

TAX UPDATE

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Losses and Choices—Stimulus Bill Net Operating Loss Rules

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Stimulus Bill

As you should be aware by now, the Congress on Friday passed the American Recovery and Reinvestment Act of 2009 (ARRA 2009) which contained a number of tax provisions in Division B of the Bill. The entire set of tax provisions can be downloaded from the House Rules Committee at:

http://www.rules.house.gov/111/LegText/hr1_legtext_crb.pdf

The explanation for that part of the bill is also available at:

http://www.rules.house.gov/111/LegText/hr1_cr_jesb.pdf

The bill has a large number of tax provisions, but rather than doing a rapid fire attempt to go through them all, I'm going to look at one provision today that may be of special interest as we are preparing returns for 2008—and that relates to the special rules for net operating losses. The bill provides for an elective extended net operating loss carryback provision for certain small businesses.

I. Net Operating Losses Prior to ARRA 2009

Net operating losses are governed by §172, with §172(a) allowing a deduction for the total of net operating loss carryovers and carrybacks to each year. Net operating losses defined at §172(c) as the excess of deductions over gross income, subject to the modifications found in §172(d). A number of special net operating loss treatment rules follow §172(d), items we'll generally not worry about today.

The key provision we'll look at is §172(b)(1), which is what is modified by this act. It gives us the general rule for the number of years such losses may be carried either forward or back:

(1) Years to which loss may be carried

(A) General rule

Except as otherwise provided in this paragraph, a net operating loss for any taxable year--

- (i) shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and
- (ii) shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss.

Note that carrying back the loss is, by default, required under the law. Since a taxpayer may expect to have greater income in the future, there is an option to waive that carryback period by election. That election is found at §172(b)(3), which provides:

(3) Election to waive carryback

Any taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. Such election shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss for which the election is to be in effect. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

A couple of key features to note about that election—it must be made by the due date, including extensions, to file the tax return for the year in question. If a taxpayer is late filing his/her return, the option to carryforward only goes away—the loss will need to be carried back.

As well, the election once made is irrevocable—so a taxpayer that has elected to waive the carryback cannot later change his/her mind and go back and recover old taxes.

These provisions prevent a taxpayer from doing what otherwise would be the most obvious way to handle the election—wait and see whether, in fact, a carryforward would turn out to be more valuable than the carryback. And simply delaying filing (so the return is filed) doesn't give a benefit.

II. ARRA 2009 Changes

ARRA 2009 adds a new provision for net operating losses. Both the original House Bill and the Senate Bill had net operating provisions, provisions that had certain differences. For instance, in the House bill a company that made use of the longer net operating loss period would have to reduce the loss, while in the Senate bill that haircut didn't take place. And neither bill limited the availability of the provision based on the size of a business.

The Conference Committee came up with a different net operating loss provision that's not quite like either chamber's original bill. This provision is going to create some issues for us, and will require decisions to be made in the next 60 days for some taxpayers.

A. The Longer Carryback

As it did with the bonus depreciation rules, the Congress looked back to a provision originally inserted in the law in 2002 to again attempt to provide a tax break to businesses that would serve to stimulate the economy. But this time Congress didn't just do a date modification to the provision. The 2002 §172(b)(1)(H), which still was in the law, simply said the following:

(H) In the case of a net operating loss for any taxable year ending during 2001 or 2002, subparagraph (A)(i) shall be applied by substituting "5" for "2" and subparagraph (F) shall not apply.

This time Congress created a much more verbose §172(b)(1)(H). It starts out defining the new longer period that will be applicable in some cases. §172(b)(1)(H)(i) provides:

(H) CARRYBACK FOR 2008 NET OPERATING LOSSES OF SMALL BUSINESSES.—

(i) IN GENERAL.—If an eligible small business elects the application of this subparagraph with respect to an applicable 2008 net operating loss

(I) subparagraph (A)(i) shall be applied by substituting any whole number elected by the taxpayer which is more than 2 and less than 6 for '2',

(II) subparagraph (E)(ii) shall be applied by substituting the whole number which is one less than the whole number substituted under subclause (I) for '2', and

(III) subparagraph (F) shall not apply.

Thus an eligible business will be able to select the number of years they want to carry losses back to. When combined with §172(b)(3) noted above, the choices will be:

- 5 years
- 4 years
- 3 years
- 2 years
- 0 years

Note the quirk that we can select any period going back five years except to limit it just to the prior year.

B. Applicable 2008 Net Operating Loss

Since the loss we can carryback under these rules is this new thing called an “applicable 2008 net operating loss” the definition of that term is the first thing we find as we read on in the new portion of the law. The definition is found at §172(b)(1)(H)(ii):

(ii) APPLICABLE 2008 NET OPERATING LOSS.—For purposes of this subparagraph, the term ‘applicable 2008 net operating loss’ means—
(I) the taxpayer’s net operating loss for any taxable year ending in 2008, or
(II) if the taxpayer elects to have this subclause apply in lieu of subclause (I), the taxpayer’s net operating loss for any taxable year beginning in 2008.

For calendar year taxpayers the above “pair” of years really represents the same year—the year beginning in 2008 is the same year as the one ending in 2008. But for fiscal year taxpayers there is a choice.

For full tax years, tax years as early as January 31, 2008 could be impacted by the carryback option, and the years ending as late as November 30, 2009 would also have the the option here. Fiscal year taxpayers can select one of two years.

As well, given the options noted above, there are a group of possible carryback options that will need to be considered by such taxpayers—five options for each year, with only one year being able to make use of a 3-5 year carryback.

C. Election and Limits

These are elective options, and we immediately discover there are limits on the use of this election, including the fact that this will be a one time only election. These limits are found at §172(b)(1)(H)(ii):

(iii) ELECTION.—Any election under this subparagraph shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extension of time) for filing the taxpayer’s return for the taxable year of the net operating loss. Any such election, once made, shall be irrevocable. Any election under this subparagraph may be made only with respect to 1 taxable year.

The election rules mirror those found at §172(b)(3) for electing out of a carryback entirely. So, once again, we have to make a choice by the extended due date and taxpayers who file late are going to be forced to take the two year carryback term.

D. Eligible Small Business

So who can claim this benefit? The definition of an “eligible small business” is found at §172(b)(1)(H)(iv) which provides:

(iv) ELIGIBLE SMALL BUSINESS.—
For purposes of this subparagraph, the term ‘eligible small business’ has the meaning given such term by subparagraph (F)(iii), except that in applying such subparagraph, section 448(c) shall be applied by substituting ‘\$15,000,000’ for ‘\$5,000,000’ each place it appears.

This provision cross-references two other provisions to obtain the definition. First, it looks inside this section at §172(b)(F)(iii) for the basic definition which provides:

(iii) Small business

For purposes of this subparagraph, the term "small business" means a corporation or partnership which meets the gross receipts test of section 448(c) for the taxable year in which the loss arose (or, in the case of a sole proprietorship, which would meet such test if such proprietorship were a corporation).

The gross receipts calculation is governed by §448(c), the provision that normally governs when a C corporation is forced to report on the accrual basis due to gross receipts. That section provides the following methods for computing the gross receipts:

(c) \$5,000,000 gross receipts test

For purposes of this section--

(1) In general

A corporation or partnership meets the \$5,000,000 gross receipts test of this subsection for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year does not exceed \$5,000,000.

(2) Aggregation rules

All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).

(3) Special rules

For purposes of this subsection--

(A) Not in existence for entire 3-year period

If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.

(B) Short taxable years

Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in

the short period.

(C) Gross receipts

Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.

(D) Treatment of predecessors

Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

Note that we need to substitute \$15,000,000 for \$5,000,000, but otherwise the rules above will apply for qualifying –that includes the rules for entities not around for 3 years (though, obviously, if they aren't around for three years there's little applicability to a longer carryback), and annualization requirements, inclusion of related entities and predecessors.

For most taxpayers, the issue is going to be for the three years prior to the year in question did the average gross receipts amount to less than \$15,000,000. Note that since two different tax years are involved for fiscal year taxpayers, a taxpayer could find that while they failed to qualify for the year ending in 2008, they might qualify for the year beginning in 2008 (or, less likely, vice versa—in the current climate the issue tends to be declining revenue).

E. Anti-abuse rules

While not part of §172 itself, the Act provides the IRS the right to enact anti-abuse rules. Act §1211(c) provides not only the right for the IRS to write anti-abuse rules, but also indicates the types of abuses Congress was concerned about:

(c) ANTI-ABUSE RULES.—The Secretary of Treasury or the Secretary's designee shall prescribe such rules as are necessary to prevent the abuse of the purposes of the amendments made by this section, including anti-stuffing rules, anti-churning rules (including rules relating to sale leasebacks), and rules similar to the rules under section 1091 of the Internal Revenue Code of 1986 relating to losses from wash sales.

It remains to be seen what the IRS does with this, but it seems likely that if any “creative” method of exploiting this provision is published, the IRS would have clear authority to invoke its authority here. That is, the *Wall Street Journal* rule is effectively invoked by the Congress here (that rule being that when a creative tax planning scheme is mentioned in the *Wall Street Journal* or the *New York Times*, it's fairly certain that publicity will get the IRS to take action against it).

III. Transition Rules

You may recall we started this discussion with the basic rules involving net operating losses, and the strict rules regarding the timing for deciding whether to waive a carryback period—rules that were carried into the new election we have to select a 3, 4, or 5 year period instead of the standard 2 year period. You also noticed that a January 31, 2008 fiscal year end return could make use of this provision—but since such a corporate return would have been required to be filed, even on extension, by October 15, 2008, it would seem impossible to meet the election requirements and take advantage of this rule. As well, such an entity might have decided to carry forward losses since they paid tax only at the lowest rates for their year ended January 31, 2006, but may have had a much more significant tax at January 31, 2003 (or any year in between). And we can't forget that a tentative carryback adjustment request on Form 1045 and 1138 have to be filed within 12 months of the end of the tax year).

Congress did address these issues in Act Section 1211(d)(2) which provides the following phase in rules:

(2) TRANSITIONAL RULE.—In the case of a net operating loss for a taxable year ending before the date of the enactment of this Act—

(A) any election made under section 172(b)(3) of the Internal Revenue Code of 1986 with respect to such loss may (notwithstanding such section) be revoked before the applicable date,

(B) any election made under section 172(b)(1)(H) of such Code with respect to such loss shall (notwithstanding such section) be treated as timely made if made before the applicable date, and

(C) any application under section 6411(a) of such Code with respect to such loss shall be treated as timely filed if filed before the applicable date.

For purposes of this paragraph, the term “applicable date” means the date which is 60 days after the date of the enactment of this Act.

In general, this gives taxpayers a 60 day period to change the application of a loss on returns already filed to which this provision could apply. This most directly impacts fiscal year C corporation taxpayers who will need to decide within the 60 day period whether they expect to get a greater benefit carrying the prior year's loss to one of the available election years there, or would prefer to take the loss for the year ending in 2009 back to its set of years.

One interesting thing to note is that it appears that you could elect to undo an election to carryforward the loss under the transition rules, even if you decided not to make a 3-5 carryback election on that year (that is, let it go back the standard two). Whether the IRS will see that as an “oversight” by Congress and attempt to disallow such an election remains to be seen, but the literal language of the bill certainly would allow it.

IV. State Issues

For states that conform to the federal carryback rules (and some do), there may an issue about whether they will conform with this rule. Arizona currently has a separate net operating loss calculation for corporations, but on individuals follows the federal law—but as of the moment the federal law as it existed on January 1, 2008, which did not have this 3-5 year option. It's likely in Arizona that we won't know exactly how this will be handled for quite a while