OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
May 5, 1999

CC:DOM:FS:PROC
[redacted]TL-N-6019-98

UILC: 1311.00-00
Number: **199932014**
Release Date: 8/13/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Field Service Advice responds to your memorandum dated February 3, 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:

Taxpayer	=	
Period 1	=	
Period 2	=	
Period 3	=	
$K	=	$
Production	=	
Producers	=	
Produced	=	
Product	=	
$L	=	$
$M	=	$
$N	=	$
$O	=	$
Court	=	
Court Opinion	=	

$P	=	$
$Q	=	$
$R	=	$
$S	=	$
$T	=	$
$U	=	$
$V	=	$
$W	=	$
$X	=	$
$Y	=	$
$Z	=	$
Date A	=	
Date B	=	
Year C	=	
Date D	=	

ISSUE:

Whether the taxpayer's claim for a refund in the amount of $K for Period 3 is barred by the statute of limitations, or whether the mitigation provisions at I.R.C. §§ 1311 - 1314 apply to mitigate the effect of the statute of limitations and allow payment of a refund.

CONCLUSION:

The taxpayer's claim for a refund in the amount of $K for Period 3 is barred by the statute of limitations, but the mitigation provisions at I.R.C. §§ 1311 - 1314 may apply to mitigate the effect of the statute of limitations for the limited purpose of allowing the taxpayer to write off the deductions for production expenses which arose as a result of items produced in Period 2 and which were disallowed, but only to the extent that such production expenses are in proportion to installment payments received during Period 3.

FACTS:

The taxpayer, a production company, enters into contracts with producers whereby it pays royalties to the producers in exchange for the exclusive production and selling rights for the full term of the product's copyright in the United States. Prior to being examined by the Service, the taxpayer's practice was to deduct producers' royalties in full each year, instead of treating such royalties as part of cost of goods sold for purposes of computing gross profit on installment sales.

The taxpayer's returns for Period 1, Period 2 and Period 3 were examined by the Service. The revenue agent assigned to examine Period 1 recommended that the taxpayer include producers' royalties in cost of goods sold on an installment plan, and therefore write them off over the years by decreasing the percentage of the full sale price that is considered "gross profit" reportable over the years in proportion to the installment payments, instead of deducting the full amount of minimum royalty guarantees in Period 1. The taxpayer would then be entitled to deduct costs over the years it received installment payments, by decreasing the percentage of the full sales price that is considered gross profit reportable in a given year in proportion to the installment payments received that year. The taxpayer initially agreed to this adjustment, hereinafter referred to as "the deferred gross profit issue", and Period 1 was closed by the agent with an agreed total assessment for the 1977 year of $L.

The taxpayer later decided to contest the deferred gross profit issue by filing a Period 1 refund claim (followed by an amended refund claim) for $M. The Service tentatively determined that it would allow the taxpayer's refund claim with respect to the deferred gross profit issue, which would have resulted in a reduction in the taxpayer's taxable income by $N, and would have warranted the conclusion that the taxpayer overpaid income taxes for Period 1 in the amount of $M. Notwithstanding these facts, the IRS denied the taxpayer's claim for refund because it offset the disallowance of certain royalty expenses claimed by the taxpayer, a new issue. This disallowance increased the taxpayer's taxable income by $O.

The taxpayer then filed a refund suit contesting the denial of its refund claim relating to Period 1. Although the Service had administratively developed the deferred gross profits issue only as it pertained to producers' royalties, the government attorney who defended the case decided to further include other expenses as adjustments to costs of goods sold on an installment plan, and therefore defer the write off of such expenses in proportion to the installment payments received in subsequent years.

The court granted the government's motion for summary judgment, holding that the taxpayer was not entitled to deduct advance royalty payments made in Period 1 in full on its Period 1 tax return. Instead, the taxpayer's advance royalty payments were required to be capitalized and spread over the period up until which they were overtaken by earned royalties. Additionally, the court held that the taxpayer was required to similarly capitalize certain production expenses; and the taxpayer's royalty payments to producers had to be treated as part of cost of good sold on an installment plan. See Court Opinion. Although the court fully sustained the government's position for Period 1, the statute of limitations barred the Service from making an assessment in the amount of $P with respect to Period 1.

Prior to the issuance of the court's opinion, the revenue agent assigned to examine Periods 2 and 3 had prepared a report describing the proposed adjustments to tax. The report incorporated the same methodology as the Period 1 report with respect to the deferred gross profit issue. The issue of the inclusion of producers' royalties in cost of goods sold was initially agreed to by the taxpayer for Periods 2 and 3, and resulted in adjusting taxable income in the following amounts: 1) a decrease in taxable income in the amount of $Q for Period 2; and 2) an increase in taxable income in the amount of $R for Period 3.

At the time the revenue agent's report for Periods 2 and 3 was prepared, certain proposed adjustments regarding royalty expenses and commission income were not agreed to by the taxpayer. Accordingly, the case was sent to Appeals. Appeals did not settle these issues, but instead invited the taxpayer to file protective claims for refund with respect to Periods 2 and 3, as the statutes of limitation on these periods were soon to expire. The taxpayer filed protective claims for refund for each period, seeking refunds of $S and $T, respectively. Such protective claims related only to the royalty expense and commission income issues. The taxpayer filed no protective claims with respect to the issues of deferred gross profit or production expenses prior to the expiration of the statutes of limitation. The protective claims were filed 4 years prior to the court's opinion.

Insofar as the court upheld inclusion of production expenses as costs of goods sold, and the Service had not initially proposed these adjustments, the court decision resulted in further adjustments to the taxpayer's Period 2 and Period 3 returns, in addition to those set forth in the original revenue agent's report.

As noted above, the court ruled in the government's favor on, inter alia, the deferred gross profit issue. The taxpayer was not entitled to deduct certain expenses in full on its Period 1 return, but instead had to include such expenses as cost of goods sold on an installment plan and write them off ratably over the same tax periods in which the total sales price was allowed to be spread. Some of the expenses that the court determined had to be included in costs of goods sold, and could not be fully deducted immediately, had not been included as costs of goods sold in the original revenue agent's report. Therefore, based on the court's decision, the Service made additional adjustments to the taxpayer's Period 2 and Period 3 tax liability prior to execution of a Form 870.

The net adjustment to the tax return for Period 2 was a reduction of income of $U. The amount of the reduction was computed by taking the reduction of income proposed in the original revenue agent's report, i.e., a reduction of $Q, and adding to it an increase in income of $V based on the court's decision that certain other expenses could not be immediately deducted but instead had to be included in cost of goods sold on the installment plan method of reporting income. Therefore, some

deductions allowed in the original revenue agent's report for Period 2 were disallowed. Although the statute of limitations for assessment had expired with respect to Period 2, the Service was permitted to reduce the amount of the overpayment by making an adjustment offsetting the increase in tax against the amount of the overpayment. See Lewis v. Reynolds, 284 U.S. 281 (1932).

For Period 3, the taxpayer's gross profit would have been reduced from $R to negative $W, by the inclusion, as cost of goods sold, of production and royalty expenses. Although the original revenue agent's report adjusted gross profits to include producers' royalties as an adjustment to cost of goods sold, the court further included other production expenses in costs of goods sold. However, no negative adjustment to the taxpayer's gross profits for Period 3 was allowed, as such a negative adjustment would have resulted in an additional refund or credit, and the statute of limitations for claiming such a refund or credit had expired. The allowable refund was limited to the amounts resulting from the royalty expense, commission income, and carryback adjustments, because only those amounts were protected by the protective claim for refund filed with respect to Period 3. Thus, it was determined that the taxpayer would be allowed a refund for Period 3 in the amount of $X. The revenue agent's report includes a computation showing that the taxpayer overpaid its income taxes in Period 3 by $Y. However, only $X was allowed since it was determined that $Z was barred by the statute of limitations. This $Z is the amount the taxpayer seeks to recover under the mitigation provisions.

The Form 870 executed by the taxpayer covered several tax periods, including Periods 2 and 3. The form 870 included the following language:

> Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled... If you later file a claim and the Service disallows it, you may file suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court.

The Form 870 further included a typed notation which postponed the assessing of the deficiency until the overassessments were acted upon by the Joint Committee on Taxation. The Service advised the taxpayer that the Joint Committee took no exception to the deficiencies and overassessments determined for Periods 2 and 3, on Date A.

On Date B, the taxpayer requested a refund in the amount of $Z by filing a Form 1120X for Period 3 (hereinafter the "Year C claim"). The Year C claim alleges that the statute of limitations for Period 3 remains open because of the effect of the

mitigation provisions. The "Statement explaining adjustment to Income" attached to the Year Z claim states in pertinent part:

> With respect to Period 2, the taxpayer's overpayment of tax has been reduced by a timing adjustment (not originally proposed by the IRS) with respect to the deferred gross profit issue, but the taxpayer's overpayment of tax for Period 3 was not increased by the customary, correlative adjustment because the taxpayer's then extant claim for refund did not raise the deferred gross profit issue (because the correlative Period 3 adjustment followed from a Period 2 adjustment which had not originally been proposed by the IRS).

The taxpayer takes the position that the applicable "determination" (within the meaning of I.R.C. § 1313) was made on Date A when the Joint Committee took no exception to the Form 870 agreement between the Internal Revenue Service and the taxpayer. Apparently, the taxpayer is asserting that, because the amount of the refund allowed in the Form 870 for Period 2 is less than the amount of the overpayment determined for Period 2 in the original revenue agent's report, this payment of a "reduced refund" constitutes the final disposition of a claim for refund within the meaning of section 1313.

LAW AND ANALYSIS:

For the mitigation provisions to apply, certain conditions must be met. First, a determination, (as defined in I.R.C. § 1313(a)(1)-(4)), regarding the treatment of an item of income, a deduction or credit, or the basis of the property (an "item") for an open year must establish that the same item has been treated erroneously in another year. Second, the determination must fall within one of the circumstances of adjustment described in I.R.C. § 1312(1)-(7). Third, on the date of the determination, correction of the error in the closed year must be prevented or barred by some provision or rule of law; and finally, depending on which circumstance of adjustment applies, either an inconsistent position must be maintained by the party against whom mitigation will operate, (I.R.C. § 1311(b)(1)), or the correction of the error must not have been barred at the time the party for whom mitigation will operate first maintained its position. I.R.C. § 1311(b)(2). Assuming these conditions are met, the error may be corrected by attributing income or deductions to the correct year or taxpayer or by establishing the correct basis of property. If correction of the error results in a refund, the taxpayer may

obtain a refund by filing a claim for refund within one year from the date of the determination. Similarly, if the result is a deficiency, the Commissioner has one year to send a notice of deficiency.

Determination

The determination referred to in sections 1311 and 1312 is specifically defined in section 1313(a) to mean the following four types of actions:

1. A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction that has become final;
2. A closing agreement made under section 7121;
3. A final disposition by the Service of a claim for refund;
4. An agreement between the taxpayer and the Service in accordance with regulations prescribed by the Secretary.

The taxpayer contends that the Form 870 executed in this case constitutes a "determination" within the meaning of section 1312, because it is equivalent to a final disposition by the Service of a claim for refund. In our prior Field Service Advice memorandum, we advised that the determination requirement had not been met because, although the amount of the overpayment proposed in the original revenue agent's report was reduced by way of the Form 870 agreement, the taxpayer had never filed a claim for refund with respect to the deferred gross profit/production expense issue. As noted above, the taxpayer did file protective claims for refund in order to hold open the statute of limitations, but the protective claims related only to other issues, not the deferred gross profit and production expense issues. Thus, the statute of limitations for claiming a refund with respect to the deferred gross profit issue had expired.

The taxpayer is relying on the "double disallowance of a deduction" circumstance of adjustment at I.R.C. § 1312(4), which is discussed in more detail below. The taxpayer has correctly pointed out that, in order to establish applicability of the double disallowance of a deduction circumstance of adjustment, correction of the error by way of a claim for refund must not have been barred at the time the taxpayer first maintained in writing before the Service or the Tax Court that it was entitled to the deduction or credit in the year at issue in the determination proceeding. In the prior Field Service Advice memorandum, we determined that, insofar as the taxpayer's claim for refund with respect to Period 3 was filed on Date B, and the statute of limitations for claiming a refund had expired with respect to all items except those relating to the protective claims for refund, the correction of the error by way of a claim for refund was barred at the time the taxpayer first maintained in writing before the Service that it was entitled to the deduction or

credit in the year at issue in the determination proceeding. Thus, we concluded that the taxpayer failed to satisfy the determination requirement. In this regard, we reached the following conclusion:

> It is the Service's recomputation of the proposed adjustments to which the taxpayer now asserts that the mitigation provisions should apply. However, at the time the Service performed this recomputation, the period of limitations for filing a claim for refund had already expired. The taxpayer had not kept the limitations period open on the deferred gross profit issue by filing a claim for refund. Thus, where there has been no claim for refund, there can be no "final disposition of a claim for refund" within the meaning of the mitigation provisions.

The taxpayer now requests reconsideration of the prior Field Service Advice memorandum, asserting that the deduction for production expenses which the Service disallowed by way of the Form 870 agreement was originally claimed on its Period 2 tax return. This is a new fact which was not evident when we considered the original request for Field Service Advice. Neither the taxpayer nor the Appeals Officer assigned to this case is able to produce the Period 2 tax return and show precisely where this deduction was claimed on such return. Assuming that the deduction for production expenses was, in fact, claimed on the Period 2 tax return, the taxpayer would have established that correction of the error by way of a claim for refund was not barred at the time the taxpayer first maintained in writing before the Service that he was entitled to the deduction or credit.

Circumstances of Adjustment

To open a closed year under the mitigation provisions, the facts must fit one of the following circumstances of adjustment described in section 1312:

1. Double inclusion of item of gross income;
2. Double allowance of deduction or credit;
3. Double exclusion of item of gross income;
4. Double disallowance of deduction or credit;
5. Correlative deductions or inclusions for trusts or estates or for legatees, beneficiaries, or heirs;
6. Correlative deductions and credits for related corporations;
7. Basis of property after erroneous treatment of prior transaction.

The only "circumstance of adjustment" under I.R.C. § 1312 which is potentially applicable based on the facts of this case is the double disallowance of a deduction. The opening of a closed year is authorized where the result of a determination is a double disallowance of a deduction or credit. Such a double disallowance occurs where "[t]he determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer." I.R.C. § 1312(4). A double disallowance permits a deduction to be claimed in the correct year and permits a year otherwise closed to be opened for this purpose.

To establish an adjustment under this circumstance, the taxpayer must show that the following conditions exist:

- A deduction or credit was properly allowable for one year but was not allowed in that year.

- A determination resulted in the disallowance of the deduction or credit in another year.

- At the time the taxpayer first maintained in writing before the Service or before the Tax Court that he was entitled to the deduction or credit in the year at issue in the determination proceeding, the year the deduction or credit was properly allowable was open for the purposes of filing a refund claim.

- At the time of the determination, a claim for refund of tax paid for the year of proper deduction was barred.

In the instant case, it is true that some of the deductions that the Service initially conceded that the taxpayer was entitled to in the revenue agent's report for Period 2 (and that the taxpayer alleges were claimed on its Period 2 return), were ultimately disallowed in the Form 870 agreement executed by the parties. However, the reason for the disallowance of the deductions initially claimed in Period 2 was *not* that the deductions should properly have been claimed in Period 3. The reason for the disallowance was the court opinion wherein the court held that certain production costs incurred by the taxpayer may not be deducted in full immediately but, instead, must be treated as part of the "cost of goods sold" on an installment plan, and therefore deducted ratably over the same tax periods in which the total sales price is allowed to be spread. Thus, the deductions disallowed in Period 2 would not necessarily be allowable in Period 3 but, instead, would have to be included as cost of goods sold in corresponding fractions over the years in which installment payments continue to be received. Moreover, although the available deferral from Period 2 carries over to Period 3, the Period 2 deferral is

attributable to two factors, the disallowance of the deductions for producers' royalties claimed in Period 1 and the treatment of certain production expenses as costs of sales. Therefore, it appears that a significant component of the deferral is initiated in Period 1, not Period 2.

For Period 3, the amount of the overpayment which would have been refundable to the taxpayer was reduced based on the fact that the statute of limitations for payment of a refund had expired with respect to all issues except those for which the taxpayer had filed protective claims for refund. However, as stated above, the portion of the refund disallowed for Period 3 was not the same item for which a deduction was disallowed in Period 2. For the Period 3 tax year, the taxpayer's gross profit would have been reduced from $R to negative $W by the inclusion, as cost of goods sold, of production expenses. Although the original revenue agent's report adjusted gross profits to include producers' royalties as an adjustment to cost of goods sold, the district court further included direct expenses in cost of goods sold. Thus, the difference in the adjustment proposed in the revenue agent's report and the adjustment ultimately agreed to was attributable to the district court's decision that the taxpayer cannot deduct certain expenses currently but, instead, must include such expenses as costs of goods sold and defer the write off of such expenses in proportion to the installment payments received each year. Therefore, some of the expenses which the taxpayer would have been allowed to write off in Period 3 are likely attributable to production expenses incurred in Periods 1, 2 and 3.

It is our understanding that the taxpayer's production contracts are typically for several years in duration, as they generally grant the taxpayer exclusive production and selling rights and the right to sub-license such rights for the full term of the copyright in the United States. See Court Opinion. Thus, it is unlikely that all of the deductions disallowed in Period 2 would be allowable as deductions in Period 3, as such deductions must be written off over a period of several years in proportion to installment payments received each year.

Based on the foregoing, we conclude that the only deductions to which the mitigation provisions can properly be applied in this case are the deductions disallowed for Period 2 which are attributable to production expenses incurred during that tax year, and which would have been deductible during Period 3 to the extent that such expenses are proportionate to the installment payments received during Period 3. By way of illustration, we offer the following example. Suppose the taxpayer entered into ten production contracts in year 2, each with a duration of ten years. In the first year of the contract, the taxpayer deducts all expenses for minimum royalties guarantees, production expenses, etc., amounting to $500,000. The Service disallows $400,000 of the deductions, based on the conclusion that the only expenses deductible in year 2 are those which are in proportion to the

installment payments received in year 2. The remaining $400,000 would have to be deducted over the entire ten year period of the contracts in proportion to the installment payments received in each succeeding year. Thus, the taxpayer would not be entitled to deduct in year 2 the entire $400,000 which was disallowed in year 1. Instead, the taxpayer would deduct in year 2 only those expenses which are in proportion to the installment payments actually received in year 2.

Moreover, we think it is imperative to ensure that the taxpayer in this case is not permitted to use the mitigation provisions to claim deductions for production expenses in Period 3 which are attributable to contracts entered into in Period 1. As noted above, the taxpayer's practice prior to examination by the Service was to deduct all production expenses immediately. Although the government argued successfully in court that such expenses had to be deducted pro rata over all the years during which the taxpayer received installment payments on its production contracts, the Service was precluded from making further assessments with respect to Period 1. Therefore, the taxpayer has already received the benefit of all deductions to which it is entitled for production expenses incurred in Year 1. For this reason, the taxpayer should not be allowed to attempt to use the mitigation provisions to claim any further deductions for Year 3 which are attributable to production expenses arising in Year 1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As noted above, the taxpayer asserts that the deduction for production expenses which the Service disallowed by way of the Form 870 agreement was originally claimed on its Period 2 tax return. If the deduction was claimed on the Period 2 tax return, and was not disallowed by the Service until execution of the Form 870, we agree with the taxpayer that this would be equivalent to the final disposition of a claim for refund within the meaning of section 1313(a). In this regard, we note that section 1313(a) includes "items applied by the Secretary in reduction of the refund or credit" within the description of final disposition of a claim for refund.

Treas. Reg. § 1.1313(a)-3 provides guidance on when a determination constitutes a "final disposition of a claim for refund" within the meaning of I.R.C. § 1313(a)(3). Pursuant to Treas. Reg. § 1.1313(a)-3(c), the disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 6532 for instituting

suit on the claim for refund, unless the suit is instituted prior to the expiration of such period. Under these circumstances, the taxpayer has one year from the date the determination became final to file a claim for refund.

Prior to allowing any refund under the mitigation provisions in this case, the administrative record should be checked carefully to verify that correction of the error by way of the taxpayer filing a claim for refund with respect to Period 3 was barred by the statute of limitations on the date of the determination. Generally, the taxpayer has within 3 years from the time the return was filed or 2 year from the time the tax was paid to claim a credit or refund. I.R.C. § 6511(a). You have represented that, at the time the Form 870 was executed, the statute of limitations had expired with respect to all items except those for which protective claims for refund had been filed. We suggest that this information be verified by checking the transcripts of account to determine precisely when the return for Period 3 was filed and when the taxes were paid. If correction of the error was not barred on the date of the determination, the mitigation provisions would not be applicable.

In the instant case, the Form 870 was executed on February 10, 1992, and approved by the Joint Committee on Taxation on Date A. The taxpayer did not institute a refund suit prior to expiration of the time allowed by section 6532 for instituting such a suit. Thus, the taxpayer had two years from the date of the determination within which to institute a refund suit, and an additional year after that to file a claim for refund under the mitigation provisions. Insofar as the taxpayer filed a claim for refund on Date B, the taxpayer has timely asserted entitlement to the benefit of the mitigation provisions.

We note that there is some authority for the proposition that adjustments to cost of goods sold, such as the adjustments made in the instant case, do not constitute deductions within the meaning of section 1312. B.C. Cook & Sons, Inc. v. Commissioner, 65 T.C. 422 (1975), aff'd. 584 F.2d 53 (5th Cir. 1978). In B.C. Cook & Sons, the Tax Court noted that, "...there is a crucial distinction between the treatment of either basis or cost of goods sold and deductible expenses. Both basis and cost of goods sold are offsets employed in the computation of gross income...itemized deductions, on the other hand, are subtracted from gross income in arriving at taxable income." Thus, the Court concluded that Congress did not intend the mitigation provisions to apply to reductions to gross income. B.C. Cook & Sons, 65 T.C. at 430-432.

In the instant case, the adjustments to which the taxpayer asserts that the mitigation provisions apply are adjustments to cost of goods sold. However, the Service issued an action on decision indicating nonacquiescence with the Tax Court's decision in B.C. Cook & Sons. A.O.D. 1977-77 (April 4, 1977). In the action on decision, the Service stated that, "[t]he decision of the Tax Court applies an

overly-literal interpretation of the word 'deduction' as used in Code § 1312(2). The term "deduction" in Code § 1312(2) should be interpreted to refer to items which reduce gross income whether included in the cost of goods sold or deducted from gross income in the technical sense." Moreover, the Service noted that the approach taken by the Tax Court in B.C. Cook & Sons conflicts with a number of decisions of the Court of Claims and the Courts of Appeals. See e.g., Gooch Milling & Elevator Co. v. United States, 312 F.2d 376 (5th Cir. 1962); Olin Matheson Chem. Corp. v. United States, 265 F.2d 293 (7th Cir. 1959). Moreover, in Rev. Rul. 58-327, 1958-1 C.B. 316 and Rev. Rul. 68-152, 1968-1 C.B. 369, the Service agreed to follow Gooch Milling & Elevator Co. and Olin Matheson Chem. Corp., respectively. Accordingly, the Service may not attempt to assert that adjustments to cost of goods sold, such as the adjustments made in the instant case, do not constitute deductions for purposes of application of the mitigation provisions.

If you have any further questions, please call.

By: _____
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