



STATE OF ALABAMA
DEPARTMENT OF REVENUE

Net Operating Loss (NOL) Booklet

This Booklet Contains:

Form NOL-85

Computation of Net Operating Loss

Form NOL-85A

Application of Net Operating Loss Carryback or Carryforward

Form 40X

Amended Income Tax Return

Frequently Asked Questions Section

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10/01

State of Alabama

Net Operating Loss Carryback/Carryforward For Individual Taxpayers (Forms 40 and 40NR)

What is a Net Operating Loss (NOL)?

A net operating loss is the amount by which deductions (after modifications) exceed gross income. A net operating loss may result from losses incurred in a trade or business, from the sale of assets used in a trade or business, or from personal casualties or thefts.

The following terms have the following meanings ascribed to them, unless the context clearly indicates otherwise:

1. "NOL" means "net operating loss."
2. "Carryback" means an NOL applied to a year prior to the year in which the NOL occurred.
3. "Carryover" means the excess NOL after a portion of the NOL has been applied to a carryback or carryforward year.
4. "Carryforward" means an NOL applied to a year subsequent to the year in which the NOL occurred.
5. "Intervening Year" means a year between the earliest year to which an NOL can be carried back and the year in which the NOL occurred.
6. "Loss Year" means the year in which the NOL occurred.

Classification of Items as Business or Nonbusiness.

For the purpose of computing the amount of an allowable net operating loss, certain items of income, expense or deduction will be classified as "business" or "nonbusiness." The following is a partial list of items regularly classified as business or nonbusiness:

(a) **Business.** Business income, expense and deductions include, but are not limited to: salary and wages; income or loss from a trade or business; gain or loss from sale of assets used in a trade or business; losses on Internal Revenue Code §1244 stock (up to the amount of ordinary loss allowed for federal income tax purposes); rental income or loss; income or loss from a partnership; income or loss from an Alabama S corporation; income or loss from farming; employee moving expenses; employee business expenses; and casualty and theft losses.

(b) **Nonbusiness.** Nonbusiness income, expense and deductions include, but are not limited to: medical expenses;

taxes; interest expense; charitable contributions; miscellaneous deductions other than employee business expenses; gain from the sale of a personal residence to the extent recognized in accordance with §40-18-14, *Code of Alabama 1975*; gain or loss from the sale of assets not used in a trade or business (including distributive shares of gains or losses from such assets held by a partnership or an Alabama S corporation); interest and dividend income (including distributive shares of interest and dividend income received by a partnership or an Alabama S corporation); losses on Internal Revenue Code §1244 stock (in excess of the amount of ordinary loss allowed for federal income tax purposes); federal income tax refunds or tax paid; alimony received; taxable pensions and annuities; income or loss from a trust or estate; deductible contributions to IRA retirement plans; Keogh retirement plans; employee benefit contributions paid by an employer; penalties for early withdrawal of savings; alimony paid and disability income exclusions.

How is a Net Operating Loss Computed?

In computing the amount of net operating loss allowable for a particular taxable year, the following modifications must be made:

- (a) No deduction may be taken for any net operating loss carried over from another year,
- (b) No deduction is allowed for the personal exemption or exemption for dependents allowed by §40-18-19, *Code of Alabama 1975*,
- (c) Nonbusiness deductions, including the federal income tax deduction, may not exceed nonbusiness income, and
- (d) The optional standard deduction, if claimed, is considered a nonbusiness deduction and may not exceed nonbusiness income.

EXAMPLE: In 2000, the taxpayer had a net operating loss of \$21,000 and made an election to carry forward the loss deduction. In 2001, the taxpayer had the following income and deductions:

INCOME	
Salary	\$50,000
Interest on savings	4,000
Loss on sale of business assets	(15,000)
Loss on sale of stock (nonbusiness)	(5,000)
2000 NOL carryforward	(21,000)
Unmodified Adjusted Gross Income	\$13,000

DEDUCTIONS

Nonbusiness Itemized Deductions:		
Medical & Dental	\$	1,500
Less 4% of \$13,000		<u>(520)</u>
Allowable medical	\$	980
Mortgage Interest		3,470
Contributions:		
Amount paid	\$	500
Limitation		
50% of \$13,000		6,500
Allowable contributions	\$	500
Personal casualty loss		4,000
Taxes (except federal income tax)		<u>200</u>
Total itemized deductions	\$	9,150
Federal Income Tax Deduction		1,200
Personal Exemption		3,000
Dependent Exemption		<u>300</u>
Total Deductions		\$13,650

Deductions exceed income by \$650 (\$13,000 - \$13,650). However, to determine if there is an allowable net operating loss, certain deductions must be modified. No deduction is allowed for the following:

1. 2000 NOL carryforward		\$21,000
2. Personal Exemption		3,000
3. Dependent Exemption		300
4. Excess nonbusiness deductions:		
Federal income tax	1,200	
Itemized Deductions	9,150	
Less: casualty loss	(4,000)	\$ 6,350
5. Loss on sale of stock		<u>5,000</u>
6. Total nonbusiness deductions		11,350
7. Less: nonbusiness income – interest		<u>(4,000)</u>
8. Excess of nonbusiness deductions over nonbusiness income		\$ 7,350
9. Total modifications		\$31,650

After modifying the 2001 income of \$(650), by \$31,650, there is no net operating loss available for 2001.

Taxable income before modifications	\$	(650)
Modifications		<u>31,650</u>
Modified Taxable Income		<u>\$31,000</u>

Application of an NOL Carryback

For loss years beginning after December 31, 1997, an NOL may be carried back and deducted from taxable income in each of the preceding two years or until exhausted. Loss years prior to January 1, 1998 provided for a carryback period of three years. When an NOL is carried back to a prior year, taxable income for the prior year will be recomputed as specified below:

(1) If the NOL being carried back is equal to or greater than taxable income as previously reported or last adjusted (including any deductions for NOLs carried over or carried back to such year from any loss year prior to the current loss year), taxable income will be reduced to zero. See the instructions that follow for information regarding the computation of any remaining NOL for carryover to a subsequent year, and for information on refund procedures.

(2) If the NOL being carried back is less than the taxable income as previously reported or last adjusted (including any deductions for NOLs carried over or carried back to such year from any loss year prior to the current loss year), taxable income for the carryback year is reduced by the amount of the NOL.

(3) The NOL carryback reduces adjusted gross income, and therefore, will affect those deductions, which are based on or limited by a percentage of adjusted gross income.

(a) The limitation on contributions will be reduced.

(b) The amount of medical expenses exceeding 4% of adjusted gross income may increase.

(c) If the optional standard deduction is elected, the amount will be recomputed applying the appropriate percentage to adjusted gross income after subtracting the NOL carryback.

NOTE: Tax is recomputed using the appropriate rates for the carryback year after subtraction of the NOL deduction.

Refund Procedures

To apply an NOL carryback and to request any refund due, complete Form NOL-85A and attach it to Form 40X (Amended Alabama Individual Income Tax Return) for each year to which the carryback is being applied. A claim for refund of tax based on an NOL carryback must be filed within three (3) years, including extensions, from the due date of the loss year return. If the taxpayer has an NOL and fails to claim the NOL carryback within three years, including extensions, from the due date of the loss year return, no refund will be made based on the NOL carryback. The taxpayer will be allowed to carry any available loss forward. After computing the carryback and reducing the loss available by the taxable income and required modifications for all of the carryback years, a loss may still be available to be carried forward. If so, the remaining available loss may be claimed in the first year following the loss year, providing the loss is claimed when the return is filed for the carryforward year. No deduction will be allowed in any carryback year, which has been closed by expiration of the statute of limitations or by final assessment prior to the application of the carryback.

Election to Relinquish the Entire Carryback Period

A taxpayer may elect to forego the carryback period of an NOL. If such an election is made, the NOL will then be carried forward to the first available year following the loss year. The carryforward period limitation of fifteen (15) years is not extended if an election is made to forego the carryback period. For loss years beginning after December 31, 1997, the election to forego the carryback period can be made in one of two ways. The election can be made on

or before the due date (with extensions) for filing the income tax return for the loss year. If no election is made by the due date of the loss year return, then the filing of the next year's return by the due date, including extensions, and claiming the loss on the return shall be considered the taxpayers election to forgo the carryback period. The election, once made, is irrevocable.

NOTE: For loss years prior to January 1, 1998, if an election to forego the carryback period was not timely made, then the loss had to be carried back to the earliest year available before bringing any unused amount of the loss forward.

If a proper election to forego the carryback period is not made, or not timely made, the NOL must be carried back to the earliest year preceding the loss year in which the NOL may be utilized (e.g., a 1998 NOL must be carried back to 1996). Any unused NOL may be carried to the next earliest preceding year, in order.

Application of an NOL Carryforward to a Year After the Loss Year

An NOL may be carried forward to years subsequent to the loss year in order of time or until exhausted, whichever occurs first; subject to the following limitations:

1. To each of the fifteen tax years following the loss year.
2. No deduction will be allowed in any carryforward year, which has been closed by expiration of the statute of limitations or by final assessment prior to the application of the carryforward.

Computation of Taxable Income

If the NOL being carried forward is equal to or greater than taxable income, taxable income will be reduced to zero. Taxable income is computed without considering the current NOL carryover to be applied, but will reflect any prior carryovers which have been applied. See the paragraph below for the computation of any remaining NOL for carryover to a subsequent year. If the NOL being carried forward is less than taxable income (computed without considering the NOL deduction to be applied), adjusted gross income will be reduced (but not below zero) by the amount of the NOL carryforward. The NOL carryforward reduces adjusted gross income, and therefore, will affect those deductions, which are based on or limited by a percentage of adjusted gross income.

1. The limitation on contributions will be reduced.
2. The amount of medical expenses exceeding 4% of adjusted gross income may increase.
3. If the optional standard deduction is elected, the amount will be computed by applying the appropriate

percentage to adjusted gross income after subtracting the NOL carryforward.

NOTE: Casualty, theft losses and job expenses, if claimed must also be adjusted because they are limited by a percentage of adjusted gross income.

Computation of any Remaining NOL Carryover after Application of an NOL

In order to determine the amount of an NOL available for carryover, certain adjustments must be made to the taxable income for the year in which the deduction was taken. The amount by which the NOL will be reduced is called "modified taxable income." The personal exemption (§40-18-19(a)(6)), and deduction for dependents (§40-18-19(a)(7)) are not allowable deductions in computing "modified taxable income." These modifications are applied after all prior adjustments or modifications have been made to adjusted gross income and/or taxable income in the year to which the NOL is being applied. If a prior NOL carryback or carryover was fully absorbed in the year, and a subsequent NOL is carried to the year and cannot be fully absorbed, the modifications required would be computed after taxable income has been recomputed for the year. If the subsequent NOL can be fully absorbed, after taxable income has been recomputed for the prior NOL, taxable income for the year must be recomputed, with adjusted gross income reduced again for the subsequent NOL.

EXAMPLE: Taxpayer has a net operating loss for calendar year 2000 of \$20,000 that is to be carried back to 1998. There were no other net operating loss carrybacks or carryforwards applicable to 1998. Adjusted gross income for 1998 was \$25,000 from salary and \$300 from interest. Taxpayer paid \$658 in Alabama income tax for 1998. Taxpayer had the following deductions: \$4,325 in itemized deductions, \$3,260 in federal income tax and a personal exemption of \$3,000 for a married couple filing a joint return.

Salary		\$25,000
Interest		300
Adjusted Gross Income		<u>\$25,300</u>
Less net itemized Deductions:		
Medical and Dental	\$1,187	
Less 4% of \$25,300	<u>(1,012)</u>	
Medical Deduction		\$ 175
Taxes (excluding federal tax ded.)		1,136
Mortgage Interest		2,700
Charitable Contributions		314
Total Itemized Deductions		\$ 4,325
Federal Tax Deduction		3,260
Personal Exemption		<u>3,000</u>
Taxable income for 1998		<u>\$14,715</u>

The 2000 net operating loss carryback will be applied as follows:

Taxable income for 1998	\$14,715
Plus modification for personal exemption	3,000
Modified Taxable Income	<u>17,715</u>
Less 2000 NOL carryback	(17,715)
1998 taxable income after NOL carryback	<u>\$ -0-</u>
The refund due following the carryback is computed as follows:	
1998 tax liability on \$14,715	\$ 658
1998 tax liability on \$-0-	0
Refund due	<u>\$ 658</u>

Special Rules for Joint Returns

Regulation 810-3-15-.27 specifies that in the case of a husband and wife who file a joint income tax return for any taxable year in which an NOL occurs, the loss is to be computed on the basis of the combined income and deductions of both spouses, and the modifications required are to be computed as if the combined income were the income of one individual. However, if separate returns were filed for any of the carryback years, the NOL must be computed as if separate returns were being filed in the joint loss year. Special rules are necessary when there is a change in the status of the spouses due to marriage, divorce or death.

An NOL sustained after or prior to a marriage cannot be used to reduce the taxable income of a former or future spouse, even though a joint return was filed for the carryback and/or carryforward year. The NOL can only be applied to the separate income of the spouse, which incurred the loss.

If there is a change in marital status due to the death of a spouse and in a succeeding year the survivor sustains an NOL, the loss may be carried back only to that portion of the income reported on a joint return previously filed with the decedent, which is allocated to the survivor. If a joint return is filed for the year of death of the spouse and an NOL was sustained, the loss may be carried back to a year in which the decedent filed a joint return with the surviving spouse, and/or the loss allocated to the deceased spouse may be carried back to a year in which the decedent filed a separate return. Any NOL allocated to a deceased spouse not utilized in the year the surviving spouse was entitled to file a joint return with the deceased spouse, may not be carried forward.

EXAMPLE: Husband and Wife file a joint return for 2001, but filed separate returns in some of the prior years. The net operating loss must be computed in the following manner:

	Husband	Wife	Joint
Business operations	\$(10,000)	\$(30,000)	\$(40,000)
Rental income	6,000		6,000
Sale of assets	12,000		12,000
Partnership income		4,000	4,000
Salaries	<u>5,500</u>		<u>5,500</u>
Adjusted gross income	<u>\$13,500</u>	<u>\$(26,000)</u>	<u>\$(12,500)</u>

The joint net operating loss of \$12,500 must be carried back to the earliest available joint return of Husband and Wife, or the earliest separate return of Wife filed within the last two (2) years. If no prior years are available (or if an election is made to forego the carryback), the loss may be carried forward to the earliest available joint return of Husband and Wife or earliest separate return of Wife.

EXAMPLE: Assume the same facts in the previous example except separate returns were filed for 2001. If separate returns are filed, the net operating loss of Wife would not be available to offset the income of Husband for the year, and Husband would be taxed on his separate income of \$13,500, less any applicable deductions or exemptions. The net operating loss of Wife of \$26,000 is available only to offset her separate income in any carryback or carryforward year in which she filed a separate return, or the combined income in any year in which she filed a joint return with Husband.

Reduction for Allowable NOL, Whether or Not Claimed.

An NOL carryback or carryover will be reduced by the amount available for use, whether used or not. For instance, if a taxpayer neglects to claim an NOL carryback within the prescribed time limit, the amount of loss available for carryover to other years will be reduced by the amount that could have been carried back but was not claimed. If the loss was available for use prior to the final assessment, the remaining NOL must be reduced by the amount that was available for use before the final assessment.

NOLs of Nonresidents.

In general, nonresidents are allowed the same deduction for NOLs as the deduction allowed to residents, except that the loss must be attributable to sources in Alabama, and is applied to income attributed to Alabama. A number of deductions allowed nonresidents, including the personal exemption and exemption for dependents, are limited based on the ratio of income from Alabama sources to income from all sources. When an NOL is fully absorbed, these deductions must be recomputed based on the changes to Alabama income and total income after the NOL is applied.

Frequently Asked Questions

Q. How many years may a loss be carried back or forward?

A. The loss may be carried back two (2) years (three (3) years for loss years prior to 1/1/98) and/or forward 15 years.

Q. Does the NOL have to be carried back before it is carried forward?

A. No. You may elect to forego the carryback of a net operating loss deduction and instead carry the loss for-

ward to the first available year following the loss year. For loss years beginning after December 31, 1997, this election can be made in one of two ways. The election can be made on or before the due date (with extensions) for filing the income tax return for the loss year by completing Part III of Form NOL-85. If no election is made by the due date of the loss year return, then the filing of the next year's return by the due date, including extensions and claiming the loss on the return shall be considered the taxpayer's election to forego the carryback period. This election, once made, is irrevocable.

Q. When there are two (2) or more loss years being carried to the same tax year, how are they handled?

A. If you carry two or more NOL's to the same tax year you must deduct them one at a time, in the order in which they occurred. The NOL from the earliest year is deducted first, then the NOL from the next earliest year, etc.

Q. If I determine after filing my return that I have a net operating loss for that year, but forgot to attach Form NOL-85, what should I do in order to claim the NOL?

A. You should claim the loss on the subsequent year's return by attaching Form NOL-85A to your timely filed return. Otherwise, you will be required to carry the loss back two (2) years before any portion of the unused loss can be carried forward.

Q. If I filed a joint return in the loss year with my spouse, how do I compute the NOL to carryback or carryforward for years when separate returns were filed?

A. The loss year must be computed as if separate returns were filed. See "Special Rules For Joint Returns" on page 5 of this booklet.

Q. How is the NOL applied if there has been a change in the status of the taxpayer(s) due to marriage, divorce or death?

A. When there is a change in the status of the spouses due to marriage, divorce or death, certain computations are required. See "Special Rules For Joint Returns" on page 5 of this booklet.

Q. What is considered business income and deductions for the purpose of determining an NOL?

A. Regulation 810-3-15-.27 states the following are to be considered business items: Salary and wages, Schedule C income or loss from a business or profession, gain or loss from sale of assets used in a trade or business Schedule D losses on I.R.C. §1244 stock (up to the amount of ordinary loss allowed for federal income tax purposes), Schedule E rental income or loss, Schedule E income or loss from a partnership, Schedule E income and loss from an Alabama S corporation, Schedule F income or loss from farming, employee moving expenses, Schedule A casualty and theft losses, Schedule A employee business expenses.

Q. What is considered nonbusiness income and deductions for the purpose of determining an NOL?

A. Regulation 810-3-15-.27 states the following are to be considered nonbusiness items: Schedule A medical expenses, taxes, interest expense, charitable contributions, and miscellaneous deductions other than employee business expenses; gain from the sale of a personal residence to the extent recognized in accordance with §40-18-14; gain or loss from sales of assets not used in a trade or business (including distributive shares of interest and dividend income received by a partnership or an Alabama S corporation); federal income tax refunds or federal income tax deduction amount; alimony received; taxable pensions and annuities; income or loss from a trust or estate; deductible contributions to qualified retirement plans (IRA, Keogh, etc); losses on I.R.C. §1244 stock in excess of the amount of ordinary loss allowed for federal income tax purposes; employee benefit contributions paid by an employer; penalties for early withdrawal of savings; alimony paid; or disability income exclusions.

Q. When is the sale of stock considered business or nonbusiness for the purpose of determining an NOL?

A. Only the sale of assets used in a trade or business are considered business income or deductions in determining an NOL. A stock loss constitutes a business loss only when the taxpayer is in the regular trade or business of trading or investing in stock (i.e. a dealer or professional trader in securities).

If a taxpayer sells I.R.C. §1244 stock an amount up to the amount of ordinary loss allowed for federal income tax purposes can be claimed as a business loss. Any loss in excess of the federal limitation is considered nonbusiness.

Q. Does Alabama have a provision for a "capital loss carryover?"

A. No. All losses, business or nonbusiness, are claimed in the year during which the loss occurred.

Q. I sustained a net operating loss for the calendar year ending December 31, 2000. After carrying this loss back two years and forward to my 2001 Alabama return, I still have an unused amount to carry forward. What is the last year I can carry this unused amount forward?

A. The unused carryover amount from 2001 would then be carried over to your 2002 Alabama return. If there was an unused amount after applying the carryover to your 2002 return, the unused amount could then be carried forward to future year returns until 2015 or until the loss has been fully applied.

Q. What is the statute of limitations on refunds claimed from the application of a net operating loss and what forms should I use?

A. If the claim for refund results from a net operating loss (NOL) prior to January 1, 1998, the carryback must be filed within three (3) years from the due date of the loss year return (including extensions thereof). If an election is made to carry the loss forward without carrying it back, a copy of Form NOL-85 must be attached to the loss year

return and the election must be timely (due date of the loss year return). Form NOL-85 must be completed whether carrying the net operating loss back three (3) years or carrying the loss forward.

For tax years beginning after December 31, 1997, if the claim for refund results from a net operating loss (NOL), the carryback must be filed within two (2) years from the due date of the loss year return (including extensions thereof). An election may be made to forfeit the carryback provision by completing Part III of Form NOL-85 and

attaching it to the loss year return or by applying the net operating loss to the subsequent year's timely filed return. A net operating loss can be carried back two (2) years or carried forward up to 15 years.

You must complete Form NOL-85 for the loss year to determine if you have a net operating loss and the amount of the loss that may be carried back or brought forward. If the loss is carried back, then Form NOL-85A must be attached to Form 40X of the earliest year's return to which the loss is carried.

Addresses of District Taxpayer Service Centers

Alabama income tax assistance may be obtained by calling or visiting any of the Alabama Department of Revenue Taxpayer Service Centers listed below. Additional forms and instructions may also be obtained from these centers. For refund information, call (334) 353-2540.

■ **Auburn, AL 36831-2929**
3300 Skyway Drive
P.O. Box 2929
Phone — (334) 887-9549

■ **Dothan, AL 36302-5739**
344 North Oates St.
P.O. Box 5739
Phone — (334) 793-5803

■ **Mobile, AL 36616-1406**
857 Downtowner Blvd., Suite E
P.O. Drawer 160406
Phone — (251) 344-4737

■ **Montgomery, AL 36132-7490**
1021 Madison Avenue
P.O. Box 327490
Phone — (334) 242-2677

■ **Birmingham, AL 35237-0848**
2024 - 3rd Avenue North
P.O. Box 370848
Phone — (205) 323-6387

■ **Gadsden, AL 35902-1190**
235 College Street
P.O. Drawer 1190
Phone — (256) 547-0554

■ **Muscle Shoals, AL 35662-3148**
3005 South Wilson Dam Highway
P.O. Box 3148
Phone — (256) 383-4631

■ **Decatur, AL 35602-1785**
1403A Beltline Road S.W.
P.O. Box 1785
Phone — (256) 353-2932

■ **Huntsville, AL 35814-1487**
994 Explorer Boulevard
P.O. Box 11487
Phone — (256) 922-1082

■ **Tuscaloosa, AL 35403-2467**
518 19th Avenue
P.O. Box 2467
Phone — (205) 759-2571

Obtaining Additional Forms

If you need additional NOL forms and instructions, you may download them from our Web site at www.ador.state.al.us or pick them up from any Taxpayer Service Center. Forms may also be requested by using the Order Blank below. In addition to the forms and instructions in this booklet, the Department has available the following forms:

- **NOL-F85 and Instructions**

This form is designed to compute the net operating loss sustained by a fiduciary (Form 41) that may be carried back or carried forward.

- **NOL-F85A and Instructions**

This form is designed to apply the loss as determined in Form NOL-F85, to the carryback or carryforward year.

To help reduce waste, please order only the forms and instructions necessary to prepare your return. Attach a separate sheet of paper listing the name and quantity of any additional Alabama forms you need which are not listed on the order blank.

Please allow 3 weeks for delivery.

 DETACH ALONG THIS LINE

Order Blank

The booklets, forms, and instructions listed here are available at no cost.

Please detach the order blank on the dotted line, enclose it in your own envelope, and mail to:

Alabama Department of Revenue
Income Tax Forms
P.O. Box 327470
Montgomery, AL 36132-7470

NAME	
NUMBER AND STREET OR RURAL ROUTE	
CITY, TOWN, OR POST OFFICE AND STATE	ZIP CODE

Quantity	Form
<input type="text"/>	● NOL-85 Booklet – (Forms NOL-85, NOL-85A, 40X, and instructions)
<input type="text"/>	● NOL-85 – Computation of NOL
<input type="text"/>	● NOL-85A – Carryback & Carryforward of NOL
<input type="text"/>	● NOL-F85 – Computation of Fiduciary NOL
<input type="text"/>	● NOL-F85A – Carryback/Carryforward of Fiduciary NOL
<input type="text"/>	● 40X – Amended Individual Return
<input type="text"/>	● 40X Instructions