

Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Net Operating Losses

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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Chapter 12 – Net Operating Losses

Carrybacks and Carryforwards - General Rule

After the statutory net operating loss for a taxable year has been determined, the amount of the NOL deduction for that year is calculated based on the amount of the statutory loss and any carrybacks and carryforwards of losses from other years. A loss may be carried only to certain years and must be carried to them in a specified order.

An NOL generally can be carried back to each of the two taxable years preceding the loss year (Code Section 172(b)(1)(A)(i)) and carried forward to each of the 20 taxable years following the loss year. Code Section 172(b)(1)(A)(ii). However, small businesses can elect to carry back any NOL for 2008 back three, four, or five years. See Section 48.3(b)(1). Similarly, any NOL for any taxable year ending during 2001 or 2002 may be carried back to each of the five taxable years preceding the loss year, although the taxpayer can elect not to have this provision apply. NOLs arising in taxable years beginning before August 6, 1997 generally could be carried back three years and carried forward 15 years. (Reg. Section 1.172-4(a)(1)(ii); *Young v. United States*, 103 F. Supp. 12 (W.D. Ark. 1952), *aff'd*, 203 F.2d 686 (8th Cir. 1953).)

Exceptions

Small businesses can elect to carry back losses for 2008 tax years three, four, or five tax years. Similarly, a longer carryback period was available for NOLs arising in 2001 and 2002.

In addition to these rules applicable to specific periods, some types of losses are subject to special rules on carrybacks. Such rules apply with respect to certain losses resulting from casualties, specified liability losses, excess corporate equity reduction interest losses, and losses relating to REITs. (Code Section 172(b)(1) Taxpayer Relief Act of 1997, Pub. L. 105-34, Sections 1082(a)(1) and (2).)

Small Business Losses for 2008

In general, small businesses can elect to carry back 2008 NOLs three, four, or five years, instead of two years. Code Section 172(b)(1)(H). This election applies to the taxpayer's NOL for any tax year ending in 2008, or, at the taxpayer's election, any tax year beginning in 2008. Code Section 172(b)(1)(H)(ii). It can be made for only one tax year. Code Section 172(b)(1)(H)(iii).

A small business for this purpose is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are \$15 million or less. Thus, the election can be made by small businesses, partners in partnerships that are small businesses, shareholders in S corporations that are small businesses, and sole proprietors. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

In determining whether a partnership, S corporation, or sole proprietorship qualifies as an eligible small business, the gross receipts test applies at the partnership, corporate, or sole proprietorship level. Rev. Proc. 2009-26, 2009-19 I.R.B. 935. See Section 503.3(a) for aggregation rules that apply.

A partner in a partnership can make the election for its distributive share of the qualifying partnership income, gain, loss, or deduction that is both allocable to the taxpayer and allowed in calculating the taxpayer's applicable 2008 NOL. Similarly, an S shareholder can make the election for its pro rate share of the qualifying S corporation income, gain, loss, and deduction that is allowed in calculating the shareholder's applicable 2008 NOL. An owner of a sole proprietorship can make the election for the qualifying sole proprietorship income, gain, loss, and deduction that is allowed in calculating the taxpayer's applicable 2008 NOL. The amount of the taxpayer's applicable 2008 NOL that the taxpayer can carry back is limited to the lesser of the taxpayer's items of income, gain, loss, or deduction that are allowed in calculating the taxpayer's applicable 2008 NOL and are from one or more partnerships, S corporations, or sole proprietorships that qualify as eligible small businesses, or the taxpayer's applicable 2008 NOL. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

This election generally must be made by the due date, including extensions, for filing the taxpayer's return for the tax year of the NOL. Code Section 172(b)(1)(H)(iii). However, in the case of a tax year ending before February 17, 2009, it can be made at any time before April 17, 2009. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(d)(2). Once made, the election to use a carryback other than two years is irrevocable. Code Section 172(b)(1)(H)(iii).

A taxpayer can make the election either on an original return or by filing the appropriate form:

1. A taxpayer makes the election on an original return by attaching a statement to the taxpayer's timely filed federal income tax return for the tax year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is making the election and specify the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years). If the taxpayer's tax 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.

2. A taxpayer that did not make the election on its original return can make the election by filing the appropriate form applying the NOL carryback period chosen by the taxpayer:

For corporations: Form 1139, Corporation Application for Tentative Refund, or Form 1120X,

Amended U.S. Corporation Income Tax Return.

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

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

A taxpayer that makes the election 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. 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. No statement or label is required with the appropriate form. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

The procedures in (2) also apply for taxpayers that want to revoke a prior election to revoke an election to forego the carryback period. In addition, the taxpayer should type or print across the top of the appropriate form "Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19." The taxpayer must file the revocation and new election under §172(b)(1)(H) on or before April 17, 2009. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

If a taxpayer makes this election, the special rule for losses from casualties does not apply for that year. Code Section 172(b)(1)(H)(i)(III).

The IRS is to prescribe anti-abuse rules, including anti-stuffing rules, anti-churning rules, including rules relating to sale-leasebacks, and wash sales rules. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1121(c).

Losses Resulting from Casualties

NOLs of individuals arising from a fire, storm, shipwreck, other casualty, or theft, and NOLs of a small business or a taxpayer engaged in a farming business attributable to losses incurred in federally declared disaster areas, may be carried back for three years. Code Section 172(b)(1)(F). However, qualified disaster losses incurred in 2008 and 2009 can be carried back for five years. Code Section 172(b)(1)(J). In addition, these amounts may be deducted for alternative minimum tax purposes. Code Section 56(d)(3).

Qualified disaster losses are the lesser of the sum of the deductible casualty for the taxable year attributable to a federally declared disaster occurring before December 31, 2010, and occurring in a disaster area and the deduction for the taxable year for qualified disaster expenses, or the net operating loss. Taxpayers can elect not to have the five-year carryback apply. The election must be made by the due date, including extensions, of the taxpayer's return for the year, and once made is irrevocable. Code Section 172(j).

A small business is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are \$5 million or less. A farming business is the trade or business of farming and includes the trade or business of operating a nursery or sod farm or raising or harvesting trees bearing fruit, nuts, or other crops, or other ornamental trees (other than an evergreen tree that is more than six years old at the time it is severed from the roots). Code Section 263A(e)(4).

Procedure

Unless the carryback period is relinquished, an NOL must be carried to the earliest of the taxable years to which it can be applied. Code Section 172(b)(2).

Any excess is carried over to the other taxable years, in order. Thus, unless an earlier year is permitted under one of the exceptions, an NOL is first carried back to the second preceding taxable year. The portion of the loss that remains unabsorbed in the second preceding taxable year is then carried to each of the other taxable years in chronological order. A 2003 NOL is carried back first to 2001. Any unabsorbed amount is carried to 2002. Any still-unabsorbed amount is then carried forward.

A taxable year that is shorter than a full twelve-month year is counted as a full taxable year in determining the years to which the loss may be carried. (Taxpayer Relief Act of 1997, Pub. L. 105-34, Section 1082(c).) Years for which assessment is barred are also counted. *Calumet Industries, Inc. v. Commissioner*, 95 T.C. 257 (1990). Similarly, the IRS takes the position that years discharged in bankruptcy are counted. FSA 200039007.

An individual taxpayer carrying back an NOL files either Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return. Estates and trusts not filing Form 1045 must file an amended Form 1041, U.S. Income Tax Return for Estates and Trusts, for each carryback year to which the NOL is applied. An individual taxpayer carrying forward an NOL lists the NOL deduction as a negative figure on the "other income" line of Form 1040.

A corporate taxpayer carrying back an NOL files either Form 1120X, Amended U.S. Corporation Income Tax Return, or Form 1139, Corporation Application for Tentative Refund. Form 1139 may not be filed before filing the return for the NOL year, but if used must be filed no later than one year after the NOL year. If Form 1120X is used, it must be filed within three years of the due date, including extensions, for filing the return for the year of the NOL. A corporate taxpayer carrying forward an NOL enters the amount on Form 1120, Schedule K, line 12.

Every taxpayer claiming an NOL must attach a statement showing all the important facts about the NOL, including a computation showing how the taxpayer figured the NOL deduction. Reg. Section 1.172-1(c).

In the case of consolidated groups, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a pro rata basis. Reg. Section 1.1502-21T(b)(1).

If any part of a net operating loss is not absorbed by the end of the carryforward period, it is lost. Although the NOL provisions provide some measure of income averaging, they do not ensure that all losses are deductible. However, there are ways to ensure that an NOL carryforward is not lost.

Relinquishing the Carryback Period

A taxpayer may elect to relinquish the carryback period with respect to any net operating loss for any taxable year. Code Section 172(b)(3). If a taxpayer does not make this election and fails to carry back a loss to the earliest prior year, the amount of NOL that may be deducted in another year is reduced by the amount of the NOL that would have been absorbed in a prior year. (*Eisenberg v. Commissioner*, T.C. Memo. 1963-78; see *Messina v. United States*, 202 Ct. Cl. 155 (1973).)

Although carrying an NOL back to a preceding tax year typically results in an immediate refund, a taxpayer may wish to relinquish the carryback period if tax rates in the previous two years are lower than the rates expected in succeeding years. At higher tax rates, the same dollar amount of loss produces larger tax savings.

If an election to relinquish the carryback period is made, the entire carryback period must be relinquished. Code Section 172(b)(3). The taxpayer may not elect to forgo only certain years.

Under the special rules for NOLs arising in 2001 and 2002, however, a taxpayer may choose to carry losses back to the fifth preceding year or the second preceding year, or forego a carryback altogether.

Furthermore, the election, once made for any taxable year, is irrevocable for that year. (Code Section 172(b)(3). Because the election is irrevocable, a taxpayer cannot disregard an election based on a material mistake of fact. TAM 199937020. See also, *Welch v. Commissioner*, 204 F.3d 1228 (9th Cir. 2000) (when taxpayer did not properly make the election, he failed to establish that the alleged NOL had not already been absorbed).)

The IRS has provided a limited amount of relief from this rule for NOLs arising in 2001 and 2002 and for NOLS arising in 2008.

A bankruptcy trustee, however, has the authority to avoid a debtor's irrevocable election to carry NOLs forward as a fraudulent transfer. *United States v. Sims*, 218 F.3d 948 (9th Cir. 2000). Once an election has been avoided, it is as if it never happened, and the trustee can elect as he sees fit. *Estate of Russell v. United States*, 927 F.2d 413 (8th Cir. 1991). Where a trustee in bankruptcy is barred by the bankruptcy law's statute of limitations from exercising the avoidance power, however, the election made by the bankrupt to relinquish the carryback period may not be challenged. *In re Home America T.V.-Appliance Audio, Inc.*, 232 F.3d 1046 (9th Cir. 2000).

The election to relinquish the carryback period must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year in which the NOL for which the election is to be in effect was generated. (In TAM 9144043, the National Office advised that notations written in the margin on the taxpayer's returns that included the word "elect" were affirmative statements that provided enough information to allow the losses incurred to be carried forward in accordance with an election under Code Section 172(b)(3).) The IRS does not have the authority to grant an extension of time for making the election. (PLR 8333001; PLR 8107111; PLR 8229035; PLR 8339056; PLR 8549057. See also PLR 8405041 (reaffirms position taken in PLR 8339056).)

The election is made by attaching a statement to the return for the taxable year indicating the section under which the election is being made and setting forth the information to identify the election, the period for which it applies, and the taxpayer's basis for making the election. Reg. Section 301.9100-12T(d). An election to forgo the carryback may be made in an amended return only if the amended return is filed before the due date of the original return. Reg. Section 301.9100-12T(b)(1). Despite this rule, the IRS has provided limited relief for NOLS arising in 2001 and 2002, as discussed in Section 48.3(e).

In *Young v. Commissioner* (83 T.C. 831 (1984), aff'd, 783 F.2d 1201 (5th Cir. 1986). PLR 8929033; (the election to relinquish the carryback period cannot be made on an amended return filed after the due date for the loss year, even if the original return filed did not show a loss.), the Tax Court held that failure to make a timely election in the manner prescribed irrevocably deprived the taxpayer of the right to forgo the carryback period, even though, in other documents filed, that taxpayer did not manifest an intent to forgo such period. Thus, a taxpayer who fails to comply with the requirement that the return be accompanied by a separate statement with information identifying the election has not made a valid election. *Klyce v. Commissioner*, T.C. Memo. 1999-198. The Tax Court has held an election to be valid, however, where it met the standards prescribed in the regulations, but the taxpayer cited the incorrect Code section. (*Powers v. Commissioner*, T.C. Memo. 1986-494, reaff'd, T.C. Memo. 1993-125. See also *Carlstedt Assn. v. Commissioner*, T.C. Memo. 1989-27.)

If the original return has been timely filed (by the extended due date) the election can still be made on an amended return filed within six months of the due date, excluding extensions, of the original return. Reg. Section 301.9100-2.

Rules for 2001 and 2002 NOLs and Tax Years

NOLs arising during 2001 and 2002 can be carried back five years, rather than the normal two years. Code Section 172(b)(1)(H), prior to amendment by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(a). A taxpayer may elect not to have the five-year carryback period apply. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). In this case, the normal two-year carryback period, or, if eligible, a three-year carryback period, applies, unless the taxpayer elects to forgo the carryback period entirely.

In general, the election to forgo the five-year carryback must be made by the due date, including extensions, of the return for the taxable year of the NOL and once made is irrevocable for that year. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). See Rev. Proc. 2002-40, 2002-1 C.B. 1096, for how to make this election.

Code Section 172(f)(1)(A) and (B). With respect to affiliated groups, the Supreme Court has held that an affiliated group's product liability loss must be figured on a consolidated, single-entity basis, not by aggregating product liability losses separately determined company by company. *United Dominion Industries, Inc. v. United States*, 532 U.S. 832 (S.Ct. 2001) rev'g 208 F.3d 452 (4th Cir. 2000).

See *Sealy Corporation v. Commissioner*, 171 F.3d 655 (9th Cir. 1999), affg, 107 T.C. 177 (1996) (relating to the deductibility of legal and accounting expenses); *Host Marriott Corporation v. United States*, 267 F.3d 363 (4th Cir. 2001), aff'g 113 F.Supp. 2d 790 (D. Md. 2000) (relating to the deductibility of interest accrued on federal tax deficiencies); *Internet Corporation & Subsidiaries v. Commissioner*, 117 T.C. 133 (2001) (relating to the deductibility of state tax deficiencies and interest on federal and state tax deficiencies); *United States v. Balsam Corporation*, 232 B.R. 160 (E.D.Mo. 1997), aff'd, No. 98-1225EM (8th Cir. 1998) (relating to the deductibility of tort losses); *Major Paint Company v. United States*, 334 F.3d 1042 (Fed. Cir. 2003), affg sub nom. *Standard Brands Liquidating Creditor Trust v. U.S.*, 53 Fed. Cl. 25 (Fed. Cl. 2002) (relating to the deductibility of capitalized bankruptcy costs).

