

# Procedural Rules for Claiming Set-offs Continue to Emphasize the Importance of Maintaining Contemporaneous Documentation

*By Zion Levi\**

Zion Levi examines the recent updates to the procedural rules for claiming set-offs.

Recently, the IRS issued Rev. Proc. 2005-46<sup>1</sup> updating the procedural rules pursuant to which taxpayers facing proposed transfer-pricing allocations under Code Sec. 482<sup>2</sup> (“Code Sec. 482 Adjustments”) may claim set-offs. The updated rules are quite similar to the procedural rules that governed the claiming of set-offs prior to the issuance of Rev. Proc. 2005-46<sup>3</sup> and continue to emphasize the importance of both filing with the IRS<sup>4</sup> a timely, complete and proper written notice of the basis for the claimed set-offs and maintaining contemporaneous documentation with respect to all controlled transactions.<sup>5</sup>

Set-offs are part of the “correlative allocations” that the IRS will consider when making Code Sec. 482 Adjustments.<sup>6</sup> The term “set-off” refers to the effect that other non-arm’s-length transactions have on arriving at the ultimate Code Sec. 482 Adjustments. Thus, when Code Sec. 482 Adjustments are proposed with respect to a transaction between controlled entities, and provided that the taxpayer properly asserts a set-off claim, the IRS will take into account the impact of other non-arm’s-length transactions between the same controlled entities in the same tax year “which will result in a set-off against” the proposed Code Sec. 482 Adjustments.<sup>7</sup>

To illustrate, assume that USCo, a U.S. corporation, renders services to FCo, its foreign subsidiary, in connection with the environmental cleanup of

FCo’s newly acquired property. An arm’s-length charge for such services would be \$70,000. During the same tax year, USCo also makes available to FCo the use of a truck to be used in the environmental cleanup, and the arm’s-length rental value of the truck is \$7,000. USCo bills FCo \$77,000 for the services, but does not charge FCo for the use of the truck. Nevertheless, a Code Sec. 482 Adjustment will not be made with respect to the undercharge for the truck if USCo makes a proper claim for set-off that establishes both that the excess amount charged for services was equal to an arm’s-length charge for the use of the truck and that the taxable income and income tax liabilities of USCo are not distorted.<sup>8</sup>

Regulations under Code Sec. 482 provide that a set-off claim will be taken into account only if the taxpayer:

- notifies the IRS of the basis of any claimed set-off within 30 days after the earlier of the date of the issuance of (1) a 30-day letter,<sup>9</sup> or (2) a notice of deficiency<sup>10</sup>;
- establishes that the transactions that are the basis of the claimed set-off were not at arms length;
- further establishes the appropriate arm’s-length amount of the transactions that are the basis of the claimed set-off; and
- documents all correlative adjustments resulting from the proposed set-off.<sup>11</sup>

Although Rev. Proc. 2005-46 encourages taxpayers to notify the IRS of the basis of any claimed set-offs while still under audit,<sup>12</sup> taxpayers must nevertheless formally file a written notice of the claimed set-offs

*Zion Levi, Esq.*, is a Member in the Tax Practice Group of Womble Carlyle Sandridge & Rice, PLLC in Washington, D.C.

within 30 days following the date of the issuance of a 30-day letter (or, if earlier, the notice of deficiency) “unless an extension has been granted” by the IRS.<sup>13</sup> The IRS may grant an extension, however, only if the taxpayer files a request for an extension within the aforesaid 30 days notification period.<sup>14</sup>

When the taxpayer intends to protest the 30-day letter, a notice that accompanies a timely filed protest “will be considered timely.”<sup>15</sup> Rev. Proc. 2005-46 is somewhat unclear, however, on whether a request to extend the time to file a protest is also deemed a request to extend the time to file the notice of the claimed set-offs. Careful taxpayers, therefore, timely file both requests simultaneously.<sup>16</sup>

The notification requirement is satisfied only when the notice “sufficiently” identifies the non-arm’s-length transactions that are the basis of the claimed set-offs.<sup>17</sup> A notice identifies the non-arm’s-length transactions “sufficiently” when it both establishes “a reasonable foundation” for, and permits an IRS verification of, the claimed set-offs.<sup>18</sup>

Taxpayers are cautioned that an “incomplete or improper notification will not extend the period within which the [IRS] is to be notified.”<sup>19</sup> This rule can potentially become a trap for the unwary and, consequently, taxpayers should be extra careful while preparing the notice, include all available information about the non-arm’s-length transactions that are the basis of the claimed set-offs, and “submit the notification in sufficient time to permit correction of any deficiencies within the prescribed limitation period.”<sup>20</sup>

Taxpayers are further cautioned that the IRS may reject a claim for set-offs if the taxpayer either (1) fails to furnish “information as the [IRS] may require” to examine the non-arm’s-length transactions that are the basis of the claimed set-offs, or (2) refuses to extend the statute of limitations when the IRS, in its sole administrative discretion, determines that such extension is necessary to facilitate an examination of the relevant non-arm’s-length transactions.<sup>21</sup> While not expressly stated in Rev. Proc. 2005-46, taxpayers should be allowed to

satisfy the latter requirement by executing an extension that is limited only to the examination of the relevant non-arm’s-length transactions.

The notice requirement is “separate and distinct” from the other requirements outlined above.<sup>22</sup> The other requirements involve proving the claimed set-offs by establishing that the non-arm’s-length transactions actually took place (including estab-

lishing the arm’s-length charge for such transactions) and documenting all correlative adjustments resulting from said non-arm’s-length transactions “with reasonable specificity.”<sup>23</sup> To meet this burden of proof, taxpayers should prepare and maintain

detailed contemporaneous documentation substantiating their set-off claim<sup>24</sup> and furnish such documentation “concurrently with the notification.”<sup>25</sup> The importance of maintaining contemporaneous documentation prior to the onset of the audit cannot be overstated, because the “question concerning the appropriateness of granting” taxpayers additional time to gather the necessary information “lies entirely within the administrative discretion of” the IRS.<sup>26</sup>

In conclusion, taxpayers facing proposed Code Sec. 482 Adjustments can minimize, and even eliminate, the impact of the ultimate Code Sec. 482 Adjustments by properly claiming set-offs. A few of the updated procedural rules governing the claiming of set-offs remain unclear or potentially can become a trap for the unwary. Taxpayers should be particularly careful while preparing the notice regarding their set-off claim, include all available information about the non-arm’s-length transactions that are the basis of the claimed set-offs, and submit the notice in sufficient time to permit correction of any deficiencies. When necessary, taxpayers should also consider extending the statute of limitations to allow sufficient time to fully substantiate their set-off position. Preparing and maintaining contemporaneous documentation with respect to all controlled transactions would favorably enhance the taxpayer’s set-off claim.

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## ENDNOTES

- \* Zion's practice encompasses all facets of federal income tax law, including taxation of transfer pricing and other international transactions. Zion has extensive experience in planning optimal tax strategies and in successfully representing taxpayers in tax controversies before the IRS.
- <sup>1</sup> Rev. Proc. 2005-46, IRB 2005-30, July 8, 2005. Rev. Proc. 2005-46 generally is effective for tax years beginning on or after July 25, 2005. However, taxpayers may elect to apply Rev. Proc. 2005-46 for any open tax year beginning after Oct. 6, 1994 (and, in some circumstances, after Apr. 21, 1993). The election, once made, is effective for the tax year of the election and all subsequent years. See Rev. Proc. 2005-46, §§4.01 through 4.03.
- <sup>2</sup> Unless otherwise indicated, all references to sections are to the Internal Revenue Code of 1986, as amended, and to the regulations promulgated thereunder.
- <sup>3</sup> See generally Rev. Proc. 70-8, 1970-1 CB 434.
- <sup>4</sup> For purposes of simplicity, this article refers to the IRS generically as the "person" with whom taxpayers should communicate in connection with claiming set-offs. It is noted, however, that the notification and other duties under Rev. Proc. 2005-46 are currently within the authority of the IRS's director of field operations. See Rev. Proc. 2005-46, §2.02.
- <sup>5</sup> A "controlled transaction" means any transaction between two or more members of the same group of controlled taxpayers. Reg. §1.482-1(i)(5). A "controlled taxpayer" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. Reg. §1.482-1(i)(4).
- <sup>6</sup> Reg. §1.482-1(g)(1).
- <sup>7</sup> Reg. §1.482-1(g)(4)(i).
- <sup>8</sup> Based on Example 1 of Reg. §1.482-1(g)(4)(iii). USCO's tax liability would be distorted, however, if, for example, it would have been subject to the tax on personal holding companies had it reported \$7,000 as rental income and \$70,000 as service income. See Reg. §1.482-1(g)(4)(iii), Example 2.
- <sup>9</sup> A "30-day letter" is a letter by which the IRS transmits an examination report to the taxpayer notifying the taxpayer of the proposed adjustments.
- <sup>10</sup> While the IRS, so long as it is reasonable under the circumstances, may issue a 90-day letter at any point in the audit or settlement procedure, in practice, the IRS ordinarily issues a 30-day letter first to allow the taxpayer an opportunity for an administrative review in the IRS's Office of Appeals. Code Sec. 6603(d)(3)(B).
- <sup>11</sup> Reg. §1.482-1(g)(4)(ii).
- <sup>12</sup> Rev. Proc. 2005-46, §3.06.
- <sup>13</sup> Rev. Proc. 2005-46, §2.04.
- <sup>14</sup> *Id.* Taxpayers may rely on the "timely mailed, timely filed" rule of Code Sec. 7502 to establish that a notification (or a request for an extension) posted in the U.S. mail was filed on the date of the postmark. *Id.*
- <sup>15</sup> *Id.*
- <sup>16</sup> If the taxpayer timely files a proper notification prior to filing the protest, the previously filed notification "may be incorporated by reference into the protest." Rev. Proc. 2005-46, §3.07.
- <sup>17</sup> Rev. Proc. 2005-46, §2.03.
- <sup>18</sup> *Id.* In addition to sufficiently identifying the relevant non-arm's-length transactions, the notice must also include the taxpayer's name, address and U.S. employer identification number (or Social Security number), the date and symbols listed on the 30-day letter or notice of deficiency, and the tax year(s) at issue. Rev. Proc. 2005-46, §3.03. When the taxpayer herself prepares the notice, the taxpayer must include with the notice a specified "signed declaration under penalties of perjury." Rev. Proc. 2005-46, §3.04. When a "duly authorized representative" prepares the notice, the representative can substitute, in lieu of the declaration under penalties of perjury, a declaration that she personally knows that the statements contained in the notice "and all evidence submitted are true, correct, and complete to the best of the representative's knowledge and belief." Rev. Proc. 2005-46, §3.05.
- <sup>19</sup> Rev. Proc. 2005-46, §3.06.
- <sup>20</sup> *Id.*
- <sup>21</sup> Rev. Proc. 2005-46, §3.09.
- <sup>22</sup> Rev. Proc. 2005-46, §2.03.
- <sup>23</sup> *Id.*
- <sup>24</sup> Rev. Proc. 2005-46, §2.05.
- <sup>25</sup> *Id.*
- <sup>26</sup> *Id.*

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