PUBLICATION

Using the Expanded NOL Carryback Period to Seek Tax Refunds, Part 4

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When cash flow is tight, generating additional cash can be a quest for survival. Congress has made that quest a little easier for some businesses, but quick action on or before April 17, 2009 is required in certain situations.

Where the facts are appropriate, eligible small businesses should consider seeking refunds of taxes paid in prior years by electing to extend the carryback period for certain net operating losses (NOLs) from two years to up to five years. The extended carryback period was authorized by the American Recovery and Reinvestment Tax Act of 2009, signed by President Obama on February 17, 2009 (Recovery Act).

To elect to use this extended NOL carryback period, most eligible taxpayers will have until at least September 15, 2009 (in the case of C corporations using a calendar tax year), or October 15, 2009 (in the case of individuals, including individual partners of a partnership, S corporation shareholders, and sole proprietorship owners for pass-through income, gain, loss and deduction from the business used to calculate the individual's NOLs). But taxpayers who waived the normal two-year NOL carryback period on their 2008 federal income tax returns must act on or before April 17, 2009, to take advantage of the extended NOL carryback election.

General Rules for NOL Carrybacks

Normally an NOL must be carried back to the two tax years preceding the year in which the loss is incurred, starting with the earliest tax year of the two-year period. After the NOL is applied to prior tax years, any portion that remains can be carried forward for up to 20 years. For example, a 2008 NOL would first be carried back and applied against 2006 taxable income, then applied against 2007 taxable income, and any remaining NOL would be carried forward to future years for up to 20 years.

When an NOL is carried back to a prior tax year, the adjusted gross income for the carryback year is recomputed after the NOL deduction is taken into account. Then the tax due for the carryback year (including any alternative minimum tax) is recalculated, which involves a recomputation of most deductions and credits that are based on or limited to a percentage of adjusted gross income, such as miscellaneous itemized deductions that can only be deducted to the extent they exceed 2% of adjusted gross income.

The taxpayer can claim a credit or refund of the overpayment of taxes, if any, resulting from the NOL carryback by either filing an amended return for the carryback year or an application for a tentative carryback before the applicable statute of limitations expires for the carryback year.

Although an NOL normally must be carried back to the beginning of the permitted two-year carryback period, a taxpayer can elect to waive the NOL carryback and will only be allowed to use the NOL in future tax years. The taxpayer must make the election on or before the due date for the tax return for the year the NOL arises, and such election is irrevocable.

Expanded NOL Carryback Period for Small Businesses

The Recovery Act creates an opportunity for certain small businesses to receive a quick infusion of cash by allowing them to elect to extend the normal two-year carryback period for 2008 NOLs to a three, four or five-year carryback period. The extended NOL carryback election cannot be revoked once it is made, so taxpayers should carefully consider whether to make the extended carryback election.

Eligible businesses that use a calendar tax year can only make the extended carryback election for their 2008 NOLs. Eligible small businesses that use a fiscal tax year, on the other hand, can choose whether to make the expanded carryback election for NOLs generated in the fiscal tax year beginning in 2008 or for NOLs generated in the fiscal tax year ending in 2008. Fiscal year businesses should compare the amount of NOLs for each tax year and the taxes in prior years in the expanded carryback period before making an expanded carryback election.

A. Eligibility for the Expanded NOL Carryback Election.

The extended NOL carryback election is only available for "eligible small businesses." An eligible small business is a corporation, a partnership, or a sole proprietorship having average annual gross receipts of $15 million or less for the three-year period ending with the 2008 tax year (the tax year for which the extended NOL carryback election is being made). If a partnership, S corporation or sole proprietorship satisfies the gross receipts test, then each individual partner of the partnership, shareholder of the S corporation, or sole proprietorship owner can make the extended NOL carryback election for such partner's, shareholder's or owner's share of the business's pass-through income, gain, loss and deduction from the business used to calculate the individual's 2008 NOL, and can use the extended NOL carryback period to carry back a portion of the individual's 2008 NOL equal to the lesser of (i) the individual's pass-through income, gain, loss and deduction from eligible small businesses used to calculate the individual's 2008 NOL, or (ii) the individual's 2008 NOL.

B. Making the Election.

If the taxpayer has not yet filed its 2008 federal income tax return, it can make the extended carryback election by filing its tax return by the due date (including extensions) and including a statement which:

- Clearly states that the taxpayer is electing to apply Internal Revenue Code Section 172(b)(1)(H);
- Describes the length of the extended NOL carryback period being elected by the taxpayer (three, four or five years); and
- If the election is being made by a fiscal year taxpayer for NOLs reported on its 2009 year-end federal income tax return, that the election to apply Internal Revenue Code Section 172(b)(1)(H) is being made for the taxpayer's taxable year beginning in 2008.

If the taxpayer has already filed its 2008 federal income tax return, it can still make the extended NOL carryback election, but the due date for the election depends on whether the taxpayer elected to waive the normal two-year NOL carryback period when it filed its 2008 tax return. The extended NOL carryback election is made by filing either an application for a tentative refund or an amended federal income tax return for the earliest taxable year to which the 2008 NOL is being carried back. Either filing must include a statement describing the length of the NOL carryback period being elected by the taxpayer (three, four or five years). The IRS has noted that a refund will be much faster if an application for a tentative refund is filed.

If the taxpayer has already filed its 2008 federal income tax return and did not waive the normal two-year NOL carryback period, then the election is due by the later of (i) six months after the due date of the return, determined without extensions, or (ii) April 17, 2009.

If the taxpayer has already filed its 2008 federal income tax return and waived the normal two-year NOL carryback period, a much shorter period applies. In that situation, the taxpayer can revoke its prior election to waive the two-year carryback period and elect to use the new three, four or five-year carryback, <u>but only if the revocation of the prior election and the new extended carryback election is made on or before April 17, 2009</u>.