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**REQUEST FOR PROCEDURES TO OBTAIN RELIEF
FROM THE TIMELY REPORTING REQUIREMENT OF
SECTION 1.482-1(a)(3) OF THE INTERNAL REVENUE
REGULATIONS.**

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¹ The comments presented in this paper constitute the individual views of the author who prepared it and do not represent the position of the California Lawyers Association or the Los Angeles County Bar Association. Although the author has from time to time advised clients on the applicable law which is subject of this Paper, he has not been engaged by any client to participate on this paper.

EXECUTIVE SUMMARY

Unless otherwise authorized by statute or regulation, taxpayers must report income realized from transactions with commonly controlled entities based the form and terms of the transactions as executed. Section 482² authorizes the Secretary to reallocate the income, expense or credits from transactions among commonly controlled entities where necessary to prevent the evasion or avoidance of tax or to clearly reflect income. Section 482 does not authorize taxpayers to adjust the terms of their controlled party transactions when reporting income nor may they compel the Secretary to do so.

To promote administrative efficiency the Secretary promulgated regulations at Section 1.482-1(a)(3)³ which permit taxpayers to allocate income or expenses of controlled party transactions on a basis other than the terms on which the transactions were executed where necessary to achieve an arm's length result. The regulations permit taxpayers to report allocations which result in an increase to the income from controlled party transactions at any time but do not permit taxpayers to report allocations which result in a decrease to income except on a timely original return. The timely reporting requirement is imposed by regulation and may be waived at the Commissioner's discretion.

The paper highlights circumstances where a literal application of the timely reporting requirement of Section 1.482-1(a)(3) does not result in equitable and efficient tax administration. The paper concludes that waiver of the timely reporting requirement is appropriate under some circumstances. The paper recommends that existing administrative relief procedures at Sections 301.9100-1, et seq.⁴ be extended to allow taxpayers to obtain automatic or discretionary relief from the timely reporting requirement with respect to certain adjustments to income from controlled party transactions.

² Unless otherwise noted, all references to Section 482 refer to Section 482 of the Internal Revenue Code of 1986, as amended.

³ Unless otherwise noted, all references to Section 1.482-1(a)(3) refer to Section 1.482-1(a)(3) of the Internal Revenue Regulations, as amended.

⁴ Unless otherwise noted, all references herein to Section 301.9100-1 et seq. refer to Section 301.9100-1, 2 @ 3 of the Treasury Regulations, as currently in effect.

DISCUSSION

I. CURRENT LAW

A. Section 482

Congress recognized early on commonly controlled parties could manipulate the terms of their transactions to avoid or evade taxation by sifting the incidence of taxation to one or the other parties. To combat this potential abuse, the Secretary was authorized as far back as 1919 to reallocate income or expenses from controlled party transactions where necessary to more clearly reflect income.⁵ The relevant portion of current Section 482 reads:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. ...

The Secretary has promulgated regulations under Section 482 which state that this authority will only be exercised where necessary to achieve the same taxable result as would be obtained if the same or similar transaction had been conducted between unrelated parties acting at arm's length.⁶

⁵ See, Robert N. Lent, *New Importance for Section 482 of the Internal Revenue Code*, *Wm & Mary Law Rev.* Vol. 7:365-7 (1966) for discussion which traces origin of Section 482 to Section 240(b) of the Revenue Act of 1918.

⁶ Treas. Reg. section 1.482-1(a)(1):

The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482.

Courts have applied this standard in reviewing the Commissioner's allocations.

The courts have held that the Secretary has the exclusive authority to reallocate income of controlled party transactions pursuant to Section 482 and that taxpayers were not granted rights to compel the Secretary to exercise this authority.

Unless otherwise provided by law, taxpayers were bound to respect the form and terms of their agreements when reporting the federal income tax consequences of their controlled and uncontrolled transactions.⁷ Taxpayers were bound even if the terms of their controlled party transactions did not generate an arm's length result; i.e., an allocation of income or expense which was consistent with that realized by unrelated, uncontrolled parties engaged in the same or similar transactions.

B. Section 1.482-1(a)(3)

The Secretary recognized that controlled parties may not be able to negotiate arm's length terms for their controlled transactions in advance of executing the transactions or even within the affected reporting periods and that these taxpayers could be liable for penalties on any understatements of tax resulting an adjustment to income made pursuant to Section 482.⁸ Apart from risk of penalties, requiring taxpayers to adhere to the terms of their controlled transactions even when an arm's length result is not achieved created an inefficiency in tax administration by shifting the primary responsibility to the Commissioner to determine and, where necessary, allocate the income or expense of controlled transactions. This state of affairs was inconsistent with the principle of the voluntary, self-assessment system of income taxation.

By authorizing and requiring taxpayers to determine an arm's length result from their controlled transactions and to reallocate income where necessary to report an arm's length result on their original returns, the Secretary transferred the primary obligation to voluntarily determine and

⁷ See, *Commissioner of Internal Revenue v. Danielson*, 378 F.2d 711 (3rd Cir. 1967); *Plant v. Commissioner of Internal Revenue*, 168 F.3d 1279 (11th Cir. 1999).

⁸ See, I.R.C. section 6662.

report the correct amount of income from controlled transactions back to taxpayers. To this end, the Secretary promulgated Section 1.482-1(a)(3) which provides:

Taxpayer's use of section 482. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662-6T(a)(2) or successor regulations.

While the regulation advises that taxpayers “may” depart from the terms of their controlled transactions to achieve an arm’s length result when reporting income, in actual practice taxpayers who engage in controlled transactions are compelled to determine and report income based upon an arm’s length result or risk incurring substantial understatement penalties.

The timely reporting requirement of Section 1.482-1(a)(3) permits taxpayers to report an increase to income from controlled party transactions resulting from an allocation made pursuant to this regulation at any time but prohibits taxpayers from reporting a decrease to income “based on allocations or other adjustments” to income except on a timely original return. The prohibition on taxpayer initiated delinquent or post-filing decreases to income from controlled party transactions is intended to prevent abuse by taxpayers of the transfer pricing principles to engineer more favorable tax results. The inclusion of “other adjustments” in the regulation bars taxpayer-initiated decreases to income from controlled party transactions which are not based on the application of transfer pricing principles and which are not otherwise likely to be motivated by an effort to engineer more favorable tax results.

C. Section 301.9100-1, et seq.

Uniform administration of the internal revenue laws does not preclude principled dispensations to taxpayers seeking to correct procedural or substantive foot faults made in reporting income or tax. For example, Section 301.9100-1(a)⁹ prescribes procedures whereby taxpayers may seek extensions of time to make statutory or regulatory elections which may have been omitted or improperly reported on an original return. These dispensations are commonly known as providing “Section 9100 relief” and are suited to applications of taxpayers seeking relief from the timely reporting requirement of Section 1.482-1(a)(3).

The terms of the Secretary’s delegation of authority to taxpayers at Section 1.482-1(a)(3) are defined by regulation and not set by statute. This means that the Secretary may waive the timely reporting requirement with respect to decreases in income either through extension of the Section 9100 relief procedures or promulgation of similar administrative rules. An “election” and a “regulatory election” are defined at Section 301.9100-1(b):

Election includes an application for relief in respect of tax; a request to adopt, change, or retain an accounting method or accounting period. ...;

Regulatory election means an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

A taxpayer’s determination to allocate income or expense from controlled transactions on terms other than on the terms charged may be characterized as an “election.” The taxpayer’s election to report a decrease to income of controlled transactions resulting from “allocations or other adjustment” falls under the definition of a “regulatory election” since the time for reporting this election is solely prescribed by regulation.

⁹ Unless otherwise noted the reference to Section 301.9100-1, et seq. herein refers to Section 301.9100-1 et seq. of the Code of Federal Regulations.

Under current administrative rules, the Commissioner generally will not consider applications for Section 9100 with respect to Section 482 transfer pricing issues. The Secretary or his delegate may by notice, procedure or ruling advise taxpayers that applications for relief from the timely reporting requirement of Section 1.482-1(a)(3) may be made pursuant to Section 9100 Relief and prescribe the conditions for obtaining relief.

Taxpayers may seek automatic extensions of time or other Section 9100 Relief under the procedures set out at Section 301.9100-2. By ruling, procedure or notice, automatic relief procedures have been extended to address other circumstances where relief would otherwise be routinely granted. Generally, a taxpayer seeking automatic Section 9100 Relief must advise the Commissioner that a delinquent submission is being made pursuant to these procedures. The Commissioner may then audit the submission to ensure that automatic relief is warranted.

Taxpayers may seek discretionary Section 9100 relief if the taxpayer can establish to the Commissioner's satisfaction that (1) there was reasonable cause for the failure to timely act; and, (2) that no prejudice will result to the government should the relief be granted.¹⁰ The discretionary procedures for obtaining discretionary 9100 relief are well defined, widely understood, and evenly administered. The Commissioner publishes rulings or notices to advise taxpayer of the elections for which discretionary relief may be requested. The Commissioner has the authority to extend discretionary relief procedures to the timely reporting requirement of Section 1.482-1(a)(3).

II. NEED FOR RELIEF FROM SECTION 1.482-1(a)(3).

A. Extension of Section 1.482-1(a)(3) to bar adjustments which are not mandated by Section 482 may be invalid.

Section 1.482-1(a)(3) literally prohibits all taxpayer-initiated, post-filing decreases to income from controlled transactions which result from "allocations or other adjustments." The reference to an "allocation" derives from the language of statute ("the Secretary may distribute, apportion, or allocate...") and is used throughout the Section 482 regulations generally to

¹⁰ Section 301.9100-3.

describe a departure from the terms of the controlled party transaction as executed. To parrot the statute, a distribution, apportionment or allocation of income or expense is predicated upon a determination that the result of the controlled transaction as executed departs from an arm's length result. The Secretary has authority under Section 482 to prescribe how and when an allocation should be made or reported.

The reference to "other adjustments" literally means every other adjustment to income of controlled transactions which is not the result of an allocation. The extension of the timely reporting requirement to "other adjustments" literally precludes taxpayers from correcting simple accounting errors or obvious scrivener's errors reported on an original return if the correction would have the effect of decreasing income from controlled transactions. This rule would also prevent taxpayers from decreasing the income from controlled transactions even when the adjustment is mandated by the terms of the transaction. This is an unnecessary and potentially invalid exercise of the Secretary's rule making authority under Section 482.

The Secretary does not need specific authorization under Section 482 to make "other adjustments" to income or expense from controlled party transactions. Presumably, any other adjustment to income or expense of controlled transactions short of an allocation, distribution or apportionment is made pursuant to the Secretary's general authority under Section 6201 to determine and assess a taxpayer's correct income and tax. Taxpayers generally are not precluded from filing administrative claims or delinquent returns to report decreases to income or tax resulting from any other adjustments to income so long as the claims are filed within the applicable statutory period of limitations.

While it is of uncertain significance, Section 1.482-1(a)(3) is an interpretative regulation and must be a reasonable interpretation of the language or intent of the underlying statute. Section 482 does not inhibit a taxpayer's right to report income from controlled transactions based on the terms on which they were executed. Extending the timely reporting requirement of Section 1.482-1(a)(3) to bar a taxpayer-initiated decrease to income which results from any adjustment other than an allocation may well exceed the scope of the Secretary's interpretative authority under Section 482.

As discussed below, the scope of timely reporting requirement of Section 1.482-1(a)(3) has not been well defined or evenly applied in practice. The Commissioner has raised the timely reporting requirement as a bar against claims for downward adjustments which do not result from a Section 482 mandated allocation of income or adjustments or which merely seek to correct accounting or reporting errors made on an original return. In at least one instance, the timely reporting requirement was asserted as a bar against a taxpayer's claim to seek judicial review of a contested Section 482 adjustment in a refund forum. These instances are reviewed below to illustrate the need for formal guidance and relief procedures.¹¹

B. Intersport Fashions West Inc. v. United States.

The leading precedent on the scope of the timely reporting requirement of Section 1.482-1(a)(3) is *Intersport Fashions West Inc. v. United States*.¹² The taxpayer in that case reported a post-filing decrease to income from controlled transactions on amended returns for 2001 and 2002. The decrease resulted from the identification of additional reimbursements which it claimed were owing to its foreign parent corporation. The government denied the claim as an untimely decrease to income from a controlled transaction.

To sidestep the timely reporting requirement of Section 1.482-1(a)(3), the taxpayer characterized the decrease to income as resulting from the correction of an error made in calculating its share of the parent's restructuring expenses as reported on its original tax returns. The court disagreed noting that the additional expenses claimed by the taxpayer had not been allocated to or paid by the taxpayer during 2001 and 2002 and that there was no evidence of any agreement which would have obligated the taxpayer to do so. The court concluded that the decrease to income resulted from a post-filing allocation pursuant to Section 482 and Section 1.482-1(a)(3).

¹¹ The timely reporting requirement creates an internal inconsistency since it permits one party to the controlled transaction to report an increase to the allocation of income reported from a controlled transaction and it prohibits the other party to the transaction from reporting the adjustment resulting from a correlative allocation. See, Treas. Reg. sec. 1.482-1(g)(2). Under the regulation, the same income from the transaction may be taxed twice.

¹² 109 A.F.T.R. 2d 2012-927 (Fed. Cl. 2012), appeal voluntarily dismissed.

The court clarified that its holding was limited to claims for decreases resulting from an “allocation” which is defined by Section 1.482-1 as an adjustment to income made pursuant to authority of Section 482:

The court’s use of “allocation” is confined to its meaning in Treasury Regulation 1.482-1, namely, “the results of [a taxpayer’s] controlled transactions based upon prices different from those actually charged.” 26 C.F.R. § 1.482-1(a)(3) (2006). [Emphasis added.]

An allocation must be distinguished from other adjustments to income which are mandated by the actual terms of the transaction between the controlled parties. Since the downward adjustment to income could only be characterized as a new “allocation” of expenses, the court held that the claim was barred under the timely reporting requirement of Section 1.482-1(a)(3):

Plaintiff’s attempt to add later-claimed allocations to deductions that were claimed over two years earlier on plaintiff’s original return in order to secure a tax refund of more than \$500,000 is futile. By its terms, Treasury Regulation 1.482-1(a)(3) does not permit a controlled taxpayer to claim an allocation that would decrease taxable income on an untimely or amended return. See 26 C.F.R. § 1.482-1(a)(3). [Emphasis added.]

The court then accepted for purposes of argument the claim that the adjustment could fairly be characterized as a correction of a timely reported allocation and concluded that it would still be time barred. The court analogized the timely reporting requirement of Section 1.482-1(a)(3) to a statutorily imposed reporting requirement which was controlling in two Supreme Court cases.¹³ The statute in those cases specified that taxpayers had to disclose the value of certain stock on a timely original return. The Supreme Court held this requirement absolutely precluded taxpayers from making changes to the initial reporting for any reason.

The court in *Intersport Fashion* only addressed the question whether taxpayers should be permitted to decrease to income on account of a new

¹³ *Scaife v. United States*, 314 U.S. at 461-62, and *Helvering v. Lerner Stores Corp. (Lerner)*, 314 U.S. 463, 466 (1941)

allocation. The court did not reach the broader question whether the timely reporting requirement would bar taxpayers from reporting an adjustment to income which is mandated by the terms on which the transaction was executed or an adjustment to income resulting from the correction of accounting errors or scrivener's error. These issues are still open.

C. Kenna Trading LLC, et al. v. Commissioner¹⁴

The unreviewed, unpublished order in this case is worth mentioning only because it has been cited by the administrative proceedings as a binding precedent in the Tax Court. It is not. The order denied a petitioner's post-trial motion to re-open the record and raise an affirmative issue based upon a taxpayer-initiated allocation of income. The court noted that the petitioner's motion to reopen the record which was filed more than a year after the case had been tried, fully briefed and submitted for opinion should be denied on procedural grounds. The court went on to describe the substantive grounds for the denial:

Second, with respect to [petitioner]'s request for relief under section 482, [Petitioner] identifies no basis for the Court to reallocate tax items among [petitioner] and its asserted related parties, or to compel the Commissioner to do so. Indeed, "section 482 grants no * * * right to a taxpayer to apply the provisions of section 482 at will or to compel * * * [the Commissioner] to apply such provisions." Sec. 1.482-1(a)(3), Income Tax Regs.; see also *Intersport Fashions W., Inc. v. United States*, 103 Fed. Cl. 396, 404 (2012) ("[A] controlled taxpayer may not * * * compel the Commissioner * * * to make an allocation or other adjustment."). A controlled taxpayer may, of course, "report on a timely filed U.S. income tax return the results of its controlled transactions based upon prices different from those actually charged." Sec. 1.482-1(a)(3), Income Tax Regs. But, Congress enacted section 482 as a sword only for the Commissioner, not as a sword or a shield for the taxpayer. Accordingly, the Court

¹⁴ Order dated October 7, 2014, *Kenna Trading LLC, Jetstream Business Ltd., Tax Matters Partner, et al. v. Commissioner*, Docket Nos. 7551-08 et al. (U.S. Tax Court)

lacks the authority to grant the requested section 482 relief [petitioner] seeks.¹⁵

Considering the history of the case, not much weight should be given the summary denial of the untimely motion to reopen the record. The order only reaches the narrow question whether the timely reporting requirement should bar a taxpayer from reporting a decrease to income which resulted from a post-filing Section 482 allocation of income; i.e., an adjustment which is not mandated by the terms of the transaction. Although the court cited *Intersport Fashions West* on this point, the order should not be considered a reliable barometer for future courts who might be asked to extend the timely reporting requirement to adjustments which are not allocations.

D. Hunter Douglas, Inc. v. United States.¹⁶

This case provides an interesting, if one sided, insight into the Commissioner's reading of the timely reporting requirement which sent the taxpayer into a procedural twilight zone. On its original tax return, Hunter-Douglas had deducted the amount of interest charged by and paid to an affiliate pursuant to a series of interest bearing notes. The stated rate of interest on the notes was alleged to be equal to or less than the market rate for similar borrowings, an allegation which the taxpayer claimed to have substantiated during the audit. The Commissioner determined that the taxpayer's deductible interest expense should be computed using the safe harbor interest rates prescribed by Section 1.482-2 and disallowed any deduction in excess of this amount.

Hunter-Douglas disagreed and resolved to seek judicial review of the Commissioner's allocation of income in a refund forum. On threat of further examination activity, Hunter-Douglas filed amended returns for subsequent years on which it reduced its claimed interest deductions to the amounts which would be allowable under the safe harbor rates. The company paid the deficiencies and filed timely administrative claims for refund which restored the interest deductions to the amounts originally reported, entering the twilight zone. The claims were denied by the Commissioner because

¹⁵ *Id.*, pages 2-3.

¹⁶ *Hunter-Douglas Inc. and Subs. V. United States*, (Ct. of Fed Cl.) 2014 TNT 196-16 (October 9, 2014)

they reported decreases to income from controlled transactions which were barred by the timely reporting requirement of Section 1.482-1(a)(3). Taxpayer filed its complaint for refund in the same Court of Federal Claims as heard the Intersport Fashions case.

Hunter-Douglas would have squarely presented the question whether the “timely reporting requirement” of Section 1.482-1(a)(3) can be extended a to otherwise timely claims for refunds resulting from other adjustments to income of controlled party transactions which are mandated by the prices charged and not by allocations. The court would have been called upon to consider whether application of the timely reporting requirement to “other adjustments” to income is a valid exercise of the Secretary’s rulemaking authority. These issues were not controlled by the holding in Intersport Fashion which was limited to decreases resulting from “allocations” as defined in the regulation; i.e., adjustments to income which depart from the terms of the transactions as executed.

Literal application of the timely reporting requirement to “any adjustments” to income from controlled transactions leads to the potentially absurd result whereby taxpayers would be precluded from ever obtaining judicial review of a contested Section 482 allocation of income in a post-payment forum since the predicate for refund jurisdiction is a timely administrative claim for refund which reports a decrease to income. Had the government persisted in the case, the court might have had to consider the validity of the timely reporting requirement of Section 1.482-1(a)(3) as a reasonable interpretation of Section 482, at least insofar as it applies to taxpayer claims in which the income is calculated based upon the terms of the transaction as executed or in context of refund litigation.

Even though the case was promptly resolved before an answer was filed, this taxpayer’s experience should not be considered unique. The government’s administrative determination in the case may be attributed to a lack of clear guidance regarding the scope of the timely reporting requirement

E. Administrative Guidance—Section 1.482-1(a)(3)

The Commissioner has not issued formal guidance for agents or taxpayers to help define the scope or administration of the timely reporting requirement of Section 1.482-1(a)(3). There is some informal guidance which does not address some of the issues discussed above. An International Practice Service Transaction Unit issued by the Large Business and International Division entitled Taxpayer’s Affirmative Use of Section 482 [“Practice Unit”], simply advised:

Taxpayers are not allowed to file an untimely or amended return that decreases U.S. taxable income based on allocations with respect to controlled transactions.¹⁷

The Practice Unit provided a very stripped-down example of a prohibited downward adjustment:

If it does not timely file its original return, or if it files an amended return, USS is generally not permitted to increase the price that it paid to FP for filing purposes. (In the example, increasing the price for goods increases costs of goods sold, resulting in an impermissible decrease in taxable income.)¹⁸

The Practice Unit closed with the following decision tree:

Determine if the taxpayer’s self-initiated IRC 482 adjustment was made correctly and included on a timely filed tax return including extensions. Otherwise, the taxpayer’s self-initiated adjustment should be disallowed.¹⁹

Although the distinction between reporting a Section 482 allocation of income and reporting an adjustment to income based on actual terms of transaction was not clearly drawn in the Practice Unit, it was inherent in the text and examples which described instances where the taxpayer seeks to

¹⁷ Document control # ISI/9422.09_03 (2014) last updated on March 28, 2016, page 3.

¹⁸ Document control # ISI/9422.09_03 (2014) last updated on March 28, 2016, page 8.

¹⁹ Id., page 11.

affirmatively use Section 482 to depart from the terms on which the controlled party transactions were executed for purposes of reporting income. The Practice Unit did not purport to address the timeliness of post-filing claims in which the taxpayer does not depart from the terms of the transactions to calculate or report a decrease to income from controlled party transactions, but the lack of an explicit distinction between allocations and other adjustments in the Practice Unit does not help agents or taxpayers in identifying the boundaries of the requirement.

The timely reporting requirement of Section 1.482-1(a)(3) was also considered in a Field Service Advice Memorandum [“FSA”] which addressed the question whether a taxpayer may reported a decrease to income from a controlled transaction resulting from a Section 482 allocation on an amended return.²⁰ This guidance is more helpful than the Practice Unit in identifying the boundaries of the timely reporting requirement.

The subject of the FSA had engaged in transactions with multiple controlled entities and had disclosed the results of a preliminary transfer pricing analysis for at least some of these transactions in an attachment to a Form 8275 which was submitted with its original tax return. Since the transfer pricing analysis was preliminary, the taxpayer did not fully incorporate the indicated Section 482 allocations of income or expense into the calculation of taxable income reported on the original tax return. After the transfer pricing analyses was refined, however, taxpayer filed an amended return in which the indicated arm’s length allocations were fully integrated into the calculation of income, resulting in a decrease to income reported from some controlled party transactions and an increase to the income reported from others. The taxpayer sought to offset the decreases against the increases to report a net change to income and tax.

The FSA addressed two questions: (1) whether the taxpayer’s claim for taxpayer-initiated allocations which decrease income from some transactions was barred by the timely reporting requirement of Section 1.1482-1(a)(3); and (2) whether otherwise barred decreases to income from some controlled party transactions could be applied to offset self-reported increases to income from other transactions. All the increases were the result of post-filing allocations made pursuant to Section 1.482-1(a)(3).

²⁰ FSA 200031025 (April 28, 2000).

On the first question which is directly relevant here, the result turned on whether and to what extent the decrease to income from controlled transactions claimed by the taxpayer on the amended return might relate back to the disclosures which were submitted with the original return:

In the instant case, Corp A attached to the Y1 return a Form 8275, Disclosure Statement, explaining its reasoning in arriving at the computation. Examination of the Form 8275, coupled with examination of the Schedule M-1 attached to the return, plainly set forth the computation and the considerations that led taxpayer to report the transactions in the manner that it did. Our view is that if the Tax Court found the Form 1045 was an “intrinsic part” of the original return, it would by analogy also find that the potential decrease in taxable income with respect to these controlled transactions with different CFCs disclosed on the Form 8275 attachments was reported on the Y1 timely-filed, original return.

This suggests that some discretion is allowed to the examiners when evaluating whether the timely reporting requirements have been satisfied with respect to post-filing decreases to income resulting from allocations. The FSA did not address the question whether an decrease to income which was mandated by the terms of the transaction as executed might be permitted or whether the correction of obvious accounting or reporting errors might be accepted.

A field service advice memorandum carries very little weight as precedent even in administrative proceedings. The absence of more authoritative guidance invites controversy over the scope of the timely reporting requirement. Had the FSA been issued as a Revenue Ruling, the taxpayer in Hunter-Douglas may not have had to file a complaint to have its timely refund claims considered since the amended returns merely restated the deductions which were claimed on the original timely returns.

There undoubtedly are other administrative proceedings in which the Commissioner has applied the timely reporting requirement to bar claims which are beyond the proper scope of Section 1.482-1(a)(3). During one such audit, the Commissioner asserted the timely reporting requirement was

a bar to the correction of an obvious accounting error which had been made by the taxpayer during the preparation of its timely original income tax return. The error occurred when certain fees which were timely paid to a foreign affiliate pursuant to an express contractual arrangement were mistakenly eliminated from the calculation of the parent's taxable income. The fees had been disclosed as an elimination item in the reconciliation of consolidated book income provided with the return and were reported on the information returns submitted with the parent's original return. Nevertheless, the Commissioner determined that the correction was untimely since it would result in a decrease to income reported from a controlled transaction.

In both instances, there is no evidence that the taxpayer was attempting to abuse the transfer pricing rules of Section 482 to engineer a more favorable tax result and there is no administrative or equitable argument to support the extension of the timely reporting requirement to these circumstances. These sorts of controversies might be avoided if there were formal guidance which defined the scope of the timely reporting requirement more clearly and if there were procedures which would make relief from the timely reporting requirement available in appropriate circumstances.

III. Specific Circumstances to be Addressed

A. Reporting Income Based on Actual Prices Charged—.

Taxpayers who adhere to the terms of transactions with controlled parties when calculating and reporting income have not relied on Section 482 or the Secretary's delegation of authority at Section 1.482-1(a)(3) to allocate income from controlled party transactions on terms other than those charged. The timely reporting requirement of Section 1.482-1(a)(3) should not prohibit taxpayers from reporting the correct amount of income resulting from controlled transactions to the extent that the calculation of income reported is mandated by the express terms or prices charged.

The requested procedure or guidance would clarify that the timely reporting requirement of Section 1.482-1(a)(3) does not apply to any adjustment to income which is mandated by the terms of the controlled

transaction as executed. The automatic relief procedures of Section 301-9100-2 should be extended to grant automatic relief from the timely reporting requirement where taxpayers changes to income which are mandated by the terms of the transaction as executed. The grant of automatic relief under Section 9100 could be conditioned upon the submission of an auditable statement by the taxpayer to justify the original and corrected calculation of income as one which is mandated by reference to the terms of the transaction as executed.

B. Contesting Section 482 Adjustments—

Taxpayers generally are allowed to choose the forum in which they will contest an administrative determination of their income taxes, either in a pre-assessment forum or a post-payment forum. Section 482 cannot be interpreted as authorizing the Commissioner to bar a taxpayer from contesting a Section 482 allocation of income in a post-payment, refund forum. The confusion among the Commissioner's agents over the scope of the timely reporting requirement experienced by Hunter-Douglas and other taxpayers could be clarified through formal guidance which would define a "decrease to income" for purposes of Section 1.482-1(a)(3) as one which reduces the income reported from the controlled transaction below the amount of income which was reported or which was otherwise disclosed with the taxpayer's timely original return. The guidance could specify that a taxpayer must file a reconciliation statement with the refund claim or amended return to demonstrate that the adjustment does not reduce income from the controlled transactions below that which was reported or otherwise disclosed on the original return.

C. *Correction of Non-Substantive Errors*—

The process of calculating and reporting the income or expenses from transactions with controlled party transactions entails the same or even greater degree of risk of error as does the process of calculating and reporting the income or expense from transactions with unrelated parties. For example, an item of expense incurred in conducting a controlled transaction and recorded in the taxpayer's books of account may be inadvertently omitted or undercounted during the process of converting book income to tax income or in the process of transferring the results from books

to tax return. An original tax return may contain typographic errors which have the effect of overstating income from controlled transactions. Correction of these sorts of errors does not require an “allocation” of income as that term is used in Section 1.482-1.

In less common circumstances, a restatement of a taxpayer’s financial accounts may be necessary to correct material accounting errors. A restatement of book income may also necessitate a restatement of tax income. Depending upon the nature of the error, the restatement may affect the calculation of income reported from controlled transactions on an original timely return. This may result regardless of whether the income reported on the original return was mandated by the terms of the transactions as executed or was allocated among the parties pursuant to Section 482. If the underlying activity was not accurately accounted for, the translation of the activity to taxable income may also have been inaccurately calculated.

These are not unusual errors nor are they unique to the calculation or reporting of income from controlled transactions. The regulations and administrative procedures generally encourage taxpayers to voluntarily correct reporting errors promptly by filing amended returns within the applicable period of limitations. A literal reading of Section 1.482-1(a)(3), however, would preclude taxpayers from correcting any accounting error, scrivener’s error or other non-substantive error which was reported on an original return if it had the result of overstating the income reported from controlled party transactions.

There is no justification for imposing a new regulatory requirement to prohibit taxpayers from correcting any reporting error solely because the correction would result in a decrease to income from a controlled transaction. As illustrated by the claims presented in the Intersport Fashion and in the Kenna Trading cases, the Commissioner may disagree whether the adjustment was necessary to correct an accounting or non-substantive reporting error and may harbor legitimate concern that taxpayers might seek to mischaracterize post-filing allocations as mistakes to avoid the timely reporting requirement. Reconciliation of the competing interests of taxpayers seeking to correct errors and the Commissioner seeking to prohibit post-filing tax allocations could be achieved by conditioning Section 9100 relief upon the reasonable cause procedures at Section 301.9100-3. This

advance ruling procedure allows the Commissioner to police spurious claims of accounting or non-substantive reporting errors while affording taxpayers with legitimate claims an opportunity to obtain relief from the regulatory filing requirement.

D. Substantive Changes in Section 482 Allocations.

Not often, but with potentially significant financial consequence, the application of Section 482 transfer pricing principles can result in gross misallocations of income among parties to controlled transactions. Taxpayers are permitted and incentivized to promptly correct allocation errors when they result in an increase to income from controlled transactions but are prohibited by the timely reporting requirement of Section 1.482-1(a)(3) from making a correction if it results in a decrease to income. This paper does not address the merits of providing relief from the timely reporting requirement to taxpayers who have overstated income from controlled transactions because of a defective Section 482 allocation. The holding of the Court of Federal Claims in *Intersport Fashions West* affirmed the timely reporting requirement of Section 1.482-1(a)(3) as an absolute bar against post-filing allocations by taxpayers regardless of merit. Nevertheless, there may be circumstances where the taxpayer can demonstrate reasonable cause for the initial reporting error. The Commissioner should consider allowing taxpayers to seek discretionary relief in these circumstances.

IV. Merits

The proposed guidance will promote efficient administration of the internal revenue laws by eliminating uncertainty and minimizing controversy regarding the scope and application of timely reporting requirement created by Section 1.482-1(a)(3). The proposal to allow taxpayers to obtain Section 9100 relief from the timely reporting requirement will promote the equitable administration of the internal revenue laws by allowing taxpayers to correct reporting errors which result in the overstatement of income or tax.

V. Collateral Consequences

The proposed guidance and relief procedures are unlikely to have impact

beyond the calculation and timely reporting of income from controlled transactions.

VI. Feasibility

The Commissioner has authority to issue administrative guidance on this issue and to grant automatic or discretionary relief from the regulatory reporting requirements of Section 1.482-1(a)(3). The proposed guidance and relief procedures would not require new legislation or regulations.