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Making the most of business losses in turbulent times: The advantages of net operating loss tax rules

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In today's turbulent economic times, many businesses are facing losses. If yours is in this situation, you can soften the blow by taking advantage of the net operating loss (NOL) tax rules.

Generally, NOLs can be offset against up to two years of prior years of income tax or carried forward up to 20 years and used to reduce taxable income in those years. NOL carrybacks are particularly valuable these days because they allow you to claim a refund of taxes you paid in previous years, giving your cash flow a welcome boost.

An NOL simply means that your taxable business deductions exceed your business income for the year. For corporations, partnerships, and LLCs, the concept is straightforward. If you're a sole proprietor, determining whether you have an NOL is more complicated because you need to determine which deductions and income are considered business-related and which are not.

If your business is organized as a pass-through entity-such as a partnership, S corporation, or multiple-owner LLC-NOLs are treated essentially the same way. Business losses are passed through to the partners, shareholders, or members, who deduct their share of those losses on their individual returns. If your business losses exceed your personal income, you have generated a personal NOL and may be able to carry the excess loss back or forward to other tax years on your personal return.

Consult with your CPA to determine the best course of action for you. For example, if you choose to carryback the loss, you reopen prior year returns for review by the IRS. That reality could be secondary to the fact that the carryback will generate a refund. On the other hand, if you treat the loss as a carryforward, the deduction may be more valuable to you the next year if you expect to be in a higher income tax bracket. It is also important to note that the NOL will be automatically carried back for a refund unless you make a special election not to do so.

Keep in mind, however, that if you own an interest in a pass-through entity, you can deduct business losses only to the extent of your adjusted tax basis, which isn't necessarily equal to the balance in your capital account. The rules for calculating basis are complex and they differ depending on the type of entity.

If your business is a pass-through entity and you expect a loss this year, be sure to consult your CPA to find out whether you have sufficient basis to deduct your share of the loss. If you don't, there may be year-end tax moves you can make to increase your basis and reduce your tax bill. Also, depending on the nature of your investment in the business, your ability to deduct losses may be further limited by the passive activity loss rules or the at-risk rules.

If your business is organized as a C corporation, NOLs provide no direct tax benefits to individual shareholders. They can only be used to offset corporate income in previous or future years. If you anticipate NOLs in the coming years, you might consider converting your C corporation to an S corporation (provided you qualify for an S election). Doing so would allow you to pass future losses through to shareholders, who may be able to offset them against other income. Note, however, that you can't use current or past C corporation losses to reduce future S corporation income.

If your business is a C corporation and it experiences an NOL this year, you can offset the loss against income in the previous two years and claim a refund. If your cash flow could use a more immediate boost, however, consider requesting a "quick refund" by filing Form 1139 with the IRS. You can file Form 1139 after you file your corporate income tax return (but no later than one year after the end of the NOL year).

Once you make your request, the IRS is required to act on it within 90 days. In cases of extreme hardship, you may even be able to get your refund within a week or two by filing IRS Form 911.

If your business is struggling, be sure to take full advantage of NOLs and other tax breaks that can improve your cash flow and help you weather the current economic storm.

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