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Memorandum

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to: Large Business & International
Pre-Filing & Technical Guidance, Team 3
Team 3000
Maitland, FL

from: Jennifer Nuding Brock
Senior Attorney (Cincinnati)
(Large Business & International)

subject: Alternative Tax Net Operating Loss Absorption Rules

This memorandum responds to your request for assistance and legal advice regarding the issue set forth below. The Corporate Income and Losses Industry Practice Group has received several inquiries with respect to this issue and anticipates that the issue will continue to arise in numerous cases. Some commentators have written articles on the issue in which they adopt views that are contrary to our conclusions in this memorandum. For the reasons set forth below, we believe those articles reach incorrect conclusions.

ISSUE

Whether I.R.C. § 56(d)(1) modifies § 172(b)(2) by permitting alternative tax net operating loss (ATNOL) carrybacks and carryovers from years with respect to which a taxpayer made a valid § 172(b)(1)(H) election (“WHBAA year”) to be absorbed after all other ATNOL carrybacks or carryovers, regardless of when those ATNOLs were generated.

CONCLUSION

We believe that § 56(d)(1)(A) sets forth a limitation on the amount of an alternative minimum tax net operating loss deduction and neither directs nor permits taxpayers to utilize WHBAA year ATNOLs after ATNOLs that are incurred in years after the WHBAA year. Specifically, “appropriate adjustments in application of section 172(b)(2)” pursuant to § 56(d)(1)(B)(ii) do not include utilization of WHBAA year ATNOLs after all other ATNOLs.

LAW AND ANALYSIS

Section 172(a) allows taxpayers a net operating loss deduction (NOLD) in computing their regular income tax liability. Similarly, § 56(a)(4) allows taxpayers an alternative tax net operating loss deduction (ATNOLD) in computing their alternative minimum taxable income. The ATNOLD is in lieu of the NOLD.

Section 56(d) defines the ATNOLD for a taxable year as the NOLD for a year except that:

- (1) The ATNOLD cannot exceed an amount computed under § 56(d)(1)(A); and
- (2) In determining the amount of the ATNOLD,
 - (a) The NOL for any loss year is adjusted under § 56(d)(2), i.e., ATNOLs are used in lieu of loss year NOLs per § 56(d)(1)(B)(i); and
 - (b) In applying § 172(b)(2), “appropriate adjustments” are made to take into account “the limitation of” § 56(d)(1)(A) as directed by § 56(d)(1)(B)(ii).

The amount of the ATNOLD is determined in the same manner as the NOLD, except as modified by § 56(d). A taxpayer’s NOLD for a taxable year equals the aggregate of its net operating loss (NOL) carrybacks and NOL carryovers to that year.

Section 172(b) defines the components of an NOLD, i.e., NOL carrybacks and carryovers. Section 172(b)(1) sets forth the years to which an NOL is carried (unless a valid § 172(b)(3) election is made to forego the entire carryback period), while § 172(b)(2) provides the rules for how much of an NOL is carried to each year, i.e., how much of an NOL is utilized or absorbed.

Section 172(c) defines an NOL as “the excess of the deductions allowed by this chapter over the gross income.” Such “excess” is computed with the modifications set forth in § 172(d). Section 56(d)(2) sets forth additional adjustments to the NOL for purposes of computing the ATNOLD. For convenience, we call the NOL as modified by § 56(d)(2) the alternative tax net operating loss (ATNOL). The ATNOL for a loss year is carried back and carried over in accordance with § 172(b).

Section 172(b)(1)(A) provides the general rule that an NOL for any taxable year is an NOL carryback to each of the 2 taxable years preceding the loss year and an NOL carryover to each of the 20 taxable years following the loss year. Section 172(b)(1)(H) allows a taxpayer to elect an extended carryback period (3-5 years) for one “applicable NOL”, generally NOLs generated in 2008 or 2009. This extended carryback election was added to the Code by § 13 of the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984 (November 6, 2009) (“WHBAA”), hence it is often referred to as a WHBAA election.

Section 172(b)(2) provides that the entire amount of the NOL for any taxable year must be carried to the earliest of the taxable years to which the loss may be carried (unless a § 172(b)(3) election is made). The portion of the NOL that is carried to each of the other taxable years is the excess, if any, of the amount of the NOL over the sum of the taxable income for each of the earlier taxable years to which the NOL may be carried. The taxable income for the earlier years is computed with modifications specified in § 172(b)(2). One of those modifications is that the NOLD for a prior taxable year does not include the loss year NOL or NOLs from any years after the loss year. Accordingly, generally NOLs are absorbed chronologically, i.e., NOLs from earlier years are absorbed before NOLs from later years.

Like NOLs, ATNOLs are generally absorbed chronologically. This is because, like NOLs, ATNOLs are carried back and carried over pursuant to § 172(b). Section 56 does not contain any provisions that set forth different rules except § 56(d)(1)(B)(ii) which modifies the absorption or “ordering” rules of § 172(b)(2) “to take into account the limitation of” § 56(d)(1)(A).

Section 56(d)(1)(A) limits “the amount of” the ATNOLD. Generally, ATNOLDs can offset only 90% of alternative minimum taxable income (AMTI). WHBAA provided an exception to that rule. WHBAA year ATNOLs can offset 100% of AMTI in the years to which they are carried. Section 56(d)(1)(A) provides that “the amount of” the ATNOLD for a year shall not exceed the sum of:

- (i) The lesser of:
 - (I) The portion of the ATNOLD that is attributable to ATNOLs other than WHBAA year ATNOLs; or
 - (II) 90% of AMTI (determined without regard to the ATNOLD or the § 199 deduction); plus
- (ii) The lesser of:
 - (I) The portion of the ATNOLD that is attributable to WHBAA year ATNOLs; or
 - (II) AMTI (without regard to the ATNOLD or the § 199 deduction) minus (i) above.

The above computation reflects the 90% limitation for non-WHBAA years while allowing a WHBAA ATNOL to offset 100% of AMTI for any year to which it is carried. Section

56(d)(1)(B)(i) provides that the ATNOLD is computed using ATNOLs instead of NOLs, i.e., NOLs computed with the adjustments described in § 56(d)(2). Section 56(d)(1)(B)(ii) provides that in determining the amount of the ATNOLD “appropriate adjustments in the application of section 172(b)(2) shall be made to take into account the limitation of subparagraph (A),” i.e., the limitation of § 56(d)(1)(A).

Section 13(b) of WHBAA amended § 56(d)(1)(A)(ii)(I) to read as set forth above in order to effectuate Congress’ intent to suspend the 90% limitation on the use of any ATNOLD attributable to WHBAA year ATNOLs.¹ See, Joint Committee on Taxation, Technical Explanation of Certain Revenue Provisions of the Worker, Homeownership, and Business Assistance Act of 2009 (JCX 44-09), November 3, 2009 (“Joint Committee Print”). WHBAA did not amend § 56(d)(1)(B) or any portions of § 56 other than § 56(d)(1)(A)(ii)(I).

Articles by some commentators conclude that the amendments to § 56(d) made by WHBAA provide new ordering rules for absorption of ATNOLs. None of the articles analyzes the Code amendments in detail. In fact, one of them appears to erroneously cite to § 56(d)(2).² The articles state or infer that WHBAA created a new set of ordering rules where the WHBAA year ATNOL must be used after all other available ATNOLs, regardless of when those ATNOLs arose (i.e., even if they arose after the WHBAA year ATNOL), to effectively eliminate any remaining AMTI.

Although the articles do not cite to § 172(b)(2) or § 56(d)(1)(B)(ii), the authors appear to argue that § 56(d)(1)(A)(i) and (ii) either modify the provisions of § 172(b)(2) or should be considered “appropriate adjustments” to § 172(b)(2) under the authority of § 56(d)(1)(B)(ii). While we understand how a cursory reading of § 56(d)(1)(A) could lead a taxpayer to conclude that § 56(d)(1)(A) sets forth 2 components of the ATNOLD for a year, i.e.,

- (1) A WHBAA year portion, § 56(d)(1)(A)(ii), and
- (2) the portion attributable to years other than the WHBAA year, § 56(d)(1)(A)(i),

a closer reading of the statute and an understanding of the statutory scheme of NOLs and ATNOLDs clarifies that § 56(d)(1)(A) does not set forth a new “ordering rule” that permits WHBAA year ATNOLs to be absorbed after all other ATNOLs, regardless of the loss year of those ATNOLs.

Nothing in the statute states that the amount computed in § 56(d)(1)(A)(ii) is the amount of the WHBAA year ATNOL that is absorbed in a year or that the amount

¹ The Joint Committee’s Explanation of Provisions states that the 90% limitation is suspended on the use of any ATNOLD attributable to “carrybacks” of WHBAA year ATNOLs, however, the plain language of § 56(d)(1)(A) does not limit suspension of the 90% limitation to ATNOL carrybacks of the WHBAA year ATNOL.

² Section 56(d)(2) provides adjustments to NOL computations that do not appear to support the statements or conclusions in the articles.

computed in § 56(d)(1)(A)(i) is the amount of ATNOLs from other years that are absorbed. Instead, § 56(d)(1)(A)(i) and (ii) are components of a computation set forth in § 56(d)(1)(A) that limits **the amount** of the ATNOLD for a year. Section 56(d)(1)(A) provides that “the amount of” the ATNOLD for a year “shall not exceed the sum of” the amounts computed in § 56(d)(1)(A)(i) and (ii); it does not set forth any “ordering” or absorption rules or otherwise modify or supersede the provisions of § 172(b)(2).

Section 56(d)(1)(B)(ii) is the only statutory authority for altering the application of § 172(b)(2). WHBAA did not make any changes to § 56(d)(1)(B). Section 56(d)(1)(B)(ii) provides that “**in determining the amount of**” the ATNOLD for a year “appropriate adjustments in the application of section 172(b)(2) shall be made to take into account **the limitation** of subparagraph (A).” (Emphasis added) The limitation of § 56(d)(1)(A) is that “the amount of [the ATNOLD] shall not exceed” the sum of two amounts, computed under § 56(d)(1)(A)(i) and (ii).

Since enactment, § 56(d)(1)(B)(ii) has provided that any portion of an ATNOL that cannot be utilized in a particular year due to limitations of § 56(d)(1)(A) (*e.g.*, the 90% of AMTI limitation) may be carried over to other taxable years. It has done so by modifying § 172(b)(2). For example, § 56(d)(1)(B)(ii) as initially enacted provided that, for purposes of determining the ATNOLD, § 172(b)(2) was applied by substituting 90% of AMTI for “taxable income.” At that time the only limitation of § 56(d)(1)(A) was that the amount of the ATNOLD could not exceed 90% of AMTI. The Conference Report to the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2320, explained that since NOLs cannot offset more than 90 percent of AMTI “amounts disallowed by reason of this limitation may be carried over to other taxable years.” H. Conf. Rept. 99-841 (Vol. II), at II-262, 1986-3 C.B. (Vol. 4) 1, 262.

Since enacted by the Tax Reform Act of 1986, § 56(d)(1)(B)(ii) has been amended only once; it was amended to read as it does today by § 1702(e)(1)(A) of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (August 20, 1996), effective for taxable years beginning after 1990. That amendment was a technical correction to the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, which provided an alternative tax energy preference deduction (former § 56(h)) for taxable years beginning after 1990 and contained a conforming amendment to § 56(d)(1)(A) to take that energy deduction into account.³ The amendment clarified that the amount of the ATNOLD utilized in a taxable year is “appropriately adjusted” to take into account the amount of the special energy deduction claimed for that year (which was subtracted from 90% of AMTI to arrive at the ATNOLD limitation of § 56(d)(1)(A)), thereby preserving a portion of the ATNOL carryover by reducing the amount of the NOL utilized. See H. Rpt. 104-586, section 2 of 4 (May 20, 1996)(Explanation of Energy Tax Provision).

³ Section 56(h) was repealed for taxable years beginning after 1992 and conforming adjustments were made to § 56(d)(1)(A).

The legislative history of WHBAA does not support the commentators' assertions that WHBAA created new, complex, or unusual ordering rules for utilizing ATNOLs or that WHBAA year ATNOLs are absorbed after all other ATNOLs, regardless of the year in which the ATNOL was generated. WHBAA did not amend § 172(b)(2) or § 56(d)(1)(B)(ii); it amended § 56(d)(1)(A)(ii)(I). The "Explanation of Provision" in the Joint Committee Print explains that the 90% limitation for ATNOLDs is suspended with respect to any portion of the ATNOLD that is attributable to a WHBAA year ATNOL. It does not provide that WHBAA year ATNOLs are absorbed after all other ATNOLs. With respect to the ordering or absorption rules of § 172(b)(2), the "Present Law" section of the Joint Committee Print states "NOLs offset taxable income in the order of the taxable years to which the NOL may be carried," citing § 172(b)(2) as support.

The only exception to this rule occurs when the only ATNOL that can be used to reduce AMTI for a taxable year is a WHBAA year ATNOL that arises after an ATNOL that is subject to the 90% limit and that is ineligible to offset a portion of the AMTI as a result of that limit. For example, a taxpayer comes into existence in 2008. For 2008 the taxpayer has an ATNOL of \$200 and for 2009 the taxpayer has a WHBAA ATNOL of \$100. In 2010 the taxpayer has positive AMTI, before any ATNOL deduction, of \$100. In this case only \$90 of the 2010 AMTI can be offset by the 2008 ATNOL. The only ATNOL that can offset the remaining \$10 of 2010 AMTI is the 2009 WHBAA ATNOL. Under these circumstances the normal ordering rules of section 172(b)(2) must be altered so that \$10 of the WHBAA ATNOL is absorbed. However, this is the only circumstance in which alteration of the normal absorption rule applies.

In light of the statutory scheme of NOLs and ATNOLs and the lack of any evidence that Congress intended to change the way in which NOLs are absorbed, we believe that the commentators reach incorrect conclusions in their articles.

We have coordinated the above conclusions with the Office of Associate Chief Counsel, Income Tax & Accounting. If you have any questions or would like clarification, please contact Senior Attorney Jennifer Nuding Brock of this office at (513) 263-4901.

JAMES D. HILL
Associate Area Counsel
(Large Business & International)

By: _____
Jennifer Nuding Brock
Senior Attorney (Cincinnati)
(Large Business & International)

