DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

April 6, 2001

Number: **200133004**
Release Date: 8/17/2001
CC:PA:APJP:B3/TL-N-3285-98
UILC: 1311.01-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Mary Helen Weber
Associate Area Counsel - Strategic Litigation
CC:LM:MCT:SLCIN

Richard G. Goldman
Chief, Branch 3, Office of Assistant Chief Counsel
(Administrative Provisions and Judicial Practice)
CC:PA:APJP:B03

SUBJECT: Mitigation and Carryovers

This Field Service Advice responds to your memorandum dated January 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Year 1 =
Year 2 =
X =
A =

ISSUE

Can the Internal Revenue Service assess a deficiency in Year 2, a year for which assessments are barred, if adjustments to income tax liability for Year 1 make unavailable for carryover to Year 2 net operating losses, passive activity losses, excess charitable contributions, and a credit carry forward?

CONCLUSION

If the adjustments to Year 1 are sustained by a “determination,” as defined in I.R.C. § 1313, then assessment of a deficiency may be authorized for Year 2 under the mitigation provisions.

FACTS

In Year 1, X (a TEFRA partnership) reconfigured its partnership structure. The Internal Revenue Service ("the Service") has determined that this reconfiguration may have effectuated a sale of partnership interests by certain partners, including A.

During Year 1, A owned a partnership interest in X. A filed a federal income tax return for Year 1 reporting income from wages and interest. A reduced that income by deducting net operating losses that A had carried forward to Year 1 from years preceding Year 1. Because A deducted a portion of the net operating losses carried into Year 1, A reported no income tax liability for Year 1. A was able to carry forward to Year 2 additional net operating losses, passive activity losses, excess charitable contributions, and general business credits because they were not used in Year 1. On his return for Year 2, A offset his income with deductions of the net operating losses, passive activity losses, excess charitable contributions, and general business credit carryovers from years prior to Year 1 to fully exhaust the available carryovers.

The Service proposes to increase A's income for Year 1 to reflect the recognition of gain from the sale of part of A's interest in X. If the proposed increase in income is sustained, A must use the entire amount of the carryovers from the years prior to Year 1 in Year 1, thereby making them unavailable for carryforward to Year 2. Disallowance of the deductions for the net operating losses, passive activity losses, excess charitable contributions, and general business credits in Year 2 will result in a deficiency. Because the limitations period for making assessments for Year 2 has expired, the Service will be barred from assessing the deficiency unless the mitigation provisions of I.R.C. §§ 1311 -- 1314 apply.

LAW AND ANALYSIS

The mitigation provisions of I.R.C. § 1311–1314 were designed to palliate the effect of the period of limitations in certain meticulously and narrowly drafted situations. See Bradford v. Commissioner, 34 T.C. 1051, 1054 (1960). For an adjustment to be authorized under these provisions, four conditions must be met.
First, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See I.R.C. § 1311(a).

Second, there must be a "determination" for an open tax year. As defined in I.R.C. § 1313(a), a "determination" is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treas. Reg. § 1.1313(a)-4.

Third, the determination must result in a circumstance under which an adjustment is authorized by I.R.C. § 1312. There are seven circumstances under which an adjustment is authorized. These circumstances involve double inclusion of an item of gross income (I.R.C. § 1312(1)); double allowance of a deduction or credit (I.R.C. § 1312(2)); double exclusion of an item of gross income (I.R.C. § 1312(3)); double

disallowance of a deduction or credit (I.R.C. § 1312(4)); correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (I.R.C. § 1312(5)); correlative deductions and credits for certain related corporations (I.R.C. § 1312(6)); and basis of property after erroneous treatment of a prior transaction (I.R.C. § 1312(7)).

Fourth, except for determinations described in I.R.C. § 1312(3)(B) and in I.R.C. § 1312(4), the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred. See I.R.C. § 1311(b).

As relevant in this case, I.R.C. § 1312(2) allows an adjustment to be made in a barred year if a determination allows a deduction or credit in an open tax year that was erroneously allowed to the taxpayer in the tax year for which assessments are now barred. In other words, allowance of the deduction or credit in the determination gives a taxpayer the benefit of a double allowance of the deduction or credit. A condition necessary for this adjustment is the maintenance of a position by the taxpayer that is inconsistent with the erroneous allowance of the deduction or credit. See I.R.C. § 1311(b)(1)(B).

The type of inconsistent position referred to in the statute is illustrated by the example under Treas. Reg. § 1.1311(b)-1(c)(1):

> A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

As the example under Treas. Reg. § 1.1311(b)-1(c)(2) illustrates, for an adjustment to be made in the government's favor, the taxpayer, rather than the government, must have taken an inconsistent position for another tax period:

> In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of

> the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

The examples under Treas. Reg. § 1.1311(b)-1(c) illustrate instances where an inconsistent position has been maintained. They do so, however, outside the context of a carryover from one year to another. In that context, there is little authority on the maintenance of an inconsistent position.

The principal reported authority is Bolten v. Commissioner, 95 T.C. 397 (1990). In that case, the taxpayers had claimed a net operating loss on their return for 1976, which they carried back to 1975 and forward to 1977, 1978, 1979, 1980, and 1981. Sometime after 1981, the taxpayers agreed to a substantial increase in their taxable income for 1977, 1978, and 1979. The effect of this increase was to reduce the amount of net operating losses available for carryover beyond 1979. The taxpayers and the Service entered into a closing agreement stipulating to the allowable deductions for 1975, 1977, 1978, 1979, 1980, and 1981. Subsequently, the Commissioner of Internal Revenue, pursuant to the closing agreement, determined a deficiency for 1980, proposing an increase in the taxpayers' taxable income equal to the amount by which the closing agreement had reduced the carryover available for use in that year. At the time the notice of deficiency was issued, 1980 was a closed year.

The United States Tax Court concluded that the net operating loss deduction taken in 1980 was erroneous to the extent it exceeded the amount allowed in the closing agreement. It described the situation as one covered by I.R.C. § 1312(2), which permits an adjustment if the conditions of I.R.C. § 1311(b)(1)(B) are satisfied. The conditions of that provision are satisfied if a determination adopts "a position maintained by the taxpayer" that is inconsistent with an erroneous allowance. Finding that the taxpayers made no argument regarding this requirement, the court did not address whether the requirement was satisfied. Ultimately, the court held that the mitigation provisions lifted the bar of the statute of limitations to permit assessment of a deficiency based upon a reduction of the net operating loss deduction for 1980.

The outcome of Bolten, if not the reasoning, suggests that a taxpayer, having previously carried over a loss or credit from one year to the next, maintains an inconsistent position under I.R.C. § 1313(b)(1)(B) whenever a determination duplicatively allows a deduction for the loss or duplicatively allows the credit in the earlier year. In such a circumstance, the taxpayer cannot waive the right to deduct the loss or claim the credit for the earlier year. By law, the deduction for the loss or the credit must be claimed; the premise of a carryover to a later year is that a loss or credit could not be used in an earlier year. By carrying over a loss or credit, a taxpayer essentially maintains that the loss or credit has not been fully absorbed.

This position is inconsistent with the allowance of a deduction for the loss in an earlier tax year.

Based upon Bolten, it follows that A will have maintained an inconsistent position if a determination reduces in Year 1 the amounts that were erroneously carried over as losses or credits to year 2. In proposing an adjustment for Year 1, the Service should take into account these losses and credit; doing so will not jeopardize the Service's ability to propose an adjustment for Year 2, as A, by carrying over the losses and credits to Year 2, has already maintained that these amounts could be applied in Year 1 but for a lack of offsetting income.

It should be noted that the facts of this case are not the same as those described in the example under Treas. Reg. § 1.1311(b)-1(c)(2). In that example, the taxpayer made no implied claim in an open year to a deduction also claimed in a closed year. In this case there is such a claim.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.