



1998 Income Tax School

## NET OPERATING LOSSES

### I. Computing the Net Operating

#### Loss Deduction . . . . . 3

Lists the four steps of calculating NOL deductions: (1) determining eligibility, (2) computing the NOL, (3) distributing the NOL, and (4) calculating taxes in carryback and carryforward years.

### II. Taxpayer Relief Act of 1997 Changes . . . . . 4

Except for certain businesses as described below, carryback is reduced from three years to two and carryforward is increased from 15 years to 20 for NOLs arising in tax years beginning after 8-5-97.

#### A. Exceptions to the Two-Year Carryback . . . 4

Personal losses from casualty or theft, and losses due to a Presidentially declared disaster area for farms and for businesses with \$5 million or less in average annual gross receipts, are "eligible losses" and retain the three-year carryback.

#### Which Answer Is Best for the Taxpayer? . . . . 5

When some of an NOL is due to losses that are eligible for three-year carryback and the rest can be carried back only two years, the NOL must be allocated between the two categories. The most advantageous allocation method is the one that offsets as much high-bracket income as possible.

#### Which Answer Is Likely to Prevail? . . . . . 5

It appears most logical to allocate the NOL on a pro rata basis between eligible and ineligible losses.

#### B. Other Exceptions to Carryback Period . . . 6

Real estate investment trust NOLs have no carryback. Losses arising from certain liabilities such as product liabilities can be carried back 10 years.

### III. Filing Dates . . . . . 6

Form 1045 must be filed not before the income tax return for the year in which the NOL occurred and not after the end of the following tax year. Form 1040X for claiming a

refund from carrying an NOL back must be filed within three years of the due date (including extensions) of the tax return for the year the NOL occurred. Election to forgo carryback must be made on the tax return for the year the NOL occurs or on an amended return filed within six months of the due date (without extensions) of the return.

### IV. Illustration of NOL Computations . . . . . 6

This is an example of how to calculate deductions for a couple with a \$21,100 loss in 1998 and positive income in two carryback years.

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#### B. Distributing the NOL . . . . . 14

#### C. Calculating Taxes in Carryback and Carryover Years . . . . . 18

### V. Carrying an NOL between Joint and Separate Returns . . . . . 22

Discusses problems arising when a joint return is filed for some of the years involved in an NOL calculation, carryback, or carryforward and separate returns are filed in the other years involved. In such cases the NOL or the deductions arising from it must be allocated between the spouses.

#### A. Allocation of NOLs from a Joint Return . . . . . 22

#### B. Allocation of Income and Deductions on a Joint Return . . . . . 22

#### C. Summary of the Allocation Rules . . . . . 23

#### D. Separate Instead of Joint Returns May Reduce Tax Liability . . . . . 23

Circumstances under which it may be beneficial to file separate returns in the NOL year.

### VI. Special Issues in the NOL Calculation . . . . . 24

#### A. Passive Losses . . . . . 24

Only losses that are deductible under the passive

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loss rules can become part of an NOL.

**B. Gain or Loss from Sale of Assets Used in a Trade or Business . . . . . 24**

This is treated as a business gain or loss for the purpose of calculating an NOL.

**C. Gain or Loss from S Corporations and Partnerships . . . . . 24**

Gains and losses flow through in the year they occur to the individual partners or shareholders and become part of their NOL calculations.

**D. Alternative Minimum Tax . . . . . 25**

For purposes of calculating AMT, NOL is limited to 90% of alternative minimum taxable income. An NOL greater than this amount could create AMT liability in a carryforward or carryback year.

**VII. Making Optimal Use of an NOL Deduction—Planning . . . . . 25**

Tax benefits of an NOL can be wasted if other tax benefits are taken in the same year as the NOL or in carryback or carryforward years.

**A. Excess Nonbusiness Deductions Are Wasted in an NOL Year . . . . . 25**

**B. Shifting Nonbusiness Income to Loss Year . . . . . 26**

Shifting nonbusiness income to the NOL year

prevents wastage of excess nonbusiness deductions in an NOL year.

**C. Excess Nonbusiness Capital Losses in an NOL Year Are Wasted . . . . . 26**

Try to shift capital losses to offset capital gains in other years.

**D. Electing to Waive the NOL Carryback May Reduce Tax Liability . . . . . 26**

Taxpayers may elect, within six months of the nonextended due date of the tax return for the NOL year, to forgo carryback.

**E. Control Timing of an NOL . . . . . 27**

If the timing of an NOL can be controlled, it should be taken in the year in which it provides the greatest tax benefit.

**F. Use Up an NOL before It Expires . . . . . 27**

Try to accelerate income so that as much of it as possible is offset by an NOL that is about to expire.

**VIII. Summary . . . . . 27**

**Appendix—NOL Worksheets . . . . . 28**



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## NET OPERATING LOSSES

The net operating loss deduction (NOL) is used to offset the sometimes harsh results of the annual accounting period used for income taxes. NOL deductions allow taxpayers to carry business losses (as limited by the loss limitation rules, such as the at-risk rules, passive loss rules, and hobby loss rules) incurred in one taxable year back three years and/or forward up to 15 years to be used to offset taxable income in those years. **The principle of NOLs is simple, but actual computation of NOL deductions can be complex.**

Complexity arises because the provisions of I.R.C §172 remove several other tax benefits before an NOL deduction is calculated. Those benefits are removed by (1) **modifying the deductions** of the NOL year to determine the net operating loss that can be carried to other years, and (2) **modifying the income** that is used to absorb the net operating loss in the years to which the loss is carried.

### I. COMPUTING THE NET OPERATING LOSS DEDUCTION

Computation of NOL deductions must be carried out in successive steps:

Step One: **Determining Eligibility.** First, the taxpayer's eligibility for an NOL deduction must be determined. Generally, individuals are allowed to reduce their own income with their own losses from other years. Partnerships, limited liability companies, and S corporations generally cannot claim an NOL. Instead, the partners, members, or shareholders use their separate shares of the partnership, limited liability company, or S corporation business income and deductions to figure their individual NOLs.

Step Two: **Computing the NOL.** Next, the net operating loss must be computed. This is done by **modifying** the net loss for the NOL year by **removing** certain deductions that are **not allowed** in computing the net operating loss.

Step Three: **Distributing the NOL.** The net operating loss is then distributed among the years eligible for an NOL deduction from that net operating loss.

Step Four: **Calculating Taxes in Carryback and Carryover Years.** Taxes are recalculated for any year to which an NOL is carried back. The NOL is used as a deduction in calculating taxes due in the carryover years.

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## II. TAXPAYER RELIEF ACT OF 1997 CHANGES

The Taxpayer Relief Act of 1997 reduced the carryback period for most NOLs from three years to two and increased the carryforward period from 15 to 20 years. These changes are effective for NOLs that arise in tax years beginning **after August 5, 1997**. Therefore, the changes are effective for calendar year taxpayers beginning in 1998.

### A. EXCEPTIONS TO THE TWO-YEAR CARRYBACK

The TRA of 1997 retained the three-year carryback for the portion of the NOL that is an “eligible loss.” An eligible loss includes:

1. Personal (as opposed to business) losses from fire, storm, shipwreck, or other casualty or from theft.
2. Losses attributable to a Presidentially declared disaster area for:
  - a. A farming business
  - b. Corporations, partnerships, limited liability companies, and sole proprietorships that have no more than \$5,000,000 of annual average gross receipts for each three-taxable-year period ending after December, 31, 1985.

**Example 1.** Terry Tornado is an apple producer. In 1998, her apple orchard and home were destroyed by a very localized windstorm. There was no Presidentially declared disaster area resulting from the storm. For 1998, Terry had a \$50,000 NOL. \$40,000 of the 1998 NOL was caused by damage to her orchard in excess of her insurance. The other \$10,000 was caused by damage to her home in excess of her insurance.

If Terry does not elect to forgo the NOL carryback, she must carry \$10,000 of her 1998 NOL back to 1995 and \$40,000 of her 1998 NOL back to 1996.

In some cases, it may be difficult to determine what portion of an NOL is attributable to an eligible loss and what portion is attributable to losses that are not eligible losses.

**Example 2.** Clarence Jacobs raises wheat and runs a stained glass business in Oklahoma. Due to drought, Clarence lost all of his wheat crop in 1998. His wheat land is in an area that was declared to be a disaster area by President Clinton. Unrelated to the drought, Clarence also realized a loss in his stained glass business. His wife, Betty, is a nurse. In 1998, they had the following income and deductions.

#### 1998 Income and Deductions for Clarence and Betty Jacobs

|   |             |
|---|-------------|
| Income  |             |
| Wages (line 7 of Form 1040)                         | \$ 20,000   |
| Taxable Interest (line 8a of Form 1040)             | 5,500       |
| Schedule C (line 12 of Form 1040)                   | (30,000)    |
| Schedule F (line 18 of Form 1040)                   | (70,000)    |
| Adjusted Gross Income (line 33 of Form 1040)        | \$ (74,500) |
| Standard Deduction (line 36 of Form 1040)           | 7,100       |
| Personal Exemption Deduction (line 38 of Form 1040) | 10,800      |
| Taxable Income (line 39 of Form 1040)               | \$ (92,400) |

Clarence and Betty have an \$80,000 NOL for 1998. If Clarence and Betty do not forgo the carryback, the portion of that NOL attributable to the drought must be carried back to 1995, and the remainder of the NOL must be carried back to 1996. The committee reports for the 1997 Taxpayer Relief Act give no guidance on how the NOL is to be allocated between “eligible losses” and other losses.

Two questions arise when making the allocation.

1. Is all of the \$70,000 farm loss attributable to the drought?

The entire \$70,000 farm loss could be allocated to the drought. It is arguable that without the drought there would be no farm loss, so all of the loss is attributable to the drought. However, the IRS could argue that low prices for commodities, high input costs, or other factors caused part of the loss and therefore allocate part of the farm loss to causes other than the drought. Such a position would be difficult to administer, because it could be difficult to determine what are high input costs, low output prices, or other causes of a loss. Until further guidance is issued, it seems logical to allocate all losses to the drought or other weather condition that caused the disaster area declaration if the producer’s major commodity is destroyed by the weather. Therefore, in this example, Clarence can argue that the entire \$70,000 farm loss is attributable to the drought.

2. How is the \$80,000 NOL allocated between the \$70,000 farm loss and the \$30,000 stained glass business loss?

Four possible answers are:

1. **Allocate the NOL first to the eligible losses.** Therefore, \$70,000 of the NOL is attributable to the drought, and \$10,000 is attributable to the stained glass business.
2. **Allocate the NOL first to the losses that are not eligible.** Therefore, \$30,000 of the NOL is attributable to the stained glass business loss, and \$50,000 is attributable to the drought.
3. **Allocate the NOL on a pro-rata basis.** Therefore,  $\$30,000/\$100,000 \times \$80,000 = \$24,000$  is attributable to the stained glass business loss, and  $\$70,000/\$100,000 \times \$80,000 = \$56,000$  is attributable to the drought.
4. **Allocate the NOL based on the NOL that would have resulted if the other loss had not occurred.** If there had not been a farm loss, the NOL would have been \$10,000. If there had not been a stained glass business loss, the NOL would have been \$50,000. Therefore,  $\$10,000/\$60,000 \times \$80,000 = \$13,333$  is attributable to the stained glass business, and  $\$50,000/\$60,000 \times \$80,000 = \$66,667$  is attributable to the drought.

## Which Answer Is Best for the Taxpayer?

The best answer for the taxpayer depends upon his or her tax bracket in the carryback and carry-over years. The taxpayer would like to **use the NOL to offset as much high-bracket income as possible.**

**Example 3.** If Clarence and Betty from Example 2 had \$50,000 of income in the 28% bracket in 1995 and \$30,000 of income in the 28% bracket in 1996, then **Answer #2** above is the best for them, because it allows them to use the entire \$80,000 NOL against 28% bracket income.

## Which Answer Is Likely to Prevail?

**Answer #3 seems to be the most logical of the answers.** All of the other answers would allocate none of the NOL to a loss if that loss is not large enough to create an NOL on its own. Such an allocation seems harsh, because such a loss did in fact increase the taxpayer’s NOL. Until further guidance is issued by the Treasury or the IRS, Answer #3 appears to be the easiest to defend.

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## B. OTHER EXCEPTIONS TO CARRYBACK PERIOD

An NOL of a real estate investment trust (REIT) cannot be carried back to any years before the loss year. Losses that arise from product liability can be carried back 10 years. Losses resulting from a liability under a federal or state law can be carried back 10 years if the act (or failure to act) giving rise to the liability occurred at least three years before the beginning of the taxable year. Similarly, losses arising from a tort of the taxpayer who uses accrual accounting can be carried back 10 years if the liability arises from a series of actions (or failures to act) over an extended period of time and a substantial portion of the actions (or failures to act) occurs at least three years before the beginning of the taxable year.

## III. FILING DATES

**Form 1045.** If the NOL is carried back, the resulting refund can be claimed by filing Form 1045 by the end of the tax year following the year in which the NOL occurred. However, the Form 1045 cannot be filed before the income tax return is filed for the year the NOL occurred. For example, a calendar year taxpayer with a 1998 NOL must file Form 1045 after the 1998 income tax return is filed and before the end of 1999.

**Form 1040X.** The refund from carrying an NOL back can also be claimed by filing Form 1040X for each of the carryback years. The Form 1040X must be filed within three years of the due date (including extensions) of the tax return for the year the NOL occurred. For example, a calendar year taxpayer with a 1998 NOL must file Form 1040X for 1998 by April 15, 2002, if he or she did not get an extension to file the 1998 tax return.

**Practitioner Note.** The election to forgo [elect not to carry back the loss] the carryback must be made on the tax return for the year in which the NOL occurred or on an amended return for that year filed **within six months** (excluding extensions) of the **due date** for the original return. For example, a 1997 calendar year taxpayer has until October 15, 1998 to make the election on an amended return. If this deadline is not met, the taxpayer cannot forgo the carryback.

## IV. ILLUSTRATION OF NOL COMPUTATIONS

To illustrate the calculation of an NOL and the use of that NOL to reduce taxable income in other years, assume that Leonard and Ruth Frost are married, have two children, and file a joint return. Their income and deductions for 1996, 1997, and 1998 are shown in the following table:

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## Income and Deductions for Leonard and Ruth Frost (Line references are to the 1998 forms)

|   | 1996<br>(First<br>Carryback Year) | 1997<br>(Second<br>Carryback Year) | 1998<br>(Loss Year) |
|---|-----------------------------------|------------------------------------|---------------------|
| <b>Income</b>   |                                   |                                    |                     |
| Wages (line 7 of Form 1040)                                       | \$ -0-                            | \$ -0-                             | \$ 5,900            |
| Taxable interest (line 8a of Form 1040)                           | 700                               | 300                                | 300                 |
| Business (line 12 of Form 1040)                                   | 21,000                            | 31,000                             | (32,000)            |
| Capital—  |                                   |                                    |                     |
| Short-term (line 1 of Schedule D (Form 1040))                     | -0-                               | -0-                                | (900)               |
| Long-term (line 8 of Schedule D (Form 1040))                      | (1,000)                           | -0-                                | -0-                 |
| Gain from Form 4797 (line 11 of Schedule D (Form 1040))           | -0-                               | -0-                                | 500                 |
| Other gain (loss) from Form 4797 (line 14 of Form 1040)           | -0-                               | -0-                                | 5,000               |
| Jury duty pay (line 21 of Form 1040)                              | -0-                               | -0-                                | 100                 |
| <b>Total Income</b> (line 22 of Form 1040)                        | <u>\$20,700</u>                   | <u>\$ 31,300</u>                   | <u>\$(21,100)</u>   |
| <b>Adjustments</b>  |                                   |                                    |                     |
| 50% of SE Tax (line 27 of Form 1040)                              | 1,484                             | 2,190                              | -0-                 |
| Other (line 32 of Form 1040)                                      | -0-                               | -0-                                | 100*                |
| Total adjustments (line 32 of Form 1040)                          | <u>1,484</u>                      | <u>2,190</u>                       | <u>100*</u>         |
| <b>Adjusted Gross Income</b> (line 33 of Form 1040)               | <u>\$19,216</u>                   | <u>\$ 29,110</u>                   | <u>\$(21,200)</u>   |
| <b>Standard Deduction</b> (line 36 of Form 1040)                  | -0-                               | -0-                                | 7,100               |
| <b>Itemized Deductions</b>  |                                   |                                    |                     |
| Medical expenses (line 1 of Schedule A (Form 1040))               | 5,000                             | 5,000                              | N/A                 |
| Less 7.5% of AGI (line 3 of Schedule A (Form 1040))               | 1,441                             | 2,183                              | N/A                 |
| Medical deduction (line 4 of Schedule A (Form 1040))              | 3,559                             | 2,817                              | N/A                 |
| Mortgage interest (line 10 of Schedule A (Form 1040))             | 5,000                             | 4,000                              | N/A                 |
| Misc. itemized deduction (line 23 of Schedule A (Form 1040))      | 500                               | 500                                | N/A                 |
| Less 2% of AGI (line 25 of Schedule A (Form 1040))                | 384                               | 582                                | N/A                 |
| Net misc. itemized deductions (line 26 of Schedule A (Form 1040)) | <u>116</u>                        | <u>-0-</u>                         | <u>N/A</u>          |
| Total Itemized deductions (Line 28 of Schedule A (Form 1040))     | 8,675                             | 6,817                              | N/A                 |
| <b>Personal exemption deduction</b> (line 38 of Form 1040)        | 10,200                            | 10,600                             | 10,800              |
| <b>Taxable income</b> (line 39 of Form 1040)                      | 341                               | 11,693                             | (39,100)            |
| Income Tax (line 40 of Form 1040)                                 | 51                                | 1,751                              | -0-                 |
| Self-employment tax (line 50 of Form 1040)                        | <u>2,967</u>                      | <u>4,380</u>                       | <u>-0-</u>          |
| <b>Total tax liability</b> (line 56 of Form 1040)                 | <u>3,018</u>                      | <u>6,131</u>                       | <u>-0-</u>          |

\* Jury duty pay turned over to employer



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## A. COMPUTING THE NOL

The Frosts' net operating loss for 1998 is calculated on Schedule A, Form 1045 as shown (in Figure 1). Schedule A (Form 1045) is completed as follows:

- **Line 1:** Enter the negative \$21,200 adjusted gross income. Note that it should be entered as a negative figure, because it is combined with a negative figure on line 2c.
- **Line 2a:** Enter the \$7,100 standard deduction.
- **Line 2b:** Enter the \$10,800 personal exemption deduction.
- **Line 2c:** Combine the figures on lines 2a and 2b and enter the \$17,900 result as a negative figure.
- **Line 3:** Combine lines 1 and 2c. Since line 1 is negative, the amount on line 2c will increase the size of the negative amount. In this example, the amount to be entered on line 3 is a negative \$39,100 (\$21,200 + \$17,900). Since the amount on line 3 is negative, there may be an NOL. **If line 3 were positive, there would be no need for further calculations, because there could be no NOL.**
- **Line 4:** Enter the \$10,800 personal exemption deduction. The adjustment made on line 4 is necessary to add back the personal exemption deduction, which was used to calculate taxable income (loss) on line 3 but is not allowed in the calculation of the NOL.

**Lines 5 through 22** of Schedule A (Form 1045) are designed to apply two NOL rules:

1. Nonbusiness deductions are allowed in computing an NOL only to the extent of nonbusiness income; and
2. Capital losses are allowed in computing an NOL only to the extent of capital gains.

Since nonbusiness capital losses are included in both of these rules, **the two rules interact with each other.** These rules are applied by adding back the losses and deductions that were used in calculating the taxable income (loss) reported on line 3 of Schedule A (Form 1045) but are not allowed in computing an NOL.

**In order to complete lines 5 through 22, the taxpayer's capital losses, capital gains, ordinary deductions, and ordinary income must each be sorted to determine what portion should be treated as "business" and what portion should be treated as "nonbusiness."** To help with that sorting process, we have designed four worksheets. Blank copies of the worksheets are reproduced at the end of this chapter. The worksheets for this example are filled in as follows (Figures 2 through 5).

The Frosts' \$900 short-term capital loss from Schedule D (Form 1040) is reported on line A of NOL Worksheet 1 and is treated as a **nonbusiness capital loss** for purposes of the NOL computation. Their \$500 capital gain from Form 4797 is reported on line G of NOL Worksheet 2 and is treated as a **business capital gain** for purposes of the NOL computation. The Frosts' ordinary deductions and income are sorted out on NOL Worksheet 3 and NOL Worksheet 4, respectively.

The foregoing information is all that is necessary to complete lines 5 through 22 of Schedule A (Form 1045).

- **Line 5:** Enter the \$900 nonbusiness capital loss.
- **Line 6:** Enter zero, because they have no nonbusiness capital gains.



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Figure 1—Schedule A (Form 1045) for Leonard and Ruth

**Schedule A—Net Operating Loss (NOL).** See instructions.

|  |  |    |          |
|--|--|----|----------|
| 1  | Adjusted gross income from 1997 Form 1040, line 33. Estates and trusts, skip lines 1 and 2 . . .   | 1  | <21,200> |
| 2  | Deductions (individuals only):   |    |          |
| a  | Enter amount from your 1998 Form 1040, line 35 . . . . .   | 2a | 7,100    |
| b  | Enter your deduction for exemptions from 1998 Form 1040, line 37 . . . . .   | 2b | 10,800   |
| c  | Add lines 2a and 2b . . . . .  | 2c | (17,900) |
| 3  | Combine lines 1 and 2c. Estates and trusts, enter taxable income . . . . .   | 3  | <39,100> |
| Note: If line 3 is zero or more, do not complete rest of schedule. You do not have a net operating loss. |  |    |          |
| <b>Adjustments:</b>  |  |    |          |
| 4  | Deduction for exemptions from line 2b above. Estates and trusts, enter exemption amount from tax return . . . . .  | 4  | 10,800   |
| 5  | Total nonbusiness capital losses before limitation. Enter as a positive number . . . . .   | 5  | 900      |
| 6  | Total nonbusiness capital gains . . . . .  | 6  | -0-      |
| 7  | If line 5 is more than line 6, enter difference; otherwise, enter -0- . . . . .  | 7  | 900      |
| 8  | If line 6 is more than line 5, enter difference; otherwise, enter -0- . . . . .  | 8  | -0-      |
| 9  | Nonbusiness deductions. See instructions . . . . .   | 9  | 7,100    |
| 10   | Nonbusiness income other than capital gains. See instructions . . . . .  | 10 | 300      |
| 11   | Add lines 8 and 10 . . . . .   | 11 | 300      |
| 12   | If line 9 is more than line 11, enter difference; otherwise, enter -0- . . . . .   | 12 | 6,800    |
| 13   | If line 11 is more than line 9, enter difference; otherwise, enter -0-. Do not enter more than line 8 . . . . .  | 13 | -0-      |
| 14   | Total business capital losses before limitation. Enter as a positive number . . . . .  | 14 | -0-      |
| 15   | Total business capital gains . . . . .   | 15 | 500      |
| 16   | Add lines 13 and 15 . . . . .  | 16 | 500      |
| 17   | If line 14 is more than line 16, enter difference; otherwise, enter -0- . . . . .  | 17 | -0-      |
| 18   | Add lines 7 and 17 . . . . .   | 18 | 900      |
| 19   | Enter the loss, if any, from line 17 of Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 16, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line, skip lines 19 through 21 and enter on line 22 the amount from line 18 . . . . . | 19 |          |
| 20   | Enter the loss from line 18 of Schedule D (Form 1040). (Estates and trusts, enter the loss from line 17 of Schedule D (Form 1041).) Enter as a positive number . . . . .   | 20 |          |
| 21   | Subtract line 20 from line 19 . . . . .  | 21 |          |
| 22   | Subtract line 21 from line 18. If zero or less, enter -0- . . . . .  | 22 | 900      |
| 23   | Net operating loss deduction for losses from other years. Enter as a positive number . . . . .   | 23 |          |
| 24   | Add lines 4, 12, 22, and 23 . . . . .  | 24 | 18,500   |
| 25   | <b>Net operating loss.</b> Combine lines 3 and 24. If the combined amount is less than zero, enter it here and on page 1, line 1a. If the combined amount is zero or more, you do not have a net operating loss . . . . .  | 25 | <20,600> |

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Figure 2

## NOL Worksheet 1

Allocation of Capital Losses between Business Capital Losses and Nonbusiness Capital Losses

| Where loss is reported on tax return<br>1998 Sch. D (Form 1040) <sup>1</sup> | Amount reported on<br>tax return | Disposition           | Business | Nonbusiness |
|--|----------------------------------|-----------------------|----------|-------------|
| A. Lines 1 & 2, column f   | 900                              | Allocate <sup>2</sup> |          | 900         |
| B. Line 4, column f  |                                  | Allocate <sup>2</sup> |          |             |
| C. Line 5, column f  |                                  | Allocate <sup>3</sup> |          |             |
| D. Line 6, column f  |                                  | Allocate <sup>4</sup> |          |             |
| E. Lines 8 & 9, column f   |                                  | Allocate <sup>2</sup> |          |             |
| F. Line 11, column f   |                                  | Allocate <sup>2</sup> |          |             |
| G. Line 12, column f   |                                  | Allocate <sup>3</sup> |          |             |
| H. Line 14, column f   |                                  | Allocate <sup>4</sup> |          |             |
| I. TOTALS  | 900                              |                       |          | 900         |

<sup>1</sup> Enter the amount from the designated lines on Schedule D only if they are losses. Enter the amounts as positive numbers.

<sup>2</sup> In most cases, losses reported on lines 1, 2, 4, 8, 9, and 11 of schedule D (Form 1040) are nonbusiness capital losses for purposes of the NOL calculation, since losses from property used in a trade or business are reported on Form 4797 and are treated as ordinary deductions. However, losses reported on those lines can be business capital losses if the asset on which the loss was realized was an I.R.C. §1221 asset rather than an I.R.C. §1231 asset but was purchased for a trade or business reason rather than for investment. For example, loss realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital loss for purposes of the NOL calculation. See *Trammel Crow*, 79 T.C. 541 (1982).

<sup>3</sup> The character of the loss reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the loss to the partnership, S corporation, or fiduciary. In most cases, losses reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital losses, but see footnote 1 for a discussion of when losses from an I.R.C. §1221 asset may be treated as a business capital loss for purposes of the NOL calculation.

<sup>4</sup> Capital loss carryovers must be allocated between business and nonbusiness capital losses according to the proportionate contribution of business and nonbusiness capital losses to the capital loss carryover.

Notes on completion of Schedule A (Form 1045):

Use this worksheet to complete lines 5 and 14 of Schedule A (Form 1045)

Figure 3

NOL Worksheet 2

Allocation of Capital Gains between Business Capital Gains and Nonbusiness Capital Gains

| Where gain is reported on tax return<br>1998 Sch. D (Form 1040) <sup>1</sup> | Amount reported on<br>tax return | Disposition           | Business | Nonbusiness |
|--|----------------------------------|-----------------------|----------|-------------|
| A. Line 1, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| B. Line 2, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| C. Line 4, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| D. Line 5, column g  | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| E. Line 8, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| F. Line 9, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| G. Line 11, column g   | 500                              | Allocate <sup>4</sup> | 500      | _____       |
| H. Line 12, column g   | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| I. Line 13, column g   | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| J. TOTALS  | 500                              |                       | 500      | _____       |

<sup>1</sup> Enter the amounts from the designated lines only if they are gains.

<sup>2</sup> In most cases, gains reported on lines 1, 2, 4, 8, 9, and 13 of Schedule D (Form 1040) are nonbusiness capital gains for purposes of the NOL calculation, because gains from property used in a trade or business are reported on Form 4797 and are carried to Line 11 of Schedule D (Form 1040) if they are treated as long-term capital gain. However, gains reported on lines 1, 2, 4, 8, 9, and 13 of Schedule D (Form 1040) can be business capital gains if the asset on which the gain was realized was an I.R.C. §1221 asset rather than an I.R.C. §1231 asset but was purchased for a trade or business reason rather than for investment. For example, gain realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital gain for purposes of the NOL calculation. See *Trammel Crow*, 79 T.C. 541 (1982).

<sup>3</sup> The character of the gain reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the gain to the partnership, S corporation, or fiduciary. In most cases, gains reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital gains, but see footnote 2 for a discussion of when gains from an I.R.C. §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

<sup>4</sup> Gain from Form 4797, Part I, is business gain. Gain from Form 2439, Form 4684, Form 6252, Form 6781, or Form 8824 is nonbusiness gain in most cases. See footnote 2 for a discussion of when gains from an I.R.C. §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

Notes on completion of Schedule A (Form 1045):

Use this worksheet to complete lines 6 and 15 of Schedule A (Form 1045)

# 1998 Workbook

Figure 4

## NOL Worksheet 3

### Allocation of Deductions between Business Deductions and Nonbusiness Deductions

| Location on<br>1998 Form 1040                            | Item                          | Amount<br>on tax<br>return | Disposition           | Amount as<br>Business | Amount as<br>Nonbusiness | AMT<br>Nonbusiness   |
|--|-------------------------------|----------------------------|-----------------------|-----------------------|--------------------------|----------------------|
| A. Line 23   | IRA deduction                 | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| B. Line 24   | Student loan<br>interest ded. | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| C. Line 25   | MSA deduct.                   | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| D. Line 26   | Moving expenses               | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| E. Line 27   | SE Tax                        | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| F. Line 28   | SE health<br>insurance        | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| G. Line 29   | Keogh & SEP                   | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| H. Line 30   | Penalty, early<br>withdrawal  | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| I. Line 31a  | Alimony                       | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| J. Line 32   | Other <sup>1</sup>            | 100                        | Allocate              | 100                   | _____                    | _____                |
| I. Line 36   | Std. Ded.<br>(if claimed)     | 7,100                      | Nonbusiness           | xxxxxxx               | 7,100                    | xxxxxxx <sup>2</sup> |
| Schedule A (Form 1040) (Itemized Deductions, if claimed) |                               |                            |                       |                       |                          |                      |
| J. Line 4  | Medical                       | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____ <sup>3</sup>   |
| K. Line 9  | Taxes                         | _____                      | Allocate <sup>4</sup> | _____                 | _____                    | xxxxxxx              |
| L. Line 14   | Interest                      | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____ <sup>5</sup>   |
| M. Line 18   | Contributions                 | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| N. Line 19   | Casualty                      | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| O. Line 26   | Misc. (2% floor)              | _____                      | Allocate <sup>6</sup> | _____                 | _____                    | xxxxxxx              |
| P. Line 27   | Other misc.                   | _____                      | Allocate <sup>7</sup> | _____                 | _____                    | _____                |
| Q. TOTALS  |                               | 7,200                      |                       | 100                   | 7,100                    | _____                |

<sup>1</sup> Include only "other" items such as unreimbursed expenses of artists (I.R.C. §62(b)), jury duty pay turned over to taxpayer's employer. Do not include amounts reported on lines 23 through 31.

<sup>2</sup> If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

<sup>3</sup> The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

<sup>4</sup> The state and local income taxes paid are allocated between business and nonbusiness deductions according to the income of the year that created the taxes. For this allocation, salaries and wages are treated as business income. Taxes are not allowed as a deduction when calculating AMT.

<sup>5</sup> The alternative minimum tax interest deduction is the same as the regular tax interest deduction except for the following adjustments: (1) if debt on a personal residence has been refinanced, interest on debt in excess of the debt before refinancing cannot be deducted for AMT purposes; and (2) the investment interest deduction must be recalculated to include income from private activity bonds in investment income and the expenses on those bonds in investment expenses.

<sup>6</sup> Since the amount on line 26, Schedule A, is reduced by 2% of AGI, the amounts allocated to business and nonbusiness must be reduced on a pro rata basis. Therefore, the amount in the business column should be the amount from line 26, Schedule A, multiplied by the total business miscellaneous deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. The amount in the nonbusiness column should be the amount from line 26, Schedule A, multiplied by the total nonbusiness deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. Miscellaneous itemized deductions are not allowed as a deduction when calculating AMT.

<sup>7</sup> Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 27, Schedule A, are nonbusiness deductions.

# 1998 Workbook

Figure 5

NOL Worksheet 4

*Allocation of Ordinary Income between Business and Nonbusiness Ordinary Income*

| Location on 1998 Form 1040 | Item                                     | Amount on tax return | Disposition              | Amount as Business | Amount as Nonbusiness | AMT Nonbusiness |
|----------------------------|--|----------------------|--------------------------|--------------------|-----------------------|-----------------|
| A. Line 7                  | Wages, salary, etc.                      | 5,900                | Business                 | 5,900              | xxxxxxx               | xxxxxxx         |
| B. Line 8a                 | Taxable interest                         | 300                  | Nonbusiness              | xxxxxxx            | 300                   |                 |
| C. Line 8b                 | Tax-exempt interest                      |                      | Nonbusiness <sup>1</sup> | xxxxxxx            | xxxxxxx               |                 |
| D. Line 9                  | Dividends                                |                      | Nonbusiness              | xxxxxxx            |                       |                 |
| E. Line 10                 | Taxable refunds                          |                      | Allocate <sup>2</sup>    |                    |                       |                 |
| F. Line 11                 | Alimony                                  |                      | Nonbusiness              | xxxxxxx            |                       |                 |
| G. Line 12                 | Business income (loss) Schedule C        | <32,000>             | Business                 | <32,000>           | xxxxxxx               | xxxxxxx         |
| H. Line 14                 | Form 4797 gains or losses                | 5,000                | Business                 | 5,000              | xxxxxxx               | xxxxxxx         |
| I. Line 15                 | Taxable amount of IRA distributions      |                      | Nonbusiness              | xxxxxxx            |                       |                 |
| J. Line 16b                | Taxable amount of pensions               |                      | Nonbusiness              | xxxxxxx            |                       |                 |
| K. Line 17                 | Rents, royalties, and partnership income |                      | Usually business         |                    | xxxxxxx               | xxxxxxx         |
| L. Line 18                 | Farm income (or loss)                    |                      | Business                 |                    | xxxxxxx               | xxxxxxx         |
| M. Line 19                 | Taxable unemployment                     |                      | Business                 |                    | xxxxxxx               | xxxxxxx         |
| N. Line 20b                | Taxable social security benefits         |                      | Nonbusiness              | xxxxxxx            |                       |                 |
| O. Line 21                 | Other income                             | 100                  | Allocate                 | 100                |                       |                 |
| P. TOTALS                  |  | <27,000>             |                          | <21,000>           | 300                   |                 |

<sup>1</sup> Nontaxable interest is nonbusiness income for AMT purposes only.

<sup>2</sup> The state and local income tax refund is to be allocated between business and nonbusiness income according to the income of the year that created the refund. For this allocation, salaries and wages are treated as business income. State and local income tax refunds are not included when calculating AMT.

# 1998 Workbook

- **Line 7:** Enter the \$900 excess of line 5 over line 6. **The purpose of line 7 is to prevent a taxpayer from using nonbusiness capital losses in excess of nonbusiness capital gains as part of an NOL that will be carried to another tax year.**
- **Line 8:** Enter zero, because line 6 does not exceed line 7. If line 6 did exceed line 7, the excess could be used to qualify nonbusiness ordinary deductions for purposes of the NOL computation. (See line 11 of Schedule A (Form 1045)).
- **Line 9:** Enter \$7,100, the standard deduction.
- **Line 10:** Enter \$300, the \$300 of interest, which is treated as nonbusiness income.
- **Line 11:** Enter \$300, the sum of lines 8 and 11.
- **Line 12:** Enter \$6,800, the excess of line 9 over line 11. **The purpose of line 12 is to add back ordinary nonbusiness deductions that exceed nonbusiness income.** That amount is not allowed as part of the NOL, because the NOL rules allow only business losses to be carried to another tax year.
- **Line 13:** Enter zero, because 11 is less than line 9.
- **Line 14:** Enter zero, because there are no business capital losses.
- **Line 15:** Enter \$500, the business capital gains.
- **Line 16:** Enter \$500, the sum of lines 13 and 15.
- **Line 17:** Enter zero, since line 14 is not more than line 16. **Line 17 is designed to calculate the business capital losses that must be added back to the taxable income (loss) on line 3.** In this example the amount is zero since the business capital gains exceed the business capital losses.

- **Line 18:** Enter \$900, the sum of:
  1. The **nonbusiness capital losses** that must be added back because they **exceed nonbusiness capital gains**, and
  2. The **business capital losses** that must be added back because they exceed the sum of:
    - a. Business capital gains, plus
    - b. Excess nonbusiness capital gains.

- **Lines 19 through 21:** Leave blank. These lines are designed to add back any capital losses that are carried over under the capital loss carryover years. Because they have no loss on line 18 of Schedule D (Form 1040), **Leonard and Ruth can skip these lines.**
- **Line 22:** Enter the \$900 from line 18.
- **Line 23:** Enter zero, because they had no previous NOLs.
- **Line 24:** Enter \$18,500, the sum of lines 4, 12, 22, and 23.
- **Line 25:** Combine the negative \$39,000 on line 3 with the positive \$18,500 on line 24, and enter the \$20,600 result as a **negative figure.**

## B. DISTRIBUTING THE NOL

For most individual taxpayers, a net operating loss in a year beginning after August 5, 1997, can be carried **back** two years from the loss year and **forward** 20 years after the loss year. Different rules apply to years for which the real estate investment trust rules apply or for which the taxpayer had a tort liability.



**Practitioner Note:** The taxpayer has the option of forgoing the two-year carryback and instead carrying the NOL forward only. The election to forgo the carryback must be made by the due date of the return (including extensions) for the year in which the NOL arises. The election is for a particular tax year and, once made for any tax year, is irrevocable for that tax year. If the election is not made by that date, the NOL will be considered absorbed as if it had been carried back, even if the taxpayer does not claim the NOL as a deduction in the carryback year. As a result, only the unabsorbed amount from the carryback period is available for the 20-year carryover period.

**The loss must be carried to the carryback and carryforward years in chronological order.** Therefore, if the carryback is not waived, the first carryback year is the second year before the loss year. The second carryback year is the first year before the loss year. Any NOL remaining after the second carryback year (the entire NOL if the carryback is waived) is carried to the first year after the loss year.

Leonard and Ruth decide **not** to forgo the two-year carryback of the \$20,600 NOL. Therefore, **they must compute the amount of NOL absorbed by the carryback years.**

**The amount of net operating loss absorbed by a year to which the loss is carried is equal to the taxable income as modified for that year.** Therefore, the amount to be carried to the second eligible year (1997 in this example) is the original NOL minus the modified taxable income of the first eligible year (1996 in this example). The amount carried to the third eligible year (1999 in this example) is the amount carried to the second year minus the modified taxable income of the second year. This process is repeated until the net operating loss is fully absorbed or until it is carried to the last eligible year.

**Schedule B (Form 1045) (see Figure 6) is designed to calculate the amount of NOL that is absorbed in an intervening year.** To illustrate the use of Schedule B (Form 1045), it has been completed for Leonard and Ruth. Column (a) is not used, because the NOL in this example cannot be carried back to the third preceding year.

Column (b) is completed as follows:

- **Top of the form:** Enter 12/31/96, the end of the carryback year.
- **Line 1:** Enter \$20,600, the NOL carried from 1998 to 1996.
- **Line 2:** Enter \$341, the taxable income as reported on the original 1996 return.
- **Line 3:** Enter \$1,000, the net capital loss for 1996.
- **Line 4:** Enter zero, because they had no passive losses, taxable social security benefits, IRA deductions, or excludable savings bond interest.
- **Line 5:** Enter \$95, the adjustment calculated on lines 9 through 33 of this schedule. The adjustment reflects the change in itemized deductions caused by the \$1,000 adjustment to AGI. **The itemized deductions that are based on AGI are recalculated using the modified AGI,** and the difference between the amount reported on the 1996 return and the amount calculated using modified AGI is reported on line 5 of Schedule B (Form 1045). In this example, the \$95 is made up of \$75 from adjusting the deductible medical expense (line 16) and \$20 from adjusting the miscellaneous itemized deductions (line 32).

**Practitioner Note:** If the taxpayer is subject to the phase-out of itemized deductions in the carryback years, a worksheet in the instructions for Schedule B (Form 1045) must be used to calculate the adjustment to itemized deductions that are reported on line 5 of Schedule B (Form 1045). The phase-out applies if the Schedule B (Form 1045), line 11 amount is equal to or greater than \$117,950 (\$58,975 for married filing separately) for 1996, \$121,200 (\$60,600 for married filing separately) for 1997, or \$124,500 (\$62,250 for married filing separately) for 1998.



# 1998 Workbook

Figure 6

| Schedule B—Net Operating Loss Carryover. See instructions.  |                                    |   |   |        |        |
|---|------------------------------------|---|---|--------|--------|
| Complete one column before going to the next column.  | (a) 3rd preceding tax year ended ▶ | (b) 2nd preceding tax year ended ▶ 12/31/96 | (c) 1st preceding tax year ended ▶ 12/31/97 |        |        |
| 1 Net operating loss deduction. In column (a), enter as a positive number the net operating loss from Schedule A, line 25. In columns (b) and (c), enter amounts from line 8 below, columns (a) and (b), respectively . . . . .                           |                                    |   | 20,600                                      |        | 8,964  |
| 2 Taxable income from tax return (or as previously adjusted) before 1998 NOL carryback. (For individuals, if line 37 of Form 1040 is zero, subtract line 36 (Form 1040) from line 35 (Form 1040), and enter the difference as a negative number . . . . . |                                    | 341   |   | 11,693 |        |
| 3 Net capital loss deduction from Sch. D (Form 1040), line 19, or from Sch. D (Form 1041), line 18. Enter as a positive number . . . . .  |                                    | 1,000                                       |   |        |        |
| 4 Adjustments to adjusted gross income. See instructions . . . . .  |                                    | -0-   |   |        |        |
| 5 Adjustment to itemized deductions. See instructions . . . . .   |                                    | 95  |   |        |        |
| 6 Deduction for exemptions from tax return (or as previously adjusted). Estates and trusts, enter exemption amount . . . . .  |                                    | 10,200                                      |   | 10,600 |        |
| 7 Modified taxable income. Combine lines 2 through 6. If zero or less, enter -0- . . . . .  |                                    |   | 11,636                                      |        | 22,293 |
| 8 Net operating loss carryover. Subtract line 7 from line 1. If zero or less, enter -0-. See instructions . . . . .   |                                    |   | 8,964                                       |        | -0-    |
| <b>Adjustment to Itemized Deductions (Individuals Only)</b>   |                                    |   |   |        |        |
| Complete lines 9 through 33 ONLY if, for any of the 3 preceding years, you itemized deductions.   |                                    |   |   |        |        |
| 9 Adjusted gross income per return (or as previously adjusted) before 1998 NOL carryback . . . . .  |                                    | 19,216                                      |   |        |        |
| 10 Add lines 3 and 4 above . . . . .  |                                    | 1,000                                       |   |        |        |
| 11 Modified adjusted gross income. Add lines 9 and 10 . . . . .   |                                    | 20,216                                      |   |        |        |
| 12 Medical expenses from Sch. A (Form 1040), line 1 . . . . .   |                                    | 5,000                                       |   |        |        |
| 13 Multiply line 11 by .075 . . . . .   |                                    | 1,516                                       |   |        |        |
| 14 Subtract line 13 from line 12. If zero or less, enter -0- . . . . .  |                                    | 3,484                                       |   |        |        |
| 15 Medical expenses from Sch. A (Form 1040), line 4 (or as previously adjusted)   |                                    | 3,559                                       |   |        |        |
| 16 Subtract line 14 from line 15 . . . . .  |                                    |   | 75  |        |        |

# 1998 Workbook

Figure 6 (continued)

Form 1045 (1996) Page 4

**Schedule B—Net Operating Loss Carryover (Continued)**

Complete one column before going to the next column.

|   | (a) 3rd preceding tax year ended ▶ | (b) 2nd preceding tax year ended ▶ | (c) 1st preceding tax year ended ▶ |
|---|------------------------------------|------------------------------------|------------------------------------|
| 17 Modified adjusted gross income from line 11 . . . . .  |                                    | 20,216                             |                                    |
| 18 Enter as a positive number any NOL carryback from a year before 1998 that was deducted in figuring line 9 on page 3 . . . . .  |                                    | -0-                                |                                    |
| 19 Add lines 17 and 18 . . . . .  |                                    | 20,216                             |                                    |
| 20 Refigure your charitable contributions using line 19 as your adjusted gross income. See instructions . . . . .   |                                    | -0-                                |                                    |
| 21 Charitable contributions from Sch. A (Form 1040), line 18 . . . . .  |                                    | -0-                                |                                    |
| 22 Subtract line 20 from line 21 . . . . .  |                                    |                                    | -0-                                |
| 23 Casualty and theft losses from Form 4684, line 16 . . . . .  |                                    | -0-                                |                                    |
| 24 Multiply line 11 by .10 . . . . .  |                                    | -0-                                |                                    |
| 25 Subtract line 24 from line 23. If zero or less, enter -0- . . . . .  |                                    | -0-                                |                                    |
| 26 Casualty and theft losses from Form 4684, line 18 (or as previously adjusted) . . . . .  |                                    | -0-                                |                                    |
| 27 Subtract line 25 from line 26 . . . . .  |                                    |                                    | -0-                                |
| 28 Miscellaneous itemized deductions from Sch. A (Form 1040), line 23, . . . . .  |                                    | 500                                |                                    |
| 29 Multiply line 11 by .02 . . . . .  |                                    | 404                                |                                    |
| 30 Subtract line 29 from line 28. If zero or less, enter -0- . . . . .  |                                    | 96                                 |                                    |
| 31 Miscellaneous itemized deductions from Sch. A (Form 1040), line 26 (or as previously adjusted) . . . . .   |                                    | 116                                |                                    |
| 32 Subtract line 30 from line 31 . . . . .  |                                    |                                    | 20                                 |
| 33 Combine lines 16, 22, 27, and 32. If line 11 is more than \$111,800 for 1994 (\$55,900 if married filing separately), more than \$114,700 for 1995 (\$57,350 if married filing separately), or more than \$117,950 for 1996 (\$58,975 if married filing separately), complete the worksheet on page 4 of the instructions. Otherwise, enter the amount from this line on line 5 (page 3) . . . . . |                                    |                                    | 95                                 |

# 1998 Workbook

- **Line 6:** Enter \$10,200, the personal exemption deduction.
- **Line 7:** Enter \$11,636, the total of lines 2 through 6. That is the amount of NOL absorbed in 1996.
- **Line 8:** Enter \$8,964, the \$20,600 NOL carried to 1996 minus \$11,636 of modified taxable income.

Column (c) is completed as follows:

- **Top of the form:** Enter 12/31/97, the end of the second carryback year.
- **Line 1:** Enter \$8,964, from line 8, column (a).
- **Line 2:** Enter \$11,693, the taxable income that was reported on the original return for 1997.
- **Lines 3 through 5:** Leave blank. Since there was no net capital loss deduction in 1997, there is no adjustment to adjusted gross income and, therefore, no adjustments to itemized deductions based on adjusted gross income.
- **Line 6:** Enter \$10,600, the personal exemption deduction for 1997.
- **Line 7:** Enter \$22,293, the sum of lines 2 and 6.
- **Line 8:** Enter zero. Since the modified taxable income on line 7 exceeds the NOL carried to 1997 on line 1, **there is no NOL to carry to 1999.**

## C. CALCULATING TAXES IN CARRYBACK AND CARRYOVER YEARS

In this example, Form 1045 (see Figure 7) is completed by entering the \$20,600 NOL from 1998 on line 1 in box (a). Columns (a) and (b) are not used in this example, because the NOL cannot be carried back to the third preceding year. The \$20,600 NOL carried to 1996 is entered on line 11 in column (d). The \$8,964 NOL carried to 1997 is entered on line 11 in column (f).

- The income, deductions, and taxes as originally reported on the 1996 and 1997 tax returns are reported in columns (c) and (e), respectively, on lines 10 through 26.
- The income, deductions, and taxes for 1996 and 1997 after the NOL carryback are reported in columns (d) and (f) respectively on lines 10 through 26.
- **For columns (d) and (f), the itemized deductions on line 13 must be calculated using the adjusted gross income on line 12 (of Form 1045) as the base for calculating the deductions that are based on adjusted gross income.**
- To help with these adjustments, we have added notes at the bottom of a Schedule A (Form 1040) that explain the adjustments that need to be made (A blank copy of Worksheet 5 is included in the Appendix at the end of this chapter). If these notes are followed, the result on line 28 of Schedule A (Form 1040) is the itemized deduction that should be entered on line 13 of the after-carryback column of Form 1045.

**In this example,** Leonard and Ruth have no adjusted gross income after the NOL carryback to 1996. Therefore, their floor amounts for medical deductions and for miscellaneous deductions are zero. Their total itemized deductions after the carryback equal \$10,500 as shown on Worksheet 5 in Figure 8. That amount is reported on Form 1045, line 13, column d.

Leonard and Ruth have \$20,146 of adjusted gross income **after the NOL carryback to 1997**. That gives them a \$1,511 **floor** for medical expenses and a \$403 **floor** for miscellaneous itemized deductions. Their total itemized deductions after the NOL carryback are \$7,586, as shown on Worksheet 5 in Figure 9. That amount is reported on Form 1045, line 13, column f.



# 1998 Workbook

Figure 7

**Form 1045** **Application for Tentative Refund** OMB No. 1545-0098

▶ Before you fill in this form, read the separate instructions.  
▶ Do not attach to your income tax return—mail in a separate envelope.  
▶ For use by individuals, estates, or trusts.

**1997**

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**Name (and name of spouse if filing jointly)**  
Leonard and Ruth Frost

**Social security or employer identification number**  
172-01-1045

**Number, street, and apt. or suite no. If you have a P.O. box or a foreign address, see the instructions.**  
\_\_\_\_\_

**Spouse's social security number**  
172-02-1045

**City, town or post office, state, and ZIP code**  
\_\_\_\_\_

**Telephone no. (optional)**  
( ) \_\_\_\_\_

---

**1** This application is filed to carry back: **a** Net operating loss from Schedule A, page 2, line 25) \$ **b** Unused general business credit \$

**2a** For the calendar year 1997, or other tax year beginning \_\_\_\_\_, 1997, ending \_\_\_\_\_, 19 **b** Date tax return was filed \_\_\_\_\_

**3** If this application is for an unused credit created by another carryback, give year of the first carryback ▶ \_\_\_\_\_

**4** If you filed a joint return (or separate return) for some, but not all, of the tax years involved in figuring the carryback, list the years and specify whether joint (J) or separate (S) return for each ▶ \_\_\_\_\_

**5** If social security number for carryback year is different from above, enter a SSN ▶ \_\_\_\_\_ and b Year(s) ▶ \_\_\_\_\_

**6** If you changed your accounting period, give date permission to change was granted ▶ \_\_\_\_\_

**7** Have you filed a petition in Tax Court for the year(s) to which the carryback is to be applied? . . . . .  Yes  No

**8** Does this carryback include a loss or credit from a tax shelter required to be registered? . . . . .  Yes  No

**9** If you are carrying back a net operating loss, did this cause the release of foreign tax credits or the release of other credits because of the release of the foreign tax credit? See instructions. . . . .  Yes  No

---

| Computation of Decrease in Tax<br><small>Note: If fa is blank, skip lines 10 through 16.</small>                      | 3rd preceding tax year ended ▶ |                     | 2nd preceding tax year ended ▶ 12/31/96 |                     | 1st preceding tax year ended ▶ 12/31/97 |                     |
|---|--------------------------------|---------------------|---|---------------------|---|---------------------|
|   | (a) Before carryback           | (b) After carryback | (a) Before carryback                    | (b) After carryback | (a) Before carryback                    | (b) After carryback |
| <b>10</b> Adjusted gross income from tax return or as previously adjusted . . . . .                                   |                                |                     | 19,216                                  | 19,216              | 29,110                                  | 29,110              |
| <b>11</b> Net operating loss deduction after carryback. See instructions . . . . .                                    |                                |                     |   | 20,600              |   | 8,964               |
| <b>12</b> Subtract line 11 from line 10 . . . . .   |                                |                     | 19,216                                  | -0-                 | 29,110                                  | 20,146              |
| <b>13</b> Deductions. See instructions . . . . .  |                                |                     | 8,675                                   | 10,500              | 6,817                                   | 7,586               |
| <b>14</b> Subtract line 13 from line 12 . . . . .   |                                |                     | 10,541                                  | -0-                 | 22,293                                  | 12,560              |
| <b>15</b> Exemptions . . . . .  |                                |                     | 10,200                                  | 10,200              | 10,600                                  | 10,600              |
| <b>16</b> Taxable income. Line 14 minus line 15   |                                |                     | 341                                     | -0-                 | 11,693                                  | 1,960               |
| <b>17</b> Income tax. See instructions—attach explanation . . . . .   |                                |                     | 51                                      | -0-                 | 1,751                                   | 294                 |
| <b>18</b> General business credit . . . . .   |                                |                     |   |                     |   |                     |
| <b>19</b> Other credits. Identify . . . . .   |                                |                     |   |                     |   |                     |
| <b>20</b> Total credits. Add lines 18 and 19 . . . . .  |                                |                     | -0-                                     | -0-                 | -0-                                     | -0-                 |
| <b>21</b> Subtract line 20 from line 17 . . . . .   |                                |                     | 51                                      | -0-                 | 1,751                                   | 294                 |
| <b>22</b> Recapture taxes . . . . .   |                                |                     |   |                     |   |                     |
| <b>23</b> Alternative minimum tax . . . . .   |                                |                     |   |                     |   |                     |
| <b>24</b> Self-employment tax . . . . .   |                                |                     | 2,967                                   | 2,967               | 4,380                                   | 4,380               |
| <b>25</b> Other taxes . . . . .   |                                |                     |   |                     |   |                     |
| <b>26</b> Total tax liability. Add lines 21 through 25 . . . . .  |                                |                     | 3,018                                   |                     | 6,131                                   | 4,674               |
| <b>27</b> Enter amount from line 26, cols. (b), (d), and (f) . . . . .  |                                |                     | 2,967                                   |                     | 4,674                                   |                     |
| <b>28</b> Decrease in tax. Line 26 minus line 27 . . . . .  |                                |                     | 51                                      |                     | 1,457                                   |                     |
| <b>29</b> Overpayment of tax due to a claim of right adjustment under section 1341(b)(1)—attach computation . . . . . |                                |                     |   |                     |   |                     |

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**Sign Here** Under penalties of perjury, I declare that I have examined this application and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Your signature: Leonard Frost Date: 15 April 1998

Spouse's signature (if Form 1045 is filed jointly, BOTH must sign): Ruth Frost Date: 15 April 1998

Preparer Other Than Taxpayer: Name ▶ Tony Tax Prayer Date: 15 April 1998

Address ▶ \_\_\_\_\_

For Paperwork Reduction Act Notice, see page 4 of the instructions.

Cat. No. 10670A

Form 1045 (1997)

# 1998 Workbook

Figure 8 Worksheet 5

| SCHEDULES A&B<br>(Form 1040)                                |   | Schedule A—Itemized Deductions<br>(Schedule B is on back)   |       | 1996<br>Attachment<br>Sequence No. 07      |        |
|---|---|---|-------|--|--------|
| Department of the Treasury<br>Internal Revenue Service (90) |   | ▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).  |       | Your social security number<br>172 01 1045 |        |
| Name(s) shown on Form 1040<br><b>Leonard and Ruth Frost</b> |   |   |       |  |        |
| Medical and Dental Expenses                                 | 1   | Caution: Do not include expenses reimbursed or paid by others.<br>Medical and dental expenses (see page A-1)  | 5,000 |  |        |
|   | 2   | Enter amount from Form 1040, line 32. [ 2 ]   |       |  |        |
|   | 3   | Multiply line 2 above by 7.5% (.075)  |       |  |        |
|   | 4   | Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-   |       |  | 5,000  |
| Taxes You Paid  | 5   | State and local income taxes  |       |  |        |
|   | 6   | Real estate taxes (see page A-2)  |       |  |        |
|   | 7   | Personal property taxes   |       |  |        |
|   | 8   | Other taxes. List type and amount ▶   |       |  |        |
| 9   | Add lines 5 through 8   |   |       |  |        |
| Interest You Paid   | 10  | Home mortgage interest and points reported to you on Form 1098  | 5,000 |  |        |
|   | 11  | Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-2 and show that person's name, identifying no., and address ▶  |       |  |        |
|   | 12  | Points not reported to you on Form 1098. See page A-3 for special rules.  |       |  |        |
|   | 13  | Investment interest, if required, attach Form 4952. (See page A-3)  |       |  |        |
| 14  | Add lines 10 through 13   |   |       | 5,000                                      |        |
| Gifts to Charity  | 15  | Gifts by cash or check. If you made any gift of \$250 or more, see page A-3   |       |  |        |
|   | 16  | Other than by cash or check. If any gift of \$250 or more, see page A-3. If over \$500, you MUST attach Form 8283   |       |  |        |
|   | 17  | Carryover from prior year   |       |  |        |
|   | 18  | Add lines 15 through 17   |       |  |        |
| Casualty and Theft Losses                                   | 19  | Casualty or theft losses. Attach Form 4684. (See page A-4)  |       |  |        |
| Job Expenses and Most Other Miscellaneous Deductions        | 20  | Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106-EZ. (See page A-4) ▶  |       |  |        |
|   | 21  | Tax preparation fees  |       |  |        |
|   | 22  | Other expenses—investment, safe deposit box, etc. List type and amount ▶  | 500   |  |        |
|   | 23  | Add lines 20 through 22   | 500   |  |        |
| 24  | Enter amount from Form 1040, line 32. [ 24 ] - 0 -                        |   |       |  |        |
| 25  | Multiply line 24 above by 2% (.02)  |   |       |  |        |
| 26  | Subtract line 25 from line 23. If line 25 is more than line 23, enter -0- |   |       | 500  |        |
| Other Miscellaneous Deductions                              | 27  | Other—from list on page A-4. List type and amount ▶   |       |  |        |
| Total Itemized Deductions                                   | 28  | Is Form 1040, line 32, over \$117,950 (over \$58,975 if married filing separately)?<br>NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the larger of this amount or your standard deduction.<br>YES. Your deduction may be limited. See page A-5 for the amount to enter. |       |  | 10,500 |

1. The medical expense deduction floor is 7.5% of the after-carryback amount on line 12, Form 1045.
2. The contribution deduction limitation (50%, 30% or 20% of AGI) is calculated using the original adjusted gross income from line 10, Form 1045. [I.R.C. §170(b)(1)(F)].
3. Casualty and theft losses are calculated using the after-carryback amount on line 12, Form 1045 to determine the 10% of adjusted gross income floor.
4. The miscellaneous deductions are calculated using the after-carryback amount on line 12, Form 1045 to determine the 2% of adjusted gross income floor.

# 1998 Workbook

Figure 9 Worksheet 5

| SCHEDULES A&B<br>(Form 1040)  |   | Schedule A—Itemized Deductions<br>(Schedule B is on back)   |       | OMB No. 1545-0074                                 |       |
|---|---|---|-------|---|-------|
| Department of the Treasury<br>Internal Revenue Service (25)   |   | ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).  |       | 1997<br>Attachment<br>Sequence No. 07             |       |
| Name(s) shown on Form 1040<br><b>Leonard and Ruth Frost</b>   |   |   |       | Your social security number<br><b>172 01 1045</b> |       |
| <b>Medical and Dental Expenses</b>  | 1   | Caution: Do not include expenses reimbursed or paid by others.<br>Medical and dental expenses (see page A-1)  | 5,000 |   |       |
|   | 2   | Enter amount from Form 1040, line 33. [ <b>2,20,146</b> ]   |       |   |       |
|   | 3   | Multiply line 2 above by 7.5% (.075)  | 1,511 |   |       |
|   | 4   | Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-   |       |   | 3,489 |
| <b>Taxes You Paid</b><br>(See page A-2)   | 5   | State and local income taxes  |       |   |       |
|   | 6   | Real estate taxes (see page A-2)  |       |   |       |
|   | 7   | Personal property taxes   |       |   |       |
|   | 8   | Other taxes. List type and amount ▶   |       |   |       |
| 9   | Add lines 5 through 8   |   |       |   |       |
| <b>Interest You Paid</b><br>(See page A-2)  | 10  | Home mortgage interest and points reported to you on Form 1098  | 4,000 |   |       |
|   | 11  | Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶  |       |   |       |
|   | 12  | Points not reported to you on Form 1098. See page A-3 for special rules.  |       |   |       |
|   | 13  | Investment interest. Attach Form 4952 if required. (See page A-3)   |       |   |       |
| 14  | Add lines 10 through 13   |   |       | 4,000   |       |
| <b>Gifts to Charity</b><br>If you made a gift and got a benefit for it, see page A-3.                     | 15  | Gifts by cash or check. If you made any gift of \$250 or more, see page A-3   |       |   |       |
|   | 16  | Other than by cash or check. If any gift of \$250 or more, see page A-3. You MUST attach Form 8283 if over \$500  |       |   |       |
|   | 17  | Carryover from prior year   |       |   |       |
|   | 18  | Add lines 15 through 17   |       |   |       |
| <b>Casualty and Theft Losses</b>  | 19  | Casualty or theft losses. Attach Form 4684. (See page A-4)  |       |   |       |
| <b>Job Expenses and Most Other Miscellaneous Deductions</b><br>(See page A-5 for expenses to deduct here) | 20  | Unreimbursed employee expenses—job travel, union dues, job education, etc. You MUST attach Form 2106 or 2106-EZ if required. (See page A-4) ▶   |       |   |       |
|   | 21  | Tax preparation fees  |       |   |       |
|   | 22  | Other expenses—investment, safe deposit box, etc. List type and amount ▶  | 500   |   |       |
|   | 23  | Add lines 20 through 22   | 500   |   |       |
|   | 24  | Enter amount from Form 1040, line 33. [ <b>2,20,146</b> ]   |       |   |       |
|   | 25  | Multiply line 24 above by 2% (.02)  | 403   |   |       |
| 26  | Subtract line 25 from line 23. If line 25 is more than line 23, enter -0- |   |       | 97  |       |
| <b>Other Miscellaneous Deductions</b>   | 27  | Other—from list on page A-5. List type and amount ▶   |       |   |       |
| <b>Total Itemized Deductions</b>  | 28  | Is Form 1040, line 33, over \$121,200 (over \$60,600 if married filing separately)?<br>NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the larger of this amount or your standard deduction.<br>YES. Your deduction may be limited. See page A-5 for the amount to enter. |       |   | 7,586 |

1. The medical expense deduction floor is 7.5% of the after-carryback amount on line 12, Form 1045.
2. The contribution deduction limitation (50%, 30% or 20% of AGI) is calculated using the original adjusted gross income from line 10, Form 1045. [I.R.C. §170(b)(1)(F)].
3. Casualty and theft losses are calculated using the after-carryback amount on line 12, Form 1045 to determine the 10% of adjusted gross income floor.
4. The miscellaneous deductions are calculated using the after-carryback amount on line 12, Form 1045 to determine the 2% of adjusted gross income floor.



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**Notice:** The NOL reduces taxable income **but not** self-employment taxable income. The \$20,600 NOL deduction reduces income taxes for 1996 by \$51, and the \$8,964 NOL deduction reduces income taxes for 1997 by \$1,457. Those amounts are claimed as a refund on line 28 of Form 1045.

## V. CARRYING AN NOL BETWEEN JOINT AND SEPARATE RETURNS

Taxpayers who file a joint return for some of the years involved in an NOL calculation, carryback, or carryforward and file separate returns for other of those years may have to make an allocation of the NOL or income and deductions between the spouses.

### A. Allocation of NOLs from a Joint Return

An NOL must be allocated between the spouses if the NOL is created in a year in which the spouses file a joint return and is carried to a year for which the same spouses did not file jointly. [Treas. Reg. §1.172-7(d).] For example, if an NOL arises while the spouses are married and file jointly and is carried to a year after they are divorced, the NOL must be allocated between the spouses to determine what portion goes to each of the former spouses.

The joint NOL is allocated between the spouses on a pro rata basis using the NOLs that would have been generated by each of the spouses individually if they had filed separately. The husband's percentage of the joint NOL is calculated by dividing the NOL he would have on a separate return by the sum of the NOL he would have on a separate return and the NOL his wife would have on a separate return. The wife's percentage of the joint NOL is calculated by dividing the NOL she would have on a separate return by the sum of the NOL she would have on a separate return and the NOL her husband would have on a separate return.

**Example 4.** Assume the joint NOL is \$1,000, the husband's individual NOL would have been \$900, and the wife's individual NOL would have been \$300. The amount allocated to each spouse is calculated as follows:

$$\text{Amount allocated to husband H: } \$900 \div \$1,200 \times \$1,000 = \$750$$

$$\text{Amount allocated to wife W: } \$300 \div \$1,200 \times \$1,000 = \$250$$

If only one spouse has an individual NOL, then all of the joint NOL is allocated to that spouse.

**Example 5.** Assume that the joint NOL is \$4,000, the husband's individual NOL is \$7,000, and the wife has no individual NOL. The husband's share of the joint NOL is \$4,000.

### B. ALLOCATION OF INCOME AND DEDUCTIONS ON A JOINT RETURN

Income and deductions must be allocated between spouses if an NOL that arose in a year they were not married is carried to a year during the marriage for which they file a joint return [Rev. Rul. 65-140, 1965-1 C.B. 127].

**For example,** suppose that a married couple had filed joint returns until the death of one spouse. If the surviving spouse has an NOL in a year after the other spouse died, and that NOL is carried back to a year before the other spouse died, then the income and deductions for the carryback year must be allocated between the spouses, since the NOL can be used to offset only the surviving spouse's income in the carryback year.

If an NOL is carried from a year after two taxpayers are divorced back to a year in which they filed a joint tax return, then the income, deductions, and tax payments on the joint tax return must be allo-



cated between the taxpayers to determine their respective shares of the income tax refund that results from the carryback. Each spouse's percentage of the recomputed joint liability is calculated by dividing his or her recomputed separate liability by the total of the two spouses' recomputed separate liability. [Rev. Rul. 86-57, 1986-1 C.B. 362].

## C. SUMMARY OF THE ALLOCATION RULES

The rules for allocating NOLs and income and deductions are summarized in the following table.

### ALLOCATION REQUIREMENTS FOR NOLS

| NOL Year                  | Carryover/Carryback Year |                                 |                           |
|---------------------------|--------------------------|---------------------------------|---------------------------|
|                           | Not Married              | Married Filing Jointly          | Married Filing Separately |
| Not married               | No allocations           | Income and deductions allocated | No allocations            |
| Married filing jointly    | NOL allocated            | No allocations                  | NOL allocated             |
| Married filing separately | No allocations           | No allocations                  | No allocations            |

## D. SEPARATE INSTEAD OF JOINT RETURNS MAY REDUCE TAX LIABILITY

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

**Example 6.** Assume a married couple has no children, does not itemize deductions, and has the following adjusted gross income and NOL in a loss year and the first carryback year:

|         | Loss Year (1998) | Carryback Year (1996) |
|---------|------------------|-----------------------|
| Husband | (\$20,000)       | \$30,000              |
| Wife    | <u>\$21,500</u>  | \$40,000              |
| Total   | \$ 1,500         | \$70,000              |

Also assume that the husband would have a \$20,300 NOL if he filed a separate return.

If this couple files a joint return for the loss year, their income tax (on \$1,500 AGI) will be zero, but there will be no NOL to carry back. Therefore, the tax for the carryback year will be calculated on an adjusted gross income of \$70,000 and will be \$11,090.

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If the couple files separate returns for the loss year, W would pay a tax of \$2,291 and H will have an NOL of \$20,300 to carry back. That NOL deduction will reduce their joint adjusted gross income in the carryback year to \$49,700, and the income tax due will be \$5,689. Therefore, the total tax due for the two years if separate returns are filed in the loss year will be  $\$2,291 + \$5,689 = \$7,980$ —a savings of \$3,110, as compared to the joint return for the loss year.

## VI. SPECIAL ISSUES IN THE NOL CALCULATION

One of the most difficult issues in calculating a net operating loss is deciding whether to include a particular gain or loss as part of the net operating loss. Three common issues are discussed and illustrated below.

### A. PASSIVE LOSSES

The passive loss rules are applied before the net operating loss rules. Therefore, only losses that can be deducted under the passive loss rules can become a part of an NOL. A loss that is suspended by the passive loss rules becomes a part of the NOL computation **in the year it comes out of suspension**. In that year, it is characterized as a business or nonbusiness loss according to the source origin of the loss.

### B. GAIN OR LOSS FROM SALE OF ASSETS USED IN A TRADE OR BUSINESS

Gain or loss from the sale of an asset used in a trade or business is **treated** as a business gain or loss for purposes of the NOL calculation.

**Example 7.** Calvin realized a \$5,000 loss when he sold a machine that he used in his shoe repair business. That loss is treated as a business loss in calculating his NOL.

### C. GAIN OR LOSS FROM S CORPORATIONS AND PARTNERSHIPS

S corporations and partnerships are not allowed to carry business losses to other tax years by deducting net operating losses. Instead, the losses flow through to the shareholders or partners in the year of the loss and become a part of the shareholder's or partner's NOL calculation.

For purposes of the shareholder's or partner's NOL calculation, gains and losses flowing out of an S corporation or partnership are characterized as business or nonbusiness according to their status inside the S corporation or partnership.

**Example 8.** Georgia's construction business is operated as an S corporation. The corporation realized a \$7,000 gain on the sale of a piece of machinery. That gain flows through to Georgia and is treated as a business capital gain in calculating Georgia's NOL.

**Example 9.** Theodore is a 25% partner in a partnership that leases cars under long-term leases. The partnership realizes a \$40,000 loss from its leasing activity. Theodore has no other passive income or losses.

Theodore's \$10,000 share of that loss is a passive loss to him. Since he has no passive income in the year of the loss, it is suspended under the passive loss rules and therefore is not a part of his NOL calculation in the year of the loss. It will become a part of his NOL calculation in the year it is allowed as a deduction under the passive loss rules.

**Observation.** It is to the taxpayer's benefit to treat capital gain and ordinary income as nonbusiness, since that may increase the amount of nonbusiness losses and deductions that are allowed. By contrast, it is to the taxpayer's benefit to treat capital losses and ordinary deductions as business losses and deductions, since they add to the NOL regardless of the amount of nonbusiness capital gain and ordinary income.

## D. ALTERNATIVE MINIMUM TAX

The regular tax NOL is not allowed for purposes of calculating alternative minimum taxable income (AMTI). Instead, an AMT NOL is allowed, but it is limited to 90% of the AMTI. If the regular tax NOL is sufficiently larger than the AMT NOL, the NOL **could create an AMT liability** for a carry-back or carryforward year.

## VII. MAKING OPTIMAL USE OF AN NOL DEDUCTION—PLANNING

- The tax benefit of an NOL **can be wasted** if other tax benefits are used in the year of the NOL or in a year the NOL deduction is claimed.
- In the NOL year, some other tax benefits may reduce the NOL, **even though they do not reduce taxable income in that or any other year.**
- In the year an NOL deduction is claimed, some other tax benefits may reduce the net operating loss to be carried to subsequent years **even though they do not reduce taxable income in that year or any other year.**
- Since some of those tax benefits could be shifted to another tax year, it is useful to know which ones waste net operating losses.

**Observation:** Payments to an individual retirement account (IRA) or other retirement plan are always treated as nonbusiness deductions for purposes of calculating an NOL.

## A. EXCESS NONBUSINESS DEDUCTIONS ARE WASTED IN AN NOL YEAR

If nonbusiness deductions exceed nonbusiness ordinary income plus excess nonbusiness capital gains in an NOL year, the excess nonbusiness deductions **will never provide a tax benefit.** Therefore, those deductions **should be shifted** to another tax year if possible. 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 nonbusiness ordinary income plus net nonbusiness capital gains exceed nonbusiness deductions, they will increase the NOL.

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Shifting excess nonbusiness deductions involves the **same kind of planning** as bunching itemized deductions every other year and claiming the standard deduction in the alternate years. Therefore, medical expenses, taxes, interest expenses, and charitable and miscellaneous deductions should be shifted as much as possible. Above-the-line nonbusiness deductions such as alimony payments should also be shifted whenever possible. If the maximum retirement plan contributions are not being made, contributions could be bunched in the years in which they would offset taxable income or add to the NOL.

## B. SHIFTING NONBUSINESS INCOME TO LOSS YEAR

The problem of nonbusiness deductions in excess of nonbusiness ordinary income plus excess nonbusiness capital gains can also be alleviated by increasing nonbusiness ordinary income and/or nonbusiness capital gains in the loss year. Such an increase will be effectively tax-free until the sum of nonbusiness ordinary income and excess nonbusiness capital gains exceeds nonbusiness deductions.

## C. EXCESS NONBUSINESS CAPITAL LOSSES IN AN NOL YEAR ARE WASTED

Nonbusiness capital losses in excess of nonbusiness capital gains provide no tax benefit in an NOL year, since they are not allowed as part of the NOL computation. If those capital losses were shifted to a year in which there was no NOL, or to an NOL year that had excess nonbusiness capital gains, the losses would provide a tax benefit.

## D. ELECTING TO WAIVE THE NOL CARRYBACK MAY REDUCE TAX LIABILITY

- In some cases, the NOL deduction is more useful to the taxpayer in the years following the NOL year than in the two carryback years.

- The higher tax rates for high-income years may make the NOL deduction worth more in the carryforward years than in the carryback years. If the carryback years have low income compared to carryforward years, it would be advantageous to forgo the carryback if the carryover years will make use of most or all of the NOL.

- Capital losses in the carryback or carryover years may prevent using part or all 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 will be wasted if an NOL is carried to the final year the investment tax credit can be claimed and the NOL reduces taxable income to zero for that year.) In those cases the election can be used to minimize the loss of the NOL deduction or credits.**
- Finally, there may not be enough taxable income in the 20 carryover years to use up 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.

**Practitioner Note #1. To forgo the NOL carryback, Lars and Jane must attach the following statement to their 1998 income tax return** or to an amended return filed within 6 months of the due date (excluding extensions) of the original return.

**Practitioner Note #2.** Many computer software programs for preparing income tax returns have a box to check to create the statement that forgoes the carryback. Be sure to check that box if the taxpayer wants to forgo the carryback.

### Election to Forgo NOL Carryback Period Lars and Jane Simmons SS# 172-03-1045

Taxpayer elects 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.

## E. CONTROL TIMING OF AN NOL

If the NOL can fall in one of two or more years at the taxpayer's discretion, it should be placed in a year in which it will generate the greatest tax benefit. The years in which the NOL generates the greatest benefit are those that have the highest taxable income (and in which the taxpayer is therefore in the highest marginal tax bracket) and the years with little long-term capital gains or tax credits that will waste the NOL.

## F. USE UP AN NOL BEFORE IT EXPIRES

If the time for using an NOL 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.

## VIII. SUMMARY

The NOL calculations are complex, but they can be managed if they are taken one step at a time. 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 should decrease the NOL. It is also important to remember that the NOL deduction claimed in any carryback or carryover year is not necessarily the amount of the NOL that is absorbed that year. **Therefore, a year to which the NOL is carried can absorb more of the NOL than is used as an NOL deduction.**

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## APPENDIX–NOL WORKSHEETS

### NOL Worksheet 1

#### Allocation of Capital Losses between Business Capital Losses and Nonbusiness Capital Losses

| Where loss is reported on tax return<br>1998 Sch. D (Form 1040) <sup>1</sup> | Amount reported on<br>tax return | Disposition           | Business | Nonbusiness |
|--|----------------------------------|-----------------------|----------|-------------|
| A. Lines 1 & 2, column f   | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| B. Line 4, column f  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| C. Line 5, column f  | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| D. Line 6, column f  | _____                            | Allocate <sup>4</sup> | _____    | _____       |
| E. Lines 8 & 9, column f   | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| F. Line 11, column f   | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| G. Line 12, column f   | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| H. Line 14, column f   | _____                            | Allocate <sup>4</sup> | _____    | _____       |
| I. TOTALS  | _____                            |                       | _____    | _____       |

<sup>1</sup> Enter the amount from the designated lines on Schedule D only if they are losses. Enter the amounts as positive numbers.

<sup>2</sup> In most cases, losses reported on lines 1, 2, 4, 8, 9, and 11 of schedule D (Form 1040) are nonbusiness capital losses for purposes of the NOL calculation, since losses from property used in a trade or business are reported on Form 4797 and are treated as ordinary deductions. However, losses reported on those lines can be business capital losses if the asset on which the loss was realized was an I.R.C. §1221 asset rather than an I.R.C. §1231 asset but was purchased for a trade or business reason rather than for investment. For example, loss realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital loss for purposes of the NOL calculation. See *Trammel Crow*, 79 T.C. 541 (1982).

<sup>3</sup> The character of the loss reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the loss to the partnership, S corporation, or fiduciary. In most cases, losses reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital losses, but see footnote 1 for a discussion of when losses from an I.R.C. §1221 asset may be treated as a business capital loss for purposes of the NOL calculation.

<sup>4</sup> Capital loss carryovers must be allocated between business and nonbusiness capital losses according to the proportionate contribution of business and nonbusiness capital losses to the capital loss carryover.

Notes on completion of Schedule A (Form 1045):

Use this worksheet to complete lines 5 and 14 of Schedule A (Form 1045)

# 1998 Workbook

## NOL Worksheet 2

### Allocation of Capital Gains between Business Capital Gains and Nonbusiness Capital Gains

| Where gain is reported on tax return<br>1998 Sch. D (Form 1040) <sup>1</sup> | Amount reported on<br>tax return | Disposition           | Business | Nonbusiness |
|--|----------------------------------|-----------------------|----------|-------------|
| A. Line 1, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| B. Line 2, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| C. Line 4, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| D. Line 5, column g  | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| E. Line 8, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| F. Line 9, column g  | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| G. Line 11, column g   | _____                            | Allocate <sup>4</sup> | _____    | _____       |
| H. Line 12, column g   | _____                            | Allocate <sup>3</sup> | _____    | _____       |
| I. Line 13, column g   | _____                            | Allocate <sup>2</sup> | _____    | _____       |
| J. TOTALS  | _____                            |                       | _____    | _____       |

<sup>1</sup> Enter the amounts from the designated lines only if they are gains.

<sup>2</sup> In most cases, gains reported on lines 1, 2, 4, 8, 9, and 13 of Schedule D (Form 1040) are nonbusiness capital gains for purposes of the NOL calculation, because gains from property used in a trade or business are reported on Form 4797 and are carried to Line 11 of Schedule D (Form 1040) if they are treated as long-term capital gain. However, gains reported on lines 1, 2, 4, 8, 9, and 13 of Schedule D (Form 1040) can be business capital gains if the asset on which the gain was realized was an I.R.C. §1221 asset rather than an I.R.C. §1231 asset but was purchased for a trade or business reason rather than for investment. For example, gain realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital gain for purposes of the NOL calculation. See *Trammel Crow*, 79 T.C. 541 (1982).

<sup>3</sup> The character of the gain reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the gain to the partnership, S corporation, or fiduciary. In most cases, gains reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital gains, but see footnote 2 for a discussion of when gains from an I.R.C. §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

<sup>4</sup> Gain from Form 4797, Part I is business gain. Gain from Form 2439, Form 4684, Form 6252, Form 6781, or Form 8824 is nonbusiness gain in most cases. See footnote 2 for a discussion of when gains from an I.R.C. §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

Notes on completion of Schedule A (Form 1045):

Use this worksheet to complete lines 6 and 15 of Schedule A (Form 1045)



# 1998 Workbook

## NOL Worksheet 3

### Allocation of Deductions between Business Deductions and Nonbusiness Deductions

| Location on<br>1998 Form 1040                            | Item                          | Amount<br>on tax<br>return | Disposition           | Amount as<br>Business | Amount as<br>Nonbusiness | AMT<br>Nonbusiness   |
|--|-------------------------------|----------------------------|-----------------------|-----------------------|--------------------------|----------------------|
| A. Line 23   | IRA deduction                 | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| B. Line 24   | Student loan<br>interest ded. | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| C. Line 25   | MSA deduct.                   | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| D. Line 26   | Moving expenses               | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| E. Line 27   | SE Tax                        | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| F. Line 28   | SE health<br>insurance        | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| G. Line 29   | Keogh & SEP                   | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| H. Line 30   | Penalty, early<br>withdrawal  | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| I. Line 31a  | Alimony                       | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| J. Line 32   | Other <sup>1</sup>            | _____                      | Allocate              | _____                 | _____                    | _____                |
| I. Line 36   | Std. Ded.<br>(if claimed)     | _____                      | Nonbusiness           | xxxxxxx               | _____                    | xxxxxxx <sup>2</sup> |
| Schedule A (Form 1040) (Itemized Deductions, if claimed) |                               |                            |                       |                       |                          |                      |
| J. Line 4  | Medical                       | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____ 3              |
| K. Line 9  | Taxes                         | _____                      | Allocate <sup>4</sup> | _____                 | _____                    | xxxxxxx              |
| L. Line 14   | Interest                      | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____ 5              |
| M. Line 18   | Contributions                 | _____                      | Nonbusiness           | xxxxxxx               | _____                    | _____                |
| N. Line 19   | Casualty                      | _____                      | Business              | _____                 | xxxxxxx                  | xxxxxxx              |
| O. Line 26   | Misc. (2% floor)              | _____                      | Allocate <sup>6</sup> | _____                 | _____                    | xxxxxxx              |
| P. Line 27   | Other misc.                   | _____                      | Allocate <sup>7</sup> | _____                 | _____                    | _____                |
| Q. TOTALS  |                               | _____                      |                       | _____                 | _____                    | _____                |

<sup>1</sup> Include only "other" items such as unreimbursed expenses of artists (I.R.C. §62(b)), jury duty pay turned over to taxpayer's employer. Do not include amounts reported on lines 23 through 31.

<sup>2</sup> If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

<sup>3</sup> The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

<sup>4</sup> The state and local income taxes paid are allocated between business and nonbusiness deductions according to the income of the year that created the taxes. For this allocation, salaries and wages are treated as business income. Taxes are not allowed as a deduction when calculating AMT.

<sup>5</sup> The alternative minimum tax interest deduction is the same as the regular tax interest deduction except for the following adjustments: (1) if debt on a personal residence has been refinanced, interest on debt in excess of the debt before refinancing cannot be deducted for AMT purposes; and (2) the investment interest deduction must be recalculated to include income from private activity bonds in investment income and the expenses on those bonds in investment expenses.

<sup>6</sup> Since the amount on line 26, Schedule A, is reduced by 2% of AGI, the amounts allocated to business and nonbusiness must be reduced on a pro rata basis. Therefore, the amount in the business column should be the amount from line 26, Schedule A, multiplied by the total business miscellaneous deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. The amount in the nonbusiness column should be the amount from line 26, Schedule A, multiplied by the total nonbusiness deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. Miscellaneous itemized deductions are not allowed as a deduction when calculating AMT.

<sup>7</sup> Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 27, Schedule A, are nonbusiness deductions.

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## NOL Worksheet 4

### Allocation of Ordinary Income between Business and Nonbusiness Ordinary Income

| Location on 1998 Form 1040 | Item                                     | Amount on tax return | Disposition              | Amount as Business | Amount as Nonbusiness | AMT Nonbusiness |
|----------------------------|--|----------------------|--------------------------|--------------------|-----------------------|-----------------|
| A. Line 7                  | Wages, salary, etc.                      | _____                | Business                 | _____              | XXXXXXXX              | XXXXXXXX        |
| B. Line 8a                 | Taxable interest                         | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| C. Line 8b                 | Tax-exempt interest                      | _____                | Nonbusiness <sup>1</sup> | XXXXXXXX           | XXXXXXXX              | _____           |
| D. Line 9                  | Dividends                                | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| E. Line 10                 | Taxable refunds                          | _____                | Allocate <sup>2</sup>    | _____              | _____                 | _____           |
| F. Line 11                 | Alimony                                  | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| G. Line 12                 | Business income (loss)                   | _____                |                          |                    |                       |                 |
|                            | Schedule C                               | _____                | Business                 | _____              | XXXXXXXX              | XXXXXXXX        |
| H. Line 14                 | Form 4797 gains or losses                | _____                | Business                 | _____              | XXXXXXXX              | XXXXXXXX        |
| I. Line 15                 | Taxable amount of IRA distributions      | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| J. Line 16b                | Taxable amount of pensions               | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| K. Line 17                 | Rents, royalties, and partnership income | _____                | Usually business         | _____              | XXXXXXXX              | XXXXXXXX        |
| L. Line 18                 | Farm income (or loss)                    | _____                | Business                 | _____              | XXXXXXXX              | XXXXXXXX        |
| M. Line 19                 | Taxable unemployment                     | _____                | Business                 | _____              | XXXXXXXX              | XXXXXXXX        |
| N. Line 20b                | Taxable social security benefits         | _____                | Nonbusiness              | XXXXXXXX           | _____                 | _____           |
| O. Line 21                 | Other income                             | _____                | Allocate                 | _____              | _____                 | _____           |
| P. TOTALS                  |  | _____                |                          | _____              | _____                 | _____           |

<sup>1</sup> Nontaxable interest is nonbusiness income for AMT purposes only.

<sup>2</sup> The state and local income tax refund is to be allocated between business and nonbusiness income according to the income of the year that created the refund. For this allocation, salaries and wages are treated as business income. State and local income tax refunds are not included when calculating AMT.

# 1998 Workbook

## NOL WORKSHEET 5

| SCHEDULES A&B<br>(Form 1040)   |    | Schedule A—Itemized Deductions<br>(Schedule B is on back)   |    | OMB No. 1545-0074<br><b>1998</b><br>Attachment<br>Sequence No. 07 |  |
|--|----|---|----|---|--|
| Department of the Treasury<br>Internal Revenue Service (50)  |    | ▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).  |    | Your social security number                                       |  |
| NAME(s) shown on Form 1040   |    |   |    |   |  |
| <b>Medical and Dental Expenses</b>   | 1  | Caution: Do not include expenses reimbursed or paid by others. Medical and dental expenses (see page A-1)   | 1  |   |  |
|  | 2  | Enter amount from Form 1040, line 34, [ 2 ]   | 2  |   |  |
|  | 3  | Multiply line 2 above by 7.5% (.075)  | 3  |   |  |
|  | 4  | Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-   | 4  |   |  |
| <b>Taxes You Paid</b><br>(See page A-2)  | 5  | State and local income taxes  | 5  |   |  |
|  | 6  | Real estate taxes (see page A-2)  | 6  |   |  |
|  | 7  | Personal property taxes   | 7  |   |  |
|  | 8  | Other taxes. List type and amount ▶   | 8  |   |  |
|  | 9  | Add lines 5 through 8   | 9  |   |  |
| <b>Interest You Paid</b><br>(See page A-2)   | 10 | Home mortgage interest and points reported to you on Form 1098  | 10 |   |  |
|  | 11 | Home mortgage interest not reported to you on Form 1098, if paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶  | 11 |   |  |
|  | 12 | Points not reported to you on Form 1098. See page A-3 for special rules.  | 12 |   |  |
|  | 13 | Investment interest. Attach Form 4952 if required. (See page A-3.)  | 13 |   |  |
|  | 14 | Add lines 10 through 13   | 14 |   |  |
| <b>Gifts to Charity</b><br>If you made a gift and got a benefit for it, see page A-3.                      | 15 | Gifts by cash or check. If you made any gift of \$250 or more, see page A-3   | 15 |   |  |
|  | 16 | Other than by cash or check. If any gift of \$250 or more, see page A-3. You MUST attach Form 8283 if over \$500  | 16 |   |  |
|  | 17 | Carryover from prior year   | 17 |   |  |
|  | 18 | Add lines 15 through 17   | 18 |   |  |
| <b>Casualty and Theft Losses</b>   | 19 | Casualty or theft loss(es). Attach Form 4684. (See page A-4.)   | 19 |   |  |
| <b>Job Expenses and Most Other Miscellaneous Deductions</b><br>(See page A-5 for expenses to deduct here.) | 20 | Unreimbursed employee expenses—job travel, union dues, job education, etc. You MUST attach Form 2106 or 2106-EZ if required. (See page A-4.) ▶  | 20 |   |  |
|  | 21 | Tax preparation fees  | 21 |   |  |
|  | 22 | Other expenses—investment, safe deposit box, etc. List type and amount ▶  | 22 |   |  |
|  | 23 | Add lines 20 through 22   | 23 |   |  |
|  | 24 | Enter amount from Form 1040, line 34, [ 24 ]  | 24 |   |  |
|  | 25 | Multiply line 24 above by 2% (.02)  | 25 |   |  |
|  | 26 | Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-   | 26 |   |  |
| <b>Other Miscellaneous Deductions</b>  | 27 | Other—from list on page A-5. List type and amount ▶   | 27 |   |  |
| <b>Total Itemized Deductions</b>   | 28 | Is Form 1040, line 34, over \$124,500 (over \$62,250 if married filing separately)?<br>NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the larger of this amount or your standard deduction.<br>YES. Your deduction may be limited. See page A-5 for the amount to enter. | 28 |   |  |

1. The medical expense deduction floor is 7.5% of the after-carryback amount on line 12, Form 1045.
2. The contribution deduction limitation (50%, 30% or 20% of AGI) is calculated using the original adjusted gross income from line 10, Form 1045. [I.R.C. §170(b)(1)(F)].
3. Casualty and theft losses are calculated using the after-carryback amount on line 12, Form 1045 to determine the 10% of adjusted gross income floor.
4. The miscellaneous deductions are calculated using the after-carryback amount on line 12, Form 1045 to determine the 2% of adjusted gross income floor.