RURAL TAX EDUCATION

www.RuralTax.org

August 2011 RTE/2011-27

Net Operating Losses*

Philip E. Harris, *Professor*
Department of Agricultural and Applied Economics, University of Wisconsin-Madison

Introduction

Weather, disease and variable prices for inputs and commodities cause farmer's income to fluctuate from one year to the next. Farmers can minimize their income tax liability by managing the timing of their income and deductions to keep their taxable income level. In some cases, the leveling technique is not enough to avoid a spike in taxable income or a dip that causes taxable income to go below zero. The tax effect of the spikes can be minimized with income averaging rules. The tax effect of the dips below zero can be managed with the net operating loss (NOL) rules discussed in this fact sheet.

The concept of the NOL rules is quite simple. Taxpayers are allowed to carry business losses from the loss year to offset taxable income in other tax years. The loss can be carried back and/or forward.

Planning Pointer

The NOL rules **do not** make the best use of business deductions. Therefore, farmers should first try to level their taxable income with leveling techniques. When those techniques are not sufficient to avoid negative taxable income, the NOL rules make the best of an unfortunate situation.

* **In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA. For a list of participating land-grant universities, see RuralTax.org.**

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Carrying Rules

Unlike most NOLs, a farm NOL is carried back 5 years unless the taxpayer elects to forgo the 5-year carryback. If it is not fully absorbed (used up) in the fifth carryback year, the excess is carried to the fourth prior year and so on until it is fully absorbed. If an NOL remains after being carried to the first year before the loss year, the balance is carried to the year after the loss year and then to subsequent years until it is fully absorbed. However the NOL can be carried forward only 20 years.

Note. As discussed later in this fact sheet, if the NOL exceeds the taxable income in a carryback or carryforward year, more NOL is absorbed than the taxable income for the carryback or carryforward year.

Example 1: Pete Moss started his horticulture farm in 2005 as a sole proprietor and had several good years as his business blossomed through 2011. A late frost in 2011 followed by a late June hail storm and a drought in August led to an $80,000 farm loss that year. He had no other income or losses that year. Pete carried his $80,000 farm NOL back to 2006, which absorbed $15,000 of the NOL. The remaining $65,000 is carried to 2007 and subsequent years as shown below.

Carryback or Carryforward Year	Year	NOL Carryback or Carryforward	NOL Absorbed	NOL Remaining
Fifth year before loss year	2006	$80,000	$15,000	$65,000
Fourth year before loss year	2007	65,000	12,000	53,000
Third year before loss year	2008	53,000	11,000	42,000
Second year before loss year	2009	42,000	17,000	25,000
First year before loss year	2010	25,000	7,000	18,000
First year after loss year	2012	18,000	8,000	10,000

If the $10,000 NOL carryforward remaining after 2012 is not fully absorbed by 2031 (20 years after the 2011 NOL year), any remaining NOL is lost and can never be deducted.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Although the principle of NOLs is simple, actual computation of NOL deductions can be complex. Complexity arises because the NOL is limited to business losses that are not carried to other years under other tax rules such as the capital loss carryover rules. These limitations require taxpayers to add back some expenses and losses that were deducted to compute their taxable income. The NOL computations are further complicated by modifications that are required to compute taxable income in the years to which the NOL is carried.

Computing the NOL

One way to compute an NOL is to start with negative taxable income for the year and add back the deductions that are not allowed to be included in the NOL.

Note. If you have positive taxable income for a tax year, you do not have an NOL for that year even if your business has a net loss. Positive taxable income indicates that you have income from other sources (such as wages, non-business income, or income from other businesses) that use up all of the business loss, so there is nothing left to carry to another tax year.

Items Not Included in NOL

Several items that are included in the calculation of taxable income are not included in the NOL calculation. These usually are excluded from the NOL computation for one of two reasons.

- Generally, only **business** losses can be carried from one year to another; therefore, with a few exceptions, non-business deductions in excess of business income are not included in the NOL.
- Items that **carry to another tax year** under another carryover rule—such as capital loss carryovers—are excluded from the NOL calculation to avoid duplication.

The following items are examples of deductions that are excluded from the NOL by adding them back to the taxpayer's negative taxable income:

1. Dependent and personal exemptions deduction

Note. Instead of starting with negative taxable income and then adding back the personal and dependent exemptions deduction, Schedule A (Form 1045), Application for Tentative Refund, begins with the taxpayer's income before the personal and dependent exemptions deduction is subtracted. Consequently, if you use Schedule A (Form 1045) to compute your NOL, you do not add back your personal and dependent exemptions deduction to compute your NOL.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

2. Non-business deductions (such as itemized deductions or the standard deduction, and the deduction for contributions to a retirement plan) in excess of non-business income (such as interest, dividends, and taxable social security benefits)
3. Capital losses in excess of capital gains
4. An NOL deduction carried from another year

Example 2: Paige Turner's taxable income for 2011 before deducting exemptions is a negative $10,000 due to both business losses and non-business deductions. If her non-business deductions exceed her non-business income by $6,000, she must add that $6,000 back to her negative $10,000 taxable income, which reduces her NOL to $4,000.

If Paige's non-business deductions exceed her non-business income by more than her $10,000 negative taxable income, she does not have an NOL.

Business Income and Deductions

Business income and deductions are defined broadly for purposes of the NOL calculation. They include not only the ordinary income and deductions from a trade or business but also gain or loss from the disposition of both real property used in a trade or business and depreciable property used in a trade or business. Being employed is treated as a trade or business, which means wages are business income and deductible employee expenses are business deductions.

An exception to the business-connection requirement is that deductions attributable to casualty and theft losses from property held for personal use or for investment are treated as business losses for the NOL calculation even though they are not connected with a trade or business.

Note. Classifying **ordinary income and capital gain as non-business** is advantageous to the taxpayer because it reduces the amount of non-business deductions that must be added back to compute the NOL. Similarly, classifying **deductions and capital losses as business** is advantageous to the taxpayer.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 3: Neil Down, who is not married and does not itemize deductions, realized a $10,000 loss from his sole-proprietor farming business in 2011. However, due to other income and deductions as shown below, his taxable income for 2011 was a negative $12,850.

Income or Deduction	Amount
Business loss	($10,000)
Wage income	6,000
Investment income	500
Adjusted gross income	($3,500)
Personal exemption deduction	(3,700)
Standard deduction	(5,800)
Taxable income	($13,000)

In calculating his NOL, Neil is not allowed to deduct his personal exemption deduction. He can deduct $500 of his standard deduction because he has $500 of non-business (investment) income. Consequently, Neil adds back his $3,700 personal exemption deduction and $5,300 ($5,800 – $500) of his standard deduction to his negative $13,000 taxable income to compute his $4,000 ($13,000 – $3,700 – $5,300) NOL.

Note. Note that the $4,000 NOL equals the sum of Neil's negative $3,500 AGI and the $500 portion of his standard deduction that is allowed by his $500 investment income. His NOL could also be viewed as his $10,000 business loss reduced by his $6,000 of wage income.

Carrying the NOL Back or Forward

Most NOLs are carried back 2 years unless the taxpayer elects to forgo the carryback and carries the NOL forward only. However, some NOLs qualify for a different carryback period. By default, NOLs from a farming business are carried back 5 years. Farmers can elect to forgo the 5-year carryback and carry them back 2 years or elect to forgo the carryback altogether and carry them forward only.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Default Carryback Period (2 Years)

Generally, an NOL can be carried back to the 2 tax years immediately before the loss year. If it is not fully absorbed in those 2 years, the excess is carried forward for up to 20 years after the loss year.

Note. Any NOL that is not absorbed in the carryback and carryforward periods is lost. It cannot be deducted in any other tax year.

Farming Loss (5 Years)

Taxpayers who have an NOL from a farming business can carry that NOL back 5 years and then forward up to 20 years. A farming business is a trade or business involving cultivation of land, raising or harvesting of any agricultural or horticultural commodity, operating a nursery or sod farm, raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. Raising, shearing, feeding, caring for, training, and management of animals are also farming businesses. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else, or a business in which the taxpayer merely buys or sells plants or animals grown or raised by someone else.

Allocation of NOL that includes a farming loss

A farming loss that is eligible for the 5-year carryback is the **lesser** of two amounts:

1. The NOL computed using only the income and deductions attributable to the farming business
2. The total NOL

Therefore, the taxpayer's total NOL is allocated first to the farming loss and then to other losses.

Example 4: Sandy Beach owns and operates a crop farm. Her husband, Rocky Beach, owns and operates a trucking business. They have no children and file a joint federal income tax return. In 2011, Sandy had a $70,000 loss from her farming business and Rocky had a $30,000 loss from his trucking business. Rocky earned $20,000 in wages from a temporary job, and they earned $5,500 of taxable interest on certificates of deposit. They file a joint federal income tax return.

(continued below)

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 4 cont'd: Sandy and Rocky Beach's $80,000 NOL for 2011 is calculated as shown below.

Income, Deduction or Loss	Amount
Wages	$20,000
Taxable interest	5,500
Farming business loss	(70,000)
Trucking business loss	(30,000)
Adjusted gross income	($74,500)
Standard deduction	(11,600)
Personal exemption deductions	(7,400)
Taxable income	($93,500)
Add back excess standard deduction ($11,600 – $5,500 non-business income)	6,100
Add back personal exemption deductions	7,400
NOL	($80,000)

Question 1.
What is the NOL computed using only Sandy's farm income and expenses?

Answer 1.
It is the $70,000 farm loss shown above. Therefore, $70,000 of their total NOL is a farming NOL that is eligible for the 5-year carryback and the remaining $10,000 NOL is treated as coming from Rocky's trucking business and is eligible for the 2-year carryback.

Question 2.
What if Rocky's wages are $35,000 instead of $20,000 so that their taxable income is increased by $15,000?

Answer 2.
Their taxable income is now a negative $78,500 ($93,500 - $15,000) and their total NOL is $65,000 ($78,500 – $6,100 – $7,400). The farming NOL is limited to the $65,000 total NOL and there is no NOL treated as coming from Rocky's trucking business.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Election to waive the 5-year carryback

Farmers can elect to waive the 5-year carryback. The carryback period then reverts to 2 years.

Example 5: If Sandy and Rocky Beach from Example 4 elect to forgo the 5-year carryback of Sandy's $70,000 farming loss, it will be carried back 2 years. Sandy and Rocky could also elect to forgo any carryback of their $80,000 NOL and carry it forward to 2012 and later years.

Election to Forgo Any Carryback

Taxpayers who decide to forgo the carryback periods must include a statement with the original return for the loss year that they are waiving the carryback period. The original return must be filed by the due date (including extensions) for that year. If the original return was filed by the unextended due date without the election, the taxpayer can make the election on an amended return that is filed within 6 months of the unextended due date.

Note. If a taxpayer does not elect out of the carryback, **the NOL is absorbed by the carryback years whether or not the NOL deduction is claimed for those years.**

Example 6: Sandy and Rocky from Example 4 decided to not carry their 2011 NOL back but failed to make the election to forgo the carryback on their 2011 income tax return or an amended return. Their $70,000 NOL from 2011 is absorbed by their 2006 and 2007 modified taxable income as described in the next section whether or not they claim a refund for those years. As explained later in this chapter, Sandy and Rocky have until April 15, 2015 (October 15 , 2015 if they extended the due date of their 2011 income tax return) to file amended returns for 2006 and 2007 to claim a refund from the NOL deductions for those years. If they do not claim the refund by that date, they are barred from claiming the refund even though the NOL is absorbed by those carryback years.

Note. The burden is on the taxpayer to show the amount of NOL that is available to deduct in a carryforward year. If a taxpayer did not deduct an NOL in a closed year, the taxpayer must still keep records of the NOL absorption to verify the NOL carried to each tax year.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Absorbing the NOL

The amount of an NOL that is absorbed (used up) by a year to which it is carried is equal to that year's *modified taxable income.* Modified taxable income is taxable income increased by some of the deductions that were included to calculate taxable income. For example, the personal and dependent exemptions deduction and the net capital loss deduction must be added to taxable income.

Therefore, the amount that is carried to the second eligible year is the beginning NOL minus the first eligible year's modified taxable income. The NOL carried to the third eligible year is the amount carried to the second year minus the second year's modified taxable income. This process is repeated until the NOL is fully absorbed or until it is carried to the last eligible year.

Example 7: Sandy and Rocky from Example 4 carried Sandy's $70,000 farm NOL from 2011 back to 2006. Sandy and Rocky had $50,000 of taxable income on their 2006 and 2007 income tax returns.

Sandy and Rocky can claim a $70,000 NOL deduction on their 2006 income tax return, which reduces their taxable income to zero. The 2006 year absobs $56,600 ($50,000 taxable income + $6,600 personal exemptions deduction) of the $70,000 NOL so they have $13,400 of the NOL left to carry to 2007. Because their $56,800 ($50,000 taxable income + $6,800 personal exemptions deduction) modified taxable income in 2007 is greater than the NOL carried to 2007, the $13,600 remaining NOL is absorbed in 2007 and there is nothing to carry to 2008 and subsequent years.

Because modified taxable income is always greater than taxable income, more NOL is absorbed in each year than the amount of taxable income offset by the NOL. Therefore, some of the NOL deduction is wasted by each intervening year to which the NOL is carried if the NOL is greater than the taxable income for that intervening year.

Example 8: In Example 7, the NOL deduction on the 2006 income tax return reduced their $50,000 taxable income to zero but the 2006 year absorbed $56,600 of the NOL carryover. Sandy and Rocky lost the benefit of $6,600 of deductions.

Planning Pointer

Two planning techniques can reduce or eliminate the lost deductions.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

1. Choose the first carryback or carryforward year so that the NOL is absorbed in as few intervening years as possible.
2. Avoid the NOL by spreading income evenly over several tax years.

Example 9: If Sandy and Rocky from the previous examples had $80,000 or more of taxable income in 2009, they could avoid wasting the $6,600 of deductions that were lost by carrying the NOL back to 2006 by electing to forgo the 5-year carryback and using the 2-year carryback. Carrying the entire $80,000 NOL back to 2009 would allow them to reduce the 2009 taxable income by the full $80,000.

If Sandy and Rocky had less than $80,000 of taxable income in 2009 but expected $80,000 or more of taxable income in 2012, they could avoid wasting NOL deductions by electing to forgo any carryback and carrying all of the $80,000 NOL forward to 2012.

Example 10: The table below shows Sandy and Rocky's taxable income for 2006 through 2011; the NOL deductions for 2006, 2007, and 2009; the tax liability for each year before and after the carryback of the 2011 NOL; and the $10,314 tax reduction as a result of the NOL carryback.

Year	Taxable Income	NOL Deduction	Tax Before NOL Deduction	Tax After NOL Deduction	Tax Reduction
2006	$ 50,000	$70,000	$6,749	$ 0	$6,749
2007	50,000	13,600	6,721	4,681	2,040
2008	50,000	0	6,701	6,701	0
2009	50,000	10,000	6,669	5,169	1,500
2010	50,000	0	6,666	6,666	0
2011	-93,200	0	0	0	0
Total	$156,800		$33,506	$23,217	$10,289

If Sandy and Rocky had foreseen the losses in 2011 they may have been able to delay recognizing income in 2006 through 2010 so that there $156,800 of net income was spread evenly over the 6 years. That would avoid wasting some of the NOL deduction and would tax some of their income in the 10% bracket instead of the 15% bracket. For example, if Sandy had delayed grain sales to reduce their taxable income to $26,133.33 ($156,800 ÷ 6) each year, their total tax for the 6 years would be $18,770 as shown in the table below.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 10 cont'd:

Year	Taxable Income	Tax
2006	$ 26,133.33	$3,164
2007	26,133.33	3,136
2008	26,133.33	3,116
2009	26,133.33	3,084
2010	26,133.33	3,081
2011	26,133.33	3,070
Total	$156,800.00	$18,651

In summary, using the NOL rules saves $10,289 of income taxes compared to not using the NOL rules, but **spreading the six years of income evenly over the six years saves an additional $4,566 ($23,217 – $18,651) of income taxes**.

Calculating Taxes in Carryback and Carryforward Years

If an NOL is carried back, it is claimed as a deduction that reduces taxable income and tax for the carryback year. The recalculation of tax in a carryback year is complicated because the NOL deduction reduces AGI and that reduction in AGI may affect itemized deductions and personal and dependent exemption deductions. Consequently, the affected deductions must be recalculated.

Taxpayers can get a quick refund of taxes paid in prior years by filing Form 1045, Application for Tentative Refund, no later than the end of the tax year following the year the NOL occurred. For example, Sandy and Rocky in Example 6 have until December 31, 2012 to file a Form 1045 to claim a refund for the NOL carried back to 2006 and 2007.

Taxpayers can also claim a refund from carrying an NOL back by filing a Form 1040X, Amended U.S. Individual Income Tax Return, for each of the carryback years. Form 1040X must be filed within 3 years of the due date (including extensions) for the loss year tax return. For example, Sandy and Rocky from Example 6 have until April 15, 2015 (3 years after the April 15, 2012 due date of the 2011 return) to file amended returns for 2006 and 2007 to claim refunds from the NOL carried back from 2011. If they extended the due date of the 2011 return to October 15, 2012, they have until October 15, 2015 to amend the 2006 and 2007 tax returns.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Note. As noted earlier in this fact sheet, the election to forgo the carryback must be made on the tax return for the year the NOL occurred or on an amended return for that year filed within 6 months (excluding extensions) of the due date for the original return. A calendar year taxpayer has until October 15, 2010, to elect on an amended return to forgo the carryback of a 2009 NOL. If this deadline is not met, the taxpayer cannot forgo the carryback.

NOL Carried Between Joint and Separate Returns

If the taxpayer's filing status is not the same in the loss year and in all of the carryback or carryforward years, allocations may be required.

Taxpayers who file a joint return for at least one of the years involved in an NOL calculation and its carryback or carryforward period and file a separate return or file a return as a person who is not married for at least one of those years may need to allocate the NOL, income and deductions, or the modified taxable income between the spouses. However, income and deductions on a married filing jointly return do not have to be allocated when an NOL from a year the same couple filed separately is carried to the return.

Separate Returns May Reduce Tax Liability

If one spouse has an NOL and their joint income without the loss is lower than their average annual income, it may be advantageous to file separate returns in the NOL year. By filing separate returns, the NOL can be carried to another tax year to reduce income in a tax bracket higher than the joint income bracket of the NOL year.

Example 11: Tom and Mary Katt have no children, do not itemize deductions, and are both under age 65. The table below shows their AGI for 2011 (the loss year) and 2006 (the first carryback year for their farm NOL).

	2011	**2006**
Tom	($20,000)	$30,000
Mary	21,500	40,000
Total	$ 1,500	$70,000

If Tom files a separate 2011 return, his NOL is $20,000.

If Tom and Mary file a joint return for 2011, their income tax is zero, but there is no NOL to carry back. Therefore, their AGI for 2006 (the carryback year) is still $70,000. After deducting the $16,900 total of their $10,300 standard deduction and $6,600 personal exemptions deduction for 2006, their taxable income for 2006 is $53,100 and their income tax is $7,214.

(continued below)

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 11 cont'd: If Tom and Mary file separate returns for the loss year (2011), Mary's federal income tax is $1,533 and Tom has a $20,000 NOL to carry back. The NOL deduction reduces their 2006 joint AGI to $50,000, their taxable income to $33,100, and their income tax due to $4,214. Therefore, the total tax due for the 2 years if separate returns are filed in 2011 is $5,747 ($1,533 + $4,214)—a savings of $1,467 ($7,214 – $5,747).

Making Optimal Use of an NOL Deduction

The tax benefit of an NOL can be squandered if other tax benefits are used in the loss year or in a year the NOL deduction is claimed.

Other tax benefits may waste NOLs in two ways.

1. They may reduce an NOL in a loss year, even though they do not reduce taxable income in that or any other year.
2. In years that an NOL deduction is claimed (carryback and carryforward years), other tax benefits may reduce the NOL to be carried to subsequent years even though they do not reduce taxable income in that year or any other year.

Because some of those tax benefits could be shifted to another tax year, it is useful to know which ones waste NOLs.

Excess Non-Business Deductions and Losses

If non-business deductions exceed non-business ordinary income plus excess non-business capital gains in an NOL year, **the excess non-business deductions will never provide a tax benefit**.

Shifting Non-Business Deductions Away from Loss Year

One way to get a tax benefit from the excess non-business deductions is to shift them to another tax year.

- If those deductions are shifted to a year that has no NOL, they will offset taxable income in that year.
- If they are shifted to a year when there is an NOL but non-business ordinary income plus net non-business capital gains exceed non-business deductions, they will increase the NOL.

Shifting excess non-business deductions involves the same kind of planning as bunching itemized deductions every other year and claiming the standard deduction in the alternate years. Therefore, deductions you can shift away from the NOL year include medical expenses, taxes,

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

interest expenses, charitable contributions, and miscellaneous deductions. Shifting other non-business deductions such as alimony payments away from the NOL year can also help reduce non-business deductions down to non-business income.. If you are making less than the maximum retirement plan contributions, contributions could be bunched in the years where they would offset taxable income or add to the NOL.

Example 12: Guy and Barb Wire's tax advisor projects that they will have a $20,000 NOL for 2011. Included in that projection are $16,000 of itemized deductions of which $3,500 is real estate taxes that can be paid in 2011 or postponed until 2012. Their non-business income is $2,000 of interest income.

The $14,000 of itemized deductions in excess of their $2,000 of interest income provide no tax benefit—they do not increase their 2011 NOL and they do not reduce taxable income in 2011. If Guy and Barb postpone paying the $3,500 of real estate taxes until 2012 and have $3,500 or more of taxable income on 2012, they can preserve the tax benefit of deducting the payment of those taxes. Shifting the $3,500 payment to 2012 does not affect their 2011 NOL (it is still $20,000) and it allows them to deduct the $3,500 from their 2012 taxable income. If they are in the 15% federal income tax bracket in 2012, the deduction will save them $525 ($3,500 × 15%) of federal income taxes.

Barb and Guy could further reduce their 2012 taxable income without decreasing their 2011 NOL by shifting up to $11,500 of other non-business deductions to 2012.

Shifting Non-Business Income to Loss Year

The problem of losing the benefits of a deduction because non-business deductions in excess of non-business ordinary income plus excess non-business capital gains can also be alleviated by increasing the total amount of non-business ordinary income and non-business capital gains in the loss year. Such an increase will be effectively tax-free until the sum of non-business ordinary income and excess non-business capital gains equals non-business deductions.

If non-business ordinary income or non-business capital gains are shifted from a year without an NOL to an NOL year in which non-business deductions exceed the total of non-business ordinary income and net non-business capital gains, the shifted income is tax-free. The same result occurs if non-business ordinary income is shifted from an NOL year with an excess of non-business ordinary income and net non-business capital gains over non-business deductions.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 13: Guy and Barb Wire from Example 12 have 100 shares of XYZ stock that has a $45,000 income tax basis and is currently worth $50,000. If they sell that stock in 2011, the $5,000 of capital gain ($50,000 – $45,000) does not increase their income taxes for 2011 and does not reduce their 2011 NOL. Therefore, the $5,000 gain is effectively tax free.

Guy and Barb could repurchase $50,000 of XYZ stock or make another investment. In either case, they would have a $50,000 income tax basis in the new investment. If they later sold the new investment for $50,000 or more, their gain would be $5,000 less than the gain would have been if they kept the original XYZ stock (with a $45,000 income tax basis) and sold it for the same amount.

Shifting Non-Business Capital Losses

Non-business capital losses in excess of non-business capital gains provide no tax benefit in an NOL year because they are not allowed as part of the NOL computation. If those capital losses are shifted to a year when there is no NOL, or to an NOL year that has excess non-business capital gains, the losses will provide a tax benefit.

Example 14: The projected $20,000 NOL for Guy and Barb Wire in Example 12 includes a planned sale of RST stock for a $900 capital loss. Guy and Barb will get no tax benefit from that capital loss in 2011. It does not increase their 2011 NOL. It is not carried over as a capital loss carryover because Guy and Barb have business capital gains in 2011 that give them a net capital gain for 2011. And, it does not offset taxable income in 2010.

If Guy and Barb postpone the sale of the RST stock until 2012, they still have a $20,000 NOL for 2011 and the $900 capital loss in 2012 will reduce their taxable income.

Waiving Carryback May Reduce Tax Liability

In some cases, an NOL deduction is more useful to the taxpayer in the years following the NOL year than in the carryback years because of the higher tax rates imposed in high income years. If the carryback years have low income compared to carryforward years, forgoing the carryback is advantageous as long as the 20 carryforward years will use most or all of the NOL.

Capital losses in carryback or carryforward years may keep the taxpayer from realizing the full benefit of the NOL deduction in those years. Similarly, the NOL deduction may cause the loss of a tax credit that cannot be carried beyond the carryback or carryforward year. (For example, an investment tax credit is wasted if an NOL is carried to the final year the credit can be claimed

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

and the NOL reduces taxable income to zero for that year.) In these cases, the election can be used to minimize the loss of the NOL deduction or credit.

Finally, there may not be enough taxable income in the carryforward years to absorb the NOL. In those cases, the NOL should be carried back to the low-income years to reduce low-bracket income rather than be completely wasted.

Present Value of Carryforward

Because the timing of the tax savings differs between carrying an NOL back and carrying it forward, the present value of the tax savings should be computed to properly compare them. If the NOL is carried back, the tax savings will be received shortly after the refund claim is filed. The following discussion assumes that the request for refund is filed early in the year following the NOL year and the refund is received by April 15 of that year.

If the NOL is carried forward, the tax savings are realized when taxes would otherwise be paid in the carryforward years. The NOL deduction can be used to reduce quarterly estimated tax payments, or it can be used to reduce the tax paid or increase the refund received when the carryforward year return is filed. In either case, the present value is less than the face amount of the tax savings.

To compare the value of future tax savings with the value of refunds from previous years, the present value of future tax savings as of April 15 can be calculated. The tables in Figures 1 and 2 give discount factors for taxes saved in the 5 years following the NOL year.

- Figure 1 should be used if the tax savings are used to reduce estimated tax payments.

- Figure 2 should be used if the tax savings are used to reduce the tax paid with the return or increase the refund claimed on the return.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Figure 1. Factors for Calculating Present Value of Taxes Saved in Years Following NOL Year Assuming Savings Are Used to Reduce Quarterly Estimated Tax Payments

Interest Rate	Year 1*	Year 2**	Year 3**	Year 4**	Year 5**
1%	0.9967	0.9868	0.9770	0.9674	0.9578
2%	0.9934	0.9739	0.9548	0.9361	0.9177
3%	0.9901	0.9613	0.9333	0.9061	0.8797
4%	0.9868	0.9489	0.9124	0.8773	0.8436
5%	0.9836	0.9368	0.8922	0.8497	0.8092
6%	0.9804	0.9249	0.8725	0.8232	0.7766
7%	0.9772	0.9133	0.8535	0.7977	0.7455
8%	0.9740	0.9019	0.8351	0.7732	0.7159

*These factors were calculated using the following formula: Factor = $[1+(1+i/12)^{-2}+(1+i/12)^{-5}+(1+i/12)^{-9}]/4$, where i = interest rate divided by 100.

**These factors were calculated using the following formula: Factor = $F \times (1+i)^{-(n-1)}$, where F = the Year 1 factor, i = interest rate divided by 100 and n = year.

Figure 2. Factors for Calculating Present Value of Taxes Saved in Years Following NOL Year Assuming Savings Are Used to Reduce Payment or Increase Refund with Tax Return

Interest Rate	Year 1*	Year 2*	Year 3*	Year 4*	Year 5*
1%	0.9901	0.9803	0.9706	0.9610	0.9515
2%	0.9804	0.9612	0.9423	0.9238	0.9057
3%	0.9709	0.9426	0.9151	0.8885	0.8626
4%	0.9615	0.9246	0.8890	0.8548	0.8219
5%	0.9524	0.9070	0.8638	0.8227	0.7835
6%	0.9434	0.8900	0.8396	0.7921	0.7473
7%	0.9346	0.8734	0.8163	0.7629	0.7130
8%	0.9259	0.8573	0.7938	0.7350	0.6806

*These factors were calculated using the following formula: Factor = $(1+i)^{-n}$, where i = interest rate divided by 100 and n = the year.

The tax savings that result from carrying the NOL forward must be estimated for each year following the NOL year. Those tax savings are then multiplied by the appropriate factor from the applicable table. The interest rate is the opportunity cost of the taxpayer's capital—that is, the after-tax rate the taxpayer is paying or would pay to borrow money. (If the taxpayer is not

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

borrowing money, the appropriate rate is the after-tax rate the taxpayer is earning on investments.)

Example 15: Scott and Erin Jackson had a $57,000 NOL in 2012. Their income and deductions from 2007 and 2008 and their expected income and deductions for 2013 are shown below.

Income	**2007 (First Carryback Year)**	**2008 (Second Carryback Year)**	**2013 (First Carryforward Year)**
Taxable interest (line 8a, Form 1040)	$ 7,000	$ 7,000	$ 7,000
Business income (line 12, Form 1040)	41,000	42,700	69,614
Total income (line 23, Form 1040)	$48,000	$49,700	$ 76,614
Adjustments			
50% of SE Tax (line 25, Form 1040)*	2,897	3,017	4,889
Adjusted gross income (line 32, Form 1040)	$45,103	$46,683	$71,725
Standard deduction (line 34, Form 1040)*	10,700	10,900	11,600
Personal exemptions deduction (line 36, Form 1040)*	6,800	7,000	7,400
Taxable income (line 37, Form 1040)	$27,603	$28,783	$ 52,725
Income tax (line 40, Form 1040)*	$ 3,361	$ 3,514	$ 7,059

* The deductions and income tax for 2013 are estimated using the deductions and tax rates in effect for 2011.

If Scott and Erin carry their $57,000 2009 NOL back to 2007 and 2008, they will reduce their income taxes in those years to zero and they can claim a $6,875 refund ($3,361 for 2007 + $3,514 for 2008). The NOL would be fully absorbed in 2007 and 2008 so there would be no carryforward to 2013.

If Scott and Erin forgo the carryback, the $57,000 2012 NOL will reduce their 2013 income taxes from $7,059 to zero. The NOL would be fully absorbed in 2013 so there would be no carryforward to 2014.

(continued below)

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Example 15 cont'd:
If Scott and Erin will realize the tax savings by reducing their estimated payments for 2013, the tax savings must be discounted by a factor from Figure 1. If their after-tax opportunity cost of capital is 4%, the appropriate factor is 0.9868, and the present value of the $7,059 tax savings is $6,966. Consequently, Scott and Erin should forgo the NOL carryback because the $6,966 present value of the future tax savings from the carryforward option is greater than the $6,875 refund received by using the carryback option.

To forgo the NOL carry back, Scott and Erin must attach the statement shown below to their timely filed (including extensions) 2012 income tax return.

Scott and Erin Jackson
SSN 172-09-1045

Taxpayers elect to forgo the net operating loss carryback period under I.R.C. § 172(b)(3)(C) for the net operating loss shown on this return.

If Scott and Erin will realize the 2013 tax savings when their 2013 tax return is filed in 2014, the tax savings must be discounted by a factor from Figure 2. If their after-tax opportunity cost of capital is 4%, the appropriate factor is 0.9615 and the present value of the $7,057 tax savings is $6,787. Consequently, Scott and Erin should carry the NOL back and claim a refund for taxes paid because the $6,875 refund is greater than the $6,787 present value of the future tax savings.

Control Timing of NOL

If you have some choice in determining the tax year that an NOL is realized, it should be placed in the year that results in a deduction that will generate the greatest tax benefit. The years in which the NOL deduction generates the greatest benefit are those that have the highest taxable income (and are therefore in the highest marginal bracket) and those with little long-term capital gain or tax credits that will waste the NOL. For example, if a farmer's marginal tax rate is higher in 2006 than in 2007, accelerating an NOL into 2011 instead of delaying it to 2012 will cause the loss to offset the higher bracket 2006 income instead of the lower bracket 2007 income.

Use NOL Before It Expires

If the time for using an NOL carryforward is about to expire, accelerating income to absorb the full loss will reduce total taxes. Shifting income to make use of an NOL that would otherwise expire makes the shifted income effectively tax-free.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Farm Corporations and NOLs

A farm corporation generally figures and deducts a NOL the same way an individual, estate, or trust does. The same 5-year or 2-year carryback and up to 20-year carryforward periods apply, and the same sequence applies when the corporation carries two or more NOLs to the same year.

A corporation's NOL generally differs from individual, estate, and trust NOLs in the following ways.

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation uses different forms when claiming an NOL deduction.

Figuring the NOL

A corporation figures an NOL in the same way it figures taxable income. It starts with its gross income and subtracts its deductions. If its deductions are more than its gross income, the corporation has an NOL. However, the following rules for figuring the NOL apply.

1. A corporation cannot increase its current year NOL by carrybacks or carryovers from other years.
2. A corporation cannot use the domestic production activities deduction to create or increase its current year NOL, including any carryback or carryover.
3. A corporation can take the deduction for dividends received, explained later, without regard to the aggregate limits (based on taxable income) that normally apply.
4. A corporation can figure the deduction for dividends paid on certain preferred stock of public utilities without limiting it to its taxable income for the year.

Dividends-Received Deduction

The corporation's deduction for dividends received from domestic corporations is generally subject to an aggregate limit of 70% or 80% of taxable income. However, if a corporation has an NOL for a tax year, the limit based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the 70% or 80% of taxable income limit.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Claiming the NOL Deduction

If a corporation carries the NOL back, it has the same options for filing as an individual but it uses Form 1139, Corporation Application for Tentative Refund, instead of Form 1045, Application for Tentative Refund, and Form 1120X, Amended U.S. Corporation Income Tax Return, instead of Form 1040X, Amended U.S. Individual Income Tax Return.

If a corporation expects to have an NOL in its current year, it can automatically extend the time for paying all or part of its income tax for the immediately preceding year. It does this by filing Form 1138, Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback.

Figuring the NOL Carryover

If the NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year. Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified Taxable Income

A corporation figures its modified taxable income the same way it figures its taxable income, with the following exceptions.

- It can deduct NOLs only from years before the NOL year whose carryover is being figured.
- The corporation must figure its deduction for charitable contributions without considering any NOL carrybacks.

The modified taxable income for any year cannot be less than zero. Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership Change

A loss corporation (one with cumulative losses) that has an ownership change may be limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.

Summary

Planning the timing of income, deductions, gains, and losses can maximize the benefit of the NOL rules.

It is helpful to keep in mind that certain tax benefits are removed to determine the NOL carried to the first eligible year and the NOL carried to each subsequent year. Therefore, whether the NOL is expressed as a positive number (i.e., as a deduction) or a negative number (i.e., as the taxable loss), removal of the other tax benefits decreases the NOL.

It is also important to remember that the NOL deduction claimed in any carryback or carryforward year is not necessarily the amount of the NOL that is absorbed that year. A year to which the NOL is carried can use up more of the NOL than that year's taxable income before modifications.

IRS Publications

For more information on net operating losses, see IRS Publication 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts." It can be accessed from the IRS website, www.irs.gov.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.