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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTHERN CALIFORNIA DISTRICT,  
SAN FRANCISCO  
CC:WR:NCA:SF

FROM: DEBORAH A. BUTLER  
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Net Operating Losses Carried Back to a Year Discharged in  
Bankruptcy

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### LEGEND

Bankrupt =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

\$A =

\$B =

\$C =

\$D =

### ISSUES

Whether a net operating loss can be applied to a year discharged in bankruptcy.

### CONCLUSIONS

A net operating loss can be applied to a year discharged in bankruptcy.

### FACTS

The bankrupt filed individual income tax returns for Years 1 and 2. His Year 1 liability was \$A. For Year 2, he owed \$B in addition to his withholding in the amount of \$C.

The bankrupt filed a Chapter 7 bankruptcy petition during March of Year 4. He received his discharge during June of Year 4. No payments were made on the Years 1 and 2 tax liabilities by the bankruptcy estate. The tax debt for Year 1 was discharged. Year 2 was a priority tax year so it was not discharged.

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During March of Year 5, after the bankruptcy case was closed, the bankrupt untimely filed his tax return for Year 3. The Year 3 return showed a net operating loss in the amount of \$D. The bankrupt did not elect to forego the carryback period of the net operating loss pursuant to I.R.C. § 172(b)(3)(C).

The bankrupt is contending that the Year 3 net operating loss cannot be carried back to Year 1, because the Year 1 tax liability was discharged in bankruptcy. The bankrupt argues that the Year 3 net operating loss should be carried back to Year 2, a year in which it would produce a refund.

The revenue agent has taken the position that, pursuant to sections 172(b)(1)(A) and (b)(2), the Year 3 net operating loss should be carried back to the first of the previous three years, which is Year 1. When the Year 3 net operating loss is applied to Year 1, the entire net operating loss is absorbed. Therefore, the bankrupt's claim for refund for Year 2 must be disallowed.

#### LAW AND ANALYSIS

Pursuant to I.R.C. § 172, a net operating loss incurred by a taxpayer in a taxable year generally can be carried back and deducted from the taxable income of the three preceding years and deducted from the taxable income of the 15 succeeding taxable years.<sup>1</sup> The net operating loss deduction responds to a potential unfairness resulting from the fact that the income tax is based on an annual accounting period. As stated by the Supreme Court:

[The net operating loss rules] were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit 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.

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

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<sup>1</sup> Since its introduction into the Code in 1918, Congress has frequently changed the availability and length of the carryback and carry over periods. The periods specified are those in effect for Year 3.

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Outside the bankruptcy context, the Service may apply a net operating loss to a year which is barred from assessment by the statute of limitations in the course of calculating the tax for a non-barred year. Taxpayers on several occasions have argued that, where the statute of limitations for assessment has expired for a year in which a net operating loss has either been claimed or has been carried back to, the Service is barred from re-determining the tax for that closed year.

The courts have recognized that section 6501 generally requires that taxes be assessed within three years after a return is filed. However, the correct amount of taxable income or net operating loss may be determined for a year not in issue (whether or not the assessment of a tax for that year is barred) as a preliminary step in determining the correct amount of a net operating loss to a taxable year in issue. Section 6214(b); Calumet Industries, Inc. v. Commissioner, 95 T.C. 257, 275 (1990); Phoenix Coal Co., Inc. v. Commissioner, 231 F.2d 420, 421-22 (2d Cir. 1956).

In Phoenix Coal Co., the taxpayer carried back a portion of a 1947 net operating loss sufficient to wipe out the reported net income for 1945 and carried the remainder of the 1947 net operating loss back to 1946. The Service refunded the entire income tax for 1945 and a portion of the income tax for 1946. The Service later recomputed the taxpayer's 1945 income and determined the net income should have been higher. When the 1947 net operating loss was applied to the recomputed income for 1945, the amount of loss available to be carried back to the 1946 tax year was reduced. Therefore, a deficiency was determined for 1946. While the 1946 tax year was still open, the 1945 tax year was statutorily barred from assessment. The court held that it could consider facts relating to taxes of other taxable years in order to correctly determine the amount of taxes for the years in question, but that it could not determine whether the tax for any other taxable year has been underpaid or overpaid. The court held that the Service was not required to deduct the net operating loss carryback from the amount shown on the return for 1945, but could recompute the whole income for the earlier year using the loss as a credit. Phoenix Coal Co., 231 F.2d at 421-22.

In Calumet Industries, the taxpayer carried back a 1981 net operating loss to the 1979 tax year. The assessment period for 1979 was extended by agreement pursuant to section 6501(c)(4). The Service determined a deficiency for 1979, which was attributable in part to an adjustment of the 1981 net operating loss deduction. The assessment period for 1981 had expired when the net operating loss was adjusted for the 1979 year. The court stated:

It has long been held that we may determine the correct amount of taxable income or NOL for a year not in issue (whether or not the assessment of a deficiency for that year is barred) as a preliminary step in determining the

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correct amount of a NOL carryover to a taxable year in issue. The same principle applies regarding the carryover of an investment tax credit. (Citations omitted).

Calumet Industries, 95 T.C. at 274-75. See also Howard v. United States, 497 F.2d 1270 (7<sup>th</sup> Cir. 1974); Pacific Transport Co. v. Commissioner, T.C. Memo. 1970-41, vacated and remanded on other issues, 483 F.2d 209 (9<sup>th</sup> Cir. 1973).

The instant situation involving a discharged year can be compared to the cases involving barred years. The Service should be able to make adjustments to the discharged year to determine the correct tax for the nondischarged year.

The terms of the Bankruptcy Code do not bar the action taken by the Service in this case. Bankruptcy Code § 727(b) states that “a discharge ... discharges the debtor from all debts that arose before the date of the order for relief under this chapter.” Bankruptcy Code § 524 specifies that a discharge:

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727 ...

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, ...

Bankruptcy Code § 524(a)(1),(2).

Application of the net operating loss to the discharged Year 1 is not an “act to collect, recover or offset” the liability for Year 1. The Service is not attempting to collect or recover any tax for Year 1, nor is it attempting to offset a tax liability for another year against Year 1. Instead the application of the net operating loss carryback to Year 1 is the first step in the determination of the tax liability for Year 2, which is not discharged. Cf. Phoenix Coal Co., 231 F.2d at 422 (wherein the court specifically noted that there was no actual assessment for the barred year).

Furthermore, while a creditor is prohibited from collecting debts discharged in bankruptcy, the discharge only extinguishes the enforcement of the claim against the personal liability of the debtor. It does not extinguish the debt or the claim. Thus, the creditor can proceed against the debtor *in rem*. Johnson v. Home State Bank, 501 U.S. 410 (1992); In re Isom, 901 F.2d 744 (9<sup>th</sup> Cir. 1990); In re DiNatale, 235 B.R. 569 (Bankr. D. Md. 1999).

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Thus, the discharge does not extinguish the tax liability for Year 1. The Year 1 liability is not null and void for all purposes. Applying the net operating loss to the Year 1 liability in this case was a proper exercise of the Service's authority and not inconsistent with the bankruptcy discharge.

The Service can apply the Year 3 net operating loss to the Year 1 tax liability and disallow the Year 2 refund claim on that basis.

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