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INCOME TAX – COMPUTING AND USING A NET OPERATING LOSS FOR MICHIGAN INCOME TAX AND HOUSEHOLD INCOME PURPOSES

(Replaces Revenue Administrative Bulletin 1998-3)

RAB 2017-14. This Revenue Administrative Bulletin (RAB) describes how to compute and use a net operating loss (NOL) and a net operating loss deduction for Michigan income tax and also describes the impact of a federal net operating loss on Michigan tax credits.

INTRODUCTION

Under Part 1 of the Michigan Income Tax Act (MITA), a Michigan NOL occurs when a business has losses in excess of its gains in a particular tax year, referred to as the loss year. An individual, a trust, or an estate can sustain an NOL, which may be carried to certain other years to offset income in those years. The resulting offset to income in those other tax years is referred to as the net operating loss deduction.[1] The Michigan NOL follows the same general format and procedures as the federal NOL, but is computed independently of the federal NOL.

ISSUES

I. What is a Michigan NOL and how is it different from a federal NOL?

II. How is a Michigan NOL computed?

III. How may a Michigan NOL deduction be used?

IV. What are the requirements to claim a Michigan NOL deduction?

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[1] See MCL 206.30(1)(m) and (n).

V. What NOL deduction, if any, may be used to establish eligibility for certain Michigan tax credits?

CONCLUSIONS

I. A Michigan NOL occurs when business losses exceed income in a particular tax year, with certain modifications. The Michigan and federal NOLs are distinct because itemized deductions factor into the federal NOL but not the Michigan NOL. Additionally, the Michigan NOL includes only Michigan-sourced income, losses and deductions, while the federal NOL applies to income, losses, and deductions from any source. In all other manners, the Michigan NOL is determined in accordance with the federal NOL provisions.

II. A Michigan NOL is computed by starting with adjusted gross income as defined in the Internal Revenue Code (IRC) and then applying IRC 172 and the modifications in IRC 172(b)(2) to Michigan-sourced income, losses and deductions.

III. The Michigan NOL may be used in the manner set forth in IRC 172(b), as in effect for the applicable tax period. Generally, the NOL may be carried back and used to offset income in the two taxable years preceding the loss year and may be carried over to each subsequent year for up to twenty years following the loss year until the loss is completely absorbed.

IV. A Michigan taxpayer claiming an NOL deduction created by a carryback or carryforward of an NOL must complete form MI-1045, *Application for Michigan Net Operating Loss Refund*, and attach the form to the MI-1040 or MI-1040X. Generally, the MI-1045 must be filed within four years of the date set for filing the return for the year in which the NOL was incurred.

V. For tax years beginning in 2012, an NOL deduction may not be used to determine a taxpayer's eligibility for the homestead property tax credit or home heating credit. However, the federal NOL deduction, as limited by federal modified taxable income, may be used for all tax years to compute eligibility for the farmland preservation tax credit.

LAW AND ANALYSIS

<u>Overview</u>

Under Part 1 of the Michigan Income Tax Act (MITA), a Michigan NOL occurs when business losses exceed income in a particular tax year. Like the federal NOL deduction, the Michigan NOL deduction is a legislatively-created mechanism by which taxpayers can smooth fluctuating income from year to year for tax purposes. An individual, a trust, or an estate can sustain an

NOL in one tax year and use that loss to offset income in other tax years. The resulting offset to income in those other tax years is referred to as an NOL deduction.[2]

The Michigan NOL deduction is statutorily provided for in Section 30(1)(m) and (n) of the MITA.[3] Section 30(1) defines Michigan taxable income as federal adjusted gross income (AGI) subject to certain adjustments.[4] Two of those adjustments pertain to the net operating loss. Subsection 30(1)(m) requires that AGI be adjusted by adding back any federal NOL deduction to the extent it was used to reduce AGI. Subsection 30(1)(n) then permits a deduction of a Michigan NOL. Specifically, subsection 30(1)(n) provides:

> Deduct a net operating loss deduction for the taxable year as determined under section 172 of the internal revenue code subject to the modifications under section 172(b)(2) of the internal revenue code and subject to the allocation and apportionment provisions of chapter 3 of this part for the taxable year in which the loss was incurred.

A Michigan NOL therefore follows the general NOL provisions of IRC 172 for determining an NOL, but is applied to Michigan-sourced income, losses and deductions only. The Michigan NOL, once created, is carried to other tax periods in the same manner as provided in the IRC.

The definition of a Michigan NOL deduction under MITA subsection 30(1)(n) can be broken into three parts: 1) determination of the NOL under IRC 172; 2) modification of the NOL to remove non-Michigan sourced income and losses, and; 3) determination of the carryback or carryforward amount per IRC 172(b)(2). This RAB explains each of these parts and then demonstrates the application of each.

<u>Determining an NOL under IRC 172</u>

Subsection (c) of IRC 172 defines an NOL as the excess of the allowed deductions over gross income subject to the modifications in subsection (d).[5] Six of the seven modifications in subsection (d) apply to individuals, trusts or estates.[6] This RAB discusses only the five most common loss modifications.[7] When calculating the NOL for the loss year, IRC 172(d) requires removal of the following deductions from the calculation:

1. The net operating loss deduction.[8]
2. The deduction for excess capital loss over capital gain and any deduction granted under IRC 1202 for the sale of certain qualified small business stock.[9]

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[2] See MCL 206.30(1)(m) and (n).
[3] MCL 206.30(1)(m) and (n).
[4] MCL 206.30(1).
[5] IRC 172(c).
[6] IRC 172(d)(5) requires corporate taxpayers to remove certain deductions for dividends received from the calculation of an NOL.
[7] Modifications related to real estate investment trusts (REITs) are less common. MITA taxpayers who receive income relating to real estate investment trusts should refer to IRC 172(d)(6), applying the modifications contained therein to any NOL computation.
[8] IRC 172(d)(1).
[9] IRC 172(d)(2).

3. The deduction for personal exemptions.[10]
4. The deduction for nonbusiness losses in excess of nonbusiness gains.[11]
5. The deduction for domestic production activities.[12]

No other loss modifications are permitted except those enumerated by IRC 172(d). The modifications are the same for both the federal and the Michigan NOL.

Notwithstanding the fact that the same modifications are applied to both NOLs, the federal and the Michigan NOLs are distinct from one another because the starting points for each include different items. The federal NOL begins its computation with federal taxable income. The Michigan NOL also begins with taxable income, which is defined under MITA as AGI.[13] The distinction arises because the computation of federal taxable income includes all itemized deductions.[14] The starting point for the Michigan NOL computation, AGI, does not include itemized deductions.[15] For this reason and for reasons outlined in the following section, the federal and Michigan NOLs need not equal one another, and a Michigan NOL can exist without a federal NOL.[16]

Applying the MITA Allocation and Apportionment Provisions to the NOL

The Michigan NOL also differs from the federal NOL as the Michigan NOL excludes income, losses, and deductions from other states because the MITA requires that an NOL deduction be calculated subject to the allocation and apportionment provisions of chapter 3 for the tax year in which the loss was incurred.[17] Chapter 3 of the MITA requires a taxpayer with income from business activity which is taxable both within and outside the state to allocate and apportion net income.[18] Therefore, an NOL and the attendant deduction can be based only on Michigan-sourced income, losses and deductions.

Additionally, since income, losses and deductions from oil and gas production and nonferrous metallic minerals extraction or beneficiation that are subject to Michigan severance tax are not taxable under the MITA, they must also be excluded from the NOL computation.[19]

Carryback and Carryforward of the NOL Deduction

The Michigan NOL can be used in the same manner as a federal NOL under IRC 172(b), but does not have to be carried to the same tax periods as the federal NOL. Generally, an NOL may be carried back to each of the two taxable years preceding the loss year and to the twenty

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[10] IRC 172(d)(3).
[11] IRC 172(d)(4).
[12] IRC 172(d)(7).
[13] MCL 206.30(1).
[14] For non-itemizing taxpayers, federal taxable income includes the standard deduction.
[15] Since the standard deduction is also below the AGI line, Michigan taxable income does not include the standard deduction for non-itemizing taxpayers.
[16] *Preston v Dep't of Treasury*, 190 Mich App 491 (1991).
[17] MCL 206.30(1)(n).
[18] MCL 206.103.
[19] See MCL 206.30(w)(i), 206.31b(1)(a), 205.315, and 211.784(1)(b). See also *Cook v Michigan Dep't of Treasury*, 229 Mich App 653 (1998).

taxable years following the loss year.[20] Special carryback and carryforward provisions apply to certain other types of losses.[21]

The amount of the NOL deduction for a given taxable year is equal to the sum of all NOL carryforwards and carrybacks for the taxable year.[22] The entire amount of the NOL for a loss year must be carried back to the earliest of the taxable years to which the loss may be carried.[23] The earliest year's loss must be used first until it is completely absorbed. Later years' losses can then be used until they are also absorbed or lost.

A taxpayer may elect to relinquish the entire carryback period.[24] If a taxpayer wishes a federal NOL election to control the treatment of a Michigan NOL, a copy of the federal election must be provided to the Department with the taxpayer's Michigan return. A taxpayer who wishes to make a separate Michigan election must submit a written Michigan election in the same manner and within the time frames prescribed for federal NOLs in the IRC. Once made, an election is irrevocable.[25]

The remainder of the loss is carried to each subsequent tax year consecutively. However, when calculating the remainder to be carried to each subsequent tax year, the taxable income for the tax year in which the NOL deduction was taken must be re-computed with the modifications in IRC 172(d)(2)(3)(6) and (7).[26] Thus, before any remaining NOL can be applied to subsequent tax years, taxable income in the tax year prior to the carryback or carryforward year must be modified to remove the deductions for excess capital loss, personal exemptions and domestic production activity (DPAD).[27] The NOL is then subtracted from the modified taxable income and the remainder carried to the next succeeding tax year. This modification must be repeated for each tax year to which an NOL is carried.

Claiming an NOL Deduction

A Michigan taxpayer claiming an NOL deduction created by a carryback or carryforward of an NOL must complete form MI-1045, *Application for Michigan Net Operating Loss Refund* and attach the form to the MI-1040 or MI-1040X. To expedite the review of tax returns reflecting a Michigan NOL deduction, the Department requests that taxpayers attach:

- copies of the completed federal form 1040 for the loss year and any supporting federal tax schedules and statements that substantiate the NOL
- a copy of the completed federal form 1045 (if applicable)
- the state(s) of location for any claimed business losses on federal schedule(s)
- a copy of any attachments indicated on federal schedules
- any K-1s issued to the taxpayer
- form MI-4797, *Adjustments of Gains and Losses From Sales of Business Property*

[20] IRC 172(b)(1)(A).
[21] IRC 172(b)(1)(B)-(F).
[22] IRC 172(a).
[23] IRC 172(b)(2).
[24] IRC 172(b)(3).
[25] *Id*.
[26] IRC 172(b)(2).
[27] See IRC 172(d)(2)(3) and (7). To the extent that the taxpayer has income, losses, or deductions related to REITs, see IRC 172(d)(6) also.

- form MI-1040D, *Adjustment of Capital Gains and Losses*
- Form MI-1040H, *Schedule of Apportionment*
- the Michigan Business, Rental, and Royalty Activity Worksheet
- any other pertinent form or data related to calculating the NOL

A claim for refund based on an NOL must be filed within the four-year statute of limitations period (MCL 205.27a). Therefore, when carrying back an NOL to prior years, the MI-1045 must be filed within four years of the date set for filing the return for the year in which the NOL was incurred. If an NOL is determined to have been sustained in a year that is outside the four-year statute of limitations period, a taxpayer may still claim the NOL deduction for the open tax years. However, in doing so, the taxpayer must calculate the amount of the Michigan NOL that would have been absorbed by Michigan income subject to tax in the closed tax year(s) to determine the amount that can be carried over to the open year(s). The Department may redetermine correct taxable income in a closed tax year in order to ascertain either the amount of an NOL, or the amount of an NOL that is absorbed in the closed tax year for purposes of determining the correct NOL deduction for an open tax year.

EXAMPLE 1

Assume taxpayer A sustains an NOL of $76,000 in tax year 2010, and in 2016 files a claim to establish his NOL and request refunds. The carryback years of 2008 and 2009 are outside of the statute of limitations period as is the carryforward year of 2011. Taxpayer A may still file a claim for the NOL refunds in 2016, but applying the NOL to the closed years reduces the NOL and causes it to be fully absorbed in year 2015 as illustrated in the chart below.

Tax Year	Income	NOL Absorbed in Closed Years and Available in Open Years	NOL Balance	Closed/Open Years for Refund Claim
2008	12,000	12,000	64,000	Closed
2009	6,000	6,000	58,000	Closed
2010	Loss year	0	58,000	Closed
2011	7,000	7,000	51,000	Closed
2012	11,000	11,000	40,000	Open
2013	15,000	15,000	25,000	Open
2014	22,000	22,000	3,000	Open
2015	36,000	3,000	0	Open
2016	46,000	No NOL remains	0	Open

Taxpayer A may still file in 2016 to claim refunds with his NOL, but applying the NOL to the closed years reduces the available NOL for the open years from $76,000 to $51,000.[28] The taxpayer should file an MI-1045, *Application for Michigan Net Operating Loss Refund*, for the 2010 loss year and file amended returns for the open years with a schedule demonstrating how the NOL is absorbed.

[28] For simplification, this example assumes that none of the IRC 172(b)(2) modifications were applicable when calculating the remaining NOL for carryforward to each consecutive year.

Where there are changes in the filing status of an individual taxpayer from the year of the loss to the year of the carryback or carryforward, a taxpayer must account for the change in status in the year to which the carryback or carryforward is applied. If married taxpayers filed jointly in the year of the loss and file single or separate in the carryback or carryforward year, each individual must determine and apply their share of the joint NOL to their single or separate returns. If a taxpayer filing single in the year of loss is filing jointly in the carryback or carryforward year, the joint filers must separate their income and deductions and apply the NOL deduction to the individual who sustained the NOL as a single individual. For married taxpayers filing separate in the year of the loss who file jointly in the carryback or carryforward year, the total NOL or its remainder may be applied to the joint return.

Using a Federal NOL Deduction to Establish Eligibility for Michigan Tax Credits

Historically, the federal NOL deduction was used to compute a Michigan taxpayer's household income to determine eligibility for several Michigan tax credits, including the homestead property tax credit and the farmland preservation tax credit. For tax years beginning before 2012, household income is still used to compute a homestead property tax credit. For those tax years, the federal NOL deduction used to determine eligibility for the homestead property tax credit may not exceed federal modified taxable income. Beginning in 2012, household income was replaced by total household resources for purposes of the homestead property tax credit. An NOL deduction cannot be used to reduce total household resources for purposes of the homestead property tax credit or the home heating credit for tax years after 2011.

Because the farmland preservation credit has not been amended to replace household income with total household resources, household income continues to be used to determine eligibility for that credit for any tax year, subject to the statute of limitations. As a result, the federal NOL deduction, as limited by federal modified taxable income, may continue to be used in the computation of that credit.

Understanding the MI-1045 Application for Michigan Net Operating Loss

Part 1: Though an NOL calculation must begin with Michigan taxable income, which is defined as federal AGI, the MI-1045 form requires that the Michigan NOL be computed from Michigan income, losses and deductions only. Therefore, the form is designed to build Michigan-sourced AGI using the information reported on the federal forms and schedules pertaining to Michigan income, losses and deductions. Notably, the form does not build into Michigan AGI the deductions for NOLs or for personal exemptions even though those are included in federal AGI because to do so would require that they be removed again as part of the federal IRC 172(d) modifications appearing on the lines below the calculation of Michigan AGI. The lines below the computation of Michigan AGI on page 1 of the MI-1045 address the remaining three most common IRC 172(d) modifications: 1) the excess of nonbusiness deductions over nonbusiness income; 2) the excess capital loss deduction; and, 3) the DPAD.

Part 2: Applying a Michigan NOL deduction to a carryback year requires a taxpayer to: 1) compute Michigan AGI for the carryback year; 2) apply the NOL deduction; 3) re-compute the taxable balance after personal exemptions; and then, 4) re-compute any overpayment for the carryback year.

For subsequent carryback and carryforward years, the remaining unabsorbed NOL must be modified as directed in IRC 172(b)(2)(A) and (B) before being carried to subsequent tax years. IRC 172(b)(2) essentially requires taxable income to be modified to remove certain deductions, thus increasing taxable income. The effect is that more of the NOL must be used to absorb taxable income for purposes of determining the remaining NOL or carryforward amount. Those modifications are entered on line 42 when computing a carryback.

Part 3: Applying a Michigan NOL deduction to a carryforward year requires a taxpayer to apply the carryforward amount from the prior tax year to the taxable income of the tax year the NOL is being carried to. If there is any unabsorbed NOL remaining, it must again be modified as directed in IRC 172(b)(2)(A) and (B). The amount of the NOL that remains after applying the required modifications may be carried forward to the next consecutive year.

<u>EXAMPLE 2</u>

Loss Year 2016

For the tax year beginning January 1, 2016, taxpayer A, a Michigan resident, has income and/or losses from the following sources:

Federal AGI Year 2016		**Michigan Adjustments**	**MI-1045 Part 1 Year 2016**
Wages	25,000		25,000
Interest Income	120		120
Dividend Income	80		80
Schedule C Business Income (Loss) [18,000 MI; 2,500 IN]	20,500	2,500 Indiana	18,000 Business income attributable to MI
Capital Gain (Loss)	(3,000)		(3,000)
Pension	12,500		12,500
Schedule E, Rental Income (Loss) [All Arizona]	6,500	6,500 Arizona	0
Schedule E, Flow-Through Income (Loss) [(87,000) MI; (8,000) OH][29]	(95,000)	(8,000) Ohio	(87,000) Business income attributable to MI
Misc: State Tax Refunds	560		560
Other: Federal NOL Deduction	(4,000)		0 A federal NOL deduction is not included in a MI NOL calculation
Total Income	**($36,740)**		**($33,740)**
Adjustments			
Retirement Plan Contributions	500		500
Deductions for Self-Employment Tax	230	28 Indiana	202
DPAD	3,200	1,200 Ohio	2,000
Total Adjustments	**3,930**		**2,702**
Federal AGI	**($40,670)**		**Michigan AGI ($36,442)**

[29] Example 2 was edited to correct a typographical error.

To calculate the Michigan NOL on the MI-1045, Michigan AGI is modified as follows:[30]

14. Michigan AGI. Subtract line 13 from line 11. If greater than zero, you do not have an NOL.			14.	-36,442 00
15. Nonbusiness deductions: Add lines 12a, 12d and 12f		15. 500 00		
16. Nonbusiness income included in line 11				
a. Interest income	16a. 120 00			
b. Dividend income	16b. 80 00			
c. Net nonbusiness capital gains (before any allowable exclusion)	16c. 00			
d. Pension, IRA, and annuities	16d. 12,500 00			
e. Alimony received	16e. 00			
f. Other income	16f. 560 00			
17. Total nonbusiness income. Add lines 16a through 16f		17. 13,260 00		
18. Excess of nonbusiness deductions over nonbusiness income, subtract line 17 from line 15. If less than zero, enter "0"		18. 0 00		
19. Excess capital loss deduction (enter as a positive number. See instr.)		19. 3,000 00		
20. DPAD sourced to Michigan (enter as a positive number)		20. 2,000 00		
21. Add lines 18, 19 and 20			21.	5,000 00
22. Net operating loss. Combine lines 14 and 21. If greater than zero, STOP; you do not have an NOL.			22.	-31,442 00

<u>EXAMPLE 3</u>

Carryforward Years 2017 and 2018

Assume taxpayer A, a Michigan resident, elects to waive the carryback period and has Michigan taxable income in 2017 of $22,500 without regard to a Michigan NOL deduction or personal exemptions. The entire 2016 NOL of $31,442 is carried forward and applied to taxable income, as a $22,500 NOL deduction in tax year 2017. Because the NOL from loss year 2016 exceeds Michigan taxable income in 2017, without regard to a Michigan NOL deduction or personal exemptions, a carryforward exists for tax year 2018.

To determine the amount of the unabsorbed NOL remaining for carryforward to year 2018, the excess of the loss year NOL over the taxable income for 2017, which equals $8,942 (31,442-22,500), must be modified per the requirements of IRC 172(b)(2) to remove certain deductions included in taxable income for tax year 2017. Assuming that taxable income for tax year 2017 included DPAD of $500 sourced to Michigan and an excess capital loss of $3,000, the unabsorbed NOL is reduced to $5,442 ($8,942-$3,500) for use in tax year 2018.

[30] Example uses the 2016 form. However, forms may change from year to year.