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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR REID M. HUEY  
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FROM: Anne O'Connell Devereaux  
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SUBJECT:

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LEGEND

Taxpayer =  
Year 1 =  
Year 2 =  
Year 3 =

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Year 4 =  
Year 5 =

### ISSUE

Whether the Service can, pursuant to Taxpayer's duty of consistency, reduce in a year under examination Taxpayer's foreign subsidiary's post-1986 foreign income taxes pool by the amount of an indirect foreign tax credit erroneously claimed by Taxpayer in a year closed by the statute of limitations.

### CONCLUSION

Because all of the elements of the duty of consistency have been satisfied, the Service may bind Taxpayer to its original representation regarding the amount of foreign income taxes that were removed from the post-1986 foreign income taxes pool by virtue of the erroneous indirect foreign tax credit claimed in the closed years and remove those amounts from the open year pool.

### FACTS

Taxpayer is a domestic corporation that owned more than 50 percent of a foreign corporation ("foreign subsidiary") for all years at issue. During an examination of Taxpayer's federal income tax returns for Years 4 and 5, tax years currently open under the statute of limitations ("open years"), the examining agent discovered errors in the computation of the indirect foreign tax credit that had been claimed by Taxpayer with respect to the foreign subsidiary in Years 1, 2, and 3, tax years that are now closed by the statute of limitations ("closed years"). Specifically, for one or more of the closed years, Taxpayer claimed on its federal income tax returns an indirect foreign tax credit greater than the appropriate percentage of the amount of the then-available post-1986 foreign income taxes pool of its foreign subsidiary.

### LAW AND ANALYSIS

#### Indirect foreign tax credit

Section 901 of the Code allows certain taxpayers a credit against their U.S. tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." Section 902 deems a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation from which it receives a dividend to have paid the same proportion of the foreign income taxes actually paid by the foreign corporation as the amount of the dividend bears to the foreign corporation's post-1986 undistributed earnings. (Section 960 similarly provides for indirect foreign tax credits in connection with subpart F inclusions.) Thus, for taxable years beginning after 1986, foreign taxes deemed paid under § 902 generally are computed based on multi-year pools of earnings and taxes as follows:

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$$\text{foreign tax deemed paid} = \text{post-1986 foreign tax paid by foreign corporation} \times \frac{\text{dividend to taxpayer}}{\text{post-1986 undistributed earnings of foreign corporation}}$$

Section 902(c)(1) defines post-1986 undistributed earnings as the sum of the foreign corporation's earnings and profits accumulated in post-1986 taxable years as of the close of the taxable year in which it distributes a dividend, but without reduction for current year dividend distributions. Prior to 1997, § 902(c)(2) defined post-1986 foreign income taxes as the sum of the foreign corporation's current year foreign income taxes and foreign income taxes with respect to prior post-1986 taxable years, "to the extent such foreign taxes were not deemed paid with respect to dividends distributed by the foreign corporation in prior taxable years."<sup>1</sup> Thus, foreign taxes deemed paid with respect to a dividend in one year are not available for computing a deemed paid credit in a subsequent year.

Consequently, a taxpayer's indirect foreign tax credit for a current year and for all subsequent years is affected by the accuracy of the taxpayer's computation of the post-1986 foreign income taxes pool and the post-1986 undistributed earnings pool of its foreign subsidiaries.

### Duty of Consistency

The duty of consistency is an equitable doctrine that prevents a taxpayer from adopting a position for a particular year and, after the period of limitations for that year has expired, adopting a contrary position by claiming that the original treatment was incorrect to obtain a tax advantage in a later year. Estate of Ashman v. Commissioner, 231 F.3d 541 (5<sup>th</sup> Cir. 2000), *aff'g* T.C. Memo. 1998-145. Thus, for example, a taxpayer who benefitted from a representation in one tax year may not reduce his tax in a subsequent tax year by arguing, after the statute of limitations has expired on the earlier year, that the taxpayer's original representation was incorrect, and that more tax was due in the now-closed year. See Herrington v. Commissioner, 854 F.2d 755, 758 (5<sup>th</sup> Cir. 1988), *cert. denied*, 490 U.S. 1065 (1989); Estate of Letts v. Commissioner, 109 T.C. 290 (1997), *aff'd* 212 F.3d 600 (11<sup>th</sup> Cir. 2000). Thus, the duty of consistency prevents a taxpayer from obtaining a permanent exclusion of income that is taxable, or from deducting the same expense in multiple tax years.

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<sup>1</sup>In 1997, the phrase "deemed paid with respect to" was replaced with "attributable to" effective August 8, 1997. P.L. 105-34, § 1163(a). This change clarified that, for purposes of the indirect foreign tax credit, all taxes attributable to a dividend are removed from the pool, not just taxes actually claimed as an indirect foreign tax credit. Because this change only clarified existing law, it did not change the manner in which post-1986 foreign income taxes pools are computed. See H.R. Conf. Rep. No. 105-220, at 634 (1997).

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The duty of consistency has three elements: (1) the taxpayer represents a fact or reports an item for federal income tax purposes for a particular year; (2) the Service acquiesces in or relies upon the representation of fact or the reported item for that year; and (3) the taxpayer attempts to change the representation or reporting in a subsequent year, after expiration of the period of limitation, and the change is detrimental to the Service. Herrington, 854 F.2d at 757.

A taxpayer's inclusion or omission of a particular item on a tax return can be a representation that the facts are consistent with how the item is reported. Thus, the failure to report a particular item of income may be an implied representation of the fact with respect to that item, which the taxpayer cannot repudiate at a later date.

When the duty of consistency applies, "the Commissioner may act as if the previous representation on which the Commissioner relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." Herrington, 854 F.2d at 758; Cleo Perfume, Inc. v. Commissioner, T.C. Memo. 1998-155.

The duty of consistency is based on the theory that a taxpayer owes the Service the duty to be consistent when a fact or transaction is projected in its tax consequences into another year and will not be permitted to benefit from the taxpayer's own prior error or omission. The court in Orange Securities Corp. v. Commissioner, 131 F.2d 662, 663 (5<sup>th</sup> Cir. 1942), *aff'g* 45 B.T.A. 24 (1941), discussed the theory underlying the duty of consistency doctrine:

While it is true that income taxes are intended to be settled and paid annually each year standing to itself, and that omissions, mistakes and frauds are generally to be rectified as of the year they occurred, this and other courts have recognized that a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it.

Similarly, in Alamo Nat'l Bank v. Commissioner, 95 F.2d 622, 623 (5<sup>th</sup> Cir. 1938), *cert. denied*, 304 U.S. 577 (1938), the court stated that "in income taxation what is done in one tax year is sometimes projected into another where the same fact must govern. There being continuity, there ought to be consistency in treatment."

#### First element

The first element of the duty of consistency is that the taxpayer must have made a representation or reported an item for tax purposes. Herrington, 854 F.2d at 758. For purposes of the duty of consistency, a taxpayer's treatment of an item on a

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return can be a representation of the facts that are consistent with the manner in which the taxpayer reports the item on the return. Estate of Letts, 109 T.C. at 299. For example, a failure to report income may be an implied statement of the facts relating to the taxpayer's receipt of funds, which, under the duty of consistency, a taxpayer cannot later repudiate. See Wentworth v. Commissioner, 244 F.2d 874, 875 (9<sup>th</sup> Cir. 1957), *aff'g.* 25 T.C. 1210 (1956) (not reporting the receipt of funds on an income tax return was a representation that the funds were a loan repayment); Portland Oil Co. v. Commissioner, 109 F.2d 479, 485-486 (1<sup>st</sup> Cir. 1940), *aff'g.* 38 B.T.A. 757 (1938) (not reporting a sale in 1929 was a representation that the sale did not occur in 1929).

An indirect foreign tax credit claimed on Taxpayer's return is a representation regarding the amount of foreign taxes in Taxpayer's foreign subsidiary's post-1986 foreign income taxes pool. Thus, the first element of the duty of consistency is present in this case.

### Second element

The second element of the duty of consistency is that the Commissioner must have relied on the taxpayer's representation. This element is present if the Commissioner accepts the taxpayer's income tax return and permits the statute of limitations to expire for that year. Herrington, 854 F.2d at 758. However, if the Commissioner knew or had reason to know prior to the expiration of the statute of limitations that a taxpayer had made a representation that was incorrect and failed to correct that representation before the expiration of the statute of limitations, then the duty of consistency does not apply. Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 91 (1971), *aff'd per curiam*, 456 F.2d 622 (5<sup>th</sup> Cir. 1972); Erickson v. Commissioner, T.C. Memo. 1991-97; Gmelin v. Commissioner, T.C. Memo. 1988-338, *aff'd without published opinion*, 891 F.2d 280 (3d Cir. 1989). To avoid the second element, a taxpayer must provide the Service with sufficient facts such that the Service has actual or constructive knowledge of a possible mistake in the reporting of the erroneously disclosed item. The Service may rely on a presumption of correctness of a return or report that is furnished under penalties of perjury, absent sufficient facts to supply the Service with actual or constructive knowledge to the contrary. Hughes & Luce, L.L.P. v. Commissioner, T.C. Memo. 1994-559, *aff'd*, 70 F.3d 16 (5<sup>th</sup> Cir. 1995). As stated by the Court of Appeals for the First Circuit, the duty of consistency requires that the taxpayer's misrepresentation "must be one on which the government reasonably relied, in the sense that it neither knew, nor ought to have known, the true nature of the transaction mischaracterized by the taxpayer." Lewis v. Commissioner, 18 F.3d 20, 26 (1<sup>st</sup> Cir. 1994) (citations omitted).

It appears that the second element is present in this case. It does not appear that any information came to light with respect to Taxpayer's income tax returns for the closed years that would have caused the Service to know or have reason to know

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prior to the expiration of the statute of limitations for the closed years that Taxpayer miscalculated the indirect foreign tax credit such that the Service should have adjusted Taxpayer's income tax liability in the closed years to reflect such errors. By accepting Taxpayer's income tax returns for the closed years as filed with regard to the indirect foreign tax credit, and by allowing the statute of limitations to expire concerning this issue, the Service relied upon Taxpayer's representation in its income tax returns for the closed years that Taxpayer properly calculated its foreign subsidiary's post-1986 foreign income taxes pool and therefore claimed the proper amount of indirect foreign tax credit.

### Third element

The third element of the duty of consistency is that the taxpayer must have attempted to change the previous representation after the expiration of the statute of limitations. Herrington, 854 F.2d at 758; Beltzer v. United States, 495 F.2d 211, 212 (8<sup>th</sup> Cir. 1974). The third element is present in this case. Now that the statute of limitations has expired with respect to the assessment and collection of income tax for the closed years, and contrary to its prior representation as to the accuracy of the amount of indirect foreign tax credit claimed for those years, Taxpayer contends, in effect, that the foreign taxes were not removed from the foreign subsidiary's post-1986 foreign income taxes pool because of the error in the closed year computation and that those taxes are available to compute an indirect foreign tax credit in the open years.

### Conclusion

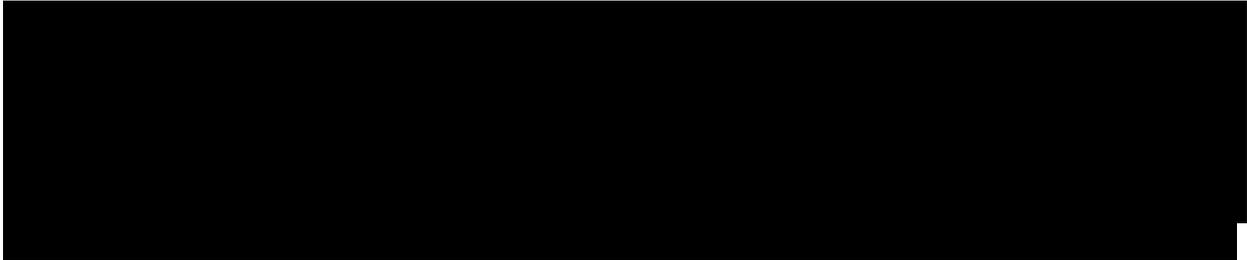
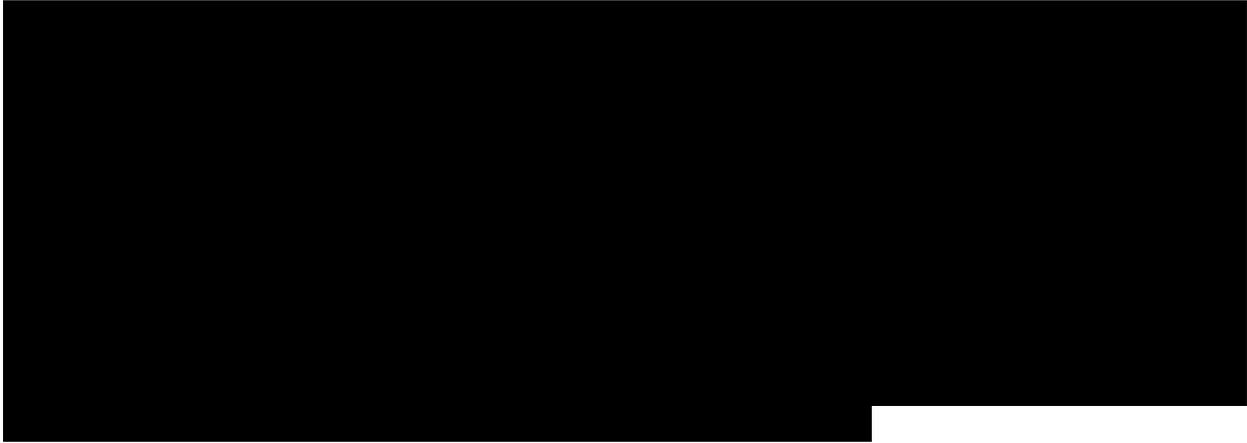
Because all of the elements of the duty of consistency have been satisfied, the Service may bind Taxpayer to its original representation regarding the amount of foreign taxes that were removed from the foreign subsidiary's post-1986 foreign income taxes pool by virtue of the erroneous indirect foreign tax credit claimed in the closed years and remove those amounts from the foreign subsidiary's post-1986 foreign income taxes pool for open years. Accordingly, Taxpayer cannot now claim, after the statute of limitations for assessment and collection of income tax has run for the closed years, that the foreign taxes associated with the erroneous indirect foreign tax credit claimed in the closed years remain in the foreign subsidiary's post-1986 foreign income taxes pool and are available for computing indirect foreign tax credits in open years.

Finally, the duty of consistency is an affirmative defense upon which the Service bears the burden of proof and must be raised in the pleadings. See e.g. Lefever v. Commissioner, 100 F.3d 778, 784 (10<sup>th</sup> Cir. 1996), *aff'g* 103 T.C. 525 (1994); Unum Life Insurance Company of America v. United States, 886 F.Supp. 150 (D. Maine 1995). Accordingly, we suggest that the duty of consistency and facts necessary to support its application be developed as early as possible. For this reason we suggest that the Service notify the Taxpayer of our intention to raise the duty of

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consistency as early as possible such as in a statutory notice of deficiency for the open years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please call if you have any further questions.

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