

Fishing Information Newsletter

News You Can Use from the Internal Revenue Service

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Message from the Editor

The offer in compromise article in this edition of the Fishing Information Newsletter (FIN) concludes our series on collection issues. Of course, we would be happy to address other collection issues that you may suggest. Just send us an email, write, or call. This newsletter also includes an article on net operating losses that we hope you will find helpful.

The November newsletter is the last that will be published under my editorship. The FIN is in the process of being transferred to the Taxpayer Education & Communications (TEC) section of the Small Business/Self-Employed Operating Division of the IRS. I'll talk more about this in the next newsletter. As a result, the October newsletter is longer than normal as we empty our vault of completed articles prior to the TEC transfer. If this FIN has more information than you want at one time, just file the newsletter and refer to it when the topics are germane to your situation. To make this easier, next month we will provide you with an updated FIN index. Also, the November FIN will contain an article about recommended record-keeping procedures to help you prepare for the filing of your 2001 return.

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Please send us your topic ideas and questions....

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Net Operating Losses – Tax Aspects for Individuals

*By George Bousseilaire, Revenue Agent
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With market conditions changing to the general detriment to fisher in recent years, a number of fisheries have experienced economic decline, and in some cases, closure. Accordingly, profits may trend to losses in some of these fisheries. When evaluating income for a given year, if business deductions exceed business income, a net operating loss (NOL) may result. This article focuses on NOLs as they apply to individual (Form 1040) tax returns. However, corporations (Form 1120) and estates and trusts (Form 1041) may also experience NOLs.

Carryback Period – For NOLs generated in tax years beginning after August 6, 1997 (usually 1998 returns and forward), you must carryback the entire amount of the NOL to the 2 tax years before the NOL year. Any remaining NOL can be carried forward 20 tax years after the NOL year. For NOLs generated in tax years beginning before August 7, 1997 (usually 1997 and prior returns), the carryback period was 3 years; the carryforward period was 15 years. In the **alternative**, you can choose **not** to carry back your NOL. If you make this choice, then you can use your NOL only in the 20/15-year carryforward periods.

Foregoing the Carryback Period – A decision that must be made for each NOL is whether to 1) carryback the NOL, or 2) forego the carryback period and carryforward the NOL only. Analysis of the following items may help you with this decision.

1) How much NOL will be absorbed in each carryback year & what will be refunded? *Example:* For the 2001 tax year a taxpayer has a \$25,000 NOL, which can be carried back to the 1999 and 2000 tax years. The taxpayer's 1999 tax year reflects the following:

Schedule C net fishing income – \$25,000

Adjusted gross income – \$31,775
Standard deduction (married filing joint) – \$7,200
Exemptions (4) – \$11,000
Taxable income – \$13,575
Income tax (from Tax Tables, joint rates) – \$2,036
Child care credit – \$960
Child tax credit (2 qualifying children) – \$1,000
Net tax before self-employment tax – \$76
Self-employment tax – \$3,532
Net total tax (incl. self-employment tax) – \$3,608

Carrying back the NOL for the 2001 tax year to the 1999 tax year will result in a \$76 tax refund. Assuming the only modifications required are those for exemptions, the taxpayer's modified taxable income available to absorb the NOL is \$24,575 (\$13,575 taxable income plus \$11,000 deduction for exemptions = \$24,575). This results in a \$425 NOL available to carry to the 2000 tax year. The NOL carryback decreases the 1999 taxable income to \$0, which results in \$0 income tax payable (excluding self-employment tax). The income tax previously payable was \$76 (excluding self-employment tax), which is the limit on the refund. The \$960 child care credit and \$1,000 child tax credit are no longer allowable since these credits are limited to the income tax payable for the year. As a result, the taxpayer absorbed \$24,575 of the \$25,000 NOL with a corresponding refund of \$76.

2) What are my income tax brackets in the carryback years and what are my expected income tax brackets for the carryforward years? Assume a taxpayer's income tax bracket in the carryback years is 15%, as in the preceding example. However, due to changing circumstances, the taxpayer anticipates that the \$25,000 NOL will offset income at the 28% tax bracket in the first carryforward year (2002). Also, the child care and child tax credits will still be fully available. In this situation, from a pure dollars and cents perspective, the NOL will result in a larger tax refund (or tax reduction) in the higher-tax-bracket carryforward year. The 2002 refund (or tax reduction) will be \$7,000 instead of \$76 if carried back. The reverse is applicable if the higher-tax-bracket years are the carryback years. In this situation, the larger refund will result if the NOL is carried back.

3) Time Value of Money. One factor to consider is the time value of money. This is especially true when the tax brackets between years are not expected to

vary significantly. Generally a refund is more valuable to you if you can receive it now (through an NOL carryback claim) instead of waiting to claim the deduction on future carryforward year returns. This applies to the example above where the taxable income was \$13,575. If the taxpayer's tax situation is expected to be similar in the carryback and carryforward years to which the NOL will be absorbed, then it is unlikely that the benefit of the NOL will result in a tax benefit much higher than \$76 in any given year.

4) Method in Obtaining Refund. When you wish to carryback your NOL, a carryback claim must be filed using Form 1045 (or Form 1040X if the Form 1045 time limits have expired). On the other hand, electing to forego the carryback is less complicated and less burdensome since no amended returns are required. Even though no amended returns are required, computations of the amount available to carryforward to each carryforward year are required.

5) Your Individual Needs. Your needs at the time you incur an NOL may outweigh all other considerations. For instance, you may have cash flow concerns and receiving an immediate tax refund by carrying back the NOL may outweigh the anticipated benefits, if any, of foregoing the carryback period.

Making the Election. If you decide that you wish to forego the carryback period, simply attach a statement to the NOL year tax return. The statement *must* show that you are choosing to waive the carryback period under section 172(b)(3) of the Internal Revenue Code. An example of an acceptable statement is as follows.

“We hereby elect to forego the NOL carry back period pursuant to Internal Revenue Code Section 172(b)(3).”

This election must be filed with a timely filed tax return (due date of return with extensions). If a return was timely filed but the statement wasn't filed with the return, you must file the statement with an amended return (Form 1040X) for the NOL year within 6 months of the due date of the original return (excluding extensions). For example, if the original due date was April 15th, the amended return must be filed by October 15th of the same year. Write “Filed pursuant to section 301.9100-2” on the statement. If you do not file this statement on time, you cannot

elect to forego the carryback period. In this situation, you **must** carry back the NOL before it can be carried forward. Also, once the election is made, it is irrevocable and cannot later be changed.

How to Figure an NOL – Typical items that contribute to NOLs are losses from a trade or business (Schedule C); farming losses (Schedule F); Schedule E losses from rental real estate, royalties, partnerships, and S corporations, trusts, etc.; personal casualty losses; and moving expenses.

If your taxable income is positive, you do not have an NOL for the year. If your taxable income is negative, you **may** have an NOL. It is likely that you have an NOL if your adjusted gross income is negative since expenses exceed income. However, a calculation must be done since there are rules that limit what you can deduct when figuring an NOL. In general, the following items are either not deductible (ND) or have limits (L) on the amount deductible:

1. Personal exemptions (ND)
2. Nonbusiness capital losses in excess of capital gains (ND)
3. Business capital losses in excess of capital gains (L)
4. The section 1202 exclusion of 50% of the gain from the sale or exchange of qualified small business stock (not excludible)
5. Nonbusiness deductions in excess of nonbusiness income (L)
6. Net operating loss deduction (ND)

The NOL calculation starts with adjusted gross income and arrives at the amount of the NOL, if any, by making the 6 modifications listed above. Both the instructions to Form 1045, *Application for Tentative Refund*, and Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*, contain very good instructions for making these modifications. We recommend referring to both, but Publication 536 contains more detailed explanations.

Included in the Form 1045 are two very helpful schedules. Schedule A computes the amount of the NOL, if any, for the loss year. Schedule B computes the amount of the NOL carryover in situations where the NOL isn't fully absorbed (used) in the first (or second or third, etc.) year to which it is carried.

Form 1045 vs. Form 1040X – As previously explained, an NOL can be carried back to prior years by filing Form 1045 or Form 1040X. You can get your refund faster by using Form 1045, but you have a shorter time to file it. You can use Form 1045 to apply an NOL to all carryback years. If you use Form 1040X, you must use a separate Form 1040X for each carryback year to which you apply the NOL.

Form 1045: Form 1045 must be filed on or after the date you file your tax return for the NOL year, but not later than one year after the NOL year. For example, if you are a calendar year taxpayer with a carryback from 2001 to 1999, you must file Form 1045 on or after the date you file your tax return for 2001, but no later than December 31, 2002.

Form 1040X: Form 1040X generally must be filed within 3 years after the due date, including extensions, for filing the return for the NOL year. For example, if you are a calendar year taxpayer and filed your 1998 return by the April 15, 1999, due date, you must file a tax year 1996 claim for refund, because of an NOL carryback from 1998, by April 15, 2002. Attach a computation of your NOL using Schedule A (Form 1045) and, if it applies, your NOL carryover using Schedule B (Form 1045), discussed earlier.

If the deadline is missed, you generally cannot receive a refund for the tax reduction resulting from the NOL carryback. However, in computing the NOL amount available to carry to other years, you must subtract the amount of the NOL that would have been used had a timely carryback claim been filed. If you missed this 3-year deadline, you still may be able to obtain a refund for the 1996 tax year to the extent you paid tax for the 1996 tax year within the 2-year period prior to filing the 1996 NOL carryback claim (as long as the tax for 1996 tax year hasn't been finally determined, by a Tax Court decision, for example).

Claiming an NOL Carryforward – If the NOL is carried forward, the amount should be entered as a negative number on the "Other income" line (line 21 for 2000). **It is not a Schedule C or Schedule A deduction.** You must attach a statement that shows all the important facts about the NOL. Your statement should include a computation showing how you figured the NOL deduction.

Miscellaneous Items – An NOL deduction can only be used to reduce income tax for a prior year and does not reduce such items as self-employment tax. If a tax reduction results, there is no provision to reduce any other items such as previously assessed penalties.

NOLs are a tax benefit item and are transferred to an individual's bankruptcy estate when the taxpayer files bankruptcy. The NOL may be reduced or eliminated as a result of debt forgiveness income. This applies when the debt forgiveness occurs as a result of a bankruptcy proceeding or in a tax year when the debt forgiveness is excludable from income due to the taxpayer's insolvency. Any remaining NOL when the taxpayer exits bankruptcy will revert from the bankruptcy estate back to the taxpayer. See Publication 908, Bankruptcy Tax, for additional guidance on these issues.

Finally, Publication 536 contains the instructions for the various NOL computations when a taxpayer has different filing statuses (or different spouses) in the NOL and carryback/carryforward years.

Offers In Compromise (OIC) – The Procedures Explained

*By Michael Mida, Revenue Officer
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What is an Offer in Compromise? An offer in compromise is an agreement between a taxpayer and the Internal Revenue Service that resolves the taxpayer's liability. The IRS has the authority to settle, or compromise, federal tax liabilities by accepting less than full payment under certain circumstances. There are three reasons why IRS may legally compromise a liability :

- 1) Doubt as to liability – Doubt exists that the assessed tax is correct.
- 2) Doubt as to Collectibility – Doubt exists that you could ever pay the full amount of tax owed.
- 3) Effective Tax Administration (ETA) – There is no doubt as to liability or collectibility (i.e. the amount owed is correct and you can pay the full amount owed), but an exceptional circumstance exists that allows us to consider your offer. To be eligible you must be able to demonstrate that col-

lection of the tax would be unfair and inequitable or would create an economic hardship.

If in your judgment you fall into one of the above three categories, the OIC program may be an option for you to resolve your federal tax liabilities. Extensive information about the OIC program and all forms you will need to submit an OIC can be found in Form 656, *Offer in Compromise*, booklet. There have been sweeping changes to the OIC program in the last several months. It is important that the most recently revised Form 656 and accompanying financial statements, with a revision date of May 2001, is submitted. You can obtain this booklet by calling 1-800-829-1040 or 1-800-829-FORM, by visiting your local IRS office, or by accessing our website at <http://www.irs.gov/>.

Are You Eligible for Consideration? Doubt as to Collectibility & ETA Offers – 1) You must have filed all required federal tax returns. 2) You cannot be involved in an open bankruptcy proceeding. 3) If you are in business, you must have filed and deposited all employment taxes on time for the two quarters preceding your offer as well as be current in depositing all taxes on time in the quarter you submit your offer. 4) You must submit a complete and correct Form 656 and the required financial information on the Collection Information Statement (CIS) that is furnished with the Form 656 booklet.

Additional Requirement for ETA Offer – Submit a detailed written narrative that explains your exceptional circumstances and why paying the tax liability in full would either create an economic hardship or would be unfair and inequitable.

Doubt as to Liability – 1) You must submit a complete and correct Form 656. 2) Submit a detailed written statement explaining why you believe you don't owe the tax liability you want to compromise.

Your overall history of filing and paying taxes will be considered in all offers.

If your offer involves the submission of a financial statement, verification of expenses you have claimed generally will be required. Be prepared to submit photocopies of all expenses claimed. If receipts are requested by IRS and you do not provide them

promptly, the IRS will reject your offer without right to any appeal.

How Do You Determine the Amount of Offer? – In all three forms of offers there must be an amount of money offered that exceeds 0\$. For Doubt as to Liability offers you should offer the correct amount of tax, penalty, and interest owed based on your judgment. For ETA offers you should offer the maximum amount you can pay that in your judgment will not create an economic hardship, and this should be explained in detail in your narrative. Doubt as to Collectibility offers are a bit more complex in this area. For this type of offer the amount must be greater than or equal to the "reasonable collection potential". This means that the amount you offer must be more than the "quick sale" value of the assets you own plus the amount that could be reasonably collected from your future income. The Form 656 package gives detailed instructions on how to figure your future income and the value of your assets.

Determining Payment Terms – The OIC program allows for three payment options.

- 1) Cash, which must be paid within 90 days of acceptance, is most agreeable to IRS.
- 2) Short-Term Deferred Payment – Payment is deferred, but must be fully paid more than 90 days and up to 24 months after acceptance. This allows some time for those taxpayers who wish to liquidate assets, such as a vacation home, to fund the offer. In the case of a fisher, permits or boats that are not detrimental to income can be liquidated to fund the offer during the deferral period.
- 3) Deferred Payment – Payment terms are made over the remaining statutory period for collecting the tax. The amount paid is less than the full amount owed and may involve many years of payments.

Note: We require full payment of accepted doubt as to liability offers at the time of mutual agreement of the corrected liability. If you are unable to pay the corrected amount, you must also request compromise on the basis of doubt as to collectibility.

The IRS could ask for collateral agreements as a condition to offer acceptance. An example of a collateral agreement exists in some areas of the Alaska fishing industry. In March 1989, the Exxon Valdez oil tanker spilled 11 million gallons of oil into the ocean from a tear in the hull. Many fishers could not fish as

a result of this tragedy. Litigation is still active to recover losses and punitive damages. In this example the IRS will require an assignment of the rights to the proceeds from such litigation, up to the amount of the original tax due, as a condition to acceptance.

Liens are released after the offer is fully consummated or fully paid.

If Your Offer is Accepted – An offer examiner will evaluate your offer and may request additional documentation from you to verify financial or other information you provide. Generally, all active collection activities by the IRS are put on hold while your offer is being considered. This includes the appeal period if your offer is rejected. If your offer is accepted, you will receive an acceptance letter. You then need to 1) promptly pay any unpaid amounts that become due under the terms of your offer agreement, 2) comply with all terms and conditions of your offer or collateral agreement(s), and 3) notify IRS of any address changes. Not filing or paying all future taxes in a timely fashion could result in the default of your offer and reinstatement of the full amount you previously owed. This applies to doubt as to collectibility offers, but not doubt as to liability offers. In certain cases the future compliance provision may apply to ETA offers. The IRS will keep any income tax refund you are entitled to in the year the offer is accepted (does not apply to doubt as to liability offers).

If any payment/deposit was made with your offer and the offer is rejected, these funds are generally refunded to you. However, if you provide written consent, the IRS will keep the offer deposit and apply it to your unpaid liability.

Two Recent Changes to the OIC Program – A presidential order was signed December 21, 2000, that made a number of technical changes to the IRS Restructuring and Reform Act (RRA) of 1998. One change for OICs processed after this date is that the collection statute of limitations is no longer suspended while an OIC is pending, during the 30 days following rejection of the offer, or during the appeal period.

Previously, offers were worked by local IRS offices in areas where the taxpayer resided. On July 23, 2001, this process changed. Offers are now sent to one of two centralized locations nationwide based

upon your geographic location. These addresses are provided in the Form 656 booklet. In most cases, offers will be worked to completion at these centralized locations. However, offers not meeting centralized criteria will be forwarded to respective local offices to be worked. All doubt as to liability offers are worked by local IRS offices.

Does This Float My Boat? There are some issues that arise that pertain specifically to the fishing industry. For instance, income from fishing varies greatly. It can be feast or famine. Offer examiners frequently will average income over several years to get a fair gauge of what the annual income truly is. If you have a special circumstance that has impacted your fishing success and it will likely impact your fishing in the future, you are encouraged to explain this in detail in an addendum attached to the Form 656. Examples of this could be the farming of salmon and its impact on the fisher's catch of wild salmon relative to the overall impact on the market and prices.

It is difficult to make an offer with just the funds you have in the bank. Remember, the offer must be for the quick sale value of your assets which includes your bank account as well as cars, boats, permits etc. As a result, many times the funding for an offer comes from a third party source. In the case of a crew member, a good source to look to is the skipper or owner of the vessel. If you have fished for them for a number of years, many skippers will pitch in and help if it means that the total debt to the government can be cleared. For those individuals that own boats and permits, special considerations may be afforded via an ETA offer. Although the value of such assets may enable a fisher to fully pay what he owes, liquidating the assets to fully pay the tax liability may create an economic hardship if they are fisher's only boat and permit. Private or governmental financial institutions may be willing to loan money on the permit and boat that may satisfy the IRS in an ETA offer.

The fishing season can often take a fisher away from home for extended periods of time. Keep in mind the OIC program is a negotiation process and receipts will very likely be requested. Since a lack of response can result in the rejection of your offer without right to appeal, you may wish to execute a power of attorney (IRS form 2848) to appoint an eligible individual to act in your behalf while you are absent. If you wish to handle matters person-

ally, then please take the initiative to contact your Offer Specialist when at port or near a phone.

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(800) 829-4059 TTY/TDD (Hearing Impaired)

Tax Forms and Publications

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IRS Internet Access

World Wide Web: www.irs.gov

The IRS Web Home Page allows convenient access to tax information 24 hours a day. The Web Site provides tax forms with instructions, publications, the latest tax law changes, and much more information for individuals and businesses.

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