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Dear ,

This issue of the WKBK&Y newsletter addresses:

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2. The IRS Provides Guidance and Safe Harbor to Victims of Fraudulent Investment Schemes
3. IRS Reverses Itself—Certain Intangibles May Qualify for Like Kind Exchanges
1. **IRS Issues Guidance on 5-Year NOL Carryback Provision**

Introduction

As we stated in last month's edition, the American Recovery and Reinvestment Act of 2009 ("ARRA") contained, among other things, a provision allowing taxpayers to carryback NOLs incurred in 2008 as many as five (5) years. This is a significant change from prior law, which generally allowed only a two (2) year carryback. The extended carryback is available only for losses incurred in a tax year ending in 2008, or if the taxpayer so elects, a tax year beginning in 2008. The availability of the extended carryback period is conditioned upon a trade or business's meeting a gross receipts test. (See new Code section 172(b)(1)(H).)

The IRS recently issued guidance on how to make the election, along with guidance on how to change the carryback from two (2) to five (5) years in the event that a taxpayer claimed a 2-year carryback prior to the law change. (Rev. Proc. 2009-19.)

Though at this late date, some of the guidance in the Rev. Proc. may be of limited value to certain taxpayers, there is still opportunity for many taxpayers to take advantage of a five-year carryback under ARRA. This article outlines the procedures required to do so.

Recap of ARRA Provisions

The increased carryback is only available for losses incurred by "eligible small businesses." A business is only eligible if its average annual gross receipts over the prior three (3) years are less than \$15 million. For this purpose, all trades or businesses (sole proprietorships, partnerships, and S corporations) sharing at least fifty percent (50%) common ownership are treated as a single trade or business.

A taxpayer with a qualifying NOL may elect any number of years from three (3) to (5), and the number of years elected is irrevocable once made.

Rev. Proc. 2009-19 Clarifications

Three-Year Lookback. Rev. Proc. 2009-19 clarifies Code an ambiguity in section 172(b)(1)(H) as to whether the 3-year testing period for gross receipts includes the loss year or not. Rev. Proc. 2009-19 clarifies that the IRS adheres to the 2006-2008 interpretation. This is good for taxpayers because generally businesses' gross receipts will be much less in 2008 than in 2005, when economic conditions were much better.

Taxpayers who have Already Filed. The Rev. Proc. also provides guidance for taxpayers who have already filed using the 2-year carryback under prior law. The Code section 172(b)(1)(H) election may be made by such taxpayers, provided they make the election by the later of: (A) six months after the due date of the return (determined without extensions); and (B) April 17, 2009. This election is made by filing the appropriate Form 1045 or 1139 and writing across the top "2008 NOL CARRYBACK ELECTION PURSUANT TO REV. PROC. 2009-19". A short statement must also be attached to the Form.

Taxpayers who have not Filed. Taxpayers who have not filed their return have until the later of the due date (with extensions) or April 17, 2009. A statement that the taxpayer is making the 172(b)(1)(H) election is to be attached to the taxpayer's income tax return.

Making the Election. Under either method, the applicable statement must state that the taxpayer is electing to apply Code section 172(b)(1)(H), the number of carryback years elected, and if applicable, a statement that the taxpayer is electing to make the 172(b)(1)(H) election for a tax year that begins (rather than ends) in 2008.

In general, the taxpayer must generally timely file its income tax return to qualify for the extended carryback, although the Rev. Proc. indicates that later filers may be afforded some relief pursuant to Regs. section 301.9100-2(b).

Taxpayers owning Interests in Entities. Rather than requiring the eligible small business to make the election with respect to a business incurring a 2008 NOL (as the Code reads), the Rev. Proc. instead gives that election to the taxpayer partner or S corporation shareholder with respect to its distributive share of the business's loss. The election is made by the taxpayer on a business-by-business basis with respect to the taxpayer's distributive share of income, gain, loss, and deduction from each partnership, S corporation, or sole proprietorship.

2. The IRS Provides Guidance and Safe Harbor to Victims of Fraudulent Investment Schemes

Introduction

The IRS recently issued Rev. Proc. 2009-20, providing a safe harbor for deducting theft losses under Code section 165(c) for investors who have suffered losses from fraudulent investment schemes similar to that perpetrated by Bernie Madoff. The IRS concurrently issued Rev. Rul. 2009-9, which illustrates the tax consequences of taking a theft deduction for such a loss.

Background

Under Code section 165(e), taxpayers are allowed an itemized (Schedule A) deduction for losses arising from theft. A taxpayer claiming a theft loss is entitled to the deduction in the year he discovered the theft and must prove that there is no reasonable prospect of recovering the theft.

Theft loss deductions are subject to two significant limitations where the loss was not incurred in connection with a trade or business or an activity entered into for profit. First, there is a \$100 floor (\$500 in 2009) for each theft loss – i.e., only losses in excess of the floor (on a per-occurrence basis) are available for the deduction. Second, once all theft losses for a year are aggregated, only theft losses in excess of 10% of a taxpayer's AGI may be deducted. Furthermore, Code section 68 places a limitation on total itemized deductions, based on a percentage of the taxpayer's AGI. Code section 68(c)(3) provides that theft losses are excepted from this limitation.

Rev. Proc. 2009-20

The Rev. Proc. applies to any arrangement in which a party (the "lead figure") receives cash or property from investors, purports to earn income for the investors, reports income to the investors that are partially or wholly fictitious, and makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement, and appropriates some or all of the investors' cash or property.

A loss is a "qualified loss" for purposes of the Rev. Proc. if it results from a fraudulent arrangement in which the lead figure was charged by indictment, information, or by a criminal complaint alleging fraud, embezzlement or a similar crime that would qualify as a theft under Regs. section 1.165-8(d). A taxpayer is a "qualified investor" if he (i) generally qualifies to deduct a theft loss; (ii) did not have actual knowledge of the fraudulent scheme prior to such information becoming public; (iii) the fraudulent arrangement is not a tax shelter within the meaning of Code section 6662(d)(2)(C)(ii); and (iv) transferred cash or property to a specified fraudulent arrangement.

Losses are generally deductible in the year the loss is discovered. If a taxpayer elects the safe harbor under Rev. Proc. 2009-20, the year of discovery will be the year in which the indictment, information, or complaint is filed against the lead figure.

Generally, the amount of the loss will equal the amount of the initial investment plus additional investments and amounts reported as gain which were reinvested in the investment and reduced by amounts withdrawn and any amount for which there is a reasonable prospect of recovery. The safe harbor provision under Rev. Proc. 2009-20 allows the taxpayer to deduct 95% of a qualified loss or 75% of a qualified loss if the taxpayer intends to pursue third-party recovery. Future recoveries may require income recognition.

Taxpayers elect treatment under Rev. Proc. 2009-20 by filing the usual form for reporting theft losses – Form 4684 and marking “Revenue Procedure 2009-20” at the top of the Form and completing and attaching a form (included as Appendix A of the Rev. Proc.) that provides for the method of calculating the loss and a declaration by the taxpayer. The statement must be attached to the taxpayer’s timely filed (including extensions) income tax return for the year of the loss. If, before April 17, 2009, the taxpayer has filed a return for the discovery year that is inconsistent with the safe harbor, the taxpayer must indicate this fact on the executed statement and attach the statement to the return (or amended return) for the discovery year consistent with the safe harbor by May 15, 2009.

Taxpayers that do not elect safe harbor treatment are subject to the general requirements for deducting theft losses. For example, such a taxpayer would have to establish that the loss was from theft, that the theft was discovered in the year claimed, and that no claim for reimbursement of any portion of the loss exists for which there is any reasonable prospect of recovery.

Rev. Rul. 2009-9

Rev. Rul. 2009-9 concludes on several issues attendant to a Madoff-type scheme. The ruling confirms that the deduction is not subject to any deduction limitations because the taxpayer entered into the investment with a profit motive. Furthermore, taxpayers taking such a loss will not have to show that the loss is a trade or business loss to be entitled to NOL carryback / carryforward under Code section 172(d)(4)(C). As discussed in the above article, such a loss occurring in 2008 that results in an NOL may be eligible for an extended carryback period.

The ruling also holds that the alternative tax computation (claim of right rule) under Code section 1341 is inapplicable to theft losses. Finally, the IRS concludes that the mitigation provisions of Code section 1311-1314 (allowing a taxpayer to reopen and reduce income reported in closed tax years in certain situations) are not available to a defrauded taxpayer because there is no inconsistency with any income the taxpayer previously reported from the fraudulent investment; such income increases the amount of the taxpayer’s loss.

WKBKY Takeaway

Rev. Proc. 2009-20 is essentially a tradeoff – a taxpayer takes a reduced (95% or 75% as applicable) deduction for his losses, but gets the advantage of not having to prove the year in which he discovered it and prove theft. Instead, all that needs to be proved under the safe harbor is that criminal charges were brought against the lead figure and that the investment scheme meets the qualifications for the safe harbor. For most taxpayers, this would probably be an easier route, and by only giving up 5% of the deduction, it is probably worth utilizing the safe harbor.

Rev. Proc. 2009-9 is probably not necessary as it merely outlines the tax consequences already extant in the Code. But it will help quell concerns that Madoff victims may have over limitation and loss deductions.

3. IRS Reverses Itself—Certain Intangibles May Qualify for Like Kind Exchanges

IRS has recently published Chief Counsel Advice (“CCA”) 200911006. This ruling reflects a significant reversal the IRS’ previous position with respect to the characterization of intangibles as like-kind for purposes of tax deferral under Code section 1031. While a like-kind exchange involving these intangible assets was conceptually permissible prior to the issuance of the CCA, tax-free treatment was generally denied because of an IRS ruling policy that trademarks, trade names and similar assets were virtually indistinguishable from goodwill, an asset that is not eligible for § 1031 treatment. (See Technical Advice Memorandum (“TAM”) 200602034 (Sept. 29, 2005).)

In a complete reversal of its prior TAM position, the CCA concludes that a customer-based intangible asset is not goodwill for purposes of section 1031 if it can be separately described and valued apart from goodwill. Although the CCA is binding only on the taxpayers to whom it is directed, it helpfully explains the IRS rationale and legal authority for its changed position—citing to an analogous holding in Newark Morning Ledger Co. v. U.S., 507 U.S. 546 (1993) (finding that a paid subscriber list constituted an amortizable intangible asset separate and apart from goodwill with an ascertainable value and a limited useful life). More surprisingly, the CCA creates a factual presumption in favor of taxpayers by further concluding that, except in rare and unusual circumstances, intangibles such as trademarks, trade names and similar customer-based intangibles *can be* separately described and valued apart from goodwill.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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