Chapter 2: Net Operating Losses

INTRODUCTION

Typically, taxpayers who incur net operating losses (NOL) are facing some type of financial distress. The good news is that they may be able to get refunds of taxes paid in prior years. They may also be able to apply the losses against taxable income in future years, thereby reducing future income tax liabilities. However, self-employment tax is never affected by NOL carrybacks and carryforwards.

It is vital for practitioners to be aware of the opportunities and pitfalls presented by an NOL. Practitioners must be able to explain NOL-related choices to their clients so that taxpayers can accurately decide what is best for them.

NOLs are created when a taxpayer’s deductions exceed income. If the taxpayer is an individual, the loss may be incurred in activities reported on the following forms.

- Schedule C, Profit or Loss From Business
- Schedule F, Profit or Loss From Farming
- Schedule E, Supplemental Income and Loss
- Schedule A, Itemized Deductions

Individual losses may also be incurred in events reported on related forms, such as the following.

- Form 2106, Employee Business Expenses
- Form 4684, Casualties and Thefts
- Form 4797, Sales of Business Property
- Form 4835, Farm Rental Income and Expenses

Losses may also pass through to the taxpayer from entities reported on Schedules K-1, such as partnerships, S corporations, estates, and trusts. However, practitioners should be careful not to deduct pass-through losses without considering other issues such as basis, passive activity rules, and at-risk rules.

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1. The primary source for material in this chapter is IRS Pub. 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.
Not all deductions are allowed in computing the NOL. For example, items not allowed include the following.

- The deduction for personal exemptions
- Capital losses in excess of capital gains
- The IRC §1202 exclusion of 50% of the gain from the sale of qualified small business stock
- The IRC §199 domestic production activities deduction (DPAD)

The basic concepts for applying an NOL are simple. The NOL year is the year in which the loss occurred. A taxpayer who has an NOL must carry back the loss against income reported in previous years unless they elect to carry forward this loss against the income of future years. The carryback allows the taxpayer to receive a refund of prior year taxes. The carryforward allows the taxpayer to reduce future tax liability.

Taxpayers may elect to forgo the carryback and apply the entire loss to future years. This election must be made when the return is filed or within six months of the original due date of the return.

Once made, the election to waive the carryback cannot be revoked. Therefore, practitioners are advised to discuss the options with their clients so that elections are made with the client’s full understanding and consent. A client may prefer extra working capital during lean times, even if this means forgoing tax deductions during times of abundance and higher marginal tax rates.

There are five basic steps to using an NOL.

1. Complete the current year tax return.
2. Calculate the NOL.
3. Determine what options are best for using the NOL: Does it qualify for an exception to the usual 2-year carryback? How will the available carryback be used? Should the taxpayer forgo the carryback and carry the NOL forward to the next year?
4. Deduct the NOL in the carryback or carryforward year.
5. Determine whether there is any unused NOL to carry back to another year or carry forward to future years.

In addition to discussing the preceding items, this chapter explains the effect that the exclusion of discharge of indebtedness income has on NOLs and briefly describes NOLs from pass-through entities.

**WEIGHING NOL OPTIONS**

Calculating and applying NOLs can be complex. After being immersed in the details, practitioners may want to step back and review the big picture. Some of the issues that practitioners should consider prior to filing the return for the NOL year include the following.

1. Is the return for the NOL year being filed on a timely basis? (If not, the taxpayer cannot elect out of the carryback.)
2. What is the proper carryback period?
3. What are the projected tax savings from carrying back the NOL?
4. Will any of the taxpayer’s future plans potentially affect the projections? For example, does the taxpayer plan to get married or divorced? Will the business be liquidated?
5. What are the projected tax savings from electing out of the carryback period and carrying the NOL forward instead? If the tax rates and tax laws are scheduled to change significantly in the future, are these changes incorporated into the projection?
6. Has the taxpayer been fully informed of the choices?

7. If the taxpayer chooses to carry back the NOL, is it better to use Form 1045 or file amended returns for the carryback years?

8. If there is any NOL carryforward, is it clearly documented so that it will not be overlooked in subsequent years?

9. Is the taxpayer subject to the net investment income tax or may they be subject to it in the future?

**CALCULATING THE NOL**

An individual’s tax return may have an NOL if the result of subtracting itemized deductions (or the standard deduction) from adjusted gross income (AGI) is a negative number. If the result is a positive amount, the taxpayer does not have an NOL. On Form 1040, *U.S. Individual Income Tax Return*, for 2011, 2012, and 2013, this amount is shown on line 41.

If the amount on line 41 is negative, the income and losses on the return must be analyzed to determine whether the taxpayer has an NOL. The first step is to separate the taxpayer’s current year return into business and nonbusiness activities. Once the income and expenses are properly classified, Schedule A — NOL of Form 1045, *Application for Tentative Refund*, is used to calculate the amount of the current year NOL.

**CATEGORIZING INCOME AND LOSSES AS BUSINESS OR NONBUSINESS**

Income and expenses connected to a trade, business, or employment are considered business-related for NOL purposes. The following types of income and expenses are always considered as coming from business activities.

- Wages
- Business income/losses reported on Schedule C
- Gains/losses reported on Form 4797
- Rental income reported on Schedule E
- Farm income/losses reported on Schedule F or on Form 4835
- Educator expenses
- Business expenses of reservists, performing artists, and fee-basis government officials
- Moving expenses
- The deductible part of self-employment tax
- The deduction for self-employed health insurance
- Casualty and theft losses as calculated on Form 4684
- Employee business expenses

Other income and expenses are considered nonbusiness and are excluded from the NOL. Examples of items always considered nonbusiness include the following.

- Interest income and interest expense deducted on Schedule A
- Ordinary dividends
- Alimony received and alimony paid
- Traditional IRA contributions and distributions