OFFICE OF
CHIEF COUNSEL

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

Number: **200031025**
Release Date: 8/4/2000
CC:INTL:BR6
WTA-N-112722-99

UILC: 482.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: April 28, 2000

MEMORANDUM FOR ILLINOIS DISTRICT COUNSEL
CC:MSR:ILD:CHI
ATTN: Harmon Dow

FROM: STEVEN A. MUSHER
CHIEF, CC:INTL:Br6

SUBJECT:

This Field Service Advice responds to your memorandum dated November 3, 1998 and subsequent conversations. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Corp A =

Y1 =
Y2 =

date 1 =
date 2 =
date 3 =

$a =
$b =

$c =
$d =
$e =
$f =
$g =
$h =
$i =
$j =
$k =
$l =
$m =
$n =

ISSUES:

1. Whether a potential decrease to Corp A's taxable income from the results of controlled transactions with its controlled foreign corporations ("CFCs"), that was disclosed on Form 8275 attached to Corp A's Y1 timely-filed, original income tax return, but not otherwise reflected in the reporting of taxable income or the computation of tax or refund due in connection with such return, is considered reported on a timely-filed, original return for purposes of Treas. Reg. § 1.482-1(a)(3).

2. Whether Treas. Reg. § 1.482-1(a)(3) permits Corp A to report on an untimely or amended return a net increase in taxable income equal to the difference between an increase of taxable income with respect to Corp A's controlled transactions with a CFC and a decrease of taxable income with respect to Corp A's controlled transactions with another CFC, where each CFC is a separately tested party under a comparable profits method.

CONCLUSIONS:

1. The potential decrease in taxable income disclosed on Form 8275 should be considered reported on a timely-filed, original return for purposes of Treas. Reg. § 1.482-1(a)(3).

2. Treas. Reg. § 1.482-1(a)(3) does not permit the results of controlled transactions with a CFC to be set off against results of controlled transactions with another CFC on an untimely or amended return.

FACTS:

Corp A, a domestic corporation, is the parent corporation of a multinational enterprise with numerous wholly-owned controlled foreign corporations ("CFCs"). Corp A engages in cross-border transactions with many of the CFCs. Corp A is also subject to

the Service's Coordinated Exam Program ("CEP"). In preparing its timely-filed, original U.S. income tax return for Y1 (hereinafter the "Y1 return"), Corp A relied on the results of its transfer pricing study in conjunction with section 482 compliance.

In preparing the Y1 return, Corp A commissioned a worldwide transfer pricing study. Taxpayer used the comparable profits method ("CPM") to evaluate the reasonableness of the operating incomes reported by the CFCs within the Corp A group. According to the Y1 transfer pricing study, Corp A engaged in non-arm's length pricing with 16 CFCs.

Based upon its transfer pricing study, Corp A overpaid twelve CFCs (hereinafter the "Twelve CFCs") a total of $a, which had the effect of understating Corp A's taxable income, and four CFCs (hereinafter the "Four CFCs") overpaid Corp A a total of $b, which had the effect of overstating Corp A's taxable income. This resulted in Corp A overstating $c of net income from non-arm's length transactions as measured by Corp A's CPM analysis. Therefore, on a net basis, Corp A had a potential $c reduction to taxable income.

Pursuant to Treas. Reg. § 1.482-1(j)(2), Corp A elected the retroactive application of the final section 482 regulations to its Y1 return.[1] Absent an election, these regulations are effective for tax years beginning after October 6, 1994. Treas. Reg. § 1.482-1(j)(1).

Corp A provided information regarding the above mentioned transfer pricing study on the Form 8275 Disclosure Statement attached to the Y1 return. The attachments to the Y1 return indicated an additional potential reduction in income of $c.

Corp A did not actually reduce its taxable income by $c on its original Y1 return. Rather, it only reduced its taxable income to the extent necessary to offset the amount by which the transfer pricing study indicated it overpaid the other CFCs.[2] On an

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[1] Unless otherwise indicated, all references to section 482 and its regulations refer to the Final Intercompany Transfer Pricing Regulations under Section 482 (T.D. 8552, 1994-2 C.B. 93).

[2] The taxpayer's response to IDR EC-033, dated date 1, indicated that Corp A limited the amount by which it offset its taxable income because it was unclear whether, under the new regulations entitling taxpayers to specified use of section 482, Corp A was obligated and/or entitled to make correlative and compensating adjustments. In the Y1 amended return and Y1 qualified amended return, described infra, such adjustments were made. The amended returns, collectively, include adjustments from deemed capital contributions to CFCs from which taxable income was allocated to Corp A and deemed dividend distributions from CFCs to which taxable income was allocated

attachment to the Form 8275 (which attachment indicates it is a “statement attached to and made a part of the Form 1120, U.S. Corporation Income Tax return for Y1"), Corp A indicated it had not reduced its U.S. taxable income for Y1 by the previously-referenced excess $c amount although it was theoretically entitled to do so. In an attachment to the Form 8275, entitled “Summary of Adjustments made to Book Income Pursuant to Treasury Regulation 1.482-1(a)(3),” Corp A provided the names of the sixteen CFCs with which it allegedly engaged in non-arm’s length dealings and the amount of the net adjustments for each company. This attachment referred to the $c amount as an “Unclaimed Potential IRC Section 482 Adjustment Reducing Taxable Income.”

Thereafter, Corp A updated and revised its transfer pricing study in connection with the filing of its Y2 income tax return, and discovered that certain results reported on the Y1 return changed based upon its updated transfer pricing study. According to the updated transfer pricing study, Corp A understated its income with respect to controlled transactions with the Twelve CFCs, but not to the extent indicated on the Y1 return.[3] Further, Corp A overstated its income with respect to controlled transactions with the Four CFCs, but not to the extent indicated on the Y1 return.[4] Finally, according to the updated transfer pricing study, Corp A also understated its income with respect to

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from Corp A. The amended returns purport to make adjustments that take into consideration the treatment appropriate under various provisions such as section 78 gross-up, section 902 foreign tax credits, section 986 treatment of exchange on gain or loss on distributions of previously taxed income, and adjustments to the earnings and profits of the affected CFCs.

[3] The Twelve CFCs, as aggregated, reported total understatements to Corp A’s taxable income of $a on the Y1 return, which was subsequently reduced to understatements totaling $d (an amount less than $a) on the Y1 amended return. It should be noted that the decrease of total understatements from controlled transactions to Corp A’s taxable income from the Y1 return to the Y1 amended return is a composite of seven of the Twelve CFCs decreasing the understatements to Corp A’s taxable income (including one CFC where the updated transfer pricing study indicated that this CFC was not understatement, but rather this CFC overstated Corp A’s taxable income), two of the Twelve CFCs increasing the understatements to Corp A’s taxable income, and three of the Twelve CFCs did not report changed results from the Y1 return.

[4] The Four CFCs, as aggregated, reported total overstatements to Corp A’s taxable income of $b on the Y1 return, which was subsequently reduced to overstatements totaling $e (an amount less than $b) on the Y1 amended return. It should be noted that the decrease of total overstatements from controlled transactions to Corp A’s taxable income from the Y1 return to the Y1 amended return is a composite of three of the Four CFCs decreasing the overstatements to Corp A’s taxable income and one of the Four CFCs increasing the overstatements to Corp A’s taxable income.

controlled transactions with one CFC (hereinafter the "One CFC"), and Corp A overstated its income with respect to controlled transaction with two additional CFCs (hereinafter the "Two CFCs").[5]

Pursuant to its updated transfer pricing study documentation, Corp A filed an amended return for Y1 on date 2, which was before the audit cycle began for the Y1 return. Corp A reported on the amended return that its taxable income was understated by a total of $h, rather than by the $a amount it reported on the Form 8275 attachments to the Y1 return. Further, Corp A reported on its amended return that its taxable income was overstated by $i, rather than by the $b amount it reported on the Form 8275 attachments to the Y1 return.

The Y1 amended return sets off increases in taxable income with respect to Corp A's controlled transactions with certain CFCs against decreases in taxable income with respect to Corp A's controlled transactions with other CFCs, as summarized above. Corp A netted the total increases to its taxable income, $j, against the total decreases to its taxable income, $k, to determine that it had a net increase to its taxable income of $l.

When it filed the Y1 amended return, Corp A reported the net increase of $l, which it credited against the $c amount shown on the Form 8275 attachments to the Y1 return. Corp A thereby claimed a reduction to its Y1 taxable income on its Y1 amended return.

Subsequent to the filing of the Y1 amended return on date 1, Corp A made further refinements to its transfer pricing study. Subject to Rev. Proc. 94-69, 1994-2 C.B. 804, Corp A decreased its taxable income with respect to controlled transactions with one of the Twelve CFCs by $n within 15 days of having been first-contacted about the Y1 return, as provided for in the revenue procedure.[6] This decrease is set off against other increases to Corp A's taxable income.

LAW AND ANALYSIS:

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[5] The understatement with respect to controlled transactions with the One CFC increases Corp A's taxable income by $f, and the overstatements with respect to controlled transactions with the Two CFCs total $g.

[6] This item was included in the descriptions of all items that would (or may) result in adjustments disclosed to Exam to constitute a Qualified Amended Return under Rev. Proc. 94-69.

1. The decrease in taxable income disclosed on Form 8275 attachments should be considered as reported on the Y1 timely-filed original return.

Treas. Reg. § 1.482-1(a)(3) provides:

> If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662-6T(a)(2) or successor regulations.[7]

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[7] Temp. Treas. Reg. § 1.6662-6T(a)(2) (1994) provides:

> Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records. The results of controlled transactions that are reported on an amended return will be used only if the amended return is filed before the Internal Revenue Service has contacted the taxpayer regarding the corresponding original return. A written statement furnished by a taxpayer subject to the Coordinated Exam Program will be considered an amended return for purposes of this section if it satisfies either the requirements of a qualified amended return for purposes of § 1.6664-2(c)(3) or such requirements as the Commissioner may prescribe by revenue procedure [Rev. Proc. 94-69]. In the case of a taxpayer that is a member of a consolidated group, the rules of this paragraph (a)(2) apply to the consolidated income tax return of the group.

T.D. 8656, 1996-1 C.B. 329, removed Temp. Treas. Reg. § 1.6662-6T and adopted Treas. Reg. § 1.6662-6, effective February 9, 1996. The language of Temp. Treas. Reg. § 1.6662-6T(a)(2) is mirrored by that of Treas. Reg. § 1.6662-6(a)(2). Taxpayers may elect to apply Treas. Reg. § 1.6662-6 to apply to all open taxable years beginning after December 31, 1993.

Corp A's transfer pricing study for Y1 indicated understatements of income totaling $a, with respect to controlled transactions with the Twelve CFCs, and overstatements of income totaling $b of income, with respect to controlled transactions with the Four CFCs. Treas. Reg. § 1.482-1(a)(3) permits taxpayers to decrease taxable income on a timely-filed, original return. Thus, Corp A could have decreased its taxable income with respect to these controlled transactions with different CFCs by $c on its Y1 timely-filed original return. The question is whether that is, in fact, what Corp A accomplished through the disclosures on the Form 8275 attachments to such return.

Our view is that Corp A reported the decrease in taxable income with respect to these controlled transactions with different CFCs on the Y1 timely-filed original return. We base our view on Friedman v. Commissioner, 97 T.C. 606 (1991), in which the Tax Court concluded that a Form 1045, Application for Tentative Refund, that by itself clearly was not a return, constituted information on a return.

In Friedman, the Tax Court considered whether there was a substantial understatement of tax attributable to grossly erroneous items of one spouse on the return of the taxpayers. The taxpayers, husband and wife, jointly filed an income tax return for the 1983 year, and claimed a loss for a computer leasing transaction. The 1983 return reflected a substantial unused net operating loss. The taxpayers then filed Form 1045, Application for Tentative Refund, seeking to carry back the 1983 net operating losses to 1982 and 1981. The Service allowed the claimed tentative refunds. Subsequently, the Service determined deficiencies for taxable years 1981 to 1985 against the taxpayers. Taxpayers sought innocent spouse relief for taxpayer-wife, but the Service argued that because the original income tax returns for 1981 and 1982 were accepted as filed by the Service, no understatement existed with respect to those years, and therefore the taxpayer-wife could not receive innocent spouse relief. The Service took the position that the understatement of tax occurred on the Form 1045, and that a Form 1045 is not a return. The Tax Court rejected this argument. The Tax Court said:

> Although the Form 1045, standing alone, might not be a return, it was intended to modify and, in that regard, did become an intrinsic part of [taxpayers'] 1981 and 1982 returns. We think that relationship, resulting from the merger of the jointly executed Forms 1045 and the 1981 and 1982 joint returns, satisfies the 'on such return' language of section 6013(e)(1)(B).

The Tax Court rejected the Service's argument that the understatement must appear on the face of the original return document, and instead stated that the proper test was to consider "the return and all pertinent documents in connection therewith that gave rise to the erroneous item." 97 T.C. at 612.

In the instant case, Corp A attached to the Y1 return a Form 8275, Disclosure Statement, explaining its reasoning in arriving at the computation. Examination of the Form 8275, coupled with examination of the Schedule M-1 attached to the return, plainly set forth the computation and the considerations that led taxpayer to report the transactions in the manner that it did. Our view is that if the Tax Court found the Form 1045 was an "intrinsic part" of the original return, it would by analogy also find that the potential decrease in taxable income with respect to these controlled transactions with different CFCs disclosed on the Form 8275 attachments was reported on the Y1 timely-filed, original return.

The foregoing analysis presupposes the validity and accuracy of Corp A's disclosures on the Form 8275 attachments to the Y1 return and the corresponding contemporaneous documentation that demonstrates the results disclosed. If the disclosures on the Form 8275 attachments and the transfer pricing study upon which the disclosures rely do not reflect a good faith effort to apply the arm's length standard, or if they otherwise rely on an unreasonable basis, our conclusions would be different. You may wish to verify that the method used, its application, and the results reached by Corp A comply with the arm's length standard and the regulations under section 482.

2. Results of controlled transactions with respect to a CFC may not set off results of controlled transactions with respect to another CFC on an untimely or amended return.

As set forth in the facts, although Corp A reported an overall increase of $l in taxable income with respect to its controlled transactions with different CFCs on its Y1 amended return, that increase consisted of a net of increases of taxable income with respect to controlled transactions with some CFCs from the Y1 timely-filed original return against decreases of taxable income with respect to controlled transactions with other CFCs from the Y1 timely-filed original return. Corp A contends that the plain meaning of Treas. Reg. § 1.482-1(a)(3) supports its ability to report the aggregate results of its controlled transactions with different CFCs on an amended return, so long as such aggregate is an increase (rather than a decrease) in taxable income with respect to those different controlled transactions. Examination contends that the regulation does not permit the setoff of the results of controlled transactions with a CFC against the results of controlled transactions with another CFC. We agree with Examination's interpretation of the regulation.

The purpose of section 482, as set forth by Treas. Reg. § 1.482-1(a)(1), is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 and Treas. Reg. § 1.482-1(a)(2) provide the Service with authority to make allocations

between or among the members of a controlled group where a controlled taxpayer has not reported its true taxable income, and such allocations may take the form of an increase or decrease in any relevant amount (income, deductions, credits, allowances, etc.). Treas. Reg. § 1.482-1(a)(3) provides a controlled taxpayer with limited authority to make allocations or other adjustments under section 482 with respect to controlled transactions. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return the results of its controlled transactions based upon prices different from those actually charged. Such allocations or other adjustments with respect to controlled transactions reported on a timely filed U.S. income tax return are permitted whether they increase or decrease taxable income. Allocations or other adjustments with respect to controlled transactions reported on an untimely or amended return are permitted only to increase taxable income. No untimely or amended returns are permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions.

Accordingly, if Corp A had only a single CFC, and the adjusted results of Corp A's controlled transactions with such CFC, as measured by the updated CPM analysis, would give rise to an increase in taxable income vis-à-vis the results disclosed in connection with Corp A's timely-filed original return, then Corp A clearly would be permitted by Treas. Reg. § 1.482-1(a)(3) to file an untimely or amended Y1 return to report such increase. Provided such amended return (or written statement furnished by a taxpayer subject to the CEP) satisfied the requirements of Temp. Treas. Reg. § 1.6662-6T(a)(2), cross referenced in Treas. Reg. § 1.482-1(a)(3), it would protect against the imposition of the transfer pricing penalty on account of such increase. Indeed, the need to enable taxpayers to protect themselves against the transfer pricing penalty appears to have motivated the incorporation of the exception (as indicated by the cross reference) in Treas. Reg. § 1.482-1(a)(3), permitting taxpayers to untimely amend their original returns to report an increase in taxable income with respect to their controlled transactions.

Conversely, if Corp A had only a single CFC, and the adjusted results of Corp A's controlled transactions with such CFC as measured by the updated CPM analysis would give rise to a decrease in taxable income vis-à-vis the results disclosed in connection with Corp A's timely-filed original return, then Corp A clearly would not be permitted by Treas. Reg. § 1.482-1(a)(3) to file an amended Y1 return to report such decrease.

In a case like the instant one, where Corp A has multiple CFCs and, as measured by the updated CPM analysis, Corp A would experience increases in taxable income with respect to its controlled transactions with some of the CFCs, but would experience decreases in taxable income with respect to its controlled transactions with other CFCs, Treas. Reg. § 1.482-1(a)(3) cannot be construed to permit the setoff on an untimely or

amended return of the decreases against the increases, since the regulation would have precluded separately reporting such decreases if Corp A only owned the latter CFCs.[8]

We have also considered the case where Corp A separately applied the updated CPM analysis with respect to its controlled transactions with a single CFC in each of the CFC's different product lines ("Product Line 1" and "Product Line 2"). See Treas. Reg. § 1.482-1(f)(2)(iv). If the separate application of the updated CPM analysis would give rise to an increase in taxable income with respect to the Product Line 1 controlled transactions, but would give rise to a decrease in taxable income with respect to the Product Line 2 controlled transactions, Treas. Reg. § 1.482-1(a)(3), by its terms, would only permit an allocation or adjustment on an untimely or amended return with respect to the Product Line 1 controlled transactions, and would preclude an allocation or adjustment with respect to Product Line 2 controlled transactions. If, however, Corp A limited itself to reporting the updated results of Product Line 2 as a setoff against the updated results of Product Line 1 (i.e., did not report a net decrease in taxable income, to the extent the decrease in taxable income attributable to Product Line 2 exceeded the increase in taxable income attributable to Product Line 1), the Service should give effect to such setoff under Treas. Reg. § 1.482-1(g)(4), provided the requirements of such regulation are satisfied. For purposes of determining whether those requirements are met, we would consider that by reporting an increase of Corp A's taxable income with respect to the Product Line 1 controlled transactions "an allocation is made under section 482 with respect to a transaction between controlled taxpayers" since such increase would be an allocation or other adjustment based on controlled transactions that Corp A is authorized to make pursuant to Treas. Reg. § 1.482-1(a)(3). In the posited case, the Product Line 2 transactions as originally reported would constitute other non-arm's length transactions between the "same controlled taxpayers [i.e., Corp A and the given CFC] in the same taxable year." Furthermore, a setoff will be taken into account only if the requirements of Treas. Reg. § 1.482-1(g)(4)(ii) are satisfied. In that connection, the Service would need to ascertain whether the updated transfer pricing study that provided the foundation for the Y1 amended return (or the taxpayer otherwise) establishes, in accordance with Treas. Reg. § 1.482-1(g)(4)(ii)(A), that the Product Line 2 controlled transactions as originally reported were not at arm's length

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[8] The situation of what Corp A describes as its qualified amended return places this aspect in extreme relief. The only change on that amended return from the previous amended return was to report a decrease in taxable income with respect to Corp A's controlled transactions with respect to the One CFC. In the absence of the previous amended return, and the taxpayer's contention that any decrease with respect to a CFC may be set off against an increase with respect to another CFC (so long as the net is an increase), the subsequent amended return clearly would violate Treas. Reg. § 1.482-1(a)(3).

and the appropriate arm's length charge. The Service would also need to ascertain whether the updated transfer pricing study (or the taxpayer otherwise) documents, in accordance with Treas. Reg. §§ 1.482-1(g)(2) and 1.482-1(g)(4)(ii)(B), all correlative adjustments resulting from the setoff with respect to the Product Line 2 controlled transactions. Finally, we would consider that, by reporting a decrease of Corp A's taxable income with respect to the Product Line 2 controlled transactions, Corp A would have substantially met the notice requirement in accordance with Treas. Reg. §1.482-1(g)(4)(ii)(C), even though technically such notice might be viewed as too early (since it would not be after the earlier of a 30-day letter or statutory notice of deficiency).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

2. As discussed above, on an untimely or amended return, Treas. Reg. § 1.482-1(a)(3) only permits taxpayer-initiated allocations or other adjustments to increase taxable income. [redacted]

[redacted]

4. On its Y1 amended return and Y1 qualified amended return, Corp A claims to have made all appropriate correlative, compensating and associated secondary adjustments from the modified transfer pricing results and other changes to taxable income. [redacted] We note that Rev. Proc. 99-32, 1999-34 I.R.B. 296, provides that, for taxable years prior to the taxable year including August 23, 1999 (the revenue procedure's date of publication) — Y1 being a taxable year within this category — a controlled taxpayer that increased or decreased its taxable income pursuant to section 482 and Treas. Reg. § 1.482-1(a)(3) shall be permitted to apply the principles of Rev. Proc. 65-17, 1965-1 C.B. 833, and its progeny, in accordance with any reasonable interpretation thereof for purposes of conforming accounts to reflect the taxpayer-initiated adjustment. The Service considers an interpretation that applies Rev. Proc. 99-32 or its general principles to be such a reasonable interpretation of Rev. Proc. 65-17.

If you have any further questions, please call (202) 874-1490.

By: _____

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