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NEW NOL TAX PROVISIONS: *Their Impact on Construction Companies*



Remember the federal income taxes your company paid during the years of economic expansion? Well, if your business has subsequently generated large federal tax losses, then this year you can recover some of the taxes paid during those boom years. This mechanism is called the federal net operating loss (NOL) deduction.

An NOL occurs in a year in which deductions exceed income. The NOL carryforward and carryback provisions were designed to give taxpayers relief in cases of business-income fluctuations from one year to the next.

SOME GOOD NEWS

As a CFM, you know that you can generally carry a federal NOL back to the two tax years prior to the loss year or forward to 20 years after the loss year.

However, this all changed on November 6, 2009 when President Obama signed P.L. 111-92 Worker, Homeownership, and Business Assistance Act of 2009 (the Act) into law. This legislation includes some taxpayer-friendly attributes that deserve special attention.

Carryback Extension

The Act extends the carryback period for NOLs generated in *either the 2008 or 2009 tax years to an expanded 3-5 years* before the year of loss. Note that this is an elective provision in addition to existing NOL carryback rules, for which the maximum carryback period is two years before the year of loss.

This means you must now choose which tax year between 2003 and 2006 to assign an NOL deduction, opting for the year that will generate the largest federal income tax refund for your company.

So, under this elective provision, the NOLs generated in 2008 can be carried back to 2003, 2004, or 2005; and the NOLs generated in 2009 can be carried back to 2004, 2005, or 2006.

If your company generated losses during the calendar years or a fiscal year beginning or ending in 2008 or 2009, it would be very prudent to review its federal income tax returns for the tax years



2003 through 2006 to determine whether or not there are any federal tax dollars that could be redirected to your company's bank account. A financial analysis is necessary to make the correct choice.

An NOL for Everyone

The extended NOL carryback provision applies to all taxpayers, including corporations, individuals, estates, trusts, and exempt organizations with unrelated business income, regardless of size.

The NOL provisions in the American Recovery and Reinvestment Act of 2009 (ARRA), which applied only to 2008 NOLs, allowed a 3-5 year NOL carryback period – but only for businesses with less than \$15 million in gross receipts.

Referred to as the ARRA Eligible Small Business NOL, it precluded many larger construction companies from taking advantage of this change in the law. Taxpayers that took advantage of this NOL provision to carry back a 2008 NOL to the 2003, 2004, or 2005 tax years can now use the new provisions for any NOL generated in the 2009 tax year.

AMT NOLs – No 90% Limit

According to the Act, any AMT NOLs carried back will not be limited to 90% of the AMT income in the carryback year. This is truly significant because in many cases, due to the use of accelerated depreciation methods and certain accounting methods for tax purposes, the regular taxable income for any year is less than the AMT income.

Often, carrying back an NOL would reduce regular federal tax to zero, but the AMT liability would remain, or even increase (thanks to the restricted use of the AMT NOL) to only 90% of the recomputed AMT income.

Undo Previous NOL Decisions

Taxpayers may “undo” an election previously made to forgo the two-year carryback period for NOLs generated for tax years ending between January 1, 2008, and November 6, 2009, to now elect the extended carryback period.

The general rule states that a taxpayer may elect to waive the entire carryback period for any NOL and carry forward the NOL for 20 years. This election must be made by the return due date (including extensions) for the tax year of the NOL.

This election is generally irrevocable and requires careful analysis. This new tax law changes the rules for NOLs generated for tax years ending between January 1, 2008, and November 6, 2009, by offering taxpayers the opportunity to

revisit and rescind their previous election to forgo the carryback of such NOLs.

SOME BAD NEWS

There are some limitations to the use of the Act's newly expanded NOL provisions. Most notably, you can use an NOL deduction to offset only 50% of federal taxable income in the fifth year preceding the loss year.

For example, if an NOL is generated in 2008, and a company had \$500,000 of taxable income in the 2003 tax year, then only \$250,000 of that income is eligible for reduction by the 2008 NOL carryback. Similarly, an NOL generated in 2009 would be able to offset only 50% of the 2004 taxable income.

Note: This limitation does not apply to the preceding fourth or third years covered by the expanded carryback period. Also, this provision can be used for an NOL generated in either 2008 or 2009, but not for both tax years. So, carefully consider which year to elect the expanded carryback period.

While a remote possibility in the construction industry, if your company received any funds under the Troubled Asset Relief Program (TARP) during the government's \$700 billion bailout of financial institutions, then it can't take advantage of the new NOL terms. The new NOL provisions also don't apply to losses incurred by a real estate investment trust.

Finally, most states don't allow the carryback of NOLs. And, thanks to their ongoing budgetary challenges, it's unlikely they will conform to this federal provision.

ISSUES TO CONSIDER

The primary consideration for an owner of a pass-through entity (such as an S corporation, partnership, or LLC) is to determine if there is enough at-risk basis in the entity to deduct an NOL elected to be carried back to previous tax years. (The NOLs generated by pass-through entities are filed via the owner's individual income tax return.)

Since our tax system is designed to be progressive (i.e., the more income you make, the more taxes they take), it's also important to analyze the marginal tax rate in effect in the year of the carryback claim.

Specifically, if the carryback is reducing income taxed at a lower rate of 15% or 25%, then a taxpayer won't receive as

much benefit as if the carryback were reducing income taxed at the maximum rate of 35%. If a taxpayer anticipates income in the near future to be taxed at a higher marginal rate than the effective marginal rates on past income, then it may be more beneficial to forgo the NOL carryback.

In addition, if a taxpayer paid the AMT in a prior tax year, but not any regular federal income tax, a refund may still be available. However, the marginal rate for the AMT paid may be lower than the marginal rate for taxes in subsequent or future tax years. Therefore, it may not be beneficial to reduce the NOL to recoup taxes at a lower rate. Further, any federal tax credit carryovers, including the AMT credit carryover, may need to be adjusted as a result of a carryback claim.

The statute of limitations (SOL) on federal income tax returns generally runs for three years after the date the return was filed or the tax for the year was paid. The SOL for a calendar-year corporation return filed for 2003 by the September 15, 2004 extended due date (with all taxes paid by that date) would remain open until September 15, 2007.

If an NOL carryback to the 2003 tax year is elected, it will “reopen” the 2003 tax year. Adjustments can be made by the IRS to the reopened year up to the amount of the claimed NOL carryback deduction. So, it may make more sense to choose a shorter carryback period to avoid reopening tax years closed by the SOL.

Finally, financial statements prepared according to GAAP may be impacted if a valuation allowance was previously used against the NOLs that will now be utilized under the expanded carryback provision.

IMPEDIMENTS TO USING THE NEW NOL PROVISIONS

It’s important to determine whether the NOL for 2008 or 2009 is reduced or eliminated by the function of other sections of the federal income tax code. So, consult your tax advisor if:

- A change of ownership is determined to have occurred with a C corporation; the use of the NOL may be limited owing to rules put forth in IRC §382.
- You have an NOL from a short year resulting from an accounting-year change. (These generally can’t be carried back unless their dollar value falls within certain limits.)
- Your company is involved with corporate equity reduction transactions.

- You have NOL carryovers and carrybacks between predecessor and successor companies.

PLANNING OPPORTUNITIES TO INCREASE AN NOL

If you’ve determined that your company can both use and benefit from the new NOL carryback provisions, there are planning opportunities to help you increase the amount of the NOL:

- Initiate a cost segregation study to help identify, separate, and reclassify qualified real and personal property into shorter depreciable tax lives.
- Consider one or more accounting method changes, including depreciation method changes, converting to the completed contract method, and excluding retainages.
- Evaluate the possibility of deducting worthless debt.

Again, be sure to ask your tax advisor for guidance before undertaking any of these opportunities.

HOW TO FILE FOR AN NOL CARRYBACK

The IRS issued Rev. Proc. 2009-52 in November 2009 to provide procedural guidance. Since it’s extremely important to meet the deadline for action, you’ll need to decide relatively soon whether your company will be using the 2008 or 2009 tax year for its carryback claim.

And, you must file the carryback claim by the extended due date of the 2009 tax return.

For calendar-year corporate taxpayers, this deadline is September 15, 2010. For calendar-year individual taxpayers, it’s October 15, 2010. This is a taxpayer-favorable position by the IRS because it allows taxpayers to wait until the NOLs for both the 2008 and 2009 tax years are known before they have to elect which year’s NOL to apply the new provisions.

If you previously elected to use the general two-year carryback provision for a 2008 NOL, you may now amend that NOL carryback claim and elect a five-year carryback. This amended 2008 NOL carryback claim is also due by the extended due date of the 2009 tax return.

If the NOL carryback claim will result in a refund of \$1 million or more, consider filing Form 8302, Electronic Deposit of Tax



Refund of \$1 Million or More, with the claim. This authorizes the IRS to electronically deposit the refund directly into your company's account at any U.S. bank or other financial institution and greatly accelerates its receipt.

The IRS generally processes refund claims within 90 days of the date the claim application is filed. It's critical that the carryback claim application include all required attachments when submitted because the IRS will reject an incomplete application.

CONCLUSION

From time to time, our federal government enacts policies to encourage certain types of economic behavior on a national or regional basis.

For example, it has tinkered with the NOL rules in an attempt to mitigate the adverse economic effects of recessions and natural disasters.

Therefore, it may be in your company's best interest to determine if it can benefit from the newly expanded NOL provisions.

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