STATE OF MICHIGAN

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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 1993-9)

RAB-98- 3. This bulletin describes how to compute a net operating loss (NOL) and a net operating loss deduction for Michigan income tax and household income purposes for returns filed on or after January 1, 1998. This bulletin also describes the transitional rule for returns filed before January 1, 1998. It also reflects the amendments to §172 of the Internal Revenue Code (IRC) by 105 Public Law 34 and describes how those changes affect the Michigan net operating loss.

ISSUES

I. How should taxpayers compute a Michigan net operating loss and Michigan net operating loss deduction?

II. How many years can taxpayers carry back and carry over the net operating loss?

III. How should taxpayers compute household income when reporting a net operating loss deduction?

IV. Will the Department require taxpayers who have filed returns prior to January 1, 1998 to file amended returns?

V. What are the reporting requirements to claim a NOL deduction?

CONCLUSIONS

I. For returns filed on or after January 1, 1998, taxpayers shall compute the Michigan NOL according to the federal NOL provisions stated in IRC э172. However, this computation will use only income, losses, and deductions allocated or apportioned to Michigan under the provisions of chapter 3 of the Michigan Income Tax Act [beginning at MCL 206.102; MSA 7.557(1102)] <u>and</u> shall not include federal itemized deductions. The resulting Michigan NOL may be subtracted on the Michigan return in the year to which it is properly carried.

II. The Michigan net operating loss may be carried back or over to other tax years in the same manner as allowed under ϶172(b)(1) of the Internal Revenue Code, as in effect for the applicable tax period.

III. When computing household income, the net operating loss deduction is limited to the smaller of the federal NOL deduction or federal modified taxable income.

IV. Taxpayers who computed a Michigan NOL or NOL deduction on a return filed prior to January 1, 1998 may continue to carry that NOL forward to subsequent years until the loss has been fully absorbed. See the Transitional Rule on page 4.

V. A Michigan taxpayer claiming a NOL carryback or carryover must complete form MI-1045 APPLICATION FOR A NET OPERATING LOSS REFUND and attach the form to the MI-1040 or MI-1040X. Copies of federal forms 1045, 1040 and schedule A, and any other forms or data pertinent to calculating the NOL should also be attached. Taxpayers electing to forgo a carryback of a Michigan NOL must make a Michigan election by filing a statement with the loss year return or by attaching a copy of the federal election.

LAW AND ANALYSIS

Overview

In the past the Department limited the Michigan net operating loss deduction to the lesser of the federal net operating loss deduction or federal modified taxable income (FMTI). The Courts determined that the Michigan Income Tax Act does not limit a Michigan net operating loss or loss deduction to the federal net operating loss or deduction. Further, a Michigan net operating loss deduction is not limited to federal modified taxable income. The Court, however, noted that the legislature intended to limit a net operating loss deduction to federal modified taxable income for household income purposes.

The Michigan Compiled Laws MCL 206.30 (o) & (p); MSA 7.557(130) provide:

> (o) Add, to the extent deducted in determining adjusted gross income, the net operating loss deduction under section 172 of the internal revenue code.
>
> (p) 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 act for the taxable year in which the loss was incurred.

The Michigan Compiled Laws define household income for use in computing a homestead property tax credit, home heating credit, senior citizen prescription drug credit, or farmland preservation credit and states in pertinent part:

> "Income" means the sum of federal adjusted gross income as defined in the internal revenue code plus all income specifically excluded or exempt from the computations of the federal adjusted gross income except that beginning with the 1988 tax year, a deduction for a carryback or carryover of a net operating loss shall not exceed federal modified taxable income as defined in section 172(b)(2) of the internal revenue code. MCL 206.510(1); MSA 7.557(1510).

In *Preston v Treasury*, 190 Mich App 491; 476 NW 2d 455, (1991), the Michigan Court of Appeals held that a taxpayer may have a Michigan net operating loss without a federal net operating loss. The Court held that, through incorporation of the Internal Revenue Code, the Income Tax Act provides for a Michigan net operating loss and a Michigan net operating loss deduction. The amounts of the loss and deduction, however, do not have to be equal to the federal net operating loss and deduction.

In *Beznos v Treasury,* 224 Mich App 717; 569 NW 2d 908 (1997), the Court held that the amount of the Michigan net operating loss deduction is not limited to federal modified taxable income. Furthermore, in ruling in favor of the taxpayer, the Michigan Court of Appeals upheld the petitioner=s interpretation of the Michigan Income Tax Act regarding the computation of the Michigan net operating loss and carryover. The Court found that the petitioner=s position supported the legislative intent of the Michigan Income Tax Act.

Michigan taxable income is based on federal adjusted gross income as expressly prescribed in MCL 206.30(1); MSA 7.557(130). Therefore, the Michigan net operating loss and net operating loss deduction must be computed without regard to federal itemized deductions.

Based on these cases, the Michigan net operating loss is separate and distinct from a federal net operating loss. The Michigan net operating loss deduction is limited to neither the federal net operating loss deduction nor federal modified taxable income.

The Michigan NOL is computed according to the federal NOL provisions of § 172 of the Internal Revenue Code, using only income, losses and deductions allocated or apportioned to Michigan. MCL 206.30(1), (o) & (p); MSA 7.557(130). Further, the Michigan net operating loss is computed without regard to federal itemized deductions in the year of the loss. This Michigan NOL may then be carried back or forward to another tax year in the same manner as allowed under § 172(b)(1) of the Internal Revenue Code. The portion of such loss which shall be carried to the other taxable years shall be the excess, if any, of the amount of such loss over Michigan taxable income before the adjustment for personal and dependent exemptions or deduction.

Carryback and Carryover of the Net Operating Loss

Tax Years Commencing on or Before August 5, 1997

A Michigan net operating loss may be carried back three years and carried over to each of the subsequent 15 years until the loss is completely offset. A taxpayer may also elect to forgo a carryback and to carry over the Michigan NOL for the subsequent 15 years in the same manner as prescribed by § 172(b)(3) of the Internal Revenue Code. The Michigan election to forgo the carryback period is made by attaching a statement or a copy of the federal election to the Michigan return for the year of the loss. The statement must be filed by the due date, including extensions, for filing the loss year return. Once the election to forgo the carryback period is made, it is irrevocable.

Tax Years Commencing After August 5, 1997

Michigan will follow the federal carryback/carryover limitations as prescribed by Internal Revenue Code § 172 (b)(1) as in effect for the applicable tax period. In general, net operating losses may be carried back two years and forward 20 years. A taxpayer may elect to forgo a carryback in the same manner as described above.

Taxpayers who file the entire Michigan income tax return in conformance with the Internal Revenue Code of 1986 as in effect on January 1, 1996 may use the carryback and carryover provisions of the same IRC.

Household Income Treatment

Household income is used for the calculation of the homestead property tax credit, the home heating credit, farmland preservation credit, and the senior citizen prescription drug credit. Caution: a home heating credit for years commencing after 12/31/95 can no longer be amended to deduct a NOL carryback in household income. Beginning with the 1996 tax year, a home heating credit must be filed on or before September 30 of the year immediately following the year of the credit. MCL 206.527a(20); MSA 7.557 (1527a)(20).

The Court of Appeals stated that the limitation of a net operating loss deduction in the computation of household income is the lesser of the federal NOL deduction or federal modified taxable income as required by the Income Tax Act, *Beznos, supra*. Public Act 261 of 1988 provides that, beginning with the 1988 tax year, a deduction for a carryback or carryover of a net operating loss shall not exceed federal modified taxable income as defined in § 172 (b)(2) of the Internal Revenue Code. MCL 206.510(1); MSA 7.557 (1510) (1).

Federal modified taxable income is computed by modifying federal taxable income to remove the federal exemption allowance, the capital loss deduction, and the NOL deduction. See federal Publication 536 for a more detailed discussion of federal modified taxable income. When computing household income, the NOL deduction is limited to the lesser of federal modified taxable income or the federal NOL deduction.

Transitional Rule

A Michigan NOL shall be computed as described in this RAB on returns filed on or after January 1, 1998. The NOL may be used to the extent of income subject to Michigan income tax in the years to which it is carried.

A taxpayer who has computed a Michigan NOL in accordance with RAB 1993-9 on a return filed prior to January 1, 1998 may continue to carry the NOL forward until it is fully absorbed on the Michigan returns. The NOL so computed may be used to the extent of income subject to Michigan income tax in the years to which it is carried with no limitation applied.

Alternatively, for returns filed prior to January 1, 1998, a taxpayer may elect to recompute the Michigan NOL as described in this RAB and use up the NOL in the earliest years to which it is properly carried. In doing so, the taxpayer must first utilize the Michigan NOL to the extent of income subject to Michigan tax in all applicable years including years that are outside of the four year statutory refund period to determine the revised carryover. Amended returns may then be filed for tax periods within the statutory claim period to claim an additional refund. If the revised NOL carryover results in an additional tax due for any year within the four-year statutory period, an amended return(s) must be filed with payment of the additional tax and interest due. The computation of household income, however, remains the same as in past years.

Reporting Requirements and Forms

A Michigan taxpayer claiming a net operating loss deduction created by a carryback or carryover of an NOL must complete form MI-1045 APPLICATION FOR A NET OPERATING LOSS REFUND and attach the form to the MI-1040 or MI -1040X. This form and instructions explain how to compute a Michigan NOL, a refund for a carryback year, the Michigan NOL carryover, and the allowable amount for household income computation.

To expedite the review of tax returns reflecting a Michigan NOL deduction, the Department requests that taxpayers attach copies of the federal forms 1045, 1040 and schedule A, and any other pertinent form or data related to calculating the NOL. The Michigan MI-1045 form and instructions may be obtained by telephoning the Michigan Department of Treasury at 1-800-FORM-2-ME or by accessing the Treasury Department=s home page on the world wide web at http://www.treas.state.mi.us and clicking on the box marked Tax Forms and Treasury Publications.

Sample Calculations

The computation of a Michigan net operating loss, a Michigan net operating loss deduction and subsequent carryovers, and household income are reflected in the following examples. Note that federal itemized deductions, although included in the federal NOL, are not included in the Michigan NOL. The deduction for personal exemptions has been omitted throughout since it is not used when calculating either a federal or Michigan NOL.

EXAMPLE 1

Loss Year 1997

For tax year beginning January 1, 1997, taxpayer A, a Michigan resident, has income and/or losses from the following sources:

Schedule C loss (from business located in Michigan)	-$100,000
Interest income	20,000
Rental loss from other state	- 10,000
Adjusted gross income (AGI)	- 90,000
Itemized deductions	- 10,000
Federal taxable income	-100,000

For federal income tax purposes, the taxpayer would sustain a 1997 NOL of $100,000. For Michigan income tax purposes, the taxpayer would sustain a 1997 NOL of $80,000, which is the Michigan business loss of -$100,000 plus the taxable interest of $20,000. For household income purposes, the allowed NOL available for carryback would be the federal NOL of $100,000. The taxpayer does not elect to forego the NOL carryback.

Carryback year 1994

The following demonstrates the NOL carryback rule. In 1994, the taxpayer's 1994 federal return information is as shown below:

Wages	$15,000
Michigan business income	10,000
Federal NOL deduction	-100,000
AGI	-75,000
Itemized deductions	-15,000
Federal taxable income	-90,000

The allowable NOL deduction for household income purposes in 1994 would be the taxpayer's 1994 federal modified taxable income, which is computed as follows:

AGI (w/o NOL)	$25,000
Less: Itemized deductions	-15,000
Federal modified taxable income	10,000

For Michigan income tax purposes, the carryback of the 1997 NOL would be reflected in the 1994 amended return. The taxpayer must add back the 1994 federal NOL deduction of $100,000 and subtract in its place the 1997 Michigan NOL carryback of $80,000. The 1994 Michigan income tax liability would be computed as follows:

Federal AGI	-$75,000
Add: federal NOL deduction	100,000
Michigan income subject to tax without the NOL deduction	25,000
Subtract: Michigan NOL deduction	-80,000
Income subject to tax	-55,000
Exemption allowance	-2,100
Michigan taxable income	0
Tax @ 4.47%	0

The Michigan NOL carryover to 1995 will be $55,000, which is the 1997 Michigan NOL of $80,000 reduced by the 1994 Michigan income subject to tax (before the NOL) of $25,000. The federal NOL carryover to 1995 will be $90,000, which is the 1997 federal NOL of $100,000 less the 1994 federal modified taxable income of $10,000. The $90,000 federal NOL carryover to 1995 will be available to reduce 1995 household income to the extent of 1995 federal modified taxable income.

EXAMPLE 2

Carryback Year 1995

Taxpayer A has a federal NOL carryover of $90,000 to 1995 and a Michigan NOL carryover to 1995 of $55,000 remaining from Example 1. In 1995, the taxpayer had income from the following sources:

Michigan business income	$40,000
Pension	30,000
Rental loss from other state	-10,000
Federal NOL carryover deduction	-90,000
AGI	-30,000
Itemized deductions	-10,000
Federal taxable income	-$40,000

The allowable NOL deduction for household income purposes in 1995 would be the taxpayer's 1995 federal modified taxable income, which is computed as follows:

AGI (w/o NOL)	$60,000
Less: Itemized deductions	-10,000
Federal modified taxable income	50,000

For Michigan income tax purposes, the taxpayer must add back the 1995 federal NOL carryover deduction of $90,000, and subtract in it's place the remaining Michigan NOL carryover from 1994 of $55,000. The 1995 Michigan income tax liability would be computed as follows:

Federal AGI	-$30,000
Add: Federal NOL carryover deduction	90,000
Rental loss from other state	10,000
Subtotal	70,000
Subtract: Pension subtraction	-30,000
Income subject to tax without the NOL deduction	40,000
Subtract: Michigan NOL carryover Deduction	-55,000
Income subject to tax	-15,000
Exemption allowance	-2,400
Michigan taxable income	0
Tax @ 4.4%	0

The Michigan NOL carryover to 1996 will be $15,000 which is the Michigan NOL carryover to 1995 of $55,000 less the 1995 Michigan income subject to tax of $40,000 (before the NOL). The federal NOL carryover to 1996 will be $40,000, which is the NOL carryover to 1995 of $90,000 less the 1995 federal modified taxable income of $50,000. The $40,000 federal NOL carryover to 1996 will be available to reduce 1996 household income to the extent of 1996 federal modified taxable income

EXAMPLE 3

Michigan NOL in the absence of a federal NOL

In 1996, taxpayer B, a Michigan resident, has wages of $10,000, a Michigan business loss of -$30,000 and a gain from the sale of rental property from another state of $50,000. For federal income tax purposes, the taxpayer has not sustained an NOL, but has sustained a 1996 Michigan NOL of -$20,000**.** The taxpayer elects to forgo the carryback period by attaching a statement to the timely filed 1996 Michigan return.

In 1997 the taxpayers only source of income is wages of $15,000. The taxpayer will be able to subtract the 1996 Michigan NOL carryover of $20,000 on the 1997 Michigan return, and carry the remaining balance of $5,000 to 1998. For household income purposes, no 1997 NOL deduction would be allowed.