OFFICE OF
CHIEF COUNSEL

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) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated June 22, 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 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

ISSUE:

Whether the Internal Revenue Service through the mitigation provisions may correct a supposedly erroneous assessment against the taxpayer.

CONCLUSION:

The Service can not fashion a remedy based upon the mitigation provisions.

FACTS:

X is the parent company of a number of banks that filed consolidated returns. For tax purposes, the affiliated banks use the accrual method of accounting.

Historically, X had claimed as ordinary expenses and deducted on its returns certain loan origination costs referred to as “prepaid finders’ fees.” These fees were payments made by an affiliated bank to automobile, boat, and other dealers for referring customers.

The Service audited X’s returns for Years 1 and 2. During the course of the audit, the Service did not raise loan origination costs as an issue, even though X had deducted these costs. On Date 1, after the close of the audit cycle for Years 1 and 2, X submitted to the National Office Forms 3115, “Application for Change in

Accounting Method," proposing to change from deducting loan origination costs when incurred to capitalizing them over time. At the same time, X sent Forms 3115 to the local District Director, proposing to change its accounting for loan origination costs for Year 6 and subsequent years.

In Date 2, the National Office returned the Forms 3115 that had been submitted to it, informing X that in accordance with Announcement 93-60, 1993-16 I.R.B. 9, the Service was temporarily suspending its rulings on requests by taxpayers to change their method of accounting for loan origination costs. On Date 3, the Service, aware that X had submitted Forms 3115, began an examination of X's returns for Years 3, 4, and 5. For those years, X had deducted prepaid finders fees in the following amounts: Year 3, Amount 1; Year 4, Amount 2; and Year 5, Amount 3. The Service determined that the prepaid finders fees were capital expenditures, which should not have been treated as ordinary expenses. The Service accordingly proposed, and the taxpayer agreed, to capitalize the costs and amortize them over a five-year period. For Year 3, the Service assessed and collected a deficiency of Amount 4; for Year 4, a deficiency of Amount 5; and for Year 5, a deficiency of Amount 6. These amounts were paid on Date 4. The amounts assessed and paid reflect adjustments in addition to those that are the subject of this memorandum.

In Date 5, X claimed that it had audit protection from the finders fee issue for Years 3, 4, and 5, and asserted that the adjustments for those periods should never have been made. X has now filed refund claims for those years. However, the period of limitations for refund claims for Years 3, 4, and 5 has run, except to the extent payments were made on Date 4. Again, with the exception of these recent payments, the period of limitations for making assessments for Years 3, 4, and 5 has run as well. If it assumed that X is correct in asserting that the adjustments for Years 3, 4, and 5 were improper, X is barred from receiving a refund for Year 4, and the Service is barred from asserting and collecting a deficiency for Year 5.

Your office accepts X's argument that the adjustments proposed by the Service and agreed to by X were improper and has proposed correcting the error as follows. First, X will file refund claims for Years 3 and 4, claiming that it was entitled to take ordinary expense deductions for those years. To the extent the periods of limitations remain open, the Service will allow the claims, taking into account the amount of the finders fee deductions previously amortized. Second, the Service, under the authority of the mitigation provisions, I.R.C. § 1311 – 1314, will make an adjustment for Year 5 corresponding to the allowed refund claims for Years 3 and 4. Third, X will pay the resulting deficiency for Year 5 and then file a refund claim. This will trigger the Service's right to apply a setoff, and result in a collectible deficiency in the amount now barred. Fourth and finally, X, in claims for refund for Years 6, 7, and 8, will claim the amortization deductions attributable to the finders fees capitalized in Year 4. The Service will deny the claims on the basis these costs should have been treated as ordinary expenses and deducted in Year 4. You assert that this will open Year 4 to the extent that it is now barred.[1]

LAW AND ANALYSIS

In limited circumstances, the mitigation provisions allow an adjustment to be made in a barred year. These provisions are intended

> to provide a fair and workable formula under which taxpayers and the Government would be given relief from the unfair and unjust results occasioned by corrections, by final determinations of errors of either the taxpayer or the Commissioner of Internal Revenue, or both, in connection with proper treatment of items affecting taxable income and tax liability in more than one year.

Gooch Milling & Elevator Co. v. United States, 78 F.Supp. 94, 97 (Ct. Cl. 1948). The mitigation provisions, however, are not intended to correct all inequities occasioned by the statute of limitations. United States v. Rushlight, 291 F.2d 508, 514 (9th Cir. 1961). Accordingly, if the bar of the statute of limitations is to be lifted in this case, the "fair and workable formula" of the statute must be followed.

One limitation on mitigation is stated in I.R.C. § 1311(b)(2)(B). This section of the Internal Revenue Code limits the errors described in I.R.C. § 1312(4) that can be corrected. Only those errors for which an adjustment is not barred at the time the taxpayer first maintained that it was entitled to a deduction or credit for the tax year to which a determination under I.R.C. § 1313(a) (such as the final disposition of a claim for refund) relates can be corrected under I.R.C. § 1311(b)(2)(B).

Turning to the facts of this case, specifically, to the fourth part of your proposal, X has yet to claim a refund for Years 6, 7, and 8, so at this time there is no determination for those years. If X claims a refund for amortization deductions in Years 6, 7, and 8, and the Service rejects X's claims, there will be a determination for those years, a determination that, for the sake of discussion, we will presume is described in I.R.C. § 1312(4). As we have noted, correction of the error described in that Code section is permissible if, and only if, the limitation stated in I.R.C. § 1311(b)(2)(B) is satisfied. That limitation cannot be satisfied here, because Year 4, the year in which the supposed error was made, is now barred, and no claim has been made for Years 6, 7, and 8. In other words, I.R.C. § 1311(b)(2)(B) prevents the Service from refunding a barred but otherwise allowable deduction for Year 4.

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[1] We understand that, by this, you do not mean the correct tax treatment of the finders fees is ordinary; rather, because of Announcement 93-60, X's treatment should not have been altered.

It is thus not possible to unravel completely the adjustments proposed and agreed to for Year 4. The mitigation provisions, which make the statute of limitations somewhat pliable, cannot do so for Year 4. We will not separately consider the effect of the mitigation provisions on Years 3 and 5, because your office has proposed an integrated solution for Years 3, 4, and 5, not a partial solution for some but not all of those years.

[redacted]

If you have further questions, please call.