1961

Net operating loss tax relief

Robert J. Mooney

Recommended Citation
Quarterly, Vol. 07, no. 1 (1961, March), p. 08-22

Losses of one year may be tax deductible for another. Here is an article explaining the problems in obtaining—

NET OPERATING

THE PRACTICE OF USING ANNUAL PERIODS TO DETERMINE TAXABLE INCOME and graduated income tax rates to compute the tax liability creates a hardship for taxpayers whose income is subject to wide fluctuation. The problem is intensified for the taxpayer who has the misfortune to incur a business loss in a year in which the loss will be of no tax benefit because of lack of other income to offset the loss. Congress has recognized this inequity and has provided partial relief by providing for the offset of losses against profits of other years. The relief is not, however, a direct offset. Congress has limited the offset of loss against profit by requiring certain adjustments in determining the amount of loss of one year available to offset profit of another year.

Rules, adjustments, and modifications described in this article are applicable to the current law. The only significant changes in the law since 1954 were enacted in 1958 and 1960. The changes in 1958 pertain to the increase in the number of years subject to carryback, allocation of losses arising in fiscal years ending in 1958 and 1954, disallowance of net operating loss deductions to corporations electing to be

LOSS TAX RELIEF

by Robert J. Mooney

Seattle Office

taxed under the provisions of Subchapter S, a so-called clarification of the interrelation of corporation charitable contribution carryovers and net operating loss carryovers, and an amendment pertaining to life insurance companies in corporate acquisitions. The change in 1960 pertains to real estate investment trusts.

The effect of changes in a corporation's structure or ownership upon net operating loss deductions and the special provisions applicable to insurance companies are not covered in this article.

GENERAL RULES

Eligibility

Almost all taxpayers are entitled to the deduction for net operating loss. Excepted from this privilege are certain regulated investment companies, real estate investment trusts, corporations electing under Subchapter S, and certain life and mutual insurance companies other than marine companies. The net operating loss is not deductible in computing accumulated taxable income (in connection with unreasonable accumulations), undistributed personal holding company income, or undistributed foreign personal holding company income. Personal holding companies (both domestic and foreign), however, may carry over the net operating loss of the preceding taxable year.

Period of offset

The maximum period involved in offset of net operating loss and profit can be as long as nine years—the year of loss, three years preceding and five years succeeding the year of loss. Loss must be offset against profit in succession, first being offset against the third preceding year, then the second preceding year and so on until either the entire loss is offset against profit, or the period allowable for carryover expires. The number of years preceding the year of loss subject to the carryback of the loss was extended from two to three years in 1958 for any year beginning after December 31, 1957.

A short taxable period as, for example, one resulting from a change in accounting period or from dissolution of a corporation, is the "taxable year" for the purpose of determining carrybacks and carryovers. A net loss sustained during a short taxable period may not be annualized for carryback or carryover purposes.

A taxable year for which an election is in effect for a "tax option corporation" is counted as a taxable year to which the net operating loss is carried back or forward. However, the taxable income for such a year is treated as if it were zero for the purpose of computing the balance of the loss available as a carryback or carryover to years not covered by an election.

Definition of terms

In order to understand the adjustments applicable to the various periods involved in the use of a net operating loss carryback or carryover, it is necessary to define certain terms to identify amounts or periods. A "net operating loss" is the excess of the deductions allowable under the income tax laws over the gross income, adjusted by certain modifications which will be enumerated below. The "net operating loss carryback" is the loss which is available for offset against the profit of a year preceding the year of loss. A "net operating loss carryover" is the loss which is available for offset against the profit of a year succeeding the year of loss. The "net operating loss deduction" is the aggregate of the net operating loss carrybacks and carryovers available for a particular year. An "intervening year" is any year having a profit (after required adjustments or modifications) which is *less* than the net operating loss deduction available for that year. A "year of final deduction" is any year having a profit (after required adjustments or modifications) which is *more* than the net operating loss deduction available for that year. It is quite important to have in mind the difference between an intervening year and a year of final deduction, since modifications to income of a year vary depending on the nature of the year.

Computation of net operating loss deduction

The goal in applying the various adjustments and modifications is, of course, to arrive at the proper taxable income for a particular year after the net operating loss deduction. There are three steps in ascertaining the taxable income after deducting the net operating loss deduction. The first step is the computation of the net operating loss which becomes the carryback or carryover. The second step is the computation of taxable income after net operating loss deduction has been taken into account in the year of final deduction. If the available net operating loss deduction is more than the taxable income of a year as modified in the second step, the year is an intervening year and a third step is required. The third step is the computation of taxable income of an intervening year to determine the amount of net operating loss deduction available to succeeding years. Since the adjustments in carrying out these steps for corporate taxpayers differ from those for noncorporate taxpayers, we will discuss each type taxpayer separately.

CORPORATE TAXPAYERS

Net operating loss (step one)

The code provides an inverse method of calculating the net operating loss. Instead of determining what can be included in the net operating loss, the entire amount of the excess of the allowable deductions over includable income for a taxable year is first determined and this amount is then reduced by those items which cannot be included in the net operating loss. This leaves a figure which is the statutory net operating loss. The following items cannot be included in the net operating loss in the case of corporation.

No net operating loss deduction is allowed. This requirement is, of course, necessary to hold the maximum number of years available for a deduction of a loss carryover to the years allowed by law, i.e., three years preceding and five years succeeding the year of loss.

The Western Hemisphere Trade Corporation deduction and the deduction for partially tax exempt interest are not allowed.

If the deduction for dividends received would result in a net operating loss, it is allowed without the limitation of 85% of taxable income. This is of considerable importance to any loss corporation having substantial dividend income. In fact, a lower operating result may produce an income tax advantage in certain circumstances for a loss corporation with dividend income.

The following example illustrates the difference in results in a hypothetical situation comparing two corporations having equal dividend income and a difference of only $2 in operating loss:

	Corporate taxpayer	
	A	B
Dividends received from domestic corporations	$100,000	$100,000
Other income	200,000	200,000
Total gross income	$300,000	$300,000
Allowable deductions	215,001	214,999
Taxable income before deduction for dividends received	$ 84,999	$ 85,001
Deduction for dividends received	85,000	72,252
Net operating loss or taxable income	$ (1)	$ 12,749

Since corporate taxpayer "A" has a net operating loss, the limitation on dividends received deduction is nullified and 85% of dividends is allowed as a deduction even though this amount is more than 85% of taxable income before the deduction for dividends received.

Net operating loss carryback or carryover (steps two and three)

The net operating loss as determined above becomes, without change, a net operating loss carryback to the third taxable year preceding the year of loss. If this is the only loss available for carryback or carryover to the third preceding year, the loss carryback becomes the net operating loss deduction for that year. If the net operating loss deduction is less than the taxable income of the third preceding year, the third preceding year is the year of final deduction and no adjustment to taxable income is required other than the net operating loss deduction. The third preceding year would be considered an intervening year if the net operating loss deduction is more than the taxable income of that year. To determine whether any part of the loss remains to be used in years following the third preceding year, the taxable income of that year must be adjusted for any deduction for partially tax exempt interest or the special deduction allowed for Western Hemisphere Trade Corporations. This adjustment, however, does not relate to the determination of tax liability for the year in which a net operating loss deduction is claimed. It is solely for the purposes of determining the amount of net operating loss deduction which is available for the succeeding year.

Charitable contribution deductions

The code sections applicable to charitable contribution deductions specify that no adjustment should be made to the maximum allowable charitable contribution because of any reduction in taxable income by a net operating loss deduction arising in a year succeeding the year of contribution. The law is specific in reference to contributions in years involved in net operating loss carry*backs* as compared to years involved in net operating loss carry*overs*. This applies to both corporate and noncorporate taxpayers. The theory in allowing the contribution deduction without reduction for loss carrybacks seems to be that the taxpayer should not lose the benefit of the deduction for charitable contributions if the contributions were made in a year prior to the loss year. The taxpayer had no way of knowing that future events would reduce its taxable income in the year the contributions were made. The taxpayer, therefore, is not penalized for events happening in a year subsequent to the year of contribution.

NONCORPORATE TAXPAYERS

Nature of loss

Losses must be from a "trade or business" to qualify as a net operating loss deduction. The nature of income is also the controlling feature in certain adjustments required to determine the amount of profit offset by a net operating loss carryover or carryback.

Just what activity constitutes a "trade or business" has never been completely clear nor necessarily consistent. There are, however, some general areas that are reasonably well defined which can be used as guides to determine whether or not the income or loss is from a "trade or business" for net operating loss purposes.

Some normal consideration in this respect are: the continuity of the business; the amount of time and energy devoted to the activity by the taxpayer; and whether the taxpayer is engaged in earning a livelihood, in investment activities, or in the pursuit of pleasure or an avocation. Any one taxpayer can be engaged in more than one "trade or business" at the same time.

Income may be considered as arising from a taxpayer's trade or business even though the business was not carried on in the current year, so long as it is derived from a business which the taxpayer had carried on in another year.

Generally, for net operating loss purposes, the renting of improved real estate constitutes carrying on a trade or business, regardless of whether the taxpayer engages in any other trade or business at the same time.

Casualty and theft losses are specifically treated as business losses for net operating loss purposes.

Losses from the sale of depreciable assets or real estate used in a trade or business can produce a net operating loss.

Salaries or wages constitute income derived from a trade or business for net operating loss purposes. In one instance, the repayment of compensation received in a previous year has been treated as a net operating loss by the courts.

The Supreme Court has ruled that since a corporation and its stockholders are separate entities, losses by an investor due to the failure of a corporation in which he owns stock is not a statutory net operating loss, even though he was a majority stockholder and managed the corporation's affairs. Losses of a stockholder in a corporation would be a nonbusiness capital loss even if the business of the corporation were related to the individual's own business. However, changes in the law made in 1958 established special opportunities for investment in stocks under which losses, if any, would not be treated as capital losses, but rather as ordinary losses incurred in a trade or business of the taxpayer. These special provisions have been the subject of numerous articles. For example, see *Journal of Accountancy,* January, 1959.

An individual, by reason of being a partner in a business, is considered to be engaged in a trade or business of his own. Similarly, the net operating loss, which is allocated to the stockholders of a "tax option" corporation operating under the provisions of Subchapter S, is treated as a net operating loss of the individual stockholders. "Tax option" corporation losses cannot, however, be carried back by stockholders to years prior to 1958.

An individual can also receive the benefit of a net operating loss if he is the beneficiary of an estate or trust which terminates with unused net operating loss carryovers. In such case, the year of termination of the estate or trust and the year of the individual in which the last day of the trust or estate year falls are each considered to be taxable periods in determining the number of periods available for carryover of unused net operating loss deductions.

The net operating loss deduction is applied against income generally. That is, it is not restricted to application against business income. If it more than offsets business income, or if there is no business income, the net operating loss deduction is automatically applied against nonbusiness income or capital gain.

Net operating loss (step one)

The concept of statutory determination of net operating loss applicable to noncorporate taxpayers is the same as the concept applicable to corporate taxpayers. That is, excess of the allowable deductions over includible income for the taxpayer is first determined, and this amount is then reduced by those items which cannot be included in the net operating loss.

No net operating loss deduction is allowed in computing the net operating loss for a taxable year. As in the case of corporations, this requirement is necessary to limit the number of years available for use of net operating loss carryovers.

No deduction for personal exemptions is allowable. Deductions in lieu of personal exemptions for estates and trusts are also disallowed.

No long-term capital gain deduction is allowable and the nonbusiness capital losses may not exceed the nonbusiness capital gains.

Ordinary nonbusiness deductions may not exceed the ordinary nonbusiness gross income plus the excess of the nonbusiness capital gains over the nonbusiness capital losses. If a capital loss includes a carryover from a prior year, the business and nonbusiness capital losses included in the carryover must be segregated.

An example of business capital loss is loss incurred on securities held in an investment account by a dealer in securities. However, securities held by a dealer for sale to customers are not capital assets. Accordingly, a gain or loss on the sale of these securities would result in ordinary income or loss. Capital gain or loss incurred by an investor in securities is nonbusiness capital gain or loss.

A gain or loss from the sale of real estate or depreciable property used in business is a business gain or loss. A net gain from these sales is afforded capital gain treatment under section 1231, and is a business capital gain. A net loss from these sales is afforded ordinary loss treatment and would not be offset against capital gains.

Net operating loss carryback or carryover

As in the case of corporate taxpayers, a net operating loss of a noncorporate taxpayer becomes, without change, a net operating loss carryback to the third preceding year. Certain modifications to income are required to determine either the taxable income after net operating loss deduction (year of final deduction), or the income (of intervening year) that offsets the net operating loss in determining the loss available, if any, for succeeding years. As stated above, the modifications vary somewhat for year of final deduction and for intervening years.

Year of final deduction (step two)

The only adjustments required in a year of final deduction are modification of items based on a percentage of adjusted gross income or taxable income. The modifications in this instance are made after deducting all net operating loss carrybacks and carryovers available for the year. These modifications are for the purpose of determining tax liability.

Intervening Year (step three)

In an intervening year, any long-term capital gain deduction and any excess of nonbusiness capital loss over nonbusiness capital gain must be added back to income. Also, the income is computed without the deduction for personal exemptions or the deduction allowed estates and trusts in lieu of personal exemptions.

Items based on a percentage of adjusted gross or taxable income must also be recomputed in an intervening year. As in the case of corporations, a net operating loss carry*back* does not reduce the allowable charitable contribution. Actually, the allowable charitable contribution might be increased. This could be the circumstance if a long-term capital gain deduction or a deduction for a capital loss had been taken in the year of the contribution and a net operating loss deduction is available in excess of the taxable income for the year of contribution.

As pointed out above, the long-term capital gain deduction or the deduction for excess of capital loss over capital gain would have to be added to taxable income in an intervening year to determine the amount of income to offset the net operating loss deduction. The allowable charitable contribution is computed on the increased adjusted gross income after adding back the long-term capital gain deduction or after adding back any deduction for capital loss in excess of capital gain, but before deducting the net operating loss deduction. This sequence of modification increases the maximum allowable charitable contribution deduction. Assume, for purposes of illustration, that the only itemized deduction is a charitable contribution of $4,000.

	Before Modification	After Modification
Gross income		
Salary	$ 9,000	$ 9,000
Capital gain	2,000	2,000
	$11,000	$11,000
Capital gain deduction	1,000	—
Adjusted gross income	$10,000	$11,000
Maximum charitable contribution deduction	3,000	3,300
	$ 7,000	$ 7,700
Net operating loss deduction		8,000
Net operating loss for succeeding years		$ 300

The net operating loss deduction for an intervening year includes only carrybacks or carryovers arising in years prior to the year in which the loss arose. For example, in determining the amount of a 1959 loss which after carryback to 1956 and 1957 would be available for

1958, the modifications to taxable income of 1957 would not take into account a loss for 1960. Therefore, any modifications to items based on adjusted gross income or taxable income are computed in an intervening year using a net operating loss deduction that is the total of net operating loss carryovers and carrybacks arising in years preceding the year producing the loss which will be offset by the remaining income from the year for which the modifications are being made.

This difference can be illustrated best by use of examples.

Example 1–Assume the following operating results for a taxpayer:

1952	$ (9,000)
1953	(6,000)
1955	(18,000)
1956	(10,000)

For purposes of determining the tax liability for 1954 the taxpayer would have a net operating loss deduction equal to the total of all the carryovers and carrybacks available in the year 1954, or $43,000. However, if 1954 were an intervening year, in computing the income for 1954 which would be subtracted from the net operating loss for 1955 (for purposes of determining the portion of the 1955 loss which may be carried over to subsequent years) the net operating loss deduction for 1954 would be $15,000. That is, the net operating loss deduction for purposes of computing the modifications in an intervening year would be the total of the losses arising in the years prior to the loss year (in this instance, 1955).

Example 2 – Assume an individual incurs a net operating loss of $8,000 in 1960 and $7,000 in 1961. Information from the individual's 1957 and 1958 returns is as follows:

		1957	1958
Adjusted gross income (all from salary)		$7,000	$9,000
Itemized deductions (medical only, for purposes of illustration)			
Hospital bill	$1,210		
Less 3% of adjusted gross income	210	1,000	
Standard deduction (itemized total $675)			900
		$6,000	$8,100
Less personal exemption		600	600
Taxable income		$5,400	$7,500

The 1957 income offset against 1960 loss is \$6,000. The year 1957 is an intervening year, so the only net operating loss deduction is the loss of years preceding 1960. Therefore, no modification of 1957 items based on a percentage of adjusted gross income is required. The personal exemption for 1957 is not allowable.

The 1958 income offset against 1960 and 1961 loss is \$6,300, computed as follows:

Adjusted gross income as filed		\$9,000
Less net operating loss deduction from 1960		
Amount of loss	\$8,000	
Less 1957 modified income	6,000	2,000
Revised adjusted gross income		\$7,000
Less standard deduction		700
Income to offset 1961 net operating loss		\$6,300

The computation of standard deduction for 1958, an intervening year, is made after deducting the remaining net operating loss from 1960, because the 1960 loss is a loss arising in a year prior to the year producing the loss which offsets the remaining 1958 income.

The following examples will illustrate the adjustments to income for both years of final deduction and intervening years:

Example 1—An individual's gross income for 1957 was \$8,000 including 50% of a \$2,000 long-term capital gain. He filed a return showing an \$800 standard deduction. In 1960, he had a \$2,000 net operating loss. Computations are as follows for 1957:

Gross income per return	\$8,000
Net operating loss deduction	2,000
Adjusted gross income	\$6,000
Standard deduction (10% of adjusted gross income after net operating loss deduction)	600
Taxable income before exemptions	\$5,400

In this instance, since the total net operating loss deduction available is less than the taxable income for 1957, the year is a year of final deduction and the standard deduction is computed after deducting all net operating loss deductions available for the year. Also, the long-term capital gain deduction is allowable since the year 1957 is not an intervening year in this example.

Example 2—Individual net operating loss of $10,000 for 1960. Following items for 1957 and 1958 before net operating loss deduction:

	1957	1958
Sales (business income)	$20,000	$23,000
Business deductions	14,000	16,000
Short-term loss		(500)
Long-term gain		2,000
Standard deduction	600	775
Nonbusiness deductions	400	700

All 1957 tax is refundable. In determining the net operating loss deduction for 1958, the amount of 1957 income which is offset against the 1960 net operating loss carryback is the business net income less the standard deduction, or $5,400. No personal exemption is allowed for computing the income since the year 1957 is an intervening year in this example. The standard deduction is not recomputed for 1957, since, for purposes of modification of items related to a percentage of adjusted gross income in an intervening year, only net operating losses for years prior to the loss year are deducted. In this example, the year 1960 is the "loss year" since that is the year producing the loss which is offset against 1958 income.

Robert J. Mooney

Born in Omaha, Nebraska, Robert J. Mooney has a B.S. degree from the University of Nebraska. He joined TRB&S in 1955 and is now a supervisor in Seattle's tax department. Mr. Mooney has been active in the CPA Toastmasters' Club.

The taxable income for 1958 is computed as follows:

Gross income (including capital gains and losses)		\$24,500
Business deductions	\$16,000	
Capital gain deduction	750	16,750
Net income computed without reference to net operating loss deduction		\$ 7,750
Net operating loss deduction		4,600
Adjusted gross income		\$ 3,150
Itemized deductions		700
Taxable income before personal exemptions		\$ 2,450
Personal exemption		600
Taxable income		\$ 1,850

The capital gain deduction and personal exemption are allowed in 1958 since the adjustments to income in 1958 are for purposes of computing taxable income of a year of final deduction rather than for determining the loss available for a succeeding year. The net operating loss deduction is the 1960 loss of \$10,000 less the 1957 income of \$5,400, or \$4,600. If the itemized deductions contain any items that relate to a percentage of adjusted gross income, the items should be recomputed based on the adjusted gross income after net operating loss deduction. The net operating loss deduction for 1958 includes all available carrybacks or carryovers because the deduction is for purposes of determining taxable income of a year of final deduction rather than for determining the loss available for a succeeding year. If a standard deduction were used in 1958, the amount would also need to be recomputed.

If a net operating loss in excess of \$1,850 is incurred in 1961, the year 1958 in this example becomes an intervening year and the capital gain deduction and personal exemption would not be allowable in determining carryovers available for future years. The net operating loss deduction for determining adjusted gross income for modification of items related to a percentage of adjusted gross income would remain \$4,600 since that amount is the only remaining loss arising in a year prior to 1961.

Since a standard deduction can be reduced by a net operating loss deduction from a loss arising in a subsequent year, it is advisable to retain information concerning an individual's itemized deductions for a year even though the standard deduction is used on the return when originally filed.

* * *

Even though relief is provided for taxpayers having net operating losses, these taxpayers are still at a disadvantage taxwise when compared to taxpayers having reasonably level income from year to year. The disadvantage results from the effect of graduated income tax rates and the attempt by Congress to allow an offset for "economic" losses only.

Tax People Hold Regional Meetings

by Eli Gerver
Executive Office

TRAVEL AND ENTERTAINMENT EXPENSES, a discussion of ethics in tax practice, led by Wallace M. Jensen, Executive Partner—Tax, and a discussion by Joseph R. Levee, Director of the firm's International Tax Division, were featured at regional meetings for all the firm's tax staff.

To insure diversified experience in each group, some tax people from different regions attended the various three-day meetings held in New York, Detroit, Minneapolis and San Francisco last fall.

A substantial part of the program for each meeting was left to the discretion of the chairmen—William K. Carson, New York; Kenneth S. Reames, Detroit; James F. Pitt, Minneapolis; Leroy E. Schadlich and Durwood L. Alkire, San Francisco. Besides the topics mentioned above, each meeting included a discussion of problems encountered in Revenue Agents' Examinations, and an explanation of the Tax Research Department by Eli Gerver, Director of Research—Tax. For one afternoon of each meeting the participants were divided into two groups: one discussed technical tax problems and research techniques while the other considered problems in office administration and staff training.

Although the meetings had extensive and detailed schedules requiring hard work from all the participants, tax people welcomed the opportunity to exchange ideas and discuss problems of common concern.