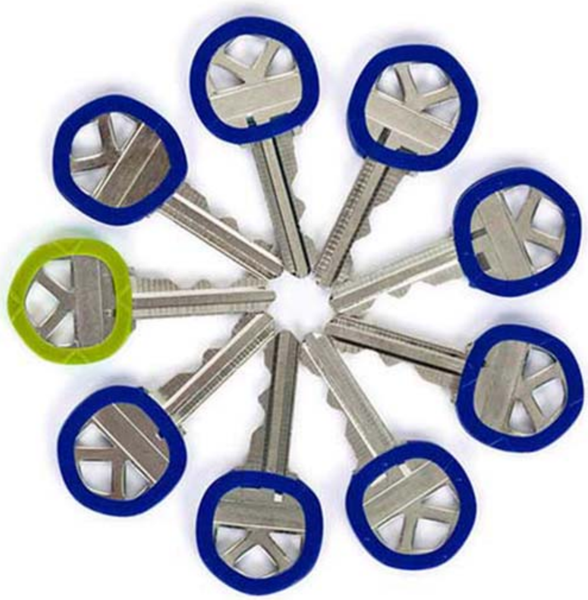

In this issue:

District court concludes that taxpayer's refund suit, relating to the carryback of a deduction for foreign taxes, was untimely

In *Trusted Media Brands Inc. v. United States*,[1] Trusted Media Brands, Inc. ("TMB") brought a refund suit seeking a refund in excess of $2.1 million. For the tax years ending June 30, 1995 ("199506"), June 30, 1997 ("199706"), and June 30, 2002 ("200206"), TMB paid taxes to foreign countries and claimed a foreign tax credit on its original 199506, 199706, and 200206 income tax returns. TMB reported a net operating loss ("NOL") for 200206, and carried the NOL back to its 199706 tax year. On December 14, 2011, TMB filed Form 1120X, *Amended US Corporation Income Tax Return*, thereby changing its election from claiming a foreign tax credit to taking a deduction for its foreign taxes paid or accrued in 200206, pursuant to IRC section 164(a)(3).

[1] No. 7:15-cv-09872 (US Dist. Ct. S.D.N.Y. 2017).

As a consequence of TMB flipping from crediting to deducting for tax year 200206, TMB's 200206 NOL increased, and TMB carried the 200206 NOL back to 199706 pursuant to IRC section 172(b)(1)(H) and filed an amended return for 199706 to reflect the NOL carryback from 200206. As a result of the carryback from 200206, TMB's 199706 taxable income decreased and its foreign tax credit limitation under IRC section 904 decreased. Consequently, TMB took the position that the excess foreign tax credits, which resulted from the decrease in the foreign tax credit limitation, could be carried back under the then-applicable version of IRC section 904(c).

Prior to filing its 200206 amended return, TMB had approximately $2.1 million of unused excess foreign tax credit limitation for its 199506 tax year, and TMB carried back the excess foreign tax credit from 199706 to 199506. TMB filed an amended return for 199506 claiming a refund of approximately $2.1 million, the overpayment resulting from the carryback of the foreign tax credit to 199506. The IRS disallowed TMB's claims for 199506, 199706, and 200206 as untimely and, after denying TMB's appeal, issued a formal notice of disallowance. TMB filed a complaint, and the United States filed a motion to dismiss.

The District Court for the Southern District of New York reviewed the applicable provisions of the IRC and the Treasury Regulations. IRC section 901(a) provides that the choice to elect either a credit or a deduction for foreign taxes paid for any taxable year may be made or changed at any time before the expiration of the period prescribed for a making a claim of credit or refund of the tax imposed for such taxable year. IRC section 6511(a) provides the general rule that a claim for credit or refund of an overpayment shall be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later.

IRC section 6511(d)(3) sets forth special rules relating to foreign tax credits, and provides that, if the claim for credit or refund relates to an overpayment *attributable to* taxes paid or accrued to any foreign country for which a *credit is allowed* against income tax in accordance with IRC section 901, in lieu of the three-year period of limitations, the period shall be ten years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued. IRC section 6511(d)(2) sets forth the special period of limitation with respect to NOL or capital loss carrybacks, and provides a three-year limitations period to claim a refund from the due date of the return for the year in which the NOL or capital loss carryback originated.

Treas. Reg. § 301.6511(d)-3 provides that, in the case of an overpayment of income tax resulting from a credit allowed under the provisions of IRC section 901, for taxes paid or accrued to a foreign country, a claim for credit or refund must be filed by the taxpayer within ten years from the last date prescribed for filing the return (not including extensions) for the taxable year with respect to which the claim is made. The regulation also states that the ten-year period is in lieu of the three-year period in IRC section 6511(a).

The United States argued that the ten-year statute of limitations for refund claims in connection with foreign taxes, set forth in IRC section 6511(d)(3), applies only in situations where the taxpayer claims a foreign tax credit, not a deduction for foreign taxes paid. In addition, even if the special ten-year rule under IRC section 6511(d)(3) were to held applicable, the United States determined that TMB's overpayment in 199506 is attributable to its 199706 foreign tax credit carrybacks and is not attributable to foreign taxes paid in 200206 and thus the TMB's refund claim was time barred.

Special Limitations Period

The district court agreed with the United States that the structure of IRC section 6511 contemplates a distinction between the rules with respect to NOL carrybacks versus foreign tax credits. The court adopted the reasoning of IRS Chief Counsel Advice (CCA) 201330021,[2] in which the "IRS confronted the very question before this [district court]." In CCA 201330021, the IRS endorsed the position that the ten-year period of limitations under IRC section 6511(d)(3) applies only to claims based on foreign tax credits *allowed* under IRC section 901, and not deductions of foreign tax for which a credit is *allowable*. The district court also cited CCA 201517005,[3] in which the IRS determined that the ten-year period under IRC section 6511(d)(3) is only available for refunds attributable to foreign tax credits; it does not apply to refunds attributable to deductions for foreign taxes.

---

[2] 2013 WL 3856944.
[3] 2015 WL 1872528.

“Attributable To”

The court cited *Electrolux Holdings, Inc. v. United States*,[4] for the proposition that the “attributable to” language in IRC section 6511(d)(3) should be narrowly construed and that the court should look to the “immediate cause” of the claim, rather than considering each link in the chain of causation leading to the claim. In *Electrolux*, the Federal Circuit narrowly construed “attributable to,” and discredited Electrolux’s tracing argument.

The court did not specifically address or distinguish existing conflicting authority, where courts have accepted tracing arguments in interpreting “attributable to” language in the IRC. Specifically, the district court did not mention *First Chicago Corp v. Comm’r*[5] or *Marshalltown Sav. & Loan Ass’n v. United States*,[6] in which the courts defined “attributable to” as “can be traced to.”

In *First Chicago*, the Seventh Circuit analyzed the IRC section 6501(h) and 6501(j) periods of limitation on deficiency assessments. On appeal, the Seventh Circuit agreed with the Tax Court dissenting opinion in *First Chicago v. Comm’r*,[7] concluding that a deficiency based on an erroneous refund is “attributable to” a taxpayer’s credit or loss carryback where the erroneous adjustment may be traced directly to the carryback or where it is an automatic mechanical adjustment due directly to the carryback.

In *Marshalltown*, the United States District Court for the Southern District of Iowa analyzed the situation where a taxpayer filed a Form 1139 and a Form 1120X for 1980, based on the carryback of an NOL from 1985 to 1979, and a resultant carryover of investment tax credits from 1979 to 1980. The District Court for the Southern District of Iowa held that, although the general refund limitations period had expired for 1980, the taxpayer’s refund claim was timely under IRC section 6511(d)(2), finding that the 1995 NOL was carried back to the 1979 tax year which, in turn, created an investment tax credit for 1980 taxes and, therefore, entitlement to a refund in 1980.

Conclusion

The district court in *Trusted Media Brands* ultimately agreed with the United States and concluded that TMB’s $2.1 million refund claim was untimely. The court reasoned that, because TMB chose to change its election to deduct foreign taxes paid or accrued in 200206, no credit for foreign taxes is allowed, and the applicable limitations period for TMB’s 200206 refund claim is three years after the time prescribed by law for filing the return, under IRC section 6511(d)(2)(A). In addition, the court concluded, even if the special ten-year rule under IRC section 6511(d)(3) were to held applicable, that the refund that TMB seeks is time barred as it is attributable to TMB’s carryback of foreign tax credits from 199706, and is not attributable to its 200206 change in election.

IRS issues Chief Counsel Advice that the small partnership exception to filing a return is *not* automatic

Every partnership must file a return for each taxable year, pursuant to Internal Revenue Code (IRC) 6031(a). A partnership that fails to timely file a complete partnership return for a taxable year as required is subject to a penalty under IRC section 6698 unless the partnership can establish its failure to file is due to reasonable cause.

In 1984, the Internal Revenue Service (IRS) published guidance in the form of a revenue procedure containing criteria under which domestic partnerships with 10 or fewer partners will not be subject to the penalty under IRC section 6698. See Rev. Proc. 84-35, 1984-1 CB 509. In relevant part, the revenue procedure provides as follows:

> A domestic partnership composed of 10 or fewer partners and coming within the exception outlined in section 6321(a)(1)(B) of the Code will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 for the failure to file a complete or timely partnership return, provided

---

[4] 491 F.3d 1327 (Fed. Cir. 2007)
[5] 742 F.2d 1102 (7th Cir. 1984).
[6] 1991 WL 331376, 1991 US Dist. LEXIS 19428 (S.D. Iowa 1991).
[7] 80 T.C. 648, 649-50 (T.C. 1983) (*en banc*).

> that the partnership, or any of the partners, establishes, if so required by the Internal Revenue Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Rev. Proc. 84-35 § 3.01.

On August 18, 2017, the IRS released CCA 201733013, addressing whether Rev. Proc. 84-53 provided an automatic exemption to partnerships from the requirement to file a Form 1065, *US Return of Partnership Income*. In CCA 201733013, the IRS initially concluded that neither IRC sections 6031 nor 6698 provide an automatic exception to the partnership return filing requirement. In addition, the IRS concluded that Rev. Proc. 84-35 neither provides an automatic exemption to filing nor automatic penalty relief because certain requirements must be shown to be satisfied before penalty relief is granted.

In reaching its conclusion that Rev. Proc. 84-35 neither provides an automatic exemption to filing nor automatic penalty relief, the IRS first noted that IRC 6698 penalty can be assessed either automatically or manually when a partnership fails to timely file a complete Form 1065 and *reasonable cause has not been established*. Since the IRS has the authority to assess the penalty before a partnership asserts a reasonable cause defense, or after a reasonable cause claim is considered and rejected, the relief of Rev. Proc. 84-35 is not automatic.

The IRS also relied upon the legislative history of IRC section 6698. It provides that the Conference Committee understood that small partnerships habitually fail to file partnership returns but believed that as long as the partners completely reported the partnership's income and deductions, the reporting would be adequate. Again, the Conference Committee required the partner's reporting before agreeing that a partnership's failure to file a return would be reasonable.

Additionally, the IRS concluded that the procedure for penalty relief provided by Rev. Proc. 84-35 precludes an automatic filing exemption and automatic penalty relief because certain requirements must be shown as satisfied before relief may be granted. At the time of filing, or penalty assessment for failing to file, the IRS is unaware as to whether the partnership qualifies under Rev. Proc. 84-35. Partners' tax returns are not linked together during return processing, so the IRS has no knowledge of whether the partnership qualifies as a small partnership under IRC section 6231(a)(1)(B), or whether the partners of a small partnership have completely and timely filed their returns. The IRS may also grant penalty relief due to reasonable cause for reasons separate from the small partnership exception, as permitted by Rev. Proc. 84-35, which means that the IRS must make a determination of reasonable cause and penalty relief on a case-by-case basis.

Based upon the above, the IRS concluded that Rev. Proc. 84-35 does not exempt domestic partnerships with 10 or fewer partners from filing a tax return nor does it provide penalty relief to an IRC section 6698 penalty.

Tax Court concludes disclosures in successor entity's return was sufficient to begin the assessment statute of limitations

In *New Capital Fire, Inc. v. Comm'r.*, T.C. Memo 2017-177, the Tax Court concluded that disclosures in the successor entity's income tax return, pursuant to an F reorganization, contained sufficient information to begin the assessment statute of limitations for the merged company. Accordingly, the Notice of Deficiency issued to the merged company more than three years after the filing of the return was held to be invalid.

On December 4, 2002, Capital Fire Insurance Co. ("Old Capital") and New Capital Fire, Inc. ("New Capital") executed a merger, whereby, New Capital was the surviving entity. New Capital and Old Capital believed that the transaction qualified as a tax-free reorganization under Section 368(a)(1)(F) ("F reorganization"), thus New Capital filed a Form 1120, *US Corporation Income Tax Return*, for tax year 2002 ("2002 Return") that included Old Capital's operations for the portion of the year in existence. In its analysis, the Tax Court noted that the entire year filing was correct if Old Capital and New Capital had engaged in an F reorganization.

With the 2002 Return, New Capital attached a statement detailing the merger and a pro forma 1120-PC, *US Property and Casualty Insurance Company Income Tax Return*, for Old Capital. In addition, New Capital included any tax payments made by Old Capital for tax year 2002 and designated that the return was a final return for Old Capital.

The IRS subsequently examined the New Capital 2002 Return and concluded that the transaction did not qualify as an F reorganization. On July 25, 2012, the IRS issued a notice of deficiency against Old Capital asserting that it was required to file a short period return from January 1, 2002 – December 4, 2002 (“Short Period Return”) and seeking to assess tax on a separate company basis.

Old Capital argued the information provided with New Capital’s 2002 Return, including pro forma Form 1120-PC and a statement detailing the merger, was sufficient to start the running of the assessment statute of limitations under Section 6501 for its Short Period Return. Accordingly, Old Capital argued that the IRS was time barred from issuing a notice of deficiency in 2012 for its Short Period Return. The IRS asserted that it was entitled to the extended assessment statute of limitations under Section 6501(c) as Old Capital was a separate taxpayer and did not file a return, and thus could not rely upon New Capital’s 2002 Return to start the statute of limitations for Old Capital’s Short Period Return.

Section 6501(a) provides that generally an assessment must be made with three years after the filing of a taxpayer’s income tax return; however, there are certain exceptions. Under Section 6501(c), the IRS has unlimited time to assess tax if a taxpayer fails to file a return. Thus, the key question in this case was whether the filing by New Capital of its 2002 Return, which included information with respect to Old Capital (including a copy of a pro forma Form 1120-PC for Old Capital), was sufficient to constitute a return by Old Capital and thus start the assessment statute of limitations under Section 6501.

To determine if the Form 1120-PC and statement constituted a return for statute of limitations purposes, the Tax Court applied the test articulated in *Beard v. Comm’r.*, 82 T.C. 766, 777 (1984). This test provides that a document may be considered a return if it meets the following requirements: (1) the document must contain sufficient data to calculate a tax liability, (2) the document must purport to be a return, (3) there must be an honest and reasonable attempt to satisfy the requirements of the tax law, and (4) the taxpayer must have executed the document under penalties of perjury.

The Tax Court held that the 2002 statement and Form 1120-PC, filed by New Capital with its 2002 Return, reported the income, deductions and credits that were at issue in the Notice of Deficiency. Accordingly, the court held that the IRS was timely provided with sufficient information to calculate Old Capital’s tax liability for 2002. Further, the court noted that the New Capital 2002 Return reflected Old Capital’s tax payments, listed the EIN, indicated a final return and included a penalties of perjury statement, so it also satisfied the second and fourth prongs of the *Beard* test.

The IRS asserted that the 2002 return was “purposefully misleading” and thus would fail the third prong of the *Beard* test. the Tax Court, however, noted that the IRS was not applying the requisite standard and held that, as there was no evidence that the 2002 Return was false or fraudulent with intent to evade tax for Old Capital, it met the requirement of “an honest and reasonable attempt to satisfy” the requirements of the tax law.

Based on the above analysis, the Tax Court held that the disclosure on New Capital’s 2002 Return, despite being a separate taxpayer from Old Capital, was sufficient to constitute a return for Old Capital and start the running of the statute of limitations. Thus, the Notice of Deficiency for Old Capital’s Short Period Return, which was issued in 2012, was invalid as the assessment statute of limitations under Section 6501(a) had expired.

TAS comments that the evolving IRS policy on Form 1042-S refund claims continues to present challenges to nonresident aliens

Internal Revenue Code (IRC) section 1441 (for individuals) generally imposes a withholding obligation on the payor of US-source income to nonresident aliens. The withheld amount must be deposited with the Treasury Department, pursuant to IRC section 6302. Additionally, withholding agents must annually file Form 1042-S, *Foreign Person’s US Source Income Subject to Withholding*, to report both the income subject to reporting, as well as the tax amounts withheld, and they must provide a copy to each payee.

In 2015, the IRS issued Notice 2015-10, 2015-20 IRB 965, indicating its intent to amend regulations to provide that a refund or credit will be allowed to a claimant with respect to an overpayment of an amount withheld only to the extent the relevant withholding agent has deposited the amount withheld and such amount is in excess of the claimant’s tax liability. If the withholding agent has only deposited a portion of the required amount of tax, the regulations will adopt a pro rata method to allocate the amount available for refund or credit with respect. Thus, the claimant will only be entitled to a refund or credit of the amount withheld to the extent that the deposit amount allocated to the claimant exceeds the claimant's tax liability (*e.g.*, withholding agent deposits only 50 percent of its withholding amount then individual claimants would only be entitled to 50 percent of claimed refund).

Additionally, the IRS updated the Internal Revenue Manual (IRM) 21.8.2.9.6.2 to clarify procedures surrounding withholding refund claims, providing for the comparison of a claimant's Form 1042-S with the corresponding withholding agent's Form 1042-S, and to prohibit a refund credit if the withholding agent has not made a deposit. The IRS also updated IRM 21.8.2.12.2.3 to provide for a programming change to have "the entire refund systemically frozen for up to 168 days" *without notice to the taxpayer*.

As a result of these changes, nonresident alien refund claimants have been facing challenges with receiving timely refunds.

On August 24, 2017, at the IRS National Tax Forum, attorney-advisers representing TAS announced that the IRS's policy on freezing all withholding refund claims was evolving. TAS advised the attendees that nonresident alien refund claims are not systemically all frozen now, and that the IRS would manually review those that were frozen. TAS indicated that it has been advocating to preserve appeal rights for nonresident alien claimants, and urging the IRS to permit refunds when provided with evidence to show withholding amounts were deposited.

To expedite a refund, TAS recommended ensuring that a taxpayer's copy of Form 1042-S *exactly* matches the withholding agent's copy. Refund denials and delays have been associated with taxpayer name inconsistencies so TAS further recommended ensuring that the taxpayer's name on Form 1040-NR, *US Nonresident Alien Income Tax Return*, matches that shown on Form 1042-S. TAS recommended that taxpayers contact the withholding agent to make any corrections or eliminate inconsistencies *prior to* submitting the Form 1042-S to the IRS.