



Net Operating Loss Guidance: Let's Try This One Again

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Ed Zollars' Tax Update
May 4, 2009

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I. The IRS Takes Its Second Swipe At New NOL Election

The IRS has issued a revised ruling to deal with IRC §172(b)(1)(H) that Congress added in February to allow certain small business taxpayers to elect from four different years to begin using qualified net operating loss carrybacks. This is the IRS's second try at issuing rules for this, and amounts to a simplified election reflecting the fact that many taxpayers were not following the requirements in the prior notice and were using the Nike slogan of "Just Do It" to handle the new rules.

The ruling also gives us examples of the application of these rules to passthrough entities and their owners. The Ruling in question is Revenue Ruling 2009-26 issued April 24, 2009.

II. The New Rules

Back in February, we previously discussed the net operating loss provisions that Congress added back shortly after the law was passed. The new law added §172(b)(1)(H) to the law which reads as follows:

(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.

(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.

(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.

(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.

About a month later, the IRS issued Revenue Procedure 2009-19 that told taxpayers

who had not already filed their returns how to handle the election. That ruling told taxpayers to do the following:

SECTION 4. APPLICATION

.01 Eligible small businesses that have not filed a return for the applicable 2008 NOL taxable year.

(1) A taxpayer within the scope of this revenue procedure that has not filed a return for the taxable year in which the applicable 2008 NOL arises makes the election under § 172(b)(1)(H) by attaching a statement to the taxpayer's federal income tax return for the taxable year in which the applicable 2008 NOL arises. The statement must --

- (a) Clearly state that the taxpayer is electing to apply § 172(b)(1)(H);
- (b) Describe the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years); and
- (c) If applicable, state that the taxpayer is electing to apply § 172(b)(1)(H) to the taxpayer's taxable year that begins in 2008.

(2) The taxpayer's return must be filed by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL. In the case of a late election, relief may be available under § 301.9100-2(b) of the Procedure and Administration Regulations. Notwithstanding this due date, an election to apply § 172(b)(1)(H) to an applicable 2008 NOL for a taxable year ending before February 17, 2009, will be treated as timely if the election is filed on or before April 17, 2009.

Note the reference to April 17, 2009—as you hopefully were aware, that was the date to fix returns filed before Congress revised the law which were eligible to have elected this treatment if they had merely had a medium for a tax advisor that could foresee this provision would be added. Since the date for that fix is past, we won't spend time on it.

The theory was simple—you attached the election to the return that generated the loss. Unfortunately, given it was March 16, more than a few preparers appear not to have gotten around to reading the ruling.

III. IRS New Ruling

The IRS notes that it has been receiving filings that did not comply with the formal election procedures outlined in Revenue Procedure 2009-19, attributing this fact to the issuance of this guidance during tax season (on March 16 to be exact). The new Revenue Procedure keeps the old election as one option, but adds a simpler option of simply filing a carryback claim (1045, 1139 or amended return) by date required by statute for this special election to be made. Note that this date will be October 15 for

individual taxpayers, and for most taxpayers will be earlier than the latest date normally available to file an application for tentative refund (which is one year after the year end for the return giving rise to the NOL).

The new ruling first repeats (in somewhat shortened form) the method originally given in Revenue Ruling 2009-19.

SECTION 4. APPLICATION

.01 Time and manner of making the election under § 172(b)(1)(H).

(1) In general. A taxpayer within the scope of this revenue procedure that has an applicable 2008 NOL may make the election under § 172(b)(1)(H) by following the procedure described in either section 4.01(2) or section 4.01(3) of this revenue procedure.

(2) Electing on original return. A taxpayer may make the election under § 172(b)(1)(H) by attaching a statement to the taxpayer's timely filed federal income tax return for the taxable year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is electing to apply § 172(b)(1)(H) and specify the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years). If the taxpayer's taxable year of the applicable 2008 NOL ends before February 17, 2009, the taxpayer must make the election on or before the later of the due date (including extensions of time) of the taxpayer's return for that taxable year or April 17, 2009.

The IRS noted, though, that they were finding some taxpayers were taking shortcuts. The ruling notes in an early paragraph in Section 1 that:

.02 The Service has received many claims from taxpayers that seek a 3-, 4-, or 5-year carryback but that inadvertently have not made a valid election in accordance with Rev. Proc. 2009-19. These inadvertent failures may be due to the fact that the enactment of § 1211 and issuance of Rev. Proc. 2009-19 occurred midway through the current tax return filing season.

The §1211 referred to above is the Act section, not the IRC section.

Thus the IRS decided that maybe they could go "go with the flow" and make what taxpayers were simply doing a valid method for making the election. The IRS goes on to note in Section 1:

.03 To provide certainty to taxpayers and to implement the intent of Congress in providing an extended carryback period, this revenue procedure modifies Rev. Proc. 2009-19 to provide that an ESB may elect a 3-, 4-, or 5-year carryback period simply by filing a Form 1045, Form 1139, or amended return that carries back the NOL for 3, 4, or 5 years. Although Forms 1045 and 1139 ordinarily are due within 12 months after the taxable year of the NOL, § 172(b)(1)(H)(iii) requires that the taxpayer elect a 3-,

4-, or 5-year carryback within 6 months after the due date (excluding extensions) of the return for the taxable year of the NOL. Thus, a taxpayer that seeks to make a timely § 172(b)(1)(H) election using Form 1045, Form 1139, or an amended return must file the form in advance of its ordinary due date.

The explanation does contain one key caution—this “do it yourself” approach has to deal with the statutory limitation on making the election by the due date (including extension periods) for the return in question. So even though even the application for tentative refund can be filed after the extended due date for the return in question, if you want to use that form to do double duty and function as an election under §172(b)(1)(G) you must watch that shorter deadline.

The specific rules for the shortcut election are spelled out as Section 4 continues:

(3) Electing on an appropriate form. A taxpayer that did not make the election under § 172(b)(1)(H) using the procedures of section 4.01(2) of this revenue procedure, and did not elect to forgo the NOL carryback period under § 172(b)(3), may make the election under § 172(b)(1)(H) as follows:

(a) What to file.

(i) A taxpayer may make the election under § 172(b)(1)(H) by filing the appropriate form applying the NOL carryback period chosen by the taxpayer. No statement or label is required with the appropriate form. The appropriate form is:

(A) For corporations: Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return.

(B) For individuals: Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return.

(C) For estates or trusts: Form 1045, or amended Form 1041, U.S. Income Tax Return for Estates and Trusts.

(ii) A taxpayer that makes the election under § 172(b)(1)(H) by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. **The taxpayer should not file an amended return for the applicable 2008 NOL taxable year. (emphasis added)**

(b) When to file. The appropriate form must be filed on or before the later of the date that is 6 months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17,

2009.

(c) Additional rules. If a taxpayer makes the election by filing an appropriate form that amends a prior refund claim, the amendment also will apply to a carryback of any alternative tax NOL for the same taxable year. In the case of an amended application for a tentative carryback adjustment, the 90-day period described in § 6411(b) will begin on the date the amended application is filed.

Note that it is also made clear that the election will apply to both the regular and alternative tax net operating loss.

Due to the special due date problem, for extension returns that are finalized near the extended due date it would seem prudent to not attempt to make the election using the carryback itself, but rather place the election with the return under the first method. So long as the return is timely filed, that method will work.

IV. Passthrough Entities

The ruling explains how to apply these rules to passthroughs as well. The issue of whether a loss qualifies for special carryback is determined at the entity level for the passthrough and not at the individual equity holder level. The ruling notes in Section 4:

.03 Partnerships, S corporations, and sole proprietorships.

(1) If the taxpayer is a partner in a partnership that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for its distributive share of the qualifying ESB partnership income, gain, loss, and deduction that is both allocable to the taxpayer under § 704 and allowed in calculating the taxpayer's applicable 2008 NOL.

(2) If the taxpayer is a shareholder in an S corporation that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for its pro rata share of the qualifying ESB S corporation income, gain, loss, and deduction under § 1366 that is allowed in calculating the shareholder's applicable 2008 NOL.

(3) If the taxpayer is an owner of a sole proprietorship that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for the qualifying ESB sole proprietorship income, gain, loss, and deduction that is allowed in calculating the taxpayer's applicable 2008 NOL.

(4) In determining whether a partnership, S corporation, or sole proprietorship qualifies as an ESB, the gross receipts test applies at the partnership, corporate, or sole proprietorship level. The aggregation rules of § 448(c)(2) apply to determine whether the partnership, S corporation, or sole proprietorship meets the gross receipts test of § 448(c).

What you do not do is aggregate the owner's proportionate share of gross income from the various passthrough entities to do an owner level test. That may work for or against your client—if the client holds a minor interest in a single large passthrough, a test made at the owner level may have allowed the loss carryback. However, given the high likelihood in that case of the passive activity loss rules getting in the way, it's more likely that clients who otherwise might be blocked may be able if they hold an interest in a small entity.

The IRS gives two examples of dealing with the aggregation rules in the ruling. The first ruling examines a partner holding three passthroughs that don't end up having to be aggregated:

(a) Example 1. Partnerships A, B, and C have average annual gross receipts of \$10 million, \$12 million, and \$14 million, respectively. Partner T owns a 40% interest in each partnership. None of the partnerships is required to be aggregated with any other entity for purposes of the aggregation rules of § 448(c)(2). Subject to the limitations in section 4.03(5) of this revenue procedure, Partner T may apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of the income, gain, loss, and deduction of each of Partnerships A, B, and C.

Example 2 was modified from the one in Revenue Ruling 2009-19, changing the reason why the entities had to be aggregated:

(b) Example 2. The facts are the same as in Example 1, except that Partnerships A and B are under common control within the meaning of § 52(b)(1). Accordingly, Partnerships A and B are treated as one person under the aggregation rules of § 448(c)(2). Because the aggregated average annual gross receipts of Partnerships A and B exceed \$15 million, Partnerships A and B do not qualify as ESBs. Partner T may not apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of the income, gain, loss, and deduction of Partnerships A and B. However, subject to the limitations in section 4.03(5) of this revenue procedure, Partner T may apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of income, gain, loss, and deduction of Partnership C.

Finally the IRS tells us how we deal with ESB and non-ESB activities held by an individual, giving us a calculation for the maximum loss we can carryback.

In the case of a holder of an interest in an ESB eligible passthrough, the loss that can be carried back is limited to the lesser of:

- Taxpayer's items of income, gain, loss or deduction that are allowed in calculating the taxpayer's applicable 2008 NOL that come from partnerships, S corporations or proprietorships that qualify as ESBS *or*
- The taxpayer's NOL for the year in question computed under the standard rules for

computation of a net operating loss [Revenue Procedure 2009-26, Section 4.03(5)]

The computation makes sense, since we can't carryback more ESB net operating loss than the total NOL we'd otherwise have, but similarly, having an ESB NOL doesn't allow other losses that don't qualify to "tag along" and go back the requisite number of years.

One other nice fact—the ruling is essentially retroactive in effect. So if you did take the shortcut already before it was allowed, you don't have to do anything at this point to have it be considered valid.

V. Summary

This provision gives us an amazing level of flexibility in finding the most advantageous year to carry a loss back to—but we must be aware of the deadlines we face. The new ruling gives us a shortcut option, but we have to be sure that clients don't file a shortcut election form after the last date for which we can make the election.

Those of you in Arizona have one other issue—it appears at this point highly unlikely that the Arizona legislature will give us individual conformity on this issue (corporation aren't allowed to carry back losses, so there's no issue there). For Arizona individuals, the benefits of carrying back 3, 4 or 5 years will have to be weighed against the additional cost and complexity that may be added for Arizona—as well as dealing with any legislation that may come down to formally tell us how to deal with this difference.