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What are Net Operating Losses, How Can They Benefit You and What Would An Examiner Look For Under Audit?

What is a "net operating loss" (NOL)?

An NOL is the excess of business deductions (computed with certain modifications) over gross income in a particular tax year. A deduction is allowed for that loss, through an NOL carryback or carryover, in some other tax year(s).

Who can benefit from an NOL?

Individuals, Subchapter C corporations, estates and trusts and charitable organizations (with respect to the unrelated business income tax) can benefit from NOLs. Pass-through entities such as partnerships and Subchapter S corporations do not benefit from the NOLs themselves, but rather the pass through the benefit of the NOL to the partners or shareholders, respectively.

What are the carryback / carryforward rules?

The general rule is that NOLs may be carried back two years or forward 20 years. Tax legislation over the past three years, including The American Recovery and Reinvestment Act of 2009 and The Worker, Homeownership, and Business Assistance Act of 2009 modified this rule, however, by expanding the carryback period for losses incurred in 2008 and 2009 to up to five years. While these provisions do not apply to 2010 losses there remain expanded carryback provisions for certain types of farming and disaster related losses and expenses. A taxpayer may elect the carryforward over the carryback option by including a statement with his return. This election is irrevocable for the year in which it is made.

Can my NOL generate a refund?

Yes. A taxpayer may report a capital loss, net operating loss (NOL), or business credit a carryback by filing Form 1045 (individuals) or Form 1139 (corporations).

How do auditors review a taxpayer's use of NOLs?

The following are examples of how auditors review a taxpayer's use of NOLs for both individuals and corporations. The auditor will:

- Review or prepare a schedule of the net operating loss deductions and how they were carried back or over.
- Determine if a timely irrevocable election under IRC §172(b)(3) to relinquish the entire carryback period was made.
- Determine the correct NOL deduction ("NOLD") in the year under examination. Generally, this does not require the NOL year(s) to be put under examination though you are allowed to review any NOL year or carryover year in order to determine the correct NOLD in the year under examination. If the carryover NOLD includes nondeductible penalties (determined by examining the transcript for transaction codes—160s, 170s, 180s), reduce the carryover by the penalty amounts.
- When making current year adjustments, evaluate whether the issue existed in a prior year; it may result in reduction of the current NOL carryforward.
- Determine if the NOLD applied in consolidated returns and carried over from acquired entities meets the limitations of Code sections 381 and 382 and the SRLY rules under Reg. 1.1502.
- Determine if the contribution deduction was treated properly. There is no contribution deduction allowable in the NOL year or any carryforward year where taxable income is completely eliminated.
- Note: There are no changes for carryback years for contributions. (IRC §172(d)(5)).

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