

Congress recently passed the "American Recovery and Reinvestment Act of 2009" (the Act) which is intended to jump-start our economy, in part through tax incentives aimed at encouraging businesses to increase investment. A key provision in the new law which is designed to help struggling businesses cope with the business downturn and spur new investment is a temporary extension of the carryback period for certain net operating losses (NOLs) from two years to up to five years for small businesses.

*Background on business losses.*

Businesses calculate taxable income by subtracting expenses from revenues. While net income is taxed immediately, net operating losses do not qualify for immediate refunds on current tax returns. However, businesses may effectively receive a refund to the extent that they can be "carried back" against income taxed in previous years. Under pre-Act law, businesses may use current losses to offset only the past two years of profits. Losses that exceed the sum of the previous two years of positive income may be "carried forward" and used to offset taxable income earned in future years. Losses can currently be carried forward for twenty years.

*New provision.*

The new law extends the maximum NOL carryback period from two years to up to five years. In other words, an eligible business may elect a three-, four-, or five-year carryback period. The extended carryback period is subject to two important conditions: (1) it only applies to 2008 NOLs, and (2) it only applies to small businesses, defined as those with gross receipts of \$15 million or less.

For those businesses that qualify, the extended carryback provision could be very helpful in two ways. First, a carryback can generate a refund because it allows the taxpayer to offset income that has already been taxed. Under pre-Act law, a small business taxpayer couldn't have used the NOL to offset the taxable income for the fifth, fourth, and third tax years preceding the NOL year, years when the taxpayer was more likely to have had taxable income. Allowing the carryback to the earlier years thus increases the likelihood that the taxpayer will be entitled to a refund, and may increase the amount of the refund. A second positive effect of the extended carryback period is that it will make temporary investment incentives such as bonus depreciation and expensing more effective. That is because businesses that are unable to absorb their current losses with past tax payments do not receive immediate benefits from investment tax incentives such as expensing or bonus depreciation. Unused deductions can't be used until future years. Because this blunts any stimulus provided by investment tax incentives, extending the carryback period enhance these incentives. The more generous carryback period can allow a company to benefit immediately from temporary investment incentives.

I should note, as a caveat, that the taxpayer must affirmatively elect the increased carryback. Absent any election, the regular NOL carryback period rules apply. Thus, even if a taxpayer qualifies as an eligible small business and the taxpayer's 2008 NOL otherwise qualifies for the increased carryback, the NOL can't be carried back more than two years unless the taxpayer elects to apply the extended carryback provision or one of the other special carryback periods applies.