

537 words

**Abstract:** Whether a business is new or established, losses can happen. The federal tax code may help soften the blow by allowing businesses to apply losses to offset taxable income in future years, subject to certain limitations.

### **Use the tax code to make business losses less painful**

Whether you're operating a new company or an established business, losses can happen. The federal tax code may help soften the blow by allowing businesses to apply losses to offset taxable income in future years, subject to certain limitations.

### **Qualifying for a deduction**

The net operating loss (NOL) deduction addresses the tax inequities that can exist between businesses with stable income and those with fluctuating income. It essentially lets the latter average out their income and losses over the years and pay tax accordingly.

Eligibility for the NOL deduction depends on having deductions for the tax year that exceed your income. The loss generally must be caused by deductions related to your:

- ❑ Business (Schedules C and F losses, or Schedule K-1 losses from partnerships or S corporations),
- ❑ Casualty and theft losses from a federally declared disaster, or
- ❑ Rental property (Schedule E).

The following generally aren't part of the NOL determination:

- ❑ Capital losses that exceed capital gains,
- ❑ The exclusion for gains from the sale or exchange of qualified small business stock,
- ❑ Nonbusiness deductions that exceed nonbusiness income,
- ❑ The NOL deduction itself, and
- ❑ The Section 199A qualified business income deduction.

Individuals and C corporations are eligible to claim the NOL deduction. Partnerships and S corporations generally aren't eligible, but partners and shareholders can calculate individual NOLs using their separate shares of business income and deductions.

### **Limitations**

Prior to the Tax Cuts and Jobs Act (TCJA), taxpayers could carry back NOLs for two years and carry forward losses 20 years. They also could apply NOLs against 100% of their taxable income.

The TCJA limits NOL deductions to 80% of taxable income for the year and eliminates the carryback of NOLs (except for certain farming losses). However, it does allow NOLs to be carried forward indefinitely.

If your NOL carryforward is more than your taxable income for the year you carry it to, you may have an NOL carryover. That's the excess of the NOL deduction over your modified taxable income for the carryforward year. If your NOL deduction includes multiple NOLs, you must apply them against your modified taxable income in the same order you incurred them, beginning with the earliest.

### **Planning ahead**

The tax rules regarding business losses are complex, especially the interaction between NOLs and other potential tax breaks. We can help you chart the best course forward.

Sidebar:

#### **A limit on excess business losses**

The Tax Cuts and Jobs Act (TCJA) established an “excess business loss” limitation, effective beginning in 2021. For partnerships or S corporations, this limitation is applied at the partner or shareholder level, after applying the outside basis, at-risk and passive activity loss limitations.

Under the rule, noncorporate taxpayers' business losses can offset only business-related income or gain, plus an inflation-adjusted threshold. For 2023, that threshold is \$289,000, or \$578,000 if married filing jointly. Remaining losses are treated as a net operating loss (NOL) carryforward to the next tax year. That is, you can't fully deduct them because they become subject to the 80% income limitation on NOLs, reducing their tax value.

**Important:** Under the Inflation Reduction Act, the excess business loss limitation applies to tax years beginning before January 1, 2029. Under the TCJA, it had been scheduled to expire after December 31, 2026.