

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 04, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200732016**
Release Date: 8/10/2007

Index (UIL) No.: 447.06-00, 172.00-00
CASE-MIS No.: TAM-151817-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:
Date of Conference:

LEGEND:

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
\$a	=
\$b	=
\$c	=
\$d	=
\$e	=

\$f =
\$g =
\$h =
\$i =
\$j =
\$k =
\$m =
\$n =
\$p =
\$q =
\$r =
\$s =

ISSUE:

If a taxpayer reduced its suspense account balance pursuant to § 447(i)(5)(B) of the Internal Revenue Code and included the amount of that reduction in gross income for a year, should the taxpayer's suspense account balance be increased when the taxpayer carries back to that year a net operating loss (NOL) that exceeds the amount of taxable income (including the § 447(i)(5)(B)(iv) amount) originally reported?

CONCLUSION:

The taxpayer's suspense account balance should not be increased after the carryback of a NOL in this situation because the provisions of § 447(i)(5)(B)(i)(II) should be interpreted in light of the requirements of the § 172(b)(2) absorption rules. The original amount included in gross income from the suspense account is part of the taxable income used to absorb the NOL carryback under the § 172(b)(2) absorption rules, thereby increasing the amount of the NOL to be absorbed in a carryback year and decreasing the amount of the NOL available for use in succeeding years. Consequently, it would be contrary to the overall purpose and legislative intent of § 447(i)(5)(B) to apply § 447(i)(5)(B)(i)(II) and increase the suspense account balance under the facts of this case.

FACTS:

The taxpayer is a C corporation engaged in the business of farming. It is a "family corporation," as that term is defined in § 447(d)(2)(C). The taxpayer files its federal income tax returns on the basis of a calendar year. The taxpayer initially used the cash receipts and disbursements method of accounting.

Prior to 1997, the taxpayer was required by § 447 to change from the cash receipts and disbursements method of accounting to the accrual method of accounting. At that time, the taxpayer established a suspense account under § 447(i) in lieu of taking into account adjustments under § 481(a). The opening balance of the suspense account

was \$a. The taxpayer was not required to make, and did not make, any adjustment to the suspense account until the Taxpayer Relief Act of 1997, P.L. 105-34, amended § 447(i) to provide for the phaseout of existing suspense accounts.

For Year 1, the taxpayer reduced its suspense account by \$b and included that amount in gross income. On its Year 1 Form 1120 (U.S. Corporation Income Tax Return), the taxpayer reported taxable income, including the suspense account income, of \$c.

For Year 2, the taxpayer reduced its suspense account by \$d and included that amount in gross income. After using the suspense account income to offset what would have been a NOL of \$d, the taxpayer reported \$0 of taxable income on its Year 2 Form 1120.

For Year 3, the taxpayer reduced its suspense account by \$b and included that amount in gross income.¹ After using the suspense account income to offset what would have been an additional loss, the taxpayer reported a NOL of \$e on its Year 3 Form 1120. It carried back that NOL to its Year 1 taxable year, where it reduced the Year 1 taxable income from \$f to \$g. The taxpayer claimed and received a refund of tax attributable to the reduction to its Year 1 taxable income.

For Year 4, the taxpayer reduced its suspense account by \$b and included that amount in gross income. On its Year 4 Form 1120, the taxpayer reported taxable income of \$h.

For Year 5, the taxpayer reduced its suspense account by \$b and included that amount in gross income. After using the suspense account income to offset what would have been an additional loss, the taxpayer reported a NOL of \$i on its Year 5 Form 1120.

The taxpayer timely filed a Form 1139 (Corporation Application for Tentative Refund) to carry back its Year 5 NOL to its Year 1 and Year 4 tax years. On line 11(c) of that form, the taxpayer stated that its taxable income from its Year 1 tax return before the Year 5 NOL carryback was \$g. This amount takes into account the Year 3 NOL carryback. On line 11(d) of the form, the taxpayer stated that its taxable income from its Year 1 tax return from which it would subtract the carryback was "\$j*". The taxpayer used an asterisk to indicate there was an explanation for this figure. The taxpayer explained that it eliminated the § 447(i) adjustment of \$b and stated that "because taxable income in Year 1 has been reduced to zero through the carryback of net operating losses, the inclusion for purposes of IRC section 447(i) has also been reduced to zero."² On line 14

¹ We note that there is an issue concerning whether the "applicable portion" should have been recalculated because the suspense account was reduced by a lesser amount in the preceding year. See § 447(i)(5)(C). However, we are not addressing that issue in this TAM because it was not specifically part of the request.

² The taxpayer made a corresponding adjustment to increase its suspense account balance by \$b.

of the form, the taxpayer reported a NOL deduction of \$i. The taxpayer applied \$j of its Year 5 NOL carryback to the Year 1 tax year and calculated its remaining Year 5 NOL to be \$k. This amount was carried to the Year 4 tax year and, as a result, the taxpayer reduced its Year 4 taxable income to \$m. The taxpayer claimed a refund of the balance of the tax it had paid for Year 1 and a portion of the tax it had paid for Year 4.

For Year 6, the taxpayer reduced its suspense account by \$b and included that amount in gross income. After using the suspense account income to offset what would have been an additional loss, the taxpayer reported a NOL of \$n for Year 6. The taxpayer timely filed a Form 1139 to carry back its Year 6 NOL to its Year 4 tax year. Similar to the calculations on the prior Form 1139, the taxpayer eliminated the § 447(i) adjustment of \$b for Year 4 (and made a corresponding adjustment to increase its suspense account balance). The taxpayer applied \$p of its Year 6 NOL to the Year 4 tax year and calculated its remaining Year 6 NOL to be \$q. This amount was carried forward to the Year 7 tax year. The taxpayer claimed a refund of the balance of the tax it had paid for Year 4.

The reported suspense account balance after the taxpayer's transactions through tax year Year 6 was \$r.

LAW AND ANALYSIS:

Section 447(i)(5)(B) provides as follows:

(B) PHASEOUT OF EXISTING SUSPENSE ACCOUNTS.—

(i) IN GENERAL.—Each suspense account under this subsection shall be reduced (but not below zero) for each taxable year beginning after June 8, 1997, by an amount equal to the lesser of—

(I) the applicable portion of such account, or

(II) 50 percent of the taxable income of the corporation for the taxable year, or, if the corporation has no taxable income for such year, the amount of any net operating loss (as defined in section 172(c)) for such taxable year.

For purposes of the preceding sentence, the amount of taxable income and net operating loss shall be determined without regard to this paragraph.

(ii) COORDINATION WITH OTHER REDUCTIONS.—The amount of the applicable portion for any taxable year shall be reduced (but not below zero) by the amount of any reduction required for such taxable year under any other provision of this subsection.

(iv) [sic] INCLUSION IN INCOME.—Any reduction in a suspense account under this paragraph shall be included in gross income for the taxable year of the reduction.

Section 447(i)(5)(C) provides that, for purposes of § 447(i)(5)(B), the term “applicable portion” means, for any taxable year, the amount which would ratably reduce the amount in the account (after taking into account prior reductions) to zero over the period consisting of such taxable year and the remaining taxable years in such first 20 taxable years.

Section 172(a) of the Code allows a net operating loss deduction equal to the aggregate of the net operating loss carryovers and net operating loss carrybacks to a taxable year.

Section 172(c) defines a net operating loss as the excess of deductions permitted by Chapter 1 over the gross income. Certain modifications, set forth in § 172(d), are taken into account in computing a NOL. For example, § 172(d)(1) provides that no NOL deduction shall be allowed when determining the NOL.

Under § 172 and the regulations thereunder, once the amount of a NOL is determined, the NOL is carried back or carried over in accordance with the rules of § 172(b). The amount carried back or carried over to a taxable year results in a NOL deduction in the year of the carryback or carryover. Sections 172(b)(1) and (2) require, generally, that a NOL for any taxable year first be carried back to each of the 2 previous taxable years, and if unabsorbed by the income in those years, carried forward to each of the 20 taxable years following the taxable year of such loss. For tax years ending in 2001 or 2002, the NOL carryback period is 5 years. See § 172(b)(1)(H). Finally, under § 172(b)(2), the entire amount of the NOL for any taxable year must be carried to the earliest of the taxable years to which such loss may be carried.

After a NOL is carried back or forward to a year, the taxpayer must calculate the amount of the NOL absorbed in the carryback/carryover year and, consequently, the amount of the NOL that remains to be used in succeeding taxable years. Section 172(b)(2) of the Code and § 1.172-5 of the Income Tax Regulations set forth the rules for calculating the absorption. Section 172(b)(2) provides that after a NOL is carried back or forward to a year, the portion of the NOL available for use in succeeding taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income (with certain modifications for individuals and REITs) for each of the prior taxable years to which such loss may be carried. For this purpose, the taxable income for such prior years is computed without regard to the NOL for the loss year or any year thereafter. See § 172(b)(2)(B) and § 1.172-5(a)(2)(i).

In the present case, the taxpayer incurred NOLs in Year 3, Year 5, and Year 6. It carried back those NOLs to Year 1 and Year 4. The taxable income as originally

reported for Year 1 and Year 4 included amounts from reducing the suspense account balance pursuant to § 447(i)(5)(B)(i)(I). When the taxpayer carried back its Year 5 NOL to Year 1, the Year 5 NOL exceeded the taxable income originally reported for Year 1 (after taking into account the Year 3 NOL carryback). Similarly, when the taxpayer carried back its Year 6 NOL to Year 4, the Year 6 NOL exceeded the taxable income originally reported for Year 4 (after taking into account the Year 5 NOL carryback). When faced with this situation, the taxpayer reduced taxable income by the amount of the suspense account balance originally included in income for that year (and made a corresponding increase to the suspense account balance). The taxpayer then applied the NOL to that lesser amount of taxable income. Consequently, the amount of the NOL that was absorbed was equal to taxable income originally reported minus the amount originally included from the suspense account.

As explained above, § 172(b)(2) and § 1.172-5 set forth explicit rules for calculating the amount of a NOL absorbed in a carryback/carryover year and, consequently, the amount of the NOL that remains to be used in succeeding taxable years. Section 172(b)(2) provides that after a NOL is carried back or forward to a year, the portion of the NOL available for use in succeeding taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income (with certain modifications for individuals and REITs) for each of the prior taxable years to which such loss may be carried. For this purpose, the taxable income for such prior years is computed without regard to the NOL for the loss year or any year thereafter. See § 172(b)(2)(B) and § 1.172-5(a)(2)(i).

Thus, when the taxpayer carried its Year 5 NOL to Year 1, the amount of the NOL absorbed in Year 1 should have been computed without regard to the Year 5 NOL and, therefore, without making any adjustment to the amount of the suspense account balance originally included in income for Year 1. Consequently, the Year 5 NOL of \$i should have been absorbed by \$g of taxable income for Year 1; \$s of the Year 5 NOL was then available for years after Year 1. The entire amount of taxable income for the carryback year, including the amount attributable to income from the suspense account, was available to absorb the NOL.

The taxpayer argues that, under § 447(i)(5)(B)(i)(II), the suspense account reduction amount (and thus the amount to be included in gross income under § 447(i)(5)(B)(iv)) is \$0 in any year in which a NOL deduction fully offsets taxable income. The taxpayer notes that the term “taxable income” is defined in § 63, and that “taxable income” is calculated by taking into account any § 172 NOL deduction. Thus, the taxpayer argues that, because the NOL deduction reduces taxable income to \$0, the suspense account is not reduced and no § 447(i)(5)(B)(iv) amount is included in gross income. Therefore, in a year in which a taxpayer’s taxable income is fully offset by a NOL carryback, there also should be no § 447(i)(5)(B)(iv) amount included in income for purposes of the § 172(b)(2) absorption calculation.

As discussed above, the portion of the NOL available for use in succeeding taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income (with certain modifications for individuals and REITs) for each of the prior taxable years to which such loss may be carried. For this purpose, the taxable income for such prior years is computed **without regard to the NOL for the loss year or any year thereafter**. See §§ 172(b)(2)(B) and 1.172-5(a)(2)(i). There is no special provision under § 172 or the regulations for making any adjustment concerning § 447 suspense accounts when calculating absorption taxable income.³ The taxpayer in this case is attempting to exclude the suspense account income from gross income in the carryback year by using the NOL to change the computation of taxable income. This is exactly what §§ 172(b)(2)(B) and 1.172-5(a)(2)(i) forbid for purposes of calculating the absorption.

In the instant case, if the original § 447(i)(5)(B)(iv) amount were recomputed and reduced to take into account the NOL carryback, the amount of the NOL carryback absorbed under § 172(b)(2) would still include the original § 447(i)(5)(B)(iv) amount. Consequently, this recomputation would result in the taxpayer paying tax twice on the amount of that adjustment – once when the NOL carryback is absorbed and then again when the suspense account balance is reduced in a later year. Therefore, because of that resulting double taxation, it is our position that the suspense account should remain reduced to the extent of the § 447(i)(5)(B)(iv) gross income inclusion as originally computed prior to the NOL carryback.

Our position is in accord with the overall intent of § 447(i)(5)(B), which was to require a measured recognition of existing suspense accounts. Furthermore, the legislative history indicates that the purpose of the specific provision at issue -- § 447(i)(5)(B)(i)(II) - - was to provide further deferral of income recognition from a suspense account in situations where an increased tax obligation would cause liquidity concerns for a corporation. The legislative history of § 447(i) provides the following:

[T]he Committee recognizes that requiring the recognition of previously established suspense accounts may impose liquidity concerns upon some farm corporations. Thus, the Committee provides an extended period over which existing suspense accounts must be restored to income and provides further deferral where the corporation has insufficient income for the year.

H.R. Rep. No. 148, 105th Cong., 1st Sess. 497-498 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 183 (1997). When a NOL is carried back to reduce taxable income to \$0 in an earlier year, that does not create a situation where there is a liquidity concern with

³ Compare § 170(d)(2)(B). When a taxpayer has both a NOL carryover and a charitable contribution carryover, § 170(d)(2)(B) reduces the charitable contribution carryover and precludes a taxpayer from receiving a double benefit. See also Rev. Rul. 76-145, 1976-1 C.B. 68.

respect to that earlier year. Therefore, the result in the instant case is in accord with the purpose of § 447(i)(5)(B)(i)(II) because the original amounts included in gross income from the suspense account in Year 1 and Year 4 should be recognized in those years.

Our conclusion under the facts of this TAM is consistent with the treatment of a taxpayer who has a NOL determined without regard to § 447(i)(5)(B) arising in the same taxable year for which a suspense account inclusion is being calculated under § 447(i)(5)(B)(i)(II). Under § 447(i)(5)(B), the taxpayer must increase its gross income up to the amount of such NOL (if less than the applicable portion) to arrive at taxable income. The result is that the taxpayer no longer has a NOL for the year and decreases its suspense account balance by the amount of such NOL. The same thing should happen when a NOL is carried back to a year in which suspense account gross income was taken into account prior to the carryback of the NOL. Such a rule would require that, when a NOL is carried back to a year in which a taxpayer has an inclusion under § 447(i)(5)(B)(iv), the taxpayer's suspense account should be reduced if the § 447(i)(5)(B)(iv) gross income inclusion increases taxable income (as computed for purposes of the second sentence of § 172(b)(2)) and decreases a NOL carryover to a succeeding year.

Accordingly, we conclude that § 447(i)(5)(B)(i)(II) does not apply under the facts of this case and the suspense account should remain reduced to the extent of the § 447(i)(5)(B)(iv) gross income inclusion as originally computed prior to the NOL carryback.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.