Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Examination of previously examined year in connection with net operating loss carryback

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

$X =
$Y =
Tax Year 1 =
Taxpayer =

ISSUES

Whether the IRS's examination of a previously audited year in connection with a claim for refund is a violation of the prohibition in section 7605(b) against unnecessary examinations or inspections, and more than one inspection of the taxpayer's books of account.

CONCLUSIONS

The re-examination of a previously audited year in connection with a claim for refund is not a second inspection for purposes of section 7605(b).

FACTS

On its tax return for Tax Year 1, the Taxpayer deducted a bad debt loss of $X. The IRS audited Tax Year 1, including the issue of the bad debt loss. During the audit, the Taxpayer argued the loss should have been deducted as a worthless stock loss rather than a bad debt loss. The Revenue Agent allowed the loss, concluding the loss would either be deductible as a bad debt or worthless stock loss.[1] The statute of limitations for assessment under I.R.C. § 6501 has expired for Tax Year 1.

In a later year, the Taxpayer filed a Form 1139, Corporation Application for a Tentative Refund, for a net operating loss ("NOL") carryback to Tax Year 1, which results in a refund of approximately $Y. The audit team considering the Taxpayer's claim for refund is examining Tax Year 1 in connection with this claim. After further consideration, it appears the loss of $X claimed for Tax Year 1 is not allowable as either a bad debt or worthless stock loss. The IRS's disallowance will be limited to the amount of the NOL carryback. The IRS will not assess additional tax for that year.

The Taxpayer objects to the examination of the bad debt/worthless stock issue as a reopening of a closed year under Internal Revenue Code section 7605(b). The Taxpayer also cites Internal Revenue Manual ("IRM") section 4.11.11.12(5) Example 1 for the proposition the IRS cannot raise this issue. The audit team issued Information Document Requests to the Taxpayer regarding this issue. The Taxpayer responded to these requests, but continues to object to the examination of this issue.

LAW AND ANALYSIS

I.R.C. § 7605(b) provides that "[n]o taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

Section 7605(b) first appeared as section 1309 of the Revenue Act of 1921. 42 Stat. 310. Congress enacted the section in response to taxpayer complaints that revenue agents were subjecting them to onerous and unnecessarily frequent examinations and investigations. See H.R. Rep. No. 67-350 at 16 (1921). The purpose of the section is to relieve taxpayers from unnecessary annoyance. 61 Cong. Rec. 5855 (Statement of Sen. Penrose) (1921). However, "Congress did not intend for section 7605(b) to be a

[1] No closing agreement or similar agreement was signed with respect to this issue.

severe restriction on the Commissioner's powers in monitoring and enforcing the Code." Law Offices-Richard Ashare, P.C. v. Commissioner, T.C. Memo 1999-282, at *6; see United States v. Powell, 379 U.S. 48, 54-55 (1964).

Rev. Proc. 2005-32, 2005-1 C.B. 1206, § 4.02 provides that "[a] reopening of a closed case involves an examination of a taxpayer's liability that may result in an adjustment to liability unfavorable to the taxpayer for the same taxable period as the closed case, with exceptions, some of which are noted below. The Service's review, including an inspection of books of account, of a taxpayer's claim for a refund on an amended excise or income tax return, as well as the Service's review of a Form 843, *Claim for Refund and Request for Abatement*, claiming a refund for an overpayment reported on a return, is not a reopening."

Section 5 of Rev. Proc. 2005-32 sets forth IRS procedures for reopening closed cases. "The Service will not reopen a case closed after examination to make an adjustment unfavorable to the taxpayer unless: (1) there is evidence of fraud, collusion, concealment, or misrepresentation of material fact; (2) the closed case involved a clearly-defined, substantial error based on an established Service position existing at the time of the examination; or (3) other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission."

In applying the procedures set forth in Rev. Proc. 2005-32, we see no reason to distinguish the facts of this case from those set forth in § 4.02 of the revenue procedure, because a taxpayer's claim for refund requires that the Service review the affected tax years whether the taxpayer files the claim through a Form 843, an amended tax return, or another means (here, a Form 1139). As such, the Service's examination of Tax Year 1 in connection with Taxpayer's claim for refund is not a reopening of a closed case under IRS procedures.

Even if the examination were considered a reopening of a closed case under IRS procedures, section 7605(b) does not prohibit a second examination. Section 7605(b) prohibits *unnecessary examination or investigations* and requires that the taxpayer be notified in writing if an additional examination is necessary. The reopening would arguably be attributable to clearly-defined, substantial error based on an established Service position existing at the time of the examination or necessary in order to avoid a serious administrative omission. "Substantial" refers to the dollar amount of the tax that would not be assessed if the case were not returned. IRM 4.8.2.8.1.1. Reopening because of a "serious administrative omission" covers situations in which a failure to reopen could:(1) result in serious criticism of the Service's administration of the tax laws; (2) establish a precedent that would seriously hamper subsequent attempts by the Service to take corrective action; (3) result in inconsistent treatment of similarly situated taxpayers who have relatively free access to knowledge as to how the Service treated items on other taxpayers' returns. IRM 4.8.2.8.1.3.

Further, even if the Service did not follow Rev. Proc. 2005-32, it would not lend validity to the Taxpayer's claim for refund. Procedural rules are merely directory, not mandatory. Hawkins v. Commissioner, T.C. Memo. 2005-149, at *4.

In Lewis v. Reynolds, 284 U.S. 281 (1932), modified on other grounds, 284 U.S. 599 (1932), the Supreme Court upheld the Commissioner's denial of a claim for refund when, upon re-examination of the previously audited return, the Commissioner determined a previously allowed deduction for attorney's fees was improper and there was an additional tax due greater than the tax paid. The additional tax was barred from assessment by the statute of limitations. The Supreme Court concluded that the Commissioner's actions were proper, stating:

> While the statutes authorizing refunds do not specifically empower the Commissioner to reaudit a return whenever repayment is claimed, authority therefor is necessarily implied. An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Lewis v. Reynolds, 284 U.S. at 283.

Moreover, the Supreme Court has recognized the IRS may reconsider the entire return, even to the extent of disallowing any deductions erroneously previously allowed, in connection with a claim for refund. See Lewis v. Reynolds, 284 U.S. at 283. Similarly, the Tax Court has held that a reexamination in connection with a claim for refund is not of the nature to which section 7605(b) applies. See Service Elec. Co., Inc. v. Commissioner, T.C. Memo. 1965-176.

In Service Elec. Co., Inc. v. Commissioner, T.C. Memo. 1965-176, the Tax Court held that section 7605(b) does not apply to an investigation in connection with a claim for refund. The court stated: "There was no second investigation of the books of Service Electric in the instant case except in connection with a claim for refund based on a tentatively allowed carryback with deficiencies being determined only of the amounts previously tentatively allowed as a refund. Such an investigation is not of the nature to which section 7605(b) of the Internal Revenue Code of 1954 has reference."

This is not a case where the IRS is subjecting the Taxpayer to onerous and unnecessarily frequent examinations and investigations. See H.R. Rep. No. 67-350 at 16 (1921). The reexamination of Tax Year 1 is not a unilateral action on the part of the IRS, but in response to the Taxpayer's election to carry back net operating losses and claim a refund. In order to determine the Taxpayer's right to the claimed refund, the IRS must determine the Taxpayer's proper tax liability. To allow the Taxpayer a refund to which it is not entitled because Tax Year 1 was previously audited would be an

improper application of section 7605(b). "Congress did not intend for section 7605(b) to be a severe restriction on the Commissioner's power in monitoring and enforcing the Code." Law Offices-Richard Ashare, P.C., T.C. Memo 1999-284; see Powell, 379 U.S. at 54-55. This is consistent with Rev. Proc. 2005-32, § 4.02, which recognizes that examinations in connection claims for refund are not reopenings.

With respect to the Taxpayer's reliance on the IRM, the example cited does not pertain to a claim for refund resulting from an NOL carryback. The example contains no reference to, or explanation, of section 7605. Furthermore, the IRM does not have the force of law, is not binding on the IRS, and confers no rights upon the Taxpayer. See Fargo, 447 F.3d at 713.

"It is a well-settled principle that the Internal Revenue Manual does not have the force of law, is not binding on the IRS, and confers no rights on taxpayers." McGaughy v. Commissioner, T.C. Memo. 2010-183; see Fargo v. Commissioner, 447 F.3d 706, 713 (9th Cir. 2006), aff'g T.C. Memo.2004–13; Carlson v. United States, 126 F.3d 915, 922 (7th Cir. 1997); Tavano v. Commissioner, 986 F.2d 1389, 1390 (11th Cir. 1993), aff'g T.C. Memo.1991–237; Marks v. Commissioner, 947 F.2d 983, 986 n. 1 (D.C. Cir. 1991), aff'g T.C. Memo.1989–575; Valen Mfg. Co. v. United States, 90 F.3d 1190, 1194 (6th Cir. 1996); United States v. Horne, 714 F.2d 206, 207 (1st Cir.1983); Einhorn v. DeWitt, 618 F.2d 347, 349-50 (5th Cir.1980).

Therefore, the reexamination of Tax Year 1 in connection with the Taxpayer's NOL carryback and claim for refund is not a violation of section 7605(b). The audit team may reexamine Tax Year 1, including the previously allowed bad debt/worthless stock deduction, to determine whether the Taxpayer is entitled to a claimed refund.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (313) 237-6440 if you have any further questions.

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