Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Deborah M. Nolan, Commissioner
(Large and Midsize Division)

from: Christopher Sterner, Division Counsel
(Large & Mid-Size Business)

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subject: Application of the Compliance Assurance Process (CAP) to Prospective or Incomplete Transactions

LMSB personnel working CAP cases receive information from CAP taxpayers relating to transactions occurring during the CAP year and transactions proposed to occur during the CAP year. Questions have arisen as to when the CAP teams may discuss information related to these transactions with the taxpayers or their authorized representatives.

ISSUE:

When can LMSB CAP teams receiving information relating to CAP year tax items discuss the information with the taxpayers or their representatives?

CONCLUSION:

Because the CAP program does not change existing Service procedures for issuing determinations regarding prospective transactions or incomplete transactions and oral discussions of these types of transactions present significant hazards, CAP teams should not discuss with taxpayers the tax implications of any transaction or item until the tax treatment of that transaction or item can no longer be affected by events that have not yet occurred.

DISCUSSION:

Some CAP taxpayers are providing information relating to proposed transactions or incomplete transactions. This information may assist the CAP team in understanding the taxpayer's business and in identifying issues for compliance review. Further, to the extent that these transactions are actually carried out as proposed, the information may accelerate the compliance review process.

The CAP Memorandum of Understanding provides that the objectives of CAP are:

(1) to have the IRS contemporaneously work with the Taxpayer to achieve federal tax compliance;

(2) to have the Parties resolve all or most issues prior to the filing of a tax return;

(3) to have the IRS reach an acceptable level of assurance regarding the accuracy and correctness of filed tax returns; and

(4) to eliminate or substantially reduce the need for a post-filing examination.

Thus, CAP is intended to achieve reporting compliance. If all of the identified items are resolved and the items are reported on the filed return as agreed, there, generally, will be no further examination of the return. CAP is not intended to assist the taxpayer in planning its transactions or in getting board of director approval of a transaction by providing guidance on a proposed transaction.

Private Letter Ruling Process

Rev. Proc. 2006-1, 2006-1 I.R.B. 1, explains the forms of advice and the manner in which advice is requested by taxpayers and provided by the Service. The letter ruling process, described in Rev. Proc. 2006-1, provides the exclusive means for taxpayers to obtain a written determination by the Service applying the tax laws to a taxpayer's specific set of facts where those facts concern prospective transactions. Rev. Proc. 2006-1 provides formal procedures for obtaining determinations concerning prospective transactions. These procedures are very detailed and provide important safeguards for the Service and taxpayers.

In providing an orderly procedure for obtaining pretransactional legal advice, the revenue procedure seeks to achieve several goals. These goals include:

(a) Consistent treatment of taxpayers;

(b) Fair treatment to similarly situated taxpayers;

(c) Establishment of procedures to determine where legal resources should be focused;

(d) Provision of a vehicle for taxpayers to request legal advice and make decisions based on that legal advice; and

(e) Establishment of a structure that allows the Service to audit an issue or a transaction to verify that the facts relied on for the legal advice are as represented.

Under the traditional audit process, the examination divisions may audit return positions to verify that the facts on which a private letter ruling relies are, in fact, consistent with the actual facts. The legal conclusion in a private letter ruling may not be relied upon if

the facts differ materially from those represented. The written description of the facts underlying the letter ruling is thus critical to determine whether the taxpayer has appropriately relied upon the ruling in taking its return position.

All of the Associates have been briefed on CAP and understand the need to accelerate the private letter ruling process in CAP cases. Thus, a taxpayer wishing certainty in a pre-transactional environment must utilize the private letter ruling process.

The decision to issue a private letter ruling or other guidance lies with the appropriate Associate Chief Counsel. Sections 5.14 and 6 of Rev. Proc. 2006-1 provide various circumstances under which the Service does not issue letter rulings. Ultimately, if the Associate office determines that the issuance of private letter rulings is not in the best interest of tax administration, the rulings will not be issued. Once an Associate Chief Counsel determines that his or her office will not issue private letter rulings involving a particular issue, any discussion about this issue before the tax treatment of that issue is complete that does not fall within the exceptions involving oral "non-binding" guidance could lead to claims of disparate treatment from non-CAP taxpayers.

Discussions about incomplete or proposed transactions between CAP teams and taxpayers provides taxpayers with legal guidance and should be avoided.

Section 2.05 of Rev. Proc. 2006-1 states that the Service does not orally issue letter rulings or determination letters, nor does it issue letter rulings or determination letters in response to oral requests from taxpayers. At the discretion of the Service and as time permits, substantive issues may be discussed. Such a discussion will not be binding on the Service or on the Office of Chief Counsel. Substantive tax issues involving the taxpayer that are under examination, in Appeals, or in litigation will not be discussed by Service employees not directly involved in the examination, appeal, or litigation of the issues unless the discussion is coordinated with the Service employees who are directly involved in the examination, appeal, or litigation. A taxpayer may seek oral technical guidance from a taxpayer service representative in a field office or Service Center when preparing a return or report. Oral guidance is advisory only, and the Service is not bound to recognize it in the examination of the taxpayer's return.

Pre-Filing Agreement Program

The PFA program does not provide pre-transactional determinations. Unlike letter rulings and other forms of written guidance provided by the Offices of the Associate Chief Counsel, a PFA does not determine the tax treatment of prospective or future transactions or events, but only of completed transactions or events whose tax treatment has not yet been reported on a return. See section 1.02 of Rev. Proc. 2005-12. Section 3.03 of Rev. Proc. 2005-12 further limits the issues eligible for PFAs. PFAs are limited to issues that require either a determination of facts or the application of well-established legal principles to known facts. Section 3.03 also provides that the Service will, in general, consider entering into a PFA regarding a methodology used by a taxpayer to determine the appropriate amount of an item of income, allowance, deduction, or credit.

The methodology PFA does not address the tax treatment of an item but rather the methodology for computing an item.

As the CAP Program expands, taxpayers may seek input from the Account Coordinators on prospective or incomplete transactions when the transactions are material and complex and the issues involved are technical issues without a clear cut answer. In this scenario, the Account Coordinators may be asked to provide legal advice or to issue advice to the taxpayer for tax planning that is not permitted. To the extent that the Service provides pre-transactional guidance, it should be pursuant to Rev. Proc. 2006-1. Because discussions about prospective or incomplete transactions could alter the taxpayers' plans, result in changes to the transaction, or lead to claims of reliance, secret law or disparate treatment such discussions should be limited.

What is a prospective or incomplete transaction or issue? A prospective transaction is one that has not yet occurred. An incomplete transaction or issue is one for which the tax consequences may be affected by events that have not yet occurred.

Below are various scenarios that may arise in a CAP case followed by a discussion considering whether issues are permissible for consideration in CAP.

1. ABC Corporation, a CAP taxpayer, enters into a contract with Z Corporation for Z to develop an improved product for ABC's business. ABC agrees to make progress payments during the CAP year. ABC provides the CAP team with a copy of the contract and asks the CAP team to consider the research credit implications.

The CAP team may consider, discuss and resolve the base amount computations including the fixed base percentage and the average annual gross receipts for the four preceding years because the fixed base percentage and the average annual gross receipts for the four preceding years are not affected by events that have not yet occurred. However, any determinations relating to the base amount computations should include the caveat that the computations may change as a result of any mergers, acquisitions or dispositions. Further, the CAP team may consider and discuss the contract between ABC and Z Corporations to determine if, under the contract, the ABC Corporation bears the risk for development of the improved product and if any research would be considered funded. The CAP team, however, should not discuss or resolve issues around whether the research is qualified research. Consideration may be given to phases of a project, however, until an activity has occurred, the facts to determine if the activity constitutes qualified research are not completed.

2. During the CAP year, XYZ Corporation, a CAP taxpayer, entered into an agreement with W Corporation for W Corporation to purchase all of the stock of its wholly owned subsidiary, S. The contract requires that the parties elect under I.R.C. § 338(h)(10) to treat the transaction as a sale of assets. Before the transaction occurs, XYZ Corporation provides the contract to the CAP team and asks the CAP team to consider various proposals to achieve a desired tax result.

While the CAP team may review the contract, the CAP team should not discuss the tax consequences of any proposals to structure transactions with the taxpayer. Any discussion about the proposals could be considered legal guidance. XYZ Corporation should consider requesting a ruling from the appropriate Associate Chief Counsel office.

3. R Corporation, a CAP taxpayer, and S Corporation propose to merge. Pending the merger, there will be golden parachute payments under I.R.C. § 280G. Prior to closing of the merger, R Corporation has asked for resolution of the golden parachute issue.

Because this transaction is not complete until the merger occurs, discussions about this issue should be avoided. Prior to closing of the merger, taxpayer could alter its transaction as a result of such discussions.

4. X Corporation, a US manufacturer and distributor of bicycles, is a CAP taxpayer. Currently, X manufactures the frame, the brake assembly, gear assembly, seat, and handlebars. It purchases the wheel assembly and tires from a company in China. And, the entire bicycle is assembled in Mexico. X Corporation indicates that it intends to claim the I.R.C. § 199 deduction.

The CAP team may consider and discuss different methods for allocating gross receipts. It may also consider and discuss the hypothetical computations, including whether X will have contributed 20% of the cost of goods sold to the product in the US by only manufacturing the brake assembly, gear assembly, seat and handlebars. The team can further explain that, if it has so met the 20% safe harbor, the taxpayer can treat the bicycle as Qualified Production Property.

5. Same as 4, except that X is contemplating purchasing the frame from the Mexican assembling company, rather than manufacturing the frame. Were X to purchase the frame from the Mexican assembling company, the only manufacturing it would be performing is the brake assembly, gear assembly, seat and handlebars. X has asked the CAP team to consider the § 199 implications of purchasing rather than manufacturing the bicycle frame.

The team should avoid discussions about the § 199 implications of the proposal to purchase the bicycle frame because the transaction is not complete. However, should the cost of purchasing the frame increase so that X is not contributing 20% to the cost of goods sold, the team should not agree to whether the manufacture of the brake assembly, gear assembly, seat and handlebar components is substantial in nature. It is questionable whether the team would even want to weigh in on the 20% safe harbor computation, because the costs of purchasing from the Mexican company may be subject to increases during the CAP year, thereby shedding doubt on X's ability to meet the safe harbor. The team can also alert the taxpayer to the shrink back rule, i.e., shrinking back to the largest components that qualify, in this instance each of the brake assembly, gear assembly, seat and handlebars. The shrink back items (the brake assembly, gear assembly, seat and handlebars) will most certainly meet the safe harbor, since they were manufactured entirely in the US in this example.

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

Please call Lisa Shuman at (202)283-8621 if you have any further questions.

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Pre-filing and Technical Guidance

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