**Preamble:** Have you ever had a carry forward return include a Net Operating Loss (NOL) and not know how / whether to remove it? This document explains how to handle these situations and how to prevent them from happening in the future.

Reference: IRS Pub 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts

**Definition:** "If your deductions for the year are more than your income for the year, you may have a net operating loss (NOL). An NOL year is the year in which an NOL occurs. You can use an NOL by deducting it from your income in another year or years."

**Discussion:** Scenarios which would generate a valid NOL (Schedule C loss, Casualty losses, Moving Expenses, etc.) are generally out-of-scope for (non-Military) volunteer preparers. However, there are common in-scope scenarios, which unless handled properly, will cause TaxWise to generate a spurious NOL. This can be difficult to detect when reviewing the current year return because it does not affect current year calculations, but will (by default) be carried forward and cause problems which need to be resolved on subsequent year returns.

#### Situations:

- NOL from prior year carried forward to current year
- NOL for current year

#### Situation: NOL from prior year carried forward to current year

You will notice this when a new created return (with automatic carry forward data from prior year) has 1040 Wkt7 red in the tree. (There may also be a red Form 1045 Page 2 in the tree – ignore that for now.) When you open 1040 Wkt7, you will see a negative amount filled in on Line 15 plus the NOL statement box will be red [See Example 1]. (If there is no offsetting miscellaneous income, 1040, Line 21 will also be negative.)

Before going further, you must determine what caused the original NOL carry forward, because the current year return may be out-of-scope. Looking at Form 1045 Page 2 (NOL calculation) from the prior year is a good place to start. (Note: it is possible that the original NOL was from a return even further back than the prior year.)

The most likely situation (if there were no out-of-scope items on the original return which generated the NOL) is that the TP had a carried forward Capital Loss and insufficient taxable income to offset the loss – resulting in a negative AGI on the original return. If the carried forward NOL from the original return is equal to the amount of the Capital Loss on the original return and the original Form 1045 Page 2 had zero on lines 2 and 3, then it is safe to assume that this is what's going on – The original Form 1045 was filled out incorrectly and the NOL is spurious and should be ignored. To remove the spurious NOL, go to the bottom of 1040 Wkt3 (for the current year return) and zero out the amount on line 2 of the Carryovers from 20xx to 20xx section – This should automatically remove the amount from 1040 Wkt7 line 15 and 1040 Wk7 should no longer be red in the tree. [See Example 2] Note: You may still have a spurious NOL for the current year – see the next section.

There are situations which will generate a valid NOL on the original return – These include: Schedule C loss, Casualty and theft losses, moving expenses, rental property, etc. *If the carry forward NOL amount is from a valid NOL on the original return, then the current year return is out-of-scope.* 

#### Situation: NOL for current year

Note: Handle "NOL from prior year carried forward to current year" (previous section) before worrying about NOL for current year.

If TaxWise thinks there is possible NOL for the current year, then it will automatically add Form 1045 Page 2 to the tree and it will be red. This may happen at any point during data entry, but may go away later – DO NOT try to handle this form unless it is still red after all data entry is complete and any diagnostic issues resolved.

If Form 1045 Page 2<sup>1</sup> is still red after all other data entry is complete [See Example 3], then line 2 (and, if necessary, line 3) should be filled in based on values from Schedule D, Lines 7 and 15. If filling these in removes the red from all other lines on the form AND line 25 is zero, then you are done [See Example 4]. (The return is in-scope and no spurious NOL will be carried forward to the next year.)

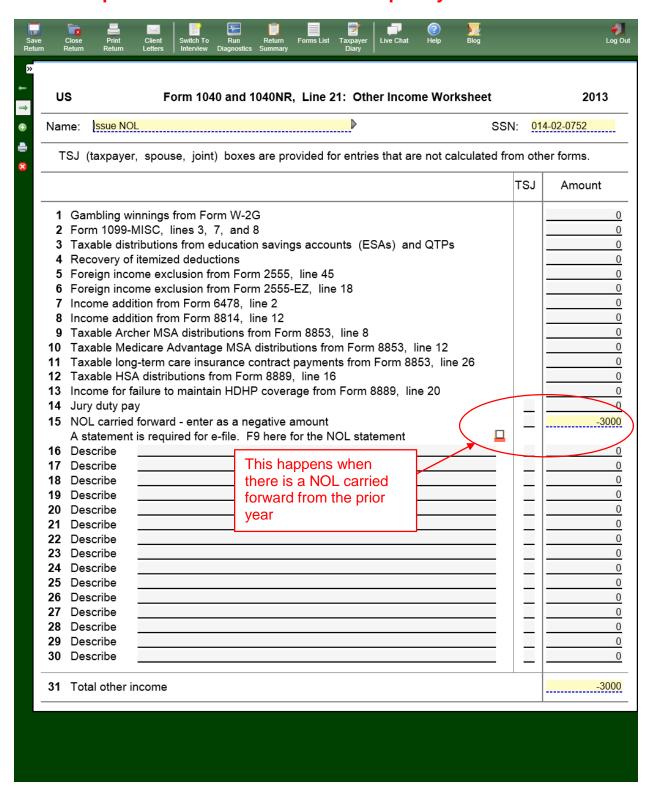
If Form 1040 Page, line 25 is still non-zero after filling in lines 2 and 3, then there is a valid NOL for the current year AND the return is out-of-scope<sup>2</sup>.

Note: Quality Reviewers should look for Form 1045 in the tree and make sure that it is filled out properly and the return is not out-of-scope, especially if the AGI is less than zero.

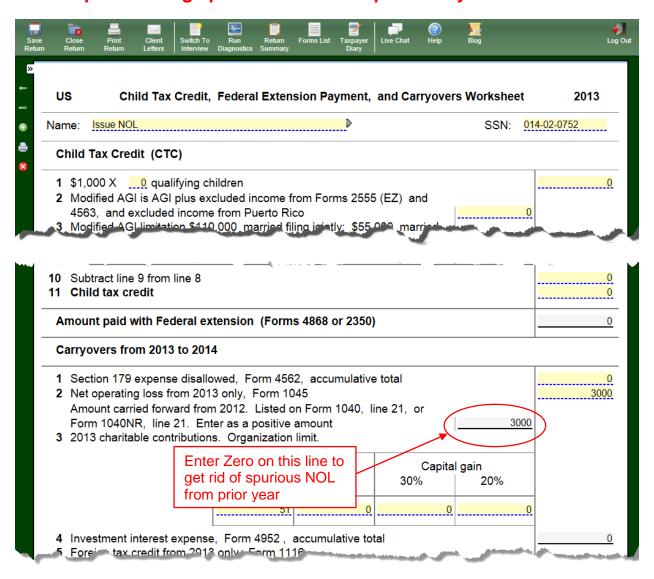
 $<sup>^{1}</sup>$  Form 1045 Page 2 will say "Schedule A: Net Operating Loss (NOL)" at the top - This has nothing to do with Form 1040 Schedule A.

<sup>&</sup>lt;sup>2</sup> Just to give an example of why NOL is out of scope, consider that an NOL can be carried back as well as carried forward!

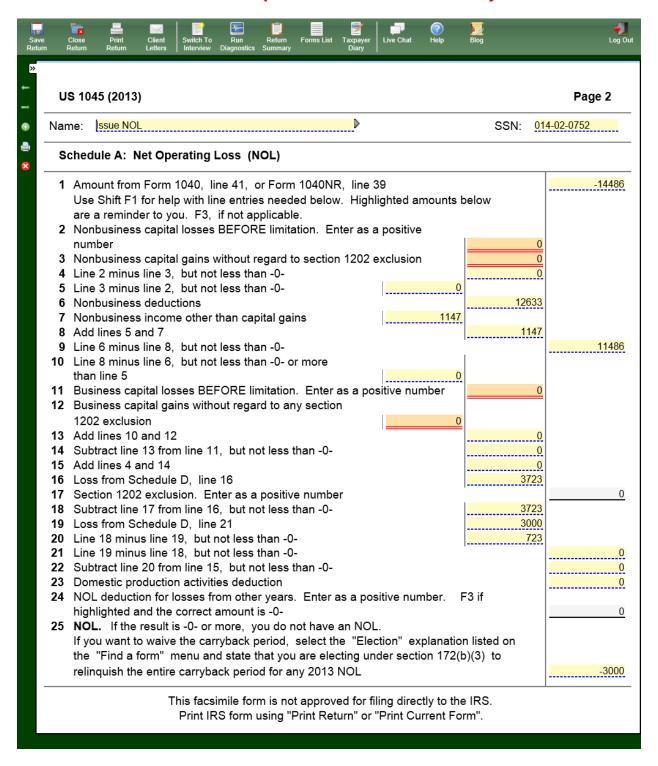
#### Example 1: NOL carried forward from prior year on 1040 Wkt7



#### **Example 2: Fixing spurious NOL from previous year on 1040 Wkt3**



# Example 3: Form 1045 Pg 2 automatically added to tree when TW thinks there is possible NOL for current year



# Example 4: Form 1045 Pg 2 filled in – eliminating spurious NOL that would have been carried forward to following year

