

Part I

Section 451. - General Rule for Taxable Year of Inclusion

26 CFR 1.451-1: General rule for taxable year of inclusion.

Rev. Rul. 2003-3

ISSUE

When is a state or local income or franchise tax refund includible in the income of a taxpayer using the accrual method of accounting under § 451 of the Internal Revenue Code?

FACTS

Taxpayer N is a corporation doing business in the State of New York. N uses an accrual method of accounting and a calendar taxable year. New York permits a net operating loss deduction for state corporate franchise tax purposes. N.Y. Tax Law § 208(9)(f) (McKinney 1998). In order to obtain a refund of New York corporate franchise taxes arising out of a net operating loss carryback, a taxpayer must file a claim with the New York State Department of Taxation and Finance (N.Y. Department). N.Y. Tax Law § 1087(d) (McKinney 1998). The N.Y. Department has the right to examine any refund claim before determining whether to allow the claim and the refund amount. N incurs a net operating loss for federal income tax purposes in tax year 2001. In 2002, N files a Form 1139 to carry back the net operating loss for federal tax purposes. Based on the federal tax net operating loss carryback, N files a claim for refund of New York corporate franchise taxes with the N.Y. Department in 2002. In 2003, N receives notice that the N.Y. Department has approved N's refund claim.

LAW AND ANALYSIS

Section 451(a) provides that an item of income shall be included in gross income for the taxable year it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy.

Generally, if a requirement that documentation be submitted is ministerial, the requirement does not affect the determination of whether all events that fix the right to

receive income or that establish the fact of liability have occurred. See United States v. General Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Properties, 476 U.S. 593 (1986); Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932); Anderson v. United States, 269 U.S. 422 (1926).

Rev. Rul. 65-190, 1965-2 C.B. 150, holds that a refund of New York State corporate franchise taxes resulting from a net operating loss carryback is accruable in the taxable year of the loss giving rise to the refund, rather than in a later year when the state authorities approve the refund claim, because the approval process is deemed to be ministerial.

Rev. Rul. 69-372, 1969-2 C.B. 104, follows Rev. Rul. 65-190 in concluding that a taxpayer must accrue Colorado State income tax refunds resulting from net operating loss carrybacks in income in the year of the loss giving rise to the refund.

In Doyle, Dane, Bernbach, Inc. v. Commissioner, 79 T.C. 101 (1982), nonacq., 1988-2 C.B. 1, the taxpayer sought a refund of its New York City corporate tax and New York State franchise tax resulting from net operating loss carrybacks. The court noted that the New York State and New York City tax authorities had the right to examine and deny all or part of a taxpayer's refund claim. Therefore, the refund was not included in the taxpayer's federal gross income until the state or local tax authorities determined that the taxpayer had a right to receive the refund.

In Yapp Corp. v. Commissioner, T.C. Memo. 1992-348, the taxpayer sought a refund of Illinois income and replacement taxes based on net operating loss carrybacks. Pointing out the factual similarities to Doyle, the court noted that the state actively examined refund claims and held that the refund was accruable in the tax year the state tax department determined that the taxpayer was entitled to a refund.

The Service has reconsidered the position taken in Rev. Rul. 65-190 and Rev. Rul. 69-372 and has concluded that approval by state authorities of state income and franchise tax refund claims is not ministerial but involves substantive review. Accordingly, N accrues the refund of its New York State corporate franchise taxes attributable to a 2001 net operating loss carryback in 2003, the year N receives notice that the N.Y. Department has approved the refund claim.

HOLDING

A state or local income or franchise tax refund is includible in the income of a taxpayer using the accrual method of accounting when the taxpayer receives payment or notice that the refund claim has been approved, whichever is earlier.

AUTOMATIC CHANGE IN METHOD OF ACCOUNTING

Any change in the timing of a taxpayer's inclusion in income of state or local income taxes or franchise tax refunds to conform with this revenue ruling is a change in method

of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Therefore, a taxpayer that does not accrue state or local income or franchise tax refunds in the year the taxpayer receives payment or notification of approval of the refund claim (whichever is earlier), but wants to use this method of accounting for taxable years ending on or after December 11, 2002, must file a Form 3115.

A taxpayer must file this Form 3115 in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (or successor), as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, with the following additional modifications: (1) the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for its first taxable year ending on or after December 11, 2002, provided the taxpayer's method of accruing state or local income or franchise tax refunds is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc. 2002-9, at the time the Form 3115 is filed with the national office; and (2) when filing the Form 3115, a taxpayer must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002-9, must write "Filed under Rev. Rul. 2003-3" at the top of the form.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 65-190 and Rev. Rul. 69-372 are revoked. Rev. Proc. 2002-9 is modified and amplified to include this automatic change in section 5A of the APPENDIX. The non-acquiescence in Doyle, Dane, Bernbach, Inc. v. Commissioner, nonacq., 1988-2 C.B. 1, is withdrawn separately elsewhere in this issue of the Internal Revenue Bulletin.

DRAFTING INFORMATION

The principal author of this revenue ruling is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Ms. Rotunno on (202) 622-7900 (not a toll-free call).