

Using Attenuated NOL Carrybacks

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The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) was signed February 17, 2009. Among other provisions that affect business, a longer carryback of net operating losses will be attractive to many companies that qualify. In general, of course, NOLs can be carried back two years and carried forward 20 years.

The NOL is first carried back to the earliest tax year for which it is allowable as a carryback or a carryover. It is then carried to the next earliest tax year, and so on. Of course, a taxpayer may choose to elect out of the entire carryback, and instead merely carry the NOL forward.

These are the basics, but there is considerable complexity, and there are different rules for certain types of losses. For example, there is a three-year carryback for eligible losses, including an individual loss from casualty or theft, and a farm or small business loss that is attributable to federally declared disaster areas. There is also a five-year carryback for farming losses, qualified disaster losses and certain amounts related to specified disasters.

The newest option comes as a result of the latest so-called recovery legislation. Notably, this applies to NOLs arising in tax years after December 31, 2007. In effect, it allows certain small businesses to elect to increase the NOL carryback period for a 2008 NOL from two to five years. An eligible business must elect the provision, and specify whether it is electing a three-, four- or five-year carryback of the 2008 NOL.

Eligibility

A small business for purposes of this rule is a corporation or partnership that meets an average \$15 million gross receipts test. A sole proprietorship also qualifies if the proprietorship would meet the test if it were a corporation. The \$15 million receipts test is determined based on average annual gross receipts for the three-year period (or shorter period of existence) ending with the tax year in which the loss arose.

Fundamentally, this new provision is likely to be used by some small businesses to get tax refunds. Under prior law, one could not use an NOL to offset the taxable income for the fifth, fourth and third tax years preceding the NOL

year. The ability to reach back farther thus represents a significant benefit. All of this involves some math, but it is hardly complicated.

Number Crunch

If the NOL is equal to or exceeds the taxpayer's combined income for the third, fourth and fifth years before the year in which the NOL arose, then the taxpayer would presumably maximize the available NOL by carrying it back to the fifth year. In that way, the NOL could be used for the fifth, fourth and third years, generating a refund.

Conversely, if the NOL is less than the combined income for those three years, the taxpayer should presumably carry it to the year in which income was taxed at the highest rate to get the highest refund. In some cases, the largest tax savings may come from carrying the NOL back to the second year before the NOL year. Taxpayers should run some numbers under all possible scenarios to make the best decision.

Applicable NOLs?

The availability of the five-year carryback applies to applicable 2008 NOLs, and a definition is in order. For non-calendar year companies, it can include any tax year beginning in 2008, provided the taxpayer so elects. Once made, the election is irrevocable.

Eligible Losses

Notwithstanding the normal two-year rule and the elective five-year rule, there is a three-year NOL carryback for eligible losses, including an individual's loss from casualty or theft, and a farm or small business loss attributable to federally declared disasters. Now, however, this three-year rule does not apply to an applicable 2008 NOL for which a small business taxpayer makes the appropriate election.

Excess Interest Losses

Corporations that have a corporate equity reduction transaction (CERT) and an excess interest loss (interest allocable to the CERT) for a loss limitation year may also have an NOL. Such an NOL is treated as a regular NOL, but it cannot be carried back to the tax year before the year in which the CERT occurred. The "loss limitation year" here is

generally the tax year in which the CERT occurred, plus each of the next two tax years.

IRS Q & A

You have to compliment the IRS for rushing to issue guidance. In the case of the new NOL expansion, the IRS chose a helpful question and answer format, and there are some great points here, including the following:

Q: Do I have to carry back my net operating loss (NOL) for the full five-year period?

A: No. You can elect to carryback the loss for any number of years from three to five, but remember that this is an irrevocable election.

Q: If my business operates on a fiscal year that ended in the middle of 2008, which year do I use?

A: You may elect for either 2008 or 2009, but not both. Whichever you choose, remember that this is an irrevocable election, and can be made for only one tax year.

Q: I had slightly more than \$15 million in gross receipts last year; am I eligible for the five-year carryback?

A: It depends. To qualify for this particular five-year carryback election the business must have an AVERAGE of less than \$15 million in

gross receipts over a three-year period ending with the year giving rise to the loss. If your business gross receipts average more than \$15 million over the three-year period, the normal two-year carryback applies.

Q: Can I use this for a 2009 return?

A: The law specifically states that the election is available for the tax year ending in 2008, unless the taxpayer elects this carryback for the tax year beginning in 2008. A calendar year taxpayer can elect only for 2008. A fiscal year taxpayer whose year ends in 2008 can elect either for its fiscal year ending in 2008 or its fiscal year beginning in 2008 and ending in 2009, but not both.

Q: How long will this law be in effect?

A: The law is in effect for a taxpayer's NOL for any tax year ending in 2008, or if elected by the taxpayer, the NOL for any tax year beginning in 2008. However, any election under this provision may be made only with respect to one tax year.

Conclusion

As taxpayers and advisors scramble, don't forget to examine the expanded NOL allowed for small businesses.

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