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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Richard G. Goldman
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Field Service Division CC:DOM:FS:PROC

SUBJECT:

This Field Service Advice responds to your memorandum dated June 15, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X=
Year 1=
Year 3=
Year 4=
Year 5=
Year 6=
Year 7=
\$a=
\$b=
\$c=
\$d=
\$e=
\$f=
\$g=

y%=

z%=

ISSUE:

Whether the amount of the taxpayer's claim for refund for fiscal year Year 1, which amount was disallowed as a refund to the taxpayer on the ground that a timely claim for refund was not filed, can now be utilized by the taxpayer to reduce a deficiency for Year 1 that was determined due to the disallowance of a portion of a net operating loss carryback from fiscal years Year 6 and Year 7 and a general business credit carryback from fiscal years Year 3 and Year 4?

CONCLUSION:

The statutory framework and case law precedent surrounding this issue would permit an offset of a deficiency attributable to the disallowance of carrybacks by carryback-related barred adjustments, but not necessarily by noncarryback adjustments.

FACTS:

X is a fiscal year taxpayer. For fiscal years Year 6 and Year 7, X incurred net operating losses (NOL's) that were carried back to Year 3 and Year 4. The NOL's freed up general business credits in those years, which in turn were carried back to Year 1. Such carryback resulted in an overpayment of tax for Year 1.

As a result of an ongoing examination of Year 1, a determination resulted that the taxpayer overpaid taxes for that year in the amount of \$a. The Service proposed to allow only \$b of the refund claim, disallowing the remainder on the ground that X did not file a timely claim for refund as to that portion. X disagreed, and the parties ultimately agreed to settle the dispute over the timeliness of the refund claim on the basis that y% of the disallowed portion (\$c) would be allowed and z% (\$d) would be disallowed. The taxpayer accordingly was refunded the total amount of \$e for Year 1 (\$b plus \$f, y% of \$c).

Subsequently, the Service examined fiscal years Year 6 and Year 7 and disallowed a portion of the NOL's claimed for those years. This resulted in the disallowance of some, but not all, of the business credits that were carried back to Year 1 and created a deficiency for that year. Without considering the \$d disallowed overpayment on the basis of an untimely refund claim described above, the parties agree that the deficiency for Year 1 is in the amount of \$g. X asserts that the amount of the overpayment whose refund was barred due to an untimely refund claim may be used to offset this deficiency, resulting in no deficiency due for Year 1.

LAW AND ANALYSIS

The amount at issue here is a deficiency that arose due to the partial disallowance of net operating losses that were carried back to Year 6 and Year 7, freeing general business credits that were carried back to Year 1. I.R.C. § 6501(h) extends the statute of limitations on assessments of deficiencies for Year 1 that are attributable to the application of a net operating loss to the period of limitations applicable to the source year of the loss, Years 6 and 7. X claims that under the authority of Lewis v. Reynolds, 284 U.S. 281 (1932), a time-barred refund claim may be used as an offset against the amount of deficiency currently being asserted. Lewis v. Reynolds permits the government to defeat a refund claim asserted by the taxpayer by the assertion of new issues or defenses relating to the same taxable period that are the subject of the claim, even though the period of limitations on assessment has expired. Taxpayer essentially is arguing by analogy that the doctrine of Lewis v. Reynolds should be applied in reverse by permitting the taxpayer to defeat a determined deficiency by asserting defenses relating to the same taxable period, even though the statute of limitations on credit or refund for that period has expired.

A variation of the Lewis v. Reynolds argument was presented in Michael v. Lullo, 173 F.3d 503 (4th Cir. 1999). In that case, the Service recomputed the liability for estate taxes, determined that a deficiency in estate tax existed, and reduced a claimed foreign death tax credit against tax in like amount. This resulted in a balance due on the previously assessed liability, even though the statute of limitations on assessment of any deficiency in estate tax had expired. The court of appeals pointed out that while the Lewis v. Reynolds doctrine would allow the Service to refuse to make a refund on the ground that there were barred deficiencies in a greater amount, Lewis v. Reynolds did not support the position that additional sums could be collected after the limitations period had expired.

The leading case on this issue is Deakman-Wells Co. v. Commissioner, 213 F.2d 894 (3rd Cir. 1954), rev'd in part 20 T.C. 610 (1953). In that case, the circuit court overturned the Tax Court's decision that the assessment period was generally open under the "25-percent omission" exception now in § 6501(e). The court also rejected the Service's alternative argument that, because the statute was open for assessment of a deficiency attributable to the disallowance of an erroneous net operating loss carryback when the deficiency notice was issued, the Service was entitled to amend its claim in Tax Court to include a greater deficiency based on items not related to the carryback. In so doing, the circuit court agreed with two earlier decisions of the Tax Court, Bouchey v. Commissioner, 19 T.C. 1078 (1953), and Leuthesser v. Commissioner, 18 T.C. 1112 (1952), which had interpreted the "attributable to" language as placing a restriction on the broader definition of a "deficiency." See 213 F.2d at 898.

Significantly for present purposes, however, the court in Deakman-Wells went beyond those earlier decisions and addressed the treatment of an adjustment that had been allowed by the Service as an offset to its carryback-related assessment:

One further point must be mentioned. In his deficiency letter ... the Commissioner not only disallowed the operating loss carry-back from the succeeding year, as [the statutory predecessor to § 6501(h)] authorized him to do, but also granted the taxpayer the benefit of an increased net operating loss carry-over from [a prior year]. For the reasons already given it was beyond the power of the Commissioner to do this, the statute of limitations having run. The deficiency in income tax due by the taxpayer for the year ended April 30, 1947, must, therefore be re-computed by the Tax Court upon the basis of the disallowance of the net operating loss carry-back from the year in the April 30, 1948 alone.

213 F.2d at 899.

In United Surgical Steel Co. v. Commissioner, 54 T.C. 1215 (1970), the taxpayer claimed certain beneficial bad debt reserve adjustments which, under a specific effective date provision, were only permissible for years that were open for assessment. The Tax Court followed the general approach of Bouche, Leuthesser, and Deakman-Wells in holding that such adjustments were not permissible with respect to the taxpayer's fiscal years 1962 and 1963, which were only open by virtue of § 6501(h), since the bad debt reserve adjustments were not related to the carryback. See 54 T.C. at 1226-27.

In Maxcy v. Commissioner, 59 T.C. 716 (1973), a deficiency was determined as a result of the disallowance of a net operating loss carryback. The taxpayer wanted to use a portion of a previously unclaimed investment tax credit to offset the determined deficiency, even though the statute of limitations on credit or refund for the same taxable year had expired. The Tax Court held that the deficiency may be so reduced. The court reasoned that when Congress enacted § 6501(k) (formerly § 6501(m)), it eliminated the previous transactional restriction that only deficiencies attributable to an NOL carryback could be determined with respect to erroneous refund allowances made for tentative carryback adjustments. The court indicated that taxpayers were similarly restricted in their ability to defend against deficiency determinations attributable to the disallowance of carryback adjustments, citing Deakman-Wells and United Surgical Steel Co., *supra*. The court reasoned that following the enactment of § 6501(m), deficiencies in respect of erroneous tentative carryback adjustments were permitted on grounds not attributable to the carryback. Maxcy, *supra*, 59 T.C. at 730. The court concluded that the elimination of the transactional restriction similarly broadened the elements that the court could consider in determining the correct amount of the deficiency, so long as such defenses did not reduce the deficiency below zero and call for the determination of

an overpayment of tax for an otherwise barred year. The court further supported its conclusion by examining the definition of a deficiency set forth in § 6211, stating that the investment tax credit may be taken into account since it is not a credit specifically excluded by § 6211(b).

Although the court appeared to cite Deakman-Wells and United Surgical Steel with approval, see 59 T.C. at 730, it distinguished those authorities as involving a "regular" carryback claim, assessable by virtue of § 6501(h), rather than a "tentative" or "quick" refund, claimed under § 6411 and assessable by virtue of what is now § 6501(k). Noting that deficiencies assessable under § 6501(k) are not restricted to carryback-related adjustments -- only by the total amount refunded, credited, or applied as a result of § 6411 -- the court reasoned that the carryback-related restrictions were eliminated for both the Service and the taxpayer alike, and permitted the taxpayer's offset. In a footnote, the court observed that "[s]uch transactional limitations would appear to continue to be applicable to deficiencies asserted under § 6501(b) [sic] in respect of payments made in response to 'regular' (as distinguished from 'tentative') claims for refund based upon net operating loss carryback." Id., n.13.

In an Action on Decision, the Service criticized the Maxcy opinion on two grounds. First, it was pointed out that, assuming arguendo that the court was correct in its interpretation of what is now § 6501(k), the decision was still incorrect since § 6501(k) only covers amounts in excess of amounts attributable to the disallowance of the loss or credit carryback -- that is, in excess of amounts that can be assessed by virtue of § 6501(h) and (j).¹ Since, in Maxcy, the entire asserted deficiency was attributable to the disallowance of a net operating loss, the operative provision was actually § 6501(h), not § 6501(k), and the restrictions applicable to such deficiencies should have applied to prevent the taxpayer from raising an unrelated adjustment as an offset. Second, the Service disagreed with the Maxcy court's interpretation of what is now § 6501(k).

The Tax Court essentially adopted the first of these criticisms -- though perhaps not consciously -- in a subsequent decision, Jones v. Commissioner, 71 T.C. 391 (1978). There, the court explained the relationship between § 6501(h) and (k), restricting Maxcy to non-carryback-related deficiency amounts assessable only by virtue of § 6501(k). See 71 T.C. at 396-98. Although it had stated in Maxcy that "[t]axpayers were similarly limited in their ability to resist the determination of such [i.e., carryback-related] deficiencies," citing Deakman-Wells and its own United Surgical Steel opinion, see 59 T.C. at 730, the court in Jones treated this as an

¹ Put differently, for § 6501(k) to come into play, the fact that the taxpayer filed a claim under § 6411 is a necessary, but not sufficient, condition. The amount of the claim must also exceed the amount, if any, attributable to an erroneous carryback.

open issue: "We need not decide whether the limitations on the assessment of deficiencies under section 6501(h) apply to petitioner as well as respondent" 71 T.C. at 399. The reason the Jones court found it unnecessary to decide this issue was its holding that the taxpayer's offsetting adjustment, a capital loss carryback to the year in question, was sufficiently related to the disallowance of the NOL carryback -- because it couldn't be claimed until the NOL was disallowed -- to be treated as "attributable to" the NOL carryback for purposes of § 6501(h). See Id. In a subsequent memorandum decision, Richmond v. Commissioner, T.C. Memo. 1980-465, the judge also treated the present issue as an open question, in dicta. See id., n. 3.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



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If you have any further questions, please call (202) 622-7940.