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Subject: Mitigation Statutes: Procedures for Collecting from Barred Years

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**LEGEND**

Taxpayer =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Date 1 =
ISSUE
The Internal Revenue Service and the Taxpayer determined by closing agreement the Taxpayer’s total tax liabilities for certain years. Within one year of the closing agreement’s execution, the Service credited the Taxpayer’s overpayment for one of the years against the Taxpayer's liabilities for the other taxable years. The Service did not, however, assess those liabilities, and the other taxable years are now barred years. Is the Taxpayer entitled to a refund of the amounts credited?

CONCLUSION
Within the applicable period of limitations, the Service may credit any overpayment of tax against any outstanding liability owed by the person making the overpayment, even if the outstanding liabilities are not assessed. The Taxpayer, therefore, is not entitled to a refund.

FACTS
After the Internal Revenue Service proposed changes to the Taxpayer’s income tax liability for Year 1, the taxpayer filed a claim to revise the use of investment tax credits. The taxpayer and the Service later agreed to certain adjustments for Year 1, Year 2, Year 3, Year 4, and Year 5. On Date 1, the Taxpayer and the Service entered into an agreement as to Final Determination of Tax Liability (Form 866-c), which determined the taxpayer’s total income tax liability for Year 1, Year 2, Year 3, Year 4, and Year 5, taking the agreed-upon adjustments into account. Also on Date 1, the Taxpayer submitted an Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment (Form 870-AD). In this waiver, the Taxpayer accepted as correct an overassessment for Year 1 in the amount of $V, and further agreed to waive the restrictions on assessment of deficiencies for Year 2, Year 3, Year 4, and Year 5, in
the amounts of, $W, $X, $Y, and $Z. On Date 2 and Date 3, refunds were sent to the Taxpayer. Notwithstanding the closing agreement and waiver, the deficiencies for Year 2, Year 3, Year 4, and Year 5 have not been assessed; instead, the overpayment for Year 1 was credited to Year 2, Year 3, Year 4, and Year 5 in amounts corresponding to the Taxpayer’s Year 2, Year 3, Year 4, and Year 5 liabilities for tax and interest. In Month of the year the closing agreement and the waiver were executed, each of these amounts was transferred from Year 1 to the tax year for which it was computed and to which it credited. Those amounts were then transferred to excess collections. The periods of limitation for assessment for Year 2, Year 3, Year 4, and Year 5 are now closed, but the period of limitation for a refund for Year 1 remains open.

LAW AND ANALYSIS

The mitigation provisions of sections 1311-1314 of the Internal Revenue Code were designed to palliate the effect of limitations in certain narrowly drawn situations. See Bradford v. Commissioner, 34 T.C. 1051, 1054 (1960). For an adjustment to be authorized under these provisions, four conditions must be met:

- First, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See I.R.C. §1311(a).
- Second, there must be a “determination” for an open tax year. As defined in section 1313(a), a determination is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treasury Regulation section 1.1313(a)-4.
- Third, the determination must result in a circumstance under which an adjustment is authorized by section 1312. There are seven circumstances under which an adjustment is authorized. These circumstances involve double inclusion of an item of gross income (section 1312(1)); double allowance of a deduction or credit (section 1312(2)); double exclusion of an item of gross income (section 1312(3)); double disallowance of a deduction or credit (section 1312(4)): correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (section 1312(5)); correlative deductions and credits for certain related corporations (section 1312(6)); and basis of property after erroneous treatment of a prior transaction (section 1312(7)).
- Fourth, except for determinations described in section 1312(3)(B) and in section 1312(4), the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred. See I.R.C. § 1311(b).

An adjustment authorized under the mitigation provisions is to be made by assessing and collecting, or refunding or crediting, the amount of the adjustment as if it were a deficiency or an overpayment for the taxable years involved, and as if one year remained on the date of the determination before the expiration of the period of limitation on assessment and collection or the period of limitation on filing claim for refund. I.R.C. § 1314(b).
All four conditions for mitigation of the effect of limitations for Year 2, Year 3, Year 4, and Year 5 were met as of Date 1, the date the closing agreement between the Taxpayer and the Service was executed. An error had occurred in the closed years Year 2, Year 3, Year 4, and Year 5, in that the Taxpayer received investment tax credits that the closing agreement implicitly determined could not be carried over from Year 1. See *Bewkes v. United States*, No. 97-14452-CIV-LYNCH, 1999 U.S. Dist. LEXIS 9900, at *12-*13 (S.D. Fla. June 16, 1999); cf. *Bolten v. Commissioner*, 95 T.C. 397 (1990) (applying mitigation provisions to permit assessment of a deficiency based upon the reduction of a net operating loss carryover). The closing agreement constituted a determination under section 1313(a)(2) for the then-open Year 1 tax year. This determination resulted in a circumstance under which an adjustment was authorized by section 1312(2). Finally, the determination adopted a position maintained by the Taxpayer, namely, that investment tax credits were allowable for Year 1, which was inconsistent with the erroneous allowance of those same credits for Year 2, Year 3, Year 4, and Year 5.

Section 1314(b) authorized assessment of adjustments for Year 2, Year 3, Year 4, and Year 5 to be made within one year of the execution of the Date 1 closing agreement. As noted, those assessments were not made, and the periods of limitation for assessment have now lapsed.

It has been suggested that the doctrine of equitable recoupment would allow the Service to reduce any overpayment for Year 1 by the amount of the unassessed deficiencies for Year 2, Year 3, Year 4, and Year 5. The doctrine of equitable recoupment allows the government to reduce or eliminate a timely refund claim by the amount of a barred deficiency claim arising out of the same transaction. See *Stone v. White*, 301 U.S. 532, 539 (1937). Equitable recoupment is a defense that permits a transaction to be examined in all of its aspects and judged as a whole. *United States v. Dalm*, 494 U.S. 596, 611 (1990). The doctrine allows a single transaction to be taxed consistently.

The mitigation provisions apply only as described in sections 1311 through 1314, and do not supplant the doctrine of equitable recoupment. In a case that falls within their general scope, the mitigation provisions do, however, preempt equitable recoupment as a remedy. See *Benenson v. United States*, 385 F.2d 26, 32 n.8 (2d Cir. 1967); *Gooding v. United States*, 164 Ct. Cl. 197, 210 (1964) (“When Congress established the detailed provisions of the mitigation sections it intended, we think, that they supersede any common-law recoupment remedies with respect to the categories designated in section 1312”); GCM 34605 (Sept. 10, 1971), 1971 GCM LEXIS 100. But cf. *First Nat’l Bank v. United States*, 565 F.2d 507, 518 (8th Cir. 1977) (holding that taxpayers were entitled to recover under the mitigation provisions, but that the government could reduce the recovery by means of equitable recoupment, notwithstanding the prohibition in I.R.C. §1314(c) on setoffs), AOD 1978-96 (Apr. 12, 1978), 1978 AOD LEXIS 157 (criticizing the court’s holdings on mitigation without discussing the court’s holding on equitable recoupment).
The Service did not assess the Taxpayer’s liabilities for Year 2, Year 3, Year 4, and Year 5, even though the mitigation provisions authorized adjustments. The Service, accordingly, cannot now use the doctrine of equitable recoupment to reduce the Taxpayer’s overpayment for Year 1 by the Taxpayer’s liabilities for Year 2, Year 3, Year 4, and Year 5.

Equitable recoupment, however, is not the only means by which the Service may reduce an otherwise allowable overpayment by the amount of barred deficiencies:

[I]f the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of any internal revenue tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 6402 and the corresponding provisions of prior revenue laws.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer’s tax liability for the year with respect to which the determination is made and to make the adjustment under section 1311 for the year with respect to which the error was made or for a year which is affected, or treated as affected, by a net operating loss deduction or a capital loss carryover from the year of the error.

Treas. Reg. § 1.1314(c)-1(e). Within the applicable period of limitations, the Service may credit the amount of any overpayment against any outstanding liability and refund any balance to the person who made the overpayment (unless the person has past-due support obligations (section 6404(c)), owes debts to federal agencies (section 6404(d)), or has past-due, legally enforceable state income tax obligations (section 6404(e)). Sec. 301.6402-1, Proced. & Admin. Regs. An outstanding liability can be established without an assessment. See Baral v. United States, 528 U.S. 431 (2000) (holding that payment may occur before assessment; Goldston v. United States, 104 F.3d 1198, 1199-1200 (10th Cir. 1997) (“Abundant precedent exists for the proposition in a variety of tax contexts that liability for federal taxes does not hinge on whether the IRS has made a valid assessment.”).

In this case, the Taxpayer’s liabilities for Year 2, Year 3, Year 4, and Year 5 were established by closing agreement. Within one year of the closing agreement’s execution, the Service credited the Taxpayer’s overpayment for Year 1 against the Taxpayer’s liabilities for the other years. Notwithstanding the Service’s failure to make assessments for Year 2, Year 3, Year 4, and Year 5, the crediting of the Year 1 overpayment against the Year 2, Year 3, Year 4, and Year 5 liabilities was permissible. Accordingly, the Taxpayer has no remaining overpayment for Year 1 and no additional refund is due the Taxpayer for Year 1.
CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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