

Chapter 2: Net Operating Losses

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Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

INTRODUCTION¹

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

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

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

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

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

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

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

¹ The primary source for material in this chapter is IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

Not all deductions are allowed in computing the NOL. For example, items **not** allowed include the following.

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

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

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

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

There are **five basic steps** to using an NOL.

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

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

WEIGHING NOL OPTIONS

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

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

6. Has the taxpayer been fully informed of the choices?
7. If the taxpayer chooses to carry back the NOL, is it better to use Form 1045 or file amended returns for the carryback years?
8. If there is any NOL carryforward, is it clearly documented so that it will not be overlooked in subsequent years?
9. Is the taxpayer subject to the net investment income tax or may they be subject to it in the future?

CALCULATING THE NOL

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

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

CATEGORIZING INCOME AND LOSSES AS BUSINESS OR NONBUSINESS

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

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

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

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

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- Pension distributions
- Royalty income reported on Schedule E
- Social security benefits
- Health savings account (HSA) deductions
- Contributions to SEP and SIMPLE IRAs and other qualified plans
- Penalties on early withdrawals of savings
- Student loan interest paid
- The deduction for tuition and fees
- The standard deduction (if used instead of itemized deductions)
- Charitable contributions

Tax-preparation software easily categorizes these activities; however, most programs require that the user manually allocate the income and expenses that are not reported on lines dedicated to certain activities. Practitioners must determine whether the source activities of the amounts reported in the following categories are business or nonbusiness for NOL purposes.

1. Taxable refunds (allocated based on the year that created the refund)
2. Capital gains and losses
3. Schedule E
4. Other income
5. Taxes deducted on Schedule A (allocated based on the year the taxes were incurred)
6. Miscellaneous itemized deductions

Rental income and related capital gains are categorized as business income. However, if the taxpayer does not materially participate in the activity, **losses** related to the rental property are only included in the NOL calculation to the extent that they are allowed under the passive loss rules of IRC §469.²

The worksheets used in the following examples were designed by the University of Illinois Tax School to aid practitioners in allocating items into business and nonbusiness categories when calculating an NOL. (See the end of this chapter for reproducible copies of these worksheets.) The worksheets include a column for calculating the amount of the NOL applicable for alternative minimum tax (AMT) purposes. AMT NOLs are discussed later in the chapter. On these worksheets, “xxxxxxx” means that an amount cannot be entered on that line.

Example 1. In 2013, Stark started a business that makes action figures based on kings and their favorite thrones. On his 2013 return, he reported interest income of \$1,000, dividends of \$14,000, and a Schedule C business loss of \$20,000. His AGI was a loss of \$5,000 ($\$1,000 + \$14,000 - \$20,000$). His 2013 standard deduction was \$6,100.

The top portion of page 2 of Stark’s 2013 Form 1040 follows.

² IRM 4.11.11 and 4.11.11.15 (Feb. 13, 2014).

For Example 1

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Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	(5,000)
	39a	Check <input type="checkbox"/> You were born before January 2, 1949, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1949, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a		
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others:	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>		
	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	6,100
	41	Subtract line 40 from line 38	41	(11,100)
	42	Exemptions. If line 38 is \$150,000 or less, multiply \$3,900 by the number on line 6d. Otherwise, see instructions	42	3,900
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	0
	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/>	44	0
	45	Alternative minimum tax (see instructions). Attach Form 6251	45	
	46	Add lines 44 and 45	46	0
	47	Foreign tax credit. Attach Form 1116 if required	47	

Stark's accountant, Catelyn, determined that he had \$20,000 of business losses and \$15,000 of nonbusiness income using the following Worksheet 1. Using Worksheet 2, she determined that he had \$6,100 of nonbusiness deductions.

NOL Worksheet 1

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

Location on 2013 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	1,000	Nonbusiness	XXXXXXXX	1,000	_____
C. Line 8b	Tax-exempt interest	_____	Nonbusiness ^a	XXXXXXXX	XXXXXXXX	_____
D. Line 9a	Ordinary dividends	14,000	Nonbusiness	XXXXXXXX	14,000	_____
E. Line 10	Taxable refunds	_____	Allocate ^b	_____	_____	_____
F. Line 11	Alimony	_____	Nonbusiness	XXXXXXXX	_____	_____
G. Line 12	Business income (loss) Schedule C	(20,000)	Business	(20,000)	XXXXXXXX	XXXXXXXX
H. Line 14	Form 4797 gain (loss)	_____	Business	_____	XXXXXXXX	XXXXXXXX
I. Line 15b	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	_____	_____	_____
L. Line 18	Farm income (loss)	_____	Business	_____	XXXXXXXX	XXXXXXXX
M. Line 19	Unemployment compensation	_____	Business	_____	XXXXXXXX	XXXXXXXX
N. Line 20b	Taxable social security benefits	_____	Nonbusiness	XXXXXXXX	_____	_____
O. Line 21	Other income	_____	Allocate	_____	_____	_____
P. Total		(5,000)		(20,000)	15,000	_____

^a Nontaxable interest is nonbusiness income for AMT purposes only.

^b 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.

NOTE: "XXXXXXXX" means that an amount cannot be added on that line.

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For Example 1

NOL Worksheet 2

Allocation of **Deductions** between Business Deductions and Nonbusiness Deductions

Location on 2013 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 23	Educator expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
B. Line 24	Business expense of reservists, etc. ^a	_____	Business	_____	XXXXXXXX	XXXXXXXX
C. Line 25	HSA & MSA ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
D. Line 26	Moving expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
E. Line 27	SE tax deduction	_____	Business	_____	XXXXXXXX	XXXXXXXX
F. Line 28	SEP, SIMPLE, & qualified plans	_____	Nonbusiness	XXXXXXXX	_____	_____
G. Line 29	SE health insurance	_____	Business	_____	XXXXXXXX	XXXXXXXX
H. Line 30	Penalty, early withdrawal	_____	Nonbusiness	XXXXXXXX	_____	_____
I. Line 31a	Alimony	_____	Nonbusiness	XXXXXXXX	_____	_____
J. Line 32	IRA deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
K. Line 33	Student loan interest ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
L. Line 34	Tuition & fee deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
M. Line 40a	Standard deduction (if claimed)	6,100	Nonbusiness	XXXXXXXX	6,100	XXXXXXXX ^b

Schedule A (Form 1040) (Itemized deductions, if claimed)

N. Line 4	Medical	_____	Nonbusiness	XXXXXXXX	_____	c
O. Line 9	Taxes	_____	Allocate ^d	_____	_____	XXXXXXXX
P. Line 15	Interest	_____	Nonbusiness	XXXXXXXX	_____	e
Q. Line 19	Contributions	_____	Nonbusiness	XXXXXXXX	_____	_____
R. Line 20	Casualty	_____	Business	_____	XXXXXXXX	XXXXXXXX
S. Line 27	Misc. (2% floor)	_____	Allocate ^f	_____	_____	XXXXXXXX
T. Line 28	Other misc.	_____	Allocate ^g	_____	_____	_____
U. Total		_____		_____	_____	_____

^a Include only "other" items such as unreimbursed expenses of artists (IRC §62(b)). Do not include amounts reported on lines 23 through 35.

^b If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

^c The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

^d 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.

^e 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.

^f Because the amount on line 27, 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 27, 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 27, 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.

^g Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 28, Schedule A, are nonbusiness deductions.

NOTE: "XXXXXXXX" means that an amount cannot be entered on that line.

FORM 1045

Once the items on a return are properly categorized as business or nonbusiness, **Form 1045, Schedule A — NOL** is used to calculate the amount of the NOL. The purpose of this schedule is to eliminate the losses, deductions, and exclusions that should not be included in the NOL from the amount shown on line 41 of Form 1040. The resulting amount on line 25 of the schedule will never show an NOL that is greater than the loss from line 41.

Example 2. Use the same facts as **Example 1**. Catelyn used this information to complete the following Schedule A — NOL. Because Stark’s standard deduction of \$6,100 (line 6) was **less** than his nonbusiness income of \$15,000 (line 8), his NOL was not adjusted for nonbusiness deductions. Therefore, line 9 is \$0.

Another way of thinking about the results of this example is that Stark’s standard deduction reduced his nonbusiness income to a net income of \$8,900 (\$15,000 nonbusiness income – \$6,100 standard deduction). The \$20,000 loss offset this amount, so his NOL to carry forward or back is \$11,100 (\$20,000 – \$8,900).

Form 1045 (2013)

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Schedule A—NOL (see instructions)

1	Enter the amount from your 2013 Form 1040, line 41, or Form 1040NR, line 39. Estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount	1	(11,100)
2	Nonbusiness capital losses before limitation. Enter as a positive number	2	
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)	3	
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-	4	0
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	5	0
6	Nonbusiness deductions (see instructions)	6	6,100
7	Nonbusiness income other than capital gains (see instructions)	7	15,000
8	Add lines 5 and 7	8	15,000
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-	9	0
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. But do not enter more than line 5	10	0
11	Business capital losses before limitation. Enter as a positive number	11	
12	Business capital gains (without regard to any section 1202 exclusion)	12	
13	Add lines 10 and 12	13	0
14	Subtract line 13 from line 11. If zero or less, enter -0-	14	0
15	Add lines 4 and 14	15	0
16	Enter the loss, if any, from line 16 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 19, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15	16	
17	Section 1202 exclusion. Enter as a positive number	17	
18	Subtract line 17 from line 16. If zero or less, enter -0-	18	
19	Enter the loss, if any, from line 21 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 20 of Schedule D (Form 1041).) Enter as a positive number	19	
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-	20	
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-	21	
22	Subtract line 20 from line 15. If zero or less, enter -0-	22	0
23	Domestic production activities deduction from your 2013 Form 1040, line 35, or Form 1040NR, line 34 (or included on Form 1041, line 15a)	23	
24	NOL deduction for losses from other years. Enter as a positive number	24	
25	NOL. Combine lines 1, 9, 17, and 21 through 24. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you do not have an NOL	25	(11,100)

Form **1045** (2013)

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In **Example 2**, the NOL equals the amount shown on line 41 of Stark's Form 1040. This is not always the case. Certain items must be adjusted when determining the amount of an individual's NOL.

1. Nonbusiness deductions are limited to the amount of nonbusiness income.
2. Capital losses are only allowed to the extent of capital gains.
3. Gain from the sale of qualified small business stock that was excluded from income under IRC §1202 must be added back into income.
4. The domestic production activities deduction (DPAD) is added back to the current year's income.
5. Any NOL deductions from previous (or future) years that are included in the current year's AGI are added back to the amount entered on line 41.

Nonbusiness Deductions Limited to Nonbusiness Income

When computing the amount of an individual's NOL, nonbusiness deductions cannot exceed the amount of the taxpayer's nonbusiness income.

Example 3. Dannery raises dragons for profit. For 2013, she reported interest income of \$1,000, rental income of \$14,000, and Schedule C losses of \$20,000. Her AGI was (\$5,000). The top portion of page 2 of her 2013 Form 1040 looks the same as Stark's from **Example 1**. However, her NOL is a different amount.

Dannery's accountant, Jonah, used the following worksheet to determine that she had business losses of \$6,000 and nonbusiness income of \$1,000. Jonah also completed Worksheet 2, as shown in **Example 2**, with the same result: total nonbusiness deductions equaled \$6,100. (Worksheet 2 for Dannery is not shown.)

NOL Worksheet 1

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

Location on 2013 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 7	Wages, salary, etc.		Business		xxxxxxx	xxxxxxx
B. Line 8a	Taxable interest	1,000	Nonbusiness	xxxxxxx	1,000	
C. Line 8b	Tax-exempt interest		Nonbusiness ^a	xxxxxxx	xxxxxxx	
D. Line 9a	Ordinary dividends		Nonbusiness	xxxxxxx		
E. Line 10	Taxable refunds		Allocate ^b			
F. Line 11	Alimony		Nonbusiness	xxxxxxx		
G. Line 12	Business income (loss)					
	Schedule C	(20,000)	Business	(20,000)	xxxxxxx	xxxxxxx
H. Line 14	Form 4797 gain (loss)		Business		xxxxxxx	xxxxxxx
I. Line 15b	Taxable amount of IRA distributions		Nonbusiness	xxxxxxx		
J. Line 16b	Taxable amount of pensions		Nonbusiness	xxxxxxx		
K. Line 17	Rents, royalties, and partnership income	14,000	Usually business	14,000		
L. Line 18	Farm income (loss)		Business		xxxxxxx	xxxxxxx
M. Line 19	Unemployment compensation		Business		xxxxxxx	xxxxxxx
N. Line 20b	Taxable social security benefits		Nonbusiness	xxxxxxx		
O. Line 21	Other income		Allocate			
P. Total		(5,000)		(6,000)	1,000	

^a Nontaxable interest is nonbusiness income for AMT purposes only.

^b 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.

NOTE: "xxxxxxx" means that an amount cannot be added on that line.

Dannery's NOL is \$6,000, as shown on the Schedule A — NOL that follows. Because her nonbusiness deductions of \$6,100 (line 6) are **more** than her nonbusiness income of \$1,000 (line 8), her NOL is adjusted for nonbusiness deductions. Therefore, line 9 is \$5,100.

Another way of understanding this result is that **Dannery's nonbusiness deduction (her standard deduction of \$6,100) is limited to her nonbusiness income (interest income of \$1,000)**. Her \$14,000 of rental income cannot be reduced by her remaining standard deduction. Instead, her business loss of \$20,000 is applied against the \$14,000 of business income, leaving only \$6,000 of loss to carry forward or back.

Form 1045 (2013)

Page **2**

Schedule A—NOL (see instructions)

1	Enter the amount from your 2013 Form 1040, line 41, or Form 1040NR, line 39. Estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount	1	(11,100)
2	Nonbusiness capital losses before limitation. Enter as a positive number	2	
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)	3	
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-	4	0
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	5	0
6	Nonbusiness deductions (see instructions)	6	6,100
7	Nonbusiness income other than capital gains (see instructions)	7	1,000
8	Add lines 5 and 7	8	1,000
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-	9	5,100
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. But do not enter more than line 5	10	0
11	Business capital losses before limitation. Enter as a positive number	11	
12	Business capital gains (without regard to any section 1202 exclusion)	12	
13	Add lines 10 and 12	13	0
14	Subtract line 13 from line 11. If zero or less, enter -0-	14	0
15	Add lines 4 and 14	15	0
16	Enter the loss, if any, from line 16 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 19, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15	16	
17	Section 1202 exclusion. Enter as a positive number	17	
18	Subtract line 17 from line 16. If zero or less, enter -0-	18	
19	Enter the loss, if any, from line 21 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 20 of Schedule D (Form 1041).) Enter as a positive number	19	
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-	20	
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-	21	
22	Subtract line 20 from line 15. If zero or less, enter -0-	22	0
23	Domestic production activities deduction from your 2013 Form 1040, line 35, or Form 1040NR, line 34 (or included on Form 1041, line 15a)	23	
24	NOL deduction for losses from other years. Enter as a positive number	24	
25	NOL. Combine lines 1, 9, 17, and 21 through 24. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you do not have an NOL	25	(6,000)

Form **1045** (2013)

Business Capital Losses. The calculation of the amount of business capital losses included in the NOL is more complicated than the calculation of nonbusiness capital losses. Business capital losses first are allowed to eliminate any nonbusiness capital gains remaining after nonbusiness capital losses and net nonbusiness deductions.

IRC §1202 Exclusion

IRC §1202 allows taxpayers who sell qualified small business stock to exclude a portion of the gain from taxable income. The definition of **qualified** small business stock for this purpose is very limited and beyond the scope of this chapter. In general, the special treatment is limited to C corporation stock which was purchased by the taxpayer at its original issue. The corporation must also have been in a qualified business.

Note. For more information about qualified small business stock, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

If a taxpayer has a substantial gain from the sale of IRC §1202 stock and also incurs a substantial loss in the same year, the excluded gain is added back to the negative income when calculating how much, if any, of an NOL the taxpayer has to carry back or forward.

Example 5. Kole made a living as a private zookeeper. In 2013, he incurred a loss of \$250,000 on the maintenance of his menagerie. To fund the ongoing operations, he sold IRC §1202 stock he had purchased in a new manufacturing enterprise during the late 1990s. He realized a nonbusiness capital gain of \$200,000 on the sale of the stock but was allowed to exclude half of that gain on his 2013 return under the provisions of §1202.

Kole filed his 2013 return as head of household. In calculating his NOL, the entire \$200,000 nonbusiness gain is used, rather than just the \$100,000 taxable gain. His standard deduction of \$8,950 offsets his nonbusiness capital gain, leaving \$191,050 (\$200,000 – \$8,950) of nonbusiness income to be offset by his \$250,000 business loss. His NOL is \$58,950 (\$250,000 business loss – \$191,050 nonbusiness income).

Domestic Production Activities Deduction

The DPAD is a special subtraction allowed by the Code to certain manufacturers and producers who employ U.S. workers. Its purpose is to lower the effective tax rate paid by the qualifying taxpayers. Unlike most deductions, it does not reflect any actual expense or economic loss incurred by the taxpayers. For this reason, the deduction is added back on line 23 of Schedule A — NOL when calculating how much of an NOL is available to carry to other years.

NOL Deductions from Previous or Future Years

As explained later in the chapter, an NOL that has been carried to the current year is entered on line 21 of Form 1040. After the NOL carryover is subtracted, line 41 might show a negative amount even if there was no operating loss incurred in the current year. Each year's NOL must be tracked separately. Therefore, line 24 of Schedule A — NOL removes other years' NOLs from the current year calculation.

CARRYBACK AND CARRYFORWARD RULES

The default treatment for most taxpayers is to carry an NOL back two years. However, there are some types of activities (such as farming) and some types of losses (such as disaster losses) that qualify for different carryback periods. Exceptions to the 2-year carryback period are discussed in detail later in this section.

The NOL is applied against the earliest year first, and any unused loss is carried to the next taxable year. If there is any remaining unused loss, it is carried forward for up to 20 years until it is depleted.

Example 6. Mycah has an NOL that is reported on his 2014 income tax return. He carries the loss back to 2012 first. If all of the loss is not used against the 2012 income, it is carried to his 2013 return. If any loss still remains, it will be carried forward for up to 20 years. Any remaining loss at the end of the 20-year carryforward period is forfeited.

When the NOL is carried back to a year that is closed by the statute of limitations, only the changes arising from the NOL can be included in the calculation of the refund claim.

Example 7. In July 2014, Sansa is hired by Mr. and Mrs. Lannister to replace their previous tax preparer. While reviewing the prior year returns, Sansa discovers that they had an NOL in 2011 and that the previous accountant had not taken advantage of it. Because there was no election made to forgo the carryback, the only choice is to carry the NOL back two years to 2009. Although the statutory period for amending the 2009 return expired in 2013, the statute of limitations is still open for the 2011 return. Therefore, the taxpayers are still allowed to file an amended return for 2009 to claim the NOL deduction.

While she is preparing the amended return for 2009 to claim the NOL carryback, Sansa realizes that the Lannisters' charitable contributions were omitted from the return. Unfortunately, the Lannisters may not claim the omitted contributions because the statutory period for the 2009 return is closed.

Note. The scenario in **Example 7** is not uncommon. If the 2011 tax year was also closed by the statute of limitations, the taxpayer would have lost all the tax benefits of the carryback NOL.

Taxpayers may waive the carryback and instead carry forward the NOL against future income. The election applies for both regular tax and AMT purposes.⁴

Often, the choice to forgo the carryback period is made:

- When the NOL is small,
- When the available carryback years have little or no tax liability, or
- When the taxpayer anticipates significantly higher income in the future compared to the available carryback years.

For individuals, estates, and trusts, the election to forgo the carryback period is made by attaching a statement to the original return for the NOL year.

SAMPLE ELECTION

The taxpayer, _____, hereby elects to forgo the carryback period pursuant to IRC §172(b)(3) for the NOL incurred in tax year 2014.

The return must be filed by the due date, including extensions, in order to make the election to waive the carryback. However, if the return is timely filed without the election, an amended return to make the election may be filed within six months of the original due date of the return. In this situation, "Filed pursuant to §301.9100-2" must be entered at the top of the election statement.

Once the election is made by individual taxpayers, it is irrevocable.⁵ IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*, describes the election as "generally" irrevocable. However, the current exceptions apply only to nonindividual taxpayers, such as consolidated groups.⁶

⁴ Rev. Rul. 87-44, 1987-1 CB 3.

⁵ IRC §172(b)(3).

⁶ Temp. Treas. Reg. §1.1502-21T(b)(3)(v)(A)(2).

EXCEPTIONS TO THE 2-YEAR CARRYBACK PERIOD

Specific types of losses have **different carryback periods**. The following losses qualify for **longer carryback periods**.

- Casualty and theft losses: 3 years
- Losses attributable to federally declared disasters incurred by qualifying businesses: 3 years
- Farming losses: 5 years
- Specified liability losses: 10 years

Note. NOLs incurred by **real estate investment trusts (REIT)** are subject to a number of special rules that are beyond the scope of this chapter. For more information, see the instructions for Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*.

Casualty and Theft Losses

For individuals incurring NOLs due to casualties or thefts, the carryback period is three years.⁷ Only the portion of the NOL relating to the casualty or theft qualifies for the 3-year carryback. **This is not an election.** It is the statutory default period for these types of losses.

Generally, individuals may **not** elect to use a different carryback period for casualty/theft NOLs. However, if the loss qualifies for one of the other exceptions to the 2-year carryback rule, the carryback period for that exception can be used. Taxpayers may also elect to forgo the carryback period and apply the NOLs prospectively.

Example 8. Ricken suffers a casualty loss when his barn catches fire. As a casualty loss, the carryback period is three years. However, because this is also part of a farm loss, he may use the 5-year carryback period applicable to farm losses. As another alternative, he may forgo both carryback periods and carry the NOL forward. He cannot use a 2-year carryback period.

Federally Declared Disaster Losses

For eligible taxpayers incurring NOLs because of federally declared disasters, the carryback period is three years.⁸ **This is not an election.** It is the statutory default period for these losses. Generally, taxpayers may not elect to use a different carryback period for these NOLs. However, they may choose to forgo the carryback period. In addition, if the losses qualify for one of the other exceptions to the 2-year carryback rule, the taxpayer may use the carryback period for that exception.

Eligible taxpayers are **small businesses** and taxpayers engaged in the business of **farming**. Small businesses for this purpose include sole proprietorships and partnerships whose annual gross receipts average **\$5 million or less** during the 3-year period ending with the tax year of the NOL.

Only the portion of an NOL **relating to the disaster** qualifies for the 3-year carryback. Any loss arising from other causes is treated as a separate NOL. The disaster-related NOL is taken into account after the NOL from other causes.⁹

⁷ IRC §172(b)(1)(F)(ii)(I).

⁸ IRC §172(b)(1)(F).

⁹ IRC §172(b)(1)(F)(iv).

Example 9. Cearsy operates a beauty salon in southern Florida. In 2014, the salon had already incurred a loss for the year-to-date when a massive hurricane devastated the area. The destruction was so widespread that the federal government declared the zone a disaster area.

Cearsy must apply the 2-year carryback period to the amount of loss she incurred **prior** to the disaster. The losses she incurred that are **attributable to the disaster qualify for the 3-year carryback period**. If the disaster loss is not all used in 2011 (the earliest carryback year), the disaster loss that carries over to 2012 is used after the loss that is not related to the disaster.

Note. For more information about disasters, see the Disaster Relief Resource Center for Tax Professionals at www.irs.gov/Tax-Professionals/Disaster-Relief-Resource-Center-for-Tax-Professionals.

Farming Losses

Farming operations qualify for a special 5-year carryback period.¹⁰ A farming loss is the **smaller** of the following amounts.

1. The amount that would be the NOL for the tax year if only income and deductions attributable to farming operations were taken into account
2. The NOL for the tax year

A farming operation involves:

- Cultivating land;
- Raising or harvesting any agricultural or horticultural commodity;
- Operating a nursery or sod farm;
- Raising or harvesting trees; or
- Raising, shearing, feeding, caring for, training, or managing animals.

A farming business does **not** include contract harvesting (custom hire or machine work) of a commodity grown by someone other than the taxpayer. It also does not include buying or selling farm products raised or grown by others.

The 5-year carryback period may be waived by attaching a statement to the timely filed return electing to forgo the 5-year carryback period for farming losses. If this election is made, the 2-year carryback period applies unless the taxpayer also makes an election to forgo the default carryback. **Elections to waive the carryback are irrevocable.**

If the return is filed without the election to forgo the 5-year carryback period, an amended return to make the election may be filed within six months of the original due date of the return. “Filed pursuant to §301.9100-2” should be entered at the top of the election statement in this situation. If the taxpayer wishes to forgo all carrybacks and only carry the NOL forward, an election to forgo the 2-year carryback should also be made at the same time.

SAMPLE ELECTION

Pursuant to IRC §§172(b)(3) and (i)(3), the taxpayer, _____, hereby elects to forgo the special 5-year carryback period for farming losses and the 2-year carryback for NOLs that were incurred in tax year 2014.

¹⁰ IRC §172(b)(1)(G).

Specified Liability Losses

The carryback period for a specified liability loss is 10 years. A specified liability loss is a loss arising from one of the following situations.

1. Product liability and expenses incurred in the investigation or settlement of, or opposition to, product liability claims
2. An act (or failure to act) that occurred at least three years before the beginning of the loss year and resulted in a liability under a federal or state law requiring:
 - Reclamation of land,
 - Dismantling of a drilling platform,
 - Remediation of environmental contamination, or
 - Payment under any workers' compensation act

The second category of losses is only applicable for taxpayers who used the accrual method of accounting throughout the period in which the act occurred.

This 10-year carryback period can be waived in favor of the 2-year carryback period, or both carrybacks can be waived with an election to carry the loss forward.

USING THE NOL

Once the tax return preparer knows the amount of the NOL for the current tax year and whether the loss is from an activity that qualifies for a special carryback period, the previous years' tax returns from the carryback period should be compared to the taxpayer's projected future income and tax liabilities. Using the information gathered, a decision must be made as to whether the optimum application of the NOL is to previous years or to future years. The ultimate decision is the responsibility of the taxpayer.

Caution. Practitioners should consult with the taxpayer at this stage and fully document the results of the consultation. Although it may be in the taxpayer's best interests to choose one option over the others, the taxpayer may prefer a short-term reward to a long-term benefit.

NOL CARRYBACKS

Methods of Filing for a Refund

Individual taxpayers have the option of filing for a refund using Form 1045 or filing amended returns using Form 1040X, *Amended U.S. Individual Income Tax Return*, for each year in the carryback period.

Following are some of the **advantages** of using Form 1045.

1. The IRS must process the form within 90 days.
2. One claim can be submitted for all of the carryback years.
3. The form clearly shows which prior year items are adjusted as a result of the NOL.

Following are the **disadvantages** of using Form 1045.

1. The form must be filed within one year of the last day of the year in which the NOL arose. For example, the deadline for using Form 1045 for a calendar-year taxpayer with a 2014 NOL is December 31, 2015.
2. Processing of the form and paying the requested refund to the taxpayer does not signify that the IRS accepted the application as correct.¹¹ The IRS may impose additional taxes, penalties, and interest after the refund is issued.
3. If the application is disallowed, no suit challenging the disallowance may be brought in any court. The claim for refund must be resubmitted on Form 1040X to be eligible for legal remedy.
4. Any amount applied, credited, or refunded that the IRS later determines to be excessive may be billed as if it were due to a math or clerical error on the return. The authority to treat the increase in tax as arising from a math error allows the IRS to immediately assess and/or collect the additional tax.¹² This process also restricts the taxpayer's rights to file a petition with the Tax Court.¹³

Following are the **advantages** of using Form 1040X.

1. The deadline for filing Form 1040X to claim a refund for the carryback of the NOL year's loss is the same as the deadline for changes to the NOL year's return. The amended return must be filed no later than three years after the due date of the return for the NOL year. For example, the deadline to file Form 1040X for 2009 to claim a refund generated by a 2011 NOL is April 15, 2015. **If the 2011 return was filed with a valid extension, the deadline for filing Form 1040X is October 15, 2015.**
2. If the IRS does not process the claim within six months from the date filed, the taxpayer may file suit in court.
3. If the IRS disallows the claim, the taxpayer has two years from the date of disallowance to file suit.

Following are the **disadvantages** of using Form 1040X.

1. Separate returns must be prepared for each carryback year.
2. It may take more than 90 days for the IRS to process the returns and issue refunds.
3. Preparers using software to prepare the return must manually adjust for some of the deductions that are based on AGI. For example, limitations on charitable deductions are not recalculated even though the carryback amount changes the AGI on the amended return.

Filing NOL Carryback Claims

When filing an NOL carryback claim for a client, practitioners should keep the following points in mind.

- Practitioners may want to obtain IRS transcripts and statements of account to verify the amounts reported for previous years before preparing Form 1045 or Form 1040X for NOL carrybacks. Even minor differences may cause the IRS to return the submission to the taxpayer for correction.
- Practitioners should also consider having the taxpayers sign Form 2848, *Power of Attorney and Declaration of Representative*, authorizing the practitioner to represent the taxpayer before the IRS in matters relating to the NOL tax year, carryback years, and carryforward years.

¹¹ Instructions for Form 1045.

¹² IRC §6213(b)(1).

¹³ Ibid.

- The instructions for Form 1045 contain a comprehensive list of attachments that must be included with the form. Included in this list are all forms and source tax documents that relate to the loss and all forms or schedules for items recalculated in the carryback years. Failure to attach documentation can result in the application being delayed or disallowed. This list should also be referred to when using Form 1040X to file a carryback claim.
- Schedule A — NOL must be included with the carryback claim. Worksheets that perform the same calculation in a similar format cannot be processed by the IRS.
- Practitioners should exercise caution when preparing returns with NOLs. As stated previously, the elections made by individuals regarding carryback periods cannot be revoked. Likewise, the absence of any election is binding on the taxpayer after the extended deadline for the return has passed.

Applying the NOL to Past Returns

The first step in applying the NOL to past returns is to recalculate the AGI for the earliest carryback year. The AGI that results after applying the NOL deduction is used to recompute income or deduction items that are based on, or limited to, a percentage of AGI. The following items are **adjusted in the order listed**.

1. The special allowance for passive activity losses from rental real estate activities
2. Taxable social security and tier 1 railroad retirement benefits
3. IRA deductions
4. Excludable savings bond interest
5. Excludable employer-provided adoption benefits
6. The student loan interest deduction
7. The tuition and fees deduction

When making calculations for each item in the preceding list, the AGI that results after applying the NOL and any previous items is used.

After all of these items are recomputed, the following deductions are **recalculated based on AGI**.

1. Itemized deduction for medical expenses
2. Itemized deduction for qualified mortgage insurance premiums
3. Itemized deduction for casualty losses
4. Miscellaneous itemized deductions subject to the 2% floor
5. Overall limit on itemized deductions
6. Phaseout of exemptions

The deductions for **charitable contributions** and **general sales taxes** are **not** recalculated.

Caution. Self-employment tax is not affected by NOL carrybacks and carryforwards.

Effect of Carryback on IRA Deductions

The effect of NOL carrybacks on IRA deductions may be one of the most confusing aspects of carrying back an NOL to prior years **if the taxpayer made nondeductible contributions to a traditional IRA** in one of the carryback years. When the **NOL is more than the taxable income** for the carryback year, the deductible IRA contribution is **not** recalculated for purposes of the remaining carryforward. Form 1045, Schedule B — NOL Carryover is used to calculate how much of the NOL can be applied to the next oldest carryback year. (Schedule B — NOL Carryover is discussed later in the chapter.) Therefore, the taxpayer receives no benefit from the additional amount that may have been deductible that year if the taxpayer's AGI had been lower. However, taxpayers get to retain their basis in the IRA to use against future distributions.

If the **NOL is less than the taxable income** in the carryback year, the deductible amount of the IRA contribution must be recalculated for purposes of determining the taxable income after carryback. Therefore, the taxpayer may now receive a tax benefit from the previously nondeductible contribution to the IRA. However, taxpayers may elect not to deduct the additional allowable amount. If the taxpayer does choose to deduct the additional amount, a revised Form 8606, *Nondeductible IRAs*, must be prepared and attached to the NOL carryback to report an adjusted basis in the IRA.

Caution. Practitioners should adjust the basis information in their carryforward reference files and/or their software so that the taxable portion of future distributions is calculated correctly.

Example 10. Aria has been making the maximum contribution to her traditional IRA every year. Because she was covered by a pension plan at work and her income was above the applicable thresholds, she was not always able to deduct the full amount of her contributions. Prior to 2013, she prepared her own taxes without the benefit of professional expertise.

In 2013, she quit her job and started a business as a private investigator. Getting started in the business was costly and she incurred a substantial loss in 2013. Her 2013 NOL was \$83,000.

The following chart shows the original and recalculated amounts for her 2011 and 2012 returns. Because Aria's **NOL is more than her taxable income** for 2011, her deductible IRA contribution is **not** recalculated for purposes of determining the remaining carryforward. However, Aria's remaining **NOL is less than her taxable income** for 2012, so her deductible IRA contribution for that year is recalculated. Aria chooses to deduct the additional amount allowable after the carryback. The IRA Deduction Worksheet from the instructions to Form 1040 was used to calculate the deductible portion of the IRA for 2012. It is not shown, but a selected portion of her Form 1045 follows. Aria must also include a revised 2012 Form 8606 with her carryback claim.

Observation. If Aria had consulted with a professional tax advisor, the advisor probably would have recommended that she fund a Roth IRA with the nondeductible portions of her IRA contributions instead of creating basis in her traditional IRA. Although some taxpayers are not eligible to make Roth IRA contributions because their AGI is too high, Aria's AGI was not prohibitively high during the years in question.

For Example 10

	2011		2012	
	Before NOL Carryback	After NOL Carryback	Before NOL Carryback	After NOL Carryback
Wages	\$64,000	\$64,000	\$64,000	\$64,000
IRA deduction (IRA contribution of \$5,000 each year)	(1,000)	(1,000)	(2,000)	(5,000)
NOL carryback/over		(83,000)		(22,100)
AGI	\$63,000	(\$20,000)	\$62,000	\$36,900
Standard deduction	(5,800)	(5,800)	(5,950)	(5,950)
Taxable income before exemption	\$57,200	(\$25,800)	\$56,050	\$30,950
Exemption	(3,700)	(3,700)	(3,800)	(3,800)
Taxable income	\$53,500	(\$29,500)	\$52,250	\$27,150

Form 1045 (2013)

Page **3**

Schedule B – NOL Carryover (see instructions)

Complete one column before going to the next column. Start with the earliest carryback year.

	2nd preceding tax year ended ► 12/31/2011		1st preceding tax year ended ► 12/31/2012		_____ preceding tax year ended ►	
	1 NOL deduction (see instructions). Enter as a positive number	83,000		22,100		
2 Taxable income before 2013 NOL carryback (see instructions). Estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction	57,200		56,050			
3 Net capital loss deduction (see instructions)						
4 Section 1202 exclusion. Enter as a positive number						
5 Domestic production activities deduction						
6 Adjustment to adjusted gross income (see instructions)						
7 Adjustment to itemized deductions (see instructions)						
8 Individuals, enter deduction for exemptions (minus any amount on Form 8914, line 6, for 2006 and 2009; line 2 for 2005 and 2008). Estates and trusts, enter exemption amount	3,700		3,800			
9 Modified taxable income. Combine lines 2 through 8. If zero or less, enter -0-	60,900		59,850			0
10 NOL carryover (see instructions)	22,100		0			0
Adjustment to Itemized Deductions						

Form 1045 Example

The final step in applying the NOL to past returns is that taxes and credits are recalculated.

Example 11. During 2010, Lyssa became ill, and her ex-husband, Peter, took over managing her affairs. During her incapacity, he embezzled \$600,000 of her investments and savings and spent it on alcohol and fast cars. The rest of the money he wasted.

Lyssa discovered the embezzlement in 2013 after she recovered from her prolonged illness. With the help of her brother Garrold, Lyssa was able to adequately document the losses. To protect the reputation of their children, Lyssa did not file a police report or press charges against Peter. After reviewing the documentation and researching the issue, her CPA informed her that, based on various court cases,¹⁴ taxpayers claiming theft losses must be able to show that theft is the most plausible explanation for the property loss. However, taxpayers are not required to pursue prosecution of the thief or even be able to prove who committed the theft.

Because theft losses are deductible in the year that the theft is discovered,¹⁵ Lyssa claimed the losses on her 2013 income tax return. After filing Lyssa's 2013 return, her CPA calculated the business and nonbusiness portions of her income and expenses. Following are the completed Form 1040, Schedule A, Form 4684, and the worksheets.

¹⁴ See, e.g., *Jordan v. U.S.*, 344 F.Supp. 87 (W.D. Ark. 1972); *Allen v. Comm'r*, 16 TC 163 (1951); *Jorg v. Comm'r*, 52 TC 288 (1969); *Meyers v. Comm'r*, TC Memo 1959-39 (Feb. 27, 1959); *Jones v. Comm'r*, 24 TC 525 (1955); and *Wilson v. Comm'r*, TC Memo 1982-107 (Mar. 4, 1982).

¹⁵ Treas. Reg. §1.165-8(a)(2).

For Example 11

Form 1040	Department of the Treasury—Internal Revenue Service (99) U.S. Individual Income Tax Return	2013	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																									
For the year Jan. 1–Dec. 31, 2013, or other tax year beginning _____, 2013, ending _____, 20				See separate instructions.																									
Your first name and initial Lyssa		Last name Baelist		Your social security number 3 5 5 5 5 5 5 5																									
If a joint return, spouse's first name and initial		Last name		Spouse's social security number																									
Home address (number and street). If you have a P.O. box, see instructions. 1 Wounded Heart			Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.																									
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Sherman, IL 62684																													
Foreign country name		Foreign province/state/county	Foreign postal code																										
<table style="width: 100%; border: none;"> <tr> <td style="width: 20%;">Filing Status</td> <td style="width: 40%;"> 1 <input checked="" type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶ </td> <td style="width: 40%;"> 4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child </td> </tr> </table>					Filing Status	1 <input checked="" type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶	4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child																						
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<table style="width: 100%; border: none;"> <tr> <td style="width: 20%;">Adjusted Gross Income</td> <td style="width: 55%;"> 23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN ▶ 32 IRA deduction 32 33 Student loan interest deduction 33 34 Tuition and fees. Attach Form 8917 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income ▶ </td> <td style="width: 25%; text-align: right;"> 36 37 91,756 </td> </tr> </table>					Adjusted Gross Income	23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN ▶ 32 IRA deduction 32 33 Student loan interest deduction 33 34 Tuition and fees. Attach Form 8917 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income ▶	36 37 91,756																						
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2014 Workbook

For Example 11

Form 1040 (2013)

Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	91,756
	39a	Check <input checked="" type="checkbox"/> You were born before January 2, 1949, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1949, <input type="checkbox"/> Blind. } checked ▶ 39a	1	
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>		
Standard Deduction for—	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	609,116
• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.	41	Subtract line 40 from line 38	41	(517,360)
• All others: Single or Married filing separately, \$6,100	42	Exemptions. If line 38 is \$150,000 or less, multiply \$3,900 by the number on line 6d. Otherwise, see instructions	42	3,900
Married filing jointly or Qualifying widow(er), \$12,200	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	0
Head of household, \$8,950	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/>	44	0
	45	Alternative minimum tax (see instructions). Attach Form 6251	45	
	46	Add lines 44 and 45	46	0
	47	Foreign tax credit. Attach Form 1116 if required	47	
	48	Credit for child and dependent care expenses. Attach Form 2441	48	
	49	Education credits from Form 8863, line 19	49	
	50	Retirement savings contributions credit. Attach Form 8880	50	
	51	Child tax credit. Attach Schedule 8812, if required	51	
	52	Residential energy credits. Attach Form 5695	52	
	53	Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53	
	54	Add lines 47 through 53. These are your total credits	54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-	55	0
Other Taxes	56	Self-employment tax. Attach Schedule SE	56	
	57	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
	59a	Household employment taxes from Schedule H	59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
	60	Taxes from: a <input type="checkbox"/> Form 8959 b <input type="checkbox"/> Form 8960 c <input type="checkbox"/> Instructions; enter code(s)	60	
	61	Add lines 55 through 60. This is your total tax	61	0
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62	5,556
	63	2013 estimated tax payments and amount applied from 2012 return	63	
	64a	Earned income credit (EIC)	64a	
If you have a qualifying child, attach Schedule EIC.	b	Nontaxable combat pay election 64b		
	65	Additional child tax credit. Attach Schedule 8812	65	
	66	American opportunity credit from Form 8863, line 8	66	
	67	Reserved	67	
	68	Amount paid with request for extension to file	68	
	69	Excess social security and tier 1 RRTA tax withheld	69	
	70	Credit for federal tax on fuels. Attach Form 4136	70	
	71	Credits from Form: a <input type="checkbox"/> 2439 b <input checked="" type="checkbox"/> Reserved c <input type="checkbox"/> 8885 d <input type="checkbox"/>	71	
	72	Add lines 62, 63, 64a, and 65 through 71. These are your total payments	72	5,556
Refund	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid	73	5,556
	74a	Amount of line 73 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/>	74a	5,556
		Routing number: _____ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		

For Example 11

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at www.irs.gov/schedulea.
▶ Attach to Form 1040.

OMB No. 1545-0074

2013

Attachment
Sequence No. 07

2

Name(s) shown on Form 1040

Your social security number

Lyssa Baelist

355-55-5555

Caution. Do not include expenses reimbursed or paid by others.				
Medical and Dental Expenses	1 Medical and dental expenses (see instructions)	1	2,398	
	2 Enter amount from Form 1040, line 38 2 91,756			
	3 Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1949, multiply line 2 by 7.5% (.075) instead	3	6,882	
	4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		0
Taxes You Paid	5 State and local (check only one box):			
	a <input type="checkbox"/> Income taxes, or	5	1,090	
	b <input checked="" type="checkbox"/> General sales taxes			
	6 Real estate taxes (see instructions)	6	7,078	
	7 Personal property taxes	7		
8 Other taxes. List type and amount ▶	8			
9 Add lines 5 through 8				9 8,168
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10	10,224	
	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11		
	12 Points not reported to you on Form 1098. See instructions for special rules	12		
	13 Mortgage insurance premiums (see instructions)	13		
	14 Investment interest. Attach Form 4952 if required. (See instructions.)	14		
15 Add lines 10 through 14				15 10,224
Gifts to Charity	16 Gifts by cash or check. If you made any gift of \$250 or more, see instructions	16		
	17 Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500	17		
	18 Carryover from prior year	18		
	19 Add lines 16 through 18			
20 Casualty or theft loss(es). Attach Form 4684. (See instructions.)				20 590,724
Job Expenses and Certain Miscellaneous Deductions	21 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶	21		
	22 Tax preparation fees	22		
	23 Other expenses—investment, safe deposit box, etc. List type and amount ▶	23		
	24 Add lines 21 through 23	24		
	25 Enter amount from Form 1040, line 38 25			
	26 Multiply line 25 by 2% (.02)	26		
27 Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-				27
28 Other—from list in instructions. List type and amount ▶				28
Total Itemized Deductions	29 Is Form 1040, line 38, over \$150,000?			
	<input checked="" type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40.			
	<input type="checkbox"/> Yes. Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.			
30 If you elect to itemize deductions even though they are less than your standard deduction, check here				30 <input type="checkbox"/>
				29 609,116

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 17145C

Schedule A (Form 1040) 2013

2014 Workbook

For Example 11

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

- ▶ Information about Form 4684 and its separate instructions is at www.irs.gov/form4684.
- ▶ Attach to your tax return.
- ▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177

2013
Attachment
Sequence No. 26

Name(s) shown on tax return

Lyssa Baelist

Identifying number

355-55-5555

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property A **Cash and securities - embezzlement over 2 year period**

Property B _____

Property C _____

Property D _____

	Properties			
	A	B	C	D
2 Cost or other basis of each property	2	600,000		
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3	0		
<i>Note: If line 2 is more than line 3, skip line 4.</i>				
4 Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4			
5 Fair market value before casualty or theft	5	600,000		
6 Fair market value after casualty or theft	6	0		
7 Subtract line 6 from line 5	7	600,000		
8 Enter the smaller of line 2 or line 7	8	600,000		
9 Subtract line 3 from line 8. If zero or less, enter -0-	9	600,000		
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	600,000		
11 Enter the smaller of line 10 or \$100	11	100		
12 Subtract line 11 from line 10	12	599,900		
<i>Caution: Use only one Form 4684 for lines 13 through 18.</i>				
13 Add the amounts on line 12 of all Forms 4684	13	599,900		
14 Add the amounts on line 4 of all Forms 4684.	14	0		
15 • If line 14 is more than line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions). • If line 14 is less than line 13, enter -0- here and go to line 16. • If line 14 is equal to line 13, enter -0- here. Do not complete the rest of this section.	15	0		
16 If line 14 is less than line 13, enter the difference	16	599,900		
17 Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 37. Estates and trusts, see instructions	17	9,176		
18 Subtract line 17 from line 16. If zero or less, enter -0-. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return	18	590,724		

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 12997O

Form **4684** (2013)

For Example 11

NOL Worksheet 1

Allocation of Income between Business Income and Nonbusiness Income

Location on 2013 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 7	Wages, salary, etc.		Business		xxxxxxx	xxxxxxx
B. Line 8a	Taxable interest	926	Nonbusiness	xxxxxxx	926	
C. Line 8b	Tax-exempt interest		Nonbusiness ^a	xxxxxxx	xxxxxxx	
D. Line 9a	Ordinary dividends		Nonbusiness	xxxxxxx		
E. Line 10	Taxable refunds		Allocate ^b			
F. Line 11	Alimony		Nonbusiness	xxxxxxx		
G. Line 12	Business income (loss)					
	Schedule C		Business		xxxxxxx	xxxxxxx
H. Line 14	Form 4797 gain (loss)		Business		xxxxxxx	xxxxxxx
I. Line 15b	Taxable amount of IRA distributions	74,317	Nonbusiness	xxxxxxx	74,317	
J. Line 16b	Taxable amount of pensions		Nonbusiness	xxxxxxx		
K. Line 17	Rents, royalties, and partnership income		Usually business			
L. Line 18	Farm income (loss)		Business		xxxxxxx	xxxxxxx
M. Line 19	Unemployment compensation		Business		xxxxxxx	xxxxxxx
N. Line 20b	Taxable social security benefits	16,513	Nonbusiness	xxxxxxx	16,513	
O. Line 21	Other income		Allocate			
P. Total		91,756			91,756	

^a Nontaxable interest is nonbusiness income for AMT purposes only.

^b 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.

NOTE: "xxxxxxx" means that an amount cannot be added on that line.

2014 Workbook

For Example 11

NOL Worksheet 2

Allocation of **Deductions** between Business Deductions and Nonbusiness Deductions

Location on 2013 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 23	Educator expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
B. Line 24	Business expense of reservists, etc. ^a	_____	Business	_____	XXXXXXXX	XXXXXXXX
C. Line 25	HSA & MSA ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
D. Line 26	Moving expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
E. Line 27	SE tax deduction	_____	Business	_____	XXXXXXXX	XXXXXXXX
F. Line 28	SEP, SIMPLE, & qualified plans	_____	Nonbusiness	XXXXXXXX	_____	_____
G. Line 29	SE health insurance	_____	Business	_____	XXXXXXXX	XXXXXXXX
H. Line 30	Penalty, early withdrawal	_____	Nonbusiness	XXXXXXXX	_____	_____
I. Line 31a	Alimony	_____	Nonbusiness	XXXXXXXX	_____	_____
J. Line 32	IRA deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
K. Line 33	Student loan interest ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
L. Line 34	Tuition & fee deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
M. Line 40a	Standard deduction (if claimed)	_____	Nonbusiness	XXXXXXXX	_____	XXXXXXXX ^b

Schedule A (Form 1040) (Itemized deductions, if claimed)

N. Line 4	Medical	_____	Nonbusiness	XXXXXXXX	_____	_____ ^c
O. Line 9	Taxes	8,168	Allocate ^d	_____	8,168	XXXXXXXX
P. Line 15	Interest	10,224	Nonbusiness	XXXXXXXX	10,224	_____ ^e
Q. Line 19	Contributions	_____	Nonbusiness	XXXXXXXX	_____	_____
R. Line 20	Casualty	590,724	Business	590,724	XXXXXXXX	XXXXXXXX
S. Line 27	Misc. (2% floor)	_____	Allocate ^f	_____	_____	XXXXXXXX
T. Line 28	Other misc.	_____	Allocate ^g	_____	_____	_____
U. Total		609,116		590,724	18,392	_____

^a Include only "other" items such as unreimbursed expenses of artists (IRC §62(b)). Do not include amounts reported on lines 23 through 35.

^b If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

^c The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

^d 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.

^e 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.

^f Because the amount on line 27, 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 27, 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 27, 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.

^g Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 28, Schedule A, are nonbusiness deductions.

NOTE: "xxxxxxx" means that an amount cannot be entered on that line.

Following completion of the worksheets, the CPA prepared the following Schedule A — NOL to determine the amount of NOL available to carry back or forward.

Schedule A—NOL (see instructions)

1	Enter the amount from your 2013 Form 1040, line 41, or Form 1040NR, line 39. Estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount	1	(517,360)
2	Nonbusiness capital losses before limitation. Enter as a positive number	2	
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)	3	
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-	4	0
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	5	0
6	Nonbusiness deductions (see instructions)	6	18,392
7	Nonbusiness income other than capital gains (see instructions)	7	91,756
8	Add lines 5 and 7	8	91,756
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-	9	0
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. But do not enter more than line 5	10	0
11	Business capital losses before limitation. Enter as a positive number	11	
12	Business capital gains (without regard to any section 1202 exclusion)	12	
13	Add lines 10 and 12	13	0
14	Subtract line 13 from line 11. If zero or less, enter -0-	14	0
15	Add lines 4 and 14	15	0
16	Enter the loss, if any, from line 16 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 19, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15	16	
17	Section 1202 exclusion. Enter as a positive number	17	
18	Subtract line 17 from line 16. If zero or less, enter -0-	18	
19	Enter the loss, if any, from line 21 of your 2013 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 20 of Schedule D (Form 1041).) Enter as a positive number	19	
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-	20	
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-	21	
22	Subtract line 20 from line 15. If zero or less, enter -0-	22	0
23	Domestic production activities deduction from your 2013 Form 1040, line 35, or Form 1040NR, line 34 (or included on Form 1041, line 15a)	23	
24	NOL deduction for losses from other years. Enter as a positive number	24	
25	NOL. Combine lines 1, 9, 17, and 21 through 24. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you do not have an NOL	25	(517,360)

Based on the amount of loss and her overall general health, Lyssa decides that she definitely wants to carry as much of the loss back as possible.

Her CPA informs her that the carryback period for a casualty loss is three years and calculates the effect of carrying back the 2013 NOL to 2010. The changes to her 2010 return are summarized in the following table. The first column of **Form 1045** (which follows the table) shows the claim related to the NOL carryback to 2010. The second and third columns of Form 1045 are based on facts that are presented in **Example 12**.

2014 Workbook

Form 1040 Line	2010	
	Before NOL Carryback	After NOL Carryback
8a Interest	\$52,557	\$52,557
15b Taxable IRA distributions	58,355	58,355
20b Taxable social security benefits	15,937	0
21 NOL carryback	0	(517,360)
22 Total income	\$126,849	(\$406,448)
37 AGI	\$126,849	(\$406,448)
40 Itemized deductions	(18,601)	(23,055)
41 Taxable income before exemption	\$108,248	(\$429,503)
42 Exemption	(3,650)	(3,650)
43 Taxable income	\$104,598	(\$433,153)

Note. Lyssa's itemized deductions for 2010 increased from \$18,601 to \$23,055 after applying the NOL carryback. This was caused by the 7.5% AGI floor for medical deductions and the 2% AGI floor for miscellaneous itemized deductions being reduced to zero. Unfortunately, as shown in **Example 12**, the increase in itemized deductions is not considered when calculating the amount of NOL available to carry over to the next tax year.

For Example 11

Form 1045	Application for Tentative Refund ▶ Separate instructions and additional information are available at IRS.gov/form1045 . ▶ Do not attach to your income tax return. Mail in a separate envelope. ▶ For use by individuals, estates, or trusts.	OMB No. 1545-0098 2013
------------------	---	--------------------------------------

Type or print	Name(s) shown on return Lyssa Baelist	Social security or employer identification number 355-55-5555
	Number, street, and apt. or suite no. if a P.O. box, see instructions. 1 Wounded Heart	Spouse's social security number (SSN)
	City, town or post office, state, and Zip code. If a foreign address, also complete spaces below (see instructions). Sherman, IL 62684	Daytime phone number
	Foreign country name	Foreign province/country

1 This application is filed to carry back:	a Net operating loss (NOL) (Sch. A, line 25, page 2) \$ 517,360	b Unused general business credit \$	c Net section 1256 contracts loss \$
--	---	--	---

2a For the calendar year 2013, or other tax year beginning _____, 2013, and ending _____, 20	b Date tax return was filed 04/06/2014
--	--

3 If this application is for an unused credit created by another carryback, enter year of 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 SSN 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 Is any part of the decrease in tax due to a loss or credit resulting from a reportable transaction required to be disclosed on Form 8886, Reportable Transaction Disclosure Statement? Yes No

9 If you are carrying back an NOL or net section 1256 contracts loss, did this cause the release of foreign tax credits or the release of other credits due to the release of the foreign tax credit (see instructions)? Yes No

Computation of Decrease in Tax (see instructions)	3rd preceding tax year ended ▶ 12/31/2010		2nd preceding tax year ended ▶ 12/31/2011		1st preceding tax year ended ▶ 12/31/2012	
	Before carryback	After carryback	Before carryback	After carryback	Before carryback	After carryback
	<i>Note: If 1a and 1c are blank, skip lines 10 through 15.</i>					
10 NOL deduction after carryback (see instructions)		517,360		409,112		353,057
11 Adjusted gross income	126,849	(406,448)	74,462	(350,588)	124,234	(244,762)
12 Deductions (see instructions)	18,601	23,055	18,407	23,407	18,486	22,759
13 Subtract line 12 from line 11	108,248	(429,503)	56,055	(373,995)	105,748	(267,521)
14 Exemptions (see instructions)	3,650	3,650	3,700	3,700	3,800	3,800
15 Taxable income. Line 13 minus line 14	104,598	(433,153)	52,355	(377,695)	101,948	(271,321)
16 Income tax. See instructions and attach an explanation	23,007	0	9,219	0	22,006	0
17 Alternative minimum tax						
18 Add lines 16 and 17	23,007	0	9,219	0	22,006	0
19 General business credit (see instructions)						
20 Other credits. Identify						
21 Total credits. Add lines 19 and 20						
22 Subtract line 21 from line 18	23,007	0	9,219	0	22,006	0
23 Self-employment tax						
24 Other taxes						
25 Total tax. Add lines 22 through 24	23,007	0	9,219	0	22,006	0
26 Enter the amount from the "After carryback" column on line 25 for each year	0		0		0	
27 Decrease in tax. Line 25 minus line 26	23,007		9,219		22,006	

27 Payment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)

Schedule B — NOL Carryover

If the NOL is more than the modified AGI of the oldest carryback year, **Schedule B — NOL Carryover** is used to calculate how much of the NOL can be applied to the next oldest year. Although certain items are recomputed when applying the NOL for purposes of calculating the change in tax liability, **those items are not recomputed for purposes of calculating the amount of NOL remaining after it is applied to the earlier tax year.** Furthermore, the deduction for personal exemptions is added back to taxable income when determining whether any NOL deduction carries over to the next oldest tax year. Consequently, the taxpayer loses the benefit of the exemptions in the years when the NOL carryover exceeds income.

Example 12. Use the same facts as **Example 11.** After completing page 1 of Form 1045, the CPA completed Lyssa’s Schedule B — NOL Carryover, which follows. When recalculating the tax for 2010, none of Lyssa’s social security benefits were taxable, as shown in the chart in **Example 11.** However, all the taxable social security benefits were included in the \$104,598 shown on line 2 of Schedule B — NOL Carryover and all of this taxable income reduces the amount of NOL that remains to be applied to the tax year ending December 31, 2011.

After carrying back the NOL to all three of the previous years, Lyssa still has \$247,309 of unused NOL to carry forward to 2014. (See the third column of line 10.)

Form 1045 (2013)

Page **3**

Schedule B — NOL Carryover (see instructions)

Complete one column before going to the next column. Start with the earliest carryback year.	<u>3rd</u> preceding tax year ended ► 12/31/2010	<u>2nd</u> preceding tax year ended ► 12/31/2011	<u>1st</u> preceding tax year ended ► 12/31/2012
1 NOL deduction (see instructions). Enter as a positive number	517,360	409,112	353,057
2 Taxable income before 2013 NOL carryback (see instructions). Estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction	104,598	52,355	101,948
3 Net capital loss deduction (see instructions)			
4 Section 1202 exclusion. Enter as a positive number			
5 Domestic production activities deduction			
6 Adjustment to adjusted gross income (see instructions)			
7 Adjustment to itemized deductions (see instructions)			
8 Individuals, enter deduction for exemptions (minus any amount on Form 8914, line 6, for 2006 and 2009; line 2 for 2005 and 2008). Estates and trusts, enter exemption amount	3,650	3,700	3,800
9 Modified taxable income. Combine lines 2 through 8. If zero or less, enter -0-	108,248	56,055	105,748
10 NOL carryover (see instructions)	409,112	353,057	247,309
Adjustment to Itemized Deductions			

NOL CARRYFORWARDS

If the carryback period is waived or if there is any NOL remaining after the carryback is applied, the NOL carryforward is entered on the subsequent year's return as a negative amount on Form 1040, line 21 (other income). After the subsequent year's return is completed, Table 1 from IRS Pub. 536 is used to calculate the remaining portion, if any, to carry forward to the next year. The NOL continues to carry forward until it is completely depleted or until it expires at the end of 20 years.

Example 13. Marrion is a professional minstrel. In 2012, he incurred an NOL of \$50,000 from hiring subcontractors to perform his contractual obligations while he was wrongfully incarcerated. Because he anticipated that the notoriety generated by his predicament would increase his revenues in later years, he elected to forgo the carryback period.

After his release in 2013, he was hired as an employee of an internationally famous traveling show. He did not resume operations of his sole proprietorship during 2013. In the brief period between his release and the end of the year, he earned \$20,000. His 2013 taxable income is calculated as follows.

Wages	\$20,000
2012 NOL carryforward	<u>(50,000)</u>
AGI	(\$30,000)
Standard deduction	(6,100)
Personal exemption	<u>(3,900)</u>
Taxable income	(\$40,000)

Marrion uses Table 1 from IRS Pub. 536 to calculate the amount of the NOL carryforward to 2014. He enters the \$50,000 NOL on line 1. He calculates line 2 by adding the NOL of \$50,000 to the taxable income of (\$40,000), as shown in the preceding table. He enters \$10,000 on line 2.

Marrion does not need to make any adjustments for deductions that were not allowed in determining the current year's income for NOL purposes, so he does not make any entries on lines 3 through 7 of the worksheet. He also does not have any deductions that are affected by AGI, so he does not complete any lines after line 10. His modified taxable income on line 9 is subtracted from his 2012 NOL to yield his carryforward to 2014 of \$36,100.

For Example 13

Table 1. **Worksheet for NOL Carryover From 2013 to 2014 (For an NOL Year Before 2013)***

*For Use by Individuals, Estates, and Trusts (Keep for your records.)
See the instructions under NOL Carryover From 2013 to 2014.*



NOL YEAR: 2012	
USE YOUR 2013 FORM 1040, FORM 1040NR (OR FORM 1041) TO COMPLETE THIS WORKSHEET:	
1. Enter as a positive number your NOL deduction for the NOL year entered above from line 21 (Form 1040 or Form 1040NR) or line 15a (Form 1041)	50,000
2. Enter your taxable income without the NOL deduction for 2013 (see instructions)	10,000
3. Enter as a positive number any net capital loss deduction	
4. Enter as a positive number any gain excluded on the sale or exchange of qualified small business	
5. Enter the amount of any domestic production activities deduction	
6. Enter any adjustments to your adjusted gross income (see instructions)	
7. Enter any adjustments to your itemized deductions from line 33 below (see instructions)	
8. Enter your deduction for exemptions from line 42 (Form 1040), line 40 (Form 1040NR), or line 20 (Form 1041)	3,900
9. Modified taxable income. Combine lines 2 through 8. Enter the result (but not less than zero)	13,900
10. NOL carryover to 2014. Subtract line 9 from line 1. Enter the result (but not less than zero) here and on the "other income" line of Form 1040 or Form 1040NR (or the line on Form 1041 for deductions NOT subject to the 2% floor) in 2014.	36,100
ADJUSTMENTS TO ITEMIZED DEDUCTIONS (INDIVIDUALS ONLY):	
11. Enter your adjusted gross income without the NOL deduction for the NOL year entered above or later years. (see instructions)	
12. Combine lines 3, 4, 5, and 6 above	
13. Modified adjusted gross income. Combine lines 11 and 12 above	
ADJUSTMENT TO MEDICAL EXPENSES:	
14. Enter your medical expenses from Schedule A (Form 1040), line 4	
15. Enter your medical expenses from Schedule A (Form 1040), line 1	
16. Multiply line 13 above by 10% (.10). But if either you or your spouse was born before January 2, 1949, multiply line 13 by 7.5% (.075)	
17. Subtract line 16 from line 15. Enter the result (but not less than zero)	
18. Subtract line 17 from line 14	
ADJUSTMENT TO MORTGAGE INSURANCE PREMIUMS:	
19. Enter your mortgage insurance premiums deduction from Schedule A (Form 1040), line 13	
20. Refigure your mortgage insurance premiums deduction using line 13 above as your adjusted gross income (see instructions)	
21. Subtract line 20 from line 19	
ADJUSTMENT TO CHARITABLE CONTRIBUTIONS:	
22. Enter your charitable contributions deduction from Schedule A (Form 1040), line 19, or Schedule A (Form 1040NR), line 5	
23. Refigure your charitable contributions deduction using line 13 above as your adjusted gross income (see instructions)	
24. Subtract line 23 from line 22	
ADJUSTMENT TO CASUALTY AND THEFT LOSSES:	
25. Enter your casualty and theft losses from Form 4684, line 18	
26. Multiply line 25 above by 10% (.10)	
27. Subtract line 26 from line 25. Enter the result (but not less than zero)	
ADJUSTMENT TO MISCELLANEOUS DEDUCTIONS:	
28. Enter your miscellaneous deductions from Schedule A (Form 1040), line 27, or Schedule A (Form 1040NR), line 13	
29. Enter your miscellaneous deductions from Schedule A (Form 1040), line 24, or Schedule A (Form 1040NR), line 10	
30. Multiply line 29 above by 2% (.02)	
31. Subtract line 30 from line 29. Enter the result (but not less than zero)	
32. Subtract line 31 from line 28	

***Note:** If you choose to waive the carryback period, and instead you choose to only carry your 2013 NOL forward, use Schedule A, Form 1045, to compute your 2013 NOL that will be carried over to 2014. Report your 2013 NOL from line 25, Schedule A, Form 1045, on the "other income" line of your 2014 Form 1040 or Form 1040NR, or the line on Form 1041 for deductions NOT subject to the 2% floor in 2014.

For Example 13

Table 1. (Continued)

TENTATIVE TOTAL ADJUSTMENT:			
33. Combine lines 18, 21, 24, 27, and 32, and enter the result here. If line 13 above is \$300,000 or less if married filing jointly or qualifying widow(er), \$275,000 or less if head of household, \$250,000 or less if single, or \$150,000 or less if married filing separately, also enter the result on line 7 above and stop here . Otherwise, go to line 34	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
ADJUSTMENT TO OVERALL ITEMIZED LIMIT:			
34. Enter the amount from Schedule A (Form 1040), line 29, or Schedule A (Form 1040NR), line 15 . . .	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
35. Add lines 17, 20, 23, 26, and 31, and the amounts on Schedule A (Form 1040), lines 9, 10, 11, 12, 14, and 28, or the amounts from Schedule A (Form 1040NR), lines 1 and 14	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
36. Add lines 17 and 27, the amount on Schedule A (Form 1040), line 14, and any gambling and casualty or theft losses included on Schedule A (Form 1040), line 28, or Schedule A (Form 1040NR), line 14	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
37. Subtract line 36 from line 35. If the result is zero, enter the amount from line 33 on line 7 above and stop here . Otherwise, go to line 38	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
38. Multiply line 37 by 80% (.80)	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
39. Subtract \$300,000 if married filing jointly or qualifying widow(er), \$275,000 if head of household, \$250,000 if single, or \$150,000 if married filing separately from the amount on line 13	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
40. Multiply line 39 by 3% (.03)	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
41. Enter the smaller of line 38 or line 40	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
42. Subtract line 41 from line 35. Enter the result (but not less than your standard deduction amount) . .	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		
43. Subtract line 42 from line 34. Enter the result here and on line 7	<table border="1" style="width: 100%; height: 20px;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%;"></td> </tr> </table>		

When losses from more than one NOL year are carried forward, the earliest year is used first. For taxpayers with numerous loss years, each year should be tracked separately to determine whether any of the NOLs have expired.

Caution. Some practitioners believe that subtracting line 25 from line 24 of Schedule A — NOL (Form 1045) is the easiest way to calculate the NOL carryforward for NOLs originating in prior years. (Schedule A — NOL is shown in **Example 11**.) Unfortunately, this is not an accurate method. Furthermore, tax software may not calculate the carryforward correctly.

Only the Table 1 worksheet of IRS Pub. 536 or Schedule B — NOL Carryover from Form 1045 yields the proper result. Practitioners are advised to **manually complete** one of these forms for each NOL year to verify the carryforward. (Schedule B — NOL Carryover is shown in **Example 12**.)

As mentioned earlier, if the return for the NOL year did not contain an election to forgo the carryback and no carryback claim has been made yet, the taxpayer has until the expiration of the statute of limitations period for the NOL year to file Form 1040X to claim a refund in the carryback years. (See **Example 7** for an illustration regarding the statute of limitations.) **If the statute for the NOL year has expired, the NOL carryforward must be calculated as if that NOL had been carried back to the applicable years.**

OTHER ISSUES

Change in Marital Status

If the taxpayer’s marital status is not the same for all the years involved in calculating the NOL carrybacks and/or carryforwards, only the spouse who had the loss can take the NOL deduction. On a joint return, the NOL carryback deduction is limited to the income of that spouse.

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Example 14. Brianne, a single taxpayer, has a 2014 NOL of \$200,000. In 2012, she had filed a joint return with Patrick, her former spouse. **They reported the following income for 2012.**

	Brianne	Patrick
Wages	\$50,000	\$300,000

The amount of the 2014 NOL that Brianne can deduct against their 2012 income is limited to her wages of \$50,000.

The refund for a person filing an NOL carryback against a joint return with a former spouse may be limited.

The **first limitation** is determined by a 2-part calculation. This limits the amount of the refund to:

1. The tax payments attributed to the person filing the carryback on the original joint return (**calculation 1**), **minus**
2. The taxpayer's share of the refigured tax after the NOL carryback (**calculation 2**)

Calculation 1 determines the amount of the taxpayer's contribution to the taxes paid on the original joint return. Only the amount of taxes paid that is attributed to the taxpayer may be refunded. The taxpayer's contribution is calculated using the following formula.

$$\begin{array}{r} \text{Any tax withholding from taxpayer's income} \\ + \text{Taxpayer's share of any tax estimates} \\ + \text{Taxpayer's share of any balance due paid} \\ - \text{Taxpayer's share of previous refunds} \\ \hline \text{Taxpayer's contribution} \end{array}$$

Unless there is an agreement or clear evidence of each spouse's contributions toward the payments of the joint tax liability, the taxpayer's share of the payments and refunds is determined based on the following formula.¹⁶

Step 1a. Calculate the tax in the carryback year for each spouse as if they filed MFS.

Step 1b. Compute each spouse's percentage of the total tax from the two MFS returns.

Step 1c. Multiply the payment or refund shown on the original joint return by the taxpayer's percentage of the total MFS tax.

The result is the taxpayer's share of tax payments and/or refunds used in the determination of their total contribution.

Calculation 2 determines the portion of the recomputed joint liability allocated to the taxpayer with the NOL carryback. The steps for this calculation are as follows.

Step 2a. Calculate the tax **after the NOL carryback** for each spouse as if they filed MFS.

Step 2b. Compute each spouse's percentage of the total tax from the two recalculated MFS returns.

Step 2c. Multiply the recomputed tax on the joint return after the NOL carryback by the taxpayer's percentage of the total MFS tax.

The result is the taxpayer's share of the joint tax liability.

The **second limitation** is that the taxpayer's refund cannot exceed the total refund calculated on the joint return after the carryback.

¹⁶ Rev. Rul. 80-7, 1980-1 CB 296.

Example 15. Use the same facts as **Example 14**. The tax on Brianne and Patrick’s original return was \$86,450. Brianne and Patrick’s original refund was \$7,170. They did not pay any tax estimates. Brianne had \$7,500 withheld from her wages and Patrick had \$86,120 withheld from his wages. The following chart shows the calculation for each taxpayer’s contribution to the taxes paid.

Brianne and Patrick Limitation 1, Calculation 1 — Allocation of Refund Calculation

	Brianne MFS	Patrick MFS	Total MFS
Total income	\$50,000	\$300,000	\$350,000
Tax withholding	\$7,500	\$86,120	
Step 1a Tax if each had filed MFS	\$ 6,099	\$ 86,975	\$ 93,074
Divided by: total MFS taxes	$\div 93,074$	$\div 93,074$	$\div 93,074$
Step 1b Percentage of total MFS taxes	6.553%	93.447%	100.00%
Multiplied by: original refund	$\times 7,170$	$\times 7,170$	
Step 1c Taxpayer’s share of joint refund	\$ 470	\$ 6,700	
Contribution to taxes paid	\$7,030	\$79,420	\$ 86,450

After carrying back \$50,000 of Brianne’s 2014 NOL, the recomputed tax using the MFJ status is \$69,472. Brianne and Patrick’s portions of the recomputed 2012 joint liability **after the NOL carryback** are calculated as follows.

Brianne and Patrick Limitation 1, Calculation 2 — Allocation of Recomputed Tax Liability

	Brianne MFS	Patrick MFS	Total MFS
Total income	\$50,000	\$300,000	\$350,000
Less: NOL carryback	(50,000)	(0)	(50,000)
Income after carryback	\$ 0	\$300,000	\$300,000
Step 2a Tax if each had filed MFS	\$ 0	\$ 86,975	
Divided by: total MFS taxes	$\div 86,975$	$\div 86,975$	
Step 2b Percentage of total MFS taxes	0.000%	100.000%	
Multiplied by: recomputed tax on MFJ return after NOL carryback	$\times 69,472$	$\times 69,472$	
Step 2c Taxpayer’s share of tax liability after NOL carryback	\$ 0	\$ 69,472	

Even though Brianne’s NOL may only be applied against her portion of the joint income, Patrick’s overpayment is directly attributable to Brianne’s NOL carryback. Therefore, he may file for a refund of his share of the payments.

Brianne and Patrick’s contribution to the taxes originally paid less their share of the tax after the NOL carryback are calculated as follows.

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	Brianne	Patrick
Limitation 1		
Calculation 1: Contribution to taxes	\$ 7,030	\$79,420
Calculation 2: Share of recomputed taxes	(0)	(69,472)
Maximum refund based on contributions to tax	\$ 7,030	\$ 9,948
Limitation 2		
Tax on original return	\$86,450	\$86,450
Tax after NOL carryback	(69,472)	(69,472)
Total potential refund from carryback of NOL	\$16,798	\$16,798
Tax Result		
Lesser of limitation 1 or 2	\$ 7,030	\$ 9,948

Brianne's maximum refund from carryback of the 2014 NOL based on her contribution to the **taxes paid is \$7,030**.¹⁷ Patrick is also entitled to a refund of \$9,948 from the taxes he paid.¹⁸

Caution. The IRS issued the following rulings that modify the preceding formulas for taxpayers in community property states.

- Rev. Rul. 2004-71, 2004-2 CB 74: Arizona and Wisconsin
- Rev. Rul. 2004-72, 2004-2 CB 77: California, Idaho, and Louisiana
- Rev. Rul. 2004-73, 2004-2 CB 80: Nevada, New Mexico, and Washington
- Rev. Rul. 2004-74, 2004-2 CB 84: Texas

Change in Filing Status but Not Marital Status

Special rules apply for calculating the NOL carryback and carryforward for couples who are **married to each other throughout the NOL carry years** but who use a mix of MFJ and MFS as their filing statuses in the carryback or carryforward years.

Separate Returns to Joint Return. If the taxpayer files an MFS return for the NOL year, the loss is treated as a joint loss on the MFJ return or returns to which it is carried.

Joint Return to Separate Returns. If the taxpayers file a joint return for the NOL year but are carrying the loss back or forward to an MFS return, the NOL must be calculated separately for each spouse. The NOL is recomputed as if each taxpayer had filed MFS in the NOL year. The NOL calculated on the joint return is allocated proportionately to each spouse based on each person's share of the total NOL as computed with the status of MFS for the NOL year.

Example 16. Cheri and Jared are married and file a joint return for 2013. They have an NOL of \$50,000. They carry the NOL back to 2011, which was a year in which they filed separate returns. Calculated separately, Cheri's NOL is \$18,000, and Jared's NOL is \$30,000. The sum of their separate NOLs (\$48,000) is less than their \$50,000 joint NOL because Jared's deductions included a \$2,000 net capital loss that is not allowed in calculating his separate NOL. The capital loss is allowed in calculating their joint NOL because it was offset by Cheri's capital gains.

Cheri's share of the \$50,000 joint NOL is \$18,750 ($\$50,000 \times (\$18,000 \div \$48,000)$). Jared's share of the joint NOL is \$31,250 ($\$50,000 \times (\$30,000 \div \$48,000)$).

¹⁷ Rev. Rul. 86-57, 1986-1 CB 362.

¹⁸ Ibid.

Death of the Taxpayer¹⁹

Business losses sustained by a decedent before death are deductible only on their final income tax return. No part of the NOL is deductible by the decedent's estate or carried over to subsequent years by a surviving spouse. However, the NOL **may** be carried back to prior years.

If the NOL was generated from jointly owned property, half of the NOL carryover belongs to the decedent and half belongs to the surviving spouse. This allows the surviving spouse to continue to carry over their share. However, the decedent's share of the carryover can only be used on the final return and any remaining amount is lost.

Alternative Minimum Tax

If any of the taxpayer's income or deductions are subject to AMT adjustments, the NOL must be recalculated to determine the **alternative tax NOL** (ATNOL), which can be applied to the AMT calculation in prior or future years. ATNOL is only adjusted for tax preferences when the preferences increased the amount of the NOL for regular tax purposes.²⁰

The following are some examples of differences that cause an ATNOL to be different from an NOL.

- Regular depreciation versus AMT depreciation²¹
- Passive activities involving farming and farm syndicates²²
- Limitations on itemized deductions²³

The amount of the ATNOL deduction is limited to the **sum of steps 1 and 2** as follows.²⁴

Step 1. The lesser of:

- The ATNOL, or
- 90% of the AMT income determined without regard to the ATNOL or the IRC §199 deduction (DPAD)

Step 2. The lesser of:

- AMT income — determined without regard to the ATNOL or the DPAD — less the amount determined in step 1, or
- The amount of the ATNOL attributable to carryforwards of 2008 and 2009 NOLs for which the election to use a 3-, 4-, or 5-year carryback was claimed²⁵

¹⁹ Rev. Rul. 74-175, 1974-1 CB 52.

²⁰ IRC §56(d)(2)(A).

²¹ IRC §56(a)(1).

²² IRC §58(a).

²³ IRC §56(b)(1).

²⁴ IRC §56(d)(1)(A).

²⁵ IRC §56(d)(3).

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Example 17. For 2014, Sheldon has an NOL carryforward from prior years. His ATNOL includes a qualified disaster loss from 2009 of \$4,000. He applies the ATNOL to his 2014 return to determine whether he owes any AMT.

Step 1.

- The ATNOL carryforward is \$80,000.
- His 2014 income for AMT purposes is \$70,000. Ninety percent of this is \$63,000.

The applicable step 1 amount is **\$63,000**.

Step 2.

- The AMT income of \$70,000 less the \$63,000 determined in step 1 is \$7,000.
- The portion of the ATNOL that is a 3-, 4-, or 5-year carryback from 2009 is \$4,000 from a qualified disaster loss.

The applicable step 2 amount is **\$4,000**.

Sheldon's total ATNOL deduction for 2014 is \$67,000, the sum of the results from steps 1 and 2.

FORM 982 ADJUSTMENTS TO NOLs

BACKGROUND

Income from discharge of indebtedness is usually taxable.²⁶ However, debt forgiveness is **not** taxable under the following conditions.

1. The debt is discharged in a bankruptcy proceeding.²⁷
2. The forgiveness occurs while the taxpayer is insolvent.²⁸
3. The debt is qualified farm indebtedness.²⁹
4. The debt is qualified real property business indebtedness.³⁰
5. The debt is qualified principal residence indebtedness that is discharged prior to January 1, 2014.³¹
6. The debt is a student loan forgiven in exchange for working a certain number of years in a particular area as part of a program designed to increase the number of professionals in certain underserved communities.³²

Note. For more information about the discharge of indebtedness, see the 2013 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Financial Distress.

²⁶ IRC §61(a)(12).

²⁷ IRC §108(a)(1)(A).

²⁸ IRC §108(a)(1)(B).

²⁹ IRC §108(a)(1)(C).

³⁰ IRC §108(a)(1)(D).

³¹ IRC §108(a)(1)(E).

³² IRC §108(f).

When debt forgiveness income is excluded from taxation because of **exceptions 1–5**, the taxpayer is required to reduce certain tax attributes by the amount not included in income.³³ Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, must be filed to report the reduction of the applicable attributes.

If the debt forgiveness is not taxable because of **exceptions 1–3**, the **NOL for the tax year of the discharge and any NOL carryforwards to that year are reduced first before any other tax attributes** unless the taxpayer elects to first reduce the basis of depreciable property before reducing other tax attributes.³⁴ IRC §1017 and Treas. Reg. §1.1017-1 provide additional information about applying the reduction to the basis of depreciable property.

If the debt forgiveness is not taxable because of **exception 4**, then the basis in the depreciable real property of the taxpayer is reduced.³⁵ If the debt forgiveness is not taxable because of **exception 5**, then the basis of the taxpayer’s principal residence is reduced. If the debt reduction is not taxable due to **exception 6**, then the Code does not require the reduction of any tax attributes.³⁶

APPLYING THE TAX ATTRIBUTE REDUCTION TO AN NOL

Reductions applied to NOLs are made **first to the current tax year**, then to the carryforwards in order of earliest to latest.

Example 18. Gendry has a blacksmithing business that he operates as a sole proprietorship on the accrual basis. It operated in the red for several years. In 2014, the business negotiates with its chief supplier to accept half of the entire balance due to the supplier. Prior to the agreement, Gendry is insolvent by \$130,000; that is, his debts are \$130,000 more than the fair market value of his assets. The agreement with the supplier allows his business to reduce its debt by \$100,000 and to remain in operation. Because the taxpayer is insolvent at the time the discharge occurs, he does not have to include the \$100,000 in his 2014 gross income.

Gendry has an NOL for 2014 of \$30,000 before any tax attributes are adjusted. He also has the following NOL carryforwards.

2011	\$20,000
2012	40,000
2013	75,000

The \$100,000 attribute reduction is applied in the following order to the NOLs.

Order Applied	NOL Year	NOL	Reduction Applied	Remaining NOL	Remaining Reduction	Notes
					\$100,000	Debt forgiven
1	2014	\$30,000	(\$30,000)	\$ 0	70,000	
2	2011	20,000	(20,000)	0	50,000	
3	2012	40,000	(40,000)	0	10,000	
4	2013	75,000	(10,000)	65,000	0	

³³ IRC §108(b).

³⁴ IRC §108(b)(5).

³⁵ IRC §108(c).

³⁶ See IRC §108.

The 2014 NOL is reduced first, then 2011 and 2012. After these reductions, there is \$10,000 remaining that reduces the NOL carryforward from 2013. Gendry has \$65,000 remaining from the 2013 NOL that he may use in future years.

Note. If Gendry were a cash-basis taxpayer, the debt forgiven by the supplier would not be includable in income. This is because payments to the supplier would have been deductible at the time they were paid instead of at the time the debt was incurred. In essence, the forgiveness of the debt and the cost of the supplies cancel each other.

PASS-THROUGH ENTITIES

S CORPORATIONS AND PARTNERSHIPS

A shareholder in an S corporation or a partner in a partnership may realize an NOL as a result of business losses passed through to the owners. Elections, such as waiving the carryback period, are made at the individual return level. However, tests such as the gross receipts test for eligible small business carrybacks are applied at the entity level.³⁷ The nature of the loss is also determined at the entity level. For example, losses from a partnership in the business of farming would qualify for the special 5-year carryback provisions on the individual's return.

A copy of the Schedule K-1 and any related calculations from the NOL year should be attached to the carryback/forward returns.

Caution. Although the pass-through activities may generate NOLs for the partner or shareholder, the loss for any particular year may be limited by the basis, at-risk, and passive activity rules. See *Dean v. IRS*³⁸ for an example of a taxpayer who lost his NOL carryback when he could not prove that he spent more than 500 hours working for the partnership that generated the loss.

FINAL YEAR OF THE ESTATE OR TRUST

Any unused NOL flows to the beneficiaries only on the **final return** of the estate or trust. The instructions for Form 1041, Schedule K-1, *Beneficiary's Share of Income, Deductions, Credits, etc.*, advise beneficiaries how to properly report the NOL on their returns. However, the preparer of Form 1041 must use the appropriate codes on the Schedule K-1 in order to facilitate the proper application of these instructions.

Generally, an unused NOL from the current year and from any carryforward years is reported to the beneficiaries on the Schedule K-1 as a **Code D** on line 11 (final year deductions). For individual beneficiaries, these deductions flow to Form 1040, line 21.

However, in the final year of the estate or trust, the unused NOL is classified as an excess deduction and reported as a **Code A** on line 11 of Schedule K-1. Code A deductions flow to Form 1040, Schedule A, line 23 (miscellaneous itemized deductions subject to the 2% limitation).

³⁷ Rev. Proc. 2009-26, 2009-19 IRB 935.

³⁸ *Dean v. IRS*, 2009-1 USTC 50,185 (9th Cir. 2008).

NOL WORKSHEETS

The following blank worksheets are provided to aid practitioners in allocating items between business and nonbusiness categories prior to preparing Form 1045, Schedule A — NOL.

NOL Worksheet 1

Allocation of Income between Business Income and Nonbusiness Income

Location on 2013 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 ^a	XXXXXXXX	XXXXXXXX	_____
D. Line 9a	Ordinary dividends	_____	Nonbusiness	XXXXXXXX	_____	_____
E. Line 10	Taxable refunds	_____	Allocate ^b	_____	_____	_____
F. Line 11	Alimony	_____	Nonbusiness	XXXXXXXX	_____	_____
G. Line 12	Business income (loss) Schedule C	_____	Business	_____	XXXXXXXX	XXXXXXXX
H. Line 14	Form 4797 gain (loss)	_____	Business	_____	XXXXXXXX	XXXXXXXX
I. Line 15b	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	_____	_____	_____
L. Line 18	Farm income (loss)	_____	Business	_____	XXXXXXXX	XXXXXXXX
M. Line 19	Unemployment compensation	_____	Business	_____	XXXXXXXX	XXXXXXXX
N. Line 20b	Taxable social security benefits	_____	Nonbusiness	XXXXXXXX	_____	_____
O. Line 21	Other income	_____	Allocate	_____	_____	_____
P. Total		_____		_____	_____	_____

^a Nontaxable interest is nonbusiness income for AMT purposes only.

^b 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.

NOTE: "XXXXXXXX" means that an amount cannot be added on that line.

2014 Workbook

NOL Worksheet 2

Allocation of **Deductions** between Business Deductions and Nonbusiness Deductions

Location on 2013 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 23	Educator expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
B. Line 24	Business expense of reservists, etc. ^a	_____	Business	_____	XXXXXXXX	XXXXXXXX
C. Line 25	HSA & MSA ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
D. Line 26	Moving expenses	_____	Business	_____	XXXXXXXX	XXXXXXXX
E. Line 27	SE tax deduction	_____	Business	_____	XXXXXXXX	XXXXXXXX
F. Line 28	SEP, SIMPLE, & qualified plans	_____	Nonbusiness	XXXXXXXX	_____	_____
G. Line 29	SE health insurance	_____	Business	_____	XXXXXXXX	XXXXXXXX
H. Line 30	Penalty, early withdrawal	_____	Nonbusiness	XXXXXXXX	_____	_____
I. Line 31a	Alimony	_____	Nonbusiness	XXXXXXXX	_____	_____
J. Line 32	IRA deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
K. Line 33	Student loan interest ded.	_____	Nonbusiness	XXXXXXXX	_____	_____
L. Line 34	Tuition & fee deduction	_____	Nonbusiness	XXXXXXXX	_____	_____
M. Line 40a	Standard deduction (if claimed)	_____	Nonbusiness	XXXXXXXX	_____	XXXXXXXX ^b

Schedule A (Form 1040) (Itemized deductions, if claimed)

N. Line 4	Medical	_____	Nonbusiness	XXXXXXXX	_____	c
O. Line 9	Taxes	_____	Allocate ^d	_____	_____	XXXXXXXX
P. Line 15	Interest	_____	Nonbusiness	XXXXXXXX	_____	e
Q. Line 19	Contributions	_____	Nonbusiness	XXXXXXXX	_____	_____
R. Line 20	Casualty	_____	Business	_____	XXXXXXXX	XXXXXXXX
S. Line 27	Misc. (2% floor)	_____	Allocate ^f	_____	_____	XXXXXXXX
T. Line 28	Other misc.	_____	Allocate ^g	_____	_____	_____
U. Total		_____		_____	_____	_____

^a Include only "other" items such as unreimbursed expenses of artists (IRC §62(b)). Do not include amounts reported on lines 23 through 35.

^b If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

^c The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

^d 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.

^e 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.

^f Because the amount on line 27, 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 27, 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 27, 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.

^g Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 28, Schedule A, are nonbusiness deductions.

NOTE: "xxxxxxx" means that an amount cannot be entered on that line.

NOL Worksheet 3

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

Where Loss Is Reported on 2013 Sched. D (Form 1040) ^a	Amount Reported on Tax Return	Disposition	Business	Nonbusiness
A. Lines 1, 2, and 3, column h	_____	Allocate ^b	_____	_____
B. Line 4, column h	_____	Allocate ^b	_____	_____
C. Line 5, column h	_____	Allocate ^c	_____	_____
D. Line 6, column h	_____	Allocate ^d	_____	_____
E. Lines 8, 9, and 10, column h	_____	Allocate ^b	_____	_____
F. Line 11, column h	_____	Allocate ^b	_____	_____
G. Line 12, column h	_____	Allocate ^c	_____	_____
H. Line 14, column h	_____	Allocate ^d	_____	_____
I. Total	_____		_____	_____

^a Enter the amount from the designated lines on Schedule D only if they are losses. Enter the amounts as positive numbers.

^b In most cases, losses reported on lines 1, 2, 3, 4, 8, 9, 10, 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 IRC §1221 asset rather than an IRC §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 TC 541 (1982).

^c 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 "b" for a discussion of when losses from an IRC §1221 asset may be treated as a business capital loss for purposes of the NOL calculation.

^d 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.

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NOL Worksheet 4

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

Where Gain Is Reported on 2013 Sched. D (Form 1040) ^a	Amount Reported on Tax Return	Disposition	Business	Nonbusiness
A. Line 1, column h	_____	Allocate ^b	_____	_____
B. Line 2, column h	_____	Allocate ^b	_____	_____
C. Line 3, column h	_____	Allocate ^b	_____	_____
D. Line 4, column h	_____	Allocate ^b	_____	_____
E. Line 5, column h	_____	Allocate ^c	_____	_____
F. Line 8, column h	_____	Allocate ^b	_____	_____
G. Line 9, column h	_____	Allocate ^b	_____	_____
H. Line 10, column h	_____	Allocate ^b	_____	_____
I. Line 11, column h	_____	Allocate ^d	_____	_____
J. Line 12, column h	_____	Allocate ^c	_____	_____
K. Line 13, column h	_____	Allocate ^b	_____	_____
L. Total	_____		_____	_____

^a Enter the amounts from the designated lines only if they are gains.

^b In most cases, gains reported on lines 1, 2, 3, 4, 8, 9, 10, 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, 3, 4, 8, 9, 10, and 13 of Schedule D (Form 1040) can be business capital gains if the asset on which the gain was realized was an IRC §1221 asset rather than an IRC §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 TC 541 (1982).

^c 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 "b" for a discussion of when gains from an IRC §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

^d 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 "b" for a discussion of when gains from an IRC §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.