Office of Chief Counsel
Internal Revenue Service
memorandum

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from: Corina Braun, Attorney
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subject: Assessment Statute for Prior Years Following Election to Claim Foreign Tax Credits

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

Can the Service process the Taxpayer's amended corporate tax returns for the and taxable years, which were filed in ?

FACTS

Taxpayer Advocate Services requested advice concerning the Service's refusal to process amended corporate tax returns filed by Taxpayer in that show U.S. tax deficiencies for the and taxable years. In , Taxpayer filed amended returns for its through taxable years that reflect changes in its election to deduct foreign tax paid and instead to claim a foreign tax credit in each year under section 901(a). The Service accepted and processed the amended returns for the , , , and taxable years. However, the Service did not accept and process the amended returns for the and taxable years, which reflected U.S. tax deficiencies attributable to reversing out deductions for foreign taxes taken on the original returns, on the grounds that the three-year period of limitations under section 6501(a) on the assessment and collection of the tax due for those years, as shown on the amended returns, had expired. The Taxpayer subsequently filed an amended return to claim a refund for the tax year attributable to the carryover under section 904(c) of creditable foreign taxes from the through taxable years, including foreign taxes deducted in and with respect to which the deficiencies attributable to

eliminating those deductions appear time-barred. The amended return was not processed by the Service.

LAW AND ANALYSIS

Section 901(a) of the Internal Revenue Code provides that a taxpayer has the option, for each taxable year, to claim a credit for foreign income taxes paid or accrued to a foreign country in such taxable year, subject to the limitations under section 904. Alternatively, a taxpayer may deduct the foreign income taxes under section 164(a)(3). The deduction and credit for foreign income taxes are mutually exclusive; section 275(a)(4) provides that no deduction shall be allowed for foreign income taxes if the taxpayer chooses to take to any extent the benefits of section 901. Section 901(a) further provides that the choice to claim the foreign tax credit for any taxable year "may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year."

Section 6511(a) of the Internal Revenue Code provides that a claim for credit or refund of an overpayment shall be filed within three years from the time the return was filed or two years from when the tax is paid, whichever is later. However, under section 6511(d)(3), if the refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country for which credit is allowed under section 901, the taxpayer has ten years from the un-extended due date of the return for the taxable year in which the foreign taxes are paid or accrued to file the claim. See §301.6511(d)-3. Treasury regulation §1.901-1(d) provides that a taxpayer can claim the benefits of section 901 at any time before the expiration of the period prescribed by section 6511(d)(3)(A). Accordingly, Taxpayer's election to claim foreign tax credits under section 901(a) in lieu of foreign tax deductions for each of the through taxable years was timely made under the applicable section 901 regulation. However, the election change that gave rise to the foreign tax credit carryforward resulting in the overpayment also gave rise to underpayments in both and , as the result of eliminating the deductions Taxpayer originally claimed for those same foreign tax payments. If assessment and collection of the tax due in those years as the result of the election change is time-barred, then Taxpayer would retain the benefit of both a deduction and a credit for a single payment of foreign tax, in contravention of section 275(a)(4). The law does not permit this result.

Equitable recoupment is an equitable remedy that precludes a taxpayer from treating one transaction differently from year to year. Equitable recoupment allows the Service to reduce a refund due a taxpayer for one year by an underpayment from a different year, but only of a "related, and inconsistent, but now time-barred tax claim relating to the same transaction." IES Indus., Inc. v. United States, 349 F.3d 574, 581 (8th Cir. 2003) (quoting United States v. Dalm, 494 U.S. 596, 608 (1990)). "The defense does not permit 'one transaction to be offset against another,' but will allow a single 'transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.'" Id. at 582 (quoting Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 299 (1946)). Equitable

recoupment focuses on the "single transaction, item, or taxable event." Id at 581; see also Bull v. United States, 295 U.S. 247, 261 (1935) (holding that equitable recoupment applied when single transaction applying to both the income tax deficiency claim and the time-barred estate tax overpayment claim arose out of the estate's receipt of money from a partnership); Stone v. White, 301 U.S. 532, 533 (1937) (holding that the government could apply equitable recoupment to a refund claim where the single transaction was the receipt of income for a period by an estate.); IES Indus., Inc. v. United States, 349 F.3d 574 (8th Cir. 2003) (holding that refunds attributable to capital losses and credits for foreign taxes withheld from dividends on foreign stock purchased cum dividend and sold ex-dividend and treated as an economic sham by the Service related to a "single transaction" sufficient to apply equitable recoupment to reduce refund claim by including dividends in taxable income); cf. Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 301 (1946) (holding that equitable recoupment did not apply where a deficiency claim for excise taxes was sought to be offset by an overpayment of the excise tax for different years).

Sections 1311 through 1314 of the Internal Revenue Code provide that the Service may apply mitigation provisions to make adjustments to tax items that would otherwise be prohibited. The following conditions must be met: 1) an error must have occurred in a taxable year which cannot otherwise be corrected by operation of law; 2) there was a determination for another year with respect to the item giving rise to the error; 3) the determination was within one of the categories enumerated in section 1312 as a circumstance of adjustment; and 4) the party who prevailed in the determination maintained a position that was adopted there and that was inconsistent with the erroneous treatment. Here, the circumstance of adjustment would be a double allowance of a deduction or credit under section 1312(2). The Taxpayer obtained a deduction for the foreign taxes in the initial filing. The Taxpayer would receive a credit for the same foreign tax on the amended returns. Whether the foreign taxes are a deduction or a credit for the same year is an inconsistent position under section 1311(b)(1). A determination for mitigation purposes include a closing agreement under section 7121 or a final disposition by the Secretary of a claim for refund. I.R.C. § 1313(a). The adjustment shall be made as if it were a deficiency determined by the Secretary as if on the date of the determination one year remained before the expiration of the periods of limitation upon assessment for the taxable year being adjusted. I.R.C. § 1314(b). As the Taxpayer is pursuing a refund, once the Secretary determines whether to allow or disallow the refund, there is a determination which can be used to apply the mitigation provisions.

The purpose of section 275(a)(4) is to prevent taxpayers from claiming the benefits of both a credit and a deduction with respect to the same taxes. However, the law is currently unclear how section 275(a)(4), equitable doctrines such as equitable recoupment, or the mitigation provisions under sections 1311 through 1314, operate to prevent taxpayers from obtaining a double benefit (through both a deduction and a credit) for a single amount of foreign income tax paid. These uncertainties have led taxpayers to request guidance from the Service to clarify the effect of a timely change in election on their U.S. tax liabilities.

Proposed regulations (85 FR 72078) address this uncertainty and would amend §1.905-3 to provide that a foreign tax redetermination includes a change by a taxpayer in its decision to claim a credit or a deduction for foreign income taxes that may affect a taxpayer's U.S. tax liability. The effect of treating a change in a taxpayer's decision to claim a credit or a deduction for foreign income taxes as a foreign tax redetermination is that the Service may assess and collect any U.S. tax deficiencies in intervening years that result from the taxpayer's change in election, even if the generally-applicable three-year assessment period under section 6501(a) has expired.

Section 7121(a) of the Internal Revenue Code authorizes the Treasury Secretary or their delegate to enter into binding agreements with a taxpayer relating to the liability of such person in respect of any internal revenue tax for any taxable period. These agreements are referred to as "closing agreements." Closing agreements are intended to dispose of debatable matters. IRM 8.13.1.2.1(4). Section 7121(b) provides that a closing agreement is "final and conclusive . . . [and] except upon a showing of fraud or malfeasance, or misrepresentation of a material fact . . . the case shall not be reopened as to the matters agreed upon or the agreement modified . . . ."

CONCLUSIONS

On its tax returns as originally filed, Taxpayer claimed deductions for the through tax years. Taxpayer was entitled to change its election and to claim credits for the through taxable years within the 10-year period referenced in §1.901-1(d). However, because the Code prohibits taxpayers from claiming both a deduction and a credit for the same foreign tax, the Taxpayer cannot both retain the foreign tax deduction on its originally filed returns and claim a credit for the same taxes on its amended tax return. Thus, the Taxpayer should not be entitled to claim the foreign tax credits for the amounts at issue on its tax return without also amending its earlier returns on which deductions for those taxes were claimed and paying any associated tax deficiency. If, however, the request for a refund is allowed, there will be a determination under section 1313 and a double-allowance of a deduction or credit as described in section 1312(2). Mitigation would thus apply, and the Service would be entitled to assess and collect the deficiencies for and in connection with allowance of the refund for in accordance with section 1314. Alternatively, the Service may enter into a closing agreement with the Taxpayer in which the Service agrees to allow the refund for subject to the elimination of the deductions for the same taxes on the earlier year returns and the payment of any resulting deficiencies. If you need assistance in drafting an appropriate closing agreement to ensure that the impact of the deductions is reversed, please let us know.

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Please call (202) 317-5004 if you have any further questions.