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subject: Net Operating Loss Carryback under § 172(b)(1)(H) and Nondeductible CFC Dividends

This generic legal advice memorandum provides advice on questions that have arisen in a complex area involving the interplay of two expired stimulus-related tax provisions that were subject to specific limitations. Notwithstanding that the provisions have expired, the questions raised could be present in taxpayer examinations and appeals for many years to come if those years involve Net Operating Losses (NOLs).

The taxpayers involved are those that elected a special, 5-year carryback of NOLs under § 172 of the Internal Revenue Code and which had nondeductible dividends from a controlled foreign corporation (CFC) in taxable income for the fifth preceding carryback year.

Please call Andrew Braden (202) 622-4960 if you have any questions about this memorandum. This advice should not be used or cited as precedent.

ISSUES

1. For an NOL carried back to the fifth preceding taxable year under § 172(b)(1)(H), does a taxpayer with nondeductible CFC dividends include the amount of those dividends in calculating the 50 percent limitation of § 172(b)(1)(H)(iv)(I)?
2. For those taxpayers with nondeductible CFC dividends in the fifth carryback year, how is the amount of NOL absorption under § 172(b)(2) calculated for that year?

CONCLUSIONS

1. Yes. Taxable income for the fifth preceding taxable year includes nondeductible CFC dividends within the meaning of § 965(e)(3) for purposes of applying the 50 percent limitation under § 172(b)(1)(H)(iv)(I).
2. The amount of the absorption under § 172(b)(2) of the NOL in the fifth preceding taxable year is the lesser of:
 - (a) 50 percent of the amount of modified taxable income for the taxable year, or
 - (b) the amount of modified taxable income for the taxable year reduced by the amount of nondeductible CFC dividends for that year.

FACTS

Situation 1 M, a corporation that computes its income on a calendar year basis, is a United States shareholder in a CFC. In 2004, M received dividends from the CFC and elected the one-time 85-percent dividends received deduction under § 965 for 2004. M has \$150x of nondeductible dividends from the CFC that are included in M's taxable income for 2004. M's taxable income for 2004, determined with the nondeductible CFC dividends and without regard to any NOL deduction, is \$650x. In 2009, M incurs an NOL of (\$900x) and elects to carry back the NOL 5 years under § 172(b)(1)(H).

Situation 2 Same facts as Situation 1, except that M's taxable income of \$650x for 2004 (determined without regard to any NOL deduction) includes \$400x of nondeductible CFC dividends.

LAW

Section 172(a) allows a deduction equal to the aggregate of the NOL carryovers and carrybacks to the taxable year. Generally, NOLs are carried back only 2 years. See § 172(b)(1)(A)(i). However, as part of the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984 (November 6, 2009), a temporary stimulus was added that allowed taxpayers to elect to carry back an NOL up to five years. This election could be made for only one taxable year that ended after December 31, 2007, and began before January 1, 2010. See § 172(b)(1)(H).

Under the election, the taxpayer could carry back the NOL three, four, or five years. The benefit of a five-year carryback election was limited in a way that a two, three, or four-year carryback was not. Specifically, the NOL carried back to the fifth preceding

year could not exceed 50 percent of taxable income for that year (the 50 percent limitation). See § 172(b)(1)(H)(iv)(I).

To determine the amount of an NOL carried to a taxable year, a taxpayer must calculate the amount of the NOL absorbed in prior years to which the NOL was carried. The second sentence of § 172(b)(2) describes this absorption calculation as the excess of the NOL from the loss year over the sum of the modified taxable income (as defined in the third sentence of § 172(b)(2)) for each of the prior taxable years to which the NOL was carried.

Prior to enactment of the 5-year carryback, Congress established a time-limited incentive for multi-national corporations to repatriate funds to the United States. Specifically, § 965(a)(1) allowed corporate United States shareholders of a CFC to deduct (at their election, for one year) 85 percent of the cash dividends received from the CFC. The benefits of this deduction were also limited, however, as Congress provided that, for any taxable year in which a taxpayer received CFC dividends, that taxpayer's taxable income could not be less than the amount of the nondeductible CFC dividends (the nondeductible CFC dividend floor). See § 965(e)(2)(A). In addition, § 965(e)(2)(B)(ii) provided that nondeductible CFC dividends are not taken into account in determining taxable income for NOL absorption purposes pursuant to § 172(b)(2).

ANALYSIS

Amount of NOL Deduction for the Fifth Carryback Year:

The nondeductible CFC dividend floor of § 965(e)(2)(A) provides that a taxpayer's taxable income cannot be less than the amount of the nondeductible CFC dividends. For NOL carrybacks, § 172(b)(1)(H)(iv)(I) limits the NOL carried back to the fifth preceding year to 50 percent of taxable income for that year (the 50 percent limitation). This memorandum addresses how these two limitations interact when a taxpayer has both nondeductible CFC dividends and a relevant five-year NOL carryback. In other words, does a taxpayer with nondeductible CFC dividends include or exclude the amount of those dividends in calculating the 50 percent limitation of § 172(b)(1)(H)(iv)(I)?

There is nothing in § 172 to indicate that nondeductible CFC dividends are excluded from taxable income for purposes of calculating the 50 percent limitation. Therefore, the nondeductible CFC dividends are included in taxable income, not excluded, in calculating the 50 percent limitation on the NOL for the fifth carry back year. If the nondeductible CFC dividends do not exceed 50 percent of taxable income in the fifth preceding year, no further limitation on the use of the NOL carryback is necessary to comply with the limitation of § 965(e)(2)(A).

On the other hand, if the amount of nondeductible CFC dividends exceeds 50 percent of taxable income in the carryback year, the limitation of § 965(e)(2)(A) applies to prohibit

the reduction of taxable income to an amount less than the amount of nondeductible CFC dividends. This limitation applies even if a further reduction otherwise would be allowed under the 50 percent limitation.

NOL Absorption in the Fifth Carryback Year:

Generally, in determining the amount of NOL absorbed in a taxable year to which it is carried, taxpayers must apply § 172(b)(2). Section 172(b)(1)(H)(iv)(II) modifies this general rule, however, to account for the 50 percent limitation of § 172(b)(1)(H)(iv)(I).

As stated above, taxable income includes nondeductible CFC dividends for purposes of applying the 50 percent limitation to an NOL carried back and deducted in the fifth preceding year. However, if § 965(e)(2)(B)(ii) is interpreted to require that the absorption under § 172(b)(2) of an NOL subject to the 50 percent limitation is determined without including the nondeductible CFC dividends in taxable income, the remaining NOL to be carried to later taxable years will thus include a portion of the NOL that was already used in the fifth preceding year. As a result, the taxpayer would get a double-benefit by using that portion of its NOL twice.

Section 965(e)(2)(B)(ii) predates the enactment of the 50 percent limitation of § 172(b)(1)(H)(iv)(I) and therefore could not have addressed the interaction of § 965 and the 50 percent limitation of § 172(b)(1)(H)(iv)(I). Further, § 172(b)(1)(H)(iv)(II) requires that appropriate adjustments be made in applying the second sentence of § 172(b)(2) to take into account the 50 percent limitation.

Accordingly, to correctly reflect the amount of NOL carryback deducted in the fifth preceding year, an adjustment must be made under § 172(b)(1)(H)(iv)(II) to include nondeductible CFC dividends in taxable income for purposes of determining the NOL absorption under § 172(b)(2). However, both the 50 percent limitation and the § 965(e)(2)(A) limitation apply in determining the absorption. Specifically, the absorption of the NOL carried to the fifth preceding year is the lesser of: (i) 50 percent of taxable income (including nondeductible CFC dividends), or (ii) the amount of such taxable income in excess of the amount of nondeductible CFC dividends.

In Situation 1, M incurs an NOL of (\$900x) in 2009 that M elects under § 172(b)(1)(H) to carry back 5 years to 2004. In 2004, M has taxable income before the NOL deduction of \$650x, which includes \$150x of nondeductible CFC dividends. Because of the 50 percent limitation on the NOL carryback under § 172(b)(1)(H)(iv)(I), the 2009 NOL carried back to 2004 cannot exceed (\$325x), which is 50 percent of M's taxable income in 2004. The allowed NOL carryback from 2009 to 2004 of (\$325x) does not reduce M's taxable income for 2004 to an amount that is below the amount of nondeductible CFC dividends of \$150x, and thus it complies with the limitation imposed by § 965(e)(2)(A).

In determining the amount of the 2009 NOL that M carries to taxable years after 2004, the second sentence of § 172(b)(2) is applied using the lesser of (i) 50 percent of modified taxable income, or (ii) the amount of modified taxable income for the carryback year in excess of the amount of nondeductible CFC dividends for that year. For this purpose, modified taxable income includes the \$150x of nondeductible CFC dividends. In this case, the absorption of the 2009 NOL carryback in 2004 is limited to (\$325x), or 50 percent of 2004 modified taxable income, which is less than \$500x, the amount of 2004 modified taxable income of \$650x in excess of \$150x, the amount of nondeductible CFC dividends for 2004. Thus, the amount of the 2009 NOL that is absorbed in 2004 is (\$325x), and the amount of the 2009 NOL carried to 2005 is (\$575x).

In Situation 2, M cannot use the allowable NOL carryback from 2009 to reduce M's 2004 taxable income of \$650x to less than \$400x, the amount of M's nondeductible CFC dividends, in accordance with § 965(e)(2)(A). The amount of M's taxable income in excess of the amount of nondeductible CFC dividends is \$250x, which is less than 50 percent of M's taxable income for 2004 of \$325x.

In determining the amount of the 2009 NOL that M carries to taxable years after 2004, the second sentence of § 172(b)(2) is applied using the lesser of (i) 50 percent of modified taxable income, or (ii) the amount of modified taxable income for the carryback year in excess of the amount of nondeductible CFC dividends for that year. For this purpose, modified taxable income includes the \$400x of nondeductible CFC dividends. In Situation 2, the absorption of the 2009 NOL carryback in 2004 is limited to (\$250x), the amount of M's modified taxable income for 2004 of \$650x in excess of \$400x, the amount of M's nondeductible CFC dividends, because this amount is less than \$325x, or 50 percent of 2004 modified taxable income. By limiting the absorption of the 2009 NOL to the amount of 2004 modified taxable income in excess of the amount of nondeductible CFC dividends for 2004, the absorption of the 2009 NOL meets the limitation imposed by § 965(e)(2)(A) that taxable income be no less than the amount of nondeductible CFC dividends. Thus, the amount of the 2009 NOL that is absorbed in 2004 is (\$250x) and the amount of the 2009 NOL carried to 2005 is (\$650x).

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