Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201604017**
Release Date: 1/22/2016

CC:ITA:B05:SJKim
PRENO-125166-15

UILC: 108.08-00
date: November 24, 2015

to: James D. Hill
Associate Area Counsel (LB&I Group 2), Counsel Manager, CIL IPG

from: Amy J. Pfalzgraf
Senior Counsel, Branch 5
Office of Associate Chief Counsel (Income Tax & Accounting)

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subject: Authority to Adjust Income Deferred under Section 108(i)

This Chief Counsel Advice responds to your request for non-taxpayer-specific legal advice. This advice may not be used or cited as precedent.

ISSUE

May the Service adjust the amount of cancellation of debt (COD) income deferred by an election under § 108(i)?

CONCLUSION

In certain factual situations, the Service may adjust the amount of COD income deferred by an election under § 108(i). Field attorneys and revenue agents handling these § 108(i) cases should contact the National Office for taxpayer-specific advice.

FACTS

B is a sole proprietor. L, an unrelated individual, holds a promissory note that B made in connection with her business, for which $800x remains outstanding. In 2009, L agrees to return the note to B in exchange for $500x in cash. B's acquisition of the note from L is a "reacquisition" within the meaning of § 108(i)(4).

B attaches a statement to her timely filed 2009 return reporting $100x, not $300x, in total COD income in connection with the note reacquisition. On the statement, B also

makes an election under § 108(i) to defer the inclusion of $100x in COD income to the 5-year period beginning with 2014.

In a later year, the Service discovers that B failed to include $200x in COD income in 2009.

LAW AND ANALYSIS

Section 108(i)(1) of the Internal Revenue Code generally provides that, at the election of a taxpayer, COD income in connection with a reacquisition of an applicable debt instrument occurring in 2009 or 2010 is includible in gross income ratably over a 5-taxable-year inclusion period beginning with the fifth taxable year following the taxable year of the reacquisition (if it occurs in 2009) or with the fourth taxable year of the reacquisition (if it occurs in 2010).

Section 108(i)(5)(B)(i) provides that a taxpayer makes a § 108(i) election by attaching to its Federal income tax return for the year the reacquisition occurs a statement that clearly identifies the applicable debt instrument acquired, the amount of income to be deferred by the election, and any other information that the Secretary requires. The election, once made, is irrevocable. Section 108(i)(5)(B)(ii).

Rev. Proc. 2009-37, 2009-2 C.B. 309, provides the exclusive procedures for making a § 108(i) election. Section 4.04 of Rev. Proc. 2009-37 allows the taxpayer to make an election for any portion of the COD income from the reacquisition of any applicable debt instrument.

Section 4.05 of Rev. Proc. 2009-37 lists the requisite information that every statement submitted under § 108(i)(5)(B) must provide: (a) the identifying information of the issuer of the applicable debt instrument; (b) a general description of the applicable debt instrument; (c) a general description of the reacquisition transaction generating the COD income; (d) the total amount of COD income resulting from the reacquisition and a general description of how the COD income was computed; and (e) the amount of COD income deferred by the election.

Section 4.11 of Rev. Proc. 2009-37 provides that a taxpayer may make a protective election if the taxpayer concludes that a particular transaction does not result in the realization of COD income. If the Service later determines that the transaction did result in COD income, the Service may require the taxpayer making the protective election to report COD income deferred pursuant to the valid and irrevocable protective election even if the statute of limitations has expired for the year in which the COD income was realized and the protective election was made.

Under §§ 5.01 and 5.02 of Rev. Proc. 2009-37, a taxpayer making a § 108(i) election (other than a protective election under § 4.11) must attach a copy of the election statement and an annual information statement to its return for each taxable year

beginning with the first taxable year following the election and ending in the taxable year when all COD income deferred under § 108(i) has been recognized. On the annual information statement, the taxpayer must report for each applicable debt instrument, among other things, the deferred COD income included for the current taxable year and the deferred COD income that the taxpayer has not included in the current or any prior taxable years.

Section 6501 generally limits the period during which tax may be assessed to 3 years after the date the taxpayer files a return. However, § 6501 merely prevents assessment and collection of tax beyond the prescribed period of limitations. Section 6501 does not prevent an adjustment that may affect other taxable years or other tax liabilities, or does not result in the assessment of a tax. There is a well-developed body of law that the Service is generally able to recompute a taxpayer's income for a closed year in determining the deficiency for an open year (the "adjustment theory"). See Commissioner v. Disston, 325 U.S. 442 (1945) (examination of events in closed years was allowed to correctly determine the gift tax liability in open years); ABKCO Industries Inc. v. Commissioner, 56 T.C. 1083 (1971) (income for a year barred by the statute of limitations recomputed to arrive at correct amount for determining net operating loss carryback or carryover to another year). The ability to adjust a taxpayer's income for a closed year is consistent with § 4.11 of Rev. Proc. 2009-37, which states that a taxpayer making a protective election will have to include deferred COD income in income if the Service later determines that the transaction at issue resulted in COD income, even if the year the COD income was realized and the protective election was made is closed.

Under a given set of facts, the Service may be able to apply the adjustment theory to adjust the amount of COD income that a taxpayer has elected to defer under § 108(i) even if the taxable year of the election is closed under § 6501. In the above example, the Service may be able to treat B as having realized $300x in COD income in 2009 and having elected to defer the entire $300x amount under § 108(i), even if the 2009 taxable year is closed under § 6501.

Whether to apply the adjustment theory of Disston and ABKCO Industries, however, requires a thorough development of the facts in each case. For that reason, we strongly recommend that, in handling any case that appears to involve a misstatement or error in a 108(i) deferral, your office develop the facts fully and contact our office for taxpayer-specific advice.

If you have any additional questions, please call our office at (202) 317-7006.