MITIGATING THE INCOME TAX EXPENSE OF A RETROACTIVE REVOCATION FOR EOS

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If an organization decides not to contest the underlying revocation issue, the goal should be to reduce the organization's tax liability to the greatest extent possible in the most efficient manner possible.

At times, the IRS can move extremely slowly.

That is an unfortunate fact of life for organizations that are either waiting for a determination or under examination. The Service's "deliberate" pace can result in many headaches. For instance, an organization awaiting a determination regarding its tax-exempt status may not be eligible to obtain certain funding or even engage in specific activities. For organizations that are subject to a prolonged examination, the consequences can be far more severe.

While the focus below is on organizations that receive a notice of deficiency after their tax-exempt status is retroactively revoked, the principles discussed apply to all entities that receive a notice of deficiency several years after the close of a tax period, including notices of deficiency that redetermine the amount of unrelated business income tax owed.

Background

In recent years, a large number of tax-exempt organizations have been subjected to highly contentious IRS examinations lasting four or more years. In some situations, those examinations were resolved in a non-adverse manner through which the organization retained its exempt status and was not subject to a redetermination of the amount of unrelated business income tax. In other situations, however, organizations had their tax-exempt status revoked or were subject to a redetermination of the amount of UBIT owed. Where the organization received a final adverse determination letter, the IRS would issue a revocation letter for the tax periods it had examined and then also issue a notice of deficiency based on the redetermined amount of tax owed for the revoked periods. Where the IRS redetermined the amount of tax owed, it would simply issue a notice of deficiency for the amount of the additional tax that it believed to be owed by the organization.

In a perfect world, the IRS would move efficiently and the issue would be fairly straightforward. In year 2, the IRS would examine a Form 990 filed in year 1, issuing a notice of determination in year 2. In this perfect-world scenario, the IRS adverse determination would affect only a single tax year—year 1—and the organization would be able to correct or challenge the determination in year 2. Here, the organization would be able to address the issues affecting year 1 while making any necessary corrections to its year 2 Form 990 and on future returns.

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Tax-exempt organizations, however, do not function in a perfect world.

When the IRS opens an examination, it usually does so for the earliest tax period for which an organization's statute of limitations is open, usually about three years before the date of the examination. Also, unlike the perfect-world scenario, IRS examinations that result in unagreed adverse determinations are rarely completed within a year. Contentious examinations that result in unagreed determinations frequently require IRS revenue agents to develop substantially more factual information. And when an examination is highly contentious, the organization subject to examination may be less cooperative in timely providing the IRS with requested information or may spend more time analyzing the information provided to the IRS, which will also result in delays. Not only will examinations require additional time, but the appeal of these examinations will require a substantial amount of time.

The result is an examination and appeals process that often lasts five or more years from the commencement of an examination, and a redetermination of the taxes from a period that began three years prior to the commencement of the examination. As such, in year 8, an organization may receive a notice of deficiency for year 1. This creates a great deal of uncertainty with respect to the intervening years, especially if the IRS did not examine those years, which usually means that the IRS did not obtain extensions of the statute of limitations for them. This in turn creates a great deal of uncertainty with respect to the amount of tax that would actually be due. Additionally, the manner in which the Service determines the amount of a deficiency upon revoking an organization's tax-exempt status often results in an inaccurate amount.

There is a big difference between the way the Service determines (1) a deficiency based on a redetermination of the amount of reported income—either unrelated business income reported on a Form 990-T or income tax reported on a taxable corporation's Form 1120—and (2) an assessment based on the revocation of an organization's tax-exempt status. Where the IRS issues an assessment based on a redetermination of the amount of income tax reported on a return, the amount of tax is the focus of the examination and the primary issue under consideration at the appeals level. As such, the amount of the assessment is likely to be known well in advance of the final IRS determination. Also, with respect to a redetermination of tax reported, the nature of the organization has not changed, so the IRS is merely addressing the manner in which certain information is reported, not changing the information itself. Finally, when the IRS makes a redetermination regarding unrelated business income, it uses the forms filed by the organization to determine the amount of tax owed.

When the IRS makes an assessment on the basis of a revocation, the assessment is far more complicated and, due to a variety of factors beyond the Service's control or knowledge, more likely to be inaccurate. By revoking the organization's tax-exempt status, the IRS is changing the very nature of the organization, as well as the purpose of the annual IRS filings the organization has submitted. Unlike examinations focused on UBIT issues, the amount of tax in revocation cases is rarely, if ever, an area of focus discussed with the IRS prior to assessment. Rather, the examination is solely focused on whether the organization should retain its tax-exempt status.

When the IRS revokes an organization's tax-exempt status, it is required to create a fictional Form 1120 using the information reported in the organization's Form 990. That fictional Form 1120 is used to determine the amount of the assessment. Many inaccuracies result from the difference between Form 990 and the hypothetical Form 1120 created from it. Form 990 is not prepared with an eye to the tax owed, and the organizations preparing it does not have any incentive to maximize its deductions. As such, any IRS assessment made solely on the basis of the information reported in a Form 990 is likely to understate deductions and so be inaccurate. This is discussed in greater detail below.

Loss period 'assessments.' A significant reason for inaccuracies in the amount listed in a notice of deficiency sent to a revoked taxpayer results because the Service cannot "assess" any tax on a loss period. Instead, the IRS is able only to assess taxes that are actually owed. As such, a notice of deficiency would be issued only for years in which an organization earned a net profit. Therefore, if the IRS revokes an organization's exempt status on the basis of an examination of three tax years, any assessment will be made only on the basis of the profitable years.

For example, if an organization that was revoked after an examination of three tax years reported a net profit of $10 in year 1, a loss of $25 in year 2, and a profit of $15 in year 3, the IRS would issue an assessment on years 1 and 3, and the notice of deficiency would state that the total amount of the tax owed is the amount of tax on $25. However, an assessment of tax on $25 of income would fail to account for the losses incurred in year 2, which could be used as a net operating loss (NOL) carryback and carryover, to eliminate the gains reported in years 1 and 3. Basically, because the IRS cannot assess a negative tax, the Service's notice of deficiency would simply ignore the existence of the second tax year, causing the Service's notice of deficiency to seek an incorrectly inflated amount of tax.

IRS examinations that result in unagreed adverse determinations are rarely completed within a year.

Some practitioners considering scenarios similar to the one above have argued that the Service's issuance of an inaccurate notice of deficiency under these circumstances is inappropriate and possibly evidence of malicious intent. The author does not believe this to be the case. As noted above, the Service is not able to issue a notice of deficiency for year 2 because, to put it most simply, there was no deficiency to notify the taxpayer about. Also, as the issuance of a notice of deficiency for years 1 and 3 requires the Service to first determine the appropriate amount of tax owed, the IRS must create a Form 1120 on the basis of the Form 990, as indicated above. When creating the Form 1120, the Service's primary goals are (1) to accurately determine the amount of tax owed in the period subject to the notice of deficiency, using the information available as of the time of the assessment, and (2) to determine the amount of the deficiency as expediently as possible. It is not the Service's goal, or even its role, to predict how an organization would use its available deductions, including NOL carryovers; such decisions should be left to the taxpayer.

Form 990 vs. Form 1120. Another factor that may cause the Service to attempt to assess more than the taxpayer actually owes is that the it is using information reported by a tax-exempt organization on a Form 990 information return to determine the amount of tax owed that would have been reported by a taxable entity on a hypothetical Form 1120. First, the purpose of the Form 990 is simply to gather a substantial amount of information about an organization. That information includes enough financial information to determine the approximate amount of tax that an organization would have owed if it was not exempt. Unlike the Form 1120, however, the purpose of the Form 990 is not to determine the actual amount of tax owed. Thus, an organization completing a Form 990 would not provide the Service with all of the information necessary to accurately assess an income tax. For example, Form 990 fails to capture all potential deductions, such as the NOL deduction. Organizations generally do not include an NOL carryover schedule with their Form 990. Such a schedule would be attached to a Form 990-T, if filed.

Second, by issuing a final adverse determination letter, the Service has changed the very nature of the organization and the purpose of its annual IRS filings. An organization preparing a Form 990 is, at the time of filing, exempt from federal income tax on related income. As such, the primary issue of concern for an organization is the relatedness of income, not the timing of the recognition of such income or the utilization of the maximum amount of deductions available to reduce such income. Since the very nature of the organization's existence would have changed, it is likely that the information reported on the organization's annual IRS filing would also have changed. An organization that receives no benefit from listing deductions on its tax filings is unlikely to spend the time and expense identifying all such deductions; however, a revoked organization that would benefit from such deductions is far more likely to undertake the effort to identify and report them. Due to the nature of the Form 990 and the purpose of organizations that file Forms 990, an assessment of tax based solely on the information reported on that form would probably be inflated from the actual amount of tax that would have been reported if the same organization had filed a Form 1120 as a taxable entity for the same period.

Finally, not only would an exempt organization filing a Form 990 be less likely to capture all potentially available deductions, but, at the time that its Form 990 was filed, such an organization may not have been able to take advantage of certain deductions to which it could have been entitled if it were a taxable entity filing a Form 1120. Therefore, by issuing a final adverse determination letter, the Service is not only changing the organization's motivation for taking certain deductions, but also changing the organization's ability to avail itself of additional potentially beneficial methods of taking deductions, which may reduce the total amount of income tax owed for any of the revoked periods.

Inaccuracy plus delay. When the IRS issues a notice of deficiency to an organization whose tax-exempt status has been revoked, the amount of the proposed assessment is probably inaccurate, a problem that is exacerbated by the length of time necessary for the IRS to actually issue a final adverse determination letter. For instance, consider a situation in which the IRS examines an organization's activities in year 1 but does not issue a final adverse determination letter until year 10. As it is the Service's general position to apply any revocation retroactively to the first day of the first year under examination, here the first day of year 1, a revocation on the basis of an examination of a single tax year will also result in the revocation of the organization's nine subsequent tax years. However, the statute of limitations for the assessment or collection of a tax is generally three years and, in the exempt organization context, it is the Service's practice to seek extension of the statute of limitations only on periods subject to examination. As such, it is possible that the IRS revocation of a ten-year period based on the examination of a single year will include the revocation of six tax years—year 2, year 3, year 4, year 5, and year 6—for which the statute of limitations has closed. This increases the likelihood that a proposed IRS assessment on the organization's year 1 would be incorrect, creating confusion and uncertainty with respect to the taxes for the years between the period actually examined by the Service and the period during which it issues its final adverse determination letter. Uncertainties and questions created by the Service's retroactive application of revocation to an exempt organization's tax years for which the statue of limitations has closed include: (1) what effect a Form 990 has on the Service's statutory period to assess or collect a tax, (2) whether the Service has the authority to revoke an organization's tax-exempt status for a period for which the statute of limitations has lapsed, (3) whether an inaccurate notice of deficiency issued solely on the basis of information reported in a Form 990 would result in a naked assessment, and (4) whether an organization may use losses incurred in periods subsequent to those subject to the notice of deficiency to offset taxable gains subject to the notice of deficiency.

Issue and analysis

The author's firm has seen several examples of the issue discussed in the scenario described above. What follows is an example of a common situation that will be used to analyze the effect, as well as ways to mitigate the impact, of the Service's issuance of a notice of deficiency on the basis of a final adverse determination.

Example. Assume the following:

1. In year 4, the Service opened an examination of year 1, year 2, and year 3.
2. The organization's Forms 990 reported a net profit in years 1 and 3 and a net loss in year 2.
3. The Service's examination and the administrative appeals process lasted seven years.
4. In year 11, the Service issued a final adverse determination retroactively revoking the organization's tax-exempt status as of the first day of year 1.
5. During the Service's protracted review of the organization's tax-exempt status, the organization continued to file its annual Forms 990.
6. During the Service's examination, the Service obtained an extension of the statute of limitations for the years examined—years 1, 2, and 3—but did not obtain an extension for any non-examined year—years 4 through 10.
7. Upon issuing the final adverse determination letter, the IRS issued a notice of deficiency for years 1 and 3 solely on the basis of the information reported in the organization's Form 990.
8. The deficient amount reported in the notice of deficiency was inaccurate and substantially greater than the actual amount of tax that would have been owed had the Service considered either the amount of the loss reported on the year 2 Form 990 or the amount of the available NOL carrybacks resulting from losses reported on the organization's Forms 990 for years 4 through 10.
9. As of the issuance of the final adverse determination letter, the statute of limitations had lapsed with respect to year 4, year 5, year 6, and year 7.

This Example raises several questions.

Form 990 and retroactive revocation. What is the effect of a filed Form 990 on tax periods subject to a retroactive revocation?

Generally, Section 6501(a) limits the period for which the Service may assess or collect a tax to within three years of the later of the date on which the return was filed or the last date on which the return was due. Section 6051(c)(4), however, provides that the parties can agree to extend the assessment period in a writing made before the close of the assessment period. To accomplish such an extension, the Service uses Form 872. In addition to extending the assessment period per an agreement between the parties, Section 6501(c)(3) provides that, where a taxpayer fails to file a return, the Service may assess the tax at any time. Thus, two situations permitting an extended statutory period for the assessment or collection of a tax include (1) a situation in which an organization agrees to extend the statutory period for the assessment or collection of a tax, usually accomplished by signing a Form 872, or (2) a situation where the organization fails to file a return with the Service.

In the Example above, it is clear that the statute of limitations for the collection or assessment of tax has not lapsed for years 1 through 3, the tax years for which the organization agreed to extend the statute of limitations by signing a Form 872. However, it is less clear whether subsequent periods not subject to the Form 872 are closed. The issue that must be addressed is whether an organization that files a Form 990 with the Service during years 4 through 7 has filed a return for purposes of Section 6501(c)(3) even though, upon revocation, a Form 1120 would have been required for such periods. In other words, is the Service able to avoid the limitations imposed by Section 6501 for tax years 4 through 7 by simply requiring the organization to file different returns for those periods in year 10? The answer is no.

For purposes of determining whether a return has been filed by a tax-exempt organization, Section 6501(g) provides that "[i]f a taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if such taxpayer is thereafter held to be a taxable organization for the taxable year for which the return is filed, such return shall be deemed the return of the organization for purposes of this section." Further, pursuant to Reg. 1.6033-2(a)(2)(i), an organization exempt under Section 501(a) that is required to file a return under Section 6033 "shall file its return on Form 990." Thus, in the scenario described above, if an organization determines that it is required to file Forms 990, and continues to do so for each year during the Service's examination before actually receiving a final adverse determination letter, the taxpayer will have filed a "return" for purposes of Section 6501(a), even though the return filed with the Service would not have been the return actually required after the issuance of the final adverse determination letter.

For purposes of determining whether it is an exempt organization required to file a Form 990, the organization needs to look no further than its initial determination letter from the IRS. As noted in Rev. Proc. 2014-4, an organization that receives a determination letter may generally rely on the Service's determination.[1] However, as discussed in Rev. Proc. 2014-9, the Service's "determination letter or ruling recognizing exemption may be revoked or modified by (1) a notice to the taxpayer to whom the determination letter or ruling was issued, (2) enactment of legislation or ratification of a tax treaty, (3) a decision of the United States Supreme Court, (4) the issuance of temporary or final regulations, or (5) the issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin."[2] As such, an organization recognized by the Service as an exempt organization may continue to rely on the Service's determination until one of the requirements of Rev. Proc. 2014-9 have been met—most often the issuance of a notice to the taxpayer in the form of a final adverse determination letter. In fact, until the IRS issues the final adverse determination, it will continue to recognize an organization as exempt under Section 501(a) and will also continue to require the organization to file annual Forms 990. Further, the Service will not accept a Form 1120 if filed by the organization prior to the Service's final determination, meaning that an organization that has received a proposed adverse determination letter cannot even file a Form 1120 until the Service issues the final adverse determination letter. As such, for purposes of Section 6501(g)(2), reliance on its initial determination letter is sufficient to determine that the organization is required to file a Form 990.

Therefore, in the Example above, for purposes of determining whether the statutory period for the Service's collection and assessment of taxes has lapsed for tax years 4 through 7, it is necessary to determine only whether the organization filed its annual Form 990 more than three years ago. If so, pursuant to Section 6501(a), the statutory period for assessment and collection will have lapsed.

Revocation beyond the statute of limitations. Can the IRS revoke an organization's tax-exempt

[1] Rev. Proc. 2014-4, 2014-1 IRB 125, § 13.01.

[2] Rev. Proc. 2014-9, 2014-2 IRB 281, § 12.

[3] This is very unlikely to happen and, if it did happen, it is very unlikely that it would be sustained.

status for periods outside the statute of limitations for collection or assessment?

It is unclear whether the closing of the statutory period of assessment or collection of taxes has any effect on the Service's authority to revoke an organization's tax-exempt status. Importantly, the Service's position is that the statutory limitations provided in Section 6501 limit only the Service's ability to "assess or collect" a tax and that the issuance of a final adverse determination by itself is neither the assessment or collection of a tax. Thus, it is the Service's position that Section 6501 does not preclude the Service from revoking an organization's tax-exempt status for any period.

This issue is interesting, though largely academic. At its essence, the Service's position is that there is no period for which it cannot revoke an organization's tax-exempt status. As such, though unlikely, it is conceivable for the Service to review and revoke and organization's tax-exempt status for periods that closed more than five or six decades ago. That would mean that no period would ever be safe from revocation, a fact that conceivably could harm the ability of organizations to rely on their IRS determination letters. This is more likely to be merely a theoretical issue than an actual issue, however, because the tangible harm resulting from the Service's revocation of an organization's tax-exempt status more than 50 years ago is fairly minimal and is unlikely to be significant enough to cause the organization to challenge the Service's determination in court.

The harm resulting from the Service's revocation of an entity's tax-exempt status is usually due to (1) the imposition of tax on the organization's income, (2) the organization's inability to obtain tax deductible contributions or the Service's decision to disallow deductions for contributions previously made by the organization's donors, (3) the disqualification of the organization from obtaining certain government grants or entering into certain agreements with the government, and (4) reputational. However, if the Service were to revoke exempt status for a period for which it can no longer collect or assess taxes, it is unlikely that the organization would suffer anything other than reputational harm. First, assuming that the organization timely filed its Forms 990, the IRS cannot assess taxes on the organization's income for the closed periods. Similarly, if the organization's donors timely filed their own tax returns, even if the Service were to attempt to deny the charitable contribution deduction taken by individual donors on their own returns,[3] the Service would be precluded from assessing or collecting any amount of tax from the donors. Finally, with respect to eligibility for grants or certain government contracts, if the IRS revokes an organization's tax-exempt status many years in the past, any contracts or grants for which the eligibility issue would be a problem would have been long since awarded.

Thus, unless an organization decided that the reputational harm was too serious to ignore, or that the principle at issue was too important, it is very unlikely that problems associated with this issue would ever be substantial enough to cause an organization to litigate the revocation of a long-closed period.

As the harm resulting from the revocation of a closed tax period is more theoretical than actual, there are no court cases that directly address this issue. There is one opinion that does come close, however. In *Christian Coalition of Florida*, 662 F.3d 1182, 108 AFTR2d 2011-7157 (CA-11, 2011), the Eleventh Circuit affirmed a district court's decision to dismiss a case without making a determination regarding the tax-exempt status of the Christian Coalition of Florida, Inc. (CC-FL). The case involved a determination by the Service denying the CC-FL's status more than 15 years after it filed for recognition as a Section 501(c)(4) organization. Upon receiving its adverse determination, the CC-FL filed Forms 1120 and paid taxes for each of the 15 years for which it had previously filed Forms 990, including periods for which the statute of limitations had closed, and the IRS issued a refund for two of those years. After the CC-FL filed its complaint in district court seeking a refund of the amount of the unrefunded taxes that it had paid and a declaration that it qualified as an exempt organization, the IRS refunded all of the amounts claimed by CC-FL because the statute of limitations had lapsed. Then the IRS moved to have the case dismissed for a lack of subject matter jurisdiction. Over the taxpayer's objections, the district court determined, and the appellate court affirmed, that despite the Service's revocation for the closed periods, upon the payment of the refund, the CC-FL refund suit was moot. Thus, although not expressly stated in the opinion, *Christian Coalition of Florida* can be understood to support the Service's position that Section 6501 limits only its ability to collect taxes related to periods for which the statute of limitations has closed, and does not preclude the it from actually revoking the exempt status of organizations for such periods.

Naked assessment? If the IRS issues an inaccurate notice of deficiency based solely on information reported in the organization's previously filed Form 990, is it possible to avoid the tax by arguing that the assessment is a naked assessment that is arbitrary and erroneous?

In general, the issuance of a notice of deficiency that is known to be incorrect may have a significant impact on the Service's ability to collect the amount of the deficiency provided in the notice. The issuance of such an erroneous deficiency notice, if deemed to be a naked assessment, may (1) shift the burden of proof from the taxpayer to the Service, (2) allow for the introduction of otherwise prohibited evidence during litigation, and even (3) preclude the Service from collecting any portion of the deficient amount.

As a general rule, a notice of deficiency issued by the Service "has the support of a presumption of correctness, and the [taxpayer] has the burden of proving it to be wrong."[4] Thus, when litigating the correctness of a notice of deficiency in Tax Court, the burden of proof is placed on the taxpayer.[5] The impact of the presumption of correctness is twofold. First, the burden of proof requires the taxpayer to introduce evidence refuting the Service's position to be successful in having the amount of the deficiency redetermined by the court. Second, due to the presumption of correctness, when considering whether to compel certain discovery, the Tax Court "will not look behind a deficiency notice to examine the evidence used or the propriety of respondent's motives."[6]

The presumption of correctness and the burden placed on the taxpayer can make litigation difficult. However, if the taxpayer can demonstrate that an assessment is arbitrary and erroneous, the presumption of correctness "fails where the Commissioner makes the assessment without any foundation or supporting evidence."[7] As such, the burden of proof shifts to the government, "where the assessment is shown to be naked and without any foundation."[8] Further, "proof that an assessment is utterly without foundation is proof that it is arbitrary and erroneous."[9] Thus, if the taxpayer proves that the notice of deficiency is arbitrary and erroneous, it may be possible to shift the burden of proof to the Service and allow for the introduction of evidence related to the Service's motives. Additionally, in rare circumstances in which the Service continues to assert the correctness of its deficiency irrespective of evidence introduced by the taxpayer showing otherwise, the Service's unsupported assessment may cause the court to rule that no portion of the deficient amount may be collected.[10]

In circumstances like those of the Example above, it is very unlikely that the Service's position will be deemed to be so "absurd" that the court will decide to disallow the collection of any portion of the amount listed in the notice of deficiency. First, a notice of deficiency that is issued after the revocation of an organization's tax-exempt status and on the basis of information provided to the Service in a Form 990 will be founded on the information reported in the Form 990. Section 6020(b)(1) allows the Service to execute a return if a taxpayer fails to make the return required by the Code. The Service has interpreted this authority to extend to the creation of substitute returns showing all of the income and gains from an information return but not showing any deductions, losses, or credits.[11] Therefore, it is the Service's position that an assessment based on a Form 1120 executed on the basis of a Form 990, though likely to be erroneous, is not arbitrary and will not be deemed to be a naked assessment that is "utterly without foundation" as discussed in *Janis*.

Second, to demonstrate that the notice of deficiency is erroneous, the taxpayer will need to introduce evidence showing the correct amount of the deficiency—i.e., the correct Form 1120 filed with the IRS. By introducing evidence that demonstrates the correct amount of the deficiency, the taxpayer is essentially taking the position that the deficiency amount is

[4] Welch v. Helvering, 290 U.S. 111, 115, 12 AFTR 1456 (1933).

[5] Tax Court Rule 142(a); See also, Helvering v. Taylor, 293 U.S. 507, 14 AFTR 1194 (1935) ("Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid").

[6] Greenberg's Express, Inc., 62 TC 324, 327 (1974).

[7] Page, 58 F.3d 1342, 1347, 76 AFTR2d 95-5488 (CA-8, 1995).

[8] Janis, 428 U.S. 433, 442, 38 AFTR2d 76-5378 (1976).

[9] *Id.*

[10] See Kohler Company, 468 F.3d 1032, 98 AFTR2d 2006-7983 (CA-7, 2006) (disallowing the entire amount reported in the notice of deficiency where the Service's position was deemed to be "untenable," the Service's argument was deemed to be "absurd," and the deficient amount listed in the notice of deficiency was deemed to be "undeniably excessive" and "arbitrary").

[11] CCA 200142024.

not $0; rather, it is merely the correct amount as reported in the Form 1120. As such, while it will help the organization dispute the notice of deficiency if it can demonstrate that the amount of the deficiency reported in the notice of deficiency is incorrect, it is unlikely that a court will determine the Service's position to be so absurd so as to render the entire amount of the deficiency uncollectable.

Closed-period NOLs. If the IRS assesses a tax on a period prior to a closed period, can the organization use closed period NOLs to reduce its taxable income for the open periods?

Though there is no published authority expressly stating that a taxpayer may carry back NOLs from closed periods to reduce the amount of tax owed in open periods, an analysis of the available authority supports the position that an organization that is revoked may use NOLs from closed periods to offset gains in open periods. Additionally, the author's experience working with the Service to address such issues supports the conclusion that the use of the closed-period NOLs is permissible.

Section 6214(a) grants the Tax Court jurisdiction to redetermine the correct amount of a deficiency. Pursuant to Section 6214(b), in redetermining a deficiency of income tax for any tax year, the court "shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency." Additionally, as of 2006, this section expressly provides that in redetermining a deficiency, "the Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims."

There are two implications of these provisions. The Tax Court has historically considered the correct amount of NOLs for closed periods when determining the amount of a deficiency for the periods before the court. In addition, if there is an overpayment for a period, and the time for seeking a seeking a refund or offsetting credit has passed as a result of a revocation of exempt status, the overpayment may be used to reduce a deficiency under the doctrine of equitable recoupment.

In applying Section 6214(b), the Tax Court has historically considered NOLs from periods not before the court in determining the proper amount of the deficiency at issue. Most significantly, in *ABKCO Industries,* 56 TC 1083 (1971) and *Robert J. Reilly,* TCM 1989-312 (1989), the Tax Court agreed that the Service was permitted to recalculate the income of a closed tax period for the purpose of determining the proper amount of NOLs that could be used to reduce the amount of taxable income for the open periods subject to the notice of deficiency. In these cases, the recalculated NOLs were substantially less than those reported on the taxpayers' return and the Tax Court was not persuaded by the taxpayers' arguments that it lacked the jurisdictional authority to consider the recalculated NOLs because the statute of limitations had closed. As such, the Tax Court has previously considered the impact of recalculated NOLs from closed periods in redetermining deficiencies under Section 6214(b).

In GCM 39458, 12/18/85, the Office of Chief Counsel concluded that, where an organization's exemption was revoked (or it was not recognized as exempt) and the organization was subject to income taxes, it was able to seek a refund for the barred overpayment of excise taxes. Focusing on the doctrine of equitable recoupment, Chief Counsel's office determined that the doctrine applied because the revocation resulted in the Service's inconsistent treatment of a single transaction and the taxpayer's becoming twice liable for taxes on the transaction. As such, the Office of Chief Counsel determined that the taxpayer could obtain a refund for the overpayment of income taxes resulting from the prior payment of excise taxes.

This goes to the heart of the issue presented in the scenario discussed above. First, in considering an organization's petition for redetermination, the Tax Court will have jurisdictional authority to consider NOLs from periods not subject to the notice of deficiency—year 2 and years 4 through 10. Additionally, the Tax Court has previously accepted the Service's argument, over taxpayer objections, that it should consider recalculated amounts of NOLs for closed periods in making its determination regarding the correct amount of income tax for which the organization is liable. Moreover, since the expansion of the doctrine of equitable recoupment to the Tax Court, the court's equitable authority to consider the organization's losses in closed periods is consistent with the Service's own interpretation of how the doctrine should be applied.

Putting it all together

Working with clients in circumstances similar to those described in the Example above, where the organization decided not to contest the underlying revocation issue, the goal of the author's firm was to work with the Service to reduce the organization's tax liability to the greatest extent possible in the most efficient manner possible. As the Service had already issued the notice of deficiency, the organization was left with no administrative remedies for addressing the inaccuracies reported in the notice of deficiency. That required the organization to either file a petition seeking a redetermination of the deficiency with the Tax Court or pay the amount of the deficiency and then seek a refund of the overpayment, potentially filing a complaint with the appropriate district court.

When advising organizations in this situation, the author's firm recommends that the organization file a correct Form 1120 for each of the open tax years subject to the notice of deficiency. In calculating the amount of tax due, the Forms 1120 should take advantage of all available deductions—including the losses incurred in year 2 as well as those incurred during the years for which the Section 6501 statutory periods had closed. After filing the corrected Forms 1120 with the Service, it would be advisable for the organization to file a petition with the Tax Court seeking a redetermination of the amount of the deficiency to the substantially reduced amount reported in its corrected Forms 1120, which should be attached to the petition.

When handling these cases, it is helpful to discuss the case with the Office of Chief Counsel attorney who is handling it for the Service as soon as possible after the petition is filed. If the Forms 1120 are complete and correct, the attorney for the Office of Chief Counsel, after having the returns reviewed for accuracy by the examining agent, will likely agree to accept the Forms 1120 as filed. Based on past experience, in as little as 90 days after filing a petition for redetermination with the Tax Court, the parties should be able to file a stipulated decision settling the case for the substantially reduced deficiency reported in the organization's Forms 1120.

Conclusion

The amount of a deficiency reported in a notice of deficiency that is issued on the basis of a final adverse determination letter is likely to be excessive because it will be based solely on information reported in the organization's Form 990 and will not consider all of the deductions available to the organization, including deductions for NOLs. As such, when receiving a notice of deficiency under such circumstances, an organization should consider filing a Form 1120 that corrects the Service's errors to reduce the amount of the deficiency. Moreover, where the amount of the deficiency provided in the notice of deficiency is substantially greater than the actual amount of the tax owed by the organization, the organization should consider seeking a redetermination of the amount of the deficiency by filing a petition with the Tax Court.

The Tax Court has the jurisdictional authority to correct the amount of the deficiency in the notice of determination and, based on the experience of the author's firm, attorneys from the IRS counsel's office are willing to work with taxpayers to quickly and efficiently resolve these issues where the taxpayer's position is well supported.