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WHAT IS THE NET OPERATING LOSS?

SOURCES:

Net Operating Losses allowed under IRC Sec. 172(a) are basically business originated & or fraud/ theft loss deductions – all of which are defined as "ordinary" losses, under the Code.

Non-ordinary losses are personal casualty, or capital losses, which have separate allowance rules.

Origination: can be any non-personal type of loss. Code Section 165 defines a "Loss" as:
"any loss sustained during the taxable year and not compensated for by insurance or otherwise"; meaning:

- Business effort originated
- Loss on sale of property "used in a trade or business", Sec. 1231(b)
- Any transaction entered into for profit, though not connected with a trade or business , Sec. 165(c)(2)
- Theft or fraud loss, Sec. 165(e)
- Gambling losses to the extent of gains, Sec. 165(d)
- Business bad debts (funds lent for a business endeavor or effort to another); "business purpose test

Special Rules:

- *Small business NOL's (revenue less than $5mm) may be carried back 3 years (not 2)
- *Farm NOL's may be carried back 5 years
- An NOL may be inherited from an estate for use by beneficiaries in their own individual return

Note: character of asset in a specific taxpayer's hands is fundamental to loss characterization

USES & ATTRIBUTES:

"NOL" Carryback & Carryover Rules:
Federal: general: 2 years carryback; 20 years carryover to date of death of taxpayer when it is then lost forever; taxpayer may elect to forgo NOL carryback and only use as carryover (this helps when prior years are lower bracket than future years may be)

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State of CA: general: eff. 2013- 50% of any 2013 NOL may be carried back 2years

- 75% of any 2014 NOL may be carried back 2 years
- 100% of any 2015 and after NOL may be carried back 2 years
- Taxpayer may elect to forgo NOL carryback and only use as carryover

-NOL's are never transferable to another taxpayer
-NOL's may not be used by the taxpayer's estate (when the taxpayer dies)

OTHER REQUIREMENTS:

1). "AT RISK": the taxpayer must be at risk, meaning have already lost the funds giving rise to an NOL, or be required to repay any loans related to the loss
2). "Business purpose" facts and circumstances test must be satisfied, where questionable
3). Importance of loss on originating return to be correctly classified; will often depend on original taxpayer intent of funds advanced, lent, lost; if wrongly conveyed, return may be amended
4). "Water glass" use applicable re tax rate saved; risk of low bracket years'absorption
5). May also negate prior year AMT, where and when applicable
6). Marital unions and dissolution consequences are enforced; no "trafficking in NOL's" allowed

PLANNING OPPORTUNITIES, as applicable:

1). High basis asset capable of change of character prior to sale at a loss: i.e.; residence inherited with a high tax basis and subsequent real estate market plunge, yet need to sell:
- rent property for more than two tax years and sell to deduct any loss as an ordinary loss (conversion of asset into trade or business property from former capital asset property)

2). Sale of known loss asset with ordinary loss in tax year with other lower income to enhance NOL carryback/carryover buoyancy, or higher other income to negate higher tax rate impact

3). Non- taxable estates: current requirement for stepped up basis under Sec. 1014(a) to be filed with IRS and detail provided to heir(s). The estate basis practitioner has an opportunity in below exemption estates to show basis as fully as allowable (different from taxable estates as concern is in the other direction)

4). Marital dissolutions: tax attributes of all community property assets should be identified and financially evaluated for tax benefit in the context of all property division

PREVENTION NOTES re incurring any loss before it happens, if possible:

1). Isolation of trade or business assets in a limited liability entity (LLC, LLP, s corp)
2). Avoid giving personal guarantees for the possible acts of others over which you have no control (think payroll liabilities for operating companies)
3). Always be a "non-responsible party" in regard to decisions re payroll wages and taxes for employees of any entity you are a principal or partner in to avoid the 100% non-payment penalty