



# tax practice and accounting news

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## Amending Closed Tax Years to Increase Carryovers

by Richard Malamud

Most CPAs occasionally have a tax question that seems so common that they assume it must occur all the time. The tax practitioner typically goes to the trusty *Master Tax Guide* or to the *Federal Tax Handbook* but surprisingly finds neither an answer nor even a discussion of the issue. Next stop, a coworker or a friend. The CPA begins by stating that he has looked everywhere and can not find the answer to a very simple question. What happens if a client's capital loss carryover from 1994 was understated by almost \$15,000, since the statute of limitations has already run on 1994? (This is a true story although the names have been eliminated to protect the innocent.)

Since the CPA finds himself perplexed by the question, his lucky tax associate who is equally puzzled devours the library in search of an answer. Being an accountant, the associate's first choice is Package X and the instructions for Form 1040X (Individual Amended Return), but neither helps. Then on to the instructions for Schedule D (capital gains and losses) and again, the associate finds no help. The next step, review one of the multi-volume tax services and several specialized books on individual tax, tax accounting, and tax controversy only to again find no obvious answer. There are, however, several cases and rulings that taken together make it clear that a closed year can be "amended." How is that possible?

### Confusion Abounds!

This same issue confronted an IRS agent as far back as 1981. The agent asked for help in answering a similar question, whether to allow an investment tax credit carryforward that although proper had not been claimed on a timely filed return or a timely amended return. The agent felt compelled to deny the proper carryover because the Internal Revenue Manual stated that:

(t)he credit must have been claimed on the original return or on a timely filed amended return or claim for the year the credit arose before a carryback or carryover can be honored. It is immaterial that... (the credit) could not have

been used in the credit year — the credit must have been tentatively claimed in the credit year.<sup>1</sup>

Given such a clear rule — no amended return, no adjustment — why did the IRS agent ask for clarification? Because the taxpayer obviously showed the agent that there were some cases and rulings that did not support the IRM's logical rule that once the statute of limitations had run, the year was closed. In fact, the IRS, to deny a taxpayer a tax deduction for which he or she was not entitled, had frequently reduced carryovers even though the original year was already closed.

The IRS, in a revenue ruling, denied a carryover when it reduced the original deduction of a charitable contribution carryover from a closed year because the amount claimed should not have been allowed; it was a gift of a future interest and therefore not a proper charitable contribution. Accordingly, the carryover of the charitable contribution was disallowed for any open year. The taxpayer, however, did receive the benefit of the deduction in the closed year, since it was too late for the IRS to audit that year (more than three years had passed). The effect of the ruling is to require carryforwards to be correct, as if the closed year had been

<sup>1</sup>GCM 38724, 1981 IRS GCM LEXIS 61, quoting the Internal Revenue Manual Supplement 45G-321, section 5.04.

### HIGHLIGHTS

**Amending Closed Tax Years to Increase Carryovers.** Professor Richard Malamud, Dept. Accounting and Law, California State University, Dominguez Hills, California, discusses a common problem: whether one can correct an understated carryover from a closed year and if there is any authority for doing so. 1295

**FASB and AICPA Ponder Use of Conservatism/Aggressiveness Terminology.** The terms "conservatism" and "aggressiveness" may become part of the accepted accounting and auditing vocabulary according to members of the Financial Accounting Standards Board and an AICPA task force. 1298

properly filed or adjusted by the IRS to reflect the disallowance of the improper deduction.<sup>2</sup>

This same principle has also been applied to ITC carryovers. Thus, where a taxpayer used part of a 1965 ITC carryover in 1966, 1967, and 1968 but was not audited until 1969, a revenue ruling concluded that even though 1965 was a closed year for statute of limitations purposes, since the property did not qualify for the original credit, the carryover could be disallowed in all open years.<sup>3</sup>

The theory in both of these rulings is that although the statute of limitations has run on the originating year, the proper calculation of the carryover from that year is "open" at least to the extent that it is being used to calculate tax or taxable income in an open year. A court has also agreed with this theory. In *Robert J. Reilly*,<sup>4</sup> the IRS audited the taxpayer's investment in a 1977 partnership and properly disallowed the loss and tax credits. The taxpayer properly claimed that the statute of limitations had run on the 1977 return as the IRS failed to get the taxpayer to sign an extension. The Tax Court held that the IRS had the authority to determine the proper tax in any open year.<sup>5</sup> Therefore, although it could not change the 1977 return, the IRS could eliminate both the loss carryforward and the tax credit carryforward, thus effectively allowing adjustments to a closed year.

Even stronger case support for the ability of the IRS to adjust a closed year can be found as far back as 1932, when the Board of Tax Appeals held that it is the duty of the IRS to consider all items in a closed year in determining the proper net operating loss carryforward. In that case, the IRS reduced the depreciation claimed in the closed year, and thereby reduced the NOL carryforward.<sup>6</sup> This same principle was used by the IRS to audit and adjust taxable income in a closed year when taxable income from that year was used as part of the long-forgotten income averaging calculation in an open year.<sup>7</sup>

### Taxpayer Adjustment of Closed Years

Given that the IRS can reduce NOL, charitable contribution, or ITC carryovers that were reported in a closed year, can the taxpayer use the same theory to increase or even create a carryforward from a closed year?

Suppose that a taxpayer reported a \$30,000 capital loss on the sale of stock on a timely filed 1994 return, having reported a sales price of \$10,000 and a cost of \$40,000. In preparing the tax return for 1998, the taxpayer discovered that the cost basis for the stock was \$55,000 (not \$40,000 as reported) because the original loss did not reflect \$15,000 of dividend reinvestments. Since the statute of limitations on the 1994 return ran on April 15,

1998, that return year was already closed by the time the taxpayer in 1999 determined that the capital loss was understated by \$15,000. What can the taxpayer do?

Let's assume that the taxpayer had only the one transaction for 1994 and no gains for the subsequent years. In that situation, the taxpayer will have used just \$3,000 per year and the only question is, can the capital loss be increased in 1998 for the additional \$15,000 basis that was not originally claimed in 1994? Since the IRS can reduce the carryforward if it's excessive,<sup>8</sup> it seems only fair that the taxpayer can do the same and increase the carryforward to the proper amount.

An appellate court in 1963 recognized that the taxpayer can use this theory to "amend" a closed year to increase a carryover from a closed year.<sup>9</sup> Two years later, the IRS issued a revenue ruling that seemed to agree that taxpayers can use this theory to "amend" a carryover even if the effect is to increase the carryover from a closed year.<sup>10</sup>

Although the case law and the revenue ruling that allowed a taxpayer to increase the carryover from a closed year to reflect the proper loss or deduction were from 1963 and 1965, it was still not clear whether this was the law. This may be due to the lack of articles in tax magazines as well as the lack of coverage in most tax books that should cover this subject. It might also be due to the fact that there is really no Internal Revenue Code section that specifically deals with this question. It was instead for the IRS and the courts to determine whether the original statute of limitations or the current year's statute of limitations controlled in the case of a carryover.

***There are several cases and rulings that taken together make it clear that a closed year can be 'amended.' How is that possible?***

It appears that at least one taxpayer was not clear on the law. Therefore a private letter ruling was requested. In that 1995 ruling<sup>11</sup> the IRS concluded that a taxpayer was not barred by the statute of limitations from recalculating and increasing the NOL originating from four years earlier. The effect of the ruling was to make clear that a taxpayer is allowed to make a retroactive adjustment to the NOL in the originating year if it affects an open year, even though no amended return is filed, accepted, or indeed permissible since the statute of limitations had run on that year.

The letter ruling clarifies the law and makes it clear that a taxpayer can adjust a capital loss carryover from a closed year, but only to the extent that the carryover affects an open year. In the above hypothetical the capital loss carryover could be increased by the \$15,000

<sup>2</sup>Rev. Rul. 77-225, 1977-2 C.B. 73.

<sup>3</sup>Rev. Rul. 69-543, 1969-2 C.B. 1.

<sup>4</sup>T.C. Memo. 1989-312, 89 TNT 133-14

<sup>5</sup>See section 6214(b).

<sup>6</sup>*Lord Forres*, 25 BTA 154 (1932).

<sup>7</sup>*Robert W. Unser*, 59 T.C. 528, 530-531 (1973). See also Rev. Rul. 74-61, 1974-1 C.B. 239.

<sup>8</sup>See *Clarence J. Simon*, T.C. Memo. 1960-34 (1960), and *Stephen J. Hajos*, T.C. Memo. 1964-328 (1964).

<sup>9</sup>*Springfield Street Railway Co. v. U.S.*, 312 F.2d 754 (Ct.Cl. 1963).

<sup>10</sup>Rev. Rul. 65-96, 1965-1 C.B. 126.

<sup>11</sup>LTR 9504032, 95 TNT 19-31.

additional basis that had not been reported on the original return.

How would the rule work if instead of reporting a \$30,000 loss in 1994, the taxpayer had actually reported no gain or loss, having sold the asset for \$10,000 and having reported a basis of \$10,000 rather than the proper basis of \$25,000 (the original \$10,000 plus the \$15,000 dividend reinvestment)? In that case, the taxpayer would be deemed to have used \$3,000 of the \$15,000 loss in 1994, even though that year was closed and the loss was never and can never be used. This reflects 1994 as if it were properly reported. The taxpayer can amend 1995 and later open years, to reflect the "proper" \$12,000 carryover from 1994, the closed year.<sup>12</sup>

#### List of Possible Adjustments From Closed Years

There are several areas in which individual taxpayers may have carryovers that they do not discover until the original year has closed. The following is a list of those items and possible reasons for the original error:

- capital loss carryovers (if the taxpayer failed to report a substantial nonbusiness bad debt or failed to report dividend reinvestments as part of the cost/basis);
- passive activity loss carryovers (where the activity was not reported or where additional deductions are found);
- charitable contribution carryover (finding a receipt after filing the return);
- NOL carryovers (where additional deductions are found); note, don't forget to adjust for the required carryback!;
- investment and other credit carryovers (where it is later determined that the property qualified for a credit);
- investment interest expense carryovers, after adjusting for net investment income (where the taxpayer forgot to trace the proceeds of a loan to the acquisition of investment property);
- alternative minimum tax credit carryovers (not having realized that one exists!);
- AMT NOL carryovers (for the same reason as regular NOL carryovers);
- home office deduction carryforward (if the taxpayer failed to claim the home office and the amounts were limited due to the net income test); and
- section 179 carryover of amounts expensed rather than depreciated (where there was a loss from the business in the prior year).

<sup>12</sup>See Rev. Rul. 81-88, 1981-1 C.B. 585, and Rev. Rul. 82-49, 1982-1 C.B. 5.

#### Procedure for Closed Years vs. Open Years

The cases, rulings, and tax return instructions are silent on what procedure should be followed by taxpayers who realize that they have understated or even failed to reflect a carryforward in a closed year that is available for a carryforward to an open year. Since there is no ability to amend a closed year, several possibilities exist. First, an amended return can be filed as an attachment to the open year to explain the "new" carryforward. Second, a statement can be included with the open year's return to explain why a new or an adjusted carryforward appears on the return. Third, the proper amount can be used on the appropriate line of the return, as if the prior year's return had been properly filed and no additional information given. This would be identical to what would occur if the prior year had been properly filed.

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According to one accountant, "I would probably list a newly discovered capital loss carryforward on Schedule D and put a statement in the return." The return should properly state that the capital loss carryforward from 1994 has been increased by \$15,000 to reflect additional basis caused by the failure to include dividend reinvestment of \$15,000 in the stock's basis when the loss was originally reported in 1994.

#### Conclusion

Taxpayers and their tax advisers correctly assume that the statute of limitations is usually three years. However, in the case of carryovers to open years, the taxpayer may have an opportunity to increase the amount of the carryover to reflect a larger amount if it is later discovered that the original carryover was understated. Unfortunately, this is a two-way street and the IRS may also reduce a carryforward if it determines that the carryforward amount is overstated, even if the origination year is now closed.

Richard Malamud, J.D., LL.M., CPA, is a professor, Dept. Accounting and Law, California State University, Dominguez Hills, California.

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