

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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UILC: 6514.00-00, 1311.00-00, 1314.02-00

date: October 19, 2011

to: Sharon D. Evans, Senior Program Analyst (TPP)
from: Blaise G. Dusenberry
Senior Technical Reviewer
(Procedure & Administration)

subject: Whether I.R.C. § 1314 holds open the period of limitation for filing suit for credit or refund under I.R.C. § 6532 for an additional year beyond the usual two year period following a notice of claim disallowance, such that I.R.C. § 6514 does not bar issuance of the credit or refund?

This Chief Counsel Advice responds to your request for assistance dated August 1, 2011. This advice may not be used or cited as precedent.

LEGEND

M Corporation =
Shareholder A =
Shareholder B =
Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

ISSUES

Whether I.R.C. § 1314 holds open the period of limitation for filing suit for credit or refund under I.R.C. § 6532 for an additional year beyond the usual two-year period following a notice of claim disallowance, such that I.R.C. § 6514 does not bar issuance of the credit or refund?

CONCLUSIONS

No. I.R.C. § 1314 does not extend the period for filing suit for a credit or refund for an additional year beyond the two-year period found in I.R.C. § 6532 when the refund or credit is sought under the mitigation provisions of the Code. The extension of the limitations period found in I.R.C. § 1314 applies only to the time frame for filing an administrative claim for refund following a final determination that qualifies a taxpayer for an adjustment under I.R.C. § 1311. The taxpayer in this case filed an administrative claim for refund within the one-year period prescribed by I.R.C. § 1314. This administrative claim was formally disallowed as untimely and the taxpayer requested Appeals consideration. Even though Appeals now considers the claim to be timely, I.R.C. § 6514(b) prevents the Internal Revenue Service from issuing a refund because the taxpayer did not file a suit for refund within the two-year period after the Service denied the taxpayer's administrative claim.

FACTS

You presented us with the facts of a case involving adjustments to the inventory of M Corporation, an 1120S corporation. M Corporation was a TEFRA entity for the Year 1 year. S corporations are no longer subject to TEFRA proceedings for S corporation tax years beginning after December 31, 1996.

The Tax Court entered a decision for M Corporation's Year 1 tax year, and the decision became final on Date 1. This decision resulted in changes at the S corporation level. First, M Corporation's ending inventory (on Date 2) was understated. The year end inventory balance was increased, and the Year 1 year's "cost of goods sold" deduction was reduced. This resulted in an increase in M Corporation's ordinary income for the 1996 tax year.

A second result of the Tax Court's decision for M Corporation's Year 1 TEFRA year was that M Corporation's beginning inventory for its Year 2 non-TEFRA year was understated as reported. An increase in the inventory balance on Date 3 would result in an increased "total cost of goods sold" for the "S corporation". Therefore, M Corporation's ordinary income for the 1997 year was overstated as reported. This overstatement of M Corporation's ordinary income flowed through to its shareholders, Shareholder A and Shareholder B, based on their pro rata shares.

On Date 4, Shareholder A and Shareholder B filed claims for refund for the Year 2 tax year. The shareholders requested refunds as a result of M Corporation's reduction in ordinary income for Year 2, which in turn was due to the increase in M Corporation's inventory balance on Date 3. The Service allowed the claim for Shareholder A and issued a refund. However, the Service disallowed the claim for Shareholder B.

On Date 5, a Notice of Claim Disallowance, Letter 105-c, was sent by certified mail to Shareholder B. The claim disallowance letter stated the following: "Your claim for credit or refund was filed more than 3 years after the tax return due date." Shareholder B

appealed the claim disallowance, asserting that Shareholder B had one year from the date the Tax Court's decision became final to file a claim for refund. The Appeals Officer determined that the claim was timely filed on Date 4. However, more than two years had elapsed since the issuance of the claim disallowance letter. The time for filing suit has not been extended by mutual agreement, and Shareholder B has not filed suit.

LAW AND ANALYSIS

Internal Revenue Code § 7422 requires the filing of a claim for refund or credit according to the provisions of law and the regulations of the Secretary, before a suit or proceeding may be brought in any court for such refund or credit. Section 6511(a) provides that a “[c]laim for credit or refund of an overpayment . . . shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires later.”

When a taxpayer timely files a claim for refund, the taxpayer receives two years to bring a lawsuit for the credit or refund, measured from the date the Secretary mails to the taxpayer notice of the disallowance of the part of the claim to which the suit or proceeding relates. I.R.C. § 6532(a)(1). Any consideration, reconsideration or action by the Secretary after the mailing of such notice does not extend the two-year period for filing suit. I.R.C. § 6532(a)(4). Further, when a taxpayer files a claim which is denied, but does not timely file suit, I.R.C. § 6514(a) provides that any refund made after the expiration of the two-year period is erroneous. As such, section 6514(a) precludes any division of the Service, including Appeals, from allowing a refund after the expiration of the two-year period.

In general, a taxpayer must file an administrative claim for refund within the time limits prescribed in I.R.C. § 6511. In certain circumstances, however, the Internal Revenue Code's mitigation provisions, I.R.C. §§ 1311-1314, allow for an expired period of limitations to be re-opened for an additional one-year period. Section 1311 provides that errors in closed years may be corrected by means of an adjustment to that year. For an adjustment to be authorized under the mitigation 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. I.R.C. § 1311(a).
- Second, there must be a “determination” for an open tax year. As defined in § 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 Treas. Reg. § 1.1313(a)-4.
- Third, the determination must result in a circumstance under which an adjustment is authorized by section 1312. These circumstances include the double inclusion of an item of gross income. I.R.C. § 1312(1).

- Fourth, depending on which circumstance of adjustment applies, either an inconsistent position must be maintained by the party against whom mitigation will operate, I.R.C. § 1311(b)(1), or the correction of the error must not have been barred at the time the party for whom mitigation will operate first maintained its position. I.R.C. § 1311(b)(2).

An adjustment in favor of the taxpayer authorized by the mitigation provisions is made by refunding or crediting the amount of the adjustment “in the same manner” as if it were an overpayment. I.R.C. § 1314(b). In other words, the adjustment “amount may be recovered under the law and regulations applicable to overpayments of tax.” Treas. Reg. § 1.1314(b)-1(a). The statutory mitigation provisions create one exception to the usual refund procedures: a special period of limitations instructing the Service to treat the closed year “as if on the date of the determination one year remained before the expiration of the periods of limitation upon . . . filing [a] claim for refund.” I.R.C. § 1314(b). As the regulation states, “the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment.” Treas. Reg. § 1.1314(b)-1(b). By the terms of the statute and regulation, this one-year period applies only to the time permitted for filing an administrative claim for refund, and does not serve to extend any other time periods associated with the refund claim process. Neither does anything in § 6532 indicate that the time frame for beginning a suit is extended when a refund is sought under I.R.C. §§ 1311-1314. Therefore, if a claim for refund brought under the mitigation provisions is denied by the Service, a taxpayer has two years from the date of the claim denial to file suit. If the taxpayer fails to timely file suit, the Service is barred from issuing that taxpayer a refund by I.R.C. § 6514.

The facts of the case you presented to us indicate that Shareholder B was qualified to bring a refund claim under the mitigation provisions. First, there is an error in a closed tax year – namely the additional income included in Shareholder B’s Year 2 tax year. Second, there is a determination for an open tax year in the Tax Court decision increasing Corporation M’s income for Year 1. Third, this determination resulted in the same item being included in income in two separate years. See Gooch Milling & Elevator Co. v. United States, 78 F.Supp. 94, 99-101 (Ct. Cl. 1948) (finding that an adjustment of inventory balances can result in the double inclusion of an item in gross income qualifying a taxpayer under Section 820 of the Revenue Act of 1938); Rev. Rul. 58-327, 1958-1 C.B. 316 (concluding that inventories constitute items of gross income within the meaning of the mitigation provisions). Finally, it appears that inconsistent positions were taken with respect to the amount of income in the Year 1 and Year 2 tax years.

To make an adjustment to the error in his closed Year 2 year, Shareholder B was required to follow the procedures of I.R.C. § 1314. The date of the determination resulting in the need for the adjustment is Date 1, the date the Tax Court decision involving Corporation M’s Year 1 tax year became final. Shareholder B thus had one year from that date to file an administrative claim with the Service. Shareholder B filed such a claim on Date 4, which was less than one year after Date 1. The Service,

however, formally disallowed this claim as untimely in a letter sent by certified mail on Date 5. From the date of disallowance, I.R.C. § 6532 provides Shareholder B two years to file a lawsuit with respect to this denial, or to secure an extension of time to file suit. Shareholder B sought review of the claim denial from Appeals, but neither filed suit nor secured an extension to file suit prior to Date 6. Some time after Date 6, Appeals came to the conclusion that Shareholder B's original administrative claim was timely filed. I.R.C. § 6532(a)(4) clearly states that any reconsideration or action by the Service on a claim that was previously denied by the certified or registered mailing of a notice of claim disallowance does not operate to extend the two-year period for filing suit. We find no reason to deviate from this rule simply because the period of limitation for filing the administrative claim arose from the mitigation provisions. It makes no difference what gives rise to the claim (mitigation, carryback, etc.), whether the original claim was timely or untimely, or whether the disallowance was proper or improper. It matters only that the Service formally denied the claim thereby starting the two-year period under I.R.C. § 6532. Therefore, the Service may not now approve Shareholder B's claim for refund after Date 6, the expiration of the two-year period for filing suit, because such a refund would be erroneous under I.R.C. § 6514.

CASE HAZARDS



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