

FREE MONEY TO CONTRACTORS FROM THE U.S. TREASURY

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Hint: It's really your own money!

Contractors living through one of the most difficult economies in our country's history are looking for cash in every corner of their balance sheets. There is an immediate need for funds to meet payroll, service equipment or comply with credit covenants. Businesses have increasingly looked to government for assistance and Congress has provided some relief. While recent legislation dramatically increases the value of net operating losses, contractors should also be aware of procedures that are already available under the Internal Revenue Code (IRC).

Net operating loss carrybacks

Corporations and individuals¹ that incur losses for income tax purposes in the ordinary course of business² have the ability to recoup taxes that have previously been paid. These losses are referred to as "net operating losses" or NOLs and a net operating loss deduction is available under Section 172 of the IRC.

As a general rule, a NOL may be carried back to each of the two preceding tax years and, to the extent it is not absorbed by taxable income during those periods, to each of the following 20 tax years following the year of loss. A NOL is carried back to the earliest year available and then, to the extent it is unused, carried forward. An election may be made to forego the carryback period. This provision assists businesses that have cyclical income or have suffered a downturn in profits by allowing them to recoup cash taxes previously paid or to offset future taxable income.

Recent legislation has dramatically enhanced the ability of contractors to use net operating losses incurred in 2008 or 2009. The American Recovery and Reinvestment Act of 2009 (ARRA)³ allowed "eligible small businesses" ("ESB," those with average annual gross receipts of \$15 million or less, measured over the most recent three-year period) to elect to carry their NOLs back three, four or five years, instead of the usual two years. The Worker, Homeownership, and Business Assistance Act of 2009 (the Act)⁴ provides all taxpayers, regardless of size, the option of electing this extended carryback period for their NOLs. These losses may now be carried back to the third, fourth, or fifth year preceding the year of loss. As a result of this tax law change, these enhanced carryback opportunities are no longer limited to "eligible small businesses" or ESB's, but instead are available to taxpayers of any size. The details of this law change, along with a discussion of the procedures used to claim the NOL deduction, follow.

Enhanced NOL carryback period. The Act provides an election for taxpayers to extend the NOL carryback period applicable to any one loss year that begins or ends in 2008 or 2009⁵ (an "applicable NOL"). Note that the election (except for ESB's that have

previously made an election under RRA) applies only to a single year and is irrevocable (the "single carryback rule"). Therefore, contractors who have NOLs in 2008 and in 2009 will want to carefully analyze the new law to determine which year's NOL will produce the greatest benefit.

Under this election, a choice must be made as to whether to carry the NOL to the fifth preceding tax year, the fourth preceding tax year or the third preceding tax year. If an election is made to carry the NOL back to the fifth preceding tax year, only 50% of taxable income in the fifth preceding tax year may be offset by the NOL carryback.⁶ Although this limits the amount of loss that may be used in the fifth preceding year, it does not eliminate a portion of the loss itself, because any loss that is not used in the fifth year will be carried forward to the fourth preceding tax year, then the third preceding tax year, and so forth. Any portion of the loss that is not used during the carryback period will carry forward to the 20 years following the loss year. Transition rules under the Act also allow taxpayers who have previously elected to forego the NOL carryback period to revoke that Election.⁷

Example: ABC Corporation (which is not an ESB) has taxable income of \$4 million in 2003, \$10 million in 2004, and \$2 million in 2005, 2006 and 2007. For its calendar year 2008, ABC incurred a NOL of \$5 million. ABC anticipated significant taxable income in 2009, so it elected, prior to the effective date of the Act, to forego the carryback period for its 2008 NOL. Under the provisions of the Act, ABC may revoke its previous election, carryback its 2008 NOL to 2003 and offset up to \$2 million of income in that year. The remaining NOL of \$3 million is then carried forward until consumed; in this instance, it will be fully absorbed in 2004.

The Act also suspends the 90% limitation on the use of Alternative Minimum Tax NOLs when the enhanced carryback period is elected. In addition, taxpayers receiving TARP funds (or affiliates of those taxpayers) are not eligible for the enhanced carryback period.⁸ As a general rule, contractors benefit from carrying back NOLs to the earliest available period, if marginal tax rates are similar in all carryback periods. However, the Act introduces a new level of complexity to these decisions. If a 2008 NOL has been incurred, and a 2009 NOL is expected, additional analysis is required.

Example: Assume the same facts in the example above. ABC Corporation has had a significant problem arise on a contract in 2009 and now anticipates a tax loss of \$10 million for that tax year. As noted above, if it elects to carryback its 2008 NOL, it will be fully absorbed. In addition, ABC will be able to carryback \$2 million of its 2009 NOL under the normal carryback rules. Thus, ABC will receive tax refunds on \$7 million of taxable income. However, if it instead elects to apply the single carryback rule to its 2009 NOL, it will be able to utilize, in total, more NOL. In that instance, it will carry back its 2008 NOL to 2006 and 2007 under the normal two year carryback rules, fully offsetting taxable income in those periods and utilizing \$4 million of NOL. In addition, it will be able to carryback its 2009 NOL to 2004, offsetting \$5 million of taxable income in that year. The remainder will carryforward to 2005 and fully offset taxable income in that period. Thus, by electing the enhanced carryback rules for 2009 instead of 2008, ABC will be able to utilize a total of \$11 million in NOLs.

How to elect enhanced carryback period. Contractors that have not previously claimed a deduction for an applicable NOL may make an election to utilize the enhanced carryback period using one of two methods. Under the first method, the election may be made by attaching a statement to the taxpayer's federal income tax return for the tax

year in which the NOL arises.⁹ If a tax return has already been filed for that tax year, an election can be made by attaching a statement to an amended return. The election statement should read: "The taxpayer is electing to apply Section 172(b)(1)(H) under Rev. Proc. 2009-52." In addition, the statement should provide that "The taxpayer is not a TARP recipient nor, in 2008 or 2009, an affiliate of a TARP recipient," and specify the length of the carryback period elected. The original or amended return containing the election statement is due on or before the due date (including extensions) for filing the taxpayer's last return for a tax year beginning in 2009. In addition, a copy of the election statement should be attached to the taxpayer's claim for tentative carryback adjustment¹⁰ and that claim for adjustment is due on the same due date for filing the return for the taxpayer's last return for a tax year beginning in 2009.

An alternative procedure exists whereby an election statement may be attached to "the appropriate form." This is useful where a previous carryback claim or amended return has been filed. For this purpose, the appropriate form is either Form 1139 or 1120X for corporations, or Form 1045 or 1040X for individuals. If amending a previously filed return, the election statement should so specify.

As noted above, an election to forego the carryback period for an applicable NOL¹¹ can be revoked under the provisions of the Act. This is accomplished by attaching a statement similar to the one described earlier and adding "The taxpayer is revoking an NOL carryback waiver and is electing to apply Section 172(b)(1)(H) under Rev. Proc. 2009-52." The revocation of an earlier election is not limited to the year in which the applicable NOL arises. For example, if a taxpayer waived the carryback period for its 2007 tax year, it may revoke that election as part of the enhanced carryback election.

All filings, including the revocation of a previous election to forego a carryback, are due on or before the due date (including extensions) for filing the taxpayer's last return for a tax year beginning in 2009. An ESB that elected an enhanced carryback period under the ARRA provision, may make a second election under the Act.

Application for tentative refund. Corporations and individuals may apply for NOL-related refunds through an expedited procedure known as a "tentative refund." This is normally preferable to filing an amended return as it should accelerate the receipt of a refund and allows the refund to be paid without the IRS's first auditing the refund claim, although the IRS may audit the claim after the refund has been paid. As noted, this refund claim is filed using Form 1139 for corporations and Form 1045 for individuals and must be filed within 12 months after the end of the tax year in which the loss originates.

Applications for tentative refund are subject to a limited review by the IRS to determine if there are errors or omissions and can be rejected by the IRS if material errors or omissions are found. Such a rejection cannot be challenged; therefore a taxpayer's only administrative recourse in that instance is to file an amended return. If the IRS accepts the application, a refund will normally be paid within 45 days. This allows the IRS to avoid paying interest on the refund. Prior to payment, offsets will be made for any outstanding tax liability and for certain other items. Requests in excess of \$2 million are subject to an additional post-refund review by the Joint Committee on Taxation.

Additional ways to accelerate cash

It goes without saying that businesses and individuals who are experiencing difficulties in profitability should take additional time in computing required quarterly estimated tax payments. There are sufficient provisions whereby taxpayers who anticipate losses or reduced taxable income in future quarters may reduce or eliminate current quarterly tax

payments.¹² However, despite the best planning, corporations may find that they have either overpaid current year taxes or that they do not have the ability to pay taxes when due as a result of current losses. Congress has provided three specific administrative remedies for these instances. Note that these are only available to corporations other than S corporations.

Quick refund of overpayment of estimated tax. A corporation, by timely filing Form 4466, may receive a "quick refund" of overpaid estimated tax. The overpayment must be at least \$500 and greater than 10% of the revised expected tax liability for a tax year. This form must be filed on or before the 15th day of the third month following the end of the tax year¹³ and must be filed prior to filing the corporation's income tax return. Note that Form 4466 cannot be filed prior to the close of the tax year to which it applies. Unless there are errors or omissions, the IRS is required by law to act on the application within 45 days of filing. If the IRS denies the application, a taxpayer must request a refund on an original or amended income tax return.

Extension of time for payment of taxes. A corporation that is expecting a current year NOL may request an extension or postponement of time to pay some or all of the tax due for the preceding year. This is an excellent tool for corporations to take advantage of expected NOLs without going through the normal procedures of concluding the tax year, filing a return, and requesting a refund based on a NOL. This is accomplished by filing Form 1138, which is due within the tax year the corporation expects the loss and extends the payment of taxes for the prior year until the last day of the month for the current year filing deadline. However, note that Form 1138 must be filed prior to the unextended due date of the payment being postponed.

Example: ABC Corporation, a calendar year entity, is enjoying a profitable year in 2009. ABC normally extends its corporate tax returns and completes them prior to the September 15th deadline. Their accountant has informed them that she anticipates a payment will be due on March 15, 2010, of \$1 million. However, in looking ahead to 2010, they anticipate a difficult year and are forecasting a significant tax loss. ABC may file Form 1138 no later than March 15, 2010, and request an extension of time to pay its 2009 remaining tax liability.

Application for extension of time for payment. Extensions of time to file income tax returns are not an extension of time to pay income taxes that are due. However, a little known procedure may be available to a corporation to extend the time to pay its income tax liability. The IRS, under IRC Section 6161(a), has the authority to grant a reasonable extension of up to six months for the payment of tax shown on a return. Form 1127 is used to request an extension of time to pay tax. In order for the IRS to grant this request, it is necessary to show an "undue hardship." For this purpose, a general statement of hardship or an inconvenience to the taxpayer is not sufficient. It is necessary to show that substantial financial loss will result to the taxpayer from making a payment on the due date and that they do not have enough cash, above the amount required for necessary working capital, to pay the tax. A complete statement of assets and liabilities must be submitted that includes book and market values of assets.

Conclusion

Contractors working harder than ever to accelerate the receipt of cash should take full advantage of recent law changes and existing provisions to recoup or save tax dollars. As always, please consult your tax advisor regarding any information provided in this article.

- ¹ Trusts and estates may also take advantage of the net operating loss deduction; however those rules will not be addressed as part of this article.
- ² Taxpayers should be aware that there are various aspects of tax law that restrict their ability to utilize net operating losses; for example, passive loss limitations under IRC § 469 or losses in the context of a change of ownership under § 382.
- ³ Public Law 111-5, enacted on February 17, 2009.
- ⁴ Public Law 111-92, signed into law by President Obama on November 6, 2009.
- ⁵ IRC § 172(b)(1)(H)(ii) defines 2008 and 2009 tax years as those years ending after December 31, 2007 and beginning before January 1, 2010.
- ⁶ The 50% limitation is applied to income net of other loss carrybacks. For example, if income in 2003 was originally \$100, and \$40 net operating loss from 2005 was previously carried back to 2003, the 50% limitation would be applied to the remaining \$60 of taxable income, assuming the taxpayer elects a 5-year carryback for a loss from 2008.
- ⁷ Act § 13(e)(4).
- ⁸ Act § 13(f)(3).
- ⁹ Revenue Procedure 2009-52.
- ¹⁰ Form 1139 for corporations and Form 1045 for individuals.
- ¹¹ Under IRC § 172(b)(3).
- ¹² See, generally, IRC §§ 6654 (for individuals) and 6655 (for corporations). These allow exceptions to underpayments for failure to pay estimated taxes by meeting safe harbors such as paying a specified percentage of current year taxes, relying on prior year tax, or annualizing income.
- ¹³ An extension of time to file the corporation's income tax return does not extend the time to file Form 4466.