DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)

SUBJECT: Mitigation provisions

This Field Service Advice responds to your memorandum dated June 7, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

ISSUE:

Whether the mitigation provisions of the Internal Revenue Code, sections 1311 through 1314, will authorize adjustments to years that are now barred.

CONCLUSION:

Adjustments to the barred years will not be possible, because the requisites for mitigation will not be met.

FACTS:

X consists of a number of limited partnerships that ostensibly contracted with third parties . The partnerships in their first tax years reported the expense of these contracts on a cash basis. Subsequently, the partnerships, having converted under section 447 of the Code to an accrual method of accounting, ratably recaptured the contract expenses over a ten-year period.

In final partnership administrative adjustments (FPAA's) to the limited partnerships, the Internal Revenue Service proposed adjustments for the first and second partnership years. Determining that the contracts were shams, the Service disallowed all expenses reported in the first tax year, and disallowed the reported cost of goods sold in the second tax year. All income reported by the partnerships was left unadjusted.

The individual partners dispute that the transactions were shams. Separately, the tax matters partner also contests the determinations that the transactions were shams. In the alternative, should the determinations be sustained, the tax matters partner asks for removal of the recapture income reported by the partnerships.

<u>LAW AND ANALYSIS</u>

Under very limited circumstances, the mitigation provisions of the Code allow an adjustment to be made in an otherwise barred tax year. For mitigation to apply, all of the following conditions must be met:

> (1) An error must have occurred that 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 is described within the categories enumerated in section 1312;
>
> (4) the party who prevailed in the determination maintained a position that was inconsistent with the error or, in the case of determinations described in sections 1312(3)(B) and 1312(4), at the time the error was made there was no bar to its correction.

<u>See</u> <u>Fruit of the Loom, Inc. v. Commissioner</u>, 72 F.3d 1338, 1341-42 (7th Cir. 1996).

For purposes of this memorandum, we assume a court will decide that the business activities of the limited partnerships were shams and will disallow deductions claimed on account of these activities. Assuming further that the each of the decisions will constitute a "determination," within the meaning of section 1313(a), we must consider whether adjustments can be made under section 1312.

Not all taxpayer errors are correctable under section 1312. One type that is correctable involves the double inclusion of an item of gross income. Under section 1312(1), an adjustment to a barred year is authorized if a determination requires the inclusion in gross income of an item that was erroneously included in gross income for another tax year. Another correctable error is described in section 1312(4). Under that section, an adjustment to a barred year is authorized if a determination disallows a deduction that should have been allowed to, but was not allowed to, the taxpayer for another tax year.

Sections 1312(1) and 1312(4) describe the only circumstances under which adjustments might conceivably be authorized for the cases discussed in this memorandum. The language of neither section, however, suggests that an adjustment is authorized when a deduction is erroneously taken in one year and a corresponding item of gross income is erroneously reported in another. A correction is authorized only when an item is included twice in gross income or disallowed twice as a deduction, not when one error of each sort occurs.

Schwartz v. United States, 67 F.3d 838 (9th Cir. 1995), illustrates this limitation. In that case, the taxpayers in one year reported an ordinary loss resulting from an options straddle. In a later year, the taxpayers reported a related capital gain. After an unfavorable court decision, the taxpayers stipulated to a deficiency for the first year. By then, the later year was barred. Relying on the mitigation provisions, the taxpayers filed an administrative claim for a refund of the taxes paid on the reported capital gain. The Service denied the claim, and the taxpayers sued in district court.

After the district court granted summary judgment to the government, the taxpayers appealed to the United States Court of Appeals for the Ninth Circuit. The appellate court concluded that the loss claimed by the taxpayers was not an item included in gross income, but an item deducted from gross income to determine tax liability. As such, it did not authorize an adjustment under section 1312 for the income reported in the barred year. Accordingly, the appellate court ruled that the statute of limitations barred the taxpayers' refund action.

As in Schwartz, in the cases described in your request for field service advice, a determination that a deduction was improperly taken in one tax year will not authorize an adjustment under the mitigation provisions in another tax year. If the later year is closed, the reported income can not be "backed out."

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If you have further questions, please call.