DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum, dated April 19, 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:

Corp X =
Corp Y =
Country A =
Products B =
Date d =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Tax Year 4 =
Tax Year 5 =
Tax Year 6 =
Tax Year 7 =
$e =

ISSUE:

Whether a proposed closing agreement should be entered into by the Internal Revenue Service.

CONCLUSION:

As drafted, the closing agreement is so ambiguous that it is virtually unenforceable. The agreement apparently does not directly conflict with any provisions of the Code. Nor does the future applicability of the agreement present problems. Thus, if the ambiguities in the agreement are cured, it may be possible to carry out its intent.

FACTS:

Corp X is based in Country A and manufactures Products B. Corp Y is the exclusive United States distributor for Corp X. Corp Y was incorporated on Date d. It was anticipated that Corp Y would operate at a loss for a number of years because of large start-up costs, which would apparently consist largely of advertising expenses. Corp Y and the Service negotiated a settlement in the form of a proposed closing agreement to address the capitalization and amortization of the start-up costs. The agreement provides, in part, as follows:

> NOW, THEREFORE, it is hereby determined and agreed for Federal income tax purposes that:
>
> 1. For [Tax Years 1 and 2], Taxpayer's cumulative net taxable loss is limited to [$e]. If losses exceed this amount, Taxpayer shall capitalize the excess losses.
>
> 2. To the extent taxpayer creates Excess Profits in [Tax Years 3, 4, 5, 6], it can apply the capitalized losses against such Excess profits. For these purposes, "Excess Profits" is defined as the amount of operating profit that exceeds the minimum operating profit set forth below:...

LAW AND ANALYSIS:

Ambiguity:

The agreement contains several terms that have undefined and unclear meanings. The question arises whether this ambiguity is enough to invalidate the agreement.

"Determined matters [in closing agreements] should be stated with such clarity as to lead reasonably to only one interpretation." Rev. Proc. 68-16 § 7.02, 1968-2 C.B.

767. See also Closing Agreement Handbook, IRM 8(13) Chapter 421 ("Handbook"). The closing agreement in the present case fails to meet this minimum requirement.

The closing agreement consists of two clauses. The first clause "limits" the taxable loss for the Tax Years 1 and 2 to $e. Though unstated, presumably this loss would create a net operating loss under I.R.C. § 172 and be treated accordingly. If Corp Y's cumulative losses exceed $e in Tax Years 1 and 2, the remaining losses are "capitalized." There is no stated limit on these losses. Presumably, should a "capitalized" loss arise, there is some important difference between it and the $e loss that is otherwise determined. A possible distinction between these types of losses is set forth in the second clause.

The second clause establishes a procedure for the application of "capitalized" losses against "Excess Profits." "Excess Profits" are defined as the amount of operating profit that exceeds a stated minimum operating profit for the Tax years 3 through 6. Operating profit is not defined, but presumably this is not equivalent to taxable income. The imprecise nature of these clauses raises several questions:

1. What is the appropriate treatment of the $e in future years? Assuming Corp Y is profitable in Tax Year 6, is a "capitalized" loss applied before the $e is applied as an NOL? Can the $e be applied against taxable income in future years even if there are no "Excess Profits" as defined in the closing agreement?

2. What is the appropriate treatment of the "capitalized" loss? To the extent that the treatment of this loss is not covered in the agreement, is this loss treated as an NOL under section 172? What happens to any remaining "capitalized" loss in Tax Year 7? See Last v. United States, 97-1 U.S.T.C. ¶ 50,105 (Ct. Cl. 1996) (interpreting closing agreement with language "[t]here is a long-term capital loss carryover of $129,044 from the 1982 tax year to the 1983 tax year" and concluding that the carryover from 1982 could be used any time allowable under section 172).

3. What is operating profit? Is this amount (as accounting principles suggest) greater than taxable income? If so, if there are positive "Excess Profits" and negative taxable income, can the "capitalized" loss be written off against operating profit (in effect, transforming the "capitalized" loss into an NOL subject to section 172)?

Though the above questions demonstrate the ambiguity of the agreement, there are other problems as well. We have concerns, for example, that the "Excess Profit" is a related specific item affecting taxable periods within the scope of the

Commissioner's Delegation Order 97. Without addressing these issues, the agreement should not be signed.

Inconsistency with the Code:

The point has been raised that the agreement conflicts with some provisions of the Code. We do not believe that, to the extent the agreement is at odds with the Code, this invalidates it.

Normally, advertising expenses that are in the nature of selling expenses are deductible, if they reasonable and related to the taxpayer's business activities. Treas. Reg. § 1.162-1(a). Only in the unusual situation where advertising is directed towards getting future benefits beyond those traditionally associated with ordinary product advertising must the costs of the advertising be capitalized. Rev. Rul. 92-80, 1992-2 C.B. 57.

As far as the argument that the agreement allows Corp Y to capitalize its advertising expenses is concerned, there is no language in this agreement that supports this conclusion.[1] Moreover, if the expenses were deducted currently and resulted in an NOL, the NOL can be carried forward twenty years under section 172. The effect of the NOL carryforward is to allow, albeit indirectly, deductions for start-up costs in future years.

It is also asserted that the agreement conflicts with the NOL rules under section 172. As discussed above, this conflict is unclear. If the "capitalized" loss is not treated as an NOL, then this loss may indeed conflict with the NOL rules. But this conflict, if present, is not fatal to the agreement.

There is no explicit requirement that closing agreements not conflict with other provisions of the Internal Revenue Code.[2] The only implicit restraint on them are the provisions elsewhere in the Code providing that certain sections should be given effect notwithstanding any other rule of law. See, Handbook ¶ 713. Thus, closing agreements are not invalid merely because they conflict with some other Code provision. In fact, closing agreements may be set aside only in rare instances.

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[1] No doubt the intent of the agreement is to allow the capitalization of certain start up expenses. Nonetheless, based on the four corners of the agreement, this intent is not relevant. See Rink v. Commissioner, 47 F.3d 168, 171 (6th Cir. 1995)

[2] On a philosophical level, in fact, one would expect that the parties to closing agreements could always make the claim that it conflicts with some provision of the Code. If the treatment under the Code of items included in a closing agreement were clear, there would be little reason to enter into the agreement.

It is well settled that a closing agreement may not be set aside except "upon a showing of fraud, malfeasance or misrepresentation of a material fact." Estate of Johnson v. Commissioner, 88 T.C. 225, 231, aff'd, 838 F.2d 1202 (2d Cir. 1987), (1987) citing I.R.C. § 7121(b)(2). An erroneous interpretation of law in a closing agreement is not a mistake of fact and is not grounds for setting aside an agreement. Kercheval v. United States, 99-1 U.S.T.C. ¶ 50,220 (4th Cir. 1999). Further, court decisions interpreting closing agreements conclude that changes in law do not affect the status of closing agreements. Bankers' Reserve Life v. United States, 42 F.2d 313 (Ct. Cl.), cert. denied, 282 U.S. 871 (1930) (holding that later finding that statute applied in closing agreement was unconstitutional did not invalidate the agreement.).[3] In short, once a closing agreement is signed it is final; whether or not the agreement comports with other provisions of the Code.

Treatment of future years:

Concern has been expressed regarding the indefinite future treatment of the "capitalized" loss under the agreement. We do not believe that the indefinite nature of this treatment presents a problem because, although the agreement does not determine the specific amount of a capitalized loss, it does provide a fixed treatment for it.

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A closing agreement may cover any current or future year. Treas. Reg. § 301.7121-1(a). Agreements for future periods may relate to one or more items affecting tax liability. Treas. Reg. § 301.7121-1(b)(3).

Rev. Proc. 68-26, 1968-1 C.B. 770, and the Handbook set forth the procedures for drafting effective closing agreements. Closing agreements must be unambiguous. Rev. Proc. 68-26 § 7.02, 1968-1 C.B. at 787; Handbook, Chapter 421. Determinations with respect to future years are not appropriate when "correct treatment will depend primarily upon circumstances that will arise subsequent to the agreement, such as the application of capital gains rates to the future sales of real estate or the treatment of farm losses for future years." Rev. Proc. 68-26 § 7.03, 1968-1 C.B. 787; Handbook, Chapter 422 (1). Similarly, closing agreements should not contain provisions that render them inoperative upon the occurrence of some future event. Handbook, Chapter 42(14)(1). This does not mean, however, that closing agreements cannot contain provisions that fix the future treatment of certain items. Rev. Proc. 68-16, Exhibit C, 1968-1 C.B. at 797; Handbook, Exhibit 16; ¶ 42(14)(2).

The examples set forth in the Rev. Proc. and the Handbook illustrate closing agreements that fix the future treatment, rather than the precise amount, for certain items. Rev. Proc. 68-16, Ex. C and Exhibit 16 of the Handbook are sample

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[3] Closing agreements are subject to subsequently enacted statutory provisions that are not retroactive. Handbook, ¶ 830.

closing agreements that provide a method for allocations under section 482 between a parent and subsidiary. The agreement contains many clauses that are dependent upon future events, particularly clause (h) which reads as follows:

> (h) in the event the taxpayer is granted offset relief, pursuant to Section 5 of Revenue Procedure 64-54, and / or pursuant to Revenue Procedure 69-13, as a result of the Section 482 allocation referred to in clause (a) subsequent to the date this agreement is executed on behalf of the Commissioner, there shall be included in taxpayer's gross income for the year payment is made pursuant to clause (e) to the extent of earnings and profits available in the year the payment specified in clause (e) is made, such a dividend being in the amount of the excess of payment over the maximum which taxpayer could have received free of further federal income tax consequences under Revenue Procedure 65-17, had such offset relief been finally determined prior to or concurrently with taxpayer's execution of this closing agreement. If payment has been made pursuant to clause (d)(1)(ii), the amount of such dividend income shall be reduced to the extent of the unpaid balance of any outstanding promissory note specified in clause (e)(1)(ii), such reduction not to exceed the amount of the dividend referred to in this clause, and such note shall then be decreased by the amount of such reduction.

The exact dividend to be included in the taxpayer's income in this example is dependent upon events which are unknown at the time the closing agreement is signed. For example, sufficient earnings and profits must be available. And if a promissory note is created under clause (e) of the agreement (which addresses payments from the subsidiary to the parent as a result of a section 482 adjustment) this note can affect the value of the resulting dividend. In short, at the time the closing agreement is signed it cannot be determined whether a dividend will arise or the value of the dividend. Yet, this closing agreement is still valid. Clearly, closing agreements do not need to conclusively determine the amount of future deductions.

Courts also have addressed closing agreements that contain indefinite treatment of future items. First Nat'l City Bank v. United States, 218 Ct. Cl. 661 (1978). Under the closing agreement in First Nat'l City Bank, the bank's devaluation loss could be recognized only if assets exceeded liabilities at the close of the taxable year. The court did not question the validity of the closing agreement and held that the taxpayer was bound by its provisions.

In this case, the closing agreement establishes a precise treatment for Corp Y's losses for the Tax Years 1 and 2. Losses will be allowed up to $e and capitalized beyond that point. The treatment in future years is also fixed. Corp Y can utilize specific amounts of the capitalized amount, if available, in each of the years covered in the closing agreement. This is not forbidden. See Handbook ¶ 713(4) (providing an example closing agreement which determines an NOL of x in 1985 and allows a portion of the loss to be carried back to 1982). The circumstances arising subsequent to the agreement that will affect its operation are Corp Y's normal operations during those years. Thus, to the extent the closing agreement in the present case is otherwise valid, the future uncertainties arising in the agreement do not invalidate it.

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By: ____________________

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