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To:

Cc:

Subject: 199 172 965 issue

This responds to your request for advice on the proper application of sections 199, 172, and 965 in a taxable year for which Taxpayer elects the one-time dividends-received deduction under section 965. The generalized fact pattern is as follows:

Taxpayer has in Year 2 an NOL in the amount of \$ that is available to carry back to Year 1, a year for which Taxpayer elects the benefits of section 965. In Year 1 Taxpayer has nondeductible CFC dividends (965 dividends reduced by the % dividends received deduction) in the amount of \$, \$ of other taxable income (prior to the NOL carryback deduction), and \$ of qualified production activities income (QPAI) that could give rise to a deduction under section 199 for income attributable to domestic production activities.

Apparently, Taxpayer asserts that it may claim a domestic production deduction under section 199 in Year 1. Because the taxable income limitation of section 965(e)(2)(A) does not permit Taxpayer to reduce its taxable income below \$, the amount of the nondeductible CFC dividends, Taxpayer argues that the section 199 deduction gives rise to a net operating loss in Year 1 that may be carried over to other years, citing the second paragraph of section 7.01 of Notice 2005-64. The company's tax computation program does not allow any section 199 deduction in this fact pattern.

For the reasons discussed below, we agree with the company that Taxpayer is not entitled to any section 199 deduction in Year 1.

The base for determining the section 199 deduction in any year is the lesser of QPAI or taxable income. Treas. Reg. §1.199-1(b)(1) provides that "the definition of taxable income under section 63 applies, except that taxable income is determined without regard to section 199" and certain exclusions. Section 63 defines taxable income as "gross income minus the deductions allowed by this chapter [referring to Chapter 1]." The net operating loss deduction under section 172 is included in Chapter 1. Accordingly, §1.199-1(b)(1) creates a stacking rule that the NOL carried back is taken into account for purposes of computing the taxable income base for the section 199 deduction. This stacking rule is illustrated in Example 1 in §1.199-1(b)(2).

Accordingly, in the generalized fact pattern, before the allowable deduction under section 199 is computed, the NOL carryback from Year 2 will operate to offset the \$ of other taxable income. However, the NOL cannot offset the \$ of taxable income attributable to the nondeductible CFC dividends. See section 965(e)(2)(A), which provides that the taxable income of any U.S. shareholder for any taxable year shall in no event be less than the amount of nondeductible CFC dividends received during the taxable year. Although taxable income cannot be less than \$, section 199 would permit Taxpayer to calculate a section 199 deduction as a percentage of \$, the lesser of taxable income or QPAI. As provided in the first paragraph of section 7.01 of Notice 2005-64, allowable deductions in excess of the taxable income floor will generally give rise to an NOL for the election year that may be carried to other years.

However, in this case Taxpayer cannot use its section 199 deduction to create an NOL because of section 172(d)(7), which was added to the Code in 2005 as a technical correction to the American Jobs Creation Act of 2004, which added section 965 to the Code. See section 403(a)(17) of the Gulf Opportunity Zone Act, P.L. 109-135. Section 172(d)(7) provides that the section 199 deduction is not taken into account in computing the amount of net operating loss sustained in a taxable year. The Committee reports state that “[t]he provision clarifies that the manufacturing deduction is not taken into account in computing any net operating loss or amount of any net operating loss carryback or carryover. Thus, the deduction under section 199 cannot create, or increase, the amount of a net operating loss deduction.” Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 4440, the “Gulf Opportunity Zone Act of 2005,” as Passed by the House of Representatives and the Senate.* (JCX-88-05), December 16, 2005, at page 78. The effect of allowing a section 199 deduction based on taxable income from nondeductible CFC dividends would be to create or increase the amount of an NOL for the section 965 election year, contrary to the restriction in section 172(d)(7). Section 1.199-1(b)(1) also provides that “the deduction under section 199 is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover.” In contrast, an NOL in the section 965 election year may include the amount of a section 170 charitable contribution deduction that is limited to an amount computed on the basis of taxable income, as illustrated in Example 2 of Section 7.04 of Notice 2005-64. This is because there is no provision in section 172(d) that restricts the section 170 deduction in the way that section 172(d)(7) restricts the section 199 deduction. The company does not follow this example, because they read section 965(e)(2)(B)(i) as precluding taxpayers from computing a charitable contribution deduction on the basis of nondeductible CFC dividends—if that amount of taxable income is not “taken into account” in computing the election year NOL, then it cannot give rise to a deduction that goes into the election year NOL. However, the Notice interprets this restriction only to back the nondeductible CFC dividends out of income for purposes of calculating the amount of the NOL in the election year, and not as limiting the amount of taxable income for purposes of calculating allowable deductions under other provisions of the Code. Accordingly, in our view section 965(e)(2)(B)(i) does not preclude the inclusion of a charitable deduction based on taxable income that includes nondeductible CFC dividends from giving rise to an NOL for the election year. Accordingly, in the fact

pattern described above, Taxpayer has \$ of taxable income and no net operating loss for Year 1, the section 965 election year. This conclusion is not in conflict with the first paragraph of section 7.01 of Notice 2005-64, because pursuant to section 172(d)(7), no section 199 deduction is allowed to enter into the computation of the NOL.

The second paragraph of section 7.01 of Notice 2005-64 is similarly not in conflict with this conclusion. This paragraph of the Notice describes the effect of the rule in section 965(e)(2)(B)(ii), providing that nondeductible CFC dividends are not taken into account in determining taxable income for the election year for purposes of the second sentence of section 172(b)(2), which applies in determining the amount of an NOL that is absorbed in a carryover or carryback year. The Notice states that the amount of the allowable NOL that is absorbed in the election year is limited to the excess of taxable income over the amount of nondeductible CFC dividends. This merely confirms that, consistent with the rule of section 965(e)(2)(A) prohibiting an NOL deduction from offsetting nondeductible CFC dividends in the election year, the NOL available for carryover or carryback similarly is not reduced by nondeductible CFC dividends in the election year. It is not inconsistent with the priority rule established in §1.199-1(b)(1) that bases the section 199 deduction on taxable income after taking into account the NOL deduction for the taxable year. In the fact pattern described above, although the entire Year 2 NOL is carried back from Year 2 to Year 1, the taxable income for year 1 is \$ in accordance with section 965(e)(2)(A). Further, \$ of the Year 2 NOL is absorbed in Year 1 and \$ remains available to carry forward to Year 3. There is \$ of Year 1 section 172(b)(2) taxable income because the Year 1 nondeductible CFC dividend and section 199 deduction, as well as the Year 2 NOL, are not taken into account in determining the Year 1 section 172(b)(2) taxable income. Thus, the Year 2 NOL is absorbed to the extent of the \$ Year 1 section 172(b)(2) taxable income. This paragraph of the notice does not address the computation of an NOL arising in the election year, which is governed by section 172 as modified by section 965(e)(2)(B)(i) and provides that the nondeductible CFC dividends are not taken into account in determining the amount of an NOL for the election year.

In the fact pattern described above, the taxpayer does not have an NOL for Year 1 because, pursuant to section 172(d)(7), section 199 deductions are not allowed in computing an NOL and the taxpayer does not have other deductions in Year 1 that exceed its Year 1 gross income. Nothing in the Notice would override the limitation on the section 199 deduction provided in section 172(d)(7), which was enacted with retroactive effect after the Notice was issued.

If you have any questions please call us.