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Navigating the Net Operating Loss: Deductions Allowed Under IRC Section 172

Section 172 of the Internal Revenue Code (IRC) plays a vital role for businesses in managing Net Operating Losses (NOLs), offering both financial relief and tax benefits. NOL occurs when the deductible expenses of business exceed its taxable income, resulting into a loss for the year. This loss is permitted to carry forward and enables businesses to offset taxable income in future years with these losses, which is crucial for maintaining financial health and liquidity.

Eligible taxpayers for NOL deductions include Individuals, C Corporations, Non-life insurance Companies, Estates and Trusts.

However, Partnerships and S Corporations cannot claim NOLs at the entity level: instead, the losses pass through to their partners and shareholders respectively.

Carrybacks and Carryovers

a **Historical Background**

Previously, businesses could carryback NOL to offset income from the previous two years and carry forward the losses for up to 20 years. An irrevocable election must be made by the taxpayer to waive the applicable carryback period. The election is required before the due date, including extensions, of the return within the tax year in which the NOL arose.

b **Changes under the Tax Cuts and Jobs Act (TCJA), 2017**

This Act eliminated the carryback provision for NOL arising after December 31, 2017 and further permitted losses to be carried forward indefinitely. However, the deductions were capped at 80 per cent of taxable income for any single tax year.

c *Provisions of the CARES (The Coronavirus Aid, Relief and Economic Security) Act, 2020*

In response to the COVID-19 pandemic, the CARES Act temporarily reinstated the carry back provisions for NOL generated in 2018, 2019, and 2020, allowing these to be carried back for up to five years. It also suspended the 80 per cent limitation for tax years 2018 through 2020.

Entity based provisions

a **Individuals**

Once NOL for a specific year is established, an Individual can carryback for 2 years for tax years beginning in 2018, 2019 & 2020, or carry forward to future years for an indefinite period until it is utilized. If the NOL is carried back to a prior year, the taxable income for that year is recalculated to reflect the NOL, potentially resulting in certain changes to deductions and credits that were claimed in that year, termed as carryback year. This adjustment is necessary because the NOL reduces the taxable income from the originally reported figures. Conversely, if the NOL is carried forward, especially in situations where carryback option is waived, it is simply applied as a deduction on the tax return for the first year it is carried forward, without needing to recalculate the taxable income for that year.

If NOL applied to the first year of carryback or the first year of carryforward (if there is no carryback period) is only partially utilized, the remaining NOL can be carried over to the next year or carryforward period. To determine the leftover NOL, the taxable income for the carryback or carryforward year is recalculated with certain adjustments, which are usually less extensive than those used to compute the original NOL. The portion of the NOL that exceeds the recalculated (adjusted) taxable income is the amount that can be carried forward to the subsequent year. This process continues each year during the carryback or carryforward period until the NOL is fully utilized or the carryforward period expires, if it is limited.

Individuals can use Schedule B on Form 1045 to calculate the NOL for a carryback year, or they can refer to Worksheet 2 in IRS Publication 536 when calculating for a carryforward year.

b **Corporations**

Corporations also follow the same procedure as Individuals when calculating NOL. An unused NOL is available for carryback or carryforward when the NOL exceeds taxable income in the carryback or carryforward year. NOL carryforwards is an asset on the company's general ledger. An entry of deferred tax asset is created for the NOL carryforward, which can be offset against net income in the future years.

S Corporations cannot claim NOLs. Further, NOLs cannot be carried over between C Corporation and S Corporation. When the entity changes its status from an S Corporation to C Corporation, the losses of S Corporation are passed to its shareholders.

Corporations with an NOL may file Form 1138 for extension of time for payment of taxes in the preceding year in case of carryback.

NOLs in computing State Tax

Some states do not permit the Federal NOL deduction, as corporation's taxable income is generally determined based on the Federal taxable income. Other States may require specific adjustments due to limitations on carrybacks or carryforwards. Additionally, some States calculate their own NOL deduction separately from the Federal deduction or may not allow NOL deduction at all.

We have illustrated a few examples below to provide a fair understanding of Section 172.

a **Scenario 1 (CARES Act)**

Let's assume it's year 2020, business has income of $300,000 and allowable deduction of $500,000.

The above will lead to $200,000 NOL ($500,000 - $300,000)

For this, the available NOL can be used as follows:

i) Carry back Option (CARES Act)

Suppose the business had taxable income of $100,000 in 2019 and $150,000 in 2018.

- The business can carry back the $200,000 NOL to 2018, reducing its taxable income for that year to zero and obtaining a refund for the taxes paid on that $150,000.
- The remaining $50,000 NOL can be carried back to 2019, reducing the taxable income for that year to $50,000, and resulting in another tax refund.

ii) Carry forward Option (Post-2020 Rules)

If the business chooses to carry forward the NOL instead, it can use the $200,000 to offset taxable income in future years. For example, if the business has a taxable income of $250,000 in 2021, it can apply the $200,000 NOL to reduce its taxable income to $50,000, thereby significantly lowering its tax liability for 2021.

b **Scenario 2 (TCJA Act)**

Let's say it's the year 2021 and the entity has incurred $50,000 in NOLs while in the year 2022 and 2023 it has a taxable income of $40,000 and $35,000 respectively.

Now the impact of NOL shall be:

i) Calculation for 2022

Taxable income in 2022: $40,000

NOL carried forward from 2021: $50,000

80% of taxable income which can be utilized in 2022 = $32,000

The remaining NOL after 2022 is $18,000, which may be carried over to 2023.

ii) Calculation for 2023

Taxable income in 2023: $35,000

NOL Carried forward from 2021: $18,000

80% of taxable income which can be utilized in the year 2023 = $28,000

We can utilize remaining NOL of $18,000 in the year 2023.

Conclusion

Section 172 is an essential tool for businesses to manage net operating losses, offering both carry back and carry forward options to mitigate tax burdens, providing quick tax refunds and improving cash flows during the times of crisis. By understanding and applying these provisions, businesses and individuals can gain significant financial relief and enhance their tax planning strategies, helping them navigate economic fluctuations and sustain growth and optimizing long term tax strategy.

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