evident that unless the transferor is liable for the tax, there could be no liability asserted against the transferee. IRC 6902(a) states, in part, that the Government does not have the



burden of proof in **Tax Court proceedings to show that the transferor was liable for the tax.** There is a presumption of correctness in the Commissioner's determination, and unless the transferee offers evidence as to the transferor's tax liability, the amount established by the Commissioner will be sustained. If the transferee contends that the transferor owes no tax, the burden of proving this rests on the transferee. If there has previously been a decision on the merits, the transferee is collaterally estopped from raising the issue of the transferor's tax liability. Under IRC 6902(a), however, the Government does have the burden in the Tax Court of showing that the petitioner is liable as a transferee of property of a taxpayer. Documentation must show the tax liability (i.e., transcript of account, Revenue Agent's Report (RAR), Notice of Deficiency, etc.).

- (11) Generally, the IRS must prove all reasonable efforts have been made to collect the tax liability from the transferor-taxpayer. Courts generally consider a transferee's liability to be secondary to the primary liability of the transferor. Secondary liability means the transferee derives its liability from the transferor's liability based on the receipt of property under circumstances that subject the transferee to the liabilities of the transferor. Before pursuing a transferee, the IRS must generally exhaust all legal remedies it may have against the transferor for collection of the tax. The general rule is that the IRS must show that all reasonable collection remedies against the transferor have been exhausted and that further collection efforts would be futile. See *Gumm v. Commissioner*, 93 T.C. 475, 480 (1989). The extent to which the IRS must proceed against the transferor depends on the facts and circumstances. For example, the IRS need not pursue a corporate taxpayer that has been stripped of its assets or a trust that has distributed its property to a beneficiary and terminated. Documentation should show that the transferor is in bankruptcy, has dissolved, or has distributed all of the assets and collection is not possible or that collection was pursued but could not be secured. A TXMOD will show the action taken by the Collection function.
- (12) Generally, the IRS must prove the transferor was insolvent when the transfer was made or the transfer of assets left the transferor insolvent.

**Note:** Transferee in equity liability is highly dependent on the state or federal law upon which the liability is based. In some states, depending on state law, insolvency may not be necessary for a transferee in equity proceeding. Consult Area Counsel if there are transferor-transferee situations when the transferor was not insolvent at the date of, or rendered insolvent by the transfer of property.

- a. As stated earlier, the mere fact that there has been a transfer of assets does not establish transferee liability. Any individual may transfer property for little or no consideration, without causing any liability to the transferee, provided the transferor was solvent at the time the transferor transferred the property. In cases involving constructive fraud (transfers made without actual intent to hinder, delay or defraud the government's collection efforts, but efforts to collect the transferor's tax liability were hindered) the Government often must also prove that the transferor was insolvent when the transfer was made or the transfer of assets left the transferor insolvent. Insolvency need not be present in cases involving actual fraud (i.e., transfers made with specific intent to hinder, delay or defraud the government from collecting the transferor's tax liability). The transferor's insolvency is an essential element of constructive fraud, but it

does not need to be established when actual fraud exists. The examiner will need to look to the applicable state fraudulent conveyance statute and/or the **fraudulent transfers involving debt** provision in 28 U.S.C. 3301-3308 for the basis on which actual fraud could be found. If the transferor liabilities exceeded the transferor's assets, the Government should be able to show that the transferor was insolvent.

- b. The liabilities should include liability for taxes, penalties, and interest to the date of transfer. It should also include additional liabilities as a result of an examination (i.e., when it is found that the transferor embezzled money, the legal duty to repay the embezzled money would be included as an additional liability). However, in calculating the value of the transferor's assets, any assets the Government cannot reach to satisfy the tax debts will not necessarily be considered. This means that assets exempt from levy may not have to be considered as assets in determining insolvency of the transferor.
- c. The fact that the transferor was insolvent at one time during the year does not establish proof of insolvency at the time the transferor made the transfer and if several transfers were made, the Government must make a separate determination of insolvency for each of the transfers involved.
- d. In many instances, the Government's transferee suit occurs several years after the transfer took place. It goes without saying that the greater the span of time between the transfer date and the institution of the suit, the more difficult it becomes for the Government to prove insolvency.
- e. Documentation should show that the transferor's tax liabilities and other liabilities (mortgages, debts payable, etc.) exceeded the transferor's assets at the time of transfer. For example, a copy of the transferor's balance sheet at time of insolvency, documents showing bankruptcy, documents showing dissolution of a corporation (contact Secretary of State), documents showing how the assets in a decedent's estate were distributed, etc., should be obtained to support this.
- f. Where a transferee transfers assets to a third party without consideration, the third person, who now becomes a transferee of the transferee, may be liable for the tax liability of the original transferor. This liability is limited to the extent that the second transferee received assets identified as originally belonging to the transferor. However, the transferee liability can only be asserted against the **transferee of the transferee** if the first transferee was liable as such, and the second transferee received the assets under circumstances making him/her liable at law or in equity for the liabilities of the first transferee.
- g. Many state corporate merger and consolidation statutes provide that a surviving corporation is liable for the debts of a predecessor corporation when the surviving corporation is the result of a formal merger or consolidation of two corporations. In these cases, the surviving corporation is primarily liable for the tax debts of the predecessor corporation as a **successor in interest**. The successor in interest can essentially become the taxpayer and therefore primarily liable for the predecessor's tax liability. See *Southern Pacific Transportation Co. v. Commissioner*, 84 T.C. 387 (1985).
- h. Where a transferee transfers to a third party for full and valuable consideration the assets previously received from the transferor, the transferee does not thereby cease to be a transferee, nor is the price at which the transferee sold the property the measure of the transferee liability.

4.10.13.3.2.2  
(07-27-2023)  
**Transferee At Law**

- (1) See IRM 4.11.52.2.1, Transferee At Law, IRM 5.17.14, Legal Reference Guide for Revenue Officers, Fraudulent Transfers and Transferee and Other Third-Party Liability, and particularly IRM 5.17.14.3.3.1, Transferee Liability Directly imposed on the Transferee (At Law).
  - a. Pursuant to 31 USC § 3713(b), a representative of a person or an estate (except a trustee acting under the Bankruptcy Code, Title 11) paying any part of a debt of the person or estate before paying a debt due to the United States is personally liable to the extent of the payment for unpaid claims of the United States. See IRM 5.17.13.7, Personal Liability of the Fiduciary Under 31 USC § 3713(b), for additional discussion.
- (2) In determining the extent of the transferee's liability at law, the value of the assets received by the transferee is generally immaterial since the extent of such liability is determined by reference to the amount of tax liability of the transferor that the transferee has agreed to pay (determined by contract or statute). Some state statutes, however, may also limit liability to the value of assets received.
- (3) Documentation required for transferees at law must show:
  - a. The assets that were transferred and the fair market value at the date of transfer;
  - b. A transcript of account showing the tax liability of the transferor for a period which accrued prior to the transfer and remained unpaid at the time of the assertion of transferee liability; and
  - c. At the time of transfer of the assets, the transferee assumed the tax liability of the transferor by contract or statute. A copy of the contract and/or statute should be obtained.
- (4) Transactions such as statutory mergers are not transferee situations in the typical sense, but may result in liability for the successor corporation. See IRM 4.10.13.3.2.1 (6) and IRM 5.17.14.2.3.

4.10.13.3.3  
(03-16-2015)  
**Statutory Period and Consents**

- (1) A transferee is considered a separate entity. The statute of limitations for the transferee is separate and distinct from the transferor's statute of limitations.
- (2) The period of limitation for the assessment of the liability of a transferee is as follows:
  - a. The initial transferee - one year after the expiration of the period of limitations for assessment against the transferor as shown by the filing date of the original return or as extended by Form 872 or other statute extension form.

**Note:** When the transferor's statute has been extended using Form 872-A and the transferor's tax liability has been assessed, Form 872-A is terminated. The computation of the transferee's statute of limitation will be one year from the assessment of the transferor's liability.
  - b. A transferee of a transferee - one year after the expiration of the period of limitation for assessment against the preceding transferee, but not more than three years after the expiration of the period of limitations for assessment against the initial transferor.
  - c. A fiduciary - not later than one year after the liability arises or not later than the expiration of the period for collection of such tax, whichever is later.

d. Fraud - IRC 6501(c)(1) provides that, where the transferor files a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time. In such cases, the statute of limitations on the transferee would also be indefinite, since the transferee's statute is open for one year after the transferor's statute expires. However, unless the transferor's fraud penalty has been definitively established by judicial decision or otherwise (such as by agreement on Form 870) the transferee's statute of limitations should be protected by a consent form. Where the transferor's fraud penalty has not been definitively established, do NOT rely on fraud to keep the transferee's statute of limitations open. Securing a statute extension by consent from the transferor will protect the Government's interest in the event that the fraud issue against the transferor is lost.

- (3) When it is necessary to extend the statute of limitations of transferees who are not primarily liable, the consent form used is Form 977, Consent to Extend the Time to Assess Liability at Law or in Equity for Income, Gift, and Estate Tax Against a Transferee or Fiduciary, or Form 4016, Consent Fixing Period of Limitation Upon Assessment of Employment or Miscellaneous Excise Taxes Against a Transferee. The extended date on Form 977 or Form 4016 may not be equal to or shorter than the statutory period prescribed by IRC 6901(c). The consent will be secured in duplicate.
- (4) When a Form 977 or Form 4016 is executed and no Form 2045, Transferee Agreement, has been secured, the transferee may subsequently raise the defense that the transferor is liable (by claiming that the transferee is not a transferee). In this situation, the IRS may only be able to proceed against the transferor if a Form 872 has been secured. To be safe, it is wise to secure consents from both the transferee (Form 977 or Form 4016) and the transferor (Form 872) until it has been determined who is liable for the tax.

**Note:** Filling out a Form 2045 does not conclusively establish transferee liability under IRC 6901. Also see 26 CFR 301.6901-1(c) and 26 CFR 301.6901-1(d).

#### 4.10.13.3.3.1

(07-27-2023)

#### Trust Fund Doctrine

- (1) If the period of limitations for assessment against a transferee has expired, action against the transferee under the trust fund doctrine for the collection of the unpaid tax assessed against the transferor should be considered.
- (2) The trust fund doctrine is most commonly used to impose transferee liability on a shareholder for taxes incurred by a corporation when the shareholder receives assets from a corporation. See *Starnes v. Commissioner*, 680 F. 3d 417 (4th Cir. 2012) and *Benoit v. Commissioner*, 238 F. 2d 485, 491 (1st Cir. 1956). Recovery under the doctrine is limited to the value of the property transferred. Many states have also enacted statutes to permit creditors of a corporation to sue shareholders. See IRM 5.17.14.3.3.3 Trust Fund Doctrine.
- (3) If timely assessments have been made against the transferor and the period for instituting a suit for collection provided in IRC 6502(a) has not expired, but the time for transferee proceeding has expired, the case, accompanied by a report containing facts in support of the transferee's liability, should be forwarded to Area Counsel through Technical Services.

4.10.13.3.3.2  
(07-27-2023)  
**Protecting the  
Transferor's Statute of  
Limitations**

- (1) In attempting to collect the transferor's tax liability through a transferee case, the transferor's tax liability should always be assessed or a statutory Notice of Deficiency issued prior to the expiration of the transferor's statute of limitations unless one of the exceptions below has been met:
  - a. A valid consent (Form 872, Form 872-A, etc.) to extend the transferor's statute of limitations has been obtained;
  - b. A validly executed Form 2045, Transferee Agreement, has been secured in duplicate from all transferees. Managerial involvement in this determination should be documented both on Form 4318 and on the Form 895, Notice of Statute Expiration. If not secured from all identified transferees, action should be taken to prevent the statute from expiring, such as issuing a notice of deficiency to the transferor. Should there be doubt in a particular case as to whether it would be advisable to accept an agreement from the transferee as a basis for not proceeding against a dissolved corporation, advice should be requested from Area Counsel. Form 2045 does not extend the transferor's statute of limitations, but is an agreement between the transferee and the Commissioner, that the Commissioner agrees to discontinue action against the transferor in return for an admission by the recipient of the assets that the transferee is the transferee. The transferee assumes and agrees to pay the amount of any and all Federal income taxes finally determined or adjudged as due and payable by the transferor, to the extent of such transferee's liability at law or in equity. The transferee will not, in the absence of the prior written consent of the Commissioner, sell, transfer, or assign without adequate consideration all or any substantial portion of their assets. In the event of a corporate transferee, the agreement will be accompanied by a copy of the minutes of the corporate board of directors evidencing authorization of such agreement.

**Note:** Filling out a Form 2045 does not conclusively establish transferee liability under IRC 6901.
  - c. The transferor has an indefinite statute of limitations (i.e., judicially determined fraud - IRC 6501(c), no returns filed by the transferor etc.).
- (2) If a liability in tax is determined in the case of the transferor and the statute of limitations has expired, the deficiency should be asserted against the transferee(s) within the period of limitations applicable to him or her.
- (3) Although it may appear unlikely that the IRS will be able to collect from the transferor, the Tax Court indicates that the IRS should attempt to exhaust its reasonable collection efforts before attempting to collect from a transferee, or otherwise show that collection from the transferor would be futile. Issuing a notice to the transferor helps establish this effort.

4.10.13.3.3.3  
(03-16-2015)  
**How State Corporate  
Dissolution Law Affects  
an Examination**

- (1) Transferee situations are common with dissolved corporations. If the corporation has been dissolved, there may be no assets against which to collect any proposed assessments. In that event, it may be necessary to utilize transferee liability provisions of IRC 6901 to collect the corporate liability. A transferee case will be developed concurrently with the corporate examination if the elements needed to establish a transferee case are present. Otherwise, the examiner may consider limiting the scope of the examination. See IRM 5.17.14, Legal Reference Guide for Revenue Officer - Fraudulent Transfers and Transferee and Other Third-Party Liability for additional information.

- (2) Federal law, not state law, sets the statute of limitations on assessment and collection of federal taxes for transferee liability cases, unless Congress provides otherwise. State corporate dissolution law does not shorten the assessment limitations period provided by IRC 6501. State law may, however, adversely affect the capacity of a dissolved corporation or its last board of directors to represent the dissolved corporation or to act on its behalf. This will affect the corporation's ability to extend the statute of limitations, to agree to tax liabilities or to litigate corporate liabilities.
- (3) State corporate dissolution law governs how a corporation may dissolve. The state law may provide a specific time period for a dissolved corporation to wind up its affairs. Some states have a specific period in which to wind up affairs, while others do not. Only the individuals named in the applicable state law are authorized to act for the dissolved corporation and only during the winding up period. Such appointment may divest others (the officers prior to dissolution) of authority to act on behalf of the corporation. **A consent must be executed by the authorized officer of a dissolved corporation on or before the last date of the winding up period in order to be valid and to hold the period of limitations open after the end of the winding up period.**
- (4) Caution should be exercised in obtaining waivers of restriction on assessment and extensions of the statutes of limitations in dissolved corporation and transferee cases. Examiners should not rely on any such agreements without the approval of Area Counsel.
- (5) The state law which governs the corporate dissolution is the law of the state in which the corporation was incorporated.

**Example:** If a corporation has its offices in Florida, does business entirely in Florida, was examined by the IRS in Florida, but was incorporated under Delaware law, authority to execute a consent should be tested under Delaware law, not Florida law.

- (6) Examiners should consult the applicable state corporate dissolution law and identify which individuals (corporate officers, board of directors, etc.) are legally authorized to act for the dissolved corporate entity. Area Counsel may be contacted to request an opinion on whom is authorized to act for the corporation.
- (7) The examiner will also ensure that the individuals authorized to represent the dissolved corporation have been appointed to these duties by the corporation. Documentation will be obtained to satisfy this requirement and will be attached to any consent or waiver that the authorized individuals sign. A provision should be added below the signatures of the appointed individuals stating their title

**Example:** Trustee of X corporation, a dissolved corporation. Also, a provision should also be added that the corporation has dissolved, but is continuing as a corporate body under (name the section of state law).

- (8) The corporation and its authorized officers/directors may perform the following acts up to the end of the winding up period:
  - a. Execute a valid extension of the statute of limitations (i.e., Form 872, Form 872-A, etc.);



- b. Execute a valid assessment agreement (i.e., Form 4549, Form 870, etc.). Otherwise the corporation will be unable to agree to the adjustments; and
  - c. Institute litigation on behalf of the corporation.
- (9) Precautions that should be taken in obtaining waivers of restriction on assessment and extensions of the statute of limitation in transferee and dissolved corporation cases.
  - a. Obtain the transferee's agreement to the liability prior to the expiration of the transferor's limitation period, if at all possible;
  - b. Clearly explain (and document) the effect of executing a Form 2045, Transferee Agreement; and
  - c. Clearly explain (and document) the extent of a transferee's monetary liability.

**Note:** Filling out a Form 2045 does not conclusively establish transferee liability under IRC 6901.
- (10) Some state corporate dissolution law provides that the dissolution of a corporation may be revoked within stated periods. If this occurs, this may affect the authority of the corporation or its directors. Examiners should always inquire if a revocation of dissolution has occurred.
- (11) IRC 6901 is only applicable to income, estate, and gift taxes. Transferee liability procedures are not available to employment, excise, and other types of taxes in the Code unless they are involved in the liquidation of a corporation, partnership, or upon the reorganization of a corporation pursuant to IRC 368(a). See also 26 CFR 1.507-1(b)(8) regarding transferee liability for chapter 42 excise taxes in the case of reorganizations and transfers between private foundations described in IRC 507(b)(2). A liquidation is deemed to have occurred if the business entity has ceased to do business and the assets of the entity have been distributed to the owners.

4.10.13.3.3.4  
(03-16-2015)

**Consents to be Used in  
Mergers and  
Consolidations**

- (1) Many state corporate merger and consolidation statutes provide that when a corporation is dissolved, the successor corporation is not a transferee. In states with such laws, the new or surviving corporation assumes primary liability for the debts of the merged or consolidated corporation. Action to assess the primary liability against the new/surviving corporation should be taken within the statutory period of limitations for assessment against the merged or consolidated corporation. If the period of limitations needs to be extended in order to make this assessment, Form 872 or Form 872-A must be executed by the new/surviving corporation before the expiration of the period of limitations for assessment against the merged or consolidated corporation. The corporate name on Form 872 or Form 872-A will be completed and signed as: "B Corporation, Inc., Successor in interest to A, Inc."
- (2) The examiner should ensure that the successor corporation is solely responsible for the liabilities of the dissolved entity. Many merger and consolidation agreements allocate some or all of the liabilities to other parties, including the sellers, with respect to the dissolved entity. Documents verifying the terms of sale should be scrutinized where possible to resolve any discrepancies.

4.10.13.3.4  
(03-16-2015)  
**Administrative  
Procedures**

- (1) If the transferee case is originated through a related examination, the examiner will initiate control of the transferee examination. The transferee will be controlled using a "dummy" TIN on non-master file. See IRM 4.4.23 Aims Procedures and Processing Instructions, Openings, for more detailed information on master file and non-master file procedures.
- (2) Form 5354, Examination Request Non-Master File, will be completed.
- (3) PSP will initiate non-master file controls on all transferee cases referred from the Collection function.
- (4) IRM 8.7.5.9(1) Issuing a Notice of Liability on an Unagreed Transferee Case says Tax Computation Specialists (TCS) are generally responsible for the preparation of Notices of Liability in transferee/transferor cases.
- (5) Each individual or entity that is a transferee will have a separate case file. A Form 895, Notice of Statute Expiration, will be attached to the transferee case file for each tax period. Form 895 will be completed with the transferee's name as transferee and taxpayer identification number. The return form and taxable year or period will be that of the transferor. If the transferee case was originated as referral from Collection function, the transferee statute of limitations will be computed by reference to an Individual Master File On-Line (IMFOL) with definer code -T (Tax Module) or M on the transferor, as no returns will be contained in the file from Collection. See IRM 2.3.51.2 , Command Code IMFOL, for more information.

4.10.13.3.4.1  
(03-16-2015)  
**Developing the Elements  
of a Transferee Case**

- (1) If the transferee case was received from Collection, the examiner will determine whether all of the elements required in a transferee case have been documented by the Revenue Officer (RO) on Form 3031 Report of Investigation of Transferee Liability. If the elements required, as outlined earlier, have not been documented, the examiner will contact the transferee (and if needed, the transferor), to interview and obtain additional documentation to support the elements required in the transferee case.
- (2) If a transferee case is initiated during the examination of a transferor, the examiner will develop the elements required in a transferee case and obtain documentation to support each of the elements. The transferee will be advised that they are under examination as a transferee. An interview with the transferee will need to be scheduled and conducted in order to develop all elements and to obtain supporting documentation.
- (3) The examiner will charge time to activity code (AC) 812 - detail to the Collection function.

4.10.13.3.4.2  
(03-16-2015)  
**Transferee Waivers**

- (1) When all of the elements have been fully developed and documented, the examiner will prepare the applicable waivers, solicit an agreement and payment from the transferees, and hold a closing conference.
- (2) Form 870-T, Waiver of Restrictions on Assessment and Collection of Transferee or Fiduciary Liability and Acceptance of Overassessment (for income tax cases), or Form 2504, Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment (Employment Tax Adjustments Not Subject to IRC 7436), modified with special language, should be used to solicit an agreement from the transferee for the amount of the transferor's tax, penalties, and interest. The waiver will be completed as follows:



1. The name and address block will be completed with the name of the transferee as transferee;  
**Example:** Joe Smith, Transferee
  2. The social security or employee identification number will be that of the transferee;
  3. The tax period ended, tax, and penalties blocks will be completed with the tax period and unpaid balance of the transferor's tax and penalties. For transferee cases originated from an examination, the amounts will be taken from the examination report net of any payments. For transferee cases referred from Collection, a transcript of account will be obtained using command code IMFOL-T and will be analyzed by summarizing the total amount of tax (net of any payments) and each penalty for each tax period. These totals will be inserted on the waiver (these amounts plus interest should reconcile to the modified balance per the IMFOL-T). An index of all tax modules available will be obtained using command code IMFOL-I to ensure that all tax periods with an outstanding tax are included on the waiver; and
  4. A special paragraph will be added to the remarks section of Form 870-T or to the reverse side of Form 2504. See all of section IRM 4.10.13.3. If the value of the assets transferred is less than the transferor's unpaid liability, the transferee's liability is limited to the value of the assets transferred. A special paragraph with language for the limited liability will be used. In this case, Form 870-T will reflect the total transferor's tax and penalty liability, but the paragraph will state the amount to which the liability is limited.
- (3) Form 2045, Transferee Agreement, will be solicited. By signing this form, the transferee admits liability as a transferee of assets received from the transferor, and assumes and agrees to pay the tax liability of the transferor. The government is then relieved of the burden of proof regarding the transferee liability. To protect the government's interest solicit Form 2045 from each transferee. Form 2045 may be obtained from only one transferee provided that the assets received by the transferee are sufficient in amount to cover the total transferor's liability. If the transferee is a corporation, a copy of the minutes of the board of directors authorizing an officer to enter into this agreement should be attached to this form.

**Note:** Filling out a Form 2045 does not conclusively establish transferee liability under IRC 6901.

4.10.13.3.4.3  
(03-16-2015)

**Transferee Case File and Report**

- (1) Each transferee should be a separate case file, as it is separate and distinct from the transferor examination. Whenever the transferee's name is written in the file, it should have the title "Transferee" after it to distinguish it from an income tax examination of the same entity.
- (2) Form 4665, Report Transmittal, should set forth all necessary facts of a confidential nature. This will include a clear statement of the present ability of the transferor and each transferee to pay, with names, addresses, amounts and nature of property held by each that may be subjected to use in payment of the tax.
- (3) Each transferee file will contain a transferee report, which is prepared in memorandum form. The memorandum will be very detailed if the case is

unagreed. It will list the name, address, and Taxpayer Identification Number (TIN) of the transferee and the transferor. The memorandum will contain the following:

- a. A list of all of the transferor's tax periods and the respective unpaid tax liabilities and penalties
  - b. How the transferor's unpaid tax liability was determined (i.e., tax returns that were filed but the balance due was unpaid, income tax examination, etc.)
  - c. Whether the transferee is a transferee at law or in equity
  - d. A complete background containing the facts and reasons for recommending the transferee action, with reference to the documentation used to support the facts
  - e. A list of the elements required to support the Government's burden of proof and how they have been met. The documentation that supports each element should be referenced
  - f. An analysis that lists all of the transferor's assets prior to insolvency and their disposition. It will include a description of each asset, its fair market value at the date of transfer, the date each asset was disposed of, and who received the assets
  - g. How insolvency and the date of insolvency were determined
  - h. Information relating to Collection function's involvement in collecting the transferor's unpaid liability; and
  - i. Any attempts to conceal assets and evade payment of taxes
- (4) Documentation and workpapers will be attached to the memorandum. If it is voluminous, the workpapers and documentation will be attached to a Form 4318-A, Continuation Sheet for Form 4318, Examination Workpapers Index, which will be used to index the workpapers.
  - (5) A Form 5344, Examination Closing Record, will not be completed for the transferee case file.

4.10.13.3.4.4  
(03-16-2015)

**Corporate Transferor -  
Information to Include in  
the Transferee Report**

- (1) In cases in which the transferor is a corporation, the examiner will include the following information in the transferee report:
  - a. Whether or not the corporation is insolvent, has been dissolved, or is in the process of liquidation. If the corporation has been dissolved, information should be furnished showing the date and manner of dissolution.
  - b. A description, including the amount and value of the property or assets of the corporation at the time of dissolution or liquidation.
  - c. Whether or not any property or assets were retained by the corporation; and, if so, a description, including the amount, present value, and location of such property or assets should be furnished, together with the name and address of the person having custody thereof. A list of the liabilities of the corporation should also be furnished. Mortgages, judgments, and other liabilities which may take priority over tax liens by reason of being recorded prior to the filing of notices of such liens as provided in IRC 6323 should be listed separately.
  - d. If subsequent to the taxable year or years being examined, any of the assets of the corporation that have been transferred to another corporation through a sale or a reorganization, consolidation or merger, a description, including the value of the assets transferred, and a statement showing whether the consideration given for such assets were cash, stock or both. If both cash and stock passed as consideration, a

statement of the amount of cash paid and the number of shares of stock transferred, both common and preferred, and the value of such stock at the time of transfer. A statement should also be furnished as to the present financial condition of the corporation taking over the assets, together with the address of such corporation. If the reorganization, consolidation or merger was made pursuant to a written agreement or under the provisions of a State statute, a copy of such agreement should be secured and made a part of the report or reference made to the State statute.

- e. Whether the liabilities of the corporation were assumed by any other corporation or person: and if so, a copy of the agreement under which such liabilities were assumed should be furnished.
- f. The full name of each stockholder who received assets of the corporation at the time of liquidation, the present address of each of such stockholders, and the number and par value of the shares of stock held by each at the time of liquidation.
- g. Whether the stockholders of the corporation received both cash and other property in the liquidation of the corporate assets. If so, the amount of cash received by each stockholder and a description, including the amount and value of the property received by each stockholder and the present financial condition of each should be furnished.
- h. Whether any assets of the corporation were transferred without adequate consideration to any other corporation or person. If so, a complete statement of all the facts and circumstances pertaining to such transactions, particularly the name, present address, and financial status of each transferee, should be furnished, together with a description of the assets transferred, the consideration paid therefor, and the value of the assets received by each transferee.
- i. A statement should also be furnished showing the name and present address of each stockholder who has not paid in full the amount of his/her subscription to the capital stock of the corporation and the amount owing thereon.
- j. State specifically the source or sources from which the information was obtained; that is, whether from the books and records of the corporation concerned, from public records, or from statements of former officers, stockholders, employees, etc.
- k. Copies of the records should be obtained if they are not too voluminous.

4.10.13.3.4.5  
(03-16-2015)

**Deceased Transferor -  
Information to Include in  
the Transferee Report**

- (1) In cases in which the transferor is deceased, the examiner will include the following information in the transferee report:
  - a. The correct name, late address, and the date of death of the decedent, the full name and present address of the executor or administrator, and the title or name and the location of the court having jurisdiction of the estate; also, whether or not the decedent left a will, and, if so, a copy thereof.
  - b. Whether a proof of claim for the tax referred to has been filed and, if so, the date of filing and with whom it was filed.
  - c. A copy of the inventory of the property and assets or any similar document filed by the executor or administrator with the court.
  - d. Whether complete distribution has been made of all of the property and assets of the estate, and, if so, a copy of the report of the executor or administrator or of the final order or decree of the court showing the dis-

tribution in kind or otherwise of the property and assets of the estate. The date of such report, order, or decree should be given.

- e. Unless clearly and fully shown by the information called for above, a description, including the actual amount or value in money, of all of the property and assets received by each distributee, the dates such property and assets were received and whether received as a specific bequest or whether the distributee is an heir at law or a residuary legatee, together with the name and present address and financial status of each distributee.
- f. A description, including the amount or value in money, of the undistributed property and assets, if any, remaining in the hands of the executor or administrator as of the date of the report.
- g. If the executor or administrator has been discharged, or if the estate has been closed, a copy of the final order or decree of the court discharging him/her or closing the estate should be furnished, unless this is contained in or is clearly shown by any other documents called for herein. The exact date of such order or decree should be shown thereon or in the report.
- h. State specifically the source or sources from which such information was obtained; that is, whether from the books and records of the taxpayer, from public records, or from a statement of persons having knowledge of the facts, such books and records being identified and the pages or folio numbers thereof indicated. Copies of the records should be obtained if not too voluminous.

4.10.13.3.4.6  
(03-16-2015)  
**Closing an Unagreed  
Transferee Case**

- (1) If the transferee case is unagreed, the examiner will prepare the 30-day letter using Letter 955, 30 Day Letter - Straight Deficiencies of Both Deficiencies and Overpayments, modified as necessary.
- (2) Special language will be inserted as the opening paragraph to Letter 955, depending on the circumstances of the case. See IRM 4.10.13.3.6

4.10.13.3.4.7  
(03-16-2015)  
**Closing an Agreed  
Transferee Case**

- (1) If the transferee case is agreed, the case will be forwarded to Technical Services for special handling. Technical Services will prepare Form 1296, Assessment Against Transferee or Fiduciary, see IRM 4.8.8, Technical Services, Miscellaneous Responsibilities.
- (2) Technical Services will fax Form 1296 with agreement forms (Form 870-T, Form 2504) or Form 906, Closing Agreement On Final Determination Covering Specific Matters, and Form 3198 to Centralized Case Processing (CCP). The case will not be updated to CCP. Technical Services will also complete Form 10904, Request for Record Deletion from AIMS/ERCS, using disposal code 28 and include the form inside the case file. Technical Services will then forward the case file to their Planning and Special Programs (PSP), Audit information Management System (AIMS)/Examination Return Control System (ERCS) Analyst for deletion of the AIMS record.

- 4.10.13.3.4.8  
(03-16-2015)  
**Closing a Transferee Case with less Than Six Months Remaining on the Transferee Statute of Limitations**
- (1) If the transferee examination is within six months of the statute expiration date or if the transferee failed to file a valid protest to the 30-day letter (Letter 955), the transferee case will be forwarded to Technical Services for issuance of a Notice of Transferee Liability.
- 4.10.13.3.5  
(07-27-2023)  
**Liability of Transferee for Interest**
- (1) When the value of assets transferred exceeds the transferor's tax liability, the transferee may be liable for interest for periods before and after the transferee received a notice of liability. See IRM 5.17.14.3.4 for a detailed description of a transferee's potential liability for interest.
- 4.10.13.3.5.1  
(03-16-2015)  
**Limited Liability Where the Value of the Assets Transferred Is Less Than the Transferor's Liability**
- (1) If the fair market value of the property transferred is less than the amount of the transferor's unpaid tax liability, the transferee may if state law so allows, be liable for interest on the use of the property from the date the transferee receives the assets until the notice of transferee liability is issued, but the transferee is not liable for IRC 6601 interest or penalties on the tax itself. Interest under state law does not extend beyond the date of the notice of liability.
- (2) When closing a transferee case in which the assets transferred are less than the transferor's liability, Form 3198 should be annotated: "Transferee Case - Limited Liability".
- 4.10.13.3.6  
(03-16-2015)  
**Transferee Letters**
- (1) The group prepares the preliminary 30-day letter for transferee cases. Technical Services prepares the notices of transferee liability and notices of fiduciary liability in all transferee cases.
- (2) The 30-day letter, the notice of transferee liability and the notice of fiduciary liability all have three different parts:
- The letter to the transferee, which is modified by a paragraph for transferee/fiduciary liability. The letter to be used as the 30-day letter is Letter 955
  - The letter to be used as a notice of transferee/fiduciary liability is Letter 902-T, Notice of Liability
  - The attachment to the letter, lists the name, address, TIN, tax, penalty, and interest liability of the transferor. It also lists the name, address, and TIN of the transferee followed by statements as to the extent of the transferee's liability and how the transferee's liability arose. See subsection IRM 4.10.13.3.6.1, for the paragraphs to use and how to prepare the attachment to the letter.
  - The waiver/agreement on assessment and collection of additional tax, modified by a special paragraph for transferee/fiduciary liability. Form 870-T will be used for income tax cases. Form 2504 will be used for employment or excise tax. Form 890-T, Waiver of Restrictions on Assessment and Collection and Acceptance of Overassessment as to Transferee or Fiduciary Liability for Estate, Gift and Generation - Skipping Transfer Tax will be used for estate tax cases. Refer to subsection below for the paragraph to use to modify the waiver. The total transferor's unpaid tax and penalty liability will be inserted in the applicable blanks even if the transferee's liability is limited. If the liability is limited, the paragraphs modifying the waiver will state the amount the liability is limited to.

- e. Exhibits may be attached to the above letter package to aid the transferee in understanding why the transferee is a transferee or any supporting computations. Examination reports will not be sent with preliminary (30-day) letters asserting liability against transferees.
- (3) Area Counsel will review all proposed notices of transferee liability prior to issuance. IRM 4.8.9.10.2.1 Mandatory Area Counsel Review, requires mandatory review by Area Counsel.
- (4) No notices of transferee liability will be issued for employment or excise tax. IRC 6901 states that the liability will be assessed, paid, and collected in the same manner as in the case of the taxes with respect to which the liabilities were incurred. Since no notice of deficiency is issued to a taxpayer for employment or excise taxes, no notice of transferee liability will be issued to a transferee for employment or excise taxes.
- (5) If the 30-day letter or notice of transferee liability is issued for a transfer, it should be asserted in the first paragraph of the letter that the substantive liability is founded.
- (6) If in an estate tax case, a preliminary letter or a notice of liability is issued to a transferee, trustee, or beneficiary of property includible in the gross estate under IRC 2035, IRC 2036, IRC 2037, IRC 2038, IRC 2040, IRC 2041, or IRC 2042, it should be issued within the 3-year period provided by IRC 6501. If such property is in trust and is includible under IRC 2035-2038, inclusive, in lieu of the single term “transferee”, the designation “transferee and trustee” should be inserted. If such property is insurance includible under IRC 2042, in lieu of the single term “transferee”, the designation “transferee and beneficiary” should be inserted.
- (7) If the letter to the transferee covers a deficiency for 1 year and refund due to the transferor for another year, the statutory notice statement paragraph should be revised to read as follows (unless the refund is protected by a claim filed within the statutory period prescribed for filing claims for refund):

“The overassessment shown herein will be made the subject of a certificate for the overassessment which will be applied against the tax liability of the transferor in accordance with IRC 6402 of the Internal Revenue Code to the extent permitted by the law.”

- (8) If the transferor’s liability has been judicially determined, the adjustments to net income, explanations, and computations of tax should be omitted and the following type of paragraph inserted:

“The correctness of the amount of the deficiency due from John E. Doe, (address, has been determined by decision of the Tax Court of the United States, Docket No. (number).”

4.10.13.3.6.1  
(03-16-2015)

**Opening Paragraphs in Preliminary Letters to Transferees**

- (1) When Letter 950 is sent to transferees, the following opening pattern paragraphs will be used in straight deficiency cases (if employment tax is involved, the words “income tax” will be changed to “employment tax” and “years” will be changed to “periods”).
  - a. **Income tax case pattern paragraph P-30:**



“We have proposed an assessment against you in the amount of (\$amount), plus penalties and interest thereon as provided by law, constituting your liability as a transferee of the property of (Name, Transferor), (address), for income taxes due for the taxable year(s) ended (date of year-end), as shown in the attachment to the letter”.

**b. Estate tax case pattern paragraph P-31:**

“We have proposed an assessment against you in the amount of (\$amount), plus penalties and interest thereon as provided by law, constituting your ability as a transferee of the property of the estate of (Name), (address) for estate tax, penalties and interest thereon, as shown in the attachment to the letter.”

**c. Gift tax case pattern paragraph P-32:**

“We have proposed an assessment against you in the amount of (\$amount), plus penalties and interest thereon as provided by law, constituting your liability as a transferee of property of (Name, Transferor), (address), for gift tax, penalties and interest thereon, for the calendar year(s) (year), as shown in the attachment to the letter.”

- (2) When Letter 955 is sent to a fiduciary regarding his/her liability under IRC 6901 and Title 31 of the United States Code, *Section 3713*, because the fiduciary paid debts or distributed assets without first satisfying the tax due to the United States from the estate, one of the following opening paragraphs will be used:

**1. Income Tax Case pattern paragraph P-33:**

“We have proposed an assessment against you in the amount of (\$amount), plus, penalties, and interest thereon as provided by law, constituting your personal liability as a fiduciary of the estate of (name), (address), for income taxes, penalties and interest thereon due from (Decedent name) or (Estate), (address) for the tax year(s) ended (year-end), as shown in the attachment to the letter.”

**2. Estate Tax Case pattern paragraph P-34:**

“We have proposed an assessment against you in the amount of (\$amount) plus penalties and interest thereon provided by law, constituting your personal liability as a fiduciary for estate tax due from the estate of (name), (address), as shown in the attachment to the letter.”

**3. Gift Tax Case pattern paragraph P-35:**

“We have proposed an assessment against you in the amount of (\$amount), plus, penalties and interest thereon as provided by law, constituting your personal liability as a fiduciary for gift tax due from (name), deceased, for the calendar year(s) (year), as shown in the attachment to the letter. ”

- (3) In mixed deficiency and overassessment cases involving transferee or fiduciary liability, the opening paragraphs inserted in Letter 955 will be suitable revisions of pattern paragraphs P-30 to P-35 as shown above.
- (4) If the value of the assets received by a transferee is less than the unpaid tax liability of the transferor, the opening paragraphs P-30 to P-32 will be used, but modified by the following phrase:

“(\$amount) of the unpaid liability plus interest thereon provided by law constitutes your liability as a transferee of the assets of (transferor name).”

4.10.13.3.6.2  
(03-16-2015)

**Opening Paragraphs for Notices of Transferee Liability**

- (1) The opening paragraph of the notice of transferee liability is dependent upon the circumstances of the case. The language for the various opening paragraphs is contained in IRM 4.8.9.17.5.2, Transferee Letter Opening Paragraphs.

4.10.13.3.6.3  
(03-16-2015)

**Attachment to the Letter for Notices of Transferee Liability**

- (1) The attachment to the letter is an explanation to the transferee as to where the proposed assessment originated. The attachment to the letter is divided into two parts:
  - a. First is the transferor’s section, which lists the name, address, and TIN of the transferor. The unpaid income tax liability and penalties for each tax period subject to transferee liability will also be listed. If the transferor has made payments to reduce the liability, the payments will be netted against the tax, penalties, and interest for the earliest tax periods first. The payments will be allocated to the tax, penalties and interest previously assessed against the transferor on the basis of the ratio of the separate amounts of tax, penalties and interest to the aggregate amount assessed. The net figures will be reflected on the attachment to the letter and on the waiver. If the transferee’s liability is limited, the list of the transferor’s unpaid liability will reflect the transferor’s total unpaid liability and will not be adjusted because of the transferee’s limitation. The following statement will be placed below the listing of the unpaid liability: “Interest thereon as provided by law will be charged on the unpaid liability until it is paid in full”.
  - b. Second is the transferee’s section, which lists the name, address, and TIN of the transferee.
- (2) The attachment to the letter will be prepared in the format, with the language, shown in IRM 4.8.9, Statutory Notices of Deficiency.

4.10.13.3.7  
(03-16-2015)

**Assessments**

- (1) Form 1296, Assessment Against Transferee or Fiduciary, will be prepared by Technical Services when an assessment is to be made against a transferee. A separate Form 1296 is prepared for each transferee for each taxable year/period of the transferor. If the value of the assets received by the transferee is less than the unpaid liability of the transferor and more than one year is involved, the transferee’s liability should not be allocated to the various years. Instead, the liability should be shown as one amount on the Form 1296 for the earliest year of the transferor without identifying it with any particular year of the transferee. In limited liability cases such as these, instructions should be included on Form 1296 for computation of interest. The interest starting date and the interest rate will be annotated on Form 1296. An appropriate cross-reference should be made on the other Form 1296, if any.
- (2) If a statutory notice is issued to the transferor prior to completion of the action against the transferee(s), the return of the transferor will be forwarded at the expiration of the 90-day period for assessment if no appeal is filed, or earlier if



an agreement is received. After assessment, the case file of the transferor will be sent back to the appropriate examination group to complete and associate with the transferee case.

- (3) If a waiver of restrictions on assessment and collection for the entire deficiency is filed by the transferor, and no preliminary action has been taken with respect to the transferees, the case will be forwarded for assessment of the tax. After assessment, the case is returned to Examination function for appropriate action with respect to the transferee liability if the tax has not been paid by the transferor.
- (4) When a preliminary action 30-day letter has been taken against the transferor and/or transferee(s), and a waiver of restrictions on assessment for all or any part of the unpaid liability is filed by one but not all of the transferees, the agreement, together with Form 1296, will be forwarded for assessment. The assessment will be made, the agreement and Form 1296 will be transmitted to the appropriate group. Subsequent closing action on the case, including advice to the remaining transferees of discontinuance of transferee action, will depend on whether the transferor's tax liability has been discharged by payment.
- (5) If statutory notice of deficiency to the transferor is issued concurrently with a notice of liability to the transferee(s) and no petitions are filed within the 90-day period, the entire file will be sent for assessment and subsequent action to clear the accounts if the transferor's tax is paid.
- (6) Technical Services will prepare Form 1296 and forward them for assessment when a transferor's case is before the Tax Court, and the transferees fail to file petitions within 90 days after Examination issued notices of liability to them. Appeals office will be informed of any payments made by the transferees.
- (7) Examination function's consideration of a transferor-transferee case will not be concluded until the record shows that either the tax due from the transferor has been paid or closing action has been taken with respect to the transferor and transferees.
- (8) Form 3198 should be prepared in all transferor-transferee cases, and remarks noted where applicable: "Transferee case Agreed/Unagreed, route to Technical Services." Technical Services will make the decision as to whether a transferee assessment will be made. If so, Technical Services will prepare Form 1296 with proper instructions and will send it along with the case file to Case Processing.

4.10.13.4  
(03-16-2015)  
**Related Party  
Transactions (IRC 482)**

- (1) The purpose of IRC 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent tax avoidance with respect to such transactions. IRC 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer
- (2) IRC 482 also applies to cases involving transactions with foreign related parties or domestic related parties. The original purpose of IRC 482 and its predecessor statutes was to prevent arbitrary shifting of profits, making of fictitious sales, and other methods for "milking" among related parties, particularly when a foreign party was involved. While the principal target of IRC 482 appears to have been U.S. income shifted to commonly controlled foreign entities, IRC 482 also applies to prevent tax avoidance and to correct income distortion arising from transactions between domestic entities.

- (3) The actual text of IRC 482 is very short and concise. The Treasury Regulations under IRC 482 and case law interpreting IRC 482 provide guidance on its application. In addition to this IRM section on IRC 482 please refer to IRM 4.11.5, Allocation of Income and Deductions Under IRC 482.

4.10.13.4.1  
(03-16-2015)  
**Purpose and Scope of  
IRC 482**

- (1) Under 26 CFR 1.482-1(a)(1), “the purpose of IRC 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions”. Further, IRC 482 places a controlled taxpayer on tax parity with an uncontrolled taxpayer.
- (2) Under 26 CFR 1.482-1(a)(2), the IRS has the authority to make allocations “between and among the members of a controlled group if a controlled taxpayer has not reported its true taxable income.” The IRS may allocate all income, deductions, credits, allowances, basis, or any other item affecting taxable income of a controlled taxpayer to prevent the evasion of taxes or to clearly reflect income. The IRS may allocate income even if the intent to evade or avoid tax is not present if such allocation will more clearly reflect the income of the controlled taxpayer. 26 CFR 1.482-1(f)(1)(i).
- (3) The focus of IRC 482 is economic reality, not the taxpayer’s motivation and purpose.
- (4) Under IRC 482, the IRS’s deficiency determinations are presumptively correct. The taxpayer bears the burden of proving that the IRS’s deficiency determinations are arbitrary, capricious, and unreasonable.

4.10.13.4.2  
(03-16-2015)  
**Two or More  
Organizations, Trades or  
Businesses**

- (1) To justify a reallocation under IRC 482, the Service must find:
- that there are two or more trades, business, or organizations;
  - that such enterprises are owned or controlled by the same interests; and
  - that the reallocation is necessary in order to prevent the evasion of taxes or to reflect properly each enterprise’s income.
- (2) The phrase “two or more organizations, trades or businesses” has caused some concern in determining the applicability of IRC 482. “Organization includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation.” 26 CFR 1.482-1(i)(1). “Trade or business includes a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation.” 26 CFR 1.482-1(i)(2).
- (3) A shareholder’s transactions with his controlled corporation may be subject to IRC 482. In *Fegan v. Commissioner*, 71 T.C. 791, 804 (1979), the taxpayer argued the IRS’s allocation of additional rental income to him from his controlled corporation was improper because he was an individual and not an organization, trade, or business as referred to in IRC 482. The IRS argued that the taxpayer was within the meaning of IRC 482 because that provision permits an allocation of income from a related organization to an individual who is in a trade or business. The Tax Court held that the taxpayer’s lease of real property, equipment, and furnishings to a corporation that the taxpayer owned was a trade or business within the meaning of IRC 482.
- (4) It is the IRS’s position that a shareholder/employee who receives a salary for services rendered is engaged in a trade or business for purposes of IRC 482. Rev. Rul. 88-38, 1988-1 C.B. 246.

4.10.13.4.3  
(03-16-2015)  
**Specific Situations in  
Which IRC 482 Could Be  
Applied**

- (1) The following is a summary of various situations in which an IRC 482 issue could be raised. Neither this summary nor the citations furnished are meant to be all inclusive.

4.10.13.4.3.1  
(03-16-2015)  
**Loans or Advances - 26  
CFR 1.482-2(a)**

- (1) IRC 482 may apply to intercompany loans or advances. 26 CFR 1.482-2(a) states as follows: “Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm’s length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district” (now Area Director) may make appropriate allocations to reflect an arm’s length rate of interest for the use of such loan or advance.”
- (2) The arm’s length rate of interest provisions under IRC 482 only applies to bona fide indebtedness between members of a controlled group of entities. Examples of such indebtedness include: (1) loans or advances of money or other consideration (whether or not evidenced by a written instrument); and (2) indebtedness arising in the ordinary course of business from sales, leases, or rendition of services by or between members of the group or any other similar extension of credit. 26 CFR 1.482-2(a)(1)(ii)(A). IRC 482 does not apply to indebtedness that is not bona fide such as contributions to capital or leases of property. 26 CFR 1.482-2(a)(1)(ii)(B).
- (3) Is an arm’s length interest rate charged? An arm’s length rate of interest is the rate of interest that was charged, or would have been charged, at the time the indebtedness arose in independent transactions with or between unrelated parties under similar circumstances. To determine whether an interest rate is arm’s length, consider all relevant factors including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties. 26 CFR 1.482-2(a)(2)(i).
- (4) 26 CFR 1.482-2(a)(2)(iii) provides safe harbor interest rates for intercompany loans and advances made after May 8, 1986. The rate of interest actually charged is considered arm’s length if it is between 100 percent and 130 percent of the applicable federal rate (AFR). See(26 CFR 1.482-2(a)(1)(iii)(B)(1)). If no interest is charged or if the interest charged is less than 100 percent of the AFR, then 100 percent of the AFR (compounded semi-annually) will be considered an arm’s length rate (26 CFR 1.482-2(a)(1)(iii)(B)(2)) . If the interest rate charged is higher than 130 percent of the AFR, then 130 percent of the AFR (compounded semi-annually) will be considered an arm’s length rate unless the taxpayer establishes a more appropriate rate of interest (26 CFR 1.482-2(a)(1)(iii)(B)(3)). Two exceptions to these safe harbor interest rate rules exist. First, the safe harbor rules do not apply if the lender is regularly engaged in the business of making loans to unrelated parties (26 CFR 1.482-2(a)(2)(iii)(D)). Second, the safe harbor rules do not apply to loans or advances when their principal or interest is expressed in a currency other than U.S. dollars (26 CFR 1.482-2(a)(2)(iii)(E)).
- (5) There are certain coordination rules with respect to interest adjustments required under certain other IRC provisions (26 CFR 1.482-2(a)(3)). For example, if IRC 7872 could apply in addition to IRC 482, then IRC 7872 should be used as the primary position. If there is a dispute over whether IRC 7872

applies, or if it is unclear whether it applies, then IRC 482 should be raised as an alternative position (Prop. Reg. 1.7872-2(a)(2)(iii)).

- (6) When considering loans between two related entities, the IRS is not necessarily bound to the position of “imputing” interest income under IRC 482. Under certain circumstances, the IRS may use IRC 482 to reallocate interest expense claimed by one entity to its affiliate. In *Kahler Corp. v. Commissioner*, 486 F.2d 1 (8th Cir. 1973), rev’d, 58 TC 496 (1972), the common parent of an affiliated group borrowed funds from third party lenders. Subsequently, the parent reloaned some of its borrowed funds to two of its subsidiaries. The loans from the parent to the subsidiaries were made on an interest-free basis. The affiliated group did not file a consolidated return. The parent was in a higher tax bracket than its subsidiaries, and thus, received a significant benefit from the interest expense deduction that it claimed. On the other hand, both of the subsidiaries were in much lower-tax brackets and would not have derived as much of a tax benefit from the interest deductions. The IRS imputed interest income to the parent and increased the interest expense deductions of the subsidiaries. The Court held that the IRS’s allocation was necessary under IRC 482 to clearly reflect the income of the parent and the subsidiaries.
- (7) Similarly, in *Latham Park Manor, Inc v. Commissioner*, 69 TC 199, 220-221 (1977), in his concurrence, Judge Scott stated:

“In economic reality, MIC was the true borrower. Making a proper allocation of the interest deductions and amortized loan costs (which is the substance of the adjustment made by respondent in the notice of deficiency) fully eliminates the tax avoidance here occasioned by the relationship of the parties...”

#### 4.10.13.4.3.2 (03-16-2015)

#### **Performance of Services - Before January 1, 2007 26 CFR. 1.482-2(b) (1968)**

- (1) The Treasury Department issued regulations covering service transactions between controlled entities in 1968. T.D. 6952, 1968-1 C.B. 218; 26 CFR 1.482-2(b) (1968). The 1968 controlled services regulations were partly amended in 1994 by T.D. 8552, 1994-2 C.B. 93, but remained relatively unchanged until 2006 when the IRS adopted new temporary regulations that covered controlled service transactions. T.D. 9278, 2006-2 C.B. 256; Temp. 26 CFR 1.482-9T (August 4, 2006); issued in final form in T.D. 9456, 2009-33 I.R.B. 188; 26 CFR 1.482-9 (August 4, 2009).
- (2) Prior to its amendment by 26 CFR 1.482-9T, 26 CFR 1.482-2(b) (referred to hereafter as “Former 26 CFR 1.482-2(b)”) required that where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group at a charge that is not an arm’s length charge, the IRS may make allocations to reflect an arm’s length charge for the services.
- (3) Former 26 CFR 1.482-2(b)(2)(i). authorized the IRS to make allocations to reflect arm’s length charges for services undertaken for the joint benefit of the members of a controlled group, or services performed exclusively for the benefit of one member of the controlled group. However, if the benefits to the other members were so indirect or remote that unrelated parties would not have charged for the services, the IRS was not authorized to make a section 482 allocation regarding those services.
- (4) In determining the amount of the arm’s length charge, Former 26 CFR 1.482-2(b)(3) provided that if services are not an “integral part” of the business

activity of either the member rendering the services or the member receiving the benefit of the services, then the arm's length charge shall be equal to costs of the service, unless the taxpayer establishes a more appropriate charge. However, if the services are an "integral part" of the business activity of either the member rendering the service or the member receiving the benefit of the service, then the arm's length charge is the amount that would have been charged for the same or similar services in independent transactions between unrelated parties under similar circumstances. Former 26 CFR 1.482-2(b)(7) provided four separate tests for determining whether a particular service was considered to be an "integral part" of an entity's business. If any of the four tests were satisfied, then the services at issue were considered to be an "integral part" of the business activity, and an arm's length charge was not deemed equal to the costs or deductions of those services but instead required a determination of the actual amount that would have been charged between unrelated parties under similar circumstances for those services.

- (5) Some cases applying Former 26 CFR 1.482-2(b) to controlled service transactions are set forth below. This is not an exhaustive list of cases covering this area.
- (6) In *Haag v. Commissioner*, 88 TC 604, 622 (1987), the United States Tax Court held that IRC 482 may be used to allocate income from a professional service corporation to a shareholder/employee. In *Haag*, a physician assigned his interest in a medical partnership to his professional corporation. Although the doctor provided medical services to the corporation, he received either no salary or minimal salary for the years at issue. The court stated that "Petitioner would not have agreed to work for no compensation if he had bargained at arm's length with an uncontrolled entity" and upheld the government's IRC 482 adjustment, which was "the difference between the amount of compensation petitioner would have received in each year absent of incorporation and the amount he actually received."
- (7) In *Keller v. Commissioner*, 77 T.C. 1014 (1981), in determining the applicability of IRC 482 to a pathologist's compensation, his total compensation (salary, pension plan contributions, and medical benefits) was compared to what the petitioner would have bargained for in an arm's-length transaction with an unrelated party.
- (8) Due to employment tax considerations, it appears when inadequate compensation is paid to a shareholder/employee, consideration should be given to whether loans to the shareholder should be recharacterized as compensation instead of treating them as dividend distributions.
- (9) In *Haber v. Commissioner*, 52 T.C. 255 (1969), an S corporation made loans to one of its shareholder/employees over several years but reduced the shareholder/employee's salary by the amount of the loans. The loans were recharacterized as compensation for services.
- (10) Although raising an IRC 482 issue on compensation from an S corporation will usually have a wash effect on income tax, it should be considered when the shareholder otherwise has no earnings subject to FICA tax.
- (11) In *Bell v. Commissioner*, T.C. Memo 1982-660, three physicians formed a C corporation and a separate S corporation. The S corporation earned income from providing X-ray services to the C corporation. IRC 482 was used to



allocate income from the S corporation to the C corporation. The income allocated was then treated as dividend distributions from the C corporation to its shareholders.

- (12) If an existing business is transferred to multiple corporations, the examiner, in addition to considering IRC 482, should consider the applicability of IRC 269 and IRC 1551.
- (13) In *Rubin v. Commissioner*, 460 F.2d 1216 (2d Cir. 1972), payments by Corporation A to Corporation B were allocated under IRC 482 to the shareholder of Corporation B who had performed the management services for Corporation A. The taxpayer's services constituted a trade or business separate from his interest in Corporation B and were subject to IRC 482.
- (14) In *Ach v. Commissioner*, 42 T.C. 114 (1964), the taxpayer sold her successful dress shop to her son's insolvent corporation for less than adequate consideration. Although the taxpayer continued to provide significant managerial services to the business, she was not remunerated for her services. The court upheld the IRS's use of IRC 482 to allocate 70% of the profits of the dress shop to the taxpayer. The court held the parties had not dealt at arm's length and the sole purpose for the transfer of the dress shop was for the corporation to utilize net operating losses it would have otherwise lost.

4.10.13.4.3.3  
(03-16-2015)

**Performance of Services  
After December 31, 2006  
and Before August 1,  
2009 - 26 CFR. 1.482-9T**

- (1) The Treasury Department issued proposed regulations in 2003 covering controlled service transactions. 68 Fed. Reg. 53448 (Sep. 10, 2003). In response to comments received on issues covered by the 2003 proposed regulations, the Treasury Department issued Temp. 26 CFR 1.482-9T. These temporary regulations were later clarified and the effective date modified by *Notice 2007-5*, 2007-1 C.B. 269. Rev. Proc. 2007-13, 2007-1 C.B. 295, also identified specified covered services within the meaning of Temp. 26 CFR 1.482-9T(b).
- (2) The 2006 temporary regulations generally apply for tax years beginning after December 31, 2006 through July 31, 2009. On July 31, 2009, the IRS adopted the final version of the Treasury Regulations covering controlled service transactions. The final 2009 services regulations generally apply to taxable years beginning after July 31, 2009; however, taxpayers may affirmatively elect to retroactively apply certain provisions of the 2009 services regulations to taxable years beginning after September 10, 2003. See 26 CFR 1.482-9(n).

4.10.13.4.3.4  
(03-16-2015)

**Performance of Services  
After July 31, 2009 - 26  
CFR. 1.482-9**

- (1) 26 CFR 1.482-9 provides methods to determine taxable income from a controlled services transaction. A controlled services transaction includes any activity by one member of a group of controlled taxpayers that results in a benefit to one or more other members of the controlled group. 26 CFR 1.482-9(l)(1). An activity includes: (1) the performance of functions; (2) assumptions of risks; (3) use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances; and (4) making available to the recipient any property or other resources of the renderer. 26 CFR 1.482-9(l)(2).
- (2) For an activity rendered by one member of a group of controlled taxpayers to be considered a controlled services transaction, the activity must result in a benefit to one or more other members of the controlled group. An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that

enhances the recipient's commercial position, or that may reasonably be anticipated to do so. Further, an activity is generally considered to confer a benefit if an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity. 26 CFR 1.482-9(l)(3)(i).

- (3) Rules on activities that may not confer a benefit.
  - a. **(Indirect or remote benefit)** An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay an uncontrolled party to perform a similar activity, and would not be willing to perform such an activity itself. 26 CFR 1.482-9(l)(3)(ii). Examples 2 and 3 of 26 CFR 1.482-9(l)(5) illustrate the indirect or remote benefit concept.
  - b. **(Duplicative activities)** If an activity performed by a controlled taxpayer duplicates an activity that is performed or reasonably anticipated to be performed, by another controlled taxpayer for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient. 26 CFR 1.482-9(l)(3)(iii). Examples 4, 5, and 6 of 26 CFR 1.482-9(l)(5) illustrate the duplicative activities concept.
  - c. **(Shareholder activities)** An activity is not considered to provide a benefit to a related party if the sole effect of that activity is to protect the renderer's capital investment in the recipient or other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirement applicable specifically to the renderer. 26 CFR 1.482-9(l)(3)(iv). Examples 7 through 14 of 26 CFR 1.482-9(l)(5) illustrate the shareholder activities concept.
  - d. **(Passive association)** A controlled taxpayer will generally not be considered to obtain a benefit resulting from the controlled taxpayer's status as a member of a controlled group. 26 CFR 1.482-9(l)(3)(v). Examples 15 through 19 of 26 CFR 1.482-9(l)(5) illustrate the passive association concept.
- (4) The 2009 services regulations require that the amount charged in a controlled services transaction be determined under one of the following methods:
  - a. The services cost method, as described in 26 CFR 1.482-9(b)
  - b. The comparable uncontrolled services price method, as described in 26 CFR 1.482-9(c)
  - c. The gross services margin method, as described in 26 CFR 1.482-9(d)
  - d. The cost of services plus method, as described in 26 CFR 1.482-9(e)
  - e. The comparable profits method, as described in 26 CFR 1.482-5 and 26 CFR 1.482-9(f)
  - f. The profit split method, as described in 26 CFR 1.482-6 and 26 CFR 1.482-9(g); and
  - g. Unspecified methods, as described in 26 CFR 1.482-9(h).
- (5) Each method must be applied in accordance with the best method rule of 26 CFR 1.482-1(c), the comparability analysis of 26 CFR 1.482-9(d), and the arm's length range of 26 CFR 1.482-9(e). See 26 CFR 1.482-9(a).
- (6) A central part of Former 26 CFR 1.482-9(b) was that an arm's length charge for services that were not "integral" were deemed equal to costs or deductions of rendering the services. 26 CFR 1.482-9 preserves aspects of this "deemed



equal to the costs or deductions” treatment through the services cost method. The services cost method is designed to minimize compliance burdens for intragroup back-office services common across many industries. The services cost method as set forth in the 2009 services regulations may be applied if a taxpayer satisfies four conditions.

- a. First, the service must be a “covered service” within the meaning of 26 CFR 1.482-9(b)(3). “Covered services” consist of (1) specified covered services or (2) low margin covered services. A list of specified covered services is provided in Rev. Proc. 2007-13. Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to seven percent. 26 CFR 1.482-9(b)(3)(ii).
  - b. Second, the service must not be an “excluded activity” under 26 CFR 1.482-9(b)(4). The following types of activities are excluded activities: (1) manufacturing; (2) production; (3) extraction, exploration, or processing of natural resources; (4) construction; (5) reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement; (6) research, development, or experimentation; (7) engineering or scientific; (8) financial transactions, including guarantees; and (9) insurance or reinsurance.
  - c. Third, the service must meet the business judgment rule. 26 CFR 1.482-9(b)(2)(iii). Under this rule, the taxpayer must reasonably conclude in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group. 26 CFR 1.482-9(b)(5). The reasonableness of the taxpayer’s conclusion is determined based on all the facts and circumstances.
  - d. Fourth, the taxpayer must maintain adequate books and records. 26 CFR 1.482-9(b)(2)(iv). The taxpayer’s books and records must be adequate to permit verification by the IRS of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question. 26 CFR 1.482-9(b)(6). In addition, the books and records must include a statement evidencing the taxpayer’s intention to apply the services cost method to evaluate the arm’s length charge of such services.
- (7) Under certain conditions, the 2009 services regulations also permit taxpayers to use shared service arrangements to allocate costs within a controlled group. 26 CFR 1.482-9(b)(7). A shared services arrangement must: (1) include two or more participants; (2) include as participants all controlled taxpayers that benefit from one or more covered services subject to the shared services agreement; and (3) be structured such that each covered service confers a benefit on at least one participant. 26 CFR 1.482-9(b)(7)(ii)(A). Examples illustrating the shared services arrangement rules are set forth in 26 CFR 1.482-9(b)(8).
- (8) The 2009 services regulations contain coordination rules for service transactions that contain elements of different types of transactions. For example, a transaction structured as a service transaction may also involve the transfer of tangible or intangible property. In evaluating whether to value these integrated transactions as a single transaction or whether to value each component sepa-

rately, depends on which approach will provide the most reliable measure of an arm's length result. 26 CFR 1.482-9(m).

4.10.13.4.3.5  
(03-16-2015)

**Use of Tangible Property  
- 26 CFR 1.482-2(c)**

- (1) Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities is transferred by lease or other arrangement to another member of such group without charge or at a charge that is not equal to an arm's length rental charge, the IRS may make appropriate allocations to properly reflect an arm's length charge. 26 CFR 1.482-9(c)(1). Generally, an arm's length charge equals the amount of rent that was charged, or would have been charged, for the use of the same or similar property, during the time it was in use, in independent transactions between unrelated parties under similar conditions. 26 CFR 1.482-9(c)(2).
- (2) If a taxpayer leases property from an unrelated party and then subleases the property to a related party, an arm's length rental charge is equal to all the deductions claimed by the taxpayer for the period the property is used unless the taxpayer can establish a more appropriate arm's length rental charge or the taxpayer or the related party subleasing the property were regularly engaged in the business of renting property of the same general type as the property in question to unrelated parties. 26 CFR 1.482-9(c)(2)(iii).
- (3) Some cases applying IRC 482 to the use of tangible property by lease are set forth below. This is not an exhaustive list of cases covering this area.
- (4) A shareholder's rental of a commercial building to her controlled corporation for a non-arm's length rent is subject to IRC 482. See *Peck v. Commissioner*, T.C. Memo 1982-17; *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Thomas v. Commissioner*, T.C. Memo. 1983-462.
- (5) This may be particularly abusive in situations where the corporation has a net operating loss. To the extent the shareholder has an allowable rental loss after applying IRC 482 and any other relevant provisions of the Code, IRC 469 should be considered to disallow any passive activity loss.
- (6) A partnership's rental of a building to a related corporation for a non-arm's length rent is also subject to IRC 482. *Boyer v. Commissioner*, 58 T.C. 316 (1972).

4.10.13.4.3.6  
(03-16-2015)

**Cost Sharing  
Arrangements - 26 CFR.  
1.482-7A and 26 CFR  
1.482-7**

- (1) The development of intangible assets may be funded by the use of a cost sharing arrangement if all legal requirements are satisfied. Generally, under a cost sharing arrangement, two or more cost sharing participants agree to jointly contribute to the costs of developing an intangible asset in proportion to their reasonably anticipated benefits.
- (2) Treasury Regulations issued in 1968 first governed cost sharing arrangements without providing detailed guidance. See 26 CFR 1.482-9(c)(1) (1968). However, during the early 1990s proposed and temporary Treasury Regulations were issued that provided more detailed guidance on cost sharing arrangements. Final Treasury Regulations covering cost sharing arrangements were issued in December of 1995 and then amended in May of 1996. See T.D. 8632, 1996-1 C.B. 85; T.D. 8670, 1996-1 C.B. 99. These regulations were amended again in 2003 to provide guidance on the treatment of stock-based compensation in cost sharing arrangements. See T.D. 9088, 2003-2 C.B. 841. The 1995 cost sharing regulations, as amended by T.D. 8670 and T.D. 9088, are currently designated as 26 CFR 1.482-7A. With the exception of 26 CFR

1.482-7A(a)(3), 26 CFR 1.482-7A(d)(2), and 26 CFR 1.482-7A(j)(2)(i)(F) (addressing the requirement to share stock-based compensation costs), 26 CFR 1.482-7A applies to taxable years beginning after December 31, 1995 26 CFR 1.482-7A(a)(3), 26 CFR 1.482-7A(d)(2), and 26 CFR 1.482-7A(j)(2)(i)(F) apply for taxable years beginning after August 25, 2003) and remain applicable through January 4, 2009. Temporary Treasury Regulations were issued on January 5, 2009, which made significant changes to the prior 1995 cost sharing regulations. T.D. 9441, 2009-7 I.R.B. 460. The final cost sharing regulations were issued in December 2011 and are designated under 26 CFR 1.482-7. T.D. 9568, 2012-12 I.R.B. 499. The final cost sharing regulations are effective December 16, 2011.

- (3) Under 26 CFR 1.482-7A, “a cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.” 26 CFR 1.482-7A(a)(1). Taxpayers may utilize cost sharing only for “qualified” cost sharing arrangements. To be “qualified,” a cost sharing arrangement must: (1) include two or more participants; (2) provide a method to calculate each controlled participant’s share of intangible development costs, based on factors that can reasonably be expected to reflect that participant’s share of anticipated benefits; (3) provide for adjustment to the controlled participants’ shares of intangible development costs to account for changes in economic conditions, the business operations, and practices of the participants, and the ongoing development of intangibles under the arrangement; and (4) be recorded in a document that is contemporaneous with the formation of the cost sharing arrangement.”
- (4) Participants in a cost sharing arrangement may be either controlled participants or uncontrolled participants. A controlled participant’s participation is only recognized if it: (1) reasonably anticipates that it will derive benefits from the use of covered intangibles; and (2) substantially complies with the accounting and administrative requirements of the cost sharing regulations. 26 CFR 1.482-7A(c)(1). The accounting requirements are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis. 26 CFR 1.482-7A(i). The administrative requirements are that the controlled participant must maintain sufficient documentation as set forth in the cost sharing regulations and also must attach to its U.S. income tax return a statement indicating that it is a participant in a cost sharing arrangement, and listing the other controlled participants in the arrangement. 26 CFR 1.482-7A(j).
- (5) A qualified cost sharing arrangement must specify each participant’s share of the “intangible development costs.” 26 CFR 1.482-7A(b)(2). This share means all of the costs incurred by the participant relating to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. 26 CFR 1.482-7A(d). Costs incurred related to the intangible development area include operating expenses, other than depreciation and amortization, and arm’s length charges for the use of tangible property that a participant makes available to the qualified cost sharing arrangement. *Id.*

- (6) Intangible development costs must be shared among the controlled participants in proportion to their shares of reasonably anticipated benefits. 26 CFR 1.482-7A(a)(1) and 26 CFR 1.482-7A(e). A controlled participant's reasonably anticipated benefits are the aggregate benefits it reasonably anticipates that it will derive from the covered intangibles. 26 CFR 1.482-7A(e)(2). For that purpose, benefits are the additional income generated or costs saved by the use of the covered intangibles. 26 CFR 1.482-7A(e)(1). A controlled participant's share of reasonably anticipated benefits is equal to its reasonably anticipated benefits divided by the reasonably anticipated benefits of all controlled participants. 26 CFR 1.482-7A(f)(3)(i).
- (7) Reasonably anticipated benefits must be determined using the most reliable estimate of reasonably anticipated benefits. In making that determination, the quality of the data and assumptions used in the analysis must be considered. 26 CFR 1.482-7A(f)(3)(i). Significant divergences between the projected and actual benefits may mean the projections are unreliable. 26 CFR 1.482-7A(f)(3)(iv)(B). Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20 percent of the participant's projected benefit share. *Id.*
- (8) If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of the cost sharing arrangement, then each other controlled participant must make a buy-in payment to the owner of the pre-existing intangible property. 26 CFR 1.482-7A(g)(2).
- (9) Under the 2011 cost sharing regulations, a cost sharing arrangement in existence on January 5, 2009, and satisfying the legal requirements of the 1995 cost sharing regulations, will continue to be regarded as a cost sharing arrangement if certain conforming changes are made to the arrangement. 26 CFR 1.482-7(m). The cost sharing arrangement must have been amended by the parties to conform with 26 CFR 1.482-7(k) by July 6, 2009. In addition, taxpayers must have filed a cost sharing arrangement statement with the IRS no later than September 2, 2009. 26 CFR 1.482-7(m)(2)(viii). Cost sharing transactions and platform contributions taking place prior to January 5, 2009 are subject to the 26 CFR 1.482-7A. 26 CFR 1.482-7(m)(2)(i).
- (10) The 2011 cost sharing regulations were significantly changed from the 26 CFR 1.482-7. The 2011 cost sharing regulations are set out in 26 CFR 1.482-7. 26 CFR 1.482-7(g) provides methods to determine an arm's length result for a platform contribution transaction, including the comparable uncontrolled transaction method, the income method, the acquisition price method, the market capitalization method, the residual profit split method, and unspecified methods. The 2011 cost sharing regulations also provide new rules on determining divisional interests (26 CFR 1.482-7(b)(4)) and reasonably anticipated benefits share (26 CFR 1.482-7(e)), along with many other provisions. Considering the complexity of the cost sharing regulations, consider contacting the Office of Associate Chief Counsel (International) and the Transfer Pricing Practice if you have questions regarding the examination of a taxpayer's cost sharing arrangement.

4.10.13.4.3.7  
(03-16-2015)  
**Transfers of Intangible  
Property - 26 CFR.  
1.482-4**

- (1) The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in 26 CFR 1.482-4:
  - a. The comparable uncontrolled transaction method, described in 26 CFR 1.482-4(c);
  - b. The comparable profits method, described in 26 CFR 1.482-5;
  - c. The profit split method, described in 26 CFR 1.482-6; and
  - d. Unspecified methods described in 26 CFR 1.482-4(d).
- (2) Each of the methods must be applied in accordance with all of the provisions of 26 CFR 1.482-1, including:
  - a. The best method rule of 26 CFR 1.482-1(c);
  - b. The comparability analysis of 26 CFR 1.482-1(d); and
  - c. The arm's length range of 26 CFR 1.482-1(e).
- (3) The arm's length consideration for the transfer of an intangible determined under 26 CFR 1.482-4 must be commensurate with the income attributable to the intangible. See 26 CFR 1.482-4(f)(2) (Periodic adjustments).
- (4) Pursuant to 26 CFR 1.482-4(b), intangible property for purposes of IRC 482 is an asset that comprises any of the following items and has substantial value independent of the services of any individual:
  - a. Patents, inventions, formulae, processes, designs, patterns or know-how;
  - b. Copyrights and literary, musical, or artistic compositions;
  - c. Trademarks, trade names, or brand names;
  - d. Franchises, licenses, or contracts;
  - e. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  - f. Other similar items.
- (5) Consideration for a transfer of intangible property shall be in the form of a royalty to the transferor where the transferor retains a substantial interest in the property and the transferee pays nominal or no consideration unless a different form is more appropriate. 26 CFR 1.482-4(f)(1)

4.10.13.4.3.8  
(10-28-2015)  
**Transfer of Tangible  
Property - 26 CFR  
1.482-3**

- (1) The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in 26 CFR 1.482-3(a). Each of the methods must be applied in accordance with all of the provisions of 26 CFR 1.482-1 including the best method rule of 26 CFR 1.482-1(c), the comparability analysis of 26 CFR 1.482-1(d), and the arm's length range of 26 CFR 1.482-1(e). 26 CFR 1.482-3(a), the transfer pricing methods are:
  - a. The comparable uncontrolled price method, described in 26 CFR 1.482-3(b);
  - b. The resale price method, described in 26 CFR 1.482-3(c);
  - c. The cost-plus method, described in 26 CFR 1.482-3(d);
  - d. The comparable profits method, described in 26 CFR 1.482-5;
  - e. The profit split method, described in 26 CFR 1.482-6; and
  - f. Unspecified methods, described in 26 CFR 1.482-3(e).
- (2) The value of tangible property may be affected by the value of intangible property associated with the tangible property's transfer. Generally, the transfer of tangible property that has intangible property associated with the transfer



will not be considered a transfer of intangible property if the purchaser does not acquire any rights to exploit the intangible property other than the rights relating to the resale of the tangible property under normal commercial practices. 26 CFR 1.482-3(f). In such a case, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled transaction. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible, then it may be necessary to determine the arm's length consideration for the intangible property separately from the tangible property under the methods in 26 CFR 1.482-4

- (3) There are numerous cases involving the sale of goods between a controlled domestic corporation and a controlled foreign corporation. A referral to International Specialists is required in these cases.
- (4) In accordance with Rev. Rul. 69-630, 1969-2 C.B. 112, (as modified by Announcement 99-1, 1999-1 C.B. 302) in the cases of a bargain sale between two corporations owned by the same shareholder, the income of the seller will be increased to reflect the arm's-length price, and the basis of the property to the purchaser will be increased by a like amount. Additionally, the amount of the increase will be treated as a distribution by the selling corporation to the shareholder and as a capital contribution by the shareholder to the purchasing corporation, unless the transaction giving rise to the IRC 482 allocation did not have as one of its principal purposes the avoidance of income tax.
- (5) The sale of property by a shareholder to his controlled corporation is subject to IRC 482. *Anderson v. Commissioner*, T.C. Memo 1976-28. The sale of land by a partnership to its controlling corporate partner is also subject to IRC 482. *Aladdin Industries v. Commissioner*, T.C. Memo 1981-245.
- (6) In *Dolese v. Commissioner*, 82 T.C. 830 (1984), following a disproportionate distribution of property from their partnership, the partners contributed the land to a charitable organization. IRC 482 was applied to allocate the charitable contributions among the partners consistent with the percentage interests in the partnership.
- (7) Similarly, in *Northwestern National Bank of Minneapolis*, 556 F.2d 889 (8th Cir. 1977), the IRS successfully reallocated to a wholly-owned subsidiary a charitable deduction claimed by the parent consisting of assets acquired from the subsidiary by means of an upstream dividend. The subsidiary in this case acquired 10% of the stock of a company for a cost of \$100,000. Over time the fair market value of the stock rose to \$800,000. After consideration of various alternatives, the subsidiary declared a dividend to its 100% corporate parent of the stock. Within two weeks of receiving its dividend, the parent donated the stock to a charitable foundation. The taxpayer argued IRC 482 was inapplicable to a transaction that originated as a dividend distribution. In addressing this, the court stated (at 891-892):

"There is nothing in the language of IRC 482 or its corresponding regulations that is inconsistent with applying IRC 482 to transactions between subsidiary corporations that might not occur in similar form between unrelated taxpayers. The purpose behind the dividend distribution was to obtain a tax advantage not available in an arm's length transaction. This transaction was made possible solely on the basis of appellant's relationship with and control of Bank Building Company, and the end result was a distortion of the respective net income of..."

4.10.13.4.3.9  
(10-28-2015)

**Otherwise  
Nonrecognized Gains or  
Losses - 26 CFR.  
1.482-1(f)(1)(iii)**

- (1) IRC 482 controls when it conflicts with IRC 351 as long as the Commissioner does not abuse his discretion to reallocate income and expenses. *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962). In footnote 4, the court in *Aladdin Industries v. Commissioner*, T.C. Memo 1981-245, stated: "It has been routinely held, absent an abuse of discretion by the Commissioner, IRC 482 will override specific non-recognition provisions of the code. *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952), cert. denied 344 U.S. 874 (1952)." These cases generally involve the transfer of an asset with built in gain or loss or the splitting of income from deductions to obtain an inappropriate or abusive tax benefit.

4.10.13.4.4  
(10-28-2015)

**Burden of Proof and  
Issue Development**

- (1) There is generally acknowledged a three-tiered approach to the burden of proof in IRC 482 cases:
  - a. If the notice of deficiency is clear that the IRS is relying on IRC 482, the burden of proof is on the taxpayer to establish the allocation is unreasonable, arbitrary, or capricious. See, e.g., *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1131 (1985), aff'd on this issue, rev'd in part, and remanded, 856 F.2d 855, 860 (7th Cir. 1988).
  - b. If IRC 482 is not raised until after the notice of deficiency, but the taxpayer is notified far enough in advance of trial so as not to prejudice him, the burden of proof shifts to the IRS to establish all elements in order to support the allocation under IRC 482.
  - c. If IRC 482 is raised too late to allow the taxpayer sufficient warning, the IRS cannot rely on IRC 482 at all.
- (2) See generally *CAL-FARM Insurance Co. v. United States*, 647 F. Supp. 1083 (E.D. Cal. 1986); *Achiro v. Commissioner*, 77 T.C. 881 (1981). In *CAL-FARM*, the taxpayer tried to convince the court it had not been given adequate notice of the IRS's reliance on IRC 482 and therefore, the IRS should be prohibited from relying on it. The court found in favor of the IRS, noting the "first line of the text of the notice [statutory notice of deficiency] refers to an attached examination report prepared by an Internal Revenue Service revenue agent. The revenue agent refers to IRC 482 at page 3 [of the examination report]." Therefore, it is important for examiners to ensure reports clearly reflect the IRS's reliance on IRC 482, even if this is an alternative position. In so doing, the burden of proof will remain with the taxpayer to show the IRS's proposed adjustment is "unreasonable, arbitrary, and capricious."
- (3) It is important to note IRC 482 applies only at the discretion of the Commissioner. 26 CFR 1.482-1(a)(3) states "[e]xcept as provided in this paragraph, IRC 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions." A taxpayer may report on a timely original tax return the results of its controlled transactions based upon prices different from those actually charged. However, 26 CFR 1.482-1(a)(3) does not permit a taxpayer to file an untimely or amended return to decrease taxable income from controlled transactions. See *Intersport Fashion West, Inc. v. United States*, 103 Fed. Cl. 396 (Fed. Cl. 2012). However, taxpayers may claim a setoff against the IRS's IRC 482 allocation for any other non-arm's length transaction between the same controlled taxpayers in the same taxable year as the IRS's IRC 482 allocation only if the taxpayer:



- a. Establishes that the transaction that is the basis of the setoff was not arm's length and the amount of the appropriate arm's length charge;
  - b. Documents all correlative adjustments resulting from the proposed setoff; and
  - c. Notifies the IRS of the basis of any claimed setoff within 30 days after the earlier of the date of a letter in which the IRS transmits an examination report notifying the taxpayer of proposed adjustments or the date of the issuance of the notice of deficiency. 26 CFR 1.482-1(g)(4).
- (4) For specific guidance on issue development in transfer pricing examinations refer to the IRS's Transfer Pricing Audit Roadmap, which is available at [www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf](http://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf)

4.10.13.4.5  
(03-16-2015)  
**Examination Reports  
and Processing**

- (1) To accomplish tax parity, the IRS may allocate items of income or expense among controlled taxpayers. IRC 482. The initial transfer pricing adjustment made by the IRS, which ordinarily increases the income of the taxpayer, is known as a "primary adjustment." The corresponding decrease in income of the other related party on the other side of the controlled transaction is known as the "correlative allocation."
- (2) When the IRS makes an allocation under IRC 482, appropriate correlative allocations will also be made with respect to any member of the group affected by the allocation. Thus, if the IRS makes an allocation of income, it will not only increase the income of one member of the group, but correspondingly decrease the income of the other member of the group. 26 CFR 1.482-1(g)(2)

4.10.13.4.5.1  
(10-28-2015)  
**Required Elements**

- (1) A statement will be made in the report to the primary taxpayer to the effect that:
- a. Separate examination reports have been prepared reflecting the IRC 482 correlative allocation with respect to the correlative taxpayer.
  - b. The correlative allocation is deemed to have been made in instances where the correlative allocation has no effect on the income tax liability of the correlative taxpayer.
- (2) The correlative allocation should not be made until the primary adjustment has been resolved. Pursuant to 26 CFR 1.482-1(g)(2)(iii), the primary adjustment may be resolved in one of the following ways:
- a. The assessment of tax following execution of Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment.
  - b. Acceptance of a Form 870-AD, Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment .
  - c. Payment of the deficiency.
  - d. Stipulation in the Tax Court.
  - e. Final determination of tax liability by offer-in-compromise, closing agreement, or court action.
- (3) To provide uniform treatment of all IRC 482 cases, agreed or unagreed, reports on the primary taxpayer and the correlative taxpayer should be prepared concurrently; kept together (not separate) and transmitted to the next function (i.e., Technical Services, Appeals Office, or campus processing center).

- (4) In cases with no tax effect of a correlative allocation (foreign entity, loss entity, etc.), the examiner should make a statement in the preliminary statement to the effect that the correlative allocation is deemed to have been made when and if the adjustments are agreed to and assessment has been made or deficiency has been paid. It is important that this statement included in all reports in order that the taxpayer to which the correlative allocations apply may not escape the effect of these adjustment in the event of a subsequent exam or carryback of losses or credits or other events that have a tax effect.
- (5) To ensure that overpayments resulting from the correlative allocations are not scheduled and refunded to the taxpayer, the examiner will note Form 3198 accordingly.

4.10.13.4.5.2  
(10-28-2015)

**Agreed IRC 482 Issues  
Involving Primary  
Adjustments and  
Correlative Allocations  
to U.S. Taxpayers**

- (1) In order to have an agreed IRC 482 Allocation of income and deductions among taxpayers' issue, all related parties must be in full agreement with the IRC 482 issue.
- (2) Obtain a signed agreement (Form 870 Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment.) or payment of the deficiency for the taxpayer to which the primary adjustment applies.
- (3) Make the correlative allocations and obtain agreements for the overassessment.
- (4) The taxpayers will be advised that their cases can be more expeditiously adjusted and closed if the taxpayer scheduled to receive refunds will voluntarily consent in writing to have the refunds applied against the proposed deficiencies.
- (5) The taxpayer's written statement can be incorporated in Form 870. The examiner's report in the overassessment cases must include a statement of whether consents as provided for in this paragraph have been furnished and, if not, the reason. The suggested format for the written statement is as follows: **The undersigned taxpayer also consents and agrees to the application of so much of the overassessment as represents an overpayment, together with allowable interest thereon, as a credit to the deficiency in tax in the amount of (\$amount), together with interest thereon, due from \_\_\_\_\_ for the year \_\_\_\_\_. This is provided that the amount of the overpayment, if any, together with allowable interest, which is in excess of the said deficiency and interest, is otherwise credited or refunded in accordance with IRC 6402, or the corresponding provisions of prior revenue laws.**
- (6) The examiner should refer to Rev. Proc. 99-32, in situations where the taxpayer requests permission to receive payment without further Federal income tax consequences from the taxpayer to which the correlative allocation applies.
- (7) The examiner will note Form 3198 Special Handling Notice for Examination Case Processing appropriately.

4.10.13.4.5.3  
(10-28-2015)

**Unagreed IRC 482  
Issues Involving Primary  
Adjustments and  
Correlative Allocations  
to U.S. Taxpayers**

- (1) In unagreed IRC 482 cases where the correlative allocation is the only adjustment on the related entity, do not write a complete report for the correlative allocation. Submit the files on related entities with tax computation sheets in each case file. Prior to closing, the examiner will draft a letter inviting the related entities to file a claim.
- (2) In unagreed IRC 482 cases when there are other adjustments on the related entities do not make the correlative IRC 482 allocations, but explain fully the reason for not making the correlative allocation including any inconsistent positions. This explanation should be made in the taxpayer's portion of the Revenue Agent's Report (RAR).
- (3) In all unagreed IRC 482 issue cases, the taxpayer to which the correlative allocation applies should be advised of the period of limitations under IRC 6511 for filing a claim. If the period for filing a claim for refund expires in less than 180 days, the examiner should solicit a Form 843, Claim Refund and Request for Abatement, from the taxpayer. Such claims should be picked up and submitted with the case, if possible.
- (4) To ensure that overpayments resulting from the correlative allocations are not scheduled and refunded to the taxpayer, the examiner will appropriately note Form 3198.

4.10.13.4.5.4  
(03-16-2015)

**Related Cases Not  
Managed In the Same  
Compliance Area  
Involving Primary  
Adjustments and  
Correlative Allocations  
to U.S. Taxpayers**

- (1) When a return is examined in one office and an issue is the transfer of income or deduction to a related taxpayer under examination in another area office, the office making the initial examination will (except in cases arising out of partnership and/or fiduciary return or S corporations) immediately, upon identification of a potential IRC 482 adjustment advise the examiner of the issue(s) and amount involved.
- (2) Immediately upon conclusion of the examination, a notice should be issued to the outside office that will contain sufficient information to enable the receiving office to make the correlative allocation(s) to the related return(s). The initiating office examiner's case files will contain copies of the notification.
- (3) Upon receipt of notification, the receiving office will take prompt action to make adjustments for the transfer of income or deduction resulting from the initial examination. In the event the return has been examined and closed, reopening procedures will be considered.
- (4) If the corresponding return is not under examination, the examiner should secure the return and prepare the report.

4.10.13.5  
(10-28-2015)

**Adjustments Between  
Correlative U.S.  
Taxpayers to Achieve  
Consistent Tax  
Treatment (a/k/a  
Whipsaw Issues)**

- (1) Transactions that affect the income, deductions, or credits of two or more taxpayer's returns should be treated consistently between the taxpayers. If the examiner determines the transaction is not treated consistently on the returns of the taxpayers involved in the transaction, corresponding adjustments must be made to ensure proper treatment. The taxpayers that are affected by this transaction are considered "correlative taxpayers". Also see IRM 4.10.7.4.9 on Whipsaw Issues.
- (2) Adjustments made between correlative taxpayers will usually increase the tax liability of one taxpayer and reduce the tax liability of the other.

- (3) Service policy (Policy Statement P-4-34) requires that the case of the taxpayer whose tax liability has been reduced will not be closed until the taxpayer whose tax liability was increased agrees to the corresponding adjustment(s) and signs a consent agreeing to the increase in tax or a court establishes the correctness of the adjustment(s). See IRM 1.2.1.5.13, Policy Statement 4-34, Closing of overassessment case to be withheld until deficiency of related taxpayer is established. Adjustments of this type occur most frequently in the following returns:
  - a. Husband and wife filing separate returns;
  - b. Taxpayers claiming duplicate dependency exemptions;
  - c. Grantor, trust, and beneficiaries;
  - d. Parent and child;
  - e. Decedent and decedent's estate;
  - f. Taxpayers in which the Commissioner has invoked the provisions of IRC 482 as described above;
  - g. Parent and subsidiary corporations; and
  - h. Taxpayers involved in whipsaw issues.
- (4) If at all possible, correlative taxpayer's cases should be associated and remain together until the taxpayer whose report reflects a deficiency has been assessed, or until the correlative taxpayer's case is placed in suspense. If this is not possible, the procedures in IRM 4.10.13.4.5.4, Related Cases Not Managed In the Same Compliance Area Involving Primary Adjustments and Correlative Allocations to U.S. Taxpayers, should be followed.
- (5) Procedures for disposition of related cases for flow-through entities will be closed using the procedures in IRM 4.31, Pass-Through Entity Handbook.

4.10.13.5.1  
(03-16-2015)  
**Definition of Terms**

- (1) Primary Adjustment - The adjustment, which generally increases the tax liability of the initial taxpayer, and generally creates a corresponding decrease in the tax liability of one or more taxpayers involved in the transaction.
- (2) Primary Taxpayer - The taxpayer whose tax liability is affected by the primary adjustment.
- (3) Correlative Allocation - The adjustment that generally creates a corresponding decrease in the tax liability of the taxpayer(s) involved in the transaction with the primary taxpayer. Appropriate collateral Allocations may include correlative allocations, conforming adjustments, and setoffs, as described in 26 CFR 1.482-1(g).
- (4) Correlative Taxpayer - The taxpayer who is involved in the transaction with the primary taxpayer whose tax liability is affected by a correlative Allocation.

4.10.13.5.2  
(03-16-2015)  
**Correlative U.S. Taxpayers Controlled in One Area**

- (1) The examiner for the primary taxpayer will request the return(s) of all correlative taxpayer(s) in the Area if a manageable number of correlative taxpayers are involved. The cases will remain associated until the primary and correlative Allocations have been proposed and assessments have been made, or until the correlative taxpayers' cases are placed in suspense pending the resolution of the primary taxpayer's case.
- (2) If a large number of correlative returns are involved or if the correlative taxpayers reside in other Posts of Duty (PODs) within the Area, PSP's assistance will be requested in ordering and controlling the related taxpayers.

- (3) If the correlative taxpayer resides in another Area, both cases may be controlled by an examiner by requesting a CC ESTABD to obtain the return not on AIMS or through the transfer of the related return(s) if:
  - a. the adjustment is of major importance
  - b. it is for convenience of the government or
  - c. it would promote the effective and efficient conduct of the examination
- (4) If the above are not applicable, the procedures outlined in the subsection Related Taxpayers Controlled in More Than One Area below should be followed.
- (5) If a return must be transferred from one Area to another, the provisions of the subsection Transfers of Returns Prior to the Initial Appointment in IRM 4.10.2.12, Transfers of Returns Prior to the Initial Appointment, will be followed. If this is not possible, contact the Area PSP in which the correlative taxpayer is controlled.
- (6) The correlative taxpayer(s) will be given notice of the examination (using the procedures outlined in IRM 4.10.2, Pre-Contact Responsibilities) as soon as it is known that adjustments proposed for the primary taxpayer will affect the tax liability of the correlative taxpayer.
- (7) A protective claim, Form 1040X or Form 1120X, will be solicited from taxpayers with correlative Allocation(s) that reduces the tax liability and the period for filing a claim for refund when the statute expires in less than 180 days. This will hold the taxpayer's statute open to receive any refund or credit that is due up to the amount of the claim. Letter 897 will be sent to the taxpayer each year requiring protection. Once a protective claim is received, Form 895, Notice of Statute Expiration, will be attached and the statute will be updated according to IRM 25.6, Statute of Limitations.

4.10.13.5.2.1  
(03-16-2015)

**Primary and Correlative  
U.S. Taxpayer's Reports**

- (1) Prepare the correlative taxpayer's report concurrently with the primary taxpayer's report. Solicit the agreement from the primary taxpayer, whose tax liability has been increased, prior to the agreement for the correlative taxpayer, whose tax liability has been reduced.
- (2) The primary taxpayer's report will include a statement that "a separate examination report reflects correlative Allocations to the taxable income of the correlative taxpayer(s)."

**Caution:** Rules regarding the disclosure of information apply to correlative Allocations, despite the relationship between primary and correlative taxpayers. The correlative report should not disclose tax return information of the primary taxpayer except to the extent explaining the correlative Allocation is necessary.

- (3) If agreements are secured from the primary and correlative taxpayers, note Form 3198 so that overassessments resulting from the correlative Allocations are not refunded to the taxpayer prematurely.

4.10.13.5.2.2  
(07-27-2023)

**Reports Applying  
Overassessments  
Against Deficiencies  
Involving Correlative  
U.S. Taxpayer**

- (1) The correlative taxpayer(s) should be given the option of applying any overassessment against the deficiencies of the primary taxpayer as follows:
  - a. If the correlative taxpayers are agreeable to the adjustments, the examiner will tell the primary and correlative taxpayers that their cases may be closed more expeditiously if the taxpayer's report reflecting an overassessment would agree to apply the overassessment and any interest to the deficiency of the taxpayer(s) reflecting deficiencies.
  - b. The agreement form of the taxpayer having the overassessment will be modified to add a consent to apply the overpayment to the related deficiency. This will be accomplished by adding a paragraph, as follows, to the agreement form: **The undersigned taxpayer also consents and agrees to the application of the part of the overassessment that represents an overpayment, and interest allowable thereon, as a credit to the deficiency in tax, in the amount of \$\_\_\_\_\_, and interest thereon, due from (related taxpayer) for the Year(s) \_\_\_\_\_; provided the amount of any overpayment and interest allowable thereon that is in excess of the deficiency and interest, is otherwise credited or refunded in accordance with IRC 6402 of the Internal Revenue Code, or corresponding provisions of prior laws.**
  - c. If the taxpayer(s) agree to apply the overassessment to the deficiency, annotate Form 3198, Special Handling Notice, for the taxpayer(s) with the overassessment: "Apply the overassessment and any interest thereon to (name of taxpayer with deficiency, the taxpayer identification number (TIN), and tax period)." An appropriate notation will also be made in the workpapers.

4.10.13.5.2.3  
(03-16-2015)

**Protested Primary  
Adjustments Involving  
Only U.S. Taxpayers for  
Primary Adjustment and  
Correlative Allocation**

- (1) If the primary taxpayer whose report reflects a deficiency does not agree to the primary adjustment(s) and submits a protest to the 30-day letter, the correlative taxpayer(s) whose report(s) reflect an overassessment will remain associated.
- (2) Correlative allocation(s) that reduce the correlative taxpayer's tax liability will be advised of the nature of the adjustment(s), the reason the overpayment cannot be refunded at this time and the possible need to protect the statute of limitations from expiring.
- (3) Primary and correlative taxpayers will be forwarded together to Appeals for consideration.
- (4) Prior to sending the protested case to Appeals the following action must be taken:
  - a. If adjustments other than the correlative allocation(s) exist that result in a deficiency (instead of an overassessment), a partial agreement will be solicited for all non-correlative adjustment. A partially agreed report will be prepared using Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. It must specifically state that the correlative allocation is not reflected in the computation of the deficiency or overassessment. The case will be sent to Case Processing for a partial assessment if the deficiency is agreed. Form 3198 will be noted "Make partial assessment and return to (group) to be associated with related case(s)."
  - b. The correlative taxpayer(s) will be invited to file a claim for refund (protective claim) if the period for filing a claim for refund expires in less than 180 days. Letter 907 will be sent to solicit a claim for each taxable year



needing protection. Once a protective claim is received, Form 895, Notice of Statute Expiration, will be attached and the statute will be updated according to IRM 25.6.22, Statute of Limitations, Extension of Assessment Statute of Limitations by Consent.

- c. Form 3198 will be noted to ensure that overpayments resulting from the correlative allocation(s) are not refunded to the taxpayer prematurely.
- d. The statute of limitations will be protected by the office having custody of the case if a deficiency may result from a determination adverse to the Government in the related case.

4.10.13.5.2.4  
(03-16-2015)  
**Statutory Notice of  
Deficiency Issued for  
Correlative Allocations  
Involving Only U.S.  
Taxpayers**

- (1) If a statutory notice of deficiency is issued to the taxpayer whose tax liability is increased, due to the primary adjustments, and a timely petition is filed with the Tax Court, the Area will transfer the correlative taxpayer(s) cases (whose tax liability has been reduced) to Appeals to be associated with the case in which the petition has been filed with the Tax Court, if the procedures in item (4) of subsection IRM 4.10.13.5.2 , above, have been followed.
- (2) If a statutory notice of deficiency is to be issued to the taxpayer(s) with correlative allocation(s) that reduce the tax liability for other adjustments, do not include the correlative allocations in deficiency computation. The statutory notice of deficiency must contain an explanation of the correlative allocations so the taxpayer clearly understands the nature of the correlative allocation(s). If the correlative allocations completely offset the tax liability, you cannot issue a statutory notice because you have no deficiency.

4.10.13.5.3  
(03-16-2015)  
**Correlative U.S.  
Taxpayers Controlled in  
More than One Area**

- (1) If the examiner has not secured the correlative return in another Area according to the procedures described in IRM 4.10.13.5.2 above before the examination of the primary taxpayer has been concluded (agreed, protest received, or forwarded for statutory notice of deficiency) and the correlative allocation(s) affect the tax liability of a taxpayer in another Area (except cases arising from flow-through entity returns), the correlative taxpayer's Area must be notified of the correlative allocation(s) and the status of the primary taxpayer.
- (2) The primary Area will secure the name, address, and TIN of the correlative taxpayer and notify the correlative Area by:
  - a. Completing Form 5346, Examination Information Report;
  - b. Attaching an INOLES transcript of the correlative taxpayer to Form 5346; and
  - c. Attaching copies of the primary taxpayer's workpapers and to aid the correlative Area in proposing the correlative allocations.
- (3) A copy of Form 5346 will remain in the primary taxpayer's case file. The original Form 5346 and attachments will be mailed to the correlative taxpayer's Area, addressed to the Area Director, Attention: Chief, PSP.
- (4) Upon receipt of Form 5346 in the correlative taxpayer's Area, PSP will determine if the correlative taxpayer is currently under examination.
  - a. If the correlative is not under examination, the return will be ordered, and assigned for examination of the correlative adjustments



- b. If the return is under examination, Form 5346 will be routed to the examiner conducting the examination for consideration and inclusion of the correlative adjustments with any other adjustments in the examination report
- c. If the return has been examined and closed, it will be ordered and reopened to make the correlative adjustment(s)

4.10.13.5.3.1  
(03-16-2015)  
**Primary U.S. Taxpayer  
Must Close Before the  
Correlative U.S.  
Taxpayer**

- (1) The correlative allocation(s) that reduce the correlative taxpayer's tax liability will be held open until the additional tax for the primary taxpayer has been agreed.
- (2) The case(s) of the correlative taxpayer(s) whose adjustment(s) reduce tax liability will be held and placed in IRC 1254 suspense until the examination of the primary taxpayer whose tax liability was increased has been conducted. It will be held in suspense pending notice from the primary taxpayer's Area that the primary taxpayer's examination, whose tax liability was increased, has been concluded.

4.10.13.5.3.2  
(03-16-2015)  
**Suspense of the  
Correlative U.S.  
Taxpayer's Returns**

- (1) The following procedures must be completed before the correlative taxpayer's case can be placed in suspense, maintained, and controlled in the Area Office:
  - a. The correlative taxpayer will be invited to file a claim for refund (protective claim) if the period for filing a claim for refund expires in less than 180 days. Letter 907 will be sent to solicit a claim for each taxable year needing protection. Once a protective claim is received, Form 895, Notice of Statute Expiration, will be attached and the statute will be updated according to IRM 25.6.22, Statute of Limitations, Extension of Assessment Statute of Limitations by Consent.
  - b. Form 3198 will be noted to ensure that overpayments resulting from the correlative allocation(s) are not refunded to the taxpayer prematurely.
  - c. All issues except for the correlative adjustments will be completed prior to forwarding the case for suspense. If possible, partial agreements will be secured for all non-suspense issues using Form 870. It must specifically state that the correlative allocation is not reflected in the computation of the deficiency or overassessment. If a partial agreement was obtained, a partial assessment must be made by Case Processing prior to routing the case for suspense. The examiner will prepare an RAR (Form 4549-A, Form 4605-A, etc.) as far as the corrected taxable income line for any unagreed non-suspense issue, and Form 886-A, Explanation of Items, on all cases submitted for suspense. Form 3198, Special Handling Notice, will be noted "Partial Assessment - After partial assessment is made, forward to Technical Services for suspense."
  - d. Inform the taxpayer that the case has been placed into a suspense status by sending Letter 1014, Notice to Taxpayer - Reasons for Suspended Action on Return Examination.

4.10.13.5.3.3  
(03-16-2015)  
**Area Notification of U.S.  
Taxpayer Correlative  
Allocations That Affect  
Income Tax Liability**

- (1) After the correlative taxpayer's Area has received notice from the primary Area on Form 5436, Examination Information Report and has contacted the taxpayer concerning the correlative allocations which result in a deficiency (instead of an overassessment), the correlative Area will notify the primary Area by letter of the correlative taxpayer's:
  - a. agreement;
  - b. default after issuance of a statutory notice of deficiency; or

- c. filing of a petition with the Tax Court.
- (2) If the correlative Area also has control of the return of another correlative taxpayer whose correlative allocations produce an overassessment, the case will be associated with the related case containing a deficiency and the procedures in item (4) of subsection IRM 4.10.13.5.2.3 above will be followed.
- (3) When the primary Area receives notification that all correlative cases are agreed or have defaulted after issuance of the statutory notice of deficiency, then they will advise all correlative Areas to the process and close all related taxpayer cases consistent with the information that was previously sent to them.
- (4) If the primary Area receives notification that a related taxpayer has filed a petition with the Tax Court, the primary Area will advise all related Areas and will themselves suspense all correlative cases pending the final outcome of the taxpayer that filed a petition with the Tax Court. The instructions in subsection IRM 4.10.13.5.2.3 above will be followed in placing the case into suspense.
- (5) Once the case of the taxpayer that filed a petition with the Tax Court has been concluded, the Area will notify the primary Area of the resolution, which will in turn notify the correlative Areas.
- (6) If the deficiency of the correlative taxpayer becomes an overassessment:
  - a. the correlative Area will notify the primary Area if the correlative taxpayer agrees to the overassessment.
  - b. if the agreement is not secured, the primary Area will be notified of the forwarding of the case for processing the overassessment and the basis for closing the case. When the primary Area receives notice, they will close the overassessment case.
  - c. The primary Area will then notify all correlative Areas and similar action on overassessment cases will be taken.

4.10.13.6  
(07-27-2023)  
**Activities Not Engaged  
in For Profit - Hobby  
Loss (IRC 183)**

- (1) IRC 183(a) provides that no deductions shall be allowed in the case of an activity not engaged in for profit, other than those otherwise allowable under the Code, and supplies some criteria to be used in making the determination as to profit motive. IRC 183(d) gives the taxpayer a rebuttable presumption that an activity is a business and not a hobby, if profit results from the activity in three out of five (two out of seven in the case of horse racing, breeding, or showing) consecutive years.
- (2) Since a full presumption period is not available when the taxpayer first begins the activity, IRC 183(e) allows him to make an election which will defer the determination until he has had the opportunity to achieve the presumption during the initial years of the activity.
- (3) Examiners should be aware that failure to make a profit does not in and of itself indicate a lack of a profit motive. This is true regardless of whether the taxpayer has made an election under IRC 183(e) or not. The question of profit motive is a factual one, and all facts must be considered in making any determination.

- 4.10.13.6.1  
(07-27-2023)  
**Development of IRC 183(a) Issues**
- (1) In order for an amount to be deductible under IRC 162, the taxpayer must be engaged in a trade or business activity for profit. In order for an amount to be deductible under IRC 212, the taxpayer must be engaged in an activity for the production of income. Normally, business expenses must meet the requirements of either **carrying on a trade or business** (IRC 162) or **for the production of income** (IRC 212). If the taxpayer fails to meet the requirements of either IRC 162 or IRC 212, the activity is then considered under IRC 183. In other words, the examiner should first determine if the activity has a profit motive. The examination should not begin with consideration of IRC 183.
- 4.10.13.6.1.1  
(03-16-2015)  
**Factual Development**
- (1) Examiners should determine whether or not the activity is engaged in for profit from all available facts and circumstances without regard to the presumption under IRC 183(d) or the possible election under IRC 183(e). This determination should take into consideration the “relevant factors” listed in 26 CFR 1.183-2(b) as well as all other pertinent facts. See Exhibit 4.10.13-4 and Pub 5558, Activities Not Engaged in for Profit Internal Revenue Code Section 183 Audit Technique Guide, for more guidance.
- (2) The IRC 162 position (i.e., substantiation, personal use, etc.) must be developed before the case can be forwarded to Appeals or placed in suspense. Appeals has indicated concern about cases coming in with inadequate factual development of the issue. Discussion of IRC 183(d) and IRC 183(e) with the taxpayer should be postponed until, and if, the activity has been determined to be an activity not engaged in for profit.
- 4.10.13.6.1.2  
(03-16-2015)  
**Passive Activity Loss Rules**
- (1) The passive activity loss rules of IRC 469 should be also be considered. Since IRC 469 adjustments are timing adjustments while IRC 183 adjustments are permanent adjustments, the IRC 183 issue should generally be treated as the primary position and the IRC 469 issue should be treated as an alternative position when both issues are present.
- 4.10.13.6.1.3  
(03-15-2015)  
**Determine If Prior Years Are Being Held In Suspense**
- (1) If a potential IRC 183(a) issue exists, check with the Technical Services IRC 183 suspense coordinator. If the earlier years are not in suspense, and the activity is determined to be engaged in for profit, allow the deductions to the extent they are otherwise, allowable by the Code (i.e., IRC 162). If the activity is not engaged in for profit and IRC 183(e) is elected, the case must be placed in suspense.
- 4.10.13.6.1.4  
(07-27-2023)  
**Deductions Under IRC Section 183 Which the Taxpayer May Claim**
- (1) IRC 183(b) provides for two types of deductions allowed with regard to activities not engaged in for profit. They are the IRC 183(b)(1) and IRC 183(b)(2) deductions.
- (2) Deductions under IRC 183 are allowable only on Schedule A as itemized deductions. Deductions under section IRC 183(b)(1) would appear in the proper places on Schedule A (e.g., as mortgage interest or taxes) and any deduction under IRC 183(b)(2) would be a miscellaneous Itemized Deduction subject to the 2% floor or limited to 2% of adjusted gross income (AGI). The hobby income limitation is applied before the 2% rule.
- Note:** The Tax Cuts and Jobs Act (TCJA) suspended miscellaneous itemized deductions, so these deductions are not available for tax years beginning after December 31, 2017 and before January 1, 2026.

4.10.13.6.2  
(03-16-2015)  
**Placing Cases in  
Suspense**

- (1) Check with the taxpayer and/or the IRC 183 Suspense Coordinator in Examination Technical Services to determine if there is a prior election on file. See IRM 4.8.2, IRC 183(e) Hobby Loss Suspense.

4.10.13.6.2.1  
(03-16-2015)  
**Election on File**

- (1) Requisition the returns for all open years not in the suspense file. Examine each of the years that have significant audit potential. If the returns for any years subsequent to the year of the initial IRC 183(a) election do not show significant audit potential, they may be forwarded, unaudited, to suspense along with the year(s) of the initial IRC 183(a) election.
- (2) Secure Audit Information Management System (AMDISA), IMFOLT/R on all open years.
- (3) Prepare a report showing the audit results including the IRC 183(a) issue. The cases examined must be completely worked prior to going into suspense.
- (4) Form 3198 should indicate that the case is an IRC 183(a) case and is related to a previously suspended case and should be routed directly to suspense.
- (5) Process the case in the normal manner.
- (6) All non-hobby loss issues must be resolved prior to putting the case in suspense. If that issue is unagreed refer to IRM 4.10.13.6.3(2). If needed, secure a statute extension for any non-hobby loss issue(s).

4.10.13.6.2.2  
(03-16-2015)  
**Election Not on File**

- (1) Determine if the taxpayer wants, and is eligible, to elect IRC 183(e). The election must be made before the statute of limitations of the return reporting the **first** year of the activity expires. If an election has not been made prior to the expiration of the statute on the initial year, an election **cannot** be accepted.
- (2) Inform the taxpayer of all the legal and procedural implications of the IRC 183(e) election. If the taxpayer does not wish to make the election, the case, and the issue should be processed based on the merits that have already been determined. When possible, a written statement should be obtained from the taxpayer or his representative stating that he does not elect the provisions of IRC 183 with respect to the tax year(s) containing the IRC 183(a) issue. (If the taxpayer declines to provide such a statement, the examiner should make appropriate comments in the workpapers.) Attach the statement to the return(s).
- (3) If the taxpayer wishes to make an IRC 183(e) election:
  - a. Secure fully completed and properly signed Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.
  - b. Requisition all returns beginning with the initial year.
  - c. Obtain AMDISA, IMFOLT/R for all tax returns.
  - d. Perform audit functions as warranted, paying particular attention to the development of the IRC 183 issue without making a determination as to whether the activity is presumed to be for profit or not.
  - e. The open years that are examined must be completed prior to going into suspense.
  - f. Attach Form 3198, Special Handling Notice for Examination Case Processing, to the outside of the case file and indicate **Suspense Case IRC**

**183(e) - Forward to Technical Services.** The group should forward the case direct to Technical Services with Form 3210 Document Transmittal.

- g. Make appropriate comments in the workpapers to document the election and advise the taxpayer to retain all pertinent books and records for each of the presumptive period years.
- h. Attach the election to the back of the first year's return with the form number showing above the tax return.
- i. All partial assessments or unagreed issues should be resolved prior to suspending.

**4.10.13.6.3**  
(03-16-2015)  
**Reports**

- (1) If there are other issues which are agreed and generate a deficiency, two reports will be required. One report will contain the agreed issues and the other report only the IRC 183(a) issues as unagreed. Include in the agreed report a statement regarding the IRC 183(a) suspense issue as unagreed. On the unagreed report, the IRC 183(a) issues should be written up as if the case will go directly to Appeals. Form 3198 Special Handling Notice for Examination Case Processing, should indicate "Partial Agreement - after assessment forward to Technical Services for IRC 183(e) suspense."
- (2) If there are other unagreed issues besides the IRC 183(a) issue, the unagreed report will contain both the unagreed issue(s) and the "IRC 183(a) issue(s)" before the case is forwarded to Appeals. Note the Form 3198, Special Handling Notice for Examination Case Processing, for the case to be forwarded to Technical Services for suspense after resolution of unrelated issues.

**4.10.13.6.4**  
(10-28-2015)  
**Election to Postpone Determination**

- (1) Form 5213 , Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit, extends the statute of limitations for assessment of tax for all years in the presumption period until two years after the due date (determined without regard to extensions) for filing the return for the last year in the presumptive period.
- (2) The IRC 183(e) election extends the period for assessment of the additional tax attributable to the IRC 183 activity and automatic adjustments resulting from the change in adjusted gross income. Therefore, it is necessary that a separate Form 5213 be obtained for each separate activity which is in question. Unrelated IRC 183 issues should be resolved before placing the case in suspense.
- (3) Changes in filing status should be considered. When individuals marry, remarry, or divorce in any of the years, a separate statute extension should be secured for that year.
- (4) All non-hobby loss issues must be resolved prior to suspension of the hobby loss issue. If the non-hobby loss issue is unagreed, a statute extension must be secured for that unagreed issue. Also see paragraph (2) of IRM 4.10.13.6.3 .
- (5) Upon the filing of all or a sufficient number of returns of the presumptive period, the cases will be returned to the examiner for a determination. The examiner should make sure that any profits have not been a result of income manipulation.

4.10.13.7  
(07-27-2023)  
**Change in Accounting Method**

- (1) An accounting method is used to determine when a taxpayer reports income and expenses.
- (2) During an examination, it may become necessary to determine whether a taxpayer is using a permissible method of accounting and to propose changes to improper or incorrect methods.
- (3) A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. This subsection covers the following basic rules:
  - a. For identifying if such a change is required, and
  - b. For calculating the required audit adjustments
- (4) Due to the rapidly changing rules for changes in accounting methods, examiners should also consult the Methods of Accounting & Timing Issue Practice Group
- (5) Additional information relating to Changes in Accounting Methods is found in IRM 4.11.6, Changes in Accounting Methods, which should be consulted in conjunction with this IRM section.

4.10.13.7.1  
(10-28-2015)  
**General Rule of Methods of Accounting**

- (1) IRC 446(a) requires taxable income to be computed under the method of accounting that the taxpayer uses to compute book income. However, a taxpayer may be allowed to maintain their general ledger, subsidiary ledgers, and journals under one method but use a different method to report taxable income as long as the taxpayer clearly reflects income and maintains worksheets to ensure that all book to tax adjusting entries have been made. However, if no method of accounting is used regularly or if the method used does not clearly reflect income, then the computation of taxable income may be changed by either the taxpayer (obtaining required permission) or examiner to a method that clearly reflects income. IRC 446(b).

4.10.13.7.2  
(07-27-2023)  
**Cash Method of Accounting**

- (1) The cash method of accounting is the most common method used by small businesses. IRC 446(c)(1) specifically identifies the cash method as a permissible method of accounting. The cash method generally requires the taxpayer to include an item in income when the item is actually or constructively received and permits a deduction for an expense when paid (26 CFR 1.446-1(c)(1)(i)). The cash method will generally, be allowed unless there is a specific provision of the Code or Treasury Regulations that require the use of a different method.
- (2) Special rules under 26 CFR 1.471-1 generally require taxpayers to maintain or use an inventory when the production, purchase, or sale of merchandise is an income-producing factor. Rules under 26 CFR 1.446-1(c)(2)(i) generally require taxpayers who are required to maintain inventories to use an accrual method of accounting for purchases and sales of merchandise. Therefore, as a general rule, taxpayers who maintain inventories are not allowed to use the overall cash method of accounting but may use a hybrid method. See IRM 4.10.13.7.2.2 , IRM 4.10.13.7.4 and 26 CFR 1.446-1(c)(1)(iv)(a).
- (3) Under IRC 448(a), the following entities are generally prohibited from using the cash receipts and disbursements method of accounting:
  - a. C corporation



- b. Partnership with a C corporation as a partner
  - c. Tax shelter (within the meaning of IRC 448(d)(3) )
- (4) IRC 448(b) lists exceptions to the general rules of IRC 448(a). A C corporation or a partnership that has a C corporation as a partner may use the cash method if the entity:
- a. Is a farming business (defined in IRC 448(d)(1)), but see the rules of IRC 447 in IRM 4.10.13.7.2 (5) which require the farming business to meet the gross receipts test of IRC 448(c) in order to use the cash method.)
  - b. Is a qualified personal service corporation (defined in IRC 448(d)(2))
  - c. Meets the gross receipts test in IRC 448(c). For taxable years beginning on or before December 31, 2017, the gross receipts test was generally met and the cash method permitted only if the taxpayer was engaged in the trade or business of farming and had average gross receipts of not more than \$1 million (with a higher \$25 million limit reserved for family corporations). For taxable years beginning after December 31, 2017, a taxpayer meets the gross receipts test if a taxpayer is not a tax shelter, as defined in IRC 448(d)(3), which cross-references IRC 461(i)(3), and has average annual gross receipts of \$25 million or less (as adjusted for inflation) for the three prior tax years. Further, aggregation rules for gross receipts may apply (26 CFR 1.448-1T(f)(2)). Under the aggregation rules all persons treated as one employer under IRC 52(a) or IRC 52(b); or IRC 414(m) or IRC 414(o) are treated as one person for purposes of the gross receipts test. This means that while a single entity may have gross receipts under the limit, the limit may be exceeded, and the gross receipts test failed if related entities have sufficient gross receipts.
- (5) Although IRC 448(b)(1) specifically states that the cash method prohibition on C corporations and partnerships with C corporations as partners, does not apply to farming businesses. Due to tax shelter problems specifically associated with farming and ranching, IRC 447 was enacted. IRC 447 deals specifically with methods of accounting for corporations engaged in farming. Under IRC 447(a), neither a C corporation that engages in farming nor a partnership with a C corporation as a partner that is engaged in farming may use the cash method. But IRC 447(c) lists exceptions to the general rules of IRC 447(a) and permits the cash method for S corporations engaged in farming and for C corporations engaged in farming that meet the gross receipts test of IRC 448(c).
- (6) An S corporation may use the cash method of accounting unless the entity is a tax shelter within the meaning of IRC 448(d)(3) , or is otherwise required to use an accrual method (e.g., taxpayer maintains an inventory).
- (1) For tax years beginning before January 1, 2018, two revenue procedures provided exceptions to certain rules relating to accounting methods, as follows. If the taxpayer had gross receipts less than \$1 million, the exceptions from mandatory use of an accrual method when inventory must be taken is waived by Rev. Proc. 2001-10 (modified by Rev. Proc. 2018-31 and successor). Under this revenue procedure, taxpayers with average annual gross receipts of \$1 million or less were not required to use an accrual method of accounting under IRC 446 and are not required to account for inventories under IRC 471. A taxpayer had average annual gross receipts of \$1 million or less if the taxpayer's average annual gross receipts for each prior three taxable year period

4.10.13.7.2.1  
(07-27-2023)

**Inventory Exceptions  
That May Allow the Use  
of the Cash Method for  
Tax Years Beginning On  
or Before December 31,  
2017**

ending with the applicable prior tax year did not exceed \$1 million. Aggregation rules for gross receipts may have applied. See 26 CFR 1.448-1T(f)(2).

- (2) Qualifying taxpayers that do not want to account for inventories under IRC 471 must treat inventoriable items in the same manner as materials and supplies that are non incidental under 26 CFR 1.162-3. An inventoriable item is any item either purchased for resale to customers or a raw material purchase for use in producing finished goods.
- (3) Further, if an eligible small business has average annual gross receipts of \$10 million or less, the exceptions from the mandatory use of an accrual method under Rev. Proc. 2002-28 (modified by Rev. Proc. 2018-31 and successor) which was effective for tax years beginning before January 1, 2018, may apply. Under this revenue procedure, eligible small businesses with average annual gross receipts of \$10 million or less are not required to use an accrual method of accounting under IRC 446 and are not required to account for inventories under IRC 471 . This revenue procedure does not apply to any farming business. A taxpayer has average annual gross receipts of \$10 million or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three taxable-year period ending with the applicable prior tax year do not exceed \$10 million. Aggregation rules for gross receipts may have applied. A taxpayer that satisfied the gross receipts criteria for each prior three-year period was required to determine whether its principal business activity code was an eligible code under the North American Industry Classification System (NAICS) at [www.census.gov](http://www.census.gov). Additionally, the following NAICS codes were ineligible for the qualifying small business exception:
  - a. Mining activities within the meaning of NAICS codes 211 and 212;
  - b. Manufacturing within the meaning of NAICS codes 31–33;
  - c. Wholesale trade within the meaning of NAICS code 42;
  - d. Retail trade within the meaning of NAICS codes 44 and 45; and,
  - e. Information industries within the meaning of NAICS codes 5111 and 5122.
- (4) A taxpayer could still qualify under Rev. Proc. 2002-28 in limited circumstances even if the NAICS code is ineligible.
- (5) A qualifying taxpayer may use the automatic consent procedures in Rev. Proc. 2015-13 and Rev. Proc. 2018-40 (and successors) depending on the year of change to make a voluntary change to the cash method of accounting. . Taxpayers treating as materials and supplies that are not incidental must deduct the cost of these items only in the year that they are actually consumed or used in operations. Inventory items that are sold are considered used or consumed when sold. When a cash basis taxpayer applies this regulation the inventory items are not deducted until the later of (1) the year used or consumed, or (2) the year the items were paid for.

4.10.13.7.2.2  
(07-27-2023)  
**Inventory Exceptions  
That May Allow the Use  
of the Cash Method for  
Tax Years Beginning  
After December 31, 2017**

- (1) Generally, a taxpayer that is required to maintain inventories must use an accrual method of accounting for purchases and sales of merchandise pursuant to 26 CFR 1.446-1(c)(2)(i).
- (2) If the taxpayer is a small business taxpayer (defined in IRM 4.10.13.7.2.2 (4), it can use the cash method of accounting and adopt or change its accounting method to account for inventories:

- a. in the same manner as materials and supplies that are non-incidental, or
  - b. to conform to its treatment of inventories in an applicable financial statement (as defined in IRC 451(b)(3)), or
  - c. if it does not have an applicable financial statement, the method of accounting it uses in its books and records prepared in accordance with its accounting procedures. See IRC 471(c)(1).
- (3) If the taxpayer accounts for inventories in the same manner as non-incidental materials and supplies, the taxpayer must deduct the cost of these items only in the year that the items are actually used or consumed in the taxpayer's operations, or in the year in which the taxpayer actually pays for the goods, whichever is later. See 26 CFR 1.162-3(a)(1).
- (4) **Small business taxpayer.** For purposes of this section, a taxpayer is a small business taxpayer if it:
  - a. has average annual gross receipts of \$25 million or less (indexed for inflation) for its three-taxable-year period and
  - b. is not a tax shelter (as defined in IRC 448(d)(3)).
- (5) Small business taxpayers (defined in IRM 4.10.13.7.2.2 (4)) may use the automatic consent procedures in Rev. Proc. 2018-40 (or successor) to make a voluntary change to the cash method of accounting and account for inventoriable items as non-incidental materials and supplies, or to conform to its treatment of inventories in an applicable financial statement, or if the taxpayer does not have an applicable financial statement, the method of accounting it uses in its books and records.
- (6) The gross receipts test for tax years beginning after December 31, 2017, applies only to the three prior tax years. A taxpayer can exceed the limit in one year, but if gross receipts are under the three-year average in a subsequent year, the taxpayer is again a "Small Business Taxpayer". The old rule of "fail once, fail forever" no longer applies.

4.10.13.7.3  
(10-28-2015)  
**Accounting for Long  
Term Manufacturing  
Contracts**

- (1) IRC 460 defines a long-term contract as any contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable year it was started. 26 CFR 1.460-1(b) defines a contract for the manufacture of personal property as a manufacturing contract. In contrast, a contract for the building, installation, or construction of real property is a construction contract.
- (2) The rules for manufacturing contracts are described in 26 CFR 1.460-2. Specifically, a contract for the manufacture of property shall not be treated as a long-term contract unless the contract involves the manufacture of:
  - a. Any unique item of a type which is not normally included in the finished goods inventory of the taxpayer (IRC 460(f)(2)(A)), or
  - b. Any item which normally requires more than 12 calendar months to complete (without regard to the period of the contract) (IRC 460(f)(2)(B))
- (3) Per 26 CFR 1.460-2(b), an item is not considered unique if it meets one or more of the following safe harbors:
  - a. The item has a short production period. An item is not unique if it normally requires 90 days or less to complete.

- b. An item is not unique if the total allocable contract costs attributable to customizing activities (that are incident to or necessary for the manufacture of the item) do not exceed 10 percent (10%) of the estimated total allocable contract costs allocable to the item.
  - c. A unique item ceases to be unique no later than when the taxpayer normally includes similar items in its finished goods inventory.
- (4) To determine the time normally required to complete an item, a taxpayer must consider all relevant production activities performed and costs incurred by itself and by related parties, as defined in 26 CFR 1.460-1(b)(4).
  - (5) The production period for an item begins when the manufacturer incurs at least 5% of the total estimated costs, including the planning and design stages, and ends when the item is ready to be held for sale and all reasonably expected production activities are complete (26 CFR 1.460-2(c)). Reference the final regulations for manufacturers with long-term contracts.

4.10.13.7.3.1  
(03-16-2015)  
**Audit Techniques**

- (1) To identify a long term contract issue:
  - a. Ask the taxpayer for a list of all contracts open at year-end
  - b. Select contracts to review
- (2) To determine if the taxpayer is a service provider or a manufacturer:
  - a. Review the bid file and statement of work
  - b. Request contract files to identify the effective date, contract price, type of contract (fixed price, cost plus, cost share, time, and material)
- (3) To determine if the length of the contract exceeds 12 months:
  - a. Identify the delivery schedule for the items produced under the contract
  - b. Request a list of subcontractors because this may add to the total length of the contract
- (4) To determine if the item is unique:
  - a. Request a copy of the proposal
  - b. Review the proposal for customizing costs

4.10.13.7.4  
(07-27-2023)  
**General Rules for Inventories**

- (1) Under 26 CFR 1.471-1, a taxpayer generally must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business unless it qualifies as a small business taxpayer (defined in IRM 4.10.13.7.2.2 , Small business taxpayer. A taxpayer that is required to maintain inventories must use an accrual method of accounting with regard to purchases and sales 26 CFR 1.446-1(c)(2)(i)). Inventory includes all raw materials and supplies that have been acquired for sale, or that will be physically incorporated into the merchandise intended for sale, plus work in process, and finished goods. Accounting for inventories may be required even if the inventory balance is zero at the end of the taxable year. J. P. Sheahan Associates, Inc. v. Commissioner, T.C. Memo 1992-239.
- (2) Since the sale of merchandise is an income-producing factor for manufacturers, they must use an accrual method to account for sales and purchases unless IRC 471(c) applies for years beginning after December 31, 2017. Determining whether merchandise is an income-producing factor requires computing a ratio of the total annual purchases to gross receipts. If the percentage is

greater than 15, the courts have held that merchandise is an income producing factor. See for example *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo 1969-79.

- (3) Rev. Proc. 2001-10 and Rev. Proc. 2018-31, discussed in IRM 4.10.13.7.2.1, Inventory Exceptions That May Allow the Use of the Cash Method for Tax Years Beginning On or Before December 31, 2017, provided some taxpayers relief from the requirement to account for inventories under IRC 471(a) in years beginning before January 1, 2018. These taxpayers were required to use the method described in 26 CFR 1.162-3 to account for inventory items.
- (4) For tax years beginning after December 31, 2017, the “small business taxpayer” provisions in IRC 448(c) also apply to IRC 471. If the test in IRC 448(c) is met, (and the taxpayer is not a tax shelter) the taxpayer is not required under IRC 471(a) to account for inventories. For the accounting method to clearly reflect income, inventory items must be accounted for as provided by IRC 471(c)(1)(B). If the non-incidental materials and supplies (NIMS) method provided by IRC 471(c)(1)(B)(i) is used by the taxpayer, the inventory items are computed as provided by 26 CFR 1.162-3. Taxpayers meeting the IRC 471(c) requirements may account for sales and purchases using the cash method. Taxpayers using the cash method deduct inventory costs in the later of the year sold or the year in which the taxpayer pays for the inventory items acquired.

4.10.13.7.5  
(07-27-2023)

#### Accrual Method Timing Issues

- (1) The underlying principle of accrual method accounting is the matching of income and expenses in the proper year. If a taxpayer with inventory were to use the cash method of accounting, then purchases could possibly be deducted in a different period from the recognition of income from the sale of those items. Under an accrual method, items are included in income when the following tests are met:
  - a. All the events fixing the taxpayer’s right to receive the income have occurred (26 CFR 1.451-1(a). This right could be fixed when the goods are shipped, delivered, accepted, or when title passes to the purchaser. (26 CFR 1.446-1(c)(1)(ii)(C))
  - b. The amount of income can be determined with reasonable accuracy. This means that only an estimate of the amount is sufficient for income to be recognized. 26 CFR 1.451-1(a) and 26 CFR 1.446-1(c)(1)(ii)(A).
- (2) For expenses, 26 CFR 1.461-1(a)(2)(i) provides, under an accrual method of accounting, a liability is incurred and generally taken into account for federal income tax purposes, in the taxable year in which:
  - a. All events necessary to establish the fact of liability have occurred
  - b. The amount of the liability can be determined with reasonable accuracy, and
  - c. Economic performance has occurred.
- (3) The first two requirements, above, are commonly referred to as **the all events test**. The application of the economic performance rule depends on the nature of the costs. If costs arise out of the provision of services or property, or the use of property, economic performance generally occurs when the property or services are provided, or the property is used. Specific costs, identified in the regulations as payment liabilities, are taken into account when paid. Note that there are other timing rules (e.g., the 3 1/2 month rule for prepaid services or



the recurring item exception) in the Code that may take precedence over these generalized economic performance rules.

- (4) If the liability has met the all-events test under IRC 461 as of year-end, a deduction for accrued vacation pay and bonuses to unrelated taxpayers is allowed only if paid within 2 1/2 months of year-end (Temp. Reg. 1.404(b)-1T, Method or arrangement of contributions, etc., deferring the receipt of compensation or providing for deferred benefits).
  - a. An employee must actually receive payment for the taxpayer to get the deduction for the prior year (IRC 404(a)(11)).
  - b. A corporation using an accrual method is allowed to deduct accrued compensation (including vacation pay and bonuses) payable to cash-basis controlling shareholders as of the day such compensation is received (actually or constructively) by the shareholder IRC 267(a)(2).
- (5) Losses on sales or exchanges between related parties are disallowed IRC 267(a)(1).

4.10.13.7.6  
(10-28-2015)  
**Changing Accounting Methods**

- (1) Once a method of accounting is adopted, the taxpayer must request permission to change methods. If the taxpayer files two consecutive tax returns using an impermissible method, the taxpayer must then request permission to change to a permissible (i.e., correct) method. A permissible method is considered adopted after one return is filed.
- (2) A change in method of accounting is a change in:
  - a. The overall method of accounting, such as cash to accrual, or
  - b. The treatment of any material item. A material item is any item that involves the proper time for the inclusion in income or the taking of an item as a deduction in any given period
- (3) Some of the more common accounting method changes for taxpayers include changes in inventory valuations, depreciation methods, and recording income from long-term contracts. A change in accounting method is handled differently from the correction of an error, which is remedied by filing an amended income tax return. Examples of errors include:
  - a. Posting errors
  - b. Misclassification of items (although often times a “misclassification of items” is an error, if it is consistent and timing impact, then to correct the misclassification is a change in a method of accounting).
  - c. Errors in the computation of Foreign Tax Credit

4.10.13.7.7  
(07-27-2023)  
**Voluntary Changes in Accounting Method**

- (1) Voluntary changes are initiated by the taxpayer by filing a Form 3115, Application for Accounting Method Change, using Rev. Proc. 2015-13 (or successors):
  - a. **Automatic Changes:** Revenue procedures with a cumulative list of automatic accounting changes, and the requirements to make these changes, are issued periodically and effective until replaced by a later revenue procedure. The IRS also issues revenue procedures amending the cumulative list of automatic changes during the time period between the issuances of the revenue procedures with the cumulative lists. The most recent cumulative list revenue procedures are Rev. Proc. 2015-14, Rev. Proc. 2018-31, Rev. Proc. 2019-43, and Rev. Proc. 2022-14 . For



changes identified in these revenue procedures (or successors) as an automatic change, Form 3115 must be attached to the taxpayer's timely filed, with extensions, tax return for the year of change, and a copy of the Form 3115 must be submitted to the appropriate office.

- b. **Non-Automatic Changes:** For any change that is not designated as eligible for automatic change procedures, Form 3115 must be filed during the year of change. The method change cannot be made until approved by the Commissioner and the Letter Ruling issued.
- (2) User fees are generally not required when applying for one of the automatic changes in accounting methods. The taxpayer receives deemed consent to make the change if it complies with the **application procedures and** terms and conditions associated with the requested method change. The taxpayers must also comply with the procedural requirements under Rev. Proc. 2015-13. The IRS does not send an acknowledgment of receipt for a Form 3115 (original or copy) filed under the automatic change procedures.
  - (3) Form 3115, Application for Accounting Method Change, filed for a non-automatic change should be filed as early as possible by the taxpayer to allow for processing time prior to the due date of the return for the year of change. Normally, an acknowledgment of receipt will be mailed within 60 days of the filing date for non-automatic change requests. For a Form 3115 filed under the non-automatic procedures, the national office will set forth the Commissioner's grant or denial of the taxpayer's request for the Commissioner's consent in a letter ruling. If the letter ruling grants the Commissioner's consent, it will identify the item or items being changed, the terms and conditions under which the taxpayer must implement the change, and the IRC 481(a) adjustment (if any).
  - (4) For taxpayers not under examination, advantages for making a voluntary change include a four-year adjustment period of a taxpayer unfavorable (positive) adjustment under IRC 481(a), possible audit protection for prior years, and no assessment of penalties and interest.
  - (5) A taxpayer under examination may file a Form 3115 to request a method change but limited terms and conditions apply unless the taxpayer qualifies for an exception. If under examination, the IRC 481(a) adjustment period for a positive IRC 481(a) adjustment is reduced to two taxable years. However, a taxpayer may take into account a positive IRC 481(a) adjustment over four years, if it meets one of the following four exceptions:
    - a. **Three-Month Window** - The taxpayer files a Form 3115 during the three-month window that begins on the 15th day of the seventh month and ends on the 15th day of the 10th month of the taxpayer's tax year end; the taxpayer has been under examination for at least 12 consecutive months as of the first day of the three-month window; and the item the taxpayer is requesting to change is not an issue under consideration.
    - b. **120-day Window** - The taxpayer requests a method change for an item during the 120-day period beginning the day after an examination ends if the item is not an issue under consideration.
    - c. **Present method not before the director** - The taxpayer requests a method change for an item that is from a clearly permissible method of accounting since the IRS does not have the authority to change a taxpayer from a permissible method of accounting or the taxpayer requests a method change for an item that is from an impermissible method adopted subsequent to the year(s) under examination.

- d. **New member of a consolidated group in CAP** - A Form 3115 filed for a new member of a consolidated group whose parent is participating in the Compliance Assurance Process (CAP) if this is the only reason the new member is under examination and the issue is not under consideration for the new member.
- (6) A Taxpayer under examination does not receive audit protection when filing a Form 3115 unless one of six exceptions applies:
- a. **Three-month window** - See IRM 4.10.13.7.7 (5), Voluntary Changes in Accounting Method.
  - b. **120-day window** - See IRM 4.10.13.7.7 (5), Voluntary Changes in Accounting Method.
  - c. **Present method not before the director** - See IRM 4.10.13.7.7 (5), Voluntary Changes in Accounting Method.
  - d. **New member of a consolidated group in CAP** - See IRM 4.10.13.7.7 (5), Voluntary Changes in Accounting Method.
  - e. **Change resulting in a negative IRC 481(a) adjustment** - A taxpayer will have audit protection if the change results in a negative IRC 481(a) adjustment for the year of change and would have resulted in a negative IRC 481(a) adjustment for each year under examination.
  - f. **No examination-imposed change and item not under consideration** - If a taxpayer files a Form 3115, and the issue is not adjusted, placed in suspense or under consideration, audit protection will apply beginning the day after the examination of the year ends. In other words, audit protection is reinstated if the IRS does not raise the issue for the examination year(s). Special rules apply to Form 3115 filed by taxpayers with multiple owners (e.g., CFCs and 10/50 corporations) to allow adequate time for each examination team involved to decide whether to pursue an issue before audit protection attaches.
- (7) In addition to these exceptions, a taxpayer under examination may file a Form 3115 **without the benefit of audit protection** for prior years (including the years under examination) if the method of accounting to be changed is described in Rev. Proc. 2015-14 and successors as a change that is made without audit protection provisions.

4.10.13.7.8  
(10-28-2015)  
**Involuntary Changes in Accounting Method**

- (1) Rev. Proc. 2002-18, provides guidance for IRS-initiated or involuntary accounting method changes. Section 2.03 of the procedure states that the “taxpayer does not have a right to a retroactive change, regardless of whether the change is from a permissible or impermissible method.” Accordingly, the examiner is not obligated to consent to a retroactive change in accounting method requested by the taxpayer either by a formal or informal claim. However, if the examiner initiates a change in accounting method issue that, upon development, results in a taxpayer favorable result, the examiner should follow through using the IRS initiated change procedures.
- (2) Examiners will be faced with potential accounting method change issues in three situations:
  - a. The examiner determines that the accounting method used by the taxpayer is impermissible and does not clearly reflect income - IRC 446(b) issue.
  - b. The taxpayer changed its method of accounting without obtaining the consent of the Commissioner - IRC 446(e) issue.

- c. The taxpayer filed an amended return or claim (formal or informal) which constitutes a “retroactive” change in accounting method. -IRC 446(e) issue. See Rev. Rul. 90-38.

The examiner has the authority to select a proper method, and the selection may only be challenged by showing the IRS abused its discretion. *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79.

- (3) Examples of method change issues that may be raised during an examination include:
  - a. Changing from cash to accrual method as required by IRC 448
  - b. Change from improper depreciation methods under IRC 167 and IRC 168
  - c. Expensing items required to be capitalized under IRC 263 or IRC 263A
  - d. Changing the timing of accrual under IRC 451 or IRC 461
- (4) When the examiner initiates an accounting method change:
  - a. The entire IRC 481(a) adjustment is taken into account in the earliest year of examination
  - b. There is no four-year spread
  - c. Interest and penalties may be assessed
- (5) See also section 2.09 of Rev. Proc. 2015-13 and successor for Changes Made as Part of an Examination.

4.10.13.7.9  
(10-28-2015)  
**IRC 481(a) Adjustment**

- (1) IRC 481(a) adjustment prevents the duplication or omission of income and expenses as a result of a change in accounting method. It is computed as of the beginning of the year of change (the earliest year under examination). Simply stated the adjustment represents the cumulative difference (without regard to the statute of limitations) between the taxpayer's present and proposed methods.

4.10.13.7.9.1  
(07-27-2023)  
**IRC 481(b) Tax Limitation**

- (1) IRC 481(b)(1) provides a limitation on the Chapter 1 tax for the taxable year of change that is attributable to the adjustments required under IRC 481(a) if the entire amount of the IRC 481(a) adjustment is taken into account in the year of change. If such adjustment increases the taxpayer's taxable income for the year of the change by more than \$3,000, then the Chapter 1 tax for such year that is attributable to the adjustment shall not exceed the lesser of:

- The Chapter 1 tax attributable to taking such adjustment into account in computing taxable income for the taxable year of the change under IRC 481(a) and 26 CFR 1.481-1, or
- The aggregate of the hypothetical increases in Chapter 1 tax that would result if the adjustment was included ratably in the taxable year of the change and the two preceding taxable years.

**Note:** While IRC 481(b) may limit the tax, it does not change the year in which the tax is due. This computation is mandatory.

- (2) IRC 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change. If the taxpayer establishes from its books and records what its taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, then the tax attributable to the IRC 481(a) adjustment will not exceed the smallest of the following amounts:

- The lesser amount determined under IRC 481(b)(1) above or
- The net increase in the Chapter 1 taxes that would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(3) Steps for computing the tax limitation under IRC 481(b) :

- a. Compute the increase in Chapter 1 tax for the year of the change that is attributable to the adjustments required under IRC 481(a). Calculate this increase by taking the difference in tax that would be due in the year of change **with** the IRC 481(a) adjustment and the tax computed for such year **without** the IRC 481(a) adjustment.
- b. Compute the Chapter 1 tax attributable to the IRC 481(a) adjustments for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustment had been received or accrued in each of such taxable years. Calculate this increase by taking the excess of the tax for such year computed with the allocation of one-third of the net adjustment to such taxable year over the tax computed without the allocation of any part of the adjustment to such year.
- c. If the taxpayer satisfies the conditions set forth in IRC 481(b)(2), compute the Chapter 1 tax attributable to the IRC 481(a) adjustment for the taxable year of change and the consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish its taxable income under the new method of accounting. Calculate this increase by taking the excess of the tax for such year computed **with** the allocation of the net adjustment to such taxable year over the tax computed **without** the allocation of any part of the adjustment to such year.

(4) For the purpose of computing the increase in taxes, net operating loss under IRC 172 or capital loss carryback or carryover under IRC 1212 should be considered. This would include the net increase or decrease in tax attributable to any taxable year preceding the year of change to which no adjustment is allocated under IRC 481(b)(1) or (b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years to which the adjustments under IRC 481(b)(1) or (b)(2) are allocated.

(5) For additional guidance, refer to information located on the Virtual Library for changes in accounting methods.

4.10.13.7.9.2  
(07-27-2023)  
**Partnerships and S Corporations**

- (1) In the case of a change in method of accounting by a partnership/S Corporation, the adjustments required by IRC 481(a) shall be made on the partnership/S corporation's return. However, the limitations on tax under IRC 481(b) apply to the individual partners/shareholders. IRC 481(b) applies to partners/shareholders whose taxable income is increased by more than \$3,000 as a result of such adjustments to the flow-through entity's ordinary income. See IRM 4.10.8.4.4.3 and Exhibit 4.10.8-3 for report writing procedures.

4.10.13.7.9.3  
(07-27-2023)

**Example Of The  
Required Calculation  
Under IRC 481(a)**

- (1) The following illustrates a IRS-imposed change in accounting method from the overall cash method to the overall accrual method. Assume that 2018 is the earliest year under exam. This would be the year of change.

Account	1/1/2018	12/31/2018
Accounts Receivable	\$200,000	\$250,000
Raw Materials	25,000	20,000
Work in Process	10,000	15,000
Finished Goods	15,000	10,000
Accounts Payable	(50,000)	(45,000)
Total	\$200,000	\$250,000

- (2) The IRC 481(a) adjustment is \$200,000. This represents the net difference in the increase in income from the cash to accrual method. The current year adjustment is \$50,000. This is the net difference between the balances at the beginning and the end of the year. It reflects an increase in income that would be reported under an accrual method of accounting. If it had been a taxpayer-initiated change, the taxpayer would have been required to report the \$200,000 ratably into taxable income over four years (\$50,000 per year).

4.10.13.7.9.4  
(07-27-2023)

**Example Of The  
Required Calculation  
Under IRC 481(b)**

- (1) In the preceding example, the IRC 481(b) tax limitation is applicable because the IRC 481(a) adjustment is over \$3,000. For the IRC 481(b)(1) computation, the adjustment should be hypothetically spread evenly between the current year (2018) and the two prior tax years (2017 and 2016).

**Note:** If the taxable income of the two prior years is in the same tax bracket as the year of adjustment, including the total of all adjustments, there would be no benefit from applying the IRC 481(b) limitation. Likewise, benefits could be limited if the taxpayer has a NOL carryback. The two prior year returns are only used for computation purposes. No tax is assessed on these tax years. Any difference in tax from completing this calculation will be shown as a credit in the tax due on the current year's examination.

- (2) IRC 481(b) Computation: The IRC 481(a) adjustment is \$200,000 and the current year adjustment is \$50,000. The first computation is to calculate the Chapter 1 tax for 2018

Description	Total Adjustment	2016	2017	2018
IRC 481(a)	\$200,000	\$66,667	\$66,667	\$66,667
Add'l Tax	\$78,000	\$16,667	\$22,667	\$22,667
IRC 481(b) Credit	(\$15,999)	\$0	\$0	\$0
Tax Due	\$62,001	\$0	\$0	\$0

- (3) The total Chapter 1 tax per IRC 481(b) is \$62,001, which is considerably less than the Chapter 1 tax calculated on the entire IRC 481(a) adjustment in 2018, the year of change (\$78,000). The taxpayer will be allowed a credit of \$15,999 against the tax resulting from the IRC 481(a) adjustment in 2018.

**Note:** The taxpayer will still owe tax on the current year adjustment of \$50,000. The current year adjustment is not considered in the IRC 481(b) computations. Also, self-employment (SE) tax and the Net Investment Income Tax (NIIT) are not considered in the IRC 481(b) computation.

4.10.13.7.10  
(07-27-2023)  
**For Tax Years Beginning  
After December 31, 2017**

- (1) The cash method generally will be allowed unless there is a specific provision of the Code or Treasury Regulations that requires the use of a different method such as IRC 447, IRC 448 or IRC 471. Taxpayers with inventory must generally use an accrual method under 26 CFR 1.446-1 and 26 CFR 1.471-1 unless the taxpayer is a small business taxpayer (defined in paragraph (4) below).
- (2) If a taxpayer is a small business taxpayer (defined in paragraph (4) below), it can adopt or change its accounting method to account for inventories:
  - a. in the same manner as materials and supplies that are non-incidental, or
  - b. to conform to its treatment of inventories in an applicable financial statement (as defined in IRC 451(b)(3)),
  - c. or if it does not have an applicable financial statement, the method of accounting used in its books and records prepared in accordance with its accounting procedures. See IRC 471(c)(1)
- (3) If a small business taxpayer (other than a tax shelter) adopts or changes its accounting method to account for inventories noted in paragraph (2) above, such method shall not be treated as failing to clearly reflect income.
- (4) A small business taxpayer is a taxpayer that:
  - a. has average annual gross receipts of \$25 million or less (indexed for inflation) for the prior three-taxable-year period and
  - b. is not a tax shelter (as defined in IRC 448(d)(3)).
- (5) In general, voluntary changes are initiated by the taxpayer by filing a Form 3115, Application for Change in Accounting Method, under either the automatic or non- automatic change procedures of Rev. Proc. 2015-13 (or successor). See Rev. Proc. 2018-40 (or successor) for a description of changes that a small business taxpayer can make using the automatic change procedures.
- (6) Involuntary changes are covered by Rev. Proc. 2015-13. It is important to note that any change in accounting method adjustment must conform to the applicable Code sections, such as IRC 263A; IRC 446; IRC 448; IRC 451; IRC 460; IRC 471; and IRC 481(a).
- (7) If the examiner's IRC 481(a) adjustment increases taxable income for the year of the change by more than \$3,000, a tax computation is mandatory under IRC 481(b).
- (8) Examiners should review inventory and change in accounting method information on the Virtual Library.



4.10.13.7.11  
(07-27-2023)  
**Summary**

- (1) The taxpayer's method of accounting must clearly reflect income. The cash method generally, will be allowed unless there is a specific provision of the Code or Treasury Regulations that require the use of a different method such as IRC 448 or IRC 471. Special rules under 26 CFR 1.471-1 generally require taxpayers to maintain inventories if the production, purchase, or sale of merchandise is an income-producing factor. Special rules under 26 CFR 1.446-1(c)(2)(i) generally require the use of an accrual method by a taxpayer required to maintain inventories.
- (2) For taxpayers who are required to maintain inventories, there were two safe harbor exceptions to the general rule for years beginning prior to January 1, 2018:
  - a. For all taxpayers with gross receipts of less than \$1 million, the exceptions from mandatory use of an accrual method and maintaining inventories under Rev. Proc. 2001-10 may apply. See IRM 4.10.13.7.2.1, Inventory Exception That May Allow the Use of the Cash Method for Tax Years Beginning On or Before December 31, 2017.
  - b. For eligible taxpayers, Rev. Proc. 2002-28 allows small businesses with average annual gross receipts of \$10 million or less, to use the cash receipts and disbursements method of accounting.
- (3) For years beginning after December 31, 2017, the TCJA has significantly increased the gross receipts threshold for the "small business taxpayer exception". Found in IRC 448(c) the threshold is now average gross receipts of \$25,000,000 or less (indexed for inflation) for the prior three-year period. A taxpayer who qualifies under IRC 448(c) is not prohibited from using the cash method (unless a tax shelter). In addition, IRC 471(a) and IRC 263A do not apply. If IRC 471(a) does not apply, taxpayers are still required under IRC 471(c) to account for inventory items using one of three methods specified in IRC 471(c)(1)(B).
- (4) Qualifying small business taxpayers that are permitted to use the cash method for an eligible trade or business and that do not want to account for inventories under IRC 471 must treat all inventoriable items in such trade or business in the same manner as materials and supplies that are not incidental under 26 CFR 1.162-3. An inventoriable item is any item produced for sale, purchased for resale to customers, or used as a raw material in producing finished goods.
- (5) Voluntary changes are initiated by the taxpayer by filing a Form 3115 under either the automatic or non-automatic change procedures in Rev. Proc. 2015-13 (or predecessor/successor).
- (6) Involuntary changes are covered by Rev. Proc. 2002-18. A IRS-imposed change can only be made if the taxpayer is using an impermissible method. While the taxpayer can request to change from one permissible method to another permissible method, the service cannot make such an adjustment. It is important to note that any change in accounting method adjustment must conform to the applicable Code sections, such as IRC 263A, IRC 446, IRC 448, IRC 451, IRC 460, IRC 471, and IRC 481(a).
- (7) If the examiner's IRC 481(a) adjustment increases taxable income for the year of the change by more than \$3,000, a tax computation is mandatory under IRC 481(b).

- (8) Examiners should review inventory and change in accounting method information on the respective Inventory & 263A and the Change in Methods book on the Methods of Accounting and Timing shelf in the **Corporate Issues & Credits Knowledge Base** and the Schedule C, E, & F, Expense book in the Expenses and Deductions shelf on the **Form 1040 Knowledge Base** for current developments.

4.10.13.8  
(07-27-2023)

**Real Estate Developers:  
Alternative Treatment of  
Common Improvements  
Under Rev. Proc. 92-29**

- (1) Real estate developers are allowed to use an alternative cost method of accounting for common improvements under Rev. Proc. 92-29, 1992-1 C.B. 748. Please refer to statute extension Form 921, Form 921-I, Form 921-P and IRM 25.6.22, Extension of Assessment Statute of Limitations by Consent, for additional guidance.
- (2) The Rev. Proc. 92-29 Program is currently assigned to Technical Services. Refer to IRM 4.8.8.22, Rev. Proc. 92-29, Alternative Cost Method for Real Estate Developers, for additional information. IRM 4.8.8.22 provides detailed guidance on Rev. Proc. 92-29 and IRM 4.8.8.22.2 makes it clear that the preparation of Rev. Proc. 92-29 statute extensions is the responsibility of Technical Services.
- (3) A developer that fails to substantially comply with the provisions of this revenue procedure will not be permitted to use the alternative cost method, and therefore, may not include the common improvement costs that have not been incurred under IRC 461(h) in the basis of properties for purposes of determining gain or loss from such properties.
- (4) A developer may allocate estimated costs of common improvements to the basis of lots sold despite the limitations imposed by IRC 461. Developers who wish to use the **ten-taxable year horizon** under Rev. Proc. 92-29 may receive an automatic consent by filing a timely and correct request with the IRS.

**Note:** If the ten-taxable year horizon will not be used, the developer must request a Private Letter Ruling to obtain permission.

- (5) Rev. Proc. 92-29, section 6.01, requires the developer to file a request for consent with the District Director. However, the reorganization of the Internal Revenue Service in 2001 abolished the office of District Director. Developers must file a request with the Area Director for the internal revenue area where the legal residence or principal place of business of the person required to make the return (if the developer is an individual, estate, or trust is located), or the area where the principal place of business or the principal office or agency (if the developer is a corporation or partnership is located).
- (6) When the Area Director's office receives Rev. Proc. 92-29 documents (i.e. initial requests, statute extensions, annual statements, or supplemental requests), they should be forwarded to the local Rev. Proc. 92-29 Coordinator in Technical Services. . Refer to the Virtual Library Exam Procedures Knowledge Base for Technical Services' contact information.
- (7) Developers who wish to use the alternative method of accounting for their estimated common improvement costs without regard to the ten-taxable year horizon discussed in Rev. Proc. 92-29 Section 6.02 must request a Private Letter Ruling to obtain permission to use the alternative cost method of accounting for their common improvement costs.

- (8) Common improvements vary depending on the type of development. Examples of common improvements include streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis court, and swimming pools. Common improvements must meet the following requirements:
- Be real property or real property improvements that benefit two or more properties separately held for sale by a developer.
  - The developer must be contractually obligated or required by law to provide the common improvement(s). For example, an agreement to provide improvements in exchange for a building permit is a common improvement (*Herzog Bldg. Corp. v. Commissioner*, 44 T.C. 694 (1965)); a statement in a buyer's Housing and Urban Development report that the developer will provide improvements does not qualify as a contractual obligation (*Rev. Rul. 76-247, 1976-1 C.B. 217*), and an oral promise to a buyer to provide improvements is not sufficient (*Bryce's Mountain Resort, Inc. v. Commissioner*, T.C. Memo. 1985-293).
  - The common improvement(s) must **not** be depreciable by the developer.
- (9) For any taxable year, the estimated cost of common improvements is equal to the amount of common improvement costs incurred under IRC 461(h) plus the amount of common improvement costs the developer reasonably anticipates it will incur during the ten succeeding taxable years (ten-taxable year horizon).
- (10) A developer may include in the basis of properties sold, their allocable share of the estimated cost of common improvements without regard to whether the costs are incurred under IRC 461(h). There is an important limitation, however. As of the end of any taxable year, the total amount of common improvement costs included in the basis of the properties sold may not exceed the amount of common improvement costs that have been incurred under IRC 461(h).
- (11) Taxpayers must comply with certain requirements on a project-by-project basis in order to use the Alternative Cost Method. If this limitation precludes a developer from including the entire allocable share of the estimated cost of common improvements in the basis of the properties sold; the costs not included may be taken into account in a subsequent taxable year to the extent additional common improvement costs have been incurred under IRC 461(h).
- File an original initial request for each real estate project with the Service as explained in IRM 4.10.13.8. The developer must also attach a copy of each request to its timely filed (determined with regard to extensions of time) original federal income tax return for the taxable year. Each request must include all information set forth in Rev. Proc. 92-29, section 6.04. The request must include a copy to the return, a schedule of common improvements, costs, and estimated completion date.
  - Sign a restricted consent extending the statute of limitations on assessment with respect to the use of the alternative cost method **for each year** the alternative cost method is used.

**Note:** The Bipartisan Budget Act of 2015 (BBA) abolished TEFRA procedures. Effective for tax years beginning after December 31, 2017, a taxpayer filing a Form 1065 falls under BBA unless the taxpayer elects out of BBA. Contact the Rev. Proc. 92-29 coordinator or subject matter expert (SME) in Technical Services for guidance on statute extensions for BBA tax years.

- File an annual statement for each project with the Service as explained in IRM 4.10.13 IRM 4.8.8.22.2.2 . The developer must also attach a copy of

each annual statement to its timely filed (determined with regard to extensions of time) original federal income tax return for the taxable year. The annual statement must include all information set forth in Rev. Proc. 92-29, section 8.02 describing the project and updating the estimated costs of common improvements, how the costs were allocated, the number of lots sold, the costs incurred under IRC 461(h), and the costs included in the basis of lots sold.

- d. File a supplemental request on or before the expiration of the period previously approved and continue to use the alternative cost method with respect to common improvements not completed at that time. The supplemental request must be filed in the same manner as for the initial request described in IRM 4.10.13 and IRM 4.8.8.22.2.2. The supplemental request must include all information set forth in Rev. Proc. 92-29 Section 9.02. including describing the project and updating the estimated costs of common improvements, how the costs were allocated, the number of lots sold, the costs incurred under IRC 461(h), and the costs included in the basis of lots sold. The taxpayer must also submit an updated statute extension.

- (12) Examiners examining developers who have elected the alternative cost method should:

- a. Review Rev. Proc. 92-29,
- b. Secure information regarding any required filings by the taxpayer from the Rev. Proc. 92-29 Coordinator or SME in Technical Services,
- c. Ensure the taxpayer has made the proper computations, and
- d. Verify that the taxpayer did not include in the basis of lots sold, the costs of improvements that were never built or that do not meet the requirements set forth in Rev. Proc. 92-29.

4.10.13.9  
(07-27-2023)  
**Self-Rented Property  
and Renewable Options**

- (1) Self-rental income is rental income of a taxpayer from property leased to a trade or business activity in which the taxpayer materially participates. See 26 CFR 1.469-2(f)(6). Self-rentals are a common business practice, primarily used to limit the taxpayer's non-tax liability with respect to the rental property.
- (2) While rental income is generally passive income, which can offset unrelated passive losses, certain types of rental income are recharacterized as nonpassive income, the most common being self-rental income. If a taxpayer leases property to a business in which he materially participates within the meaning of temporary 26 CFR 1.469-5T, net rental income is treated as nonpassive income under this rule. Self-rental income is reportable on Schedule E. However, it should not be entered on the individual taxpayer's Form 8582, Passive Loss Limitations, where it could otherwise be used to offset passive losses from other activities. However, a net loss from a self-rental activity remains passive and should be reported on the Form 8582. More information on self-rentals is located on the Virtual Library Form 1040 Knowledge Base.
- (3) There is an exception to the recharacterization of self-rental income. 26 CFR 1.469-11(c)(ii) permits self-rental income to be treated as passive income if there is a written binding lease entered into before February 19, 1988. As a practical matter, the Service seldom sees leases signed prior to 1988 that bind current years. Thus, self-rental income is generally recharacterized as nonpassive income and cannot be entered on Form 8582.

- (4) The question often arises whether a new lease, signed after 1988 under a renewable option provision in a pre-1988 contract qualifies for the written binding lease exception described in paragraph (3), above. A new lease as a result of an option to renew provision does not meet the exception in 26 CFR 1.469-11(c)(ii). The clear language of 26 CFR 1.469-2(f)(6) and 26 CFR 1.469-11(c)(ii) provides that the grandfather exception, which permits self-rental income to be treated as passive income, applies only to rental obligations in existence before February 19, 1988. State law generally draws a distinction between options and the underlying enforceable obligation. While an option may exist, generally there is no underlying enforceable legal obligation until the option is exercised, which clearly is post-1988 for most renewable options in current years. Thus, rental income based on a renewable option is nonpassive income. This income should not be entered on Form 8582 as passive income, which would allow unrelated passive losses to become deductible.

**Note:** See *Krukowski v. Commissioner*, 114 T.C. 336 (2000) for an example of a case in which the Court held that the renewable option did not constitute a pre-1988 binding contract.

4.10.13.10  
(03-16-2015)  
**Personal Holding  
Company Deficiency  
Dividends**

- (1) A personal holding company (PHC) is a closely-held company whose income is derived from passive income and/or from payments received for personal services performed by a shareholder.
- (2) The PHC penalty tax is self-assessed and calculated on Part 1 of the Schedule PH, Form 1120, U.S. Personal Holding Company (PHC) Tax.
- (3) The PHC is purely computational; there is no intent provision, unlike the Accumulated Earnings Tax, IRC 531 and IRM 4.10.13.2.
- (4) IRC 542 (a) provides two objective tests for determining PHC status on a year by year basis:
  1. adjusted ordinary gross income test
  2. a stock ownership test
- (5) Under the provisions of IRC 541, a tax of 20 percent is imposed on a PHC's undistributed personal holding company income.
- (6) The personal holding company provisions were enacted to combat the use of "incorporated pocketbooks" by wealthy taxpayers as a means of sheltering investment income from taxation at the higher individual rates and enjoying the benefits of the graduated rate structure at both levels. The original intent of these provisions was to discourage companies from holding excessive accumulations of earnings by forcing distributions to be paid.

**Note:** Personal holding companies are not subject to the accumulated earnings tax of IRC 531.

4.10.13.10.1  
(03-16-2015)

**Procedures for Personal Holding Company Cases**

- (1) The examiner should prepare an initial report recommending the assertion of the PHC tax, where appropriate. The report should reflect separate computations of PHC income, PHC tax liability, and income tax liability. The examiner should follow the procedures for “Excepted Agreed” cases, including preparation of Form 4549-A, Form 4665, and Form 886-A. **If the case is unagreed, this report becomes the final report and normal procedures for unagreed cases apply.**
- (2) See IRM 4.10.8.11, Personal Holding Company (PHC) - Deficiency Dividends for detailed report writing instructions and sample forms in IRM 4.10.8 Exhibits 4.10.8.4 and 4.10.8.5.

4.10.13.10.1.1  
(03-16-2015)

**Deficiency Dividend Procedures**

- (1) If neither jeopardy assessment nor fraud is involved, and the taxpayer agrees to all adjustments including the liability for PHC tax in the amount proposed, the taxpayer may be relieved of the liability for the PHC tax by payment of “deficiency dividends”. If the corporation makes the payment of this deficiency dividend within 90 days following formal notification, the corporation is relieved of having to pay the PHC tax.
- (2) The examiner must notify the taxpayer regarding the deficiency dividend procedures of IRC 547. The proper sequence is:
  - Securing a signed agreement from the taxpayer, where the taxpayer agrees to the amount of the tax liability, signing Form 870 to allow a proper assessment,
  - Payment of the deficiency dividend, and
  - The filing of a claim by the taxpayer claiming credit for a deficiency dividend deduction.
- (3) A determination of the taxpayer’s liability for PHC tax must be made in the manner prescribed by IRC 571(c). Three means of making a qualifying determination are:
  - a. Form 2198, Determination of Liability for Personal Holding Company Tax, an informal agreement as provided in the regulations.
  - b. Another determination method – the date of determination by a decision of the Tax Court of the United States is the date upon which decision becomes final, as prescribed in IRC 7481 . See section 26 CFR 1.547-2(b)(1)(ii). And under 26 CFR 1.547-2(b)(1)(iii), the date upon which a judgment of a court becomes final.
  - c. Form 866, Agreement as to Final Determination of Tax Liability, a final determination under IRC 7121.

4.10.13.10.2  
(03-16-2015)  
**Form 870**

- (1) The taxpayer’s agreement to the additional tax shown on the initial report is indicated by signing Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. The Form 870 must include the following statements as outlined in IRM 4.10.8.9 Examination of Returns - Report Writing:
  - The waiver of restrictions on assessment and collection contained herein is subject to the approval of Form 2198, Determination of Liability For Personal Holding Company Tax, relating the taxpayer’s liability for Income and Personal Holding Company Tax.
  - This waiver will not take effect until after the expiration of the 120-day period beginning with the effective date of Form 2198.



- If the taxpayer complies with IRC 547, Deduction for deficiency dividends, relating to the payment of deficiency dividends, by paying the deficiency dividends within 90 days after the effective date of Form 2198 and filing a proper claim on Form 976 subsequent to the payment of the deficiency dividends and within 120 days after the effective date of Form 2198, then the amount of the deficiency stated on this waiver shall be reduced by the amount necessary to give effect to the timely paid deficiency dividends and the remainder, if any, will be assessed.
- If, at the expiration of the 120-day period beginning with the effective date of the Form 2198, a Form 976 has not been filed or timely deficiency dividend payments have not been made, the entire amount of the deficiency shown in this waiver will be assessed.

**Note:** The four conditions noted above should be placed on an attachment to Form 870 with a heading that reads: "This statement is attached to and made a part of Form 870 in the case of (Taxpayer's Name)."

4.10.13.10.3  
(03-16-2015)  
**Form 2198**

- (1) After the Form 870 is signed, the examiner should prepare Form 2198 Determination of Liability For Personal Holding Company Tax, relating the taxpayer's liability for Income and Personal Holding Company Tax, secure the taxpayer's signature on the original and one copy. The original should be initialed by the examiner and group manager to indicate their acceptance of the form. The case should then be submitted to Technical Services (TS). See IRM 4.8.8.4.2, Reviewer Responsibilities.
- (2) The reviewer will sign the Form 2198 provided sufficient time remains on the statute in addition to the 120-day period for filing a Form 866.
- (3) The original of the approved Form 2198 is attached to the return for the last taxable year covered by the agreement. The duplicate Form 2198, Letter 1152 (DO), and three Form 866 are mailed to the taxpayer by registered or certified mail, as appropriate.

**Note:** 26 CFR 1.547-2(b)(1)(v) provides that the date of determination is the date the Form is mailed to the taxpayer, with one exception. If the dividends are paid after the agreement is approved but before it is mailed, the effective date is the date the agreement was signed by the Service.

4.10.13.10.4  
(03-16-2015)  
**Final Closing Agreement  
Procedures**

- (1) Form 866 Agreement as to Final Determination of Tax Liability is not routinely used in lieu of Form 2198 Determination of Liability for Personal Holding Company Tax unless advised by Counsel for a unique situation. If Form 866 is utilized as the agreement document, the examiner should prepare the agreement and secure the taxpayer's signature. The Form 866 is then forwarded to Technical Services for processing as provided in the Closing Agreement manual section, Form 866 Closing Agreements - Processing Closing Agreements in Appeals.
- (2) After the closing agreement is approved, a copy is forwarded to the taxpayer along with three Form 976 Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust by the designated review. Form 3198, Special Handling Notice, is attached to the case file identifying it as a closing agreement case.

4.10.13.10.5  
(03-16-2015)  
**Post-Determination  
Procedures**

- (1) The case is suspended by Technical Services until the earlier of:
  - a. Receipt of Form 976 from the taxpayer, or
  - b. 120 days from the “date of determination”

4.10.13.10.5.1  
(03-16-2015)  
**Form 976 Procedures**

- (1) The Code allows the real estate community, specifically personal holding, REIT and RIC, to reduce their taxable income by declaring a dividend and distributing it to their shareholders. The dividend would be substantially all the income earned for the year. If for some reason it was found out that not all the appropriate amount of income is declared the taxpayer may declare a deficiency dividend using a issue the dividend.
- (2) When and where to file:
  - a. File Form 976 within 120 days after the determination date
  - b. A PHC must file Form 976 with the IRS office where the determination of PHC status was made
  - c. A RIC or a REIT must file Form 976 with the Internal Revenue Service Center where the income tax return for the tax year for which the determination applies was filed, unless the situations below apply
  - d. If the determination is made by a RIC or REIT under IRC 860(e)(4), file Form 976 with the Internal Revenue Service, P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409. This is the same address for filing Form 8927, Determination Under IRC 860(e)(4) by a Qualified Investment Entity
  - e. If the determination is from an agreement with the delegate (under IRC 547(c)(3) or IRC 860(e)(3)) any claim resulting from the deficiency dividend deduction may be filed with the delegate or corresponding IRS office
- (3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of the deduction for dividends paid under IRC 561 for the tax year for which the tax liability exists if it had been distributed during that year.
- (4) If the taxpayer files a timely Form 976, the claim is date stamped and the case is returned to the examiner to verify the accuracy of the information reflected on the claim.
- (5) If Form 976 is filed after the 120-day period, the case will be returned to the examiner for disallowance of the claim.
- (6) The disallowance of a Form 976 claim is affected by the issuance of a certified notice of disallowance of claim, unless the taxpayer has executed Form 2297 (Waiver of Statutory Notification of Claim Disallowance). A letter of explanation may also accompany the notices. The tax is then assessed per the full amount reflected in the initial report.
- (7) If the Form 976 claim is determined to be allowable in full or in part, the examiner should prepare:
  - a. A report to allow a credit for the deficiency dividends. This report will be the same as the initial report except that credits on Line 8 of Form 4549-A will show “PHC Deficiency Dividend Deduction” and the applicable amount, and the “Other Information” section will state whether Form 976 has been allowed in full or in part (See IRM 4.10.8.11.

b. Form 3189, Deficiency Dividend Case Transmittal, see IRM 4.10.8 Exhibit 4.10.8-5.

- (8) Form 3189 should be flagged to identify the case as a PHC case. The restricted interest box should also be checked and "IRC section 547" annotated.
- (9) See *Notice 2003-19, 2003-1 C.B. 703*, under IRC 860 and 26 CFR 1.860-2 concerning a deficiency dividend deduction for a "qualified investment entity" (RIC or REIT), which reflects the "place of filing" as "Ogden Submission Processing Center".

4.10.13.10.6  
(03-16-2015)  
**Miscellaneous  
Considerations**

- (1) Neither Form 2198 nor Form 866 should be entered into unless sufficient time remains to allow assessment after the 120-day period and before expiration of the statutory period. However, a consent extending the period of limitation on assessment may be executed in the normal manner.
- (2) IRC 6501(f) provides a six-year period of assessment instead of the normal three-year period if a corporation failed to file Schedule PH or a schedule setting forth specified information regarding its income and shareholders.
- (3) Deficiency dividends are deemed to be paid from earnings and profits of the year under examination rather than those of the current period. However, the dividends are taxable to the shareholders in the year in which paid.
- (4) Although the taxpayer is relieved of the liability for PHC tax by the payment of deficiency dividends, the liability for restricted interest and any applicable penalties remains.
- (5) The IRC 465 at-risk rules only apply to corporation that meet the PHC stock ownership test (without regard to the income test).
- (6) Alternative minimum tax adjustment for circulation expenses applies only to PHCs (IRC 56(b)(2)(C), Adjustments in computing alternative minimum taxable).

4.10.13.11  
(04-22-2022)  
**Economic Substance  
Doctrine**

- (1) On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 was enacted. This law amended the Internal Revenue Code to codify the Economic Substance Doctrine under IRC 7701(o). It also amended penalty provisions under IRC 6662, IRC 6662A, IRC 6664, and IRC 6676. Consult Chief Counsel, Procedure and Administration, Branches 6 and 7, for questions on the potential application of the economic substance doctrine.
- (2) Tax benefits alone do not qualify as meaningful economic change or a substantial purpose for entering a transaction. Similarly, achieving a financial accounting benefit does not qualify as a substantial purpose if the origin of that financial accounting benefit is a reduction in federal income tax. In addition, a relevant transaction lacks economic substance if the tax benefit dwarfs economic change or nontax purpose for entering the transaction.
- (3) IRC 6662 was amended to add a new penalty to be applied to any underpayment attributable to transactions lacking economic substance. IRC 6662(b)(6) increases the penalty to 40 percent if the relevant facts affecting the tax treatment are not adequately disclosed. The penalty is applicable for transactions entered into after March 30, 2010. IRC 6662(b)(6) applies a 20 percent penalty on noneconomic substance transactions. Contact Chief Counsel,

Procedure and Administration, Branches 1 and 2, for questions about applying a penalty connected to economic substance doctrine or codified economic substance doctrine.

- (4) There is a cutoff for amendments or supplements to a return that would otherwise reduce the 40 percent penalty (for nondisclosed noneconomic transactions) to a 20 percent penalty (for disclosed noneconomic transaction). The cutoff is the earlier of two dates. The first date is when the contacts the taxpayer about an examination for the first time. The second date is any other specific date provided by the Treasury Secretary. Therefore, when analyzing whether a noneconomic transaction is adequately disclosed, disregard amendments or supplements to a return made after the earlier of (i) when the IRS first contacted the taxpayer about the examination and (ii) if the Treasury Secretary has established a specific date, that specific date.
- (5) For guidance on applying the economic substance doctrine and related penalties., see IRC 6662 (b)(6), Penalty for Underpayments attributable to a Transaction Lacking Economic Substance.
- (6) See *Notice 2010-62* and *Notice 2014-58* for additional guidance regarding the application of the Economic Substance Doctrine and penalties associated with the doctrine.

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**Exhibit 4.10.13-1 (03-16-2015)****Bardahl Manufacturing Formula - Modified by The Empire Steel Casting Decision**

Following is the formula used by the Tax Court to compute working capital needs in the Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo 1965-200 case.

- (1) Determine the amount of current and accumulated earnings.
- (2) Require justification of current and accumulated earnings only to the extent represented by the excess of current assets over current liabilities including Federal income taxes due.
- (3) Use the formula for determining working capital needs:
  - a. Determine the operating expenses for the full year, including the cost of goods but excluding depreciation.
  - b. Determine the adjusted operating cycle in terms of percent of a year.
  - c. Multiply (a) by (b) to get the amount of net liquid assets necessary to meet ordinary operating expenses.
  - d. The adjusted operating cycle is the time required to convert cash into raw materials, raw materials to inventory, inventory into sales and accounts receivable and the period required to collect the outstanding accounts. (In the Bardahl case, the computation was based on the operating expenses of the succeeding year.)
- (4) Ascertain the amount needed to meet specific and definite plans for expansion, extraordinary expenses, etc.
- (5) Compare the funds required or computed in (3) plus (4) with the funds available as computed in (2). If funds available exceed funds required, the excess is unreasonable accumulation.
- (6) Check to see whether corporate funds were used for non-liquid investments which have no relationship to the business. Such investments are considered as additional working capital. If this amount when added to the funds available as computed in (2) exceeds the funds required as computed in (3) plus (4) the excess is an unreasonable accumulation.



**Exhibit 4.10.13-2 (07-27-2023)****Bardahl-Apollo Formulas Compared - Example**

As discussed earlier, Exhibit 4.10.13-1 addresses the Bardahl Formula. The Apollo formula (stemming from a court case: Apollo Industries v C.I.R, 358 F 2nd 867 (1966)) may have application to non-manufacturing businesses. The following shows a comparison of the Bardahl formula to the Apollo formula.

Item to compare	A-Bardahl	B-Apollo	How the amount was determined (both methods)	Analysis
1. Cost of Materials	\$800,000.00	\$800,000.00	Sample amount given	Cost of materials is a subset of cost of good sold
2. Average beginning-ending inventory	80,000.00	80,000.00	Sample amount given	None
3. Material turnover per year	10.00%	10 times	A: Line 1/ Line 2 / B: Line 2/ Line 1	For B, no impact on final result
4. Months/days per material inventory turnover	1.2 months	36.5 days	A: Line 3 x 12 months / B: 365 days / Line 3	No impact on final result
5. Average daily cost of material	No step	2,191.78	B: Line 2 / Line 4	No impact on final result
6. Days cost of material tied up in inventory	No step	80,000.00	B: Line 4 X Line 5	Same as Line 2 as a result of steps on Lines 3 to Line 6
7. Sales	\$2,400,000.00	\$2,400,000.00	Sample amount given	None
8. One day sales	No step	\$6,575.34	B: Line 7 / 365 days	None
9. Trade accounts receivable at end of year	\$600,000.00	\$600,000.00	Sample amount given	None
10. Percentage of year sales uncollected	25.00%	No step	A: Line 9 / Line 7	None
11. Average number of months sales uncollected	3 months	No step	A: 12 months X Line 10	No impact on final result
12. Days sales tied up in accounts receivable	No step	91.25 days	B: Line 9 / Line 8	None
13. Cost of Sales	\$1,000,000.00	\$1,000,000.00	Sample amount given	None

**Exhibit 4.10.13-2 (Cont. 1) (07-27-2023)**  
**Bardahl-Apollo Formulas Compared - Example**

Item to compare	A-Bardahl	B-Apollo	How the amount was determined (both methods)	Analysis
14. Expenses (including estimated Federal Income Tax Payments)	500,000.00	500,000.00	Sample amount given	None
15. Total of 13 and 14	\$1,500,000.00	\$1,500,000.00	A & B: Line 13 plus Line 14	None
16. Depreciation	100,000.00	100,000.00	Sample amount given	None
17. Annual operating costs	\$1,400,000.00	\$1,400,000.00	A & B: Line 15 less Line 16	None
18. Operating cycle percentage	35.00%	No step	A: Line 3 plus Line 10	None
19. Ordinary operating expense	\$490,000.00	No step	A: Line 18 X Line 17	None
20. Daily operating cost	No step	\$3,835.62	B: Line 17/ 365 days	None
21. Operating cost tied up in accounts receivable (91.25 x \$3,835.62)	No step	\$350,000.00	B: Line 12 X Line 20	None
22. Material cost	No step	\$80,000.00	B: Line 2	None
23. Operating cost during collection period	No Step	\$350,000.00	B: Line 21	None
24. Working capital needs	\$490,000.00	\$430,000.00	A: Line 19 / B: sum of Lines 21 to 23	Working capital difference in both methods

**Exhibit 4.10.13-3 (03-16-2015)****Letter 572 - Proposal to Issue a Notice of Deficiency for Excess Accumulated Earnings Under IRC Section 531**

- a. IRM 4.10.13.2.8, Notification of Unreasonable Accumulation of Earnings says: “In any proceeding before the Tax Court involving the allegation that a corporation has permitted its earnings and profits to accumulate beyond reasonable business needs, the burden of proof is on the Commissioner unless a notification is sent to the taxpayer under IRC 534(b). However, if such a notification is sent to the taxpayer and the taxpayer timely submits the statement described in IRC 534(c), the burden of proof will be on the Commissioner as to the grounds given in the statement”
- b. Letter 572 replaces Pattern Letter P-572. It also streamlines the Notice of Deficiency for the tax that IRC 531 requires to be paid on accumulated earnings. It allows the taxpayer(s) time to respond to the letter by submitting a statement and including facts sufficient to show the basis for the accumulation. We will then determine whether the Notice of Deficiency should be issued. The letter primarily will affect corporation returns Form 1120. It points to the earnings and profits accumulate beyond the reasonable needs of the business.
- c. IRM 4.8.8.2(2), Accumulated Earnings Tax, indicates that only officials and Technical Services’ reviewers delegated to sign notices of deficiency pursuant to Servicewide Delegation Order 4-8 are authorized to sign notifications under IRC 534(b) according to Rev. Proc. 56-11, 1956-1 C.B. 1028. Therefore, the case is forwarded to Technical Services to sign Letter 572. Technical Services will return the case to the group for certified mailing and suspense.

**Exhibit 4.10.13-4 (03-16-2015)**

**Activities Not Engaged in For Profit Check Sheet**

Pub 5558, Activities Not Engaged for Profit Audit Technique Guide Internal Revenue Code Section 183, has been developed to provide guidance to examiners in pursuing the application of IRC 183, Activities Not Engaged in for Profit, (sometimes referred to as the “hobby loss rule”).

The purpose of the guide is to:

1. Assist in distinguishing between a business activity (where deductions may be allowable under IRC 162)
2. Assist in the identification of a non-business “for profit” activity (where deductions may be allowable under IRC 212)
3. Assist with an activity not engaged in for profit (where deductions are strictly limited by specific rules contained in IRC 183)
4. Assist in the identification of a personal activity (where deductions are generally disallowed by IRC 262, except to the extent otherwise allowable),
5. Provide examination techniques,
6. Supply applicable law, and
7. Provide written guidance in report writing.

This guide is not designed to be all inclusive. This guide is not legal precedent and should not be relied upon as such. It is not designed to remove the discretion given to managers and examiners in the application of a variety of audit techniques or procedures appropriate to any given examination.

26 CFR 1.183-2(b) lists certain relevant factors normally to be taken into account in making a determination regarding the purpose of an activity, it being intended that such factors are not necessarily all-inclusive and that no one factor shall be determinative:

1. Manner in which taxpayer carries on activity:
  - Are books and records accurate and complete? If not, why not?
  - Are books comparable to types of books kept by others in same activity?
  - What advertising and promotion activity did the taxpayer perform to gain clients/buyers (describe in detail)?
  - What other relationship did the taxpayer have with his clients/buyers (trace each transaction in gross receipts to the individual who paid the taxpayer the money)? with his suppliers? with his employees?
  - Has taxpayer abandoned the unprofitable methods? What method replaced them?
  - Does taxpayer have a license to operate?
  - Is taxpayer insured for business?
  - Is the activity conducted in an area zoned for business?
  - Does the city, country or state regulate the activity? Has taxpayer been investigated by them? Does he file sales tax reports with the state?
  - Was any element of the activity admittedly personal?
  - Is the activity still being conducted? With what result? What is the plan for future years?
  - How is the taxpayer’s telephone number listed in the white/yellow pages?
  - Can taxpayer provide affidavits from witnesses?
2. Expertise of taxpayer and/or advisors:
  - Pre-activity research by taxpayer.
  - History of all similar activities by taxpayer and related family members.
  - Education background.
  - What did taxpayer tell preparer when first introducing the activity during the preparation of the return?
  - What is preparer’s (and other advisor’s) background?

**Exhibit 4.10.13-4 (Cont. 1) (03-16-2015)****Activities Not Engaged in For Profit Check Sheet**

- What related organizations does taxpayer belong to? When did he join?
  - What related publications does taxpayer subscribe to? How long?
3. Time and effort expended by the taxpayer in carrying on the activity:
- How many hours per day? What task?
  - What is the routine?
  - Which person does what part of the activity?
4. Expectation that assets used in activity may appreciate in value:
- Analyze each asset, whether capital, depreciable, intangible or part of inventory. How much is each asset worth today?
  - Has the taxpayer ever offered to sell any of the assets?
  - Has anyone every offered to buy any of the assets?
  - See 26 CFR 1.183-1(d)(1) regarding appreciation of farmland.
5. Success of the taxpayer in carrying on similar or dissimilar activities:
- Look at copies of taxpayer's returns (back 10-15 years if possible).
  - Did taxpayer ever have a hobby not shown on tax returns but of similar nature? Get details.
6. Taxpayer's history of income or losses with respect to the activity:
- Chart gross receipts since beginning of activity (including any unclaimed amounts). Look for pattern.
  - Chart any expenses. Look for pattern.
  - Chart net profits/losses.
- Note:** If the current examination year is the first year of activity, wait until the next year is filed before closing the first year (needs group manager approval).
7. Amount of occasional profits, If any, which are earned
8. Financial status of the taxpayer:
- For all years activity claimed, chart amount of profit/loss, other taxable income, other non-taxable income.
  - Chart the tax savings for all years (including credits claimed).
9. Elements of personal pleasure or recreation:
- By the taxpayer
  - By the members of the taxpayer's family
  - By the taxpayer's friends