

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Large Business & International, Team 1716
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subject: Whether the taxpayer may obtain a refund with respect to the carry back of its 2008 CNOL where the taxpayer failed to carry back its 2007 CNOL

This is in response to your request for legal advice on whether

(the taxpayer) may obtain a refund with respect to the carry back of its 2008 consolidated net operating loss (CNOL). This memorandum may contain privileged information. Any disclosure may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views. This document should not be used or cited as precedent.

Issue: Is the taxpayer entitled to a refund with respect to its 2005 and/or 2006 taxable years based upon its carryback of the 2008 consolidated net operating loss (CNOL) to those years?

Conclusion: Yes. The overpayments in 2005 and 2006 are attributable to the 2008 CNOL carryback and, therefore, may be refunded. Only the portion of the 2008 CNOL that exceeds the taxpayer's reported taxable income in 2005 and 2006 may be carried over to later years.

Facts:

The taxpayer is an affiliated group that files consolidated returns. The taxpayer reported consolidated taxable income of approximately \$4 million and \$2 million, respectively, in 2005 and 2006, and a consolidated net operating loss (CNOL) of approximately \$5 million in 2007.

The taxpayer did not make a §172(b)(3) election to forgo the carryback period for its 2007 CNOL. The taxpayer has not filed any amended returns or tentative carryback applications to claim a refund with respect to the 2007 CNOL carryback. The time for filing an amended return or claim with respect to 2007 has expired.

As originally filed, the taxpayer's consolidated return for 2008 reported a CNOL of approximately \$1 million. The taxpayer did not file an application for a tentative carryback refund with respect to its 2008 CNOL. Prior to expiration of the period of limitations for refunds, the taxpayer filed an amended return (Form 1120X) for its 2008 taxable year in which it claimed an increased CNOL of approximately \$18M. The amended return included a timely election for an extended (3-year) carryback of its 2008 CNOL under § 172(b)(1)(H).

The taxpayer timely filed amended returns for its 2005 and 2006 taxable years to claim the 2008 CNOL carryback. The 2008 CNOL was applied to the full amount of taxable income originally reported, without reduction for the 2007 CNOL carryback. Since the period of limitations on refunds has expired for 2007, a refund resulting from carry back of the 2007 CNOL to 2005 and 2006 consequently is barred.

Law and Analysis:

Section 172(a) allows a net operating loss deduction (NOLD) for a taxable year. The NOLD for a year equals the sum of the net operating loss (NOL) carryovers to the year and the NOL carrybacks to the year.

Section 172(b)(1) provides that generally an NOL is carried back two years. Under § 172(b)(1)(H) the taxpayer can elect an extended carryback period (3-5 years) for an applicable NOL. The 2008 CNOL in this case is an applicable NOL that the taxpayer properly elected to carry back three years.

Section 172(b)(2) provides that the entire amount of the NOL for any taxable year must be carried to the earliest of the taxable years to which the loss may be carried. The portion of the loss that is carried to each of the other taxable years is the excess, if any, of the amount of the loss over the sum of the taxable income for each of the earlier taxable years to which the loss may be carried. "Taxable income" for purposes of § 172(b)(2) generally means correct taxable income. See, e.g., Rev. Rul. 81-88, 1981-1 C.B. 585. Revenue Ruling 81-88 provides an exception to this general rule by concluding that in certain circumstances "taxable income" as used in § 172(b)(2) means reported taxable income (with such modifications as specified in § 172(b)(2)). We discuss this exception in detail below.

A taxpayer may elect to waive the carryback period of an NOL. § 172(b)(3). The taxpayer must do so by the due date (including extensions) of the return for the year of the NOL. *Id.*

In this case the taxpayer did not make a § 172(b)(3) election for its 2007 taxable year. Accordingly, under § 172(b) the entire 2007 CNOL must be carried back to 2005 and a portion of the loss must be carried back to 2006. § 172(b)(1)(A) and (b)(2). The taxpayer did not do so. The taxpayer's failure to carry back the 2007 CNOL leads to the issue in this case.

Section 6511(a) provides that generally a claim for credit or refund of an overpayment shall be filed within 3 years from the date the return was filed or 2 years from the time the tax was paid, whichever is later. Section 6511(d)(2)(A) provides an exception to this general rule when the overpayment is attributable to an NOL carryback. The refund period of limitations for the year of the NOL controls when a claim relates to an overpayment that is attributable to an NOL carryback. Specifically, in lieu of the general 3-year period set forth in § 6511(a), a claim that relates to an overpayment attributable to an NOL carryback must be filed by the later of: (1) three years after the time prescribed by law for filing the NOL taxable year return (including extensions thereof); or (2) the period prescribed in § 6511(c) for the NOL taxable year.

The period of limitations to file a claim with respect to an overpayment attributable to carryback of the 2008 CNOL has not expired. Accordingly, the taxpayer is entitled to a refund of any overpayments from 2005 and 2006 that are attributable to the 2008 CNOL carryback.

Procedure and Administration Regulation § 301.6511(d)-2(a)(3) provides rules for determining whether an overpayment is attributable to an NOL carryback. If

(1) a claim for credit or refund involves an overpayment based not only on an NOL carryback but also on other items, and

(2) the claim with respect to any items is barred,

the portion of the overpayment attributable to the open items is determined by treating the open items as the first adjustment to be made in computing the overpayment.

Revenue Ruling 81-88, 1981-1C.B. 585, clarifies the regulation. The Ruling concludes that "[i]n determining the amount of an overpayment of income tax from a net operating loss carryback that may be refunded or credited, the taxable income of the first carryback year should not be reduced by the amount of an unclaimed deduction that is barred by the expiration of the period of limitations."

In this case, the taxpayer's CNOL carrybacks from 2007 and/or 2008, which are part of the taxpayer's CNOL deduction for 2005 and 2006, reduced the taxpayer's 2005 and 2006 taxable income to zero. Therefore, the taxpayer has overpayments for 2005 and 2006. The question is what part, if any, of those overpayments is attributable to the 2008 CNOL carryback, as opposed to the 2007 CNOL carryback, since refunds attributable to the 2007 CNOL carryback are barred.

Revenue Ruling 218, 1953-2 C.B. 176, addressed a similar situation - the only distinguishing fact being that the barred adjustment was an NOL carryover instead of an NOL carryback. In Rev. Rul. 218, the Service concluded that in determining the net income against which the NOL carryback from the open year could be applied, the net income had to first be reduced by the earlier year NOL carryover, "which was available as a deduction" against net income even though the taxpayer failed to take that deduction. Revenue Ruling 218 was revoked by Rev. Rul. 81-88. General Counsel Memo. 34336, (Aug. 20, 1970), discussed possible revocation of Rev. Rul. 218. In G.C.M. 34336, the Chief Counsel attorney concluded that Rev. Rul. 218 was erroneous and should be revoked because it was in "substantial conflict" with the provisions of §301.6511(d)-2(a)(3). General Counsel Memo. 38292 (Feb. 22, 1980) also concluded that Rev. Rul. 218 was inconsistent with § 301.6511(d)-2(a)(3) and should be revoked. The GCM specifically stated that in Rev. Rul. 218 the first adjustment (the 1946 NOL carryover) was a "barred item."

Likewise, in this case the 2007 CNOL carryback to 2005 and 2006 is a "barred item" for purposes of § 301.6511(d)-2(a)(3) and an "unclaimed deduction" for purposes of Rev. Rul. 81-88. Accordingly, for purposes of determining whether the 2005 and 2006 overpayments are attributable to the 2008 CNOL carryback, the portion of the overpayments attributable to the 2008 CNOL carryback is determined by treating the 2008 CNOL carryback as the first adjustment to be made in computing the overpayments.

Section 172(a) provides for an NOL deduction. The NOL deduction for a taxable year is comprised of NOL carryovers to that taxable year plus NOL carrybacks to that year. In this case, the 2005 and 2006 NOL deductions should have included NOL carrybacks from 2007 and 2008 (we are not aware of any carryovers into 2005 and 2006). By failing to carry back the 2007 CNOL, the taxpayer in effect understated its 2005 and 2006 NOL deductions. Since the period of limitations has expired with respect to the 2007 CNOL carryback and the taxpayer never claimed the 2007 CNOL carryback, the 2007 CNOL carryback portions of the 2005 and 2006 NOL deductions are now barred unclaimed deductions.

A Field Service Advice (FSA) issued on October 6, 1993 (available in Westlaw at 1993 WL 1468171 and available in Lexis at 1993 FSA LEXIS 164) addressed the issue of the impact of a taxpayer's failure to carry back an NOL. As in the case before us, the taxpayer in the FSA failed to carry back NOLs and the time within which to do so had expired. The taxpayer then incurred NOLs in open years and claimed refunds from

carryback of those open NOLs, computed without taking the barred NOL carrybacks into account. Chief Counsel, International (INTL), concluded that the open year NOL carrybacks were not offset by the earlier year NOLs for which the taxpayer did not claim carrybacks (the "barred carrybacks"). In so holding, INTL relied on Rev. Rul. 81-88 and noted that although Rev. Rul. 81-88 did not specifically address the situation, it had revoked Rev. Rul. 218, which was on point.

For the reasons set forth above, we conclude that the barred 2007 CNOL carrybacks to 2005 and 2006 should not be taken into account in determining how much of the taxpayer's overpayments in 2005 and 2006 are attributable to the 2008 CNOL carryback. Accordingly, based on the facts provided to us, we conclude that the taxpayer's 2005 and 2006 overpayments are attributable to the 2008 CNOL carryback, and therefore, the claims for credit or refund are timely.

Amount of CNOL available for carryover after 2008

Section 172(b)(2) is the NOL absorption rule. It provides that the entire amount of the NOL for any taxable year must be carried to the earliest of the taxable years to which the loss may be carried. The portion of the loss that is carried to each of the other taxable years is the excess, if any, of the amount of the loss over the sum of the taxable income for each of the earlier taxable years to which the loss may be carried. "Taxable income" for purposes of § 172(b)(1) generally means correct taxable income, regardless of what was reported by the taxpayer and whether the assessment and/or refund period of limitations has expired with respect to a taxable year. See, e.g., Springfield Street Railway Co. v. United States, 312 F.2d 754 (Ct.Cl.1963); Rev. Rul. 81-88, 1981-1 C.B. 585.

Revenue Ruling 81-88 provides an exception to this general rule by concluding that in certain circumstances "taxable income" as used in § 172(b)(2) means reported taxable income (with such modifications as specified in § 172(b)(2)). The exception set forth in Revenue Ruling 81-88 applies where a claim for credit or refund involves an overpayment based not only on an open NOL carryback but also on other items and the claim with respect to any items is barred. In such cases, the taxpayer gets the benefit of the open NOL claim (e.g., the taxpayer can claim a greater refund because the "open" NOL carryback is taken into account before any barred deductions, including barred NOL carrybacks) and, therefore, more of the "open" NOL must be applied than would be the case if the correct taxable income was taken into account. The Rev. Rul. concludes that "[t]his construction of section 172(b)(2) is in harmony with section 6511(d), as interpreted by section 301.6511(d)-2(a)(3) of the regulations."

Accordingly, in this case the entire \$18 million 2008 CNOL is carried back to 2005. The amount of the 2008 CNOL that is carried back to 2006 is the excess of the 2008 CNOL over the reported taxable income for 2005 or approximately \$14 million (\$18M - \$4M). The amount of the 2008 CNOL that is carried over to 2007 is approximately \$12 million, the excess of the 2008 CNOL over the sum of the taxpayer's reported taxable income

for 2005 and 2006 [\$18M – (4M +2M)]. The taxpayer had a CNOL for 2007, accordingly, none of the 2008 CNOL is absorbed in 2007 and the amount of the 2008 CNOL that is carried over to 2009 is approximately \$12 million.

None of the taxpayer's 2007 CNOL is carried over to years after 2008. The entire \$5 million 2007 CNOL is carried back to 2005. The amount of the 2007 CNOL that is carried back to 2006 is \$1 million, the excess of the 2007 CNOL over the correct taxable income for 2005, not taking the 2007 CNOL or later CNOLs into account pursuant to § 172(b)(2)(B), (\$5M - \$4M). Correct taxable income is used in determining how the 2007 CNOL is absorbed because the exception in Rev. Rul. 81-88 only applies to the "open" CNOL carryback, i.e., the 2008 CNOL carryback). The remaining 2007 CNOL is absorbed in 2006 and none of the 2007 CNOL is carried over to years after 2007 since there is no excess of the 2007 CNOL (\$5M) over the sum of the correct taxable income for 2005 and 2006 (\$4M + \$2M).

We have coordinated the above conclusions with the Offices of Associate Chief Counsel, Corporate and Income Tax & Accounting. If you have any questions or would like clarification, please contact Senior Attorney Jennifer Nuding Brock of this office at (513) 263-4901.

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