

## Part 1. Computing Federal Income Tax

### Vol. 1D Deductions

#### CHAPTER 1D:15 Net Operating Losses <sup>1</sup>

LexisNexis Tax Advisor -- Federal Topical § 1D:15.01

#### § 1D:15.01 Net Operating Losses Overview

The Internal Revenue Code allows the net operating losses (NOLs) incurred by a taxpayer in a particular tax year to be carried forward or backward and deducted against income in profitable years, thereby preserving some value for deductions in loss years. The Code roughly defines a NOL as the excess of deductions allowed over gross income. The amount of excess deductions is computed with certain modifications provided in [IRC Section 172\(d\)](#). In determining a NOL deduction, the taxpayer should follow a five step procedure: (1) The taxpayer should complete its tax return for the year; (2) the taxpayer should then determine whether it has a NOL for a particular taxable year, and the amount; (3) the taxpayer should next decide whether it has taxable income in an available carryback year, and if so if it is a better economic decision to waive the carryback period and, instead, carry the NOL forward to a future year; (4) the taxpayer should then deduct the NOL in the carryback year or make such record as necessary to insure that the NOL is deducted in the carryforward year; (5) lastly, the taxpayer should determine the amount of your unused NOL. The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year. Most, but not all taxpayers, are eligible to deduct NOLs, with certain pass-through entities forming the largest non-eligible category group. Although the current NOL carryover provisions can span a period of up to twenty-five tax years, from the year that is five years before the loss year carrying over to twenty years after the loss year, these provisions are frequently amended often as a means of attempting to stimulate the economy. For example, *The American Recovery and Reinvestment Act of 2009* extended the carryback period from two to five years for tax years, beginning in or ending in 2008 for small businesses with gross receipts of \$15 million or less. Less than one year later, Congress again extended the carryback rules in *The Worker, Homeownership and Business Assistance Act of 2009*, allows all businesses to carry back net operating losses for up to five years for losses incurred either in 2008 or 2009, but not both (at the election of the taxpayer).

[1] Allowance of a Net Operating Loss ("NOL") Deduction.

[IRC Section 172](#) and the NOL rules are “fairness” provisions that attempt, albeit in a specific and limited way, to mitigate some of the harsher consequences that could otherwise result from the fact that federal income taxation is determined based on an annual accounting period. In general, a taxpayer computes tax liabilities based on a taxable year, which is often, but not always, a calendar year, and usually, but again, not always, a twelve-month period. Some taxpayers, notably individual wage earners, earn a steady income that exceeds allowable deductions in each and every tax year. By contrast, other taxpayers, notably corporations and individual business owners, can experience substantial fluctuations in income from year to year, and not infrequently can incur net losses within the relatively arbitrary boundaries of a given tax year. Absent the NOL provisions, a taxpayer with episodic years of profit and loss would pay higher taxes in the profitable years and would enjoy no benefit from deductions in the loss years.

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The Code allows the NOLs in a particular tax year to be carried forward or backward and deducted against the income in profitable years, so that tax deductions in a loss year are not entirely wasted.<sup>7</sup> However, there is a modest, and sometimes immodest, economic bias against taxpayers built into the NOL carryforward and carryback provisions. In particular, a taxpayer pays taxes in the good years and then, in the future, when an NOL is created, the loss can be carried back to generate a refund, but no “interest” or other adjustment is made with respect to the tax amounts paid to the U.S. government in the profitable years. In addition, the carryback and carryover rules are very strict in terms of the particular years, and sequence of years, to which NOLs can be applied.

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*Five-Year Carryback of Net Operating Losses.* In the *American Recovery and Reinvestment Act of 2009*, the NOL carryback period was extended from two to five years for tax years beginning in or ending in 2008 for small businesses with gross receipts of \$15 million or less. *The Worker, Homeownership and Business Assistance Act of 2009* allows all businesses to carry back NOLs for up to five years for losses incurred either in 2008 or 2009, but not both (at the election of the taxpayer). Businesses are limited to offsetting 50 percent of the taxable income in the fifth preceding year, but can offset up to 100 percent of taxable income in the four succeeding tax years. Small businesses that have already elected to carry back 2008 NOLs under the *American Recovery and Reinvestment Act* may also elect to carry back losses incurred in 2009.