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Mistakes happen. Often they are not discovered until years later when a fresh set of eyes chances upon them. And by that time remedial action may be too late. This is as true in the world of tax as it is elsewhere.

In this article I discuss the interaction of net operating losses (NOLs) and mistakes in closed tax years. An NOL is the excess of a taxpayer's deductions over the taxpayer's gross income for a given year.[1] Taxpayers can generally use an NOL from one year—the "loss year"—to reduce taxable income in the two preceding years via a carryback, or the following twenty years via a carryover.[2] The ability to use a loss from one year to offset income in another year enables a taxpayer to "set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."[3]

But what if the taxpayer makes a mistake in calculating its NOL? Or what if, upon carrying an NOL to an earlier year, the taxpayer or the Internal Revenue Service (IRS) discovers a mistake in the original tax return for that year? If the mistake caused an underpayment, the IRS may seek to assess additional tax. In contrast, if the mistake caused an understatement of the NOL, the taxpayer may carry the increased NOL to another year and seek a refund. But both of those actions—assessing tax and claiming a refund—are subject to time limits.[4] Once those time limits expire for a particular year, the statute of limitations closes that year—often referred to as a "closed year"—and prohibits future assessments and refund claims.

The interaction of NOLs and mistakes in closed years leads to a number of questions. For example, suppose a taxpayer fails to claim a deduction in a loss year for which the statute of limitations is expired. If the taxpayer carries the loss forward to a year for which the statute of limitations is not expired—an "open year"—can the taxpayer increase the amount of the loss to reflect the missed deduction? Or suppose a taxpayer understates income in a prior year for which the statute of limitations is expired. Does a carryback from an open year to the closed year apply against the taxpayer's reported taxable income or correct taxable income?

These questions—and many others like them—boil down to two issues. First, if a taxpayer files a refund claim on account of a timely carryback to a year that is otherwise closed by the statute of limitations, how does a mistake in the closed year affect the amount of the refund? Second, how does a mistake in a closed year affect the amount of the NOL that a taxpayer can carry to an open year?

With respect to the first issue, Revenue Ruling ("Rev. Rul.") 81-88 provides three rules for determining the amount of an allowable refund.[5] First, if correcting

1. I.R.C. § 172(c) (Westlaw 2009).

2. *Id.* § 172(b)(1)(A). In this article, NOL carrybacks are referred to simply as "carrybacks," and NOL carryovers simply as "carryovers."

3. Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957).

4. *See* I.R.C. § 6501(a) (Westlaw 2010) (allowing the IRS three years from the filing of a tax return to assess tax); *id.* § 6511(a) (Westlaw 2008) (allowing a taxpayer three years from the filing of a tax return—or two years from the payment of tax—to file a refund claim).

5. Rev. Rul. 81-88, 1981-1 C.B. 585.

the mistake *decreases* income in the closed year, then the taxpayer must ignore the mistake and apply the carryback against reported income.[6] Second, if correcting the mistake *increases* income in the closed year, then the taxpayer must reduce the carryback by the amount of that increase and apply the net carryback against reported income.[7] Third, if there are multiple mistakes and correcting them both increases *and* decreases income in the closed year, then the taxpayer must reduce the carryback by the amount of any net increase and apply the net carryback against reported income.[8]

For the second issue—the amount of the remaining NOL—different rules apply to carryovers and carrybacks. In the case of carryovers, taxpayers must adjust the amount of a carryover to an open year to account for mistakes in a closed year.[9] This is true regardless of whether correcting the mistake increases or decreases income in the closed year. In contrast, the rule for carrybacks depends on when the mistake occurs. If the mistake occurs *before* the refund year, then the same rule applies: taxpayers must account for mistakes in a closed year when determining the amount of the NOL that they can carry to an open year.[10] But if the mistake occurs *in* the refund year, the rule depends on the type of mistake. In some cases the IRS asserts that taxpayers must account for the mistake, while in others the IRS asserts that taxpayers must ignore the mistake.[11] To support that distinction, the IRS takes the questionable step of interpreting the same statutory language to mean different things in different situations.

I try to accomplish two goals in this article. The first is simply to provide a lay of the land for the rules that apply when NOLs and mistakes in closed years collide. To make the discussion more concrete, I adopt a series of examples that illustrate how the rules work in practice. In this regard, I note that some of the IRS-imposed rules in this area are not litigation tested, and a court could take a different view in the event of a taxpayer challenge. My second goal is a bit more ambitious. Because the rules in this area are highly fact dependent and apply in a multitude of factual scenarios, the existing authorities leave some unanswered questions. While I do not purport to answer (or even identify) them all, I do try to address at least some of them.[12]

Part I discusses the interaction of carryovers and mistakes in closed years. In Part I.A, I address the rules that apply when a mistake occurs *in* the loss year, and in Part I.B, I address the rules that apply when a mistake occurs *after* the loss year. Part II then discusses the interaction of carrybacks and mistakes in closed years. In Part II.A, I address the rules that apply when a mistake occurs *in* the refund year, and in Part II.B, I address the rules that apply when a mistake occurs *before* the refund year.

6. *Id.*; *see infra* Part II.A.1.

7. Rev. Rul. 81-88; *see infra* Part II.A.2.

8. Rev. Rul. 81-88; *see infra* Part II.A.3.

9. *See infra* Part I.

10. *See infra* Part II.B.

11. *See infra* Part II.A.

12. *See infra* Part II.A.3.

## I. CARRYOVERS AND MISTAKES

When it comes to carryovers, the task is determining how a mistake in a closed year affects the amount of a carryover that a taxpayer can use in an open year. To do this, "all adjustments to taxable income, whether or not barred by the statute of limitations, [are] taken into account."[13] To illustrate this rule, I use a series of examples involving Comeback Corp., a corporate taxpayer that follows an initial loss year with a profitable one.

### *A. Mistakes in the Loss Year*

Assume Comeback reports a $110 NOL in Year 1 and carries the NOL forward to offset $100 of income in Year 2.[14] After the assessment statute of limitations for Year 1 expires, the IRS determines that Comeback understated Year-1 income by $20.[15] In this situation, "[t]he fact that the statutory period for assessment of income taxes for the year in which the loss was sustained has expired does not preclude the making of such adjustments as may be necessary to correct the net operating loss deduction."[16] This is because, in the case of a carryover, the assessment statute of limitations runs from the year in which the taxpayer *uses* the NOL, not the year in which the taxpayer *incurs* the NOL.[17] As a result, the IRS can reduce Comeback's carryover from Year 1 to Year 2 from $110 to $90.[18] After applying the reduced carryover against the $100 of Year-2 income, Comeback has $10 of remaining Year-2 income and, assuming a 35% tax rate, pays $3.50 of tax.[19]

In this example, reducing Comeback's carryover to reflect the additional $20 of Year-1 income reaches the right economic result. In the aggregate, Comeback had $10 of net income (a $110 reported loss in Year 1, $20 of unreported income in Year 1, and $100 of income in Year 2) and paid $3.50 of tax. If Comeback did not reduce its carryover by the $20 of unreported Year-1 income, then Comeback could use the full $110 carryover to offset all $100 of its Year-2 income, pay no Year-2 tax, and have a

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13. Rev. Rul. 81-88.

14. Because Comeback incurred the NOL in Year 1, there are no earlier years to which Comeback can carry the loss.

15. The IRS generally has three years from the date a taxpayer files a tax return for a particular year to assess tax with respect to that year. I.R.C. § 6501(a) (Westlaw 2010).

16. Rev. Rul. 56-285, 1956-1 C.B. 134 (citing Phoenix Coal Co. v. Comm'r, 231 F.2d 420, 421 (2d Cir. 1956)). In unofficial guidance, the IRS encourages examiners "to audit originating NOL tax years when they believe that taxable income may have been understated, even if the return is otherwise closed by statute," because "[t]hese examinations may significantly reduce or eliminate the NOL carryforwards into open examination tax years." *Cash Intensive Business Audit Techniques Guide: Chapter 6*, Internal Revenue Serv. (Apr. 2010), www.irs.gov/pub/irs-utl/cashchapter6_210655.pdf.

17. *See* I.R.C. § 6501(a).

18. *See* Barenholtz v. United States, 784 F.2d 375, 380–81 (Fed. Cir. 1986); Phoenix Elecs., Inc. v. United States, 164 F. Supp. 614, 615–16 (D. Mass. 1958); Petersen v. Comm'r, 30 T.C.M. (CCH) 95 (1971); Kausal v. Comm'r, 15 T.C.M. (CCH) 1500 (1956); Forres v. Comm'r, 25 B.T.A. 154, 158–59 (1932).

19. I assume a 35% tax rate throughout this article.

$10 NOL to use in the future. In other words, Comeback would end up with a $3.50 tax benefit (the tax effect of the remaining $10 NOL) rather than a $3.50 tax payment. The $7 difference between those two results is the tax effect of the $20 understatement in Year 1.

"[T]he same logic that allows the Commissioner to correct a[n] NOL with an upward adjustment in a year barred by the statute of limitations also allows the taxpayer to correct a[n] NOL with a downward adjustment in such a year."[20] Indeed, "[i]t would [be] inequitable to allow the government . . . to make an upward adjustment in the taxpayer's NOL, even though the statute of limitations has run, without also permitting the taxpayer to make a downward adjustment in similar circumstances."[21] As a result, if Comeback instead failed to report a $30 deduction in Year 1, Comeback could increase the carryover to Year 2 from $110 to $140.[22] After applying the increased carryover against the $100 of Year-2 income, Comeback would have no remaining Year-2 income, pay no Year-2 tax, and have $40 of remaining NOL to use in the future.

Here again, adjusting Comeback's carryover to reflect the $30 missed deduction in Year 1 reaches the correct economic result. In the aggregate, Comeback had a $40 net loss (a $110 reported loss in Year 1, a $30 unreported deduction in Year 1, and $100 of income in Year 2), paid no tax, and has a $40 NOL to use in the future. If Comeback did not increase its carryover, then Comeback would have only $10 of remaining NOL (the original $110 carryover from Year 1 minus $100 of Year-2 income). The $30 difference between the two carryover balances is the amount of the missed deduction in Year 1.

### B. *Mistakes After the Loss Year*

The same rules that apply when a mistake occurs in the loss year also apply when a mistake occurs in a closed year that follows the loss year. This time, assume that after reporting a $110 loss in Year 1, Comeback carries the NOL forward to offset $60 of income in Year 2 and $40 of income in Year 3. After the assessment statute of limitations for Year 2 expires, the IRS determines that Comeback understated Year-2 income by $20. As before, the IRS can reduce Comeback's carryover from Year 1 to Year 3 to reflect the Year-2 understatement.[23]

The IRS makes the adjustment using the mechanics of § 172(b)(2), which provides ordering rules for determining the amount of an NOL that a taxpayer can

20. I.R.S. Gen. Couns. Mem. 38,292 (Feb. 22, 1980), *available at* 1980 WL 131356.

21. *Id.*

22. *See* Rev. Rul. 81-88, 1981-1 C.B. 585; I.R.S. Chief Couns. Adv. 2011-51-021 (Dec. 23, 2011), *available at* 2011 WL 6464324; I.R.S. Non-Docketed Serv. Adv. Rev. 11,305 (Dec. 6, 2000), *available at* 2000 WL 34423086; I.R.S. Non-Docketed Serv. Adv. Rev. 5,996 (Sept. 23, 1997), *available at* 1997 WL 33324345; I.R.S. Priv. Ltr. Rul. 95-04-032 (Oct. 31, 1994). The same rule applies if correcting a mistake converts an income year to a loss year, thereby generating an NOL even though one did not originally exist. *See* Rev. Rul. 81-88.

23. *See* State Farming Co. v. Comm'r, 40 T.C. 774, 783 (1963).

carry to other years. Under those rules, a taxpayer must first carry an NOL to the earliest possible year—usually two years before the loss year.[24] If the NOL exceeds the "taxable income" for the earliest year, the taxpayer can carry the excess to the second-earliest year, and so on until the taxpayer absorbs the entire NOL.[25]

Courts consistently interpret § 172(b)(2)'s reference to "taxable income" to mean *correct* taxable income rather than *reported* taxable income.[26] And as a general matter, the IRS follows suit.[27] When a tax return is accurate as filed, there is no difference between correct taxable income and reported taxable income. But when there is a mistake on the original tax return—as in the case of Comeback—the distinction between applying § 172(b)(2) by reference to correct taxable income versus reported taxable income can be significant. Returning to the example helps illustrate this point.

Section 172(b)(2) requires Comeback to carry the $110 NOL to the earliest possible year—Year 2 in this example.[28] Under the judicial interpretation of § 172(b)(2), if Comeback's NOL exceeds *correct* Year-2 taxable income, then Comeback can carry the excess to Year 3. Comeback's $110 NOL exceeds the $80 of correct Year-2 income by $30, and so Comeback has a $30 carryover to Year 3. After applying that carryover against $40 of Year-3 income, Comeback is left with $10 of Year-3 income and pays $3.50 of tax. In this example, the rules achieve the correct economic result: Comeback has $10 of net income (a $110 loss in Year 1, $60 of reported income and $20 of unreported income in Year 2, and $40 of income in Year 3) and pays $3.50 of tax.

Consider the result if Comeback instead applied its $110 NOL from Year 1 against *reported* Year-2 income. The $110 NOL exceeds $60 of reported Year-2 income by $50, and so Comeback would have a $50 carryover to Year 3. After applying that carryover to offset the $40 of Year-3 income, Comeback would pay no Year-3 tax and would have a $10 NOL to use in the future. As a result, applying § 172(b)(2) by reference to correct taxable income leaves Comeback in a *worse* position than applying § 172(b)(2) by reference to reported taxable income.

The same analysis applies if, instead of understating income, Comeback overstates income by failing to report a $30 deduction in Year 2. Comeback's $110 NOL from Year 1 exceeds the $30 of *correct* Year-2 income by $80, and so Comeback has an $80

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24. I.R.C. § 172(b)(2) (Westlaw 2009). Under the general rule, taxpayers can carry an NOL to the preceding two years and the succeeding twenty years. *Id.* § 172(b)(1)(A). But a taxpayer can elect to forgo the carryback period. *Id.* § 172(b)(3).

25. *Id.* § 172(b)(2).

26. *See, e.g.*, Phoenix Coal Co. v. Comm'r, 231 F.2d 420, 422 (2d Cir. 1956) (carryback); ABKCO Indus., Inc. v. Comm'r, 56 T.C. 1083, 1089 (1971) (carryback); *State Farming Co.*, 40 T.C. at 783 (carryover); Springfield St. Ry. v. United States, 312 F.2d 754, 759 (Ct. Cl. 1963) (carryback).

27. *See, e.g.*, I.R.S. Non-Docketed Serv. Adv. Rev. 20,377 (Jan. 10, 2001), *available at* 2001 WL 34145366 ("We are convinced . . . that 'taxable income' in section 172(b)(2) means correct taxable income as opposed to reported taxable income . . . ."); I.R.S. Gen. Couns. Mem. 39,358 (Sept. 27, 1983), *available at* 1985 WL 291769 ("'Taxable income' for purposes of section 172(b)(2) means correct taxable income."). *But see infra* Part II.A.1.

28. I.R.C. § 172(b)(2). Because Comeback incurred the NOL in Year 1, there are no earlier years to which Comeback can carry the loss.

carryover to Year 3. After applying that carryover to offset the $40 of Year-3 income, Comeback pays no tax in Year 3 and has a $40 NOL to use in the future. Once again, the rules achieve the correct economic result: Comeback sustained a $40 net loss (a $110 loss in Year 1, $60 of reported income and a $30 unreported deduction in Year 2, and $40 of income in Year 3) and has a $40 NOL to use in the future.

Recall that if Comeback instead applied its $110 NOL against *reported* Year-2 income, Comeback would pay no Year-3 tax and would have a $10 NOL to use in the future. So in contrast to the example in which Comeback understates income, when Comeback overstates income, applying § 172(b)(2) by reference to correct taxable income leaves Comeback in a *better* position than applying § 172(b)(2) by reference to reported taxable income.

## II. CARRYBACKS AND MISTAKES

While the analysis of carryovers involves only one issue—the amount of the NOL that a taxpayer can use in an open year—the analysis of carrybacks involves two. First, how does a mistake in a closed year affect the amount of a taxpayer's refund on account of a timely carryback? Second, as with carryovers, how does a mistake in a closed year affect the amount of the NOL that remains available to use in open years?

The answers to these questions depend on whether the mistake occurs *in* the refund year or *before* the refund year. Once again, I use a series of examples to illustrate the rules. This time the examples involve Fading Fast Inc., a corporate taxpayer who follows an initial profitable year with a loss year.

### *A. Mistakes in the Refund Year*

Rev. Rul. 81-88 imposes three rules for determining the amount of an allowable refund when a refund claim involves both a timely carryback and a time-barred adjustment: (1) if the time-barred adjustment *decreases* income, then the taxpayer must ignore the adjustment and apply the carryback against reported income;[29] (2) if the time-barred adjustment *increases* income, then the taxpayer must reduce the carryback by the amount of that increase and apply the net carryback against reported income;[30] and (3) if there are time-barred adjustments that both increase *and* decrease income, then the taxpayer must reduce the carryback by the amount of any net increase and apply the net carryback against reported income.[31]

When it comes to determining the amount of the remaining NOL, the analysis again turns on the ordering rules of § 172(b)(2). Under those rules, a taxpayer must first carry an NOL to the earliest possible year. If the NOL exceeds the taxpayer's "taxable income" in the earliest year, the taxpayer can carry the excess to the second-earliest year, and so on until the taxpayer absorbs the entire NOL. Recall that courts consistently interpret § 172(b)(2)'s reference to "taxable income" to mean *correct* taxable

29. *See infra* Part II.A.1.

30. *See infra* Part II.A.2.

31. *See infra* Part II.A.3.

income,[32] and that the IRS generally does the same.[33] But in the context of a refund claim that involves both a timely carryback and a time-barred adjustment that decreases income, the IRS creates an exception and applies § 172(b)(2) by reference to *reported* taxable income. The following discussion illustrates the significance of that exception.

Assume Fading Fast reports $100 of income and pays $35 of tax in Year 1, and reports a $110 NOL in Year 2. While the statute of limitations for claiming a Year-1 refund on account of a carryback of the Year-2 NOL is still open, Fading Fast carries the NOL back to Year 1 and files a refund claim.[34] In reviewing the claim, the IRS determines that Fading Fast made a mistake on its Year-1 tax return.

*1. Barred Item Decreases Income*

Suppose the mistake is a failure to report a $30 deduction in Year 1, and the statute of limitations for Fading Fast to claim a Year-1 refund due to the missed deduction is expired.[35] As a result, Year 1 involves both a timely carryback from Year 2 and a time-barred adjustment that *decreases* income. The first rule of Rev. Rul. 81-88 instructs Fading Fast to ignore the time-barred adjustment and apply the carryback against reported income. So Fading Fast ignores the $30 missed deduction in Year 1, applies the $110 carryback against $100 of reported Year-1 income, and receives a $35 refund (the full amount of Year-1 tax).

The IRS bases the first rule of Rev. Rul. 81-88 on Treasury Regulation ("Treas. Reg.") § 301.6511(d)-2(a)(3), which states:

> If the claim involves an overpayment based not only on a net operating loss . . . but based also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitation, the portion of the overpayment attributable to the items not so barred shall be determined by treating the allowance of such items as the *first adjustment* to be made in computing such overpayment.[36]

32. *See* cases cited *supra* note 26.

33. *See* I.R.S. Non-Docketed Serv. Adv. Rev. 20,377 (Jan. 10, 2001), *available at* 2001 WL 34145366; I.R.S. Gen. Couns. Mem. 39,358 (Sept. 27, 1983), *available at* 1985 WL 291769.

34. In the case of a carryback, the refund statute of limitations runs from the year in which the taxpayer *incurs* the loss, not the year in which the taxpayer *uses* the loss. I.R.C. § 6511(d)(2)(A) (Westlaw 2008). Taxpayers have three years from the filing date of the tax return for a loss year to file a refund claim on the basis of a carryback of the loss to an earlier year. *Id.* § 6511(a). Taxpayers also have an alternative two-year period from the payment date of the tax for which a refund is sought. *See* Rev. Rul. 65-281, 1965-2 C.B. 444.

35. Under the general refund statute of limitations, a taxpayer must file a refund claim by the later of (1) three years from the filing date of the tax return for the refund year, or (2) two years from the payment date of the tax for which the refund is sought. I.R.C. § 6511(a).

36. Treas. Reg. § 301.6511(d)-2(a)(3) (Westlaw 2014) (emphasis added). Similar provisions exist in other overpayment contexts. *See id.* § 301.6511(d)-1(a)(4) (covering time-barred items and losses from bad debts or worthless securities); *id.* § 301.6511(d)-2(a)(3) (covering time-barred items and capital loss carrybacks); *id.* § 301.6511(d)-4(a)(3) (covering time-barred items and investment credit carrybacks); *id.* § 301.6511(d)-7(a)(3) (covering time-barred items and work incentive program credit carrybacks).

By requiring the timely carryback to be the "first adjustment" in determining the refund, Treas. Reg. § 301.6511(d)-2(a)(3) prevents taxpayers from adjusting reported income in the refund year to reflect a time-barred item.

As a historical note, the first revenue rulings in this context required taxpayers to determine the refund by applying the carryback against *correct* Year-1 income.[37] In other words, those revenue rulings instructed taxpayers to apply the time-barred adjustment first and the timely carryback second. But the IRS Office of Chief Counsel ("Chief Counsel") eventually recognized the conflict between that approach and Treas. Reg. § 301.6511(d)-2(a)(3).[38] Moreover, Chief Counsel observed that applying the carryback against correct income results in an "obvious detriment"[39] to the taxpayer who is "in effect punished twice"[40] for missing a deduction. First, the taxpayer loses the benefit of the time-barred deduction in the closed year. Second, the taxpayer receives a smaller refund from the carryback.[41] As a result, Rev. Rul. 81-88 revoked the prior revenue rulings and adopted a rule that is consistent with Treas. Reg. § 301.6511(d)-2(a)(3).[42]

Having determined the amount of the Year-1 refund, Fading Fast now turns to the amount of the remaining NOL. In the absence of Rev. Rul. 81-88, Fading Fast might research § 172(b)(2) and find that courts consistently interpret § 172(b)(2)'s reference to "taxable income" to mean correct taxable income.[43] Under that interpretation, Fading Fast would compare the $110 carryback from Year 2 to the $70 of correct Year-1 income and conclude that it has a $40 NOL to use in the future.

But Rev. Rul. 81-88 requires a different result. When a refund claim involves both a timely carryback and a time-barred adjustment that decreases income, the IRS interprets § 172(b)(2)'s reference to "taxable income" to mean *reported* taxable income.[44] Under that interpretation, Fading Fast compares the $110 carryback from

37. *See* Rev. Rul. 218, 1953-2 C.B. 176, *revoked by* Rev. Rul. 81-88, 1981-1 C.B. 585; Rev. Rul. 65-96, 1965-1 C.B. 126, *revoked by* Rev. Rul. 81-88.

38. *See* I.R.S. Gen. Couns. Mem. 34,336 (Aug. 20, 1970), *available at* 1970 WL 22485; I.R.S. Gen. Couns. Mem. 38,292 (Feb. 22, 1980), *available at* 1980 WL 131356 (reviewing a draft of Rev. Rul. 81-88).

39. I.R.S. Gen. Couns. Mem. 34,336.

40. I.R.S. Gen. Couns. Mem. 38,292.

41. In this example, if Fading Fast applies the $110 carryback from Year 2 against $70 of correct Year-1 income, Fading Fast would receive only a $24.50 refund (35% of $70) rather than a $35 refund. Because the regular refund statute of limitations for Year 1 is expired, Fading Fast cannot claim a Year-1 refund on account of the missed deduction.

42. Chief Counsel first recognized the conflict between the focus on correct taxable income and Treas. Reg. § 301.6511(d)-2(a)(3) in 1970. *See* I.R.S. Gen. Couns. Mem. 34,336. But the IRS did not publish Rev. Rul. 81-88 for another eleven years. *See* Rev. Rul. 81-88. It seems the delay was due, at least in part, to the fact that the Tax Division of the U.S. Department of Justice was considering related issues as part of a docketed case and had "requested that no revenue ruling be published" until they finished their analysis. I.R.S. Gen. Couns. Mem. 36,006 (Sept. 25, 1974), *available at* 1974 WL 35783.

43. *See* cases cited *supra* note 26.

44. *See* Rev. Rul. 81-88.

Year 2 to the $100 of reported Year-1 income and concludes that it has only a $10 NOL to use in the future.

In support of the IRS's interpretation, Chief Counsel asserts that applying § 172(b)(2) by reference to correct taxable income in this context would lead to incorrect results.[45] In particular, it would allow Fading Fast to carry $40 of the NOL to future years ($110 NOL minus $70 of correct Year-1 income) after Fading Fast had already carried $100 of the NOL back to obtain a full refund of Year-1 tax under the first rule of Rev. Rul. 81-88. In the aggregate, therefore, Fading Fast would be able to use $140 of NOL when its actual NOL is only $110. The $30 difference, of course, is the amount of the missed Year-1 deduction. As this example shows, determining Fading Fast's remaining NOL by reference to correct taxable income in this situation would allow Fading Fast to recoup the benefit of the $30 missed deduction by "double-dipping" a portion of the Year-2 NOL.[46] To avoid that result, the IRS interprets § 172(b)(2)'s reference to "taxable income" to mean reported taxable income in this scenario.[47]

But this leaves the IRS in the questionable position of interpreting the same statutory language to mean different things in different situations. The IRS recognizes its inconsistency[48] but asserts that reading "taxable income" to mean reported taxable income in this context is "in harmony" with Treas. Reg. § 301.6511(d)-2(a)(3).[49] Put differently, the IRS's position is that when a taxpayer computes its *refund* under Treas. Reg. § 301.6511(d)-2(a)(3) by ignoring a time-barred adjustment, the taxpayer must also compute its *remaining* NOL under the principles of Treas. Reg. § 301.6511(d)-2(a)(3) and ignore the time-barred adjustment.[50] As a result, Fading Fast's missed deduction affects neither the amount of the Year-1 refund nor the amount of the remaining NOL.

So where does all of this leave Fading Fast? In the end, Fading Fast incurred a $40 net loss ($100 of reported income in Year 1, a $30 unreported deduction in Year 1, and a $110 NOL in Year 2) but is left with only a $10 NOL to use in the future ($110 Year-2 NOL minus $100 of reported Year-1 income). Therefore, Rev. Rul. 81-88 denies Fading Fast the benefit of the $30 missed deduction.

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45. I.R.S. Gen. Couns. Mem. 38,292.

46. *See id.* (expressing concern that applying § 172(b)(2) by reference to correct taxable income "would give the taxpayer refunds based on taxable income of 185x dollars when the amount of taxpayer's NOL is only 165x dollars"). "Double-dipping" means seeking the same benefit twice from the same source. *See* BLACK'S LAW DICTIONARY (9th ed. 2009) (Westlaw).

47. I.R.S. Gen. Couns. Mem. 38,292.

48. *Id.* ("We are convinced . . . that for most purposes 'taxable income' in section 172(b)(2) means correct taxable income as opposed to reported taxable income. However, we do not reach this conclusion with regard to the instant factual situation.").

49. Rev. Rul. 81-88; *see also* I.R.S. Non-Docketed Serv. Adv. Rev. 5,946 (July 2, 1996), *available at* 1996 WL 33325650.

50. *See* I.R.S. Gen. Couns. Mem. 38,292 ("We think, however, that where the earliest carryback year is still open the amount of the NOL absorbed in that year should be computed according to Treas. Reg. § 301.6511(d)-2(a)(3) since any refund the taxpayer claims would be computed according to Treas. Reg. § 301.6511(d)-2(a)(3).").

### 2. *Barred Item Increases Income*

Assume instead that Fading Fast understated Year-1 income by $20 and the statute of limitations for the IRS to assess additional Year-1 tax is expired. As a result, Year 1 involves both a timely carryback and a time-barred adjustment that *increases* income. The second rule of Rev. Rul. 81-88 instructs Fading Fast to reduce its carryback from Year 2 by the amount of that increase and apply the net carryback against reported Year-1 income. So Fading Fast reduces its $110 carryback by the $20 understatement, applies the $90 net carryback against $100 of reported Year-1 income, and receives a $31.50 refund (the tax effect of the $90 net carryback).

As an initial matter, Treas. Reg. § 301.6511(d)-2(a)(3) does not control the amount of Fading Fast's Year-1 refund in this example. This is because the Treas. Reg. applies only when a refund claim involves both a timely carryback and a time-barred adjustment. In this example, although Fading Fast's *refund year* involves a time-barred adjustment, its *refund claim* does not. Rather, because the time-barred adjustment in this example increases income, Fading Fast's refund claim is based solely on a timely carryback.[51]

Because Treas. Reg. § 301.6511(d)-2(a)(3) does not apply, the IRS must rest the second rule of Rev. Rul. 81-88 on some other authority. That other authority is *Lewis v. Reynolds*, which permits the IRS to consider time-barred adjustments that increase income when determining the amount of a taxpayer's refund.[52] In *Lewis*, the trustees of a decedent's estate filed a refund claim for the decedent's final tax year.[53] After reviewing the claim, the IRS allowed some additional deductions and disallowed others, the net effect of which was an increase in tax due.[54] Although the IRS did not assess that additional tax because the statute of limitations for assessment was expired, the IRS denied the refund claim.[55] The trustees argued that the statute of limitations barred the IRS from recalculating the amount of tax due.[56]

Holding for the IRS, the U.S. Supreme Court observed that when the IRS evaluates a refund claim, "the ultimate question . . . is whether the taxpayer has overpaid his tax."[57] To answer that question, the IRS may examine a taxpayer's return to determine whether an upward adjustment to income is warranted. If the assessment statute of limitations is expired, the IRS cannot assess additional tax for any upward

51. *Id.* (explaining that when a refund year involves both a timely carryback and a time-barred adjustment that increases income, "there is only a claim for refund based on a[n] NOL; the upward adjustment is not a claim for a refund").

52. 284 U.S. 281, 283 (1932); *see also* Comm'r v. Van Bergh, 209 F.2d 23, 24–25 (2d Cir. 1954).

53. *Lewis*, 284 U.S. at 282.

54. *Id.*

55. *Id.* at 282–83.

56. *Id.*

57. *Id.* at 283 (quoting Lewis v. Reynolds, 48 F.2d 515, 516 (10th Cir. 1931)).

adjustment that it discovers.[58] The IRS can, however, consider that upward adjustment in determining the amount by which the taxpayer has actually overpaid its tax.[59]

But if the rationale of *Lewis* authorizes the IRS to offset a carryback with a time-barred upward adjustment under the second rule of Rev. Rul. 81-88, then shouldn't the same rationale permit a taxpayer to preserve a carryback with a time-barred downward adjustment under the first rule of Rev. Rul. 81-88? Chief Counsel rejects this analogy and, citing the requirement in Treas. Reg. § 301.6511(d)-2(a)(3) that a timely carryback be the "first adjustment" in determining the amount of a refund, maintains the position in Rev. Rul. 81-88.[60]

Fading Fast now turns to determining the amount of the remaining Year-2 NOL. In the absence of Rev. Rul. 81-88, Fading Fast might think that because it absorbed $90 of the NOL when determining the Year-1 refund, it should treat that same $90 as having been absorbed when determining the remaining NOL. Under that rationale, Fading Fast would have a $20 NOL to use in the future.

Alternatively, Fading Fast might read Rev. Rul. 81-88 and think that the IRS wants taxpayers to apply § 172(b)(2) by reference to *reported* taxable income any time one of the three rules of Rev. Rul. 81-88 applies to determine the amount of the taxpayer's refund. Under that approach, Fading Fast would compare the $110 carryback from Year 2 to the $100 of reported Year-1 income and conclude that it has a $10 NOL to use in the future.

But here the IRS reverts to the default rule and applies § 172(b)(2) by reference to *correct* taxable income.[61] Why? Recall that the IRS applies § 172(b)(2) by reference to reported taxable income when Treas. Reg. § 301.6511(d)-2(a)(3) applies to determine the amount of a refund.[62] The IRS explains that when a taxpayer determines its refund under Treas. Reg. § 301.6511(d)-2(a)(3), the taxpayer must also determine its remaining NOL under the principles of Treas. Reg. § 301.6511(d)-2(a)(3)—that is, both determinations must ignore the time-barred adjustment.[63] But in this example the Treas. Reg. does not apply. While the refund year involves a time-barred adjustment, Fading Fast's refund claim does not. As a result, the IRS's rationale for applying § 172(b)(2) by reference to reported taxable income does not apply. Under the default interpretation of § 172(b)(2), Fading Fast compares the $110 carryback from Year 2 to the $120 of correct Year-1 income ($100 of reported income plus $20 of unreported income) and concludes that it has no remaining NOL to use in the future.

So where does all of this leave Fading Fast? In the aggregate, Fading Fast has $10 of net income ($100 of reported income in Year 1, $20 of unreported income in Year 1, and a $110 loss in Year 2) and pays $3.50 of tax. Therefore, notwithstanding the

58. I.R.C. § 6501(a) (Westlaw 2010).

59. *See* Comm'r v. Van Bergh, 209 F.2d 23, 25–26 (2d Cir. 1954).

60. *See* I.R.S. Chief Couns. Adv. 2012-15-008 (Apr. 13, 2012), *available at* 2012 WL 1240275.

61. *See* Rev. Rul. 85-64, 1985-1 C.B. 365.

62. *See supra* Part II.A.1.

63. *See* I.R.S. Gen. Couns. Mem. 38,292 (Feb. 22, 1980), *available at* 1980 WL 131356.

expired assessment statute of limitations for Year 1, the IRS has effectively recouped the tax due on Fading Fast's $20 understatement. Contrast this with the result when Fading Fast failed to report a $30 deduction: Fading Fast lost the benefit of the missed deduction.[64] In other words, while the IRS gets a second chance to correct mistakes in its favor, taxpayers do not.

*3. Barred Items Both Decrease and Increase Income*

This time assume Fading Fast fails to report $20 of income and a $30 deduction in Year 1. Assume also that the statute of limitations for the IRS to assess additional Year-1 tax and the statute of limitations for Fading Fast to claim a Year-1 refund due to the missed deduction are both expired. As a result, Year 1 involves a timely carryback and time-barred adjustments that both increase and decrease income.

The third rule of Rev. Rul. 81-88 instructs Fading Fast to reduce the carryback from Year 2 by the amount of any net increase in Year-1 income on account of the time-barred adjustments, and apply the net carryback against reported Year-1 income. In this example, there is no net increase in Year-1 income: the time-barred adjustment that decreases income (the $30 missed deduction) exceeds the time-barred adjustment that increases income (the $20 of unreported income). So Fading Fast applies the unadjusted $110 carryback against $100 of reported Year-1 income and receives a $35 refund (the total Year-1 tax).

Treas. Reg. § 301.6511(d)-(2)(a)(3) applies in this example because Fading Fast's refund claim involves both a timely carryback and a time-barred adjustment that decreases income. The fact that the refund year also involves a time-barred adjustment that increases income is of no consequence. Under these facts, the third rule of Rev. Rul. 81-88 is consistent with Treas. Reg. § 301.6511(d)-(2)(a)(3) because it instructs Fading Fast to apply the carryback as the first adjustment to determine the amount of the refund.

What about the remaining carryover? Should Fading Fast apply § 172(b)(2) by reference to reported taxable income or correct taxable income? Neither the courts nor the IRS has addressed this issue. But it seems likely that, under the facts of this example, the IRS would require Fading Fast to apply § 172(b)(2) by reference to reported taxable income. My reasoning here is twofold.

First, in the context of Rev. Rul. 81-88's first rule, the IRS asserts that when a taxpayer determines the amount of its refund under Treas. Reg. § 301.6511(d)-(2)(a)(3), the taxpayer must also determine the amount of its remaining NOL by applying § 172(b)(2) by reference to reported taxable income. As already discussed, in this example Fading Fast must determine the amount of the Year-1 refund under Treas. Reg. § 301.6511(d)-(2)(a)(3). As a result, consistent with the IRS's position in the context of Rev. Rul. 81-88's first rule, the IRS would likely require Fading Fast to determine the amount of the remaining NOL by applying § 172(b)(2) by reference to reported taxable income.

64. *See supra* Part II.A.1.

Second, applying § 172(b)(2) by reference to correct taxable income in this example would lead to the same result the IRS sought to avoid in connection with Rev. Rul. 81-88's first rule. In particular, it would allow Fading Fast to carry $20 of the NOL to future years ($110 NOL minus $90 of correct Year-1 income) after Fading Fast had already carried $100 of the NOL back to obtain a full refund of Year-1 tax under the third rule of Rev. Rul. 81-88. That would give Fading Fast the benefit of a $120 NOL when its actual NOL is only $110 (the $10 difference is the excess of the $30 missed deduction over the $20 understatement). As before, determining the remaining NOL by reference to correct taxable income would allow Fading Fast to recoup some of the missed deduction by double-dipping a portion of the Year-2 NOL.

Recognizing these two points, Fading Fast decides to apply § 172(b)(2) by reference to reported taxable income. As a result, Fading Fast compares the $110 carryback from Year 2 to the $100 of reported Year-1 income and concludes that it has a $10 NOL to use in the future.

But what if Fading Fast instead failed to report $50 of income and a $30 deduction in Year 1? Again, the third rule of Rev. Rul. 81-88 directs Fading Fast to reduce the carryback by the net increase in Year-1 income on account of the time-barred adjustments, and apply the net carryback against reported Year-1 income. Under the revised facts, the time-barred adjustments result in a $20 net increase in income ($50 of unreported income minus a $30 missed deduction). So Fading Fast reduces the $110 carryback by the net increase, applies the $90 net carryback against $100 of reported Year-1 income, and receives a $31.50 refund (the tax effect of the $90 net carryback).

What about the amount of the remaining NOL? Recall that when the refund year involves both a timely carryback and a time-barred adjustment that increases taxable income, the IRS applies § 172(b)(2) by reference to correct taxable income. Under the example in Part II.A.2 above, the combination of that interpretation and the second rule of Rev. Rul. 81-88 allowed the IRS to recoup the entire amount of the time-barred understatement. A similar result would occur here. Fading Fast would compare the $110 carryback to the $120 of correct Year-1 taxable income and conclude that it has no remaining NOL. In the aggregate, therefore, Fading Fast would have $10 of net income ($100 of reported income in Year 1, $50 of unreported income in Year 1, $30 of unreported deduction in Year 1, and a $110 loss in Year 2), pay $3.50 of tax, and have no remaining NOL to use in the future.

That is surely the result the IRS would want in this example. But recall that when the time-barred adjustments resulted in a net decrease in income, the IRS needed to apply § 172(b)(2) by reference to reported taxable income to prevent Fading Fast from double-dipping a portion of its NOL. The IRS has already taken the questionable step of interpreting § 172(b)(2)'s reference to "taxable income" to mean different things under different rules of Rev. Rul. 81-88. But would the IRS also try to interpret § 172(b)(2) in different ways under the *same* rule of Rev. Rul. 81-88? Although the answer is not entirely clear, it seems the IRS has some exposure here to taxpayers applying § 172(b)(2) by reference to reported taxable income—the taxpayer-favorable interpretation. If the IRS justifies applying § 172(b)(2) by reference to reported taxable income in the context of the first rule of Rev. Rul. 81-88 because Treas. Reg. § 301.6511(d)-2(a)(3) determines the amount of the refund, then the same reasoning should apply in the context of the third rule of Rev. Rul. 81-88.

### *B. Mistakes Before the Refund Year*

Rev. Rul. 81-88 does not apply when a mistake precedes the refund year.[65] This is because the refund year does not involve both a timely carryback and a time-barred adjustment. Rather, the refund year involves only a timely carryback.

Assume Fading Fast reports $100 of income and pays $35 of tax in Year 1, reports $60 of income and pays $21 of tax in Year 2, and reports a $110 NOL in Year 3. Assume further that the statute of limitations for Fading Fast to claim a Year-1 refund due to the carryback is expired, but the statute of limitations for Fading Fast to claim a Year-2 refund due to the carryback remains open.[66] Fading Fast files a refund claim for *Year 2* and, in reviewing the claim, the IRS discovers that Fading Fast made a mistake in its *Year-1* tax return.

While unusual, this fact pattern has arisen in litigation.[67] In the case of a carryback, the refund statute of limitations runs from the loss year (Year 3 in this example) rather than from the carryback year.[68] That means the refund statute of limitations should ordinarily expire at the same time for both Year 1 and Year 2. But if a taxpayer consents to extend the assessment statute of limitations for Year 2,[69] the ordinary refund statute of limitations for Year 2—as opposed to the carryback refund statute of limitations—remains open until six months after the extended assessment statute of limitations expires.[70] As a result, it is possible that the time for Fading Fast to claim a Year-1 refund due to the carryback could expire before the time for Fading Fast to claim a Year-2 refund due to the carryback.

#### *1. Barred Item Decreases Income*

Suppose Fading Fast's mistake is a failure to report a $30 deduction in Year 1. Assume also that the statute of limitations for Fading Fast to claim a Year-1 refund due to the missed deduction is expired.[71] As a result, while Year 1 involves a time-barred adjustment that decreases income, Year 2 (the refund year) involves only a timely carryback.

To determine the amount of the Year-2 refund, Fading Fast must first determine the amount of the NOL that it can carry from Year 3 to Year 2. Here again, the

65. I.R.S. Gen. Couns. Mem. 38,292; *see also* Rev. Rul. 81-88, 1981-1 C.B. 585.

66. *See* I.R.C. § 6511(d)(2) (Westlaw 2008).

67. *See* Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956); ABKCO Indus., Inc. v. Comm'r, 56 T.C. 1083 (1971); Springfield St. Ry. v. United States, 312 F.2d 754 (Ct. Cl. 1963).

68. I.R.C. § 6511(d)(2)(A).

69. *Id.* § 6501(c)(4)(A) (Westlaw 2010).

70. Rev. Rul. 65-281, 1965-2 C.B. 444.

71. *See* I.R.C. § 6511(a).

mechanics of § 172(b)(2) come into play. As in the context of carryovers, courts and the IRS interpret § 172(b)(2)'s reference to "taxable income" to mean correct taxable income.[72] Applying this interpretation, Fading Fast determines that its $110 carryback from Year 3 exceeds the $70 of correct Year-1 taxable income by $40.[73] As a result, Fading Fast can carry $40 of the NOL to Year 2.

Armed with this information, Fading Fast can now determine the amount of its Year-2 refund. Because Year 2 involves a timely carryback but not a time-barred item, neither Rev. Rul. 81-88 nor Treas. Reg. § 301.6511(d)-2(a)(3) applies. Rather, under the general refund rules, Fading Fast applies the $40 carryback against the $60 of Year-2 income and receives a $14 refund (the tax effect of the $40 carryback).[74]

If Fading Fast had instead applied the $110 carryback from Year 3 against the $100 of reported Year-1 income, there would be only $10 of remaining NOL to use in Year 2 and Fading Fast would receive only a $3.50 refund (the tax effect of the remaining $10 carryback). Therefore, when the missed deduction occurs before the refund year, applying § 172(b)(2) by reference to correct taxable income results in a larger refund for Fading Fast by preserving more of the NOL for use in Year 2.

#### 2. *Barred Item Increases Income*

Assume instead that Fading Fast understates Year-1 income by $20 and that the statute of limitations for the IRS to assess additional Year-1 tax is expired.[75] As a result, while Year 1 involves a time-barred adjustment that increases income, Year 2 (the refund year) involves only a timely carryback.

Here again, courts interpret § 172(b)(2)'s reference to "taxable income" to mean *correct* taxable income.[76] Applying this interpretation, Fading Fast compares the $110 carryback from Year 3 to the $120 of correct Year-1 income ($100 of reported income and $20 of unreported income) and concludes that it has no remaining NOL to carry to Year 2. As a result, Fading Fast receives no Year-2 refund.

## III. CONCLUSION

The rules that apply in the context of NOLs and mistakes in closed years are unintuitive and very fact dependent. Different rules apply to carryovers and carrybacks, and the rules vary depending on whether correcting a mistake increases or decreases taxable income in the closed year. It is, therefore, critical to understand the facts before embarking on an analysis in this area.

72. *See* cases and sources cited *supra* notes 26–27.

73. As discussed above, a taxpayer must first carry an NOL to the earliest possible year—usually two years before the loss year. I.R.C. § 172(b)(2) (Westlaw 2009).

74. *See* Springfield St. Ry. v. United States, 312 F.2d 754 (Ct. Cl. 1963). The IRS agreed with *Springfield* in I.R.S. Gen. Couns. Mem. 34,336 (Aug. 20, 1970), *available at* 1970 WL 22485.

75. *See* I.R.C. § 6501(a) (Westlaw 2010).

76. *See* Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956); ABKCO Indus., Inc. v. Comm'r, 56 T.C. 1083 (1971).

In the context of carryovers, courts have made clear that taxpayers and the IRS may adjust the amount of an NOL to reflect time-barred adjustments in the loss year.[77] The same is true when the time-barred adjustment occurs after the loss year.[78] Courts achieve that result by interpreting § 172(b)(2)'s reference to "taxable income" to mean *correct* taxable income.[79]

In the context of carrybacks, however, the rules are more complicated. When it comes to determining the amount of a taxpayer's refund on account of a carryback to a closed year, Rev. Rul. 81-88 provides that the proper treatment of a mistake in the refund year depends on whether correcting the mistake increases or decreases taxable income. According to the IRS, taxpayers must ignore mistakes that decrease taxable income and account for mistakes that increase taxable income.[80] As discussed above, the IRS grounds its position in this regard on Treas. Reg. § 301.6511(d)-2(a)(3) and *Lewis*.[81]

When it comes to determining the amount of the remaining NOL, however, the IRS stands on less solid ground. If correcting the mistake in the refund year increases taxable income, the IRS takes a position that is consistent with existing case law and requires taxpayers to apply § 172(b)(2) by reference to *correct* taxable income.[82] The same is true if the mistake occurs before the refund year, regardless of whether correcting the mistake increases or decreases taxable income.[83]

But if correcting the mistake in the refund year decreases taxable income, the IRS carves out an exception and interprets § 172(b)(2) by reference to *reported* taxable income.[84] This leaves the IRS in the tenuous position of interpreting the same statutory language to mean different things in different situations. It remains to be seen whether courts will agree with the IRS's approach.

77. *See supra* Part I.A.

78. *See supra* Part I.B.

79. *See supra* Part I.B.

80. *See supra* Part II.A.1–2.

81. Lewis v. Reynolds, 284 U.S. 281 (1932); *see supra* Part II.A.2.

82. *See supra* Part II.A.2.

83. *See supra* Part II.B.

84. *See supra* Part II.A.1.