

# Tax Action Memo®

TAM-1340  
March 24, 2009

## IRS Issues Guidance on 2008 NOL Carrybacks for Small Businesses

<p><b>Type of Clients:</b> Businesses.</p> <p><b>Situation:</b> A small business client had a net operating loss last year and paid tax within the five prior years.</p> <p><b>Deadline:</b> Unless the 2008 return is extended, 4/17/09.</p>	<p><b>Tax Action Required:</b> Make sure clients with 2008 NOLs take advantage of the longer carryback period to maximize cash refunds of previously paid taxes. Now that our questions have been answered, you can get the refund claims out ASAP.</p>
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### Background

The recently enacted American Recovery and Reinvestment Act of 2009 (the Stimulus Act) includes a provision that extends the normal two-year carryback period for NOLs to as much as five years for 2008 NOLs of Eligible Small Businesses (ESBs). This provision was intended to throw a lifeline to struggling businesses, providing them with an infusion of cash by allowing them to cash in on taxes they paid while the economy was booming.

We discussed this new longer carryback provision in TAM-1337 (3/3/09)<sup>1</sup>, but there were a number of unanswered questions at that time. The IRS has now issued Rev. Proc. 2009-19 answering these questions. For the most part, the IRS's guidance is both practical and taxpayer friendly. They've even promised to try to shorten the normal 90-day period for processing Forms 1045 and 1139 from 90 days to 45 days. Thank you, IRS.

See TAM-1337 for a detailed discussion of the new provision, including things to consider when deciding the NOL carryback period to elect (three, four, or five years). This release provides answers to provisions of the law that were previously unclear or required further IRS guidance to implement.

### Eligible Small Business (ESB) Definition

According to IRC Sec. 172(b)(1)(H)(iv), an ESB is a business that satisfies (for the year of the loss) the Section 448(c) test for determining which businesses may use the cash method of accounting (or would satisfy it if the limit were \$15 million rather than \$5 million and if the test applied to sole proprietorships as well as corporations and partnerships). This definition left a couple of unanswered questions.

**Question 1—What Years Are Included the Three-year Testing Period?** A business is an ESB if its average annual gross receipts for the applicable three-year period doesn't exceed \$15 million. It was not entirely clear, however, as to what was meant by the "applicable three-year period". Some commentators interpreted it to be the three-year period ending with the 2008 NOL year (i.e., 2006–2008). Others interpreted it to be the three-year period ending with the tax year before the 2008 NOL year (i.e., 2005–2007).

<sup>1</sup> A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, go to <http://ppc.thomson.com/subscriptions/tabn>. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."



According to the IRS, the applicable three-year testing period for the \$15 million gross receipts test ends with the 2008 NOL year [Rev. Proc. 2009-19, Sec. 2.06]. Thus, a calendar-year business is an ESB if its average annual gross receipts from 2006–2008 (assuming it's been in business that long) don't exceed \$15 million. This is good—including the 2008 NOL year (obviously a very bad year) in the testing period should allow more businesses to qualify for the longer carryback. End of story—simple and taxpayer friendly, just the way we like it.

**Question 2—How Do You Apply the Test to Pass-through Entities and Sole Proprietorships?** Clearly, a lot of small businesses are operated as partnerships, S corporations, and sole proprietorships. These businesses do not pay federal income taxes—instead their income and losses are reported on the partners', shareholders', or proprietors' Forms 1040. So, how do you tell if one of these businesses is an ESB?

According to the IRS, in determining whether a partnership, S corporation, or sole proprietor is an ESB, the three-year gross receipts test is applied at the entity level. The Section 448(c)(2) aggregation rules for businesses under common control are also done at the entity level. [See Rev. Proc. 2009-19, Sec 4.04(4).] Once again, this is a simple and taxpayer friendly solution. Way to go, IRS!

**Note:** Although the test to determine if a partnership, S corporation, or sole proprietorship is an ESB is done at the entity level, the partners, shareholders, or proprietor report their relative share of the entity's 2008 NOL and make any desired elections with respect to those losses on their Form 1040. We'll have more on this later.

**Example 1:** Troy owns 40% of Partnerships A, B, and C, which have average annual gross receipts of \$10 million, \$12 million, and \$14 million, respectively. None of the partnerships are required to be aggregated with any other entity under the Code Sec. 448(c)(2) aggregation rules. Since the Section 448 aggregation rules don't apply, Partnerships A, B, and C each pass the \$15 million gross receipts test, so all three are ESBs. [See Rev. Proc. 2009-19, Sec 4.04(6)(a), Example 1.]

**Example 2:** Assume the same facts as in Example 1, except Troy owns 51% of Partnerships A and B. In this case, the Section 448 aggregation rules kick in for Partnership A and B. Because their combined average annual gross receipts are \$22 million (\$10 million + \$12 million), Partnerships A and B are not ESBs. However, Partnership C is not part of the combined group, so it is once again an ESB. [See Rev. Proc. 2009-19, Sec 4.04(6)(b), Example 2.]

### **Dealing with 2008 NOLS from ESB Partnerships, S Corporations, and Sole Proprietorships**

As just discussed, the test to determine if the partnership, S corporation, or sole proprietorship is an ESB is done at the entity level. Great, but once you determine that the business is an ESB, who makes the ESB elections, who does the carryback claim, and who gets the refund of previously paid taxes?

According to the IRS, each partner in an ESB partnership makes the applicable ESB election with respect to his or her distributive share of the ESB partnership loss that is included in the partner's individual NOL. Ditto for the taxpayer's share of losses passed through from an ESB S corporation, as well as a loss realized by an ESB sole proprietorship. The amount of the taxpayer's applicable 2008 NOL that can be carried back for up to five years under the ESB rules is limited to the lesser of the (1) the taxpayer's NOL or (2) the part of the NOL that is attributable to amounts from an ESB partnership, S corporation, or sole proprietorship.

Essentially, this means is the taxpayer must first compute the individual NOL for 2008 and then calculate how much of that NOL is attributable to amounts from an ESB partnership, S corporation, or sole proprietorship. Only that portion of the NOL qualifies for the ESB election.

**Calculating an Individual's NOL.** An individuals' NOL calculation starts with the taxable income or loss reported on Form 1040. However, the following items are not deductible for NOL purposes and must be added back to taxable income or loss to compute the NOL generated for the year [IRC Sec. 172(d); Reg. 1.172-3]:

- Personal exemptions.

- NOL carryover from another year.
- Excess of nonbusiness capital losses over nonbusiness capital gains.
- The exclusion for 50% of the gain realized on the sale of qualified small business stock.
- Excess of nonbusiness deductions over nonbusiness income. Nonbusiness income includes items such as dividends, interest, nonbusiness capital gains in excess of nonbusiness capital losses, and annuities. Nonbusiness deductions include items such as alimony payments; IRA and other retirement plan contributions for the taxpayer; nonbusiness itemized deductions, including medical expenses, taxes, interest, and charitable contributions; and the standard deduction.
- Excess of business capital losses over the total of (1) business capital gains and (2) any nonbusiness capital gains remaining after reducing for nonbusiness capital losses and other nonbusiness deductions (i.e., the taxpayer cannot take a deduction for a net capital loss when computing the NOL) [Reg. 1.172-3(a)(2)(i)]. A net Section 1231 loss is treated as an ordinary business loss and thus is included in the NOL [Reg. 1.172-3(a)(3)(ii)].
- The Section 199 domestic production activities deduction [Reg. 1.199-1(b)(1)].

The business or nonbusiness character of items passed through from a partnership is determined at the partnership level. Thus, a partner's share of partnership income (or loss) is business income (or loss) if it was incurred in the partnership's trade or business, or nonbusiness income (or loss) if it was not. Ditto for a shareholders' share of S corporation income (or loss).

**Practice Tip:** Schedule A of Form 1045 provides a worksheet for computing an individual NOL.

**Example 3:** Assume the same facts as in Example 1. Troy and his wife, Karen, report the following items on their 2008 Form 1040:

Wages Karen	\$	60,000
Interest and dividends		1,000
Schedule E—pass through ESB partnership losses:		
Partnership A		(20,000)
Partnership B		(30,000)
Partnership C		<u>(51,000)</u>
Adjusted Gross Income (Loss)		(40,000)
Mortgage interest		(8,000)
Real estate and deductible sales taxes		(3,000)
Personal exemptions		<u>(7,000)</u>
Taxable loss	\$	<u><u>(58,000)</u></u>

They have a taxable loss of \$58,000. Their 2008 NOL is \$41,000, calculated as follows:

Taxable loss	\$	(58,000)
Add back nonbusiness deductions in excess of nonbusiness income:		
Nonbusiness income	\$	1,000
Nonbusiness deductions (\$8,000 + \$3,000 + \$7,000)	<u>18,000</u>	<u>17,000</u>
2008 NOL		<u><u>\$ (41,000)</u></u>

Troy and Karen's \$41,000 NOL is made up of \$101,000 ESB partnership losses, less \$60,000 wages. Since all of the NOL is attributable to ESB partnership losses, they can make an ESB election to carryback their entire \$41,000 NOL to as far as 2005.

### How Do You Make the ESB Election?

The new longer carryback period for NOLs attributable for ESBs is an elective rather than automatic provision. According to IRC Sec. 172(b)(1)(H)(iii), the ESB election must be made in the manner prescribed by the IRS.

**Note:** What we are referring to as the ESB election, actually includes two or three elective elements.

1. *Basic Election.* First the taxpayer must elect to apply IRC Sec. 172(b)(1)(H). Otherwise, the normal two-year carryback period applies (assuming another special carryback period doesn't apply).
2. *Length of Carryback Period.* The taxpayer must also specify whether they want the carryback period extended by one, two, or three years (to a total of three, four, or five years). The choice of periods will generally depend on the level of income in the prior years—see TAM-1337.
3. *Fiscal Year Option.* For fiscal year taxpayers, the default is that the 2008 NOL year is the tax year *ending* in 2008. However, such taxpayers have the option of electing instead to apply the election to the year *beginning* in 2008.

Once the ESB election is made, it is irrevocable and cannot be changed [i.e., taxpayer cannot change the length of the carryback period (for example, from five years to four years), or revoke the election totally]. Failure to make the ESB election means the normal two-year NOL carry back period applies (assuming another special carryback period doesn't apply).

According to Rev. Proc. 2009-19, how the ESB election must be made, depends on whether or not the return for the 2008 NOL year has already been filed.

**Making the ESB Election on the Return for the 2008 NOL Year.** If the return for the 2008 NOL has not yet been filed, the ESB NOL election is made by attaching an election statement to the taxpayer's federal income tax return for the year of the 2008 NOL. [See Rev. Proc. 2009-19, Sec. 4.01.] The statement must clearly state—

1. The taxpayer is electing to apply IRC Sec. 172(b)(1)(H).
2. The length of the NOL carryback period elected (three, four, or five years).
3. If applicable, the taxpayer is electing to apply IRC Sec. 172(b)(1)(H) to the taxable year beginning in 2008. (This applies only to fiscal year taxpayers that don't want to use the year ending in 2008 as the 2008 NOL year.)

For the election to be effective, the return (with the election statement attached) generally must be filed by the due date (including extensions) for filing the tax return of the year of the NOL [IRC Sec. 172(b)(1)(H)(iii)]. However, the election will be considered timely filed if it is filed (with the original or amended return, or a refund claim) by 4/17/09. Also, a taxpayer who timely files a return by its original due date without the ESB election may be able to use the relief of Reg. 301.9100-2(b) to file the election as late as six months after the due date (excluding extensions) for filing the taxpayer's return for the 2008 NOL year. (In this case, you'd use the following procedures to make the ESB election.)

**Making the ESB Election after the Return Has Been Filed.** If the return for the 2008 NOL year has already been filed, the ESB election is made by attaching the election statement (as described earlier) to—

- Form 1139 (Corporation Application for Tentative Refund), for a corporation.
- Form 1045 (Application for Tentative Refund), for individuals.

**Note:** Instead of filing a Form 1139 or 1045, the taxpayer can file the election statement with an amended return (Form 1120X or 1040X) for the earliest taxable year to which the 2008 NOL is being carried. However, there's little reason to do so as filing Forms 1139 and 1045 will result in a quicker refund. (We'll have more on the benefits of using Forms 1139 and 1045 later.)

For the election to be effective, the taxpayer must file the appropriate form (with the ESB election statement) within six months after the due date (excluding extensions) for filing the taxpayer's return for the 2008 NOL year, or, if later, 4/17/09.

The taxpayer should enter on the top of the form "2008 NOL Carryback Election Pursuant to Rev. Proc. 2009-19." However, if the taxpayer is amending a previously filed carryback claim, the taxpayer should instead enter "Amended NOL Carryback Election Pursuant to Rev. Proc. 2009-19."

**Electing to Revoke a Previous Election to Forgo the Two-year Carryback Period.** For 2008 NOLs in tax years ending before 2/17/09, any previously filed election under IRC Sec. 172(b)(3) to waive the two-year carryback period may be revoked (notwithstanding that this election is normally irrevocable). According to the IRS, the revocation and new ESB election must be made by filing Form 1139 or 1045 (or an amended return) *no later* than 4/17/09. In this case, the taxpayer should enter across the top of the form "2008 NOL Carryback Election and Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19."

### **Tips for Getting the Refund in Your Clients Hands ASAP**

To receive a refund of previously paid taxes the taxpayer must file, either (1) tentative refund claim (Form 1139 or 1045) or (2) an amended return (Form 1120 or 1040X) for the year(s) to which the NOL is being carried back. (This return may also include the ESB election if it wasn't filed with the return for the 2008 NOL year. See the earlier discussion.) So, given this choice, which is the better form to use? Obviously, the answer will depend on the taxpayer's circumstances, but nine times out of ten, the answer will be Form 1045 or 1139 (whichever is applicable to the taxpayer). Here's why.

If Form 1045 or 1139 is used to carrying back the 2008 NOL, the IRS must act on the refund request within 90 days from the later of (1) the date it is filed, or (2) the last day of the month in which the filing deadline (including any extensions) falls for the 2008 NOL year [IRC Sec. 6411(b)]. Furthermore, with respect to 2008 NOL carryback claims for ESBs, the IRS has said it will work to get the refunds requested on tentative claims processed in 45 days or less where possible. In contrast, there's no set deadline or promise for when the IRS must act on an amended return.

If Form 1045 or 1139 is being used to carryback the 2008 NOL, it must be filed within one year after the end of the 2008 NOL year (i.e., by 12/31/09 for calendar-year taxpayers) [IRC Sec. 6411(a)]. It can be filed at the same time as the original return, but not before. If it's filed at the same time as the original return, it should be sent in a different envelope. Fortunately, Forms 1139 and 1045 have been updated to reflect the Stimulus Act changes. So, they're ready to go as soon as you are.

**Planning Tip:** Because of how the IRS's 90 day window for reviewing the tentative refund claim works, it may be to the taxpayer's advantage to file the return for the year of the 2008 NOL (with the ESB election) on its original due date. See Examples 4 and 5.

**Example 4:** Wilber incurred a 2008 NOL because of the ESB sole proprietorship that he operates. On 4/13/09, he filed his 2008 Form 1040 with an election to carry the 2008 NOL back to his 2003 tax return. He filed a Form 1045 two weeks later on 5/1/09 to carry the NOL back to his 2003 tax year.

Because the refund claim was filed after the due date of his 2008 return, the IRS has to act on the claim within 90 days of 5/1/09.

**Example 5:** Assume the same facts as in Example 4, except that Wilber's 2008 return was extended to 10/15/09. He actually filed the return on 4/21/09 and still filed the Form 1045 on 5/1/09. Here, the IRS has 90 days from 10/31/09 (the last day of the month in which the extended filing deadline falls) to act on the refund claim because the due date of the 2008 return occurred is later than the date the refund claim was filed.

**Observation:** In IR-2009-26, the IRS stated that it "will work to issue the refunds within 45 days or even earlier to the extent possible." However, they didn't change the 90-day required Code-set response time, nor did they clarify the starting date of the earlier 45-day hope-for response time. If it is from the date they receive the Form 1139 or 1045, it won't make any difference when the 2008 return was filed. Given, the generous spirit with which this guidance was given, it seems likely the IRS will work to get the refund out as soon as they can. Still, it never hurts to have the pressure of a Code-set deadline on your side.

Within the 90-day period, the IRS may only check the computations on the tentative refund claim and look for omissions; it can't search for new issues in the loss (or excess credit) year [Reg. 1.6411-3(b)]. Of course, the IRS can still audit the return for the year of the loss or unused credit. In addition, it can examine items in the carryback year because the carryback of a loss (or unused credit) extends the statute of limitations for the carryback year to that of the loss year. Fortunately, under this provision, additional tax attributable to items in the carryback year can only be assessed to the extent of the refund request [IRC Sec. 6501(k)].

**Planning Tip:** Taxpayers who believe they have exposure to additional taxes in the carryback year may want to consider electing a different NOL carryback period [IRC Sec. 172(b)(3)].

The main disadvantage of filing a Form 1045 (or 1139) compared to an amended return is that the tentative refund is just that. It's tentative, which means it's not considered a claim for credit or refund. Thus, you can't file a refund suit in District Court or the Court of Federal Claims if the IRS disallows the refund. Instead, you must file a regular claim for refund (on Form 1040X, 1120X, etc.). If the IRS fails to act on the refund claim within six months or disallows it, the taxpayer can then file suit for refund [Reg. 1.6411-1(b)].

If it is too late to file a tentative refund claim on Form 1045 or 1139, an amended return may be your only option. Fortunately, there's generally a three-year deadline for filing an amended return (Form 1040X or 1120X).

### Conclusion

Although this new NOL carryback provision won't help every taxpayer, it'll hopefully be a shot in the arm for ESBs with 2008 NOLs. Thanks to the IRS's practical and timely guidance, you now know how to apply the rules—you can get those refunds in your client's hands ASAP.

### References:

IRC Secs. 172, 448m, 6411, and 6501.  
Rev. Proc 2009-19, 2009-14 IRB.  
IRS News Release IR-2009-26.

**Subscriber Note:** This *Tax Action Memo* was written by Senior Manager, Robin Tuttle Christian, CPA. Ms. Christian is Managing Editor of this publication as well as a coauthor and contributing editor of several PPC publications.