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Court Rules that IRS Not Bound By Field Service Advice (FSA) – Taxpayers Cannot Rely Upon Them Either

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Overview

In a recent case, a federal district court ruled that IRS is not bound by agency-issued FSAs, and that IRS need not treat similarly situated taxpayers similarly.[1] In its opinion, the court pointed out the difference between an FSA and a private letter ruling, and sounded a warning to taxpayers attempting to rely on FSAs for a position taken on a return. The case also points out that attempting to bind IRS to an FSA may be difficult, if not impossible.

Facts of *Schering-Plough*[2]

The plaintiff entered into an interest rate swap transaction with another company in 1991.[3] The transaction required each party to make payments every 6 months from 1991 to 2010, based on a principal amount of $650 million. The plaintiff relied on an 1989 IRS Notice in which IRS stated that a lump-sum payment received in an interest rate swap transaction had to be reported as income spread over the life of the contract, rather than being reported entirely in the year the lump-sum payment was received.[4] Consistent with the 1989 Notice, the plaintiff reported as income a ratable portion of the lump-sum payment on its 1991 return. The plaintiff entered into a second interest rate swap transaction in 1992, received another lump-sum amount, and reported a ratable portion of the payment as income on its 1992 return.

Another taxpayer (unrelated to the plaintiff) who is a direct competitor with the plaintiff entered into an identical transaction. IRS auditors sought legal advice from the IRS's Office of Chief Counsel concerning the IRS' position as to the tax treatment of the transaction. The Chief Counsel's Office issued an FSA stating that the 1989 Notice applied.[5] The result was that the lump-sum amount was not fully taxable in the year of receipt. However, as for the plaintiff, IRS took the position that the lump-sum amount received upon sale of the portion of the contract should be recharacterized either as a loan or as a constructive dividend. IRS took that position based on a Treasury Regulation adopted in 1993 (and which IRS applied on a retroactive basis) that had the effect of reversing the 1989 Notice.[6] The effect of the recharacterization was that the plaintiff was required to pay $473 million in tax and interest on the transaction.

The plaintiff sought to bind the IRS to the treatment it provided to the competitor, claiming that the IRS could not treat the plaintiff differently from its competitor that entered into an identical transaction, and could not treat the plaintiff in a manner inconsistent with the FSA issued in the competitor's situation. The taxpayer relied on a 1965 Federal Claims Court opinion in a case involving the failure of the IRS to issue similar private letter rulings on a similar issue at about the same time to two different taxpayers.[7] The court held that such inconsistent treatment was improper.

The Court's Analysis

The *Schering-Plough* court held that the IRS did not have to treat the similarly situated taxpayers in the same manner, and that the FSA didn't apply to the taxpayer. The court rejected the 1965 case as precedent largely because an FSA

is not the same as a private letter ruling. For example, the court noted that an FSA is issued to IRS field personnel whereas a taxpayer requests a PLR. In addition, the court pointed out that a taxpayer requesting a PLR can rely on it because the ruling is binding on IRS with respect to that taxpayer, but FSAs cannot be relied on by taxpayers because they are not binding on IRS. Also, when taxpayers ask for PLRs they submit information to IRS and they are entitled to have a conference with it, while FSAs are issued to IRS field personnel without notice to the taxpayer, and the taxpayer has no right to a conference with the IRS. The court also noted that prior caselaw distinguished FSAs from private letter rulings.[8] As such, FSAs cannot be relied upon by taxpayers, and are not binding on the IRS.

Summary

The lesson of the case is clear – taxpayers rely on FSAs at their own risk and IRS is not bound by them.[9] However, FSAs might be able to be used as a negotiating tool, but even that might be questionable if the IRS field personnel in a particular case understands that an FSA is merely advisory and doesn't bind the agency.

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[1] Schering-Plough Corp. v. United States, No. 2:05-cv-02575 (D. N.J. Dec. 3, 2007).
[2] *Id.*
[3] In an interest rate swap transaction, the parties agree to make interest payment to each other based on a hypothetical amount of principal. Each party agrees to make payments under a different interest rate for a set term of years. The parties only exchange the interest payments, not the principal amounts.
[4] IRS Notice 89-21, 1989-1 C.B. 651.
[5] 1997 FSA LEXIS 206 (Aug. 29, 1997).
[6] Treas. Reg. §1.446-3(g)(4).
[7] International Business Machines Corp. v. United States, 343 F.2d 914 (Ct. Cl. 1965), *cert. den.*, 382 U.S. 1028 (1966).
[8] *See, e.g.,* Tax Analysts v. IRS, 117 F.3d 607 (D.C. Cir. 1997).
[9] Arguably, the court's rationale could also apply to other IRS correspondence issued without taxpayer request or right to a conference (e.g. Technical Advice Memorandum, Chief Counsel Advice, etc).