Statutes of Limitation on Assessment Magically Disappear

by Paul H. Frankel and Amy F. Nogid

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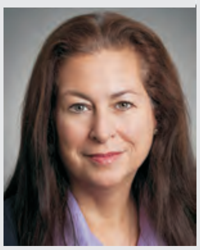

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In this article, the authors discuss federal limitations periods and some state positions regarding extended statutes of limitation and adjustments to source-year net operating losses. They also question the viability of long-standing federal precedents.

The U.S. Supreme Court has said statutes of limitation on assessment "in their conclusive effects are designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared."[1] States have several statutes of limitation:

- a standard period for assessing corporate income tax deficiencies — generally three or four years after the due date for filing the return;
- an unlimited period in cases of taxpayer fraud or failure to file a return;[2] and
- in many instances, an extended limitation period — generally five or six years — if there has been a substantial (usually 25 percent) understatement of tax, gross income, or state taxable income before or after apportionment (or some combination or variant thereof).[3]

In recent years it has become more prevalent for state tax authorities to avoid the conclusive effect of limitation periods by invoking an extended period of limitations by making discretionary adjustments or asserting that the taxpayer has engaged in fraud. Another tactic, which in substance eviscerates the protection to taxpayers of statutes of limitation, is to reduce the amount of source-year net operating losses available for carryforward as long as the application year is open to assessment. While revenue departments justify those adjustments on the basis of their being entitled to determine the "proper" amount of tax in a given open year, the practical impact often is to give tax departments up to a 20-year window — or the length of the carryforward period[4] — of opportunity to adjust taxpayers' NOLs in long-closed years.

Sometimes the reductions to source-year NOLs are made in years that had already undergone audits and are based on discretionary adjustment authority or on theories or positions that were not used by the revenue department during the source year. Sometimes taxpayers have benefited from increasing source-year NOLs or credits beyond the statutes of limitation for claiming refunds, but either taxpayers are missing out on opportunities or departments of revenue parsimoniously allow those adjustments — or both.[5] Given that the purpose of NOLs is to "ameliorate the unduly

[1] *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 301 (1946).

[2] State statutes of limitation may vary by tax type and are subject to change. Some state statutes also provide other limitation periods, such as for amended returns, for reporting federal changes, and for taxpayers involved in federal- or state-listed transactions. This article will not address unlimited statutes of limitation applicable to fraud or the failure to file returns. This article also does not address statutes of repose. As recently explained by the U.S. Supreme Court, although from a policy perspective statutes of repose and statutes of limitation substantially overlap, "each has a distinct purpose and each is targeted

(Footnote continued in next column.)

at a different actor." *CTS Corp. v. Waldburger*, 573 U.S. __ (2014). Statutes of limitation create a bar to suit that runs from the date the claim accrued, while statutes of repose place an outer limit on the right to bring an action. Further, statutes of limitation can be equitably tolled, but states of repose may not.

[3] Because of the variances in statutory language, it is important to review the particulars of the state provisions.

[4] A substantial majority of the states have a 20-year carryforward period, but there are periods of five, seven, 10, and 15 years. Practitioners should check the carryforward periods, which are often the target of temporary budget "fixes" effectuated by adopting suspension periods or limits to the amounts that can be claimed.

[5] *See*, *for example*, Ill. IT 99-0006-PLR; *Amber Inc. v. Wisc. Dep't of Taxation*, No. I-857 (Wis. Tax App. Commission 1946).

drastic consequences [to taxpayers] of taxing income strictly on an annual basis,"[6] the states' adjustments to NOLs in closed years to increase assessments in open years is particularly onerous. Federal changes may also provide an opening to states to make changes beyond those that flow directly from the federal changes, also raising fairness issues.

This article will discuss the background of federal tax statutes of limitation and extended statutory periods, NOLs for federal corporate income tax purposes, the genesis of the federal interpretation allowing adjustments to source-year NOLs, and some state positions regarding extended statutes of limitation, adjustments to source-year NOLs, and using federal changes to make assessments that would otherwise be time-barred. The article also questions the continuing viability of "long-standing" federal precedent, given the long NOL carryforward periods in vogue because of the constitutional issues raised by that tactic, and the propriety of using discretionary adjustments to thwart standard statute of limitations periods by the expansion of the statute of limitations period or stripping NOLs from closed years.

I. Federal Corporate Income Tax Statutes of Limitation

A federal corporate income tax — denominated an "excise tax" — was first imposed by Congress in 1909.[7] Assessments were required to be made "on or before the first day of June of each successive year," and the IRS commissioner was authorized to issue an assessment within three years of the due date of the return if a false or fraudulent return was filed.[8] After the 16th Amendment was adopted on February 3, 1913, the corporate income tax was included as part of the new income tax act (which also included the individual income tax), adopted on October 3, 1913; it contained limitations provisions for assessment similar to those in the 1909 act.[9]

In connection with the Revenue Act of 1934, the U.S. House Ways and Means Committee considered treating 25 percent omissions from gross income in the same manner as false or fraudulent returns were treated, which at that time were not subject to any assessment bar. The Senate Finance Committee thought the provision was too onerous because it could affect taxpayers making "honest mistakes."[10] A five-year limitations period was instead enacted as section 275(c). The 1939 code included without change section 275(c).

In *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958), the U.S. Supreme Court addressed whether section 275(c) applied if a taxpayer overstated its costs — in particular, when a taxpayer overstated the basis of the assets it sold, thereby reducing its reportable gain. The Court rejected the commissioner's argument that the extended limitations provision was intended to provide Treasury the right to assess "large errors."[11] Instead, the Court concluded that the provision's purpose was merely to provide an extended period for the commissioner to issue an assessment if Treasury was not provided "clues" regarding the taxpayer's tax position.[12] In determining the level of disclosure that would constitute a clue, many courts have taken the view that it is more than that which "would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact."[13]

However, Congress modified the extended limitation provision when it enacted the 1954 code. Section 6501(e) of the 1954 code now addressed "omission[s] from gross income," provided a six-year extended limitations period, and defined gross income for businesses as gross receipts before reduction for the cost of goods or services sold. However, the section limited the application of the extended period if the nature and amount of the omitted gross income were disclosed.

In *United States v. Home Concrete & Supply LLC*, 132 S. Ct. 1836 (2012), the Supreme Court rejected the IRS's attempt to overrule *Colony* and take an expansive view of the expanded limitations period by promulgating Treasury regulations providing that an overstated basis of an asset was an omission from gross income and the extended limitations would apply. The Court reiterated its earlier view, taken in *Colony*, that "omits . . . an amount" does not mean "reduces" or "understates." The Court also rejected the IRS's claim that use of the term "item" in one of the statute's subsections instead of "amount" supported the conclusion that the provision was focused on quantitative differences, saying that "this solitary word change in a different subsection is like hoping that a new batboy will change the outcome of

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[6] *Libson Shops Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

[7] Corporate Tax Act of 1909, P.L. 5-61.

[8] *Id.*

[9] P.L. 16-63.

[10] P.L. 73-216.

[11] *Id.* at 36.

[12] *Id.* "We think that in enacting section 275 (c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases when, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting 'gross income' or one, such as overstated deductions, affecting other parts of the return."

[13] *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336, 1347 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971). *See also Home Concrete & Supply LLC v. United States*, 599 F. Supp.2d 678 (E.D.N.C. 2008), *rev'd*, 634 F.3d 249 (4th Cir. 2011), *aff'd*, 132 S. Ct. 1836 (2012); *CC&F W. Operations Ltd. P'ship v. Commissioner*, 273 F.3d 402, 407 (1st Cir. 2001).

the World Series."[14] In invalidating Treasury's regulation, the Court also found that because statutory provision IRC section 6501 was not ambiguous, there were no "gaps for the agency to fill" by regulation.

II. Background: Using NOLs in Prior and Later Periods

Since the outset of the federal corporate income tax, the annual return concept has been used.[15] As most tax practitioners realize, the corporate income tax annual reporting period could easily be supplanted by either a more frequent or less frequent model.[16] Use of an arbitrary annual reporting regime fails to address unfairness because of shifts in income, which can adversely affect taxpayers subject to progressive taxes. Providing corporate taxpayers the right to offset their income with NOLs generated in prior or later years, albeit limited in scope, is one way Congress has offset the effects of income fluctuations.[17]

Even though the federal corporate income tax began in 1909, NOLs were not available to corporations until 1918.[18] The 1918 provision was intended as an averaging method to offer relief to taxpayers because of the "peculiarly bad conditions which resulted from the sudden termination" of World War I,[19] and allowed losses to be carried back and carried over for one year. Loss carryforwards for two years were allowed under the acts of 1921, 1924, 1926, and 1928.[20] The 1932 act reverted back to a one-year carryforward period.[21] The carryback was eliminated by the Revenue Act of 1921[22] and was not restored until 1942.[23] In 1933 the NOL carryforward was eliminated, and it was not reinstated until 1939, when a two-year carryforward period was again instituted.[24] The carryover averaging period was extended in 1950 to five years.[25]

With the enactment of the 1954 code, the basic NOL provision was placed in section 172, and provided for a two-year carryforward and five-year carryforward.[26] In 1958 the two-year carryback period was extended to three years.[27] The Tax Reform Act of 1976 extended the carryforward period to seven years for losses occurring after 1975.[28] A substantial extension of the carryforward period was made by the Economic Recovery Act of 1981; a 15-year carryover was allowed.[29] In 1997 the general carryback period was reduced to two years, but the carryforward period was substantially extended to 20 years.[30] In 2002 a temporary five-year carryback was allowed for losses occurring in 2001 and 2002.[31] In 2009 some eligible small businesses were allowed three-, four-, or five-year carrybacks.[32] NOLs now are generally available to be carried back for federal income tax purposes for two years or carried forward for 20 years.[33] Thus, during the more than century-long existence of the federal corporate income tax, the carryforward provisions have been modest in length, with the 1997 20-year carryforward a relatively recent development.

III. Federal Post-Limitations Period Adjustments to NOLs

The U.S. Tax Court held in *Ron Lykins Inc. v. Commissioner*, 133 T.C. 87, 99 (2009), that "it is well settled that the IRS and the courts may recompute taxable income from one year — even a closed year — in order to determine tax liability in another year." However, given that the cases that generated the purportedly "settled law" dealt with modest NOL carryover and carryback periods, it is time for the "settled law" to be reevaluated because of its adverse constitutional implications.

Phoenix Coal Co. v. Commissioner, 231 F.2d 420 (2d Cir. 1956), is often cited in state and other federal decisions as support for the proposition that the amount of available NOLs in a time-barred year can be reduced to determine the liability in an open year. *Phoenix Coal* involved the carryback of NOLs from 1947 to 1945 and 1946; at the time, the applicable NOL provision, IRC section 122, allowed for a

[14]132 S. Ct. at 1842.

[15]*See* Income Tax Act of Oct. 3, 1913, P.L. 63-16, section 2D; IRC section 441.

[16]The estimated tax payment requirement can be viewed as a departure from a strict annual report requirement. Further, many taxes require more frequent filings — for example, sales tax reports for large vendors.

[17]NOL carrybacks and carryforwards are also available to individual taxpayers. However, NOL use does not address the issue of fluctuating *incomes* and, arguably, is inherently arbitrary. From 1964 through 1986, Congress had allowed an individual taxpayer to elect income averaging if his income was sufficiently greater in the current year than over the average of his income over the preceding four years. P.L. 88-272, section 272, 78 Stat. 19, 105-12 (1964) (codified at IRC sections 1301-1305). Those income-averaging provisions did not, however, allow a taxpayer earning significant income in prior years to spread the income to lower-earning later years. Lower levels of inflation and decreased rate progressivity reduce the benefits of income averaging.

[18]Section 204 of the Revenue Act of 1918, P.L. 65-254.

[19]Blount Ralls, "Net Losses Under the Various Revenue Acts," 4 *Nat'l Income Tax Mag*. 93 (1926).

[20]Revenue Act of 1921, section 204; Revenue Act of 1924, section 204; Revenue Act of 1926, section 204; Revenue Act of 1928, section 117.

[21]Revenue Act of 1932, P.L. 72-154, section 117.

[22]P.L. 67-98, Ch. 136, section 204 (1921).

[23]Revenue Act of 1942, P.L. 77-753, ch. 619, section 153.

[24]Revenue Act of 1939, P.L. 76-155, section 211.

[25]Revenue Act of 1950, P.L. 81-814, ch. 994, section 215.

[26]P.L. 83-591 (1954).

[27]Section 203(a) of the Small Business Tax Revision Act of 1958, P.L. 85-866.

[28]P.L. 94-455, section 806(a) (1976).

[29]P.L. 97-34, section 207(a)(1) (1981).

[30]Taxpayer Relief Act of 1997, P.L. 105-34, amending IRC section 172(b)(1).

[31]P.L. 107-147, section 102(a) (2002).

[32]IRC section 172(b)(1)(H).

[33]IRC section 172(b).

two-year carryback and two-year carryover period. The IRS adjusted the taxpayer's 1945 income, which caused additional amounts of the 1947 NOLs to be applied to 1945, resulting in an assessment for 1946. Although the 1945 year was closed for assessment, the 1946 year was still open. The Second Circuit held that under the limitations statute, IRC section 275(a) did not apply to restrict the assessment for 1946, an open year.

The Second Circuit relied on a jurisdictional provision, IRC section 272(g), which authorized the Tax Court to "consider facts relating to taxes of other tax years in order to correctly determine the amount of taxes for the years in question, but not to determine whether the tax for any other tax year has been overpaid or underpaid." The court also relied on *Commissioner v. Van Bergh*, 209 F.2d 23 (2d Cir. 1954), another Second Circuit case that likewise involved the application of a two-year carryback period. The court reasoned that a taxpayer should be no better off by claiming a loss in an earlier or later period than in the year in which it is allowed as a deduction.

Other federal cases cited by state revenue departments to support modifying NOLs include *ABKCO Industries*,[34] when the IRS was allowed to modify the amount of the NOLs in 1964 available to be carried back to 1961 (a closed year); and *Johnson*[35] and *Lone Star Farms*,[36] which involved a carryback to the immediately prior year.

Because of the material expansion in the length of time NOLs can now be carried forward — 10 times the length of the period that was involved in *Phoenix Coal* — that decision is of dubious precedential value. To paraphrase the court in *Van Bergh*, a taxpayer should be no *worse* off because the deduction it claimed was made in a period now barred by the statute of limitations. The result — effectively adopting a 20-year statute of limitations period — was not an issue considered or decided by *Phoenix Coal.*

IV. State Positions Regarding Expanded Statutory Limitation Periods

Resorting to the expanded statute provisions, states have reopened years that the tax departments have already examined during prior audits, and they have issued assessments on positions and issues that were not pursued during the audit of the otherwise closed year. Sometimes the substantial understatement trigger is a discretionary adjustment, such as forced combination or a related-party deduction disallowance.

In addition to the issues of fundamental fairness raised by states' assertions of extended limitation periods, in many instances it is questionable whether states actually have the authority to extend the statute. Further, some states' extended statute of limitations provisions contain language strongly suggesting that the legislatures did not view changes to the otherwise closed years as required. For example, New Mexico's provision states that "if a taxpayer in a return understates by more than twenty-five percent the amount of his liability for any tax for the period to which the return relates, appropriate assessments may be made by the department at any time within six years from the end of the calendar year in which the payment of the tax was due."[37]

Further, some statutes provide that items or amounts that are adequately disclosed on the return are not to be considered in computing the percentage of the tax base used to determine whether the understatement percentage that triggers the extended statute has been met.[38] The Supreme Judicial Court of Maine considered Maine's two extended limitation provisions, one applicable to any tax if tax liability is understated by more than 50 percent and the liability is attributable to information that was required to be reported but was not reported, and another attributable solely to income tax if gross income is understated by more than 25 percent, and containing an exception if the taxpayer disclosed the amount omitted from the return.[39] The court rejected the taxpayer's argument that only the more specific provision applied, and concluded that because the provision of general applicability did not have a "clue test," the fact that the clue test might have been met under the income-tax-specific provision was irrelevant.

Even in the absence of an explicit provision, if the taxpayer disclosed its income and deductions on the face of its return in the otherwise closed year, and the revenue department had the opportunity to timely assess and simply chose not to do so, the extended statute of limitations should not be allowed to provide relief to the revenue department's own administrative inaction. Given the federal historical backdrop for the extended statute and most states' federal conformity, as well as equitable considerations, taxpayers may

[34]*ABKCO Indus. Inc. v. Commissioner*, 56 T.C. 1083, 1089 (1971), *aff'd,* 482 F.2d 150 (3d Cir. 1973) (cited in Ariz. Corp. Tax Ruling CTR 94-4).

[35]*Johnson v. Commissioner*, 41 T.C. Memo. 1980-435 (1980) (cited in *In the Matter of Davies Lake Hotel Inc.*, No. 802595 (N.Y.S. Tax App. Trib. 1989)).

[36]*Lone Star Farms Inc. v. Commissioner*, 61 T.C. 436 (1974), *aff'd without op.*, 510 F.2d 970 (3d Cir. 1975) (cited in *In the Matter of Davies Lake Hotel*).

[37]N.M. Stat. Ann. section 7-1-18(D).

[38]*See, for example*, Ala. Code section 40-2A- 7(b)(2)b(2); Cal. Rev. & Tax. Code section 19058(b)(2); Conn. Gen. Stat. section 12-233(a)(3); Hawaii Rev. Stat. section 231-40.5(b); 35 ILCS section 5/905(b)(1); N.Y. Tax Law section 1083(d)(2); R.I. Gen. Laws section 44-11-7.1(c).

[39]*Koch Refining Co. v. State Tax Assessor*, 724 A.2d 1251 (Me. 1999).

be able to argue that states should be prevented from circumventing the general statute of limitations, except in egregious situations. However, some courts have considered the issue and determined that the extended limitations period could be applied even in the absence of taxpayer culpability.[40]

It is important to review the language used in the underlying extension statute. Focusing on the statutory language enacted after *Colony*, the Wisconsin Supreme Court distinguished the federal statutory language from that used in the state statute enacted within a year of *Colony*, concluding that the taxpayer — who had said "none" as its net income properly assessable by Wisconsin — was subject to the extended limitations period.[41] Although the statute lacks language that would exclude disclosed items or income from consideration in determining whether to extend the time for assessment, the court still considered whether the taxpayer's return put the Department of Revenue on notice that it had income attributable to Wisconsin, suggesting that if the taxpayer had made adequate disclosure, the extension might not have been granted.

V. State Positions Regarding Adjustments to Source-Year NOLs

Adjusting NOLs that arose up to 20 years ago raises troubling issues. First, the taxpayer may have already undergone an audit in the loss-generation year, and by allowing an adjustment, states get a double bite of the apple with the additional administrative burdens and costs to the taxpayer that a second audit may entail.[42] Second, given that most state statutes provide that tax assessments are presumed correct and that the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made,[43] the effect of applying a 20-year statute of limitations may be to deny taxpayers their fundamental due process rights. Taxpayers may no longer retain the necessary documentation to establish that the adjustment is improper and, in fact, some states have explicit document retention requirements that do not extend 20 years.[44] Third is the real prospect of retroactive application of a new position against a taxpayer whose ability to defend itself may be severely compromised because of the passage of time. Those are the precise types of evils that statutes of limitation were meant to address.

Further, potentially applying a 20-year statute of limitations period to taxpayers with NOLs, while applying the standard three- or four-year statute of limitations period to income-generating taxpayers, results in disparate treatment violating the NOL taxpayers' right to equal protection. NOLs are valuable assets and, economically, stripping a taxpayer of its NOLs is no different from issuing an assessment.

The factual situations run the gamut, with some of the adjustments being more objectionable than others. For example, reducing the NOLs in an otherwise barred year when a single transaction was involved in both the assessment and NOL source year,[45] or a mere clerical error or uncontested adjustment is proposed,[46] may be more palatable than applying a new, contested position to the NOL source year, making adjustments when the taxpayer had already been subjected to a full field audit in the NOL source year, or asserting a position that is predicated on factual development and documentation that may be difficult if not impossible to produce because of the passage of time.

On the positive side, states taking the position that source-year NOLs can be decreased also allow NOLs to be increased.[47] Although the instances of NOL decreases appear to be more prevalent, taxpayers should consider possible upside potential when NOLs exist and may be used.

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[40] *See*, *for example*, *Taxation & Revenue Dep't of N.M. v. Bien Mur Indian Mkt. Cntr.*, 770 P.2d 873 (N.M. 1989), in which the court held that the six-year extended statute of limitations could be applied to a taxpayer that had not reported the gross receipts subject to tax, and that culpability is not required before the extended statute of limitations period can be applied. *See also Matter of Kid's Kountry*, No. 02-08 (N.M. Taxation & Revenue Dep't 2002), which concerns erroneous exclusion of receipts from return.

[41] *A.O. Smith Corp. v. Wis. Dep't of Revenue*, 43 Wis. 2d 420 (1969).

[42] Although taxpayers could also benefit from the extended period to increase the amount of the NOLs available for use in an open year, in practice taxpayers either do not often take advantage of that ability or the states have rejected those attempts. Generally, corporate taxpayers do not reevaluate their NOL source-year returns, believing that the amount of the NOLs is fixed. That practice should be reconsidered.

[43] *See*, *for example*, Ind. Code section 6-8.1-5-1(b).

[44] *See*, *for example*, Ark. Code Ann. section 26-18-506(b) (generally, retention period is six years after a return was filed); Colo. Rev. Stat. section 39-21-113(1)(b) (records to be maintained for four years after the due date or payment of tax); Conn. Agencies Regs. 12-2-12(i) (preservation required "for so long as the contents thereof may become material in the administration of the taxes . . . but in no event less than three years from the extended due date of the return"); Ind. Code section 6-8.1-5-4(b)(1)(2) (records to be kept for at least three years after the date that the final payment of the particular tax liability is due); 830 Mass. Regs. Code 62C.25.1(7) ("records must be preserved until the statute of limitation for making additional assessments for the period for which the return was due has expired," some exceptions noted).

[45] *See*, *for example*, *Turner v. Ala. Dep't of Revenue*, No. INC. 07-260 (Ala. Admin. Law Div. Jan. 29, 2008). In a personal income tax case, the 2002 NOL the taxpayer sought to carry over to 2003 and 2004 was entirely generated from a single questionable transaction.

[46] *Ala. Dep't of Revenue v. Turner*, No. INC. 90-248 (Ala. Admin. Law Div. July 24, 1991). Taxpayers did not dispute the technical accuracy of the department's adjustments.

[47] *See*, *for example*, *Turner v. Ala. Dep't of Revenue*, No. INC. 07-260; *Ala. Dep't of Revenue v. Turner*, No. INC. 90-248; Arizona Corporate Tax Ruling CTR 99-3; Ark. Corp. Income Tax Reg. section 1.26-51-427; *Appeal of E. Trading & Contracting Co.*, No. 93A-0825-PH (Cal. S. Bd. Equalization 1994); Idaho Admin. Code R. 35.01.01.201(02)(b); Idaho State Tax Commission Tribunal Ruling No. 16129 (2003); Idaho State Tax Commission Tribunal Ruling, No.

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Practically, however, taxpayers may be loath to raise the specter of historical tax return errors, given the concomitant possibility of further audit and loss of credibility. In *Amber*, the Wisconsin Tax Appeals Commission held that "correction of errors" made by the taxpayer in the loss year should be allowed because the year of application of the loss carryforward was open.[48] The taxpayer's NOL had been adjusted on audit in the source year and not protested, but the actual NOL was acknowledged by the DOR to be greater than the amount determined on audit. Although the dissent would have precluded an increase to the taxpayer's NOL because the audit assessment was final, the majority of the commission focused on the open NOL application year rather than the closed source year.

In one interesting case involving tax credits, *Smurfit Newsprint*, the Oregon Supreme Court held that the DOR could not recalculate the taxpayer's income and reduce the amount of credits available for carryforward to generate an assessment in an open year, because the statute regarding the use of credits provided that the taxpayer had the authority to determine how to use the tax credits.[49] The Oregon Tax Court refused to apply *Smurfit Newsprint* to limit Oregon's attempt to adjust depreciation deductions in a closed year because *Smurfit Newsprint* was limited to a state credit with no "'comparable context' in federal law."[50]

Another interesting case, *Harmon's of Idaho*, addressed whether the state's disallowance of NOL carryforward amounts (because those amounts first needed to be carried back) would permit the taxpayer to claim an offset against the assessment for the carryforward years.[51] The Idaho Supreme Court ruled that the three requirements for equitable recoupment — (1) there is a single transaction, (2) the transaction must be subject to two taxes based on inconsistent theories, and (3) there must be a statute of limitations bar — did not apply because the NOLs were not a single transaction and there were not two taxes being asserted based on inconsistent legal theories. The narrow view of the court regarding the scope of equitable relief is unfortunate, and it highlights the unfairness of adjusting NOLs in closed years.

As with the federal cases addressing adjustments to NOLs arising in closed years, the reported state cases have not involved adjustments to years significantly in the past. Thus, the propriety of allowing adjustments to NOLs in long-closed years has yet to be tested.

VI. State Positions Regarding Federal Changes

While some states' statutes of limitation are expressly tied to the federal statute of limitations period, often taxpayers have ongoing federal income tax audits even though their state statutes of limitation have passed.[52]

Although some state statutes expressly limit adjustments to those flowing from the federal adjustments, other statutes contain no limitation and have been held to allow any adjustments, regardless of whether there was a corresponding federal adjustment. For example, *American Brands*[53] addressed whether an amended return could be filed by a taxpayer to claim a refund after the statute of limitations for filing a refund claim had expired based on the issuance of a final determination by the IRS. The refund claim was unrelated to the federal changes, but was filed within the time allowed for filing amended returns after there had been a federal change. The court concluded that the statute, Virginia Code section 58-1118.1 (currently 58-1823), did not

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11418 (Idaho Tax Commission June 1997); *Dep't of State of Ill. v. ABC Bus.*, No. IT 11-07 (Ill. DOR 2011); Supplemental Letter of Findings No. 02-20100199 (Ind. DOR 2012); Letter of Finding No. 02-20090706 (Ind. DOR 2011); Letter of Finding No. 04-0262 (Ind. DOR Dec. 1, 2007); Letter of Finding No. 06-0076 (Ind. DOR 2007); Letter of Finding No. 02-0278 (Ind. DOR 2006); Letter of Finding No. 03-0112 (Ind. DOR 2006); Letter of Finding No. 87-24-2-0376 (Iowa DOR 1989); *In the Matter of the Appeal of Broce Constr. Co.*, 9 P.3d 1281 (Kan. Ct. App. 2000); Individual Income Tax — TY 2011 FAQs (Mont. DOR 2012); *In the Matter of Davies Lake Hotel Inc.*, No. 802595 (N.Y.S. Tax App. Trib. Jan. 20, 1989); N.C. Gen. Stat. section 105-130.8(b); *Consumer Direct, Inc. v. Limbach*, 580 N.E.2d 1073 (Ohio 1991); Order No. 94-06-23-026 (Okla. Tax Commission June 23, 1995); *Int'l Health & Life Ins. Co. v. Dep't of Revenue*, 5 Ore. Tax 320, 324-329 (Ore. T.C. 1973); *Pearce v. Dep't of Revenue*, No. TC-MD 100892C (Ore. T.C. 2011); Tenn. Revenue Ruling No. 96-14 (Tenn. DOR 1996); Va. Pub. Document Ruling, No. 94-154 (Va. Dep't of Taxation 1994); *Lake Wis. Country Club Inc. v. Wis. Dep't of Revenue*, No. I-5675 (Wisc. Tax App. Commission 1981).

[48] *Amber Inc. v. Wis. Dep't of Taxation*, No. I-857 (Wis. Tax App. Commission 1946). The Wisconsin Tax Appeals Commission has also allowed the department to reduce NOLs. *See*, *for example*, *Lake Wisconsin Country Club Inc. v. Wis. Dep't of Revenue*, No. I-5675 (Wisc. Tax App. Commission 1981).

[49] *Smurfit Newsprint Corp. v. Dep't of Revenue*, 997 P.2d 185 (Ore. 2000).

[50] *Pearce v. Dep't of Revenue*, No. TC-MD 100892C (Ore. Tax Ct. 2011).

[51] *Harmon's of Idaho Inc. v. Idaho State Tax Commission*, 760 P.2d 1156 (Ore. 1988).

[52] State law may provide that the state statute of limitation is also extended if the federal statute of limitation period is extended. For example, in *Arizona Department of Revenue v. General Motors Acceptance Corp.*, 937 P.2d 363 (Ariz. 1996), the Arizona Court of Appeals addressed the question whether Arizona could make changes to a taxpayer's income within the extended federal statute of limitations on assessment, even though no federal changes were issued. In *General Motors Acceptance Corp.*, the taxpayer had argued that the DOR could adjust its Arizona income only to the extent of asserting the state effect of federal changes. The court found the statute to be unambiguous and that the Arizona statute of limitations is automatically extended if a federal extension is entered into, "regardless of whether the federal audit yields any tax adjustment."

[53] *American Brands Inc. v. Department of Taxation*, 19 Va. Cir. 519 (1983).

limit its remedy to only those refunds that directly relate to the federal changes. The statute was later amended to provide, effective July 1, 1992, that "corrections to income tax returns are limited to changes or corrections to the federal taxable income."[54]

Similarly, in *Moorman Manufacturing*, the case known primarily for upholding as constitutional the use of a single sales factor on failure of proof grounds, the Iowa District Court held that the provision allowing the state to redetermine a taxpayer's liability within six months of a federal change applied regardless of whether the federal changes affected the taxpayer's Iowa liability.[55] However, the Iowa Supreme Court in *Kelly-Springfield Tire* rejected the DOR's broad interpretation that had been upheld in *Moorman*. It held that "unless certain enumerated circumstances have occurred which preclude the agency from making an accurate assessment of Iowa taxes within the three-year period its right of examination is barred" and, therefore, the extension only applies if adjustments made by the IRS result in a change to a taxpayer's Iowa tax liability.[56]

It is unfortunate that federal adjustments with no state tax implication can provide the wedge to open up the year to adjustments unrelated to the federal changes. Ideally, state statutes should limit state federal change reporting obligations to instances when the federal changes affect a taxpayer's state tax liability, and should limit state adjustments to those that flow from the federal changes. However, given that many states have provisions that are less than ideal, taxpayers should closely monitor the expiration of the federal statute of limitations in determining whether a year is closed for state adjustments, and states should carefully consider the potential impact on state liabilities of extending the federal statute of limitations.

VII. Concluding Thoughts: Limiting Prestidigitation

The case for limiting statutes of limitation in civil cases includes:

> (1) promoting repose (to allow peace of mind, avoid disrupting settled expectations, reduce uncertainty for the defendant and others, and reduce evidence preservation and insurance-related costs);
>
> (2) minimizing deterioration of evidence (to ensure accurate fact-finding and to reduce litigation costs);
>
> (3) encouraging the prompt enforcement of substantive law; and
>
> (4) avoiding the retrospective application of contemporary standards.[57]

With those goals in mind, in light of the recent trend of having long NOL carryforward periods, the federal precedent allowing recomputation of source-year NOLs — and the state decisions predicated on that precedent — needs to be revisited, as the scale now balances toward that practice, resulting in due process and equal protection violations. Until the problem is addressed, however, taxpayers should take advantage of opportunities to correct understatements of NOLs in years barred by statute for purposes of refund claims or assessments.

Likewise, some states' practice of extending the statute of limitations on assessments by relying on adjustments made under an exercise of their discretionary authority violates notions of fair play and justice, and is always improper. Further, that action amounts to a retroactive reopening of a closed statute and can have unanticipated and adverse financial reporting ramifications. Public corporations must comply with ASC 740 (formerly known as Statement 109, "Accounting for Income Taxes"), and must determine and disclose their potential income tax exposure regarding uncertain tax positions. States' attempts to extend statutes of limitation to collect additional tax could raise significant issues, because companies are unlikely to have set up reserves for those amounts. Taxpayers also should consider the federal statute of limitations and federal changes, and how they might affect the finality of their state returns to avoid unfortunate surprises.

Statutes of limitation on assessment and refund are critical to the effective administration of tax laws and should not be eroded by sleight of hand. Magic is best left in the hands of magicians. ✰

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[54] Ruling of the Tax Commissioner No. 93-71.

[55] *Moorman Mfg. Co. v. Bair*, No. CE3-159 (Iowa Dist. Ct., Polk Cnty., Dec. 17, 1976), *rev'd on other grounds,* 254 N.W.2d 737 (Iowa 1977), *aff'd*, 437 U.S. 267 (1978).

[56] *Kelly-Springfield Tire Co. v. Iowa State Bd. of Tax Review*, 414 N.W.2d 113 (Iowa 1987), *aff'd sub nom. Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19 (1988).

[57] Andrew J. Wistrich, "Procrastination, Deadlines, and Statutes of Limitation," 50 *Wm. & Mary L. Rev.* 607 (2008).