

# Perspective

## I.R.C. Conformity

The Worker, Homeownership, and Business Assistance Act of 2009, enacted Nov. 6, creates an opportunity for most businesses to elect to carry back either a 2008 or 2009 federal net operating loss for three, four, or five years. While it is not yet clear how many states will embrace the federal extended NOL carryback, historical data regarding similar legislation suggests that the number will be relatively low. In this article, authors Douglas M. Sayuk, Matthew H. Fricke, and Shamen R. Dugger, of Clifton Douglas, discuss considerations that taxpayers should make in deciding whether to make the extended carryback election.

## Five-Year Net Operating Loss Carryback at Federal Level May Create Conformity Issues for Some Multistate Taxpayers

BY DOUGLAS M. SAYUK, MATTHEW H. FRICKE,  
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### INTRODUCTION

**T**he Worker, Homeownership, and Business Assistance Act of 2009, enacted Nov. 6, 2009, created an opportunity for most businesses to elect to carry back either a 2008 or 2009 federal net operating loss for three, four, or five years.<sup>1</sup> The typical federal carryback period is only two years, so this legislative change allows companies generally to monetize 2008 or 2009 NOLs over a longer period of time. The act also suspends the 90 percent limit on the utilization of alternative minimum tax (AMT) losses, effectively permitting AMT taxpayers to elect to carry back their entire applicable NOL.<sup>2</sup>

Revenue Procedure 2009-52 was released by the Internal Revenue Service on Nov. 20, 2009, providing

<sup>1</sup> Pub. L. No. 111-92, 123 Stat. 2984, §13, amending I.R.C. §§ 172(b)(1)(H) and 810(b).

<sup>2</sup> Ernst & Young, Hot Topic No. 2009-44, Nov. 6, 2009

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guidance with respect to applying and electing the extended federal NOL carryback. In addition, there have been myriad interpretative articles and discussions addressing the new opportunity.<sup>3</sup> However, one of the issues that remains unanswered is which states will conform to the federal opportunity, and if conformity is approved, what would be the multistate tax and accounting implications?

In this article, we explore the proclivity for state conformity based on general tax guidance and historical data. We outline multistate considerations that should be analyzed prior to making an election or claiming a refund. Finally, we delineate what likely will be required to claim a commensurate state refund.

### BACKGROUND

Determining state conformity this early in the federal extended NOL carryback game almost requires a crystal ball. There are many indicators to be considered in this determination, each adding an equivalent amount of clarity and ambiguity. These indicators include the following:

- states allowing NOL carrybacks;
- states conforming to the 2009 American Recovery and Reinvestment Act's (ARRA) small business five-year extended NOL carryback;
- states conforming to the 2002 Job Creation and Worker Assistance Act's (JCWAA) five-year extended NOL carryback.

<sup>3</sup> These articles and discussions include the following: Ernst & Young, Hot Topic No. 2009-44; KPMG Webcast, Nov. 24, 2009; Alvarez & Marsal, 2009 Tax Advisor Weekly Issue 46.

**Table 1: States Offering NOL Carrybacks**

	<b>Period of Carryback and Carryforward</b>	<b>May Taxpayer Elect to Forgo State Carryback?</b>	<b>State Law</b>
Alaska	Two years back, 20 forward.	No, must conform with federal election	Alaska Stat. §43.20.021
Delaware	Two years back (\$30,000 limit), 20 forward	No, must conform with federal election	Del. Code Ann. tit. 30, §1903(a)(ii)(8)
Georgia	Two years back, 20 forward	No, must conform with federal election	Ga. Code Ann. §48-7-21; Ga. Regs. §560-7-3.06(3)
Hawaii	Two years back, 20 forward	No, must conform with federal election	Haw. Rev. Stat. §235-7(d); Haw. Regs. §18-235-7-15
Idaho	Two years back (\$100,000 limit), 20 forward	Yes	Idaho Code §63-3021, 63-3022(b), (c), 63-3072(e); Idaho Regs. §35.01.01.201
Indiana	Two years back, 20 forward	No, must conform with federal election	Ind. Code §6-3-2-2.6; 45 Ind. Admin. Code 3.1-1-9
Iowa	Two years back, 20 forward	No, must conform with federal election	Iowa Code Ann. §422.35.11; Iowa Regs. §701-53.2(422)
Louisiana	Three years back, 15 forward	Yes	La. Rev. Stat. Ann. §47:287.86
Maryland	Two years back, 20 forward	No, must conform with federal election	Md. Code Ann., Tax-Gen. §10-305; Md. Admin. Release Nos. 18 and 38
Mississippi	Two years back, 20 forward	Yes	Miss. Stat. Ann. §27-7-17(1)(l); Miss. Regs. §506
Missouri	Two years back, 20 forward	No, must conform with federal election	Mo. Ann. Stat. §143.451
Montana	Three years back, seven forward.	Yes	Mont. Code Ann. §15-31-119
New York	Two years back (\$10,000 limit), 20 forward.	No, must conform with federal election	N.Y. Tax Law §208.9(f); Instructions for General Business Corporation Franchise Tax Returns
Oklahoma	Two years back, 20 forward	Yes	Okla. Stat. Ann. tit. 68, §2358; Okla. Reg. 710:50-17-51
Utah	Three years back (\$1 million limit), 15 forward	Yes	Utah Code Ann. §59-7-110
Virginia	Two years back, 20 forward	No, must conform with federal election	Va. Code §58.1-402
West Virginia	Two years back (\$300,000 limit), 20 forward	No, must conform with federal election	W.Va. Code §11-24-6; W. Va. Regs. §110-24-6.4

Each indicator, along with its implications for state conformity, is addressed separately below.

## States Allowing NOL Carrybacks

An important indicator of state conformity is whether a state allows NOL carrybacks in the first place. As shown in Table 1, only 17 currently allow some form (*i.e.*, full or partial based on a monetary limit) of NOL carrybacks.<sup>4</sup>

We believe these 17 states are potentially impacted by the federal extended NOL carryback as they already allow NOL carrybacks equivalent to the standard federal two-year carryback or longer. All other states do not allow NOL carrybacks to offset prior year state taxable income and, therefore, may not be willing to conform to the federal extended NOL carryback.

## State Conformity to ARRA Extended Carryback

The scope of states potentially conforming to the federal extended NOL carryback can be further narrowed

<sup>4</sup> 1200-1st T.M., *Income Taxes, State Treatment of Net Operating Losses*, Worksheet 1, State Net Operating Loss Carryback and Carryforward Provisions.

by considering which states conformed to the ARRA, the precursor to the latest extended NOL carryback. The ARRA was enacted during February 2009 and allows a five-year NOL carryback to only eligible small businesses.<sup>5</sup> Table 2 summarizes state conformity to ARRA.

Twelve of the 17 states allowing NOL carrybacks conformed automatically or via separate legislation to ARRA. This provides further evidence of which states will likely conform to the Worker, Homeownership, and Business Assistance Act (WHBAA), because both incorporate an extended five-year NOL carryback. However, as previously noted, the ARRA specifically applied only to eligible small businesses whereas the WHBAA extended NOL carryback is farther reaching, applying to most businesses. In today's struggling economy, the WHBAA's broader reach may prove too much for states facing budgetary concerns. On the other hand, states may view the broader extended NOL carryback as a potential catalyst to stimulate their economies through business incentives.

## State Conformity to Job Creation Act

It is also important to note that a similar extended federal NOL carryback was enacted in 2002 under the

<sup>5</sup> Pub. L. No. 111-5, enacted Feb. 17, 2009.

**Table 2: State Conformity to I.R.C. Among States Offering NOL Carrybacks**

State	Version of Internal Revenue Code Adopted <sup>6</sup>	Reference
Alaska	Current	Alaska Stat. §§43.20.021 and 43.20.300
Delaware	Current	Del. Code Ann. tit. 30, §1903
Georgia	Jan. 1, 2009, not adopted ARRA	Ga. Code Ann. §48-1-2(14)
Hawaii	Dec. 31, 2008, not adopted ARRA	Haw. Rev. Stat. §235-2.3
Idaho	Feb. 17, 2009, generally conforms to ARRA	Idaho Code §63-3004
Indiana	Jan. 1, 2008, not adopted ARRA	Ind. Code Ann. §6-3-1-11
Iowa	Jan. 1, 2008, not adopted ARRA	Iowa Code Ann. §422.3
Louisiana	Current	La. Rev. Stat. Ann. §47:287.701(A)
Maryland	Current	
Mississippi	Current	Miss. Code Ann. §27-7-103
Missouri	Current	Mo. Rev. Stat. §143.091
Montana	Current	Mont. Code Ann. §15-31-113
New York	Current, conforms to ARRA extended NOL carryback	N.Y. Tax Law §208
Oklahoma	Current	Okla. Stat. Ann. tit. 68, §2353(2)
Utah	Current	Utah Code Ann. §59-7-101(19)
Virginia	Dec. 31, 2008, not adopted ARRA	Va. Code Ann. §58.1-301
West Virginia	Jan. 1, 2008, through Feb. 17, 2009	W. Va. Code §11-24-3

<sup>6</sup> "Current" indicates that the state conforms to the current version of the I.R.C., as amended, without requiring additional state legislative action. A date indicates that the state has adopted I.R.C. provisions as amended through a particular date, but that additional state legislation would be necessary to match future federal amendments. States that adopt specific I.R.C. sections rather than the entire I.R.C. are noted. The chart is intended to specify each state's general policy regarding the conformance to the I.R.C. and may not include certain special exceptions.

Jobs Creation and Worker Assistance Act. The JCWAA added I.R.C. §172(b)(1)(H) to provide a five-year carryback period for NOLs for any taxable year ending during 2001 and 2002.<sup>7</sup> According to a Virginia Department of Taxation analysis, some states conformed to the legislation with disallowance of only the bonus depreciation component, not the five-year NOL carryback component.<sup>8</sup>

Although state conformity to the JCWAA is an indicator of how many states might conform to the WH-BAA, it is by no means determinative. The current economic struggles are causing many states to look for means to balance their budgets and close their deficits. Incentives such as the extended federal NOL carryback likely would only exacerbate an existing problem and, ultimately, may be disallowed by state legislatures.

## MULTISTATE CONSIDERATIONS

If the state or states for which your company is considering filing refund claims conform to the federal NOL extended carryback legislation, there still are many factors to evaluate prior to filing a state refund claim for this opportunity.

### Confirm Loss Generation Years

Before your company files any state refund claims, it is important that all applicable federal loss years be identified and federal NOLs maximized through tax

<sup>7</sup> Rev. Proc. 2002-40, interpreting Pub. L. No. 107-147, §102(a), 116 Stat. 21 (March 9, 2002).

<sup>8</sup> Virginia Dept. of Taxn., *Reactions of Other States to the Job Creation and Worker Assistance Act of 2002* (Aug. 26, 2002).

planning strategies. Your company may have generated federal taxable income during 2008 and/or 2009 before applying tax planning strategies, but with a few adjustments may find itself in a loss for one or both tax years. Many of these strategies have been outlined as follows, focusing primarily on increased and/or accelerated deductions.

#### Planning Positions:

- Write-offs:
  1. Bad debt write-offs
  2. Inventory at lower of cost or market
- Deductions:
  1. Worthless stock deductions
  2. Transaction cost deductions
  3. Meals and entertainment deductions
  4. Consider transfer pricing reviews to reallocate intercompany expenses
  5. Lives of current-year fixed asset additions

#### Change of Accounting Methods:

- Lives of prior year fixed asset additions
- Computer software expenditures
- Product design costs
- Uniform capitalization rules (UNICAP/IRC §263A)
- Advanced payments of accrued compensation

#### Planning Strategies (Accelerate Deductions):

- Sell build-in loss property
- Accelerate capital expenditures
- Scrap inventory
- Retire assets
- Accelerate capital expenditures
- Application of 15-year class life to leasehold improvements in conforming states

In addition to confirming and maximizing the federal NOL for tax years where the extended NOL carryback

opportunity is available, it is also important to validate—and maximize where there is opportunity—the resulting state NOL. Various states make adjustments to their federal taxable income starting point, which may transform a federal loss into state taxable income and thereby eliminate the state extended carryback refund opportunity. Alternatively, there are state adjustments that may transform federal taxable income into a loss for state purposes preserving the state refund, or increase the existing federal loss thereby increasing the state refund.

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State adjustments to federal taxable income generally fall into two categories:

- depreciation, and
- state-specific tax issues.

Depreciation adjustments generally occur where federal and state depreciation rules differ, such as a state's nonconformity to federal bonus depreciation or state adoption of differing depreciation methods and/or class lives. State specific tax issues take many forms, but the most common are typically state tax deduction adjustments that occur where states do not allow all or part of the state deduction for state tax.

## Confirm That NOLs Not Subject to State Limits

Federal NOLs may be limited by several federal rules, such as corporate equity reduction transaction (CERT) rules, separate return limitation year (SRLY) rules, and I.R.C. §382 limitations. Some states conform to all or some of these federal loss limitation rules, so they should be considered before filing state refund claims.

The §382 limitation applies when a company experiences a greater than 50 percent ownership change over a three-year period, either by an acquisition, disposition, or shift in equity ownership. This rule limits the amount of post-change taxable income that may be reduced by pre-change tax attributes such as net operating losses. Unless a net unrealized built-in loss (NUBIL) is realized during the tax year, we believe the §382 limitation will not have a significant impact on the extended NOL carryback opportunity because the rule is applied on a prospective basis, not a retroactive basis.

The SRLY limitation applies in a tax year of a subsidiary (or subgroup) before it becomes a member of a consolidated group.<sup>9</sup> The SRLY rules limit the use of losses and their carryovers to both consolidated and

separate return years.<sup>10</sup> Basically, if a company acquires a target corporation that generated 2008 and/or 2009 NOLs, the target's 2008/2009 NOLs may be carried back only to offset prior year income generated by the target.

The CERT limitation applies when there is a major stock acquisition or excess distribution.<sup>11</sup> I.R.C. §172(b)(1)(E) provides that if there is a CERT and an applicable corporation has a corporate equity reduction interest loss (CERIL)<sup>12</sup> for any loss limitation year (LLY) after Aug. 2, 1989, the CERIL cannot be carried back to a tax year before the tax year in which the CERT occurs. Under §172(b)(1)(E)(ii), an LLY is defined as the tax year in which the CERT occurs and each of the two succeeding tax years. Section 172(b)(1)(E)(iii) defines an applicable corporation as (1) a C corporation that acquires stock, or the stock of which is acquired in a major stock acquisition; (2) a C corporation making distributions as to (or redeeming) its stock in connection with an excess distribution; or (3) a C corporation that is a successor of a corporation in (1) or (2) above. Therefore, in considering an extended NOL carryback election for 2008 or 2009, a company should evaluate whether a major stock acquisition

<sup>10</sup> *Id.*

<sup>11</sup> A major stock acquisition is defined by §172(h)(3)(B)(i) as the acquisition by a corporation (pursuant to a plan) of at least 50 percent (by vote or value) of the stock of another. Qualified stock purchases for which a §338 election is in effect are excepted under §172(h)(3)(B)(ii). Section 172(h)(3)(D) provides that all of a corporation's plans (or group of persons acting in concert with such corporation) as to another corporation are deemed one plan; all acquisitions made during any 24-month period are treated as pursuant to one plan. An excess distribution under §172(h)(3)(C) is the excess of the aggregate distributions (including redemptions) made by a corporation during a tax year as to its stock, over the greater of (1) 150 percent of the average of such distributions during the three tax years immediately preceding such tax year or (2) 10 percent of the stock's fair market value (FMV) at the beginning of such tax year. (For these purposes, §172(h)(3)(E) ignores nonvoting, nonconvertible preferred stock and distributions (including redemptions) thereon.) Additionally, (1) aggregate distributions made during a tax year by a corporation as to its stock, and (2) 150 percent of the average distributions during the three preceding tax years, are reduced by the aggregate stock issued by the corporation during the applicable period for money or property other than such stock. Further, for both stock acquisitions and excess distributions, all members of a consolidated group are treated as one taxpayer by §172(h)(4)(C).

<sup>12</sup> Under §172(h)(1), a CERIL is, as to any LLY, the excess of the NOL for such tax year over the NOL for such tax year, determined without regard to any allocable interest deductions otherwise taken into account in computing such loss. Allocable interest deductions are defined in §172(h)(2) as deductions allowed for interest on the portion of any debt allocable to a CERT. Debt is to be allocated to the CERT under §263A(f)(2)(A) rules (*i.e.*, the avoided-cost method). Section 172(h)(2)(C) and (D) limit the interest that can be allocated to a CERT. First, allocable interest deductions for any LLY cannot exceed the excess of the amount allowable as a deduction for interest paid or accrued by the taxpayer during the LLY, over the average of such amounts for the three tax years preceding the tax year in which the CERT occurred. Presumably, in a stock acquisition, interest expense for the three prior tax years of the acquiring and acquired corporations would be taken into account. Second, a *de minimis* rule treats a taxpayer as having no allocable interest deductions for any tax year if such deductions total less than \$1 million.

<sup>9</sup> "NOL Clarifications: SRLY and Ceilings" *The CPA Journal, Federal Taxation*, June 2001.

or excess distribution occurred during 2006, 2007, or 2008. Each of these years would be considered LLYs as a CERT could occur during 2006 with 2007 and 2008 falling within the two prohibited succession years. There is an “unforeseeable extraordinary adverse event” exception to these rules, but there’s little interpretative guidance upon which to rely.<sup>13</sup>

## Consider State Filing Method Implications

It is important to factor your company’s state filing methods before availing the extended NOL carryback opportunity. Per IRS guidelines on the extended NOL carryback, “a ‘taxpayer’ includes an affiliated group filing a consolidated return, ‘applicable NOL’ includes a consolidated net operating loss, and the common parent of the group makes the [extended NOL carryback] election.”<sup>14</sup> States in which a company is filing consolidated or combined typically will not create election issues as the same common parent making the election for federal purposes is typically the same entity making the election for state purposes. However, states where a company is filing separate returns may not qualify for the extended carryback opportunity because an entity other than the affiliated parent may be the only benefactor.

## Consider Implications for Use Of Other State Tax Attributes

It is important to review tax attributes utilized on earlier state tax returns to ensure the benefit of electing the extended NOL carryback trumps any prior benefits monetized on original returns. For example, if a company claimed an expiring state tax credit in one of the prior five years, then the extended NOL carryback may not be the most beneficial option. State tax credits are dollar-for-dollar tax offsets (*i.e.*, post-tax benefits) whereas state net operating losses are pre-tax benefits, which is a greatly decreased benefit in comparison.

## Review the Optimal Year for Election

Generally, calendar year end companies will be eligible to elect the extended NOL carryback for either 2008 or 2009, but not both years.<sup>15</sup> This decision is easily made if the company has generated a state loss in only one of the two eligible years.<sup>16</sup> However, the decision becomes more complicated if the company has generated state losses in both 2008 and 2009. Calculations should be run comparing the total benefit under both election years, while also factoring the general two-year carryback that is allowed for the year in which the election is not made and the fifth-year carryback 50 percent limitation.

<sup>13</sup> The CERT discussion was adapted from *Certs and NOL Limits* by Matthew Coscia, CPA, Coscia Greilich & Co. LLP.

<sup>14</sup> Rev. Proc. 2009-52

<sup>15</sup> Special rules apply if a company qualifies as an “eligible small business.”

<sup>16</sup> Calendar year-end companies that do not generate losses in either 2008 or 2009 do not qualify for the extended NOL carryback.

This decision is potentially exacerbated at the state level if the federal election is controlling without a separate state-level election. Simply stated, an election year that is beneficial from a federal perspective may not be beneficial from a state perspective.

## Analyze Current Year Compliance Impacts

Companies that file state refund claims should be prepared for potential impacts to current period income tax compliance. From a tax return and provision perspective, any state refunds related to prior years must be added back to federal taxable income. This means state refunds are added back to federal taxable income in the federal return corresponding to the year of refund receipt. However, for tax provision purposes under ASC 740, a company must account for any refund claims prior to actual receipt of the refund. “Under ASC 740, the effects of changes in tax law on current and deferred tax balances (including related valuation allowances) are recognized in the period the new legislation is enacted.”<sup>17</sup>

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Therefore, even if applicable amended/original returns have not been filed, nor refunds received, the effects of the extended NOL carryback legislation on current and deferred income taxes must be recognized in the reporting period covering November 6, 2009 (the federal tax law enactment date). For calendar year-end companies, this means current and deferred tax effects of the federal NOL carryback must be recognized in fourth quarter 2009 financial statements. It is important to note that some state extended NOL carryback conformity may not be addressed and ultimately enacted until next year, requiring a later reporting date.

There could be FIN 48/ASC 740-10 impacts from filing state refund claims if the state NOL extended carryback is based on tax planning incorporating some level of uncertainty. In this case, the standard two-prong test for accounting for income tax uncertainties should be applied resulting in recognition of the NOL extended carryback benefit only if it is more-likely-than-not to be sustained on its technical merits after a review by the tax authorities (including the appeals process). If the recognition test is met, the extended NOL carryback benefit may be disclosed in financial statements at the largest amount of tax benefit more-likely-than-not to be realized on settlement with a taxing authority that has full knowledge of all relevant information. No related interest and/or penalties should be accrued until refunds have been received.

<sup>17</sup> Ernst & Young, Hot Topic No. 2009-44, Nov. 6, 2009

## CLAIMING A STATE REFUND

We believe that for those states ultimately conforming to the federal extended NOL carryback, the process for refund claims will be similar to that required for federal refund claims. IRS guidelines provide that “a taxpayer may make the election under IRC § 172(b)(1)(H) by attaching a statement to the taxpayer’s federal income tax return for the taxable year in which the applicable NOL arises.<sup>18</sup> The election may be made by attaching a statement to an amended return for the taxable year of the applicable NOL.<sup>19</sup> The election statement must include the following information:

- a statement that the taxpayer is electing to apply IRC § 172(b)(1)(H) or § 810(b)(4) under Rev. Proc. 2009-52;
- a statement that the taxpayer is not a TARP<sup>20</sup> recipient, nor, in 2008 or 2009, an affiliate of a TARP recipient; and
- the length of the NOL carryback the taxpayer elects (three, four, or five years).<sup>21</sup>

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**It appears the standard federal three-year statute of limitations period is indirectly waived for a small window of time.**

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Although we do not believe it is expressly stated in the IRS guidelines, it appears the standard federal

<sup>18</sup> Rev. Proc. 2009-52.

<sup>19</sup> *Id.*

<sup>20</sup> TARP recipients are any taxpayers (or their affiliates) that received certain benefits (whether or not repaid) under the Emergency Economic Stabilization Act of 2008, Title I of Div. A of Pub. L. No. 110-343, 122 Stat. 3765.

<sup>21</sup> Rev. Proc. 2009-52

three-year statute of limitations period is indirectly waived for a small window of time. All original and/or amended federal income tax returns prepared to claim the election must be filed on or before the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009.<sup>22</sup> Simply stated, as long as all requisite amended returns are filed by the due date (including extensions) of the 2009 federal income tax return, federal statutes of limitation will not be enforced. We believe state authorities are likely to follow federal guidelines with respect to filing refund claims on amended state returns.

It is important to note that filing amended state returns for earlier tax years is likely to leave a company open to audit for the amount of the refund claim. Therefore, it is prudent to review tax positions taken on earlier state returns to ensure filing a refund claim does not in turn create additional exposure for the company.

## CONCLUSION

It remains to be seen to what extent the federal extended NOL carryback will be embraced by states. Based on historical data regarding similar legislation and general state statutory conformity to federal law, we estimate approximately 12 states may conform to the federal opportunity in some manner. Factoring the current economic downturn, this estimate could be optimistic. Whatever ultimate state conformity results, a company should plan accordingly before deciding to file state refund claims. A company should confirm loss generation years by applying tax planning strategies to increase and/or accelerate deductions, while considering the impacts of state loss limitations, filing methods, tax attributes previously utilized, and current year compliance requirements. A company should also weigh the benefits of filing state amended returns to claim an extended NOL deduction with the costs of potential audit exposure.

<sup>22</sup> *Id.*