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# IRS Insights

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## The Federal Circuit Affirms a Court of Federal Claims Decision Dismissing Foreign Tax Credit Refund Claims as Untimely

Albemarle Corporation & Subsidiaries ("Albemarle") had filed a refund suit in the Court of Federal Claims arguing that the IRS had incorrectly disallowed Albemarle's refund claims based on foreign tax credits for the 1997 and 1998 tax years.[1] The Court of Federal Claims concluded that Albemarle's refund claims for 1997 and 1998, filed in May 2009, were untimely under Internal Revenue Code ("IRC") § 6511(d)(3)(A).[2] Recently, the Federal Circuit affirmed the dismissal of Albemarle's complaint for lack of subject matter jurisdiction by the Court of Federal Claims, concluding that Albemarle's refund claims for the 1997 and 1998 tax years were time-barred.[3]

As background, in 1996, a Belgian subsidiary of Albemarle issued debentures to Albemarle and some of its US subsidiaries. From 1997 through 2001, the Belgian subsidiary made interest payments on the debentures but did not pay any Belgian withholding taxes on those payments. In 2001, the Belgian tax authorities issued a notice of adjustment asserting that the

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[1] *Albemarle Corp. & Subs. v. United States*, 2014 US Claims LEXIS 1143 (Fed. Cl. Sept. 19, 2014).
[2] Please see prior coverage of the Court of Federal Claims opinion in the November 2014 edition of *IRS Insights*. (http://newsletters.usdbriefs.com/2014/Tax/IRSI/141110_4.html)
[3] *Albemarle Corp. & Subs. v. United States*, 2015 US App. LEXIS 14174 (Fed. Cir. Aug. 13, 2015).

interest payments were subject to Belgian withholding tax. In 2002, Albemarle and the Belgian tax authorities reached an agreement, and Albemarle paid the foreign taxes.

In May 2009, Albemarle filed an amended return for the 2002 tax year, claiming a refund of the foreign taxes paid for the 1997 through 2001 tax years. The IRS disallowed the refund claim with respect the 1997 and 1998 tax years because it was not filed within the period for filing a claim seeking a refund based on a foreign tax credit under IRC § 6511(d)(3)(A).

IRC § 6511(d)(3)(A) provides a special refund statute of limitations for foreign taxes paid or accrued, and states that the statute of limitations "shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued."[4] The question before the Federal Circuit was whether the 10-year period should be calculated from the date on which Albemarle incurred the foreign tax liability and the year for which it claimed the refund (*i.e.*, 1998), or from the date Albemarle actually paid the contested liability (*i.e.*, 2002). Albemarle argued that the foreign taxes first accrued in 1998 in order to trigger Albemarle's ability to claim the foreign tax credit, and then *actually* accrued in 2002 when the foreign taxes were agreed to and paid. The United States argued that the critical year was the year in which Albemarle's foreign taxes originated (i.e., 1998).

First, the court looked at IRC §§ 901 and 905, and found that, under those sections, Albemarle's foreign taxes "accrued" in 1998, the year of origin of the tax liability. Second, the court looked at the 1997 amendment to IRC § 6511(d)(3)(A), and found that the change was made to clarify that the operable year is the year in which the foreign taxes were accrued, not the year to which the foreign tax credits were carried. Third, the court looked at Treas. Reg. § 1.904-2, which uses the phrase "actually paid or accrued," and found that it refers to the year of origin of the tax liability. Fourth, the court looked at the "contested tax doctrine" and the "all events test," and found that they do not apply to foreign tax credits; rather, the "relation back" doctrine does. Finally, the court looked at purpose of IRC § 6511(d)(3)(A), and found that a 10-year statute of limitations did not make sense if it began to run from the year in which the liability was finalized. As a result, the court concluded that the statute of limitations in IRC § 6511(d)(3)(A) started to run on the date Albemarle's return for the 1998 year was due (i.e., March 15, 1999). Therefore, the court held, Albemarle's 1998 refund claim, filed in May 2009, was time-barred.

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[4] For years prior to 1998, IRC § 6511(d)(3)(A) provided that the 10-year period ran from the date "prescribed by law for filing the return for the year with respect to which the claim is made." The Federal Circuit found that under this version, the statute of limitations clearly began to run from the year in which the foreign tax originated (*i.e.* 1997). As a result, the majority of the court's opinion focused on the current version of the statute which applied to the 1998 year.

## The Court of Federal Claims Denies Refund Claim Based Upon Impermissible Change in Accounting Method

Taxpayers who have established a method of accounting are not able to change methods simply by filing an amended return. Instead, they must follow the procedures established by the IRS to obtain the consent of the Commissioner.[5] Recently, taxpayers litigating in the Court of Federal Claims had refund claims denied because the refunds were based on a change in accounting method for which the proper consent had not been obtained.[6]

In 2004, as part of a merger, Mr. Greiner (with his wife, "Taxpayers") was compensated for cancelled stock options with a cash payment and an "earn-out" right. Earn-out payments could be made between 2005 and 2013, and whether a payment was made, and its amount, depended on the performance of certain products. Taxpayers recognized the cash payment as ordinary income in 2004, but did not recognize any income with respect to the earn-out. Instead, Taxpayers treated the earn-out under the "open" transaction method, wherein no income is recognized upon receipt of a right to receive future cash payments. Instead, payments are recognized as ordinary income when they are received. Application of the open transaction method is appropriate when it is not possible to determine with 'fair certainty' the fair market value of a contract for future payments of money. Subsequent payments made under the earn-out were recognized as ordinary income in the years received.

Later, a settlement was reached with respect to the earn-out. As a result, instead of receiving variable amounts for the remaining term, the earn-out recipients would receive fixed payments in 2008 and 2009. Taxpayers reported both payments as ordinary income in accordance with the open transaction doctrine.

In 2011, Taxpayers filed amended returns requesting refunds for 2008 and 2009. Taxpayers claimed that they should have reported receipt of the earn-out in 2004 as a "closed" transaction, wherein ordinary income is recognized equal to fair market value upon receipt of a right to receive future cash payments. The cash payments, when received, would then first reduce basis and then result in ordinary income. Taxpayers' argued that, regardless of the original treatment of the earn-out right, it was a capital asset that was "sold or exchanged" within the meaning of Internal Revenue Code ("IRC") §§ 1221 & 1222 under the settlement agreement. The 2008 and 2009 payments, as a result, should have been treated as long-term capital gain instead of as ordinary income. The IRS did not agree to the requested refunds, and Taxpayers filed a refund suit.

The United States raised several defenses in response to Taxpayers' complaint, including the argument that Taxpayers were attempting to make an unauthorized change in their method of accounting. The United States did not take a position on whether Taxpayers should have used the open or closed transaction method when accounting for the earn-out, rather, the United States argued that once a position was taken, it was a method of accounting that could only be changed with the Commissioner's consent.

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[5] *E.g.*, Rev. Proc. 2015-13.
[6] *Greiner v. United States*, 122 Fed. Cl. 139 (Fed. Cl. 2015).

The regulations provide that a change in the method of accounting includes a change in the treatment of any material item used in the overall plan of accounting for gross income or deductions.[7] A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.[8] The court noted that the hallmark of a method of accounting is the *timing* of income or deduction of a material item for reporting. Because the open transaction method determined the timing of income with respect to the earn-out, the court ruled that it was a method of accounting. Had Taxpayers adopted the closed transaction method in 2004, the timing of the recognition of the earn-out right would have been affected, so the closed transaction method was also a method of accounting. Both approaches yield the same total income, but the timing of the income is different.

The United States argued that Taxpayers established the open transaction method in 2004 and were obligated to continue on the same method. Taxpayers took the position that the United States was applying the open transaction method too broadly. They argued that the earn-out consisted of three specific material items, for which different methods of accounting could apply. Thus, they had accounted for the initial earn-out receipt and the 2006 and 2007 payments under the open method, but were entitled to account for the 2008 and 2009 settlement payments under another method (i.e., the closed method), which wasn't established until 2008.

The court did not accept this argument. The extent of what an "item" is for purposes of accounting methods is determined based on a facts and circumstances test, and in order to be treated as separate items, the payments would have to be separate and distinct. Because the court found that they were closely related, they were not three distinct items of income for which there could be different methods of accounting.

The regulations also provide exceptions for certain items that can be changed without obtaining the Commissioner's consent.[9] Taxpayers invoked several of those exceptions, one of which was that the adjustment was not a timing issue. Under either the open or closed methods, the 2008 and 2009 payments would be recognized in the year of payment; only the character of the income would be different. Taxpayers argued that because the refund request had no effect on timing, it was not a method change. The court refused to divorce the timing of the 2008 and 2009 payments from the timing effects in other years that would be altered by implication of the Taxpayers' refund request. In order for Taxpayers to recognize long-term capital gain on the disposition of the earn-out, the earn-out has to be a capital asset and Taxpayers would have had to account for receipt of the earn-out as a capital asset in 2004. The time to report the earn-out as a closed transaction was 2004, and the assessment statute of limitations for that year had run. As a result, the rules for taxing capital assets do not apply. Taxpayers' attempt to change the tax treatment of the 2008 and 2009 payment necessarily involve changing the income timing of the earn-out.

Because the court found that Taxpayers were attempting to make an unauthorized method change, the refund requests were denied. The court noted that when taxpayers make accounting method changes, IRC § 481 is used to make any adjustments necessary to prevent

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[7] Treas. Reg. § 1.446-1(e)(2)(ii)(a).
[8] *Id*.
[9] Treas. Reg. § 1.446-1(e)(2)(ii)(b).

amounts from being duplicated or omitted. That way, the IRS is able to reach into closed tax years. But because Taxpayers did not file for a method change, IRC § 481 did not apply and the IRS did not have a full opportunity to review the issue.

Based upon the above, the court determined that the Taxpayers had elected to report their earn-out income pursuant to the open transaction method of accounting. Having elected this approach, they were bound to continue employing it absent the IRS's consent to a change, which they never sought or obtained. Thus, the Taxpayers' attempt to amend their approach to reflect closed transaction reporting and subsequent capital gain was an impermissible change in method of accounting in violation of IRC § 446(e). As such, the court denied the Taxpayers' refund claim.

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## The Federal Circuit Court Refuses to Extend the Assessment Statute of Limitations Based on Third-Party Fraud

In *BASR Partnership v. United States*, the Court of Appeals for the Federal Circuit held that a third-party advisor's fraudulent activity, which led to a fraudulent position on the partnership's tax return, was not sufficient to trigger the extended statute of limitations under IRC § 6501(c)(1).[10]

Under IRC § 6501(a), the IRS generally has three years to assess additional tax from the time of filing a return, subject to specific exceptions. One of those exceptions relates to false or fraudulent returns and provides for an unlimited statute in those instances. IRC § 6501(c)(1) states:

> In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

In 1999, the partners of BASR partnership received advice from Jenkens & Gilchrist with respect to the minimization of tax on the sale of a closely held printing company. The Taxpayers also received a tax opinion from Jenkens & Gilchrist attesting to the legitimacy of the transaction. Pursuant to this advice, the partners undertook a series of transactions and formed BASR Partnership ("Taxpayer"). The Taxpayer filed its 1999 Form 1065, *US Partnership Income Tax Return*, consistent with the position set forth in the Jenkens & Gilchrist tax opinion. Both the Taxpayer and its independent third-party tax preparer relied upon the Jenkens & Gilchrist tax opinion.

In 2004, the IRS received a list of Jenkens & Gilchrist's clients that had engaged in these kinds of transactions, which included the Taxpayer. In 2010, the IRS issued a final partnership administrative adjustment ("FPAA") to seek additional tax due based upon the reversal of the tax benefit of the transactions proposed by Jenkens & Gilchrist. The Taxpayer is a partnership, a flow-through entity, which is governed under the Tax Equity and Fiscal Responsibility Act of

[10] 2015 US App. LEXIS 13617 (Fed. Cir. July 29, 2015).

1982 (“TEFRA”). Under the TEFRA procedures, the IRS may impose a partnership level adjustment for certain types of items, which then are allocated to the partners automatically. IRC § 6221.

The Taxpayer sought to challenge the FPAA on the grounds that it was not timely, as more than three years had passed since the Taxpayer filed its 1999 return. The IRS conceded that the partners of the Taxpayer “lacked the intent to evade tax” and did not argue that the Taxpayer or the Taxpayer’s tax return preparer “acted with intent to evade taxes” or to have the Taxpayer’s partners evade taxes. Instead, the IRS asserted that an attorney at Jenkens & Gilchrist had acted with fraudulent intent, resulting in a false or fraudulent position on the Taxpayer’s return, and that the attorney’s fraudulent intent was sufficient to extend the Taxpayer’s assessment statute for tax year 1999 indefinitely.

In holding that the Taxpayer needed to have the fraudulent intent to trigger the extended statute of limitations, the Court of Appeals looked at the language of the statute, statutory scheme and history. The court acknowledged that the specific language of IRC § 6501(c)(1) is silent as to the necessary party to have the fraudulent intent; however, the court concluded that this did not compel the conclusion that any unrelated party could trigger the extension. Instead, the court stated that other provisions of the Internal Revenue Code dealing with fraud lead to the conclusion that it must be the taxpayer’s intent to defraud in order for the provisions of IRC § 6501(c)(1) to apply. The court specifically pointed to IRC § 7454, which requires that the IRS must prove a taxpayer’s intent and the IRS’ interpretation that a fraud penalty under IRC § 6663(a) will only apply when it is the taxpayer’s intent to defraud. The court also expressed concern with regards to other fraud provisions in the Internal Revenue Code. For example, the court noted if the IRS’ position in this case was adopted, then a third-party’s fraud could bar a taxpayer’s payment extension under IRC § 6161(b)(3). Lastly, the court noted that the predecessor statute to IRC § 6501(c)(1) supports that Congress intended it to be the taxpayer’s fraud to trigger the extended statute of limitations.

The court also distinguished *Allen v. Comm’r*,[11] wherein the Tax Court found that a tax return preparer’s fraud was sufficient to extend the assessment statute of limitations. The Court of Appeals was not persuaded by the Tax Court’s reading of IRC § 6501(c)(1) and stated that, unlike in *Allen*, the fraud in this case was too remote to be obvious to the Taxpayer. The court noted, “[t]here are no allegations that BASR, or even its accountant, knew or should have known that the tax return was false or incorrect, much less that it was ‘obviously’ false or incorrect.”

Ultimately, the court affirmed the lower court and concluded that a taxpayer must have the requisite intent to defraud to extend the statute of limitations under IRC § 6501(c)(1). The court held that the an attorney’s fraud alone was not sufficient to extend the statute of limitations under IRC § 6501(c)(1), and thus the FPAA was untimely as it was issued more than three years after the Taxpayer filed its 1999 return.

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[11] 128 T.C. 38 (2000).

## IRS Identifies Two New Reportable Transactions: Basket Option Contracts and Basket Contracts

On July 8, 2015, the IRS published Notice 2015-47, which alerts taxpayers and their representatives that certain "basket option contracts" have been designated as Listed Transactions,[12] and Notice 2015-48, which alerts taxpayers and their representatives that certain "basket contracts" have been designated as Transactions of Interest[13] (collectively, "Notices").

Taxpayers who have entered into transactions described in the Notices, or transactions substantially similar to the transactions described in the Notices, are now subject to certain reporting requirements under Treas. Reg. § 1.6011-4(d). In addition, advisors to those taxpayers may be subject to registration and list maintenance requirements under IRC §§ 6111 and 6112, respectively.

Generally, the IRS has identified certain contracts, including basket option contracts, as having the potential for tax avoidance because such investments are viewed as having the potential to improperly result in (1) the deferral of income and (2) long-term capital gain. The contracts typically provide a return based on the performance of multiple underlying securities or assets. The IRS has focused on those contracts with reference property that is not static during the life of the contract (that is, the composition of the reference property is subject to change). Further, the IRS has focused on situations where the taxpayer (or its designee) has some level of control over the components underlying the contract. The IRS is concerned that even though the reference assets vary during the term of the contract, the taxpayer does not recognize current gain or loss relating to changes in the underlying assets and does not recognize current income produced by such assets (such as dividends or interest). Instead, the taxpayer takes the position that if the contract is held open for more than one year, the taxpayer simply recognizes long-term capital gain upon the closing of the contract.

For purposes of both Notices, the following parties are treated as participating in the listed transaction identified in the notice:

1. The purchaser of the basket option contract,
2. If the purchaser of the basket option contract is a partnership, any general partner of the purchaser,
3. If the purchaser of the basket option contract is a limited liability company, any managing member of the purchaser, and
4. The counterparty to the basket option contract.

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[12] A listed transaction is a transaction that is the same as, or substantially similar to, one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance.
[13] A transaction of interest is a transaction that the IRS and the Treasury Department believe is a transaction that has the potential for tax avoidance or evasion, but there is not sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction.

For purpose of transactions described in both Notices, the 90-day period for taxpayers to disclose listed transactions or transactions of interest set forth in Treas. Reg. § 1.6011-4(e)(2) is extended to 120 days from the notice date of July 8, 2015; therefore, they are due by November 5, 2015. For a taxpayer that participated in a transaction described in either of the Notices and for which the tax return is due between July 8, 2015, and November 5, 2015, that disclosure statement will be considered timely filed if the taxpayer files the disclosure with the Office of Tax Shelter Analysis by November 5, 2015. For material advisors, relevant disclosures under IRC § 6111 will generally be due on October 31, 2015.

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## The IRS Issues Final Regulations under Section 6402 for Filing a Claim for Credit or Refund

On July 24, 2015, the IRS released T.D. 9727, which contains final regulations for filing a claim for credit or refund under IRC § 6402 ("Final Regulations"). The Final Regulations provide guidance as to the proper place to file:

1. Claims required to be filed on specific forms;
2. Claims filed in response to an IRS notice or correspondence; and
3. All other claims, including those filed electronically.

The Final Regulations also update the prior regulations to remove outdated or inconsistent provisions. Finally, the Explanation of Provisions and Summary of Comments ("Explanation") preceding the Final Regulations contains discussions on protective and informal refund claims as well as the authority of the IRS to make refunds on equitable grounds.

The Final Regulations provide guidance to taxpayers as to the proper place to file a claim for credit or refund.[14] Treas. Reg. § 301.6402-2(a)(2) now states that if a taxpayer is required to file a claim using a particular form, then the claim, together with appropriate supporting evidence, should be filed in a manner consistent with such form, form instructions, publications, or other guidance found on the IRS website. Additionally, Treas. Reg. § 301.6402-2(a)(2) now provides that if a taxpayer is filing a claim in response to an IRS notice or correspondence, then the claim must be filed in accordance with the specific instructions contained in the notice or correspondence regarding the manner of filing of such claims. Finally, Treas. Reg. § 301.6402-2(a)(2) now explains that any other claim not described above generally must be filed with the service center at which the taxpayer currently would be required to file a tax return for the type of tax to which the claim relates or via the appropriate electronic portal.[15]

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[14] Previously, a claim for credit or refund was required to be filed with the service center serving the internal revenue district in which the tax was paid.
[15] In response to comments to the notice of proposed rulemaking, the IRS provided an explanation for its decision not to provide electronic filing guidance in the Final Regulations. The IRS determined that, to the extent that electronic filing is or becomes available for filing a claim for credit or refund, such guidance will be provided in forms, form instructions, publications, or the IRS website, rather than in the section 6402 regulations.

In the Explanation preceding the Final Regulations, the IRS noted that it had been suggested by commentators that the regulations be amended to discuss protective and informal claims. The IRS stated that while both types of claims are addressed in case law and have been recognized by the IRS in some circumstances, neither is within the scope of the Final Regulations. The Explanation also addresses suggestions that Treas. Reg. § 301.6402-2(b)(2), which explains that the IRS lacks the authority to make a refund on equitable grounds, be amended to include exceptions for IRC § 6015(f), which addresses innocent spouse relief, and IRC § 6343(d), which provides for the release of a levy in certain circumstances. In the Explanation, the IRS noted that the refund provisions of section 6402 are only triggered once an overpayment exists and is established, whereas the equitable factors address whether the taxpayer has an overpayment or otherwise may be entitled to particular relief. As a result, the IRS noted that the inclusion of an equitable considerations in the regulations to section 6402 would not be appropriate.

The Final Regulations are effective as of July 24, 2015. Thus, the amended portions of Treas. Reg. § 301.6402-2 and Treas. Reg. § 301.6402-3 apply to claims for credit or refund filed on or after this date, and the amended portions of Treas. Reg. § 301.6402-4 apply to payments made on or after this date.