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The Net Operating Loss Deduction

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The net operating loss deduction is a subject which is both important and somewhat complicated. Its importance lies in the fact that it is perhaps the principal means by which the Government shares in the adversity as well as prosperity of a taxpayer. The importance of the deduction is emphasized by the fact that it frequently arises at a crucial period in which a refund of income taxes is a prime consideration in financing a business. Another important aspect of the deduction is that it minimizes the importance of precise allocations of income or deductions between different years.

The complications arise from the fact that the determination of the deduction requires a series of very precisely defined and inter-related computations involving several years under, at the present time, at least two and sometimes more tax laws.

The net operating loss deduction was first provided by the Revenue Act of 1939, which allowed a carry-over of two years with no carry-back. The Revenue Act of 1942 added the carry-back concept. The carry-back and carry-over periods were further amended by the Revenue Acts of 1950 and 1951 and the Technical Changes Act of 1953. After the latest amendment the Internal Revenue Code of 1939 permitted a one year carry-back and a five year carry-over. The method of computation remained substantially unchanged until 1954.

The Internal Revenue Code of 1954 made some rather substantial changes with respect to the net operating loss deduction. In general, the 1954 Code extended the carry-back period to two years, liberalized the computation, and attempted to add more certainty with respect to the carry-over to successor corporations and the limitations on acquisitions of businesses for the purpose of securing such carry-overs. One of the more liberal features which is of particular interest in states such as West Virginia, which are rich in natural resources, is the elimination of the adjustments required with respect to percentage depletion.

In this discussion we will give attention first to the matter of carry-overs to successor corporations and subsequent owners, and second, to the computations required in determining the net operating loss deduction.

CARRYOVERS TO SUCCESSOR CORPORATIONS AND SUBSEQUENT OWNERS

The provisions of the 1954 Code which attempted to clarify the situation respecting carryovers to successor corporations and subsequent owners may best be understood by considering briefly some of the problems which arose under the 1939 Code. The 1939 Code included no specific provisions covering the situations in this area; consequently, the rules were developed through litigation. The general rule was established by the Supreme Court in the New Colonial Ice Co. case in 1934. Under this rule the carryover privilege depended upon the continuation of the corporate entity which incurred the loss. If the corporate identity was terminated through liquidation or reorganization, then the carryover was not available to the successor. Under this rule many valid business reorganizations were made awkward because of the need for retaining a loss corporation as the surviving corporate entity. Conversely, the rule tieing the carryover benefits to the corporate structure resulted in developing somewhat of a market for loss corporations. The usual pattern in which the transfer of the carryover benefits was accomplished was that a successful company would be merged into a loss company, care being taken to preserve the corporate entity of the latter, and the loss company would then change its name and continue the business of the successful company. To combat this practice, the Internal Revenue Service usually relied upon Section 129 of the 1939 Code which provided for disallowance of deductions, credits, etc. arising from transactions whose principal purpose was tax avoidance. The Service was not generally successful in such cases. Thus, it is evident that the absence of statutory provisions governing carryovers in liquidations and reorganizations created a damper on valid business transactions, traps for the unwary, and a premium on litigation.

It was against this background that Sections 381 and 382 were included in the 1954 Code. The Senate Finance Committee Report on the new Code states that the intent of these sections was to "...enable the successor corporation to step into the tax shoes of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law..." and to allow carryover items"...based upon economic realities rather than upon such artificialities as the legal form of the reorganization."

In general, Section 381 provides for a carryover of certain tax attributes, including the net operating loss carryover, to a successor corporation in the event of complete liquidation or certain reorganizations; and Section 382 provides special limitations on net operating loss carryovers in the case of certain reorganizations or purchases. Section 269 of the new Code should also be considered in relation to Section 382. Section 269 is basically a reenactment of the old Section 129, but the new section includes a presumption of tax avoidance which is designed to make it more effective. This statutory presumption applies where the consideration paid is substantially less than the aggregate of the adjusted basis of properties and the tax benefits. The Senate Finance Committee Report indicates that if the restrictive limitations of Section 382 do not apply, that does not prohibit the application of Section 269.

Section 381

Section 381 covers the carryover of nineteen separate tax attributes, one of which has been eliminated by the repeal of Section 452 relating to prepaid income. In addition to the net operating loss carryover, some of the more important attributes are: earnings and profits, capital loss carryover, method of accounting, inventory valuation method, depreciation method, pension, profit sharing and stock bonus plans, and unused charitable contributions.

Section 381 applies in the case of the acquisition of assets of one corporation by another in certain liquidations or reorganizations. The liquidations to which the section applies are complete liquidations of subsidiaries under Section 332, with one exception. The exception is the liquidation of a subsidiary where the cost of the stock of the subsidiary becomes the basis of the assets acquired. This exception is covered by Section 334 (b) (2) which enacted the Koppers Coal Co. and Kimbell-Diamond Milling Co. principle. It should be noted, also, that partial liquidations are not covered by Section 381.

The reorganizations which qualify for the carryover benefits of Section 381 are specifically enumerated, and no others qualify. The reorganizations which qualify are those referred to as types A, C, D, and F, which derive their designations from the respective subparagraphs of Section 368 (a) (1). These types may be described as follows:

Type A - A statutory merger or consolidation.

Type C - The acquisition of substantially all the properties of another corporation in exchange solely for voting stock of the acquiring corporation (or a corporation which is in control of the acquiring corporation).

Type D - Transfer of assets to a corporation when the transferor corporation or its shareholders are in control of the transferee corporation immediately after the transfer. Two additional requirements under this type of reorganization are that (1) the transferee corporation receives substantially all of the assets of the transferor, and (2) the stock, securities, or other property received by the transferor in exchange for its assets, together with any of its assets not exchanged, are distributed in pursuance of the plan of reorganization.

Type F - Change in identity, form, or place of organization.

You will notice that the Type B and E reorganizations are omitted from the above list of qualifying reorganizations. The Type B reorganization relates to the acquisition of the controlling stock of one corporation in exchange solely for voting stock of the acquiring corporation. The Type E reorganization is merely a recapitalization. It will be noted that neither of the omitted types of reorganization involves the loss of the corporate identity of the subject corporation. Therefore, it may be concluded that Section 381 will apply to any reorganization defined in Section 368 in which there is any necessity for its application.

If Section 381 applies, then there are certain operating rules which govern the treatment of the net operating loss carryovers of the predecessor corporations. Except in the case of the Type F reorganization, the taxable year of the predecessor corporation ends on the date of distribution or transfer; and the acquiring corporation may not carry back any of its own operating losses to a year of the predecessor corporation. Turning next to the computation of the carryover from the predecessor to the acquiring corporation, we find that the date of the transfer of the assets controls the amount which may be carried to the first year ending after the transfer. If the transfer is made on the last day of the taxable year of the acquiring corporation, then the entire carryover of the predecessor may be carried to the first succeeding year of the acquiring corporation. If the assets are transferred during the acquiring corporation's taxable year, then the carryover to that year is limited to the amount of taxable income earned by the acquiring corporation after the transfer. The period after the transfer of assets is referred to as the "post-acquisition part year" and the period before the transfer as the "pre-acquisition part year." The taxable income earned during the "pre- or post-acquisition part year" is determined by proration on a daily basis. No carryover from the predecessor corporation may be applied to income of the acquiring corporation which is allocable to the "pre-acquisition part year."

Section 382 (b)

While Section 381 provides for the carryover of net operating losses in the case of reorganizations, the amount of such carryover may be reduced under Section 382 (b). This section requires a reduction of the carryover if, after the reorganization, the stockholders of the loss corporation, whether it be the transferor or the acquiring corporation, own less than 20% of the fair market value of the outstanding stock of the acquiring corporation. The percentage of reduction is determined by subtracting the percentage of the value of the stock acquired in the reorganization from 20%, and multiplying by five. For example, if the stockholders of a loss corporation receive 12% of the stock of the acquiring corporation, the 12% acquired is subtracted from the statutory 20% and the remainder of 8% is multiplied by five, resulting in a reduction factor of 40% to be applied to the loss carryover of the predecessor. This reduction required by Section 382 (b) is not applicable if the stock of both the transferor and acquiring corporations is owned substantially by the same persons in the same proportion.

Section 382 (a)

Section 382 (a) provides a limitation on net operating loss carryovers in the case of certain purchases of the stock of corporations. It will be observed that this section differs from Sections 381 and 382 (b) which have just been discussed, in that it does not relate to carryovers from one corporation to another in liquidation or reorganization, but covers the disallowance of a carryover to a continuing corporation in the event of certain changes in ownership and business operations.

The entire net operating loss carryover will be disallowed under Section 382 (a) if, at the end of a taxable year, all of the following three conditions prevail:

1. One or more of the corporation's ten largest stockholders owns at least fifty "percentage points" more of the fair market value of the outstanding stock than such persons owned at the beginning of the taxable year, or at the begin-

ning of the prior taxable year.

2. The increase in such ownership resulted from purchase or a redemption of stock (except redemptions to pay death taxes).
3. After the change in percentage ownership, the corporation has not continued to carry on substantially the same trade or business.

In applying the above tests, the usual rules of constructive ownership of stock are applicable. Therefore, several related stockholders may actually count as one in applying this section.

The term "percentage points" is not the same as "percent." For example, a stockholder who owns 4% of a corporation's stock at the beginning of a year and 6% at the end, has increased his ownership by 50 "percent", but has increased his "percentage points" only 2.

The term "purchase" is defined in this section as meaning the acquisition of stock from an unrelated person in a transaction whereby the basis of the stock is its cost to the person acquiring it. This provision excludes the acquisition of stock in a tax-free exchange. Therefore, it appears that the restrictions of this section would not apply in a Type B reorganization, for example, where the controlling stock of a subsidiary is acquired in exchange solely for voting stock of the parent. This could be an important distinction if the subsidiary had a net operating loss carryover and it was desirable to make changes in the business operations of the subsidiary.

The final condition relating to a substantial change in the trade or business is one which is apt to cause the most trouble. The Code provides no criteria for measuring a substantial change, and no Regulations have been issued to date on this section. The Senate Finance Committee Report indicates that if "...the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business as was conducted before such increase, then the condition is met." The Conference Committee Report adds the comment that "...if the corporation continued to carry on substantially the same trade or business, the limitation would not be applicable even though the corporation also added a new trade or business." Under these circumstances it is very evident that much clarification of this section is needed.

COMPUTATION OF NET OPERATING LOSS DEDUCTION

We turn next to a consideration of the basic computations required in determining the net operating loss deduction. The nature of these computations is such that it is impractical to start a detailed discussion at any point except the very beginning. For this reason it will be necessary to cover some points which may seem rather elementary.

The terms which are used in the Code have very definite and precise meanings and it is important to have these clearly in mind. The more important terms which will be used in this discussion may be described generally as follows:

1. The "net operating loss" is the loss of any particular year computed in the specific manner prescribed in the Code.
2. The "net operating loss carryback" or "net operating loss carryover" is the amount of the net operating loss which may be carried from the loss year to any other year.
3. The "net operating loss deduction" is the amount of deduction which may be taken in the return for any particular taxable year, and is the end result of the series of computations.

This enumeration of terms also indicates the three separate steps which are necessary in computing the deduction. First, the net operating loss for the year must be computed. Second, the amount of carryback or carryover to other years must be computed. Third, the carrybacks and carryovers must be converted into the deduction.

Under the 1954 Code, losses must be carried back two years and carried forward five years; while the carryback was one year and the carryforward was five years under the latest amendment of the 1939 Code. Therefore, for several years we will have to be concerned with both the 1939 Code and the 1954 Code in connection with net operating losses. This is because the 1954 Code is applicable to the computations involving 1954 or any subsequent years and the 1939 Code governs any computations relating to years prior to 1954.

Explanation of Chart

The chart which has been distributed to you was prepared as a guide for reference in the following detailed discussion. This chart shows the factors involved in each of the three steps mentioned above under both the 1954 Code and the 1939 Code. Several general explanations should be made in connection with this chart. The chart purports to reflect all of the factors involved in the computations, but it has been necessary, of course, to sacrifice considerable detail in the interest of brevity. Items on the chart which pertain to corporations only are so indicated. Items which pertain to individuals, estates, and trusts, are indicated as being applicable to "individuals etc." Items which are not specifically designated as being applicable to either corporations or individuals, are applicable to all taxpayers. Items which relate to a specific deduction or credit in tax returns are so described in the chart. Adjustments which can be clearly described with brevity are so described, and items requiring more detailed explanation are described simply as "adjustments."

Referring now to the chart, we will attempt to discuss each item in the computations and consider the differences between the two Codes.

Step 1 - Computation of Net Operating Loss

It should be noted that the starting point for Step 1 is a loss; therefore, the items shown in the chart as eliminations have the effect of reducing the loss. The starting point in the computation is described in the same manner under both Codes except that the 1954 Code uses the term "modifications," where the 1939 Code used "exceptions and limitations." The term "modifications" will be used hereafter for convenience in referring to either Code. The similarity of description is somewhat deceptive since the term "deductions" used in both Codes does not always mean the same. This difference in the starting point for the computations leads to certain differences in the "modifications". However, these modifications are differences in form rather than substance, leading to the same end result under both Codes. In addition to the conforming modifications, the 1954 Code also made certain important substantive changes.

In the chart and discussion to follow, the modifications which are common to both Codes are covered first, and differences are covered second.

Any net operating loss deduction must be eliminated in the computation of the net operating loss of a current year. This may sound confusing, but it is actually quite simple and logical; and it emphasizes the need for careful distinction in terms. The "net operating loss deduction" is the deduction which may be taken in one year as a result of a "net operating loss" incurred in some other year. Therefore, the rule is simply that in computing the net operating loss incurred in one year, any deduction in that year arising from a carryback or carryover from another year is eliminated. The purpose of this elimination is to prevent a loss from being carried forward longer than the statutory period. For example, a 1954 loss may be carried forward through 1959; but if a part of the 1954 loss were deducted in a 1955 return and not eliminated in computing a 1955 net operating loss, it would become a part of the 1955 loss and thereby could be carried forward through 1960. This modification is required under both Codes and applies to all classes of taxpayers.

The capital gains and losses adjustment is required under both Codes, but applies only to individuals, estates and trusts. In some cases, this adjustment is inter-related with the adjustment for nonbusiness deductions. Therefore, each adjustment will first be considered separately, and then in combination.

The capital gains and losses adjustment requires that: (1) a net capital loss be eliminated, and (2) the deduction for 50% of net long-term capital gains be eliminated. The net result of the adjustment is that no net capital loss is allowed and a net capital gain is taken into consideration on a 100% basis. The following example illustrates the elimination of a capital loss. If a taxpayer had an ordinary loss of $25,000, net short-term capital gains of $5,000, and net long-term capital losses of $7,500, his return would show a loss of $26,000, consisting of the ordinary loss of $25,000 and $1,000 representing the maximum capital loss deductible in one year. In this case, the $1,000 capital loss would be deducted from the total loss of $26,000 in computing the net operating loss, leaving the $25,000 ordinary loss. The next example illustrates the conversion of a capital gain to a 100% basis. If a taxpayer had net short-term capital losses of $6,000 and net long-term capital gains of $10,000, his return would include a net capital gain of $2,000, composed of the actual net gain of $4,000 less the 50% deduction allowable for net long-term capital gains. If the ordinary loss were $25,000, the return would show a net loss of $23,000. The adjustment required in computing the net operating loss would be to reduce the $23,000 loss per return by the $2,000 long-term capital gain deduction, reducing the loss to $21,000. It will be noted that this produces the same result as reducing the ordinary loss of $25,000 by the actual capital gains of $4,000.

Since corporations are permitted no deduction for a net capital loss and no 50% deduction for long-term capital gains, the reason for requiring no adjustment in the case of corporations is obvious.

The nonbusiness deductions adjustment applies only to individuals etc., because all deductions of corporations are necessarily related to their business. This adjustment is required under both Codes, but the 1954 Code liberalized its application in one important respect. The basic rule is that nonbusiness deductions may not exceed nonbusiness income, or stated more simply, that net nonbusiness deductions must be eliminated in the computation of net operating loss.

The principal problem in this connection is the determination of what constitutes business or nonbusiness income and deductions. As you know, the term "trade or business" is used in several instances in the Code but is not defined, and this has been the subject of considerable controversy and litigation. Since this is almost a separate subject in itself, no attempt will be made to cover it in this discussion, except to point out two specific exceptions in the Code. After December 31, 1950, casualty losses were not considered as nonbusiness losses under the 1939 Code, and this provision was continued in the 1954 Code. Under the 1939 Code, losses from the sale of land or depreciable business property were generally held to be <u>nonbusiness</u> losses under the theory that the sale of such assets was not a part of the business <u>regularly</u> carried on by the taxpayer. This question was resolved favorably for taxpayers in the 1954 Code, which provides that such losses are attributable to the taxpayer's trade or business.

If nonbusiness capital gains and losses are involved, these must be considered in their dual character as capital gains and losses and as nonbusiness income and deductions. Because of their capital gain or loss character they must first be converted to a 100% recognition basis. Secondly, they must be considered in relation to their nonbusiness character. The Regulations under the 1939 Code indicate that, if there is a net nonbusiness capital gain, ordinary nonbusiness deductions may be applied against the net nonbusiness capital gain; and that if there is a net nonbusiness capital loss, this loss may not be offset against either business capital gains or ordinary nonbusiness income. The latter situation may be illustrated by the following example. If a taxpayer has business capital gains of $6,000, non-business capital losses of $5,000, ordinary nonbusiness income of $2,000, and ordinary business net losses of $10,000, the return would show a net loss of $7,000. It is assumed that the capital gains were short-term so that the amounts are already stated on a 100% basis. Therefore, the nonbusiness capital loss of $5,000 would be deducted from the loss of $7,000 per return to arrive at a net operating loss of $2,000.

In the 1954 Code there is a slight change in the phraseology of the modification relating to nonbusiness deductions. This change is not mentioned as a substantive change in the Senate Finance Committee

Report, and I have noticed no comment in the tax services, but it appears that the effect may be to liberalize the modification in situations such as the one covered by the foregoing illustration. This possibility as applied to the foregoing example would be to offset the $2,000 of ordinary nonbusiness income against the nonbusiness capital loss of $5,000, leaving a net operating loss of $4,000.

The foregoing discussion covers the modifications which are common to both Codes. Turning now to those which differ, we will consider first those under the 1954 Code and then those under the 1939 Code.

The modifications requiring elimination of the partially tax-exempt interest deduction, the Western Hemisphere trade corporation deduction, and the personal exemptions deduction are all new in the 1954 Code, but are changes in form only to conform to the structure of the new Code. All of these items are "deductions" under the 1954 Code, but were "credits" under the 1939 Code. As "deductions" they are included in the starting point for computing a net operating loss under the 1954 Code, and, therefore, their elimination is achieved by including them among the required "modifications". As "credits" under the 1939 Code these items were not included in the starting point for computing a net operating loss, and hence there was no need for their being eliminated.

The 1954 Code liberalized the computation in relation to intercorporate dividends received. This liberalization was more than is indicated by the modification in the Code and the chart we are using. In general, the 1954 Code allows a "deduction" for 85% of intercorporate dividends received, while the 1939 Code allowed a corresponding "credit". Since this deduction is not included among those which must be eliminated under the 1954 Code, the result is that the dividends received deduction is included in computing a net operating loss. Under the 1939 Code the dividends received credit was not allowed in computing a net operating loss. This more favorable treatment under the new Code is not readily evident from the chart.

Under the 1954 Code the general deduction for 85% of intercorporate dividends received is limited to 85% of the taxable income before the dividends received deduction and the net operating loss deduction. Therefore it is possible that the dividends received deduction may be less than 85% of the actual dividends. In such cases, the modification shown on the chart allows the deduction to be increased to 85% of the actual dividends received.

The deduction for dividends paid on certain preferred stock of public utilities was treated in the 1954 Code in a manner similar to that just discussed in relation to the dividends received deduction. That is, the deduction itself is now permitted, and the limitation relating to taxable income is removed for purpose of computing a net operating loss.

Under the 1939 Code it was necessary to eliminate the excess of percentage or discovery depletion over cost depletion in computing a net operating loss. This requirement was omitted from the 1954 Code. For taxpayers who are eligible for percentage depletion, this change may be very important because the excess of percentage depletion over cost depletion is frequently a substantial amount.

Under the 1939 Code it was also necessary to eliminate the excess of wholly tax-exempt interest over any interest which was nondeductible because of being incurred to carry tax-exempt securities. This requirement was also omitted from the 1954 Code.

This completes the discussion of Step 1, the computation of the net operating loss for a particular year.

Step 2 - Computation of Carrybacks and Carryovers

The second step in computing the net operating loss deduction is to compute the amount of the carryback or carryover from each loss year to the year in which the deduction is to be taken. This problem involves two phases, as shown by the chart which you have for reference. The first phase is the computation of the carryback to the earliest year to which a net operating loss may be carried under the Code applicable to the loss year; and the second phase is the computation of the amount which may be carried to a subsequent year.

As shown by the chart, the carryback to the earliest year, under either Code, is simply the net operating loss as computed in Step 1. The only problem at this stage is to determine the earliest year to which the loss may be carried. This is important, of course, because both Codes require that the loss must first be carried back to the earliest year and then to later years. Under the 1954 Code, losses must be carried back two years, except that the two-year carryback cannot be utilized to recover any excess profits tax. Under the latest amendment to the 1939 Code the carryback period was only one year. Under both Codes the carryover period is five years.

The next phase of the computations under Step 2 is to determine the carryback to a later prior year or the carryover to a subsequent year. For example, if a net operating loss for 1954 is not completely absorbed by the carryback to 1952, it then becomes necessary to compute the carryback to 1953. It should be noted in passing that the amount to be computed for 1953 is still a "carryback" from 1954 - not a "carryover" from 1952. Continuing the example, if the 1954 loss is not completely absorbed by the carrybacks to 1952 and 1953, then the "carryover" to 1955 must be computed. In this illustration, the years 1952 and 1953 are "intervening years." The amount which may be carried to any year other than the earliest year of carryback, is determined in general by deducting from the net operating loss the taxable income of the intervening years. However, here again, the taxable income of the intervening years must be computed with certain specific modifications. These modifications are similar, but not identical, to those required under Step 1.

Referring again to the chart, you will see that the first modification is to eliminate any net operating loss deduction attributable to the loss year or any year thereafter. This modification is the same under both Codes, but is not quite the same as the related modification under Step 1. The purpose of this modification is to assure the application of losses in the order and over the periods prescribed by the Code. This modification may be illustrated by the following example. Assume that a taxpayer's return shows a net operating loss deduction of $45,000 for the year 1952, consisting of a carryover of $5,000 from 1950, a carryover of $10,000 from 1951, and a carryback of $30,000 from 1953; and assume that the taxable income before the net operating loss deduction is $25,000. In this case the return would show a final loss of $20,000; this being the income for the year of $25,000, reduced by the net operating loss deduction of $45,000. The problem involved in the step being discussed is to compute the amount of the 1953 loss which is available as a carryover to 1954. The starting point is the $20,000 loss shown on the return for 1952. This loss of $20,000 must then be "modified" by eliminating the net operating loss deduction attributable to the loss year or any year thereafter. In this case 1953 is the loss year, and 1952 is the intervening year. Therefore, the portion of the net operating loss deduction which is attributable to the 1953 carryback, or $30,000, is eliminated. This converts the $20,000 loss shown on the 1952 return to an income of $10,000. This $10,000 deducted from the 1953 carryback of $30,000, leaves $20,000 available as a carryover to 1954. You will observe that the net result of the somewhat involved mechanics of the modification is that the 1950 and 1951 losses are applied first to the

1952 income, the remaining 1952 income is offset by the carryback from 1953, and the unused portion of the 1953 carryback is then available as a carryover to 1954.

The last item shown in the chart under the 1939 Code will be discussed next, since it is closely related to the adjustment we have just considered. This adjustment provides for adding back to the net operating loss deduction of the intervening year any reduction which was required in converting the carrybacks and carryovers to the intervening year into the deduction for that year. This reduction is that which would have been made under Step 3 in computing the net operating loss deduction taken on the return for an intervening year. This will be covered in more detail later. At this point we will consider its elimination only in relation to the intervening years. This may be illustrated by using the same facts as in the example used a moment ago and assuming, in addition, that a reduction of $2,000 was required in computing the net operating loss deduction for 1952. The deduction for that year would be $43,000, composed of carryovers totaling $15,000 from 1950 to 1951, and a carryback of $30,000 from 1953, less the $2,000 reduction under Step 3 for the year 1952. In the adjustment discussed above, the $30,000 carryback from 1953 would be eliminated, leaving a remainder of $13,000. In the adjustment being discussed now, the $2,000 reduction would be restored, bringing the net operating loss deduction to be taken into account for the intervening year up to $15,000. Here again, you will note that the net result is to take into account in the intervening year the amount of the carryovers from 1950 and 1951. It bears repeating, that the computations under Step 2 must be made separately for each loss year.

The capital gains and losses adjustment to be applied in intervening years is the same under both Codes, and is the same as discussed under Step 1 except that under Step 2 no distinction is required between business and nonbusiness capital gains and losses.

The remaining modifications shown in the chart under Step 2 are computed in the same manner as discussed under Step 1. It should be noted that the modification for nonbusiness deductions required under Step 1 is not required under Step 2.

Step 3 - Computation of Net Operating Loss Deduction

Up to this point, we have discussed the computations required in the loss year to determine the net operating loss, and those required in intervening years to determine the amount of carryback or carryover to other years. The final step is to compute the net operating loss deduction to be taken in the return of a particular year. As shown by the chart, the starting point for the third computation is the total of the carrybacks and carryovers to the year in which the deduction is to be taken. Under the 1954 Code this total becomes the deduction without any further modification. The removal of the requirement for any modifications in this computation was one of the more favorable changes under the 1954 Code. The chart shows the modifications required under the 1939 Code. These modifications are computed in the same manner as described under Step 1 except that no distinction is required between business and nonbusiness capital gains and losses.

Check List of Modifications

A check list of modifications has also been prepared to supplement the chart showing the steps involved in the computation of the net operating loss deduction. The check list shows all of the modifications covered by the chart and foregoing discussion rearranged to show the computation step number and year in which the modification is applicable under both Codes.

CHART SHOWING STEPS INVOLVED IN COMPUTATION OF NET OPERATING LOSS DEDUCTION

1954 CODE	1939 CODE
STEP 1 - COMPUTATION OF NET OPERATING LOSS	
Excess of allowable deductions over gross income, computed with the following "modifications": Eliminate: Net operating loss deduction. Capital gains and losses adjustment (individuals etc.). Nonbusiness deductions adjustment (individuals etc.). Partially tax-exempt interest deduction (corporations). Western Hemisphere trade corporation deduction (corporations). Personal exemptions deduction (individuals etc.). Restore - Increase in deductions resulting from removal of limitations relating to deductions for: Dividends received (corporations). Dividends paid on certain preferred stock of public utilities (corporations).	Excess of allowable deductions over gross income, computed with the following "exceptions and limitations": Eliminate: Net operating loss deduction. Capital gains and losses adjustment - may be an increase for 1951 or prior (individuals etc.). Nonbusiness deductions adjustment (individuals). Excess of percentage or discovery depletion over cost depletion. Excess of wholly tax-exempt interest over non-deductible interest.
STEP 2 - COMPUTATION OF CARRYBACKS AND CARRYOVERS	
Carryback to earliest year to which loss may be carried - Net operating loss. Carryback to later prior year, and carryover to subsequent years: Net operating loss. Eliminate - Taxable income of the intervening years, computed with the following "modifications" (in no case to be less than zero):	Carryback to earliest year to which loss may be carried - Net operating loss. Carryback to later prior year, and carryover to subsequent years: Net operating loss. Eliminate - Net income of the intervening years, computed with the following "exceptions and limitations" (in no case to be less than zero):

1954 CODE	1939 CODE
STEP 2 - COMPUTATION OF CARRYBACKS AND CARRYOVERS (CONTINUED)	
Eliminate: Net operating loss attributable to the loss year or any year thereafter. Capital gains and losses adjustment (individuals etc.). Partially tax-exempt interest deduction (corporations). Western Hemisphere trade corporation deduction (corporations). Personal exemptions deduction (individuals etc.).	Eliminate: Net operating loss deduction attributable to the loss year or any year thereafter. Capital gains and losses adjustment - may be an increase for 1951 or prior (individuals etc.). Excess of percentage or discovery depletion over cost depletion. Excess of wholly tax-exempt interest over non-deductible interest. Restore - Reduction required in converting carrybacks or carryovers into deduction (see Step 3).
STEP 3 - COMPUTATION OF DEDUCTION	
Total of carrybacks and carryovers to the year in which the deduction is to be taken.	Total of carrybacks and carryovers (to the year in which the deduction is to be taken): Eliminate (for the year in which the deduction is to be taken): Capital gains and losses adjustment (individuals etc.). Excess of percentage or discovery depletion over cost depletion. Excess of wholly tax-exempt interest over non-deductible interest. Partially tax-exempt interest credit (corporations). Dividends received credit (corporations).

CHECK LIST SHOWING MODIFICATIONS REQUIRED
IN COMPUTATION OF NET OPERATING LOSS DEDUCTION

	STEP 1- LOSS YEAR		STEP 2- INTERVENING YEARS		STEP 3- DEDUCTION YEAR	
MODIFICATIONS	1954 CODE	1939 CODE	1954 CODE	1939 CODE	1954 CODE	1939 CODE
Net operating loss deduction:						
Deduction.	x	x				
Deduction attributable to the loss year or any year thereafter.			x	x		
Reduction required in converting carrybacks and carryovers into deductions.				x		
Capital gains and losses adjustment (invididuals etc.).	x	x	x	x		x
Nonbusiness deductions adjustment (individuals etc.).	x	x				
Partially tax-exempt interest (corporations).	x		x			x
Western Hemisphere trade corporation deduction (corporations).	x		x			
Personal exemptions deduction (individuals etc.).	x		x			
Dividends received (corporations):						
Increase in deduction resulting from removal of limitations.	x					
Credit.						x
Dividends paid on certain preferred stock of public utilities - increase resulting from removal of limitation (corporations).	x					
Excess of percentage or discovery depletion over cost depletion.		x		x		x
Excess of wholly tax-exempt interest over nondeductible interest.		x		x		x