

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Roberta Peterson
Internal Revenue Agent

from: Thomas F. Harriman
Attorney
(Large Business & International)

subject: NOL carryforward audit in taxable year for issue previously audited in taxable year

Taxpayer:

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Issue

Whether Exam can audit a net operating loss (“NOL”) carryforward from the taxable years reported on the Taxpayer’s federal income tax return for the taxable year when the issue was previously audited with respect to the taxable years and the Office of IRS Appeals conceded the issue in the taxable year in favor of the Taxpayer.

Short Conclusion

No. The audit of the NOL carryforward for the taxable year is effectively a “repetitive audit” and is prohibited under I.R.C. § 7605(b) where it is disallowing the NOL on the basis that the Taxpayer was operating a hobby business in the taxable years . A NOPA for the hobby business issue in the taxable years was issued and considered by the Office of IRS Appeals, which sustained the Taxpayer in full. While the examination of whether the Taxpayer is operating a business in the taxable year can proceed, the NOL carryforward cannot be

disallowed solely on the basis that Taxpayer was a hobby business for the taxable years .

Facts

The facts as you provided them to Counsel were as follows:

was incorporated and has carried on a business activity of investment management. operates as a hedge fund. 's incorporator and sole shareholder is "Taxpayer"), a former investment banker. is 's only officer. 's only client is pays fees to for investment management. is General Partner of , and there were limited partners for the years at issue, of whom include , as well as siblings, descendants, or trusts related to him. Approximately 39% of 's holdings consist of private investments rather than public companies traded on stock exchanges.

For the taxable years , has elected to be treated as an S-Corporation.

In , purchased a property in , for ("Vineyard"); this property includes a wine vineyard, owned by . It includes a main residence , guesthouse , caretaker's house , vineyard , and olive grove .

On , a notice of proposed adjustment ("NOPA") was issued to the Taxpayer disallowing all expenses and depreciation related to the Vineyard for the taxable years . The NOPA determined that the Taxpayer was running the Vineyard as part of a hobby activity and thus all expenses should be disallowed under I.R.C. § 183. Taxpayer submitted a protest and exercised his right to administrative review by the Office of IRS Appeals for the NOPA with respect to the taxable years .

The Office of IRS Appeals heard presentations from both the Taxpayer and Service, as well as reviewing the Taxpayer's Protest and the Service's Rebuttal. Applying the nine factor test as articulated in Treas. Reg. § 1.183-2(b) for determining whether an activity is a business or a hobby, the Office of IRS Appeals concluded that all nine factors were in favor of the Taxpayer and sustained the Taxpayer in full with respect to the taxable years .

Taxpayer is now under audit for the taxable year . Among the issues involved in the audit are whether the Vineyard is a hobby or business activity under I.R.C. § 183 and whether the Taxpayer can deduct a NOL carryforward from the taxable years (“ NOL Carryforward”). The NOL Carryforward originates from losses the Vineyard incurred during the taxable years . Taxpayer argues that an examination of the NOL Carryforward stemming from previously audited taxable years is a violation of I.R.C. § 7605(b) as a repetitive audit. The Service has contacted for guidance.

Legal Analysis

I.R.C. § 7605(b) provides as follows:

No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

I.R.C. § 7605(b) imposes restrictions on two activities: (1) unnecessary examinations or investigations, and (2) more than one inspection of a taxpayer's books of account for a tax year. In construing the language of this section, courts have held that the prohibition against a second “inspection” must be read in *pari materia* with the opening clause of the section. As the Fifth Circuit Court of Appeals noted in United States v. Schwartz, 469 F.2d 977, 983 (1972), the first clause appears to be the original purpose for which the statute was enacted. See also United States v. Kendrick, 518 F.2d 842, 846 (7th Cir. 1975). In applying the restrictions of I.R.C. § 7605(b), courts have been reluctant to restrict legitimate investigations by the Service.

I.R.C. § 7605(b) first appeared as § 1309 of the Revenue Act of 1921, 42 Stat. 310. Congress designed this section in response to taxpayer complaints that revenue agents were subjecting them to onerous and unnecessarily frequent examinations and investigations. See H.R. Rep. No. 67-350, at 16 (1921). The purpose of the section is to relieve taxpayers from unnecessary annoyance. 61 Cong. Rec. 5855 (Statement of Sen. Penrose)(1921).

I.R.C. § 7605(b) was not, however, designed to prevent an agent from “diligently exercising his statutory duty of collecting the revenues.” Benjamin v. Commissioner, 66 T.C. 1084, 1098 (1976). Indeed, the Ninth Circuit Court of Appeals stated in DeMasters v. Arend, 313 F.2d 79, 87 (9th Cir. 1963), that the grants of power in § 7601 (power to canvass districts) and § 7602 (power to examine books, records, etc.) “are to be liberally construed in recognition of the vital public purposes which they serve; the exception stated in § 7605(b) is not to be read so broadly as to defeat them.”

A similar case is Digby v. Commissioner, 103 T.C. 441 (1994). In Digby, the Service audited the taxpayer's 1987 tax year. Based upon estimates, the Service allowed a flow-through loss from an S Corporation in which the taxpayer owned an interest in the 1987 tax year. A different agent audited Digby's 1988 tax return and disallowed a flow-through loss from the same S Corporation due to a lack of basis. From the documents used in the 1988 audit, the second agent also proposed to disallow the 1987 flow-through loss because of a lack of basis. A notice of deficiency was issued for both years.

In the Tax Court proceeding, the taxpayer argued that the records used to audit and adjust the 1988 tax year were the same that were needed to audit the 1987 tax year. As such, a second examination of the 1987 books and records had occurred in contravention of I.R.C. § 7605(b). The taxpayer requested the Tax Court to declare the notice of deficiency invalid and to dismiss the action.

Judge Gerber of the Tax Court disagreed and stated:

... The precise question that arises here is whether inspecting records for a later year which results in adjustments for the earlier and already examined year constitutes a second inspection for the earlier year. Section 7605(b) concerns a second inspection for the same taxable year. Accordingly, where information is obtained by means of an examination of a later or different taxable year that affects an already examined year, it may not be a second inspection within the meaning of section 7605(b), even though the same records are inspected. (at 448) (Emphasis added).

The Court went on to discuss that in those situations where an issue is continuing in nature, the records underlying the particular item in question would have been the same no matter which of the two taxable years was examined. The taxpayer's position was that a review of all the records was required to determine what was used in a prior year examination and any such documents would need to be excluded from consideration. The Court held that this was not the purpose or intended result of section 7605(b). (at 449).

In conclusion the Court stated the rule it was creating:

It is clear that Congress did not intend to restrict the Commissioner from auditing subsequent years' transactions originating from the same records, even if those records had been inspected in connection with the audit of an earlier year. Although no court has previously addressed this particular variation regarding section 7605(b), we believe that the statutory meaning and intent is clear, and the circumstances here are not a second inspection of petitioner's 1987 records. Accordingly, respondent was not required

to provide written notice to petitioner of the intent to conduct a second inspection. (at 450).

The current situation, however, is vastly different from Digby. The Taxpayer in this instance was previously examined and issued a NOPA for the taxable years . The NOPA was sent to the Office of IRS Appeals for consideration, where the issue was sustained in full for the Taxpayer for the taxable years . Thus the Taxpayer's tax returns for the taxable years reflect that the Vineyard was a for-profit business activity that was allowed to deduct expenses and take losses for its operations during those years.

In the taxable year now at issue, , the losses from the previous taxable years are being carried forward as a NOL. This situation is far different than Digby where all the years at issue were included on the same notice of deficiency and the prior year previously audited was not sent to the Office of IRS Appeals for consideration post-NOPA issuance. However, in the present matter, the Service is disallowing the NOL carryforward on the basis that the Vineyard is a hobby activity; the same issue that was audited and sent to the Office of IRS Appeals for consideration. This is the "second examination" or "repetitive audit" that I.R.C. § 7605(b) was designed to protect against.

In a situation where the NOL Carryforward was being disallowed for other reasons, this would not be a second examination of the prior taxable years. As in Digby, a new issue in later taxable years can be audited by examining books and records that were subject to a previous audit. Again, this is not Digby. In auditing the NOL Carryforward for the taxable year , the Service is reexamining the prior taxable years on the question of whether the Vineyard is a business versus a hobby activity in contravention of I.R.C. § 7605(b).

Conclusion

For the reasons discussed above, it is our opinion that the audit of the NOL Carryforward for the taxable year is a repetitive audit as prohibited by I.R.C. § 7605(b) where the sole reason for such disallowance is that the Taxpayer's Vineyard was a hobby activity for the taxable years .

Our office will maintain its file on this case pending notification from you that it may be closed. If you should have any questions regarding this memorandum, please contact the undersigned at (312) 368-8772.

JUSTIN D. SCHEID
Associate Area Counsel
(Chicago, Group 3)

By: _____
Thomas F. Harriman
Attorney
(Large Business & International)