INSIGHT: Promise and perils of tentative refunds—tax controversy aspects of NOL carrybacks under CARES Act

April 2020 | By **Robert J. Kovacev** and **Robert C. Morris**, Norton Rose Fulbright

The CARES Act included a five-year net operating loss carryback period. Robert Kovacev and Robert Morris of Norton Rose Fulbright highlight the dangers of rushing to claim these NOLs that could become more of a pitfall than a benefit for the unwary taxpayer.

The Coronavirus Aid, Relief, and Security (CARES) Act grants taxpayers a five-year carryback period for net operating losses (NOLs) generated in the 2018, 2019, and 2020 tax years. Pub. L. 116-136, Section 2303(b)(1), amending tax code Section 172(b).

Given the sudden and severe economic dislocations caused by the COVID-19 pandemic, these tentative refunds are manna from heaven for many companies who soon will be taking advantage of the much-needed liquidity and potential favorable rate differential for income that was previously taxed at higher rates. In most cases, taxpayers should receive these tentative refunds within 90 days if they elect to file a Form 1139, Corporation Application for Tentative Refund, with the Internal Revenue Service (Form 1045, Application for Tentative Refund, is the equivalent return for individuals, estates, and trusts). This remains true even if the taxpayer is under IRS audit. However, taxpayers filing Forms 1139 with the IRS should be mindful of the potential perils they face if the IRS decides to recoup the manna.

There have long been opportunities for companies facing losses to claim a "tentative refund" based on NOLs generated in loss years. Corporations may generally file a Form 1139 to request a tentative refund within 12 months of the end of the tax year in which an NOL arose. Because the deadline for filing a Form 1139 for the 2018 tax year has already expired, commentators expect that the IRS will issue guidance extending the deadline. The tax return for the year in which the NOLs are generated should be filed on or before the date the Form 1139 is filed. Subject to the considerations discussed herein, taxpayers anticipating a large refund from carrybacks of NOLs in 2018, 2019, or 2020 should consider filing tentative refund claims as soon as possible to receive rapid payment from the IRS.

There are also avenues for more immediate relief. If a corporation owes a tax liability for a prior year that would be reduced or eliminated by a NOL in the current year, it may file a Form 1138, Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback, to obtain an extension of time to pay based on the anticipated NOL carryback. If a taxpayer

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has overpaid estimated taxes for the current year due to NOLs in that year, it can obtain a quick refund by filing Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax.

After a taxpayer files Form 1139, the IRS has 90 days to perform a "limited examination of the application." Tax code Section 6411(b).The scope of this "limited examination" is very narrow and limited "to discover omissions and errors of computation" and "to determine the amount of the decrease in the tax attributable to such carryback upon the basis of the application and examination." Nothing in Section 6411 authorizes any examination of the merits of the loss being carried back nor of the merits of the tax year to which the loss is carried back, and nothing in that section authorizes an extension of the examination of the application beyond the 90-day period.

If the IRS determines that the application contains material omissions or computational errors that cannot be corrected in 90 days, it may reject the claim entirely. In that case, the taxpayer must file a regular claim for refund. Otherwise, the IRS must pay the tentative refund by the end of the 90-day period. The IRS often attempts to pay out tentative refunds within 45 days, in order to avoid having to pay interest on the amount refunded. Tax code Section 6611(e)(2) & (f)(4). This timeline is much compressed when compared to the months, if not years, that the IRS sometimes takes to process a refund claim in the ordinary course of business.

Receiving a tentative refund from the IRS is not necessarily the end of the process, however. Indeed, it is often merely the beginning of a taxpayer's entanglement with the IRS about an NOL carryback claim. If the taxpayer is already under IRS audit, the exam team will typically review the carryback as part of the audit even though the taxpayer has already received the refund. This may result in the IRS adding additional tax years to the audit cycle and possibly prolonging the audit.

For taxpayers that are not currently under exam, the IRS can, and often does, conduct intensive examinations after a tentative refund is paid of the tax year(s) giving rise to the NOL. The IRS may also examine tax years that are already closed by the statute of limitations to which the NOL is carried back. Although the examination of closed years should not give rise to any tax increased tax liability for those years, the IRS may look for unrelated issues in those years to reduce or possibly eliminate the amount of the tentative refund paid. The IRS may make adjustments to a closed year in order to reduce the amount of carryback available in other years, although any adjustments cannot exceed the amount of the carryback. Tax code Section 6501(h) and (k). See also Chief Counsel Memorandum 20114701F (May 12, 2011) (the IRS may make such adjustments even if the closed year was previously examined).

The IRS often conducts examinations of tentative refunds with uncharacteristic speed compared to ordinary examinations because a taxpayer suffering large losses may pose a collection risk for recovering the erroneous tentative refund. The pace and aggressiveness of these examinations often catches taxpayers off guard. Taxpayers who anticipate the possibility of an IRS examination by assembling substantiation and preparing in advance to defend the positions on their carryback claims have a higher probability of persuading the examination team that the NOLs were correctly claimed.

Moreover, if the IRS determines the tentative refund was issued in error, it can invoke a special streamlined assessment procedure similar to the expedited procedure used to correct computational errors. Treasury Regulation 301.6213-1(b)(2)(i). In essence, if the IRS determines that the NOL carryback was erroneous, it can issue an immediate assessment and begin collection proceedings without having to issue a notice of deficiency. Tax code Section 6213(b)(3); see, e.g., Coca-Cola v. United States (IRS can "assess the resulting increase in tax liability immediately without regard to whether the taxpayer has been mailed a prior notice of deficiency") (citations and internal quotations omitted).

Indeed, the IRS may make an assessment even before notifying the taxpayer at all, and need not provide a substantive explanation of the reasons for its determination. Treas. Reg. 301.6213(b)(2)(i). Because no notice of deficiency is issued, the taxpayer has no direct

recourse in Tax Court. It must pay the assessment, file a refund claim, and sue for a refund in federal district court or the Court of Federal Claims, or else risk the IRS moving to seize assets. The IRS could instead file an erroneous refund suit in federal district court or issue a notice of deficiency as with an ordinary examination. Because those methods lack the in terrorem effect of immediate assessment and collection, they are rarely used.

The immediate assessment procedure is particularly harsh for taxpayers because the assessment itself creates a federal tax lien on all the taxpayers' assets, potentially triggering default under the terms of debt instruments and other agreements. Tax code Section 6321. It also makes the taxpayer's assets vulnerable to seizure by levy or lien foreclosure proceedings. A taxpayer could challenge any collection actions (such as levies) through the IRS's collection appeals and Collection Due Process mechanism. Tax code Sections 6320, 6330. Usually, however, the safest course for the taxpayer in that instance is to pay the assessment and seek a refund through ordinary refund procedures.

The impact of the immediate assessment can be blunted in the case of a taxpayer who files for bankruptcy protection. A debtor in bankruptcy is protected by an automatic stay from most collection procedures, including IRS liens and levies. 11 U.S.C. Section 362(a). The bankruptcy court is vested with jurisdiction to adjudicate tax disputes without requiring prepayment, leveling the playing field for taxpayers able and willing to take that route. 11 U.S.C. Section 505(a). At least one court has held that insurance companies under rehabilitation or insolvency proceedings by state insurance commissioners have even broader protections, including the ability to obtain an injunction from a state court preventing the IRS from even making an assessment. In re Rehabilitation of Segregated Account of Ambac Assur. Corp.

Taxpayers wishing to avoid the draconian collection procedures discussed above may instead choose to file a Form 1120X, Amended U.S. Corporation Income Tax Return, to claim the refund attributable to an NOL. One of the downsides to this route is that it certainly invites an IRS audit. Moreover, it could take years for the IRS to process the Form 1120X, examine the refund claim, possibly look for offsets in closed years, and then, if necessary, obtain approval from the Joint Committee on Taxation to issue the refund (corporate refunds in excess of $5 million are reviewed by the committee). The upside is that after the process is completed, the taxpayer receives a final refund, not a tentative refund.

Taxpayers should be prepared to defend their carryback claims on short notice while balancing their need for immediate liquidity against the different procedures for claiming carryback refunds resulting from the CARES Act. Otherwise, what begins as a bonus may transform into a penalty.

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