Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201151021**
Release Date: 12/23/2011

CC:ITA:B04:SSPflanz
POSTF-146525-09

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 172.02-00

date: September 13, 2011

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subject: Effect of increased interest deductions on net operating losses

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

LEGEND

Year 1 =
Year 2 =

ISSUES

Do increased interest deductions allow Taxpayer to increase its net operating loss (NOL) for Year 1 and Year 2 even if the statutory period for filing a claim for credit or refund under § 6511 of the Internal Revenue Code has expired for those years.

CONCLUSIONS

The increased interest deductions would allow Taxpayer to increase its Year 1 and Year 2 NOLs even if the statutory period for filing a claim for credit or refund under § 6511 has expired for those years. Before Taxpayer is permitted to use the NOL in an open taxable year, however, Taxpayer must establish that the NOL was not absorbed by taxable income in the applicable carryback and carryover years preceding the open years.

FACTS

Taxpayer, on its Year 1 and Year 2 returns, took the position that its interest deductions were limited by § 163(j). LB&I, however, contends that § 163(j) does not apply to Taxpayer's Year 1 and Year 2 interest deductions and, consequently, Taxpayer's interest deductions for Year 1 and Year 2 are larger than the amounts reported by Taxpayer. LB&I has asked whether the increased interest deductions would allow Taxpayer to increase its NOL for Year 1 and Year 2 even if the statutory period for filing a claim for credit or refund under § 6511 has expired for those years.

LAW AND ANALYSIS

Section 172(c) provides that a taxpayer's net operating loss is the excess of its deductions allowed by Chapter 1 of the Internal Revenue Code over its gross income.

Once a taxpayer determines the amount of its NOL, 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 an NOL deduction in the year of the carryback or carryover. Sections 172(b)(1) and (2) require, generally, that an NOL for any taxable year first be carried back to each of the 2 previous taxable years, and, to the extent still available, carried forward to each of the 20 taxable years following the taxable year of the loss.

After an NOL is carried back or carried over, the taxpayer must determine the amount of the NOL that was absorbed in the carryback or carryover year. The purpose of the absorption computation is to determine the remaining NOL that may be used in succeeding taxable years. Section 172(b)(2) provides that the portion of the NOL carried to each taxable year is the excess, if any, of the amount of the NOL over the sum of the taxable income, with certain specified modifications, for each of the prior taxable years to which the loss may be carried. Section 1.172-4(a)(3) of the Income Tax Regulations further explains the NOL absorption rules:

> The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over.

Section 6511(a) generally provides that a claim for credit or refund of an overpayment of tax must be filed by the later of 3 years from the time the return was filed or 2 years from the time the tax was paid. Under § 6511(b), a credit or refund is not allowed unless a claim is made within the above-described period. Section 6511(d)(2), however, provides a special period of limitation for net operating loss carrybacks.

Under § 6511(d), a taxpayer generally has 3 years from the time prescribed by law for the filing of the return for the taxable year of the net operating loss to file a claim for credit or refund if it relates to an overpayment attributable to an NOL carryback. Under § 172(c) a taxpayer's net operating loss is the excess of its deductions allowed by Chapter 1 of the Internal Revenue Code over its gross income. Consequently, in the present case, an increase to Taxpayer's interest deductions for Year 1 and Year 2 would result in a corresponding increase to its NOLs for those years. Further, § 6511 has no application to the determination of whether Taxpayer has an NOL for Year 1 and Year 2 and, if it does, the amount of the NOL. Because Year 1 and Year 2 are closed years, Taxpayer cannot get a refund of taxes paid in Year 1 and Year 2, and cannot use its Year 1 and Year 2 NOL (increased as discussed above) to get a refund for the offset of income in a carryback year. *See* § 6511(d)(2). However, Taxpayer would be allowed to use its NOL in an open carryover year provided that Taxpayer can establish that the NOL was not absorbed by its taxable income (computed as specified in § 172(b)) in the carryback years or any prior carryover years.

The following example demonstrates the above-stated rules: Taxpayer A reports the following taxable income or loss (and its taxable income (prior to carryback of its NOL) equals taxable income as computed in accordance with § 172(b)(2)):

2004 – Taxable income of 50 (pre-NOL deduction); 0 after carryback of 2006 NOL
2005 - Taxable income of 60 (pre-NOL carryback); 30 after carryback of 2006 NOL
2006 – NOL of 80
2007 – Taxable income of 40
2008 – Taxable income of 60
2009 – Taxable income of 70

Assume also that the statute of limitations on credit or refund has expired for 2004 – 2007 (2004-2007 are closed years) but 2008 is an open year and that A, in 2011, correctly asserts that in 2006 it underreported a deduction by 100. Consequently, A's 2006 NOL is 180 instead of 80. Because 2006 is a closed year, A cannot use the NOL to get a refund for the offset of taxable income in a carryback year. Thus, A cannot get a refund for the offset of the remaining 30 of taxable income in 2005. In addition, A cannot use its 2006 NOL to get a refund of the 2007 taxes paid because 2007 is a closed year. To compute how much of the 180 NOL is available for A to use in its open years (years after 2007), A must determine how much of the 2006 NOL was absorbed by taxable income in the carryback and carryover years prior to the open years (2004, 2005 and 2007). The aggregate taxable income (computed in accordance with section 172(b)(2)) in 2004, 2005, and 2007 is 150 (50 + 60 + 40). Thus, A's 180 NOL in 2006 is absorbed to extent of 150 and A's remaining NOL for use in years after 2007 is 30.

A is entitled to a 30 NOL deduction in 2008, but because the 2006 NOL is fully absorbed in 2008, A does not have an NOL deduction (attributable to the 2006 NOL) in 2009.

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Please call Steve Toomey or Shareen Pflanz at (202) 622-4920 if you have any further questions.