AS SEEN IN THE TKD ADVISOR

VOLUME 3 | ISSUE 2 SUMMER 2009

TAX BENEFITS MAY MITIGATE TAX LOSSES

By Andrew Ben-Ami

In the current economic environment, where taxpayers may be sustaining losses from a variety of transactions, both individual and business taxpayers need to consider how the tax benefits from such losses can provide some measure of relief.

Individuals who sustain losses on their investment portfolios need to consider a variety of tax rules. Losses on investment securities are considered capital losses, and can only be used to offset capital gains (except that $3,000 per year may be deducted against ordinary income). Such capital losses may not be carried back to prior tax years. However, capital losses may be carried forward indefinitely to offset future capital gains. In addition to having sold stock at a loss, many taxpayers find themselves still holding stock that they consider worthless, especially where those stock investments were in companies that required government bailouts. For tax purposes, an investor can only deduct losses when the stock is actually sold, or when the stock becomes totally worthless. In this instance, totally stock of companies that are in bankruptcy or have been de-listed for trading may still have some value, and until that moment of worthlessness, no loss can be claimed. Because the demise of a company may take several years, taxpayers are often concerned about ascertaining the correct year of worthlessness. To mitigate this concern, the tax code provides for a seven-year statute of limitations to amend returns to claim a worthless stock deduction.

Recently, many investors have realized losses through investments in their Individual Retirement Accounts ("IRAs"). Such losses are seemingly of no use because the IRA is tax-exempt. However, it should be noted that losses can be recognized from IRAs, but only when all IRAs have been liquidated and the taxpayer's basis in the IRAs, if any, exceeds the total distributions from the IRA accounts. A taxpayer will have basis in an IRA if nondeductible contributions had been made to the IRA.

Taxpayers who sell their homes at a loss will discover that the tax law does not permit the loss on a sale of a personal residence to be deducted, even though gain on the sale of a home is taxable. To make matters worse, there is the potential for additional income to taxpayers whose mortgage debts are forgiven or satisfied at less than face value. In such instances the Tax Benefits May Mitigate Tax Losses Continued from previous page taxpayer would have to report ordinary income from the cancellation of debt ("COD"). In the past, the tax law generally excluded only those individuals who are insolvent from reporting COD income. However, Congress has recently provided an exception to recognizing COD income where an individual discharges up to $2 million in debt used to acquire his or her principal residence. This relief provision is currently available for the years 2007 through 2013.

Corporate taxpayers that sustained losses in 2008 through their operations ("net operating losses" or "NOLs") are generally able to carry back those losses two years to offset income and generate refund claims. Any losses that are not carried back will be carried forward 20 years. Note that a taxpayer has the right to waive the carryback period, and only carry losses forward. The recently enacted economic stimulus bill contains a provision allowing small businesses (those with up to $15 million in gross receipts) to carry back their 2008 NOLs for a period of up to 5 years. Taxpayers should note that any refund claim in excess of $2 million, arising from a NOL carryback or otherwise, will become a "Joint Committee Case," meaning that no refund will be issued until the Joint Committee on Taxation has reviewed the basis for your claim. This is usually done in the form of a limited audit by the IRS, and such a review may factor into a taxpayer's decision whether or not to waive the carryback period.

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Corporate taxpayers should also be aware that their state tax NOLs may be determined differently than their federal NOLs. Many states, New York, New Jersey and Connecticut included, severely limit or prohibit NOL carrybacks on their state corporate tax returns, thereby denying state tax refund opportunities. On a positive note, New Jersey has a program under which technology companies can transfer their NOLs, thereby realizing immediate cash benefits for taxpayers.

Individual taxpayers should take note that NOLs are not only for corporate taxpayers; individuals may be able to generate tax refunds from NOL carrybacks when their business deductions exceed their gross income. Special rules help taxpayers by allowing casualty and theft losses (not investment losses) to be deemed as business deductions.

In light of the challenging economic times, it is possible that the federal government will seek to aid certain taxpayers with losses by modifying the restrictions described above; therefore, taxpayers will need to keep abreast of developments in each new round of economic stimulus legislation.

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