

Office of Chief Counsel
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Memorandum

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to: Appeals Field Office East
Area 1
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subject: Accrual of Interest Associated with Qualified Amended Returns

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUES

Whether unpaid interest on the increase in taxpayer's 1988 income tax deficiencies resulting from a Coordinated Examination Program (CEP) Qualified Amended Return (QAR) furnished in 1994 year was accruable in 1994.

CONCLUSIONS

The unpaid interest on the increase in taxpayer's 1988 income tax deficiencies resulting from a CEP QAR consisting of a written statement furnished in 1994 was not accruable in 1994, and the taxpayer is not entitled to deduct interest relating to the amounts of the

1988 tax deficiencies in 1994 because the furnishing of the QAR failed to meet the fixed and determinable prongs of the all events test.

FACTS

Taxpayer is under the Coordinated Examination Program (CEP), is under continuing audit, and the issue being considered in this memorandum occurs over many years on a continuing basis. In an effort to simplify the facts to assist in clarifying the discussion, for purposes of this analysis, we assume the following facts. In 1994, taxpayer furnished to Exam a written statement that met the definition of a Qualified Amended Return (QAR) as defined by Rev. Proc. 94-69, 1994-2 C.B. 804, modifying Rev. Proc. 85-26, 1985-1 C.B. 580. The adjustments from the QAR resulted in an increase in tax, and taxpayer deducted the interest expense on the increase on its 1998 tax return. Taxpayer subsequently filed a claim for refund on a Form 1120X. Taxpayer asserted that it was entitled to interest on the volunteered adjustments furnished to Exam on the QAR during the examination process, and further claimed that the interest computation dated started on the due date of the return in which the volunteered adjustment related. Exam determined that taxpayer was entitled to an accrued interest expense deduction on the initial net QAR as of the date of the filed QAR plus 30 days.

LAW

QUALIFIED AMENDED RETURNS

I.R.C. § 6662 imposes an accuracy-related penalty equal to 20 percent of the portion of any underpayment that is attributable to (1) negligence or disregard of rules or regulations, or (2) any substantial understatement of income tax. I.R.C. § 6662 was amended by OBRA 1989 and, as amended, applies to returns due after December 31, 1989 (determined without regard to extensions).

Under I.R.C. § 6662(d)(2)(B)(ii), prior to the amendment by OBRA 1993, and Treas. Reg. § 1.6662-4(e),¹ the tax treatment of an item (other than a tax shelter item) that is not frivolous and is adequately disclosed is not taken into account in computing the amount of an understatement of income tax for purposes of the substantial understatement penalty.

Treas. Reg. §§ 1.6662-3(c) and 1.6662-4(f) provide the methods for making adequate disclosure for purposes of the (1) penalty for negligence or disregard of rules or regulations, and (2) the substantial understatement penalty, respectively. These methods include attaching a properly completed Form 8275, Disclosure Statement, to an original return or to a qualified amended return in the case of an item or position other than one that is contrary to a regulation.

Treas. Reg. §§ 1.6661-6(c)(2) and 1.6664-2(c)(3) generally provide that for purposes of the substantial understatement penalty and the accuracy-related penalty, respectively, a

¹ Unless otherwise specified, references to Treasury Regulations under I.R.C. §§ 6661, 6662, and 6664 are to the regulations applicable for the year at issue.

"qualified amended return" is an amended return that is filed after the due date of the return for the taxable year and before the time the taxpayer is first contacted regarding an examination of the return. A qualified amended return also includes an amended return that is filed within such time frame solely to disclose information but does not report any additional tax liability. In addition, Treas. Reg. §§ 1.6661-6(c)(4) and 1.6664-2(c)(4) provide that the Commissioner may prescribe by revenue procedure the manner in which the rules governing qualified amended returns apply to particular classes of taxpayers.

Rev. Proc. 94-69 provides special procedures for CEP taxpayers to show additional tax due or make adequate disclosure with respect to an item or a position to avoid imposition of the substantial understatement penalty imposed under former section 6661 and the accuracy-related penalty currently described in sections 6662(b)(1) and 6662(b)(2).

Section 3.01 of Rev. Proc 94-69 provides that for purposes of avoiding imposition of the penalty under section 6662(b)(1) for negligence or disregard of rules or regulations for tax returns due after December 31, 1989, and the substantial understatement penalty under former section 6661 or section 6662(b)(2), a written statement furnished by a CEP taxpayer to the Service personnel requesting the statement is treated as a qualified amended return if the written statement is:

(1) described in section 3.02 and

(2) furnished after the tax return has been filed but no later than 15 days (or any later date agreed to in writing by the appropriate District official upon a showing of reasonable cause) from the date of written notice from the Service to the taxpayer requesting that such statement be furnished with respect to the taxable year(s) involved.

Section 3.02 of Rev. Proc 94-69 defines a written statement as one that includes:

(1) the caption "Furnished under Rev. Proc. 94-69 ";

(2) a description of all items that would result in adjustments if the taxpayer, in lieu of furnishing a written statement, filed a properly completed amended return. The description of an item is adequate if it consists of information that reasonably may be expected to apprise the Internal Revenue Service of the identity of the item, its amount, and the nature of the controversy or potential controversy. For example, the statement that certain amounts deducted as expenses should instead have been capitalized is adequate only if it refers to specific accounts and amounts recorded in invoices or journal entries. Further, if a position contrary to a rule or regulation has been taken with respect to an item, the statutory or regulatory provision or the ruling in question must be adequately identified; and

(3) The following declaration signed by a person authorized to sign the return of the taxpayer: "Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief this written statement is true, correct, and complete."

Section 3.03 of Rev. Proc. 94-69 provides that a written statement need not include a recomputation of tax liability. Similarly, if an item automatically affects another item, the written statement need not include a recomputation of the affected item.

INTEREST

Pursuant to I.R.C. § 6601(a) interest is required to be paid on any underpayment of tax. I.R.C. § 163(a) allows taxpayers a deduction for interest paid or accrued within the taxable year on indebtedness, with the exception of personal interest. Indebtedness has been defined as an existing, unconditional, and legally enforceable obligation for the payment of money. *Perkins v. Commissioner*, 92 T.C. 749, 759 (1989).

TIMING OF INTEREST EXPENSE DEDUCTION

Generally, under I.R.C. § 461(a), the amount of a deduction allowed shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. I.R.C. § 446(c)(2) allows a taxpayer to compute taxable income by an accrual method of accounting. An accrual method taxpayer is entitled to deduct expenses in the year in which they are incurred, regardless of when they are actually paid. *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 599 (1986).

Under the accrual method of accounting, expenses may be deducted only if taxpayer satisfies three criteria. First, all events must have occurred that establish the fact of liability. Treas. Reg. § 1.446-1(c)(1)(ii). A liability is established or fixed when it is based on facts actually known or reasonably knowable at the end of the taxable year. *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 602 (1986). *See also United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987) (even though expenses may be deductible before due and payable, liability must first be firmly established for all events test to apply). *See also Globe Products Corp. v. Commissioner*, 72 T.C. 609, 621, 622 (1979), *acq.*, 1980-2 C.B. 1.

Second, the amount of the liability can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii). Even though the precise amount of a liability incurred is not known, a taxpayer may take a deduction if the amount can be computed with reasonable accuracy within the taxable year. Treas. Reg. § 1.461-1(a)(2)(ii). *See also Continental Tie and Lumber Corp. v. United States*, 286 U.S. 290, 297-298 (1932) (amount of liability considered determinable with reasonable accuracy when basis for calculation of liability is known or knowable at end of tax year). If an amount is properly accrued based on a computation made with reasonable accuracy and the exact amount of liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account in the later year when the exact amount is determined. Treas. Reg. § 1.461-1(a)(3).

Third, economic performance must have occurred with respect to the liability. I.R.C. § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). With regard to interest, economic performance occurs as the interest cost economically accrues. Treas. Reg. § 1.461-4(e). According to the legislative history of section 461(h), economic performance occurs with respect to interest "with the passage of time (that is, as the borrower uses, and the lender forgoes use of, the lender's money) rather than as payments are made." H. REP. NO. 861, 98th Cong., 2d Sess., 875 (1984).

For an accrual method taxpayer, interest on a tax deficiency begins to accrue in the year the underlying tax liability is fixed through agreement, by settlement, or by final order of the court, and the amount of the liability is determinable with reasonable accuracy. *Southwest Exploration Company v. Riddell*, 362 F.2d 833, 837 (9th Cir. 1966); *Fifth Avenue Coach Lines, Inc. v. Commissioner*, 281 F.2d 556, 558-560 (2nd Cir. 1960), *cert. denied*, 366 U.S. 964 (1961) (interest on tax deficiencies is not accruable where liabilities remained contested and taxpayer did not relinquish right to appeal deficiency amounts). *Exxon Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1999-247, and *Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner*, T.C. Memo. 1991-257. An accrual basis taxpayer will not be allowed to deduct interest on a tax deficiency until the liability for the deficiency is finally determined. *Kolkey v. Commissioner*, 27 T.C. 37, 65 (1956); Rev. Rul. 70-560, 1970-2 C.B. 37. In Rev. Rul. 70-560 the Service indicated that if a taxpayer agrees to a tax deficiency when asserted against it, taxpayer may accrue the interest on the deficiency in the tax year of the agreement.

ANALYSIS

The unpaid interest on the increase in taxpayer's 1988 income tax deficiencies resulting from a CEP QAR consisting of a written statement furnished in 1994 was not accruable in 1994, and the taxpayer is not entitled to deduct interest relating to the amounts of the 1988 tax deficiencies in 1994 because the furnishing of the QAR failed to meet the fixed and determinable prongs of the all events test.

FIXED PRONG OF THE ALL EVENTS TEST

The deficiency interest cannot be deducted in 1994 because the interest liability was not fixed in 1988 by the furnishing of the QAR. None of the relevant events, the end of the audit, or the signing of a Form 870 had occurred.

The furnishing of a CEP QAR consisting of a written statement by itself does not fix liability. Treas. Reg. §§ 1.6662-3(c) and 1.6662-4(f) make clear that the purpose of a QAR is to provide a method for making adequate disclosure for purposes of avoiding the accuracy-related penalty attributable to a negligence or disregard of rules or regulations, or to the substantial understatement of income tax, respectively. See also Rev. Proc 94-69, § 3.01. Neither the regulations nor the revenue procedure provides that a QAR may be used to fix liability for purposes of the deficiency interest expense.

A CEP QAR under Rev. Proc. 94-69 is a written statement, defined in section 3.02(2) as:

a description of all items that would result in adjustments if the taxpayer, in lieu of furnishing a written statement, filed a properly completed amended return. The description of an item is adequate if it consists of information that reasonably may be expected to apprise the Internal Revenue Service of the identity of the item, its amount, and the nature of the controversy or potential controversy. For example, the statement that certain amounts deducted as expenses should instead have been capitalized is adequate only if it refers to specific accounts and amounts recorded in invoices or journal entries.

The Tax Court addressed the issue of when interest on tax deficiencies accrues under section 461 in the cases of *Exxon Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1999-247, and *Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner*, T.C. Memo. 1991-257. In both cases the Tax Court held that the taxpayers' liability for tax deficiencies was not sufficiently fixed in the year taxpayers proposed to deduct related deficiency interest.

In *Exxon Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1999-247, the Tax Court denied taxpayer a deduction for interest related to allegedly uncontested tax deficiencies in the tax years to which the underlying deficiencies related based on taxpayer's failure to satisfy the fixed prong of the all events test. The Court observed that whether a liability is contested and when a contested liability is resolved are questions of fact. The Court concluded that taxpayer could not deduct the interest relating to the deficiencies in the year to which the tax adjustments related. Rather, interest could not be deducted until the earlier of either the end of the audits (when RARs were issued and taxpayer executed Forms 870 evidencing its agreement to some of the adjustments at issue) or when the Service made assessments. The Court noted that before either of these events the adjustments were not fixed and definite, since taxpayer provided "insufficient specific communication" to the Service reflecting its agreement to the proposed adjustments. The Court explained that a taxpayer's liability is fixed when agreements regarding the tax adjustments are entered into in a clear and formal manner.

In *Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner*, T.C. Memo. 1991-257, the Tax Court similarly denied taxpayer a deduction of deficiency interest in 1975-1978 relating to uncontested tax deficiencies for 1970-1977. The Court held that taxpayer's unprotested adjustments were not sufficiently settled to allow taxpayer to accrue deductions for related interest prior to the point at which taxpayer signed Forms 870-AD or Forms 866 ("Agreement as to Final Determination of Tax Liability") both of which gave the Service permission to assess. The Court observed that prior to signing these forms, taxpayer neither explicitly agreed to the proposed adjustments nor explicitly contested them.

As the Tax Court stated in *Exxon*, particularly in the case of prolonged audits where numerous adjustments are developed and negotiated over a period of years (as was the case here) statutory interest relating to the eventually agreed-upon tax adjustments is not fixed and definite until an agreement between taxpayer and the Service regarding the underlying tax adjustments is entered into in a clear and formal manner. *Exxon Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1999-247.

DETERMINABLE PRONG OF THE ALL EVENTS TEST

Taxpayer's liability for interest on the "agreed" tax deficiencies was not reasonably determinable 1994 upon the furnishing of the QAR since at that time the amount of taxpayer's underlying tax liability had not been determined. The facts on which the calculation of the final deficiency amounts would be based were not established in 1994. The audit appears to have been a prolonged one, with references to subsequently filed amended returns, adjustments and calculations. It was not until taxpayer and Exam computed the final tax liabilities, that the related interest liabilities were determinable with reasonable accuracy

CONCLUSION

Taxpayer is not entitled to deduct interest relating to the amounts of proposed 1988 tax deficiencies upon the furnishing of the QAR for failure to meet the fixed and determinable prongs of the all events test. Taxpayer did not fix its liability in 1994 by presenting the QAR written statement. Taxpayer did not enter into a partial Form 870 waiver agreement in 1994. Rather, the amounts were fixed when an agreement between taxpayer and the Service regarding the underlying tax adjustments was entered into in a clear and formal manner. In addition, the amount of interest on the tax adjustments was not reasonably determinable until all of the adjustments were agreed to and calculated.

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Please call (202) 622-4910 if you have any further questions.