



## **RECOVERY ACT**

*The Implementation of the Five-Year  
Net Operating Loss Carryback Claim  
Provisions Were Generally Effective*

**June 14, 2010**

**Reference Number: 2010-41-070**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



## HIGHLIGHTS



### THE IMPLEMENTATION OF THE FIVE-YEAR NET OPERATING LOSS CARRYBACK CLAIM PROVISIONS WERE GENERALLY EFFECTIVE

## Highlights

#### Final Report issued on June 14, 2010

Highlights of Reference Number: 2010-41-070 to the Internal Revenue Service Commissioners for the Wage and Investment Division and the Small Business/Self-Employed Division.

#### IMPACT ON TAXPAYERS

The American Recovery and Reinvestment Act of 2009 (Recovery Act) was passed to provide relief for businesses suffering current economic hardships by allowing eligible taxpayers to carry back a Tax Year 2008 Net Operating Loss (NOL) to the 5 prior tax years. The Worker, Homeownership, and Business Assistance Act (WHBAA), enacted in November 2009, expanded and extended these NOL benefits.

The Internal Revenue Service's (IRS) implementation of these acts and its ability to timely process associated refunds affects thousands of taxpayers. By the end of Calendar Year 2009, the IRS had processed Recovery Act NOL carryback claims for approximately 44,000 taxpayers totaling more than \$3 billion. The Joint Committee on Taxation estimated the initial costs of the WHBAA extended carryback provision to be up to \$33 billion.

#### WHY TIGTA DID THE AUDIT

The overall objective of this review was to determine whether the IRS provided adequate information to taxpayers related to Recovery Act and WHBAA carryback claims and whether the IRS correctly applied the laws' provisions when processing these claims.

#### WHAT TIGTA FOUND

Despite the fact that the Recovery Act was enacted during the filing season, the IRS helped foster compliance with the extended NOL carryback provisions by issuing timely

and clear guidance to taxpayers. The IRS also issued press releases reminding taxpayers of upcoming deadlines. When TIGTA identified a press release that caused confusion regarding due dates for certain taxpayers making an election, the IRS quickly clarified the information in a revised press release.

In most cases, the IRS effectively processed the carryback claims. It developed an automated tool to ensure taxpayers met the small business requirement (\$15 million in gross receipts on average) of the Recovery Act extended NOL carryback provision. There were some programming limitations in the tool; however, only a minimal number of claims were affected.

While some taxpayers received refunds even though primary or flow-through (partnership and S Corporation) returns were not processed or not filed, these problems were not significant in terms of numbers or dollars.

The IRS developed procedures to identify whether Troubled Asset Relief Program recipients inappropriately claimed the extended carryback under the WHBAA. Employer Identification Numbers are cross-referenced to a list of Troubled Asset Relief Program recipients. If the Employer Identification Number on a claim appears on the Troubled Asset Relief Program fund list, the claim is rejected.

One change based on the WHBAA that was not timely incorporated into forms and publications was that NOLs carried back to the 5<sup>th</sup> year are limited to 50 percent of the taxable income for that year. IRS officials made this change after TIGTA brought it to their attention. TIGTA also found that some claims were processed even though they exceeded the 50 percent limitation. Based on our review, the IRS promptly issued an alert to its employees.

#### WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report. IRS management agreed with the information in the report.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

June 14, 2010

**MEMORANDUM FOR** COMMISSIONER, WAGE AND INVESTMENT DIVISION  
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – The Implementation of the Five-Year Net  
Operating Loss Carryback Claim Provisions Were Generally Effective  
(Audit # 200940136)

This report presents the results of our review of the implementation of the 5-year Net Operating Loss Carryback Claim provision. The overall objective of this was to determine whether the Internal Revenue Service (IRS) provided adequate information to taxpayers related to American Recovery and Reinvestment Act of 2009 (Recovery Act)<sup>1</sup> and Worker, Homeownership, and Business Assistance Act of 2009<sup>2</sup> carryback claims and whether the IRS correctly applied the laws' provisions when processing these claims. This audit was included as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Implementing Tax Law Changes.

The Recovery Act provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

IRS management agreed with the information in the report. Management's complete response to the draft report is included as Appendix V.

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<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>2</sup> Pub. L. No. 111-92, 123 Stat. 2984 (2009).



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Copies of this report are also being sent to the IRS managers affected by the report's finding. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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## *Abbreviations*

IRS	Internal Revenue Service
NOL	Net Operating Loss
TARP	Troubled Asset Relief Program
WHBAA	Worker, Homeownership, and Business Assistance Act



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## *Background*

The American Recovery and Reinvestment Act of 2009 (Recovery Act)<sup>1</sup> became law on February 17, 2009. It included a provision to extend the Net Operating Loss (NOL) carryback period from 2 years to up to 5 years for eligible small businesses. The intention was to provide relief for small businesses suffering current economic hardships by allowing them to recover taxes paid in previous years. This change applied to individual and business filers as long as an NOL could be claimed on their return.

Recovery Act benefits related to NOL carryback claims were later expanded and extended by the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA).<sup>2</sup> Similar to the Recovery Act, NOL carryback claims under the WHBAA have a 5-year carryback period. However, most businesses,<sup>3</sup> regardless of size, are included under the WHBAA.

### **Carryback claims, absent the recent legislation, are generally carried back only 2 years**

Taxpayers who incur significant losses from business activities or natural disasters could be in a situation in which expenses and deductions exceed their income, resulting in an NOL for the tax year. Taxpayers can deduct the loss from their income in other tax years. Generally, carryback claims are applied to the 2 tax years prior to the year of the loss, and any remaining loss can be carried forward for up to 20 years. Alternatively, taxpayers may decide they do not want to carry any of the loss back. They can do this by making an irrevocable election to waive the carryback period.<sup>4</sup> By making this election, the loss may only be claimed on future tax returns.

Even without the Recovery Act provision, the carryback period can be longer under certain special circumstances. Examples include losses from casualties or thefts. Taxpayers with carryback claims resulting from either of these situations have a 3-year carryback period. Qualified disaster losses and farming losses can be carried back 5 years. There are also other special categories, most of which apply to very specific taxpayers (e.g., Qualified Gulf Opportunity Zone Losses).

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<sup>1</sup> Pub. L. No. 111-5, 123 Stat 115 (2009).

<sup>2</sup> Pub. L. No. 111-92, 123 Stat 2984 (2009).

<sup>3</sup> Most businesses that received Troubled Asset Relief Program funds are excluded from using the 5-year carryback period.

<sup>4</sup> Taxpayers make this election by attaching a formal statement to the tax return with the loss. The election must be filed by the due date or extended due date of the return to be valid. In some cases, it is advantageous for the taxpayer to forgo the carryback period. For example, if the Alternative Minimum Tax is involved, the taxpayer could apply a loss to a prior year but receive no tax benefit or refund.



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For almost all NOL carryback claims, including Recovery Act NOL carryback claims, the full amount of the loss is carried back and applied to the earliest carryback year.<sup>5</sup> Any remainder is carried over to the next earliest carryback year and so on until the entire loss is absorbed. For example, an ordinary business carryback claim for Tax Year 2008 would be first applied to Tax Year 2006 (2 years prior). Any loss remaining would then be applied to Tax Year 2007. If the loss is not absorbed in the carryback years, the balance can be carried forward and applied to future tax years until fully absorbed, for up to 20 years. The amount refunded to the taxpayer is the difference between what the taxpayer previously paid and the recalculated tax after the carryback loss is deducted from the prior years' profits.

***Apart from specific provisions, and increasing the carryback period from 2 to 5 years, the filing and processing of both Recovery Act and WHBAA claims follow the same procedures as ordinary carryback claims.***

Taxpayers with an NOL have a choice of two methods to file a claim for refund, each of which has separate rules. One method is to file an Application for Tentative Refund (Form 1045) or Corporation Application for Tentative Refund (Form 1139), which must be filed within 1 year after the end of the tax year with the NOL.<sup>6</sup> Either applicable form can be used to file for all of the carryback years.

The primary advantage of making a claim using Form 1045 or Form 1139 is that the original return with the NOL does not have to be completely processed by the Internal Revenue Service (IRS) before the claim can be worked (therefore it is "tentative"). This means the refund can be issued prior to verification of the posted tax return. The IRS is required to pay interest on refunds not issued within 45 days. The IRS Accounts Management function applies examination criteria after the claim is processed.

The second method to file a claim for refund is to file an amended return<sup>7</sup> to make the claim, although this method is less common. An amended return has to be filed for each carryback year and must generally be filed within the statutory period of 3 years from the due date of the loss year return, including extensions. Individual taxpayers are required to compute the NOL on Schedule A-NOL of Form 1045 and attach it to each amended return. They are also told to enter "Carryback Claim" on page 1 of the form, to indicate it is a carryback claim. Business taxpayers are also instructed to attach supporting documentation. The same rules apply for computing and paying interest for claims not processed within 45 days. In the case of amended returns, the Accounts Management function applies examination criteria before the claim is processed and the refund issued.

<sup>5</sup> For WHBAA NOL carryback claims, the amount that is carried back to the 5<sup>th</sup> year may be limited, as described later in the report.

<sup>6</sup> Internal Revenue Code Section 6411 (a).

<sup>7</sup> Amended U.S. Individual Income Tax Return (Form 1040X) for individuals or Amended U.S. Corporation Income Tax Return (Form 1120X) for corporations.



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**Recovery Act NOL provisions**

The Recovery Act was passed to create and save jobs and spur economic activity. Tax benefits to accomplish these purposes were an important part of the Recovery Act, with the extended NOL carryback period being one of several tax benefits included in the legislation.

In order to claim the 5-year carryback period allowed by the Recovery Act, the taxpayer must:

1. Make an election by April 17, 2009, or the extended due date of the return, whichever is later.<sup>8</sup> The election can be made by completing amended returns for the “gain” years prior to the loss or by completing the Form 1045 for individuals or Form 1139 for businesses. For both individuals and businesses using the tentative refund process, the application must be made within 6 months from the return due date. The taxpayer can elect to choose a 3-, 4-, or 5-year carryback period (we refer to these carryback claims under the new provisions as 5-year carryback claims in this report). This election is irrevocable.
2. Meet the eligible small business requirement, which means having gross receipts of less than \$15 million, averaged over the last 3 tax years. The calculation of the gross receipts average can become very complex if the taxpayer has flow-through income from partnerships or S Corporations.<sup>9</sup> The IRS developed an automated tool, called the Gross Receipts Average Calculator, to make the eligible small business determination and speed up the processing of claims.

An example of how a typical calculation over the carryback period might be made is shown in Figure 1. In this example, the taxpayer has a \$38,000 NOL for Tax Year 2008. Assuming the taxpayer did not average more than \$15 million in annual gross receipts for Tax Years 2006 through 2008, the taxpayer would be eligible to claim the 5-year NOL carryback under the Recovery Act provision. The Tax Year 2008 NOL is carried back against the profit in Tax Year 2003, giving the taxpayer a refund for taxes previously paid on the profit in that year. The remaining NOL is used similarly in the ensuing years until it is fully absorbed.

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<sup>8</sup> However, if taxpayers filed their return prior to the passage of the law, and had elected to forgo the carryback, they had to make the election by April 17, 2009.

<sup>9</sup> These business types do not pay income taxes on their income, but pass through profits and losses to their partners or shareholders.



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**Figure 1: Example of Recovery Act NOL Carryback Calculations**

Tax Year	2003	2004	2005	2006	2007	2008
Profit/Loss	\$14,000	\$13,000	\$10,000	\$8,000	\$5,000	<b>(\$38,000)</b>
Amount of Tax Year 2008 NOL Used	\$14,000	\$13,000	\$10,000	\$1,000		
Profit After Carryback Adjustment	\$0	\$0	\$0	\$7,000		
Remaining Tax Year 2008 NOL	<b>(\$24,000)</b>	<b>(\$11,000)</b>	<b>(\$1,000)</b>	\$0		

Source: Treasury Inspector General for Tax Administration example.

**WHBAA NOL provision**

On November 6, 2009, the WHBAA was signed into law. It expanded and extended tax benefits that were previously enacted as part of the Recovery Act legislation; among these is the NOL carryback provision. The WHBAA carryback provision applies to NOLs incurred in either Tax Year 2008 or 2009 and applies to all individual and business filers with NOLs, not just small businesses. However, an eligible small business under the Recovery Act legislation may elect to carryback NOLs from Tax Years 2008 and 2009. The primary changes resulting from the WHBAA are:

1. An NOL carried back to the 5<sup>th</sup> year before the loss year is limited to 50 percent of the taxable income for that year (see an example in Appendix IV).
2. The WHBAA excludes businesses that received Troubled Asset Relief Program (TARP)<sup>10</sup> funds from taking advantage of the extended NOL provision.
3. Most businesses, other than those that received TARP funds, are eligible for the extended carryback period regardless of business size.

Apart from the considerations for specific provisions, such as election deadlines and small business eligibility, and increasing the carryback period from 2 to 5 years, the filing and processing of both Recovery Act and WHBAA claims follow the same procedures as ordinary carryback claims. Individuals and businesses generally claim the losses in the same way, using the Form 1045 or Form 1139 or using amended returns.

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia; the Small Business/Self-Employed Division Headquarters in Washington, D.C.; the Submission Processing Site in Fresno, California; the Integrated Automation Technologies offices in Atlanta, Georgia, and Ogden, Utah; and with Examination function employees throughout the country during the period of April 2009 through February 2010. We conducted this performance audit in accordance with generally accepted

<sup>10</sup> Pub. L. No. 110-343, 122 Stat 3765 (2008).



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government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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## *Results of Review*

### ***Efforts to Implement Necessary Changes to Guidance and Procedures Were Generally Effective***

The IRS provided timely and clear information to taxpayers related to the special provisions to claim NOL carryback claims for up to 5 years as provided for in the Recovery Act and the WHBAA. In general, the IRS also implemented the internal procedures needed to properly process these carryback claims. As of the end of Calendar Year 2009, the IRS had processed Recovery Act NOL carryback claims for approximately 44,000 taxpayers, totaling more than \$3 billion. Because the WHBAA provision did not go into effect until late 2009, figures for the total amount of WHBAA claims were not available during the audit period. However, a Joint Committee on Taxation report estimated the initial costs of the WHBAA to be up to \$33 billion, with benefits in subsequent years partially offsetting the initial costs (this could occur because the losses are carried back instead of being carried forward).

#### **Guidance and processing related to Recovery Act NOL carryback claims was effective**

Overall, the IRS implementation of the Recovery Act NOL carryback provision went smoothly. The IRS issued timely and clear guidance to taxpayers explaining the provision related to the NOL carryback. The IRS also effectively processed the carryback claims. While some taxpayers received refunds even when primary<sup>11</sup> or flow-through<sup>12</sup> returns were not filed, these problems were not significant in terms of numbers or dollars.

Approximately 1 month after the Recovery Act was passed, the IRS issued guidance to taxpayers on how to claim the extended NOL.<sup>13</sup> Many of the Recovery Act provisions required immediate implementation, including the provision related to NOL carryback claims. The purpose of the guidance was to help taxpayers understand the deadlines and procedures for making an election for the extended NOL carryback. In issuing timely guidance, the IRS helped ensure that eligible taxpayers, regardless of their filing scenario, had the opportunity to take advantage of the tax

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<sup>11</sup> A primary return refers to the taxpayer's own income tax return.

<sup>12</sup> A flow-through return refers to information returns from partnerships or S Corporations. These business types do not pay income taxes on their income, but pass through profits and losses to their partners or shareholders. Primary taxpayers with income or losses from partnerships or S Corporations must include these items on their own returns. Flow-through income is derived from flow-through returns.

<sup>13</sup> The IRS uses revenue procedures as a means to clarify changes to tax law for the public. The IRS issued Revenue Procedure 2009-19 on March 16, 2009, to help taxpayers understand the time and manner for making an election to take the 3-, 4-, or 5-year carryback provided by Section 1211 of the Recovery Act.



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benefit. For example, taxpayers that had previously filed a return, but initially elected to forgo the regular carryback, only had until April 17, 2009, to make an election to take the extended NOL carryback. Taxpayers that had not filed but made a timely request for an extension to file could make an election as late as September 15 or October 15, 2009 (for business and individual filers respectively). The timely issuance of guidance meant that taxpayers could quickly apply for and receive refunds.

Soon after issuing the guidance, the IRS received claims that had to be rejected because taxpayers did not follow the required procedures to make a valid election. After promptly identifying the cause, the IRS issued updated guidance on April 25, 2009.<sup>14</sup> The updated guidance simplified the election procedures by allowing taxpayers to make an election by completing the appropriate form and claiming the extended carryback period. Previously, a statement with specific wording was also required, but taxpayers were not consistently including this statement. The updated guidance reduced taxpayer burden by helping to minimize rejections and the need for additional contacts between the IRS and taxpayers.

The IRS took additional actions to ensure taxpayers had enough information on the extended carryback. The IRS issued a press release reminding taxpayers of upcoming deadlines. When our auditors identified a press release that caused confusion regarding due dates for certain taxpayers making an election, the IRS quickly clarified the information in a revised press release. Further, the IRS developed a web site that contained links to more information for taxpayers, such as a “Questions and Answers” document and updated forms and instructions.

### **IRS guidance clearly explained filing and election procedures**

The guidance clearly described the election procedures and due dates for taxpayers in certain situations, helping to ensure taxpayers accurately claimed the tax benefit. Since the Recovery Act was passed during the filing season, eligible taxpayers encountered various filing scenarios in attempting to claim the benefit. Some taxpayers had already filed their income tax return or carryback application, while others had previously elected to waive the normal carryback period altogether.

***Representatives from tax and accounting associations stated that the guidance was adequate, timely, and assisted eligible taxpayers and preparers to claim the benefit.***

The forms, instructions, and publications providing guidance on NOLs properly incorporated the changes and procedures related to the Recovery Act. For example, *Net Operating Losses for Individuals, Estates, and Trusts* (Publication 536) provided a brief explanation of the new law and contained a link to more detailed information in a “What’s New” section on the cover page.

<sup>14</sup> Revenue Procedure 2009-26.



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Representatives from tax and accounting associations that we interviewed as part of our review stated that the guidance was adequate, timely, and assisted eligible taxpayers and preparers to claim the benefit.

### **The IRS effectively processed Recovery Act NOL carryback claims**

One of the primary challenges for the IRS in processing Recovery Act NOL carryback claims was determining whether the taxpayer was a qualifying small business as defined in the provision. To address this, the IRS developed an automated tool, the Gross Average Receipts Calculator, to facilitate the processing of carryback claims. The decision to develop the tool was predicated on the estimated increase in carryback claims and the complexity of the eligibility test under the law.

Typically, carryback claims are processed by Accounts Management function staff. However, to qualify for the extended carryback, taxpayers could not average more than \$15 million in gross receipts for the 3-year period ending in 2008.<sup>15</sup> Due to the difficulty in making this determination, experienced revenue agents examined claims while the tool was being developed. Once implemented, the Gross Receipts Average Calculator gathered specific information from the last three tax returns, performed the calculation of the gross receipts, and generated a conclusion for the processing staff.

In addition to implementing the Gross Receipts Average Calculator, appropriate staffing and training efforts were planned to ensure timely processing. The IRS researched historical data, periodically reassessed the volume of claims, and compared annual statistics to monitor necessary staffing levels.

The Gross Receipts Average Calculator also helped to ensure consistent treatment and review of carryback claims. Prior to its implementation on May 21, 2009, the IRS tested nearly 140 cases using the tool that were previously reviewed by revenue agents and determined the results were consistent. There were some programming limitations encountered in developing the tool. For example, the tool was unable to compute interest and dividend income and also could not process claims that had filing status changes from the previous year. However, only a minimal number of claims were affected.

### **Some taxpayers received refunds even though returns were either not processed or not filed**

Some taxpayers received Recovery Act refunds when primary or flow-through returns (partnership and S Corporation returns) were either not processed or not filed. However, this issue is not unique to Recovery Act NOL carryback returns and was not significant in terms of numbers or dollars affected. This occurred as a result of business decisions the IRS made about

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<sup>15</sup> There is no gross receipts test in standard 2-year NOL carryback processing.



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processing that balanced the need for timely customer service and for preventing improper issuance of refunds.

Out of over 12,000 business carryback claims worked through the end of October 2009, we identified 67 business return cases for which a taxpayer applied for the Recovery Act NOL carryback, but the IRS had not processed (or the taxpayer had not filed) a Tax Year 2008 return. The Tax Year 2008 return is important since it supports the NOL carryback claim. The IRS' acceptance procedures for NOL claims requires the taxpayer to attach a copy of the first two pages of the loss year return and to state when the return was filed, which should be the date of the claim or a prior date. For these 67 cases, we did not identify any claims in which these acceptance procedures were not followed. Most of these carryback claims were processed late in the calendar year. The IRS stated that these cases should be held for at least 20 cycles (weeks) prior to contacting the taxpayer. The IRS also updated its internal guidance to reflect this requirement. The IRS was following its procedures to identify and obtain potentially delinquent returns related to these cases. If the IRS determines that a tax return is delinquent, procedures direct employees to contact the taxpayer to obtain the return and, when necessary, reassess the tax amount that was refunded. We are considering the need for additional audit work in this area as part of our regular audit planning process.

The IRS stated that in seven cases, taxpayers had actually sent in their returns, but had improperly submitted the original returns with the application for tentative refund and the return had never been processed. Taxpayers are specifically cautioned not to send the original return with the application for tentative refund in both Form 1139 and Form 1045 instructions. The IRS promptly updated guidance to its employees describing this problem and how to process any such improperly submitted returns.

We also observed that some taxpayers were claiming losses for which the Gross Receipts Average Calculator indicated flow-through returns had not been filed. We reviewed a judgmental sample of 121 such cases for individual returns with flow-through losses. In all but a few cases, we could verify through additional research that no loss had inappropriately been claimed, even though the Gross Receipts Average Calculator had indicated that the return was not filed. In most cases, the flow-through business had not generated the loss claimed by the taxpayer (either no income or positive income was claimed on the taxpayer return related to the businesses with the missing returns). In some cases, we determined that the taxpayer had listed an incorrect Employer Identification Number and consequently the Gross Receipts Average Calculator had pulled the information for the wrong business. Of the cases we reviewed, only 4 cases with losses amounting to about \$1.5 million appeared to be claimed when no underlying flow-through return had been filed. As previously stated, more than \$3 billion in Recovery Act NOL claims have already been processed as of the end of Calendar Year 2009.



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**Actions taken to implement WHBAA NOL provision was also generally effective**

Legislative changes to an already complex tax law as a result of the November 2009 passage of the WHBAA prompted the IRS to issue initial guidance to taxpayers on November 20, 2009.<sup>16</sup> This timely guidance allowed taxpayers to quickly file a WHBAA NOL claim for Tax Year 2008.

New rules passed as part of the WHBAA regarding ineligible taxpayers and tax calculation limitations were properly incorporated in the initial guidance. The IRS also helped foster compliance with the new laws by reducing potential taxpayer confusion despite concurrent NOL carryback rule changes. In its guidance, the IRS clearly stated the main differences between the Recovery Act and the WHBAA. The IRS issued another “Questions and Answers” document, along with guidance explaining that the gross receipts test no longer applied and noting which tax year(s) eligible taxpayers could use as the basis for their NOL. For example, the most recent guidance contains a section of instructions for taxpayers that had filed a carryback application prior to the enactment of the WHBAA.

However, the IRS was not as quick to incorporate WHBAA changes into instructions for the Form 1045, Form 1139, or Publication 536. When we discussed the matter with IRS executives, they stated the changes would be made by the end of March 2010. As of April 7, 2010, all changes had been made to online and downloadable instructions for Form 1139 and Form 1045 and to Publication 536.

The IRS developed procedures to identify whether TARP recipients inappropriately claimed the extended carryback. Regular (non-WHBAA) carryback claims normally require a statement on the tax return indicating the taxpayer’s decision to waive the carryback period. The IRS developed a similar procedure relating to the TARP provision, requiring taxpayers to attach a statement to their claim that they did not receive TARP funds. In addition, the Employer Identification Numbers are cross-referenced against a list of TARP recipients the IRS obtains from the Department of the Treasury. The list is updated at the IRS on a monthly basis and contains the names and Employer Identification Numbers of businesses that received TARP funds or are affiliates of such businesses. If the Employer Identification Number on a claim appears on the TARP fund list, the claim is rejected.<sup>17</sup>

The IRS also developed processing procedures for its employees to help ensure the accuracy of carryback refunds. Under the WHBAA, an NOL carried back to the 5<sup>th</sup> year before the loss year

<sup>16</sup> Revenue Procedure 2009-52.

<sup>17</sup> The IRS is developing a special procedure to accommodate the limited exceptions allowed for in the law for which TARP recipients may still claim the 5-year carryback.



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is limited to 50 percent of the taxable income for that year. We reviewed a judgmental sample of 45 cases and determined that 3 claims were processed even though they exceeded the 50 percent limitation. Based on our review, the IRS promptly issued an alert to employees that some taxpayers were not limiting the carryback to 50 percent of taxable income or were incorrectly applying the limit to adjusted gross income rather than taxable income. The alert directed employees to reject improperly calculated NOL carryback claims. Effective implementation of this alert to prevent overpaying claims is important considering the estimated \$33 billion in payments that the IRS will be processing.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

The overall objective was to determine whether the IRS provided adequate information to taxpayers related to American Recovery and Reinvestment Act of 2009 (Recovery Act)<sup>1</sup> and Worker, Homeownership, and Business Assistance Act of 2009<sup>2</sup> carryback claims and whether the IRS correctly applied the laws' provisions when processing these claims.

To accomplish this objective, we:

- I. Determined if the IRS provided adequate information to taxpayers related to Recovery Act carryback claims.
  - A. Determined if legal guidance developed by the IRS was sufficient to implement the law by assessing the content and timeliness of the guidance.
  - B. Determined if other information developed by the IRS, such as instructions, forms, and publications, and information on its web site, included adequate information related to the 5-year provision, and specifically to the qualifications for the small business requirement. We reviewed the documents to determine if they were consistent with legal guidance and contained sufficient information to enable taxpayers to understand the new provision.
- II. Determined if the IRS correctly applied Recovery Act provision when processing carryback claims. This was focused primarily on the Gross Receipts Average Calculator tool. We did not review general carryback claim processing, which has been adequately addressed by prior Treasury Inspector General for Tax Administration reports.
  - A. Determined if the IRS provided timely and adequate guidance to field employees to process the initial claims by reviewing the guidance and interviewing field employees.
  - B. Determined if the development process for the Gross Receipts Average Calculator tool was adequate and if sufficient review and testing was performed prior to implementation by interviewing relevant employees and reviewing communications and documentation.
  - C. Determined if the Gross Receipts Average Calculator tool provided an accurate determination of whether the Recovery Act claims met the small business

<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>2</sup> Pub. L. No. 111-92, 123 Stat. 2984 (2009).



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- requirement by reviewing system requirements and interviewing employees about any weaknesses.
- III. Evaluated the IRS business decision to disregard missing flow-through returns<sup>3</sup> (when making the gross receipts average calculation) and, in some instances, missing primary returns.<sup>4</sup>
- A. To identify the basis for allowing missing flow-through returns, we interviewed employees about the decision process relating to flow-through returns. To determine the prevalence of this issue, we also reviewed judgmentally selected cases in which individual taxpayers had received the Recovery Act carryback and also had flow-through income as determined by having filed a Supplemental Income and Loss (Schedule E). The Recovery Act data were extracted from IRS Individual Master File<sup>5</sup> data. The population for the sample was 11,296 taxpayers as of Cycle 43 processing (October 26, 2009). We performed a judgmental sample because we wanted to identify whether the problem was widespread, but did not intend to project to the population. We selected from 11 to 43 cases to review from each of 5 strata based on the loss amounts; we selected 100 percent of the cases with losses of \$5 million or more, which amounted to 54 cases. The total number of cases selected was 142, but only 121 taxpayer cases had the necessary Gross Receipts Average Calculator prints retained in the IRS Correspondence Imaging System.<sup>6</sup> Of these cases, the Gross Receipts Average Calculator identified 61 that had missing flow-through returns. Our in-depth review of these cases consisted of reviewing various data from the Integrated Data Retrieval System,<sup>7</sup> the Correspondence Imaging System, and, in some cases, the paper tax returns.
- B. To identify the basis for allowing missing (unposted) primary returns, we reviewed IRS guidance and interviewed IRS employees. In addition, to determine the prevalence of missing primary returns, we selected all business taxpayers who had received the Recovery Act carryback as of Cycle 43 processing (October 26, 2009) and had not yet filed a return for Tax Year 2008 (a total of 12,495 taxpayers). We matched these taxpayers with data from our Data Center Warehouse extracts of return transactions to identify cases for which business taxpayers had not filed a primary

<sup>3</sup> A flow-through return refers to information returns from partnerships or S Corporations. These business types do not pay income taxes on their income, but pass through profits and losses to their partners or shareholders. Primary taxpayers with income or losses from partnerships or S Corporations must include these items on their own returns.

<sup>4</sup> A primary return refers to the taxpayer's own income tax return.

<sup>5</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>6</sup> The Correspondence Imaging System captures and stores images of correspondence from taxpayers including letters, returned notices, and standard forms.

<sup>7</sup> IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- return for Tax Year 2008, yet had received the refund. We manually reviewed Integrated Data Retrieval System records to verify that IRS records showed that the taxpayers had a filing requirement and had not filed. Through this process, we identified 67 cases for which taxpayers had not filed for Tax Year 2008 (or the IRS had not processed the return).
- C. To determine the reliability of the population data described in Steps III.A. and B., we compared the data we extracted from IRS Master File data to the summary of total Recovery Act transactions provided to us by the IRS. Because extraction criteria were not exactly the same for the two sets of data, there were some differences; however, the differences were not significant.
- IV. Determined if the IRS provided adequate information to taxpayers related to WHBAA carryback claims.
- A. Determined if legal guidance developed by the IRS was sufficient to implement the law by reviewing and evaluating the guidance.
- B. Determined if other information developed by the IRS, such as instructions, forms, and publications, included adequate information related to the 5-year provision in the WHBAA by reviewing and evaluating the other information.
- V. Determined if the IRS correctly applied WHBAA provision when processing carryback claims.
- A. Interviewed IRS employees regarding the actions they are taking to accommodate the new law.
- B. Evaluated the IRS' plan to ensure carryback claims used in the 5<sup>th</sup> taxable year are limited to 50 percent of taxable income in that year. We reviewed 45 judgmentally selected cases to determine if the 5<sup>th</sup>-year carryback amount was properly limited to 50 percent of taxable income. We decided to perform a judgmental sample to select cases from all sites processing WHBAA claims to identify whether any problems were widespread, and with the advance knowledge we would not be projecting the results to the population. The cases were selected from a total of 353 cases recorded by the IRS as of late January 2010.
- C. Evaluated the IRS' plan to identify TARP recipients and exclude them from receiving the tax benefit.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following



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internal controls were relevant to our audit objective: Wage and Investment Division policies, procedures, and practices related to processing NOL carryback claims. We evaluated these controls by interviewing relevant personnel, reviewing relevant guidance and documentation, and conducting analysis of relevant case files.



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## **Appendix II**

### *Major Contributors to This Report*

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

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Richard J. Calderon, Audit Manager

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**Appendix III**

*Report Distribution List*

Commissioner C  
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Commissioner, Large and Mid-Size Business Division SE:LM  
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    Commissioner, Small Business/Self-Employed Division SE:COM  
    Chief, Program Evaluation and Improvement, Wage and Investment Division  
    SE:W:S:PRA:PEI



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## Appendix IV

### *Example of 5<sup>th</sup>-Year Carryback Limitation*

The IRS provided the following example of the 5<sup>th</sup>-year NOL carryback limitation related to claiming the extended carryback period under the WHBAA.<sup>1</sup>

If a taxpayer elects a 5-year carryback, the NOL carried back to the 5th year is limited to 50 percent of the taxpayer's taxable income in 5<sup>th</sup> preceding year. The taxable income is determined for this purpose without reduction by the NOL being carried back 5 years or any later NOL.

For example, assume that in 2003, a taxpayer had taxable income of \$100 million, before any NOL deductions. The taxpayer had an unused 2002 NOL of \$25 million available to be carried forward to 2003 and an unused 2004 NOL of \$35 million available to be carried back to 2003. After using these NOL deductions, the taxable income for 2003 at this time would be \$40 million (\$100 million - \$25 million NOL deduction from 2002 - \$35 million NOL deduction from 2004).

Now assume that the taxpayer has an NOL of \$50 million for the 2008 tax year, and the taxpayer elects to carry this loss back to its 5th prior tax year, 2003.

Based on these facts, the additional NOL deductions allowed for 2003 from the carryback of the 2008 NOL would be limited to \$20 million, which is 50 percent of the previously determined taxable income for 2003. Thus, the 2003 taxable income, following the carryback of the 2008 NOL, would be \$20 million (the \$40 million taxable income determined before consideration of the 5-year carryback, reduced by the \$20 million NOL deduction attributable to the amount carried back from 2008).

*Source: This example was posted on the IRS' public web site under "Questions and Answers for the Worker, Homeownership, and Business Assistance Act of 2009—Section 13 5-year Net Operating Loss (NOL) Carryback."*

<sup>1</sup> All years referenced in this appendix are Tax Years.



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Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

RECEIVED  
JUN - 2 2010  
BY: *DRS*

MAY 27 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *Richard Byrd, Jr.*  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Implementation of the Five-Year  
Net Operating Loss Carryback Claim Provision Was  
Generally Effective (Audit # 200940136)

I reviewed the subject draft report and appreciate your findings regarding the five-year Net Operating Loss (NOL) carryback claim provision. The IRS has worked diligently to ensure that these American Recovery and Reinvestment Act NOL cases are worked efficiently and correctly. The IRS is committed to reducing taxpayer burden, and we recognize the importance of providing relief for small businesses suffering economic hardships and returning the revenue to the economy as expeditiously as possible. Thank you for recognizing the complexity of the issues involved and the swift response of the IRS to the changes that resulted from the legislation.

The IRS is also committed to fostering voluntary compliance. You noted several of our efforts in your report, such as the issuance of timely guidance, press releases, and the tool IRS developed to ensure the legislative criteria were met. Your report indicates that a minimal number of taxpayers received refunds without a processed return. This is a normal procedure. Taxpayers may file a tentative carryback application on or after the date the return generating the loss is filed. If the tentative carryback application is filed on the same day, or within a short period of time afterwards, the loss year tax return may not have completed processing when the Customer Service Representative begins working the tentative carryback application.

I would like to extend a special thank you for the cooperation and communication experienced throughout this audit. I appreciate the involvement of the audit team with our technical staff that ensured level-setting, including consistent data sourcing. The ability to work together was critical, and this audit team's process should be considered as a model.



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If you have any questions, please contact me, or a member of your staff may contact Peter J. Stipek, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.