

ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR Associate District Counsel, Kentucky-Tennessee
CC:SER:KYT:LOU

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Significant Service Center Advice -- Nontaxable Use of Fuel
by Non-TEFRA S Corporations

This responds to your request for Significant Advice, dated June 16, 1998, concerning a question posed by the excise tax section at the Cincinnati Service Center.

This advice is not binding and is not a final case determination. It is advisory only, does not resolve Service position, and should not provide the final basis for resolving a case. It is not to be relied upon or otherwise cited as precedent.

ISSUES

1. When an accrual basis nonTEFRA S corporation files a Form 4136 claiming a credit for certain uses of gasoline and diesel fuel under I.R.C. § 34, is the statute of limitations with respect to a shareholder extended for any adjustments resulting from this claim?
2. If the shareholder refuses to file, or does not file, an amended Form 1040 reflecting the adjustment, may the credit be denied or only a net amount be paid to the S corporation?
3. What action may be taken to ensure proper reporting of the shareholder of the adjustment caused by the granting of the credit?

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CONCLUSIONS

1. The statute of limitations with respect to the shareholder is not extended when the nonTEFRA S corporation files an amended return.
2. In general, the refund cannot be denied the S corporation because the shareholder has not filed an amended return including the additional income to the shareholder caused by the S corporation's claim. See discussion of equitable recoupment below.
3. The only way to recover the tax due from the shareholder is to solicit an extension of the period of limitations, or send a statutory notice of deficiency for the tax due as a result of the omitted income.

FACTS

The service center asks about a statute of limitations problem it faces in processing Form 4136 claims for credit for nontaxable use of fuel. The problem concerns the limited time that may exist in which to make corresponding adjustments to the shareholder returns.

The Internal Revenue Code imposes excise taxes on a variety of fuels, including gasoline, gasohol, diesel fuel, liquified petroleum gas, compressed natural gas, and aviation fuel. Generally, the tax is imposed on a distributor and the amount of the tax is normally passed on to the purchaser as an increased cost for the fuel. Commonly, a business purchaser deducts the cost of the fuel (which includes the amount of the excise tax on the fuel) under section 162. Under section 34, a credit may be allowed to a taxpayer if the fuel is put to a farm, off-highway, or other nontaxable use.

The credit is a credit against income tax allowed to the purchaser in the amount of the tax imposed on the fuel for the year in which the nontaxable use occurred. The credit is a refundable credit payable to the S corporation. Pursuant to section 1366(f)(1), it is not passed through to the shareholders. Where the purchaser is on the accrual basis of accounting, the amount of the credit must be included in income for the taxable year in which the fuel is used. Rev. Rul. 67-2, 1967-1 C.B. 13.

Your submission raises a concern about the situation in which an S corporation does not claim a credit for nontaxable use of the fuel until on or just before the expiration of the statute of limitations for the year in which the tax was paid. In this situation, a deficiency should be assessed against the shareholders because of the decreased business expense deduction allowed to the corporation and the corresponding increase in corporate taxable income passed through to the

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shareholders. Where amended shareholder returns do not accompany the claim, you stated that you are left with as short a period as one month in which to make the assessments on the shareholders' returns for the year to which the claim applies.

For purposes of discussion, we will consider the following example:

Assume that a nonTEFRA S Corporation, Truck, Inc., timely filed a Form 1120S for calendar year 1994 on March 15, 1995. Truck Inc. is an accrual basis taxpayer, deducted fuel costs (including the amount of the excise tax) on that return, and has one shareholder, Bob. Truck Inc. filed an amended Form 1120S on March 15 1998, with a claim on Form 4136 in the amount of \$10,000 for nontaxable use of diesel fuel used in refrigeration units. Truck Inc. did not include the \$10,000 in income on the amended return and filed no amended Form K-1 for Bob.

Further assume that Bob timely filed his Form 1040 for calendar year 1994 on April 15, 1995. Bob's statute of limitations for his 1994 tax year expires on April 15, 1998, and Bob has not filed an amended Form 1040X for 1994 showing an increase in income in the amount of \$10,000.

Your submission asks what actions or steps are available to the service center in this situation in which the statute of limitations for a shareholder's taxable year will expire shortly after the service center receives the Form 4136 from the S corporation.

DISCUSSION

We recognize the problems that these late claims on Forms 4136 by accrual basis nonTEFRA S corporations pose for the service center. Unfortunately, there is not a simple answer to this problem. The best course of action permitted by law is for the service center to make the assessments against the shareholders in the limited time available. The service center understands the law concerning section 34 and the operation of the law that results in additional income to the shareholder. Therefore, we recommend that the service center establish a procedure to proceed against the shareholder in an expedited manner when the S corporation files a Form 4136 just prior to the expiration of the statute of limitations. The service center may want to consider contacting the shareholder and requesting an extension of the statute of limitations from the shareholder before making the assessment against the shareholder.

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The shareholders' statutes of limitations are not extended by operation of law in this situation. An extension is unavailable under the rule of section 6501(c)(7), which allows the Service 60 days to assess the amount of additional tax reported on an amended return. That provision is intended to allow the Service to do no more than assess the amount of additional tax reported on an amended return. That section does not permit the Service to assess an amount of tax against the shareholder. The only way to recover the tax due from the shareholder is to solicit an extension of the period of limitations, or send a statutory notice of deficiency for the tax due as a result of the omitted income.

You also ask whether the mitigation provisions in sections 1311 through 1314 may assist the Service in this situation. The S corporation and its shareholders are not related parties for purposes of the mitigation provisions. Therefore, those provisions are inapplicable.

As for judicial remedies, such as the tax benefit rule and the duty of consistency, none of them clearly apply to extend the statute either. Our only remedy may be the doctrine of equitable recoupment. As the sole shareholder and the S corporation would probably be found to be in privity, equitable recoupment might allow the Service to recover the additional tax due from the shareholder by allowing the withholding of the S corporation's refund. Equitable recoupment, however, only applies if the shareholder's tax year is closed at the time the amended Form 1120S is filed. This fact has not been determined, so whether equitable recoupment applies is uncertain. We would prefer to determine whether equitable recoupment is available if presented the facts of an actual case.

In summary, in the example above, we have concluded that Bob's statute of limitations for assessment of the additional tax resulting from the filing of the Form 4136 claim, and the corresponding increase in the S corporation income, is April 15, 1998. The filing of the claim does not extend the statute of limitations applicable to assessment of the resulting deficiency against Bob.

Moreover, the amount of this deficiency cannot be recovered through an offset permitted by section 6402. The Service cannot net the deficiency of the shareholder against the claimed fuel credits. The right to offset an overpayment against an outstanding liability does not apply to a liability that has not been established through a notice of deficiency.

Our advice is limited to the legal aspects of the problem posed. From that perspective, we are advising you that the Service must assess any resulting deficiencies against the shareholders prior to the expiration of the shareholder statutes and that those statutes are not extended by the filing of the claims. The Service cannot offset the shareholder deficiencies against the corporate refund, nor can it deny the claims because they are not accompanied by amended shareholder

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returns. Unless extensions are obtained, the Service has no option other than to make the assessments in the short time available under these circumstances.

We express no opinion as to how the assessments should be made. That is, we have not addressed your questions about whether the assessments should be made based on the Service Center's own calculations, amended returns, or correspondence with the shareholders confirming that they deducted the tax as an expense on their original returns. We believe that the Service Center and other organizations are in a better position than we are to resolve such practical problems.

DEBORAH A. BUTLER

By: _____/s/_____
HARVE M. LEWIS
Chief, Passthroughs and Special
Industries Branch
Field Service Division

cc: Executive Office for Service Center Operations (EOSCO)
National Director of Customer Service (NDCSO)