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

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service)

SUBJECT: Request for Assistance

This Field Service Advice responds to your memorandum dated April 6, 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 =

Year00 =
Year 01 =
Year02 =
Year03 =

Date01 =
Date02 =
Location01 =
Industry01 =

Court01 =
Court02 =

Decision01 =

Decision02 =

Decision03 =

Case01 =

Method01 =

Amount01 =
Amount02 =

ISSUE(S):

1. X has a suit pending in the Court02 claiming a refund for the taxable year Year02. Should the government's counterclaim in the refund suit be increased?

2. Under I.R.C. § 6411, a tentative refund of $Amount01 for Year02 was allowed based on X's Form 1139. Examination determined that $Amount02 of this refund should not be allowed. Can the IRS directly assess the $Amount02 without using the normal deficiency procedures?

3. In its Form 1139, X claimed that it was entitled to use Method01 in computing its income and claimed entitlement to an alternative minimum tax credit. The AMT credit claimed on the Form 1139 related to the use of Method01 on X's Year01 return. Is X liable for the accuracy-related penalty attributable to negligence?

4. If the negligence penalty is imposed, may this penalty be assessed without using the normal deficiency procedures?

CONCLUSIONS:

1. After the amount erroneously refunded as a result of the Form 1139 is directly assessed, the government should file a counterclaim in the refund suit to recover it.

2. The amount erroneously refunded pursuant to the Form 1139 should be directly assessed

.

3. We do not recommend the imposition of the accuracy-related penalty attributable to negligence in this case.

4. This issue is moot, because we do not recommend imposing the negligence penalty.

FACTS:

X is an Industry01 company located in Location01. During the Year00 taxable year, X used Method01 when calculating its taxable income.[1] The Service determined a deficiency for Year00 based, in part, on X's use of Method01. X paid the deficiency and sued for a refund. The district court found in favor of X, Decision01, and the Service appealed. Court01 reversed, holding that a taxpayer could not use Method01 in computing its taxable income, Decision02. On Date01, the Supreme Court denied certiorari. Decision03.

On Date02, after the Supreme Court had denied certiorari in Decision03, X filed a Form 1139, Corporate Application for Tentative Refund, claiming an $Amount01 refund for Year02, resulting from carrying back a Year03 capital loss. The loss resulted, in part, from X's use of Method01 for the Year03 taxable year. A portion of the Year03 loss also resulted from the use of AMT credits that were available as a result of X's use of Method01 when computing its Year01 taxable income. The tentative refund for Year02 was paid. X currently has a suit pending in Court02 with respect to its liability in Year02

After examining the Form 1139, the Examination Division determined that $Amount02 of the refund claimed for Year02 should not be allowed. This amount was the portion of the $Amount01 refund attributable to the use of Method01 and the AMT credit.

LAW AND ANALYSIS

Issue 1

Section 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for a prior year affected by a capital loss carryback on or after the date of filing for the return for the taxable year of the loss. Among other things, the application is required to set forth the amount of the loss and the amount of the tax previously determined for the taxable year affected by the carryback. The amount of tax previously determined is ascertained in accordance with the method prescribed in section 1314(a).

Section 1314(a) provides that the amount of tax previously determined shall be the excess of the sum of the amount shown as the tax by the taxpayer on his return,

[1] The mechanics of Method01 and its impact on taxable income do not impact the issues in this advice. Method01 and its calculation are set forth in Decision02.

plus the amounts previously assessed as a deficiency or collected without assessment, over the amount of any rebates.

Sections 6411(b) provides that the tentative refund sought must be refunded within ninety days if the return is free of computational errors or material omissions.

Section 7405(b) provides that any tax that is erroneously refunded can be recovered by means of a civil action brought by the United States.

Section 6213(b)(3) provides that any amounts refunded under section 6411 that is greater than the amount properly attributable to the carryback, may be assessed without deficiency procedures as a mathematical or clerical error.

Section 6212 provides the procedures for determining deficiencies with respect to income taxes.

In general, there are three procedures for recovering amounts refunded with respect to carrybacks, if the Service finds that the refund was erroneous. Fine v. Commissioner, 70 T.C. 684, 687-8 (1978) lists the remedies as follows: 1) a suit for erroneous refund, when the refund was actually made, I.R.C. §§ 7405; 6532(b); 2) an assessment as a mathematical error of a deficiency for the year to which the tentative carryback adjustments was applied, I.R.C. § 6213(b); and 3) an assessment pursuant to a notice of deficiency issued under section 6212 of any deficiency for the year to which the tentative carryback adjustment was applied. Since X is already in litigation in Court02 with respect to the taxable Year02, if a court of competent jurisdiction renders a decision with respect to a taxable year, that decision is res judicata to any further claims by the Service with respect to that year. Bradley v. United States, 96-1 U.S.T.C. ¶ 50,195 (D.C. Minn.), aff'd without opinion, 97-1 ¶ U.S.T.C. 50,164 (1997), see also Hartzog v. United States, 6 Cl.Ct. 835 (1984); Sun Chemical Corp. v. United States, 218 Cl.Ct. 702 (1978). Thus, in cases where the taxable year at issue is already in litigation, whichever option the Service pursues, it must be done before the court's decision is final.

Here, X is already in litigation in Court02 with respect to the Year02 taxable year. You have suggested that the Department of Justice ("DOJ") file a counterclaim in the pending action. This is a viable method for recovering the refund. In the these circumstances, we recommend first making an assessment for the year in suit pursuant to I.R.C. § 6213(b) prior to recommending to DOJ that an amended counterclaim be filed. See CCDM (35)(18)57.

Issue 2.

As discussed above, another method for recovering an erroneous refund issued under I.R.C. § 6411 is by making a direct assessment as a mathematical error

under I.R.C. § 6213(b)(3). This method does not require the issuance of a notice of deficiency. After the deficiency is assessed, a transcript of account should be secured, and an amended counterclaim should be made in the pending refund suit. See CCDM (35)(18)57. Failure to amend the counterclaim will bar the government from making the adjustment after a final court decision by virtue of the doctrine of res judicata. See Bradley; Hartzog; Sun Chemical.

Issue 3.

Section 6662(a) imposes an accuracy-related penalty in the amount of 20 percent of the portion of an underpayment attributable to negligence or disregard of rules and regulations, or to any substantial understatement of income tax liability. I.R.C. §§ 6662(a), 6662(b)(1), and 6662(b)(2).

For purposes of determining whether there is a substantial understatement of income tax liability, section 6662(d)(2)(B) provides that the amount of the understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item if: 1. there was substantial authority for such treatment; or 2) the relevant facts affecting the item's tax treatment were adequately disclosed in the return or in a statement attached to the return, and there was reasonable basis for the tax treatment of such item.

Treas. Reg. § 1.6662-2(d)(2) provides that, except for limited circumstances that do not exist in this case, the provisions of sections 1.6662-1 through 1.6662-4 and 1.6662-7 apply to returns the due date of which is after December 31, 1993.

Treas. Reg. § 1.6662-3(d)(1) provides special rules for application of the negligence penalty in the case of carrybacks and carryovers. In such cases, the penalty applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, which portion is attributable to negligence or disregard of rules and regulations in the loss or credit year.

Treas. Reg. § 1.6662-4(c)(1) provides special rules for application of the substantial understatement of income tax penalty in the case of carrybacks and carryovers. In such cases, the penalty applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, that is attributable to a tainted item for the loss or credit year. A tainted item is any item for which there is neither substantial authority nor adequate disclosure with respect to the loss or credit year. Treas. Reg. § 1.6662-4(c)(3).

Negligence or fraud in a loss year may be carried through to the carryover year where the loss is generated by the negligent or fraudulent acts of the taxpayer. ARC Elect. Const. Co. v. Commissioner, 923 F.2d 1005 (2d Cir. 1991); Schwartz v. Commissioner, T.C. Memo. 1994-320; Toussaint v.Commissioner, T.C. Memo.

1984-25. Further, a taxpayer is liable for the accuracy-related penalty where they unreasonably persists in pursuing a rejected position on a subsequent return. Green v. Commissioner, T.C. Memo. 1998-274; Milkowski v. Commissioner, T.C. Memo. 1983-406; Hay v. Commissioner, T.C. Memo. 1979-334. However, unlike the instant case, the cases cited above have the common characteristic of the taxpayer taking the position giving rise to the imposition of the penalty either in the loss year, or on the subsequent return. It is not clear that an original return can be tainted by a subsequently filed return or other document that is not founded on a prohibited position.

In the instant case, the loss year is Year03. Consequently, under Treas. Regs. §§ 1.6662-3(d)(1) and 1.6662-4(c)(1), X's liability for the accuracy-related penalty should be determined with reference to positions taken in Year03. However, in this case X's entitlement to the capital loss in Year03 is apparently not in dispute. Thus, X's position with respect to the loss does not give rise to the penalty. Further, it does not appear that the amount of loss carried back to Year02 was affected by X's position on the issue. In other words, only the calculation of the amount of the refund to which X was entitled was affected by the issue and this only because X did not change a position already taken on the original and amended returns for Year02.

Issue 4.

Because we do not recommend imposing the negligence penalty in this case, the issue need not be resolved.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We do not believe these facts present a strong case for imposition of the accuracy-related penalty. In drawing this conclusion we consider the original returns and related supplemental documents together. Friedman v. Commissioner, 97 T.C. 606 (1991); Rose v. Commissioner, 24 T.C. 755 (1955); White v. Commissioner, T.C. Memo. 1991-552.[2] In addition, we consider the fact that a subsequently filed modification to a return does not nullify the original return. Badaracco v. Commissioner, 464 U.S. 386 (1984).

[2]For example, in the absence of specific authority to the contrary, the determination of whether a taxpayer has adequately disclosed the tax treatment on the return for purposes of section 6662(d)(2)(B) should take into account statements made on or attached to both the original return and any related supplemental documents.

As a preliminary matter, we believe X was in technical compliance with section 6411 in filing the claim for tentative refund, at least with respect to the calculations for Year02 that reflected positions taken on the original return. Sections 6411 and 1314 require a taxpayer to state the amount previously shown as the tax on the return for the carryback year plus any amounts previously assessed or collected without assessment minus the amount of any rebates. The provisions do not expressly require any further adjustments. Thus, X's statement of the amount shown as tax on the return for the carryback year, reflecting the shown in the original Year02 return, is sufficient to meet the requirements of sections 6411 and 1314 and should not give rise to the imposition of the accuracy-related penalty.

It is also significant that the gist of X's claim for tentative refund was the claim for the capital loss carryback. The other items appearing on the claim were part of the original or amended returns and did not give rise to the imposition of the accuracy-related penalty when originally claimed. Further, we consider the fact that X would have been under no obligation to change its position with respect to Method01 in Year02 had it not filed a claim for refund. Thus, but for the fortuitous generation of a capital loss, there would be no question that X was entitled to persist in Method01 and related items in the Year02 taxable year until the matter was resolved through an administrative or court proceeding. We are reluctant to impose a duty on X to change its position under these circumstances. Further, we are concerned with the possible perception that X is being penalized for exercising its right to claim a refund.

Of additional concern is the fact that X was undoubtedly fully aware of the ongoing proceeding in the Case01 case. Case01 was not resolved at the time X filed its claim. We are aware that Industry01 was attempting to generate a conflict in authority in hopes of getting a favorable decision from the Supreme Court on the - issue. If the issue had been resolved in the taxpayer's favor in Case01, X would have received favorable adjustments in any open year. We do not feel it appropriate to penalize a taxpayer for attempting to keep its options open by maintaining a position that was still legitimately in dispute.

In sum, we are not persuaded that any portion of the underpayment of tax resulting from the tentative claim for refund is attributable to negligence or disregard of rules and regulations, or to a tainted item in Year03. Accordingly, we do not recommend assertion of the accuracy-related penalty with respect to the underpayment resulting from X's claim for tentative refund for the Year02 year.

If you have any further questions, please call the branch telephone number.