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Memorandum

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subject: Section 447(i) Suspense Accounts and Net Operating Loss Carryovers

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND:

Taxpayer =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

\$h =

ISSUE:

If a taxpayer carries forward a net operating loss (NOL) into a taxable year, how should the taxpayer compute the reduction in its § 447(i) suspense account and the amount of NOL absorbed pursuant to § 172(b)(2) with respect to that taxable year?

CONCLUSION:

In the years at issue, Taxpayer incorrectly calculated its NOL absorption under § 172(b)(2). Under § 172(b)(2), taxable income (as computed for purposes of the NOL absorption calculation) is computed without regard to NOL deductions attributable to the loss year or any year thereafter. Thus, in the present case, taxable income (as computed for purposes of the NOL absorption calculation) includes an amount pursuant to § 447(i)(5)(B)(i). However, in accordance with the overall purpose and legislative intent of § 447(i)(5)(B), Taxpayer is permitted to reduce the suspense account to the extent the § 447(i)(5)(B)(i) amount effectively increases taxable income (as computed for purposes of the NOL absorption calculation in § 172(b)(2)) and decreases a NOL carryover to a succeeding year.

FACTS:

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). Taxpayer initially used the cash receipts and disbursements method of accounting.

Prior to 1997, 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, Taxpayer established a suspense account under § 447(i) in lieu of taking into account adjustments under § 481(a). As reported by Taxpayer, the § 447(i) suspense account balance at the end of Year 1 was \$a.

Taxpayer incurred NOLs in years prior to Year 2. Taxpayer carried forward an aggregate NOL of \$b from 6 prior years into Year 2.

For Year 2, Taxpayer reported taxable income of \$c before considering its NOL deduction. For purposes of computing the reduction in its § 447(i) suspense account, Taxpayer took a NOL deduction of \$c and calculated it had zero taxable income for Year 2. Consequently, Taxpayer did not reduce its § 447(i) suspense account for Year 2 and did not include any amount from the suspense account in gross income for Year 2. For purposes of computing the amount of NOL absorbed pursuant to § 172(b)(2) for Year 2, Taxpayer took into account the NOL deduction in making the determination that the NOL was not absorbed by any amount from the § 447(i) suspense account. Taxpayer carried forward a NOL of \$d into Year 3.

For Year 3, Taxpayer reported taxable income of \$e before considering its NOL deduction. For purposes of computing the reduction in its § 447(i) suspense account, Taxpayer entirely offset the \$e with its NOL carryovers from prior years, resulting in zero taxable income for Year 3. Consequently, Taxpayer did not reduce its § 447(i) suspense account for Year 3 and did not include any amount from the suspense account in gross income for Year 3. For purposes of computing the amount of NOL absorbed pursuant to § 172(b)(2) for Year 3, Taxpayer took into account the NOL deduction in making the determination that the NOL was not absorbed by any amount from the § 447(i) suspense account. Taxpayer carried forward a NOL of \$f into Year 4.

LAW AND ANALYSIS:

Section 447(i)(5)(B) of the Code 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) 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. 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 NOL deductions attributable to the loss year or any year thereafter. See § 172(b)(2)(B) and § 1.172-5(a)(2)(i). In summary, § 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. Further, there is no special provision under § 172 or the regulations for making any adjustment concerning § 447 suspense accounts when calculating absorption taxable income.

In the present case, Taxpayer incurred NOLs in prior years that are available as NOL carryovers to Year 2 and Year 3. The NOLs fully offset Taxpayer's taxable income in Year 2 and Year 3 (i.e., Taxpayer's taxable income is reduced to \$0 with its NOL deductions) and thus Taxpayer did not include any amount from its § 447 suspense account in taxable income. However, under the NOL absorption rules, Taxpayer will have to include a § 447 suspense account amount in its § 172(b)(2) taxable income (taxable income for absorption purposes) because there is no language in § 172(b) or § 1.172-5 that allows the exclusion of the § 447 suspense account from taxable income for this purpose. Consequently, the amount of the NOL that is absorbed will be increased by the § 447 amount included in taxable income for absorption purposes,

thus lowering the NOL available for carryover to succeeding years with no corresponding reduction of the § 447 suspense account. This disparity in treatment would result in the taxpayer being taxed twice on the § 447 suspense account amount that reduced the NOL available for carryover.

Section 170(d)(2)(B) was enacted to prevent a situation very similar to that faced by Taxpayer in the present case for taxpayers with both NOL carryovers and charitable contribution deductions. Section 170(d)(2)(B), which keeps taxpayers from obtaining an undue double benefit, provides that a charitable contribution carryover is reduced to the extent that a charitable contribution amount reduces taxable income as computed for purposes of the second sentence of § 172(b)(2) (*i.e.*, absorption taxable income) and increases a NOL carryover to a succeeding year.

For example, assume a corporation in Y1 has taxable income of \$100 before taking into account its NOL deduction and its charitable contribution deduction. Assume also the taxpayer has a NOL carryover to Y1 of \$150 and a charitable contribution of \$40 in Y1. The taxpayer has \$0 taxable income for Y1 as a result of its NOL carryover. Because its NOL carryover exceeded its taxable income prior to taking the charitable deduction into account, the taxpayer cannot deduct the charitable deduction under § 170 in Y1. For absorption purposes, the taxpayer's taxable income is \$90 (\$100 less \$10 charitable contribution (\$40 contribution limited to 10% of income)) which results in a NOL carryover to Y2 of \$60 (\$150 less \$90). If not for § 170(d)(2)(B), the taxpayer would be able to carryover to Y2 all \$40 of its charitable deduction. Section 170(d)(2)(B) requires the taxpayer to reduce its charitable contribution carryover by \$10, the amount of the carryover that reduced § 172 taxable income for absorption purposes and increased the NOL carryover to Y2. See also Rev. Rul. 76-145, 1976-1 C.B. 68.

Treatment similar to that provided by § 170(d)(2)(B) would alleviate the double taxation that the taxpayer in this case would experience. Thus, to prevent an undue double taxation, a taxpayer should reduce its § 447 suspense account, without increasing taxable income, to the extent that a § 447 suspense account amount is included in § 172(b)(2) taxable income (absorption taxable income) and the inclusion of the § 447 amount causes a reduction of the amount of NOL that is carried over to succeeding years. In applying this treatment, Taxpayer will have an aggregate NOL carryforward (from 2 prior years) to Year 3 of \$g and a corresponding reduction in its § 447 suspense account of \$h.

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 forward to reduce taxable income to \$0 in a later year, that does not create a situation where there is a liquidity concern with respect to that later year because there is no tax to pay.

Our conclusion is also consistent with the treatment of the suspense account reduction in earlier years where the amount of the NOL greatly exceeded the applicable portion. Under § 447(i)(5)(B), Taxpayer increased its gross income up to the amount of the applicable portion to arrive at taxable income. The result is that Taxpayer has a reduced NOL for the year and decreases its suspense account balance by the amount that was included in income and that reduced the NOL. Similarly, when a NOL is carried forward, Taxpayer's suspense account should be reduced if the § 447(i)(5)(B)(i) amount effectively increases absorption taxable income (as computed for purposes of the second sentence of § 172(b)(2)) and decreases a NOL carryover to a succeeding year.

If you have any further questions, please call _____ at _____ .