**INTERNAL REVENUE SERVICE**
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Date: June 14, 2000

Number: **200041005**
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CASE MIS No.: TAM-103222-00/CC:INTL:Br3

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:
Date of Conferences:

LEGEND:

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 7 =

ISSUES:

1) Whether the doctrine of election applies to prevent Taxpayer from amending its Year 1, 2, and 3 federal income tax returns to elect retroactively the fair market value method of apportioning interest expense under section 1.861-9T(g)(1)(ii).

2) In the event the doctrine of election prevents Taxpayer from amending its Year 1, 2, and 3 returns to elect retroactively the fair market value method, whether the Service should apply this technical advice memorandum without retroactive effect, pursuant to section 7805(b) of the Internal Revenue Code.

3) In the event the doctrine of election prevents Taxpayer from amending its Year 1, 2, and 3 returns to elect retroactively the fair market value method, and if relief under section 7805(b) is inappropriate, whether principles of equity nonetheless require that Taxpayer be allowed to amend its Year 1, 2, and 3 returns to elect retroactively the fair market value method of apportioning interest expense.

CONCLUSIONS:

1) The doctrine of election applies to prevent Taxpayer from amending its Year 1, 2,

and 3 returns to elect retroactively the fair market value method of apportioning interest expense under section 1.861-9T(g)(1)(ii).

2) Section 7805(b) relief is inappropriate in this case and, as a result, Taxpayer's request to apply this technical advice memorandum without retroactive effect is denied.

3) The principles of equity applicable to the current matter are embedded in the doctrine of election, the exceptions to the doctrine of election, and section 7805(b). Accordingly, equitable principles do not entitle Taxpayer to relief on any other basis.

FACTS:

On its timely filed federal income tax returns for Year 1, 2, and 3, Taxpayer elected to value its assets on the basis of the tax book value method for purposes of apportioning interest expense under section 1.861-9T. Taxpayer indicated such election by attaching a written statement to its return, signed by its General Tax Counsel. In Year 7, Taxpayer submitted an informal claim for refund, claiming additional foreign tax credits for Year 1, 2, and 3. Underlying Taxpayer's refund claim is a recomputation of its section 904 limitations for Year 1, 2, and 3, based on a reapportionment of its interest expense which, in turn, is based on a retroactive valuation of its assets according to the fair market value method.

LAW AND ANALYSIS:

<u>Issue (1): The Doctrine of Election</u>
Section 901 allows a credit for foreign income, war profits, and excess profits taxes paid or deemed paid by qualifying taxpayers that elect the foreign tax credit in lieu of a deduction under section 164(a)(3). Section 904(a) limits a taxpayer's foreign tax credit to an amount equal to the precredit U.S. tax on the taxpayer's foreign source taxable income.

Sections 861(b), 862(b), and 863(a) provide that taxable income attributable to gross income from domestic or foreign sources shall be determined by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses and other deductions that cannot be definitely allocated to some item or class of gross income. Treasury Regulation sections 1.861-8 through 1.861-17 provide specific guidance regarding the allocation and apportionment of deductions. Generally stated, deductions are allocated to classes of gross income and, as required by the operative section of the Code, apportioned between statutory and residual groupings of gross income.

In the case of interest expense, section 864(e)(2) provides that all allocations and apportionments must be made on the basis of assets. Under the asset method, interest expense is apportioned between statutory and residual groupings of gross income (or among statutory groupings) in proportion to the average total values of the assets within each such grouping for the taxable year. Treas. Reg. § 1.861-9T(g)(1)(i).

Taxpayers may elect to value their assets based on the tax book value or fair market value. Treas. Reg. § 1.861-9T(g)(1)(ii). Once a taxpayer elects to use the fair market value method, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods. Treas. Reg. § 1.861-8T(c)(2).

Thus, the section 861 regulations address prospective elections; that is, section 1.861-8T(c)(2) describes the extent to which a past year's election affects a subsequent election made on a timely filed return. The section 861 regulations do not, however, address the permissibility of retroactive elections, affecting past years. That section 1.861-8T(c)(2) requires taxpayer to "continue" using the fair market value method indicates that its rules apply on a going forward basis.

Set against this regulatory background, the judicial doctrine of election is appropriately considered. The doctrine of election generally binds a person to its initial choice, where the person had an equal right to choose one or more alternatives or inconsistent rights. J. Mertens, *Law of Federal Income Taxation* § 60.27 (1989). "[A] viable, healthy doctrine applicable to elections made under the tax laws," the doctrine of election has enjoyed widespread application. Grynberg v. Commissioner, 83 T.C. 255, 261 (1984).

The doctrine of election as it applies to federal tax law consists of two elements: (1) There must be a free choice between two or more alternatives; and (2) there must be an overt act by the taxpayer communicating the choice to the Commissioner, i.e., a manifestation of the choice. See Grynberg, 83 T.C. at 261. See also Bayley v. Commissioner, 35 T.C. 288, 298 (1960), acq., 1961-2 C.B. 4; Burke & Herbert Bank & Trust Co. v. Commissioner, 10 T.C. 1007, 1009 (1948). Pursuant to the doctrine of election, a taxpayer that makes a conscious election under the tax laws may not, without the consent of the Commissioner, revoke or amend its election merely because events do not unfold as planned. See, e.g., J.E. Riley Inv. Co. v. Commissioner, 311 U.S. 55 (1940); Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938).

Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938), is "often regarded as the fundamental authority for the development" of the doctrine of election. Estate of Stamos v. Commissioner, 55 T.C. 468, 473 (1970). In Pacific National, the taxpayer had the option to treat certain income under the deferred payment or installment method. The taxpayer reported the income using one method and later sought a refund based on a computation under the other method. Among the reasons articulated by the Supreme Court for its refusal to allow the taxpayer's change from one method to the other is that such changes would impose burdensome uncertainties upon the administration of the revenue laws and would require recomputation and readjustment of tax liability for subsequent years. Id. at 194. Pacific National established the general rule that a taxpayer that elects a proper method on a return may not later revoke or change that election and substitute another method.

The doctrine of election has been applied in a widespread manner under a variety of Code provisions. In Grynberg, the Tax Court applied the doctrine of election to prohibit taxpayer from changing its method of calculating its charitable contribution deduction to another permissible method. See also, e.g., Rose v. Grant, 39 F.2d 340 (5th Cir. 1930) (husband and wife prohibited from filing separate returns after making valid election to file joint returns); Burke & Herbert Bank & Trust Co., 10 T.C. 1007 (1948) (taxpayer prohibited from changing election to include tax-free interest in excess profits tax net income upon realization that election was disadvantageous once Commissioner determined that taxpayer erroneously omitted certain tax-free interest.)

Courts have articulated several rationales supporting the general principle that elections are considered binding. These rationales include: (1) preventing administrative burdens and inconvenience in administering the tax laws, particularly when the new method chosen requires a recalculation of tax liability for several taxable years or for other taxpayers; (2) protecting against loss of revenues by preventing taxpayers from using the benefit of hindsight to choose the most advantageous method of reporting; (3) promoting consistent accounting practice (i.e., foreclosing adjustments based on hindsight), thereby securing uniformity in the collection of revenue; and (4) providing an equitable and fair tax system by treating similarly situated taxpayers consistently. J.E. Riley Inv. Co. v. Commissioner, 311 U.S. at 59; Pacific Nat'l Co. v. Welch, 304 U.S. at 194; Mamula v. Commissioner, 346 F.2d 1016, 1018-19 (9th Cir. 1965); Barber v. Commissioner, 64 T.C. 314 (1975); Thorrez v. Commissioner, 31 T.C. 655, 668 (1958), affd. per curiam 272 F.2d 945 (6th Cir. 1959); Pacific Vegetable Oil Corp. v. Commissioner, 26 T.C. 1, 16 (1956), revd. on another issue 251 F.2d 682 (9th Cir. 1957); Estate of Curtis v. Commissioner, 36 B.T.A. 899, 906-07 (1937). While these points support application of the doctrine of election, they are properly construed as underlying explanations of the doctrine, and not required elements for its application. Accordingly, the absence of one or more of these considerations in a particular case does not render the doctrine of election inapplicable.

Taxpayer's attempt to change retroactively its method of apportioning interest expense thus satisfies the elements of the doctrine of election. Taxpayer had a choice between apportioning its interest expense on the tax book value or the fair market value, and it affirmatively elected the tax book value method for its taxable years Year 1, 2, and 3. Taxpayer communicated its election by attaching a written statement to its timely filed returns for those years.

A number of exceptions to the doctrine of election have been recognized and may permit taxpayers to change affirmative elections made on their federal tax returns: (1) The amended return was filed prior to the date prescribed for filing the original return; (2) the taxpayer's treatment of the contested item in the amended return was not inconsistent with his treatment of that item in his original return; or (3) the taxpayer's treatment of the item in the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return. See Grynberg, 83 T.C. at 262; Goldstone v. Commissioner, 65 T.C. 113, 116 (1975).

Taxpayer's facts do not fall within any of these exceptions to the doctrine of election. Taxpayer did not submit its claim for refund until Year 7, after the due dates for its Year 1, 2, and 3 returns. Taxpayer's attempt to utilize the fair market value method was inconsistent with its prior use of the tax book value method. Finally, Taxpayer properly elected the tax book method on its original Year 1, 2, and 3 returns.

Some courts have discussed further exceptions to the doctrine of election for certain taxpayer "mistakes." See, e.g., Grynberg, 83 T.C. at 261; Shull v. Commissioner, 30 T.C. 821, 828 (1958). While the scope and application of these exceptions in the context of the doctrine of election is far from clear, it is apparent that taxpayers cannot retroactively revoke an election on the sole basis that they later realize, through hindsight, that an elected choice failed to maximize their tax benefits. Such a "mistake" exception would virtually swallow the doctrine of election and thereby contradict the well-established principle that an exception to a rule cannot be construed so broadly as to render the rule meaningless. See, e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 594 (1997); Digital Equipment Corp. v. Desktop Direct, 511 U.S. 863, 868 (1994); Guidry v. Sheet Metal Workers Nat'l Pension Fund, 493 U.S. 365, 377 (1990). Thus, Taxpayer's failure to ascertain the fair market value of its assets for purposes of electing the fair market value method on its original return cannot be considered a "mistake" that entitles it to revoke its original tax book value method election. As the Tax Court observed, "Oversight, poor judgment, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences for making the election, miscalculation, and unexpected subsequent events have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the Code." Grynberg, 83 T.C. at 262 (quoting Estate of Stamos, 55 T.C. 468, 474 (1970)).

Accordingly, none of the exceptions to the doctrine of election apply to Taxpayer's attempt to change retroactively its method of apportioning interest expense. As stated, the two elements of the doctrine of election are also satisfied. The doctrine of election thus prevents Taxpayer from revoking its tax book value election and retroactively electing the fair market value method for its taxable years Year 1, 2, and 3.

This conclusion is not altered by the section 901(a) provision that allows taxpayers to elect the foreign tax credit or change that election at any time prior to the expiration of the applicable period of limitation: A taxpayer's election to apportion interest expense under the fair market value or tax book value method is not governed by its section 901(a) election, and has much broader implications. See Treas. Reg. § 1.861-8(f)(1) (listing computations unrelated to the foreign tax credit that are affected by the allocation and apportionment of deductions). See also Treas. Reg. § 1.861-9T(f)(3)(i) (describing the interaction between a U.S. shareholder's and controlled foreign corporation's (CFC's) apportionment methodologies; a CFC's interest expense apportionment will, in turn, affect several other computations, including the determination of its U.S. shareholders' subpart F income). Moreover, in circumstances where taxpayers choose to deduct, rather than credit foreign taxes, an apportionment of interest expense is necessary in order to compute the excess credits that are carried over and "used up" in the deduction year under section 904(c). See Treas. Reg. § 1.904-2(d). Neither does the 10-year period of limitation under section 6511(d)(3)(A) alter this analysis. Section 6511(d)(3)(A) provides a special period of limitation with respect to a claim for credit or refund of an overpayment attributable to foreign taxes paid or accrued. However, section 6511(d)(3)(A) is an extension to the period of limitation: it does not authorize any actions or adjustments that would otherwise not be permissible under the general 3-year period of limitation. As stated above, neither section 901 nor the 861 regulations authorize taxpayers to change retroactively their elected method for apportioning interest expense. Section 6511(d)(3)(A) does not change this result.

Finally, our analysis of this Issue (1) is also not altered by the statement in Notice 89-91 that the election under section 1.861-9T(f)(3) for a CFC to apportion interest expense under either the asset method or the gross income method "does not constitute a binding election and may be changed in subsequent years or by amended return." 1989-2 C.B. 408, 410. The CFC election between the asset method and the gross income method is separate and distinct from Taxpayer's election between tax book value and fair market value under section 1.861-9T(g)(1)(ii). Moreover, the fact that Notice 89-91 expressly provides that the CFC election under section 1.861-9T(f)(3) may be changed by amended return is wholly consistent with the notion that changing an affirmative election by amended return is not permissible in the absence of such an express provision.

Issue (2): Section 7805(b)

Taxpayer's alternative request for relief under section 7805(b) argues that it expended substantial effort and expense to determine the fair market value of its worldwide assets based on justifiable reliance on the terms of the applicable regulations and the IRS' prior interpretation of those regulations in LTR 9133034 (May 22, 1991), revoked by LTR 200004043 (November 2, 1999).

Ordinarily, a technical advice memorandum is applied retroactively. See sec. 17.02 of Rev. Proc. 2000-2, 2000-1 I.R.B. 73 at 97. However, section 7805(b)(8) states discretionary authority to prescribe the extent, if any, to which a ruling may be applied without retroactive effect. The fundamental consideration posed by a request for relief under section 7805(b) is whether a taxpayer justifiably relied on prior settled law that is altered by the ruling or regulation at issue. Gehl Co. v. Commissioner, 795 F.2d 1324, 1332 (7th Cir. 1986); CWT Farms, Inc. v. Commissioner, 755 F.2d 790, 802 (11th Cir.

1985); First Chicago Corp. v. Commissioner, 96 T.C. 421, 438 (1991).

Taxpayer relies on sections 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii) to support its position that it can retroactively elect the fair market value method on an amended return. Further, to support that it justifiably relied on the regulations at issue, Taxpayer cites to the IRS' interpretation of those sections in LTR 9133034. For the reasons explained above, sections 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii) do not support Taxpayer's position. Further, because it was not the recipient of LTR 9133034, Taxpayer may not use or cite that ruling as precedent. Sec. 6110(k)(3). Accordingly, Taxpayer has not demonstrated justifiable reliance on prior settled law. Consequently, section 7805(b) relief is inappropriate in this case and Taxpayer's request that this technical advice memorandum be applied without retroactive effect is denied.

Issue (3): Equitable Principles

In addition to its position on Issues (1) and (2), Taxpayer asserts that principles of \equity entitle it to amend its Year 1, 2, and 3 returns to elect retroactively the fair market value method of apportioning interest expense. Taxpayer argues that it expended substantial effort and cost in the fair market value approach and also that it informed Service representatives early in the audit process that it was considering changing its apportionment methodology.

Embedded in these points is an implicit assertion that the doctrine of election and section 7805(b) do not address the equitable aspects of Taxpayer's claim. This assertion is incorrect. The doctrine of election, the exceptions to the doctrine of election, and section 7805(b) embody and articulate equitable considerations. Accordingly, the application of the doctrine of election discussed in Issue (1) as well as Taxpayer's failure to qualify for relief under section 7805(b) incorporate a balancing of the equities presented by Taxpayer's claim and, as a result, equitable principles do not entitle Taxpayer to relief on any other basis.

CAVEAT:

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

- END -