

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: March 13, 2012

to: Manager, Exam-Midwest Area, Territory-Wichita, KS, Group 8
Attn: , Independence, MO, POD

from: Associate Area Counsel, Small Business/Self Employed,
Area 9, Kansas City

subject:

Partnership =
:
(general and limited partner)
(general and limited partner)

(, Trustee)

Trust =

(, Trustee)

Husband (H) =

Wife (W) =

This is in response to your request for advice on whether you should allow the Trust's claim for refund for . The Trust's claim for refund was created by a reallocation of income among the partners, primarily due to a prior-year closing agreement in settlement of an abusive executive stock option tax shelter under Notice 2003-47, 2003-2 C.B. 132. You question whether you should disallow the claim because the individual partners failed to file an amended return within the original period of limitations to

assess the increased income tax liabilities for against them.

This memorandum should not be cited as precedent.

The refund claimant (Trust) asserts that you can allow the refund because the government's claims against the individual partners are protected by the mitigation provisions, sections 1311-1314. Your concern is that the other partners might validly raise the defense of the expiration of the statute of limitations on assessment in a subsequent refund suit after paying the

liability (under the pretense of settling the matter).

Because the closing agreement was executed by the representative of the refund claimant, there is also the question of whether the agreement itself precludes the reallocation needed to support the Trust's refund claim. The closing agreement precludes deviation from its terms pertaining to the , , and taxable years, and its factual conclusions for , , and

remain valid for subsequent years, including . To the extent that the trust's refund claim for is consistent with the terms of the closing agreement, it cannot be denied based on the closing agreement terms. If, however, the refund claim requires deviation from the facts determined by the closing agreement, then the claim can be disallowed.

On September 13, 2011, we drafted a memorandum for National Office review in which we had initially concluded that the mitigation provisions would not apply and proposed to recommend that you secure the adjustments of the related parties before issuing any refund. National Office requested additional information and sought an extension of time to review our draft. We closed our initial file with a memorandum to you dated September 22, 2011, advising that we needed additional information before we could render any opinion on the application of the mitigation standards to your facts and opened a project case to provide continuing support. The advice we contemplated in the September 13, 2011, draft would have been incorrect, as the expiration of the statute of limitations precludes securing the related adjustments prior to the allowance of the refund claim. Subsequent review of the file and of the additional materials you provided support the position that the mitigation provisions will apply only *after* you allow the refund claimed by the Trust.

Securing agreements with both the Trust and the partners simultaneously, as described below, would be ideal. However, the refund claimed by the Trust cannot be denied on the grounds that the related taxpayers did not file timely amended returns. The mitigation provisions provide an exception to the statute of limitations for assessment against the partners after the refund to the Trust has been allowed.

The statute of limitations for assessment of the liability of the partners expired on . Securing assessment and payment of the individual partners' liability *before* allowing the Trust's refund would create an overpayment where the individual partners would be entitled to refunds of the amounts paid. See I.R.C. § 6401. Because the unfairness of allowing the Trust refund when the partners have had the advantage of inconsistent reporting is not a reason to disallow the refund claim, if simultaneous agreements is not agreeable to the parties, then the refund to the Trust must be allowed *before* the corresponding adjustments to the partners are proposed. Once the Trust's refund claim is allowed, the mitigation provisions provide a one-year period where assessment and collection of the partners' related liability may occur without creating a statutory overpayment.

Facts

The Partnership, , has been in existence since at least . The partners of

include, and have included since at least

:

(general and limited partner); (general and limited partner); and (, Trustee). are also husband and wife.

On or about , the Trust filed its original Form 1041 for . , the Trust filed an amended Form 1041 seeking a refund of income tax for . You were assigned to review the claim for refund of income tax filed by the Trust.

The underlying adjustments arose as a result of a closing agreement executed by the Trust in under the global settlement initiative (GSI) to settle the tax consequences of abusive nonstatutory stock option transactions for the taxable years , , and in which the Trust and some of its beneficiaries

(partners in a partnership) participated. The closing agreement was signed by H and W as both general and limited partners of the partnership and by the Trust, a family trust in which H & W are beneficiaries.

Some of the determinations in the closing agreement resulted in the reallocation to the individual partners of partnership income previously reported by the Trust for taxable year

. The revenue agent who examined the , , and years, confirmed to you that the underlying numerical adjustments claimed on the Trust's amended return for are accurate.

Your concern is that to allow the claim for refund for the Trust will cause a loss of revenue because the other partners of the partnership have not filed amended returns to take such reallocated income into account. The assessment statute for the related partners' year expired on

. The representative of the Trust maintains that the government's interest is still protected by the mitigation provisions of the Code under I.R.C. § 1311. You ask whether you can allow the claim based on this ground.

After your request, you and the examiner who worked on the GSI closing agreement met with us to discuss the issues and to provide additional information. The Trust, through the duly authorized Trustee, also had signed the closing agreement. This raised a more fundamental issue: whether the Trust's execution of the closing agreement precludes its refund claim (independent of the issue on mitigation).

You and the examiner who participated in the closing agreement have stated that the Trust's refund claim is consistent with the closing agreement. Our review also does not reveal any apparent inconsistencies between the refund claim and the closing agreement. Unless a position required to support the refund claim is contrary to any term of the closing agreement, the fact that the Trustee of the Trust signed the agreement should have no adverse impact on the refund claim.

Law and Analysis

A. MITIGATION

Section 1311(a) provides that if a determination (as defined in section 1313) is described in one or more of the paragraphs of

section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314. The mitigation provisions of the Code are limited to errors expressed in the statute and are not broadly available.

Therefore, we must analyze the facts to determine: 1) whether there is a "determination" as defined in section 1313(a); 2) whether the determination is described by one of the circumstances of adjustment in section 1312; and 3) whether, on the date of the determination, correction of the error is barred. Further, we must determine whether the party who prevailed in the determination maintained a position that was adopted there and that was inconsistent with the erroneous treatment. I.R.C. § 1311(b)(1). Finally, we must determine whether the taxpayers were in a relationship as defined by section 1313(c) and described in section 1311(b)(3). If all of the prerequisites for the mitigation provisions are met, then we must follow the rules for the amount and method of adjustment found in section 1314.

1. Determination Defined by Section 1313(a)

Section 1313(a)(3) provides that the term "determination" includes the final disposition by the Secretary of a claim for refund. A claim for refund, when allowed, is deemed finally disposed of by the Secretary "on the date of allowance of refund or credit." I.R.C. § 1312(a)(3)(A). Section 1313(a)(2) provides that the "determination" also includes a closing agreement made under section 7121. I.R.C. § 1312(a)(4) provides that an agreement between the parties, as described in the Treasury Regulations, also constitutes a determination. The Service has promulgated Form 2259 as satisfying the statutory requirements and can be used by the parties to create a determination.

At this point, there is no determination. Therefore, the mitigation provisions do not yet apply. However, upon a final disposition of the Trust's claim for refund (either by allowance of the refund or credit, by execution of a closing agreement under section 7121, or by execution of a mitigation agreement such as the one outlined by Form 2259), there will be a determination.

2. Circumstances of Adjustment, Section 1312

Section 1312(3)(A) provides that a double exclusion of an item of gross income has occurred when the determination requires the exclusion from gross income of an item included in a return filed by the taxpayer or with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year, or from the gross income of a related taxpayer.¹

In this case, the allowance of the Trust's refund is the result of exclusion of items of gross income with respect to which tax has been paid and which was erroneously excluded from the gross income from the partners. Therefore, upon the allowance of the refund to the Trust, the circumstance of adjustment in section 1312 paragraph 3(A) will be met.

3. Correction Barred on Date of Determination

In this case, correction of the error would be accomplished by assessment of an additional liability of the partners. This is because in order to be consistent with the amended return (refund claim) of the Trust, the partners would be liable for an additional tax liability for taxable year .

The statute of limitations for assessment for the partners for taxable year expired on . Therefore, at the time the determination is made, a date in the future, correction of the error will be barred.

4. Prevailing Party Maintained Inconsistent Position

Section 1311(b)(1) states, in relevant part:

an adjustment shall be made under this part only if ...
(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made, and the position ... maintained by the taxpayer ... is inconsistent with the erroneous ... exclusion.

I.R.C. § 1311(b)(1).

In this case, the "adjustment" is the assessment against the partners. The "determination" will be the allowance of the

¹ See below for a discussion concerning the relationship between the Trust and the partners.

Trust's refund claim. The allowance of the refund claim is an adoption of the position of the Trust. The allowance of the refund claim is also inconsistent with the erroneous exclusion from income by the partners. Therefore, the requirements of section 1311(b)(1) will be met.

5. Relationship of the Taxpayers

Section 1311(b)(3) provides that an adjustment may only be made against a related taxpayer if that related taxpayer stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in the claim for refund.

Related taxpayers are those who have one of the relationships listed in section 1313(c)(3). Section 1313(c)(3)(6) lists "partner" as sufficient to satisfy the relationship requirement. The Trust is one partner in a partnership where H and W are also partners.

At the time the Trust filed the amended return, the relationship between the Trust and the other partners existed. Thus, both H and W are related taxpayers for purposes of the mitigation provisions.

6. Amount and Method of Adjustment

Section 1314(a) provides the rules for calculation of the amount of the adjustment allowed under the mitigation provisions. When mitigation applies, the statute of limitations is not extended. Instead, the mitigation provisions create an exception to the defense of the statute of limitations for limited purposes. In this case, the adjustment is calculated by first determining the income originally included in the Trust's return and excluded by the Trust's claim for refund. This income is then reallocated to the individual partners. No other adjustments may be proposed, as the mitigation provisions do not act as an exception to the statute of limitations defense for other issues. I.R.C. § 1314(c).

Section 1314(b) provides for the method of adjustment. The statute states, in relevant part: "The adjustment ... shall be made by assessing and collecting ... in the same manner as if it were a deficiency determined by the Secretary ... as if on the date of the determination one year remained before the expiration of the period[] of limitation upon assessment." In this case, therefore, there is no exception to the statute of limitations defense until the date of the determination, and then for one year from that date.

At this time, the statute of limitations for assessment against the individual partners is closed. The mitigation provisions do not allow for the Service to secure amended returns from the individual partners before allowing the Trust's claim for refund. However, if a determination is created (by allowance of the Trust's refund claim or entering into a closing or mitigation agreement), and then the individual partners agree to an increase in tax for the corresponding adjustment on the same day, then the assessments would be valid because mitigation will apply to create an exception of the defense of the statute of limitations.

Even though mitigation will apply upon the creation of a determination, if the individual partners are not willing to agree to the assessment of additional tax or pay the corresponding liability subsequent to the determination, then the Service must issue a statutory notice of deficiency to the individual partners within one year of the date of the determination.

B. CLAIM NOT PRECLUDED BY CLOSING AGREEMENT

You asked whether the application of the mitigation provisions is precluded by the fact that the individual taxpayers engaged in a transaction that the Service had identified as abusive and which resulted in the Trust and related parties entering into the GSI for the prior year. The settlement agreement under the GSI reversed the taxpayer's aggressive stance. We conclude that no adverse impact results.

As long as the Trust's position is consistent with the terms of the closing agreement, the mitigation provisions apply and the claim can be allowed.

Conclusion

The Trust bears the burden to establish its entitlement to the refund claimed. As discussed above, this burden has been satisfied, as the refund claim is valid and consistent with the terms of the prior closing agreement. The government cannot deny the Trust's refund on the grounds that the individual partners did not pay a related liability.²

The mitigation provisions will apply as soon as there is a determination as defined by section 1313(a)(1). Until that time, the individual partners should not be asked to agree to assessment and payment of the corresponding liability, as doing so would create statutory overpayments as defined by section 6401. However, if the parties are in agreement, both the allowance of the Trust's refund and the assessment of the individual taxpayers' liabilities can be accomplished on the same date as long as all of the requirements of sections 1311-1314 are met.

The GSI closing agreement itself does not bar the refund claim by the trust unless the claim requires facts different from those determined conclusively in the closing agreement.

² This would be an equitable recoupment argument. It is generally our position that when the mitigation provisions apply to the facts at hand, then equitable recoupment is not available as a remedy. See Benenson v. United States, 385 F.2d 26 (2nd Cir. 1967); Gooding v. United State, 164 Ct. Cl. 197 (1964).

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

As no further action is required of us at this time, we are closing our file. If you have any questions, or would like additional information, please contact Gregory J. Stull at (816) 823-0913.

/s/ Gregory J. Stull

GREGORY J. STULL
Senior Counsel