This responds to your request dated February 6, 2004, for advice on net operating loss (NOL) issues arising at the Atlanta Service Center. Specifically, you have raised questions relating to the manner in which taxpayers recompute their federal tax liability following the carryback of a NOL that is not fully absorbed in the carryback year. You cite conflicting directions in Publication 536, Net Operating Losses (NOLs) for Individuals, Estates and Trusts (2003), the instructions to Form 1045, Application for Tentative Refund, and Internal Revenue Manual (IRM) Section 21.5.9. It is your opinion that complying with the IRM results in problematic computations and audit trails. In addition, your request raises issues regarding the proper procedure for computing refunds when a divorced taxpayer incurs a NOL that the taxpayer carries back to a year in which he or she filed a joint return.

Please be advised that this memorandum has been divided into two sections. Part 1 encompasses the issues relating to the carryback of an NOL that is not fully absorbed in the carryback year. Further, in Part 1, the filing status of the taxpayer is the same in the carryback year as it was when the NOL is incurred. Part 2 encompasses the issues relating to a NOL incurred by a single individual that is carried to a joint return year.

**Part 1 – Carryback of NOL to a non-fully absorbed year**

**Background**

As discussed more fully below, a NOL must be carried to the earliest taxable year to
which it may be carried under § 172(b) of the Internal Revenue Code, and is considered to be used up, or absorbed, to the extent of taxable income, with certain modifications, in the year to which the NOL is carried. This taxable income amount is known as “modified taxable income”. When the NOL exceeds the modified taxable income in the carryback year, the NOL is not fully absorbed and the remaining NOL is carried to succeeding taxable years.

IRM 21.5.9.

I.R.M. Section 21.5.9.5.9 provides that in a carryback year in which a NOL is not fully absorbed, the taxpayer’s adjusted gross income and taxable income should be reduced by the modified taxable income amount shown on Schedule B, Form 1045. This is accomplished on IDRS by inputting transaction code 888 and code 886, which offset adjusted gross income and taxable income, respectively, by the modified taxable income amount. In effect, therefore, the IRM provides that a taxpayer’s NOL deduction is equal to his or her modified taxable income in years in which the NOL is not fully absorbed.

Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts

Publication 536 provides instructions for computing a NOL deduction and a NOL carryover. Publication 536, on page 7, provides that a taxpayer’s NOL deduction in the carryback/carryover year is equal to the total NOL if the taxpayer has not carried the NOL to an earlier year. If the NOL has been carried to an earlier year, the taxpayer’s NOL deduction is the total NOL minus the amount of the NOL used (or absorbed) in earlier years. Thus, contrary to IRM Section 21.5.9.5.9, Publication 536 provides that the NOL deduction is equal to the total available NOL, not modified taxable income, in the carryover/carryback year.

Form 1045, Application for Tentative Refund, and Instructions (2003)

The 2003 Form 1045 instructions are consistent with Publication 536. The Form 1045 instructions provide as follows:

You generally must carry back the entire NOL to the 2nd tax year before the loss year. Any loss not used in the 2nd preceding year is then carried to the 1st preceding year. Any loss not applied in the 2 preceding years may be carried forward up to 20 years.

Conflicts arising between the IRM, Publication 536, and Form 1045 Instructions

According to the Service Center, taxpayers seeking a refund for an overpayment generally offset their adjusted gross income by the entire available NOL, rather than the modified taxable income amount, in recomputing their tax liability for the carryback year. As a result, the after-carryback figures as computed by the Service do not match the
taxpayer’s after-carryback figures, thereby necessitating an update of each taxpayer’s module. While, in years in which the NOL is not fully absorbed, regular taxable income will generally be zero whether a taxpayer’s adjusted gross income is reduced by the entire NOL or the modified taxable income amount, the differing treatment of the NOLs may affect other items such as the taxpayer’s alternative minimum tax and earned income credit computation.

Issue

If a NOL is incurred and carried back to a year in which the NOL is not fully absorbed, should adjusted gross income be reduced by the entire NOL as set forth in Publication 536 or by modified taxable income as discussed at IRM 21.5.9.5.9?

Conclusion

Except as provided in Part 2 (relating to the carryback of a single individual’s NOL to a joint return year), a taxpayer is required to carryback the entire NOL to the earliest available carryback year. Thus, in the carryback year, adjusted gross income should be reduced by the entire NOL, not the modified taxable income amount. Requiring a taxpayer to reduce adjusted gross income by only the modified taxable income amount may result in, for example, an overreporting by the taxpayer of alternative minimum taxable income and an underreporting of the taxpayer’s earned income credit.

Legal Analysis

Section 172(a) allows a deduction equal to the aggregate of the net operating loss carryovers to a taxable year plus the net operating loss carrybacks to such year.

Section 172(c) defines a “net operating loss” as the excess of the deductions allowed by Chapter 1 of the Internal Revenue Code over gross income. The excess, however, is computed with the modifications specified in § 172(d). The salient adjustments are:

(A) for individual taxpayers:

(1) No deduction is allowed for the excess of capital losses over capital gains;

(2) No personal exemptions are allowed;

(3) Deductions not attributable to a taxpayer’s trade or business are allowed only to the extent of the taxpayer’s income not derived from a trade or business (losses from the sale of business property, however, are considered business losses as are all casualty losses);
(B) for corporations, the deduction permitted for dividends received is not limited to 70 or 80 percent of taxable income. Corporations that use debt financing for acquisitions or capital restructuring are subject to additional limitations.

(C) for all taxpayers, no NOL deduction is permitted in computing the amount of an NOL for a taxable year.

I.R.C. § 172(d)(1)-(6)

Once the amount of an NOL is determined, the NOL is carried back or carried over in accordance with the rules of § 172(b). The amount carried back or carried over to a taxable year results in a NOL deduction in the year of the carryback or carryover. Sections 172(b)(1) and (2) require, generally, that a NOL for any taxable year first be carried back to each of the 2 previous taxable years, and if unabsorbed by the income in those years, carried forward to each of the 20 taxable years following the taxable year of such loss. Section 172(b)(2) provides, in part, as follows:

. . . the entire amount of the net operating loss for any taxable year (…the “loss year”) shall be carried to the earliest of the taxable years to which…such loss may be carried.

Section 1.172-4(a)(3) also addresses the carrying of NOLs to succeeding years. It provides as follows:

The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over.

As stated in § 1.172-4, when a NOL is carried back or carried over, a determination must be made regarding the amount of the NOL that was absorbed in the carryback/carryover year. The purpose of the absorption computation is to determine the remaining NOL that may be used in succeeding taxable years. Section 172(b)(2) provides that the portion of the NOL carried to each of the other taxable years is the excess, if any, of the amount of such NOL over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. Section 172(b)(2), however, requires taxpayers to make certain modifications to its taxable income in determining the NOL absorption amount. Thus, a NOL is considered to be absorbed to the extent of modified taxable income in the carryback/carryover year. Modified taxable income is taxable income computed by ignoring any excess of capital losses over capital gains, the § 1202 exclusion, and the personal exemption deduction. Further, modified taxable income is determined without regard to the NOL for the loss year or for
any taxable year thereafter, and the taxable income so computed shall not be considered to be less than zero.

Finally, § 172(b)(3)(C) allows a taxpayer to make an irrevocable election to relinquish the entire carryback period and carry forward the NOL to the taxable years following the loss year.

Illustration and Analysis (NOL not fully absorbed in a carryback year):

The following example illustrates the manner in which a NOL is carried back to offset income in the carryback year. Further, the example includes a NOL absorption computation. Please note that the example is intended to demonstrate the principles of § 172 only and, therefore, intentionally ignores all deductions (including the personal exemption deduction) except the § 213 medical expense deduction.

Year 1: Assume a taxpayer has gross income of $1,000 and incurs medical expenses of $275. The taxpayer reports the following taxable income when completing his return and makes timely payments of tax.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>1,000</td>
</tr>
</tbody>
</table>
| Medical expense      | 200    | (limited to the extent to which the expense ($275) exceeds 7.5% of AGI ($75))
| Taxable income       | 800    |

Year 2: The taxpayer has taxable income of $1,000.

Year 3: The taxpayer incurs a NOL of $1,500. Taxpayer makes no election to forego the carryback of the NOL and thus must carry the NOL back 2 years to offset the income in Year 1.

Recomputed Year 1 taxable income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Net operating loss deduction</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>500</td>
</tr>
</tbody>
</table>
deduction (275) (the deduction is not limited because the AGI, taking into account the NOL deduction, is a negative amount)

Taxable income (775)

The taxpayer is thus entitled to a refund of all the taxes paid for Year 1.

The taxpayer next must compute the amount of the $1,500 net operating loss that was absorbed in Year 1 and thus that may be carried to Year 2. Under § 172(b)(2), the amount of the NOL absorbed in Year 1 is equal to the Year 1 modified taxable income (taxable income computed with certain modifications set forth in section 172(d)). Further, modified taxable income is determined without regard to the NOL for the loss year of any year thereafter.

**NOL absorption computation - Year 1**

| Gross income | $1,000 |
| Adjusted gross income | 1,000 |
| Medical expense deduction | (200) (the deduction is again limited because AGI is $1,000) |
| Modified taxable income | 800 |

The $1,500 NOL is reduced by the $800 Year 1 modified taxable income leaving $700 to be carried to Year 2 to offset the Year 2 income.

**Recomputed Year 1 Taxable income - IRM Method:**

As discussed above, I.R.M. Section 21.5.9.5.9 provides that in a carryback year in which a NOL is not fully absorbed, the taxpayer’s adjusted gross income and taxable income should be reduced by the modified taxable income amount shown on Schedule B, Form 1045. The IRM instructions would thus produce the following result:

| Gross income | $1,000 |
| NOL deduction | (800) |
| AGI | 200 |
| Medical expense deduction | (260) (limited to the amount by which the deduction ($275) exceeds 7.5% of AGI ($15) |
Note that, following the directions in the IRM, the taxpayer in this example is still entitled to a full refund of the taxes paid for Year 1. The problem, however, with the IRM method is that it computes an incorrect adjusted gross income and an incorrect taxable income. Thus, the taxpayer's earned income credit could potentially be miscalculated because the amount of an earned income credit may be affected by a taxpayer's adjusted gross income. Further, for taxpayers subject to the alternative minimum tax (AMT), AMT liability computed on Form 6251 may be miscalculated because Form 6251 requires taxpayers to enter their adjusted gross income minus any itemized deductions.

In conclusion, § 172 requires that the entire NOL be carried back to the earliest possible year. Adjusted gross income should therefore be reduced by the entire NOL carryback rather than by modified taxable income. The provisions of the IRM should be amended to reflect the correct procedure by which NOL carrybacks are computed.

Part 2 – NOL sustained by a single taxpayer and carried to a joint return year

Part 2 of this document concerns the proper procedure for computing a refund when a single taxpayer incurs a NOL and carries the NOL back to a year in which the taxpayer filed a joint return.

Background

The questions presented for consideration in Part 2 of this document involve the procedures and computations required for processing a refund arising out of a NOL sustained by a divorced taxpayer when the NOL is carried back to a year when the taxpayer was married and filed a joint return with his or her former spouse. As discussed below, the NOL provisions are personal to the spouse incurring the loss and thus can only offset the income of that taxpayer.

Section 6013 imposes joint and several liability upon a husband and wife for the tax computed on the aggregate income reported on a joint return.

Section 6402(a) states that in the event of an overpayment, the Secretary, within the applicable period of limitations, may credit the amount of the overpayment, including any allowable interest, against any liability of an internal revenue tax on the part of the person who made the overpayment and, subject to certain exceptions, must refund the balance to that person.

Under Rev. Rul. 74-611, 1974-2 C.B. 399, husbands and wives who file joint returns have a separate interest in both the jointly reported income, as well as any overpayment attributable to the joint return. A joint income tax return does not create new property interests for the husband or the wife in each other's income tax overpayment. Consequently, because the taxpayer/wife in the revenue ruling paid the entire amount of
the tax, she is entitled to the entire amount of the overpayment and the Service may not credit the overpayment on the joint return against the separate tax liability of the husband for the prior year.

IRM 21.5.9.5.16(6)(a) addresses the carryback by a former spouse of a NOL to a joint return year. It provides as follows:

Use the following steps when a person (the loss spouse) carries a NOL back to a taxable year in which that person filed a joint return with a former spouse.

a) Recompute the total tax liability for the carryback year limiting the maximum amount of the NOL deduction to what the loss spouse’s taxable income for the carryback year would have been if the spouses had filed married filing separately for that tax year.

Issues

The questions specifically raised by your office are as follows:

1. Whether, as articulated in IRM 21.5.9.5.16 (6)(a), in a situation in which a single taxpayer incurs a NOL that is carried to a joint return year, the NOL deduction in the carryback/carryover year is equal to the loss spouse’s married filing separately taxable income in that year.

2. Whether, in computing the spouses’ married filing separately taxable incomes, taxable social security benefits, Schedule A itemized deductions, and personal exemptions must be recalculated, and if so, how.

3. Whether, once the correct NOL carryback amount has been determined, the NOL carryback is taken into account in determining the loss spouse’s recomputed tax liability for the carryback year as though each spouse had filed a return under a married filing separate status for that year?

4. Whether all taxes such as the self-employment tax, Schedule H tax and Form 5329 tax must be included when calculating the spouse’s allocation ratio when a NOL is carried from a single year to a joint tax year?

5. Whether, if the spouses are subject to the alternative minimum tax (AMT) in the carryback/joint return year, the spouse’s allocation ratio must take into account the spouses’ separate AMT income and AMT liability.

6. Whether (a) Form 1045, Schedule B, should be used to determine how much of a NOL is absorbed in the carryback year and (b) the amount of the NOL absorbed in the carryback year is always equal to the loss spouse’s separate modified taxable income, even when joint modified taxable income is smaller than the loss spouse’s separate
modified taxable income.

Conclusions:

1. For purposes of calculating the amount of a NOL incurred by a single taxpayer that may be carried to a joint return year, the amount of the NOL deduction in the carryback/carryover year is equal to the loss spouse’s married filing separately taxable income after taking the standard deduction, itemized deductions, personal exemptions, etc. into account. Thus, the position articulated in IRM 21.5.9.5.16 (6)(a) is correct.

2. Items such as taxable social security benefits, Schedule A itemized deductions, and exemptions should be recomputed using the married filing separate rules to arrive at: a) the amount of the NOL deduction in the carryover/carryback year; and b) the separate taxable income of each spouse.

3. After the correct NOL deduction has been, the NOL deduction should be taken into account by the loss spouse in determining his or her tax liability for the carryback year as if the spouses had filed separate returns in the carryback year. A separate tax liability must also be computed for the non-loss spouse. Further, the NOL deduction is taken into account in computing a new joint tax liability for the carryback year. After these calculations are completed, the recomputed joint return tax liability is allocated between the spouses based on their separate tax liability. Thus, the separate tax liabilities are computed solely for purposes of allocating the new joint tax liability and determining who is entitled to the refund.

4. Various revenue rulings and regulations suggest that all Subtitle A income taxes are to be taken into account in determining the amount of the recomputed joint tax liability allocated to each spouse. In this regard, the proper fraction to use to determine Spouse 1’s allocable joint liability would be as follows:

   \[
   \frac{\text{Spouse 1’s separate tax liability}}{\text{Spouse 1 and 2’s tax liability}} \times \text{New Joint Tax liability (using NOL)}
   \]

   S2’s allocable joint tax liability would be determined in the same manner. Taxes that are not in Subtitle A, such as the gift tax or the Schedule H tax, would not be allocated in accordance with the above computation.

5. If the spouses are subject to the AMT in the carryback/joint return year, the spouse’s allocation ratio must take into account their separate AMT income and AMT liability. Further, the procedures discussed in Part 2 of this document must be done to compute a) the AMT NOL deduction to be used in the carryback year; b) the new joint AMT liability; and c) the amount of the AMT NOL absorbed in the carryback year.

6. Form 1045, Schedule B is used to compute the amount of the NOL absorbed in the carryback year. In general, the loss spouse’s separate modified taxable income is the
amount of NOL absorbed in the carryback year. Where, however, the joint modified taxable income is smaller than the loss spouse’s separate modified taxable income, the amount of the NOL that is absorbed is equal to the modified joint taxable income.

Legal Analysis

Section 1.172-7 sets forth the treatment to be accorded spouses who filed a joint return in one or more of the taxable years involved in the computation of a NOL deduction. Those provisions, however, do not address situations where a NOL is carried to a joint return year if, as in the instant situation, the spouses are not married when the NOL is incurred.

A number of revenue rulings and court cases address the use of a NOL incurred by a single taxpayer in a joint return year. In Calvin et ux v. United States, 354 F. 2d 202 (10th Cir. 1965), the court of appeals determined that a spouse’s NOL sustained prior to marriage could not be carried over against the other spouse’s income reported on their joint return. The court explained that the NOL provisions are personal to the spouse incurring the loss and can only offset the income of that taxpayer. Likewise, in Zeeman v. United States, 395 F. 2d 861 (2d Cir. 1968), a surviving spouse was not allowed to carryback a NOL incurred after her spouse’s death to taxable years in which she filed joint returns with her deceased spouse because the deceased spouse earned all of the joint income.

In Rev. Rul. 60-216, 1960-1 C.B. 126, a husband and wife resided in a community property state and filed a joint return for 1954. They divorced in 1955. The husband incurred a NOL in 1957 that he was carried back to the 1954 joint return year. The revenue ruling holds that the husband’s NOL may be carried back and applied only against his share of the community income reported for the carryback year.

In Rev. Rul. 80-6, 1980-1 C.B. 295, a divorced taxpayer incurred a NOL that the taxpayer wanted to carryback to a joint return year. The revenue ruling, in amending the rationale set forth in Rev. Rul. 75-368, 1975-2 C.B. 480, explains the procedures for the carryback of a NOL to a joint return as follows:

The net operating loss deduction will be carried back and carried over only to the income that would have been reported by the taxpayer, if a separate return would have been filed. The joint rates will be applied to the reduced joint taxable income. The amount of the taxpayer's individual refund will be calculated by determining the taxpayer's recomputed separate tax liability [divided by] both spouses' recomputed separate tax liability [times] recomputed joint tax liability and subtracting
that amount from the taxpayer's contribution determined in accordance with [Rev. Rul. 80-7, 1980-1 C.B. 296]. The amount of the overpayment refunded to the taxpayer will be limited to the amount of the joint overpayment. In computing each taxpayer's separate tax liability, the tax rates for married individuals filing separate returns should be used.

The following is an example of the manner in which the NOL rules operate when a single taxpayer incurs a NOL and carries it to a year in which a joint return is filed. The example follows the rules set forth in the above revenue rulings and cases, which provide that a NOL is personal in nature to the taxpayer sustaining the loss and only available in other years to offset the income of the same taxpayer. Thus, when the NOL is incurred by a single taxpayer but is carried to a joint year, a separate taxable income must be computed for each spouse in the carryback year to ensure that the NOL is used to offset only the income of the spouse who incurred the loss. The example is intended to demonstrate the principles of §172 only and, therefore, the phase-outs for itemized deductions and personal exemptions are ignored. Further, a married filing jointly (MFJ) tax rate of 20% and married filing separately (MFS) rate of 25% are used for purposes of simplicity.

**Illustration and analysis of an allocation of a NOL from a single filing tax year to a joint tax year**

**Year 1**  
**Tax return information (Phaseouts are ignored for purposes of this illustration):**

Spouse 1 (S1) and Spouse 2 (S2) filed income tax return under a married filing jointly status and reported the following items:

<table>
<thead>
<tr>
<th></th>
<th>S1</th>
<th>S2</th>
<th>Joint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$100,000</td>
<td>$150,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>100,000</td>
<td>150,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Personal exemption</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>(15,000)</td>
<td>(15,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Medical expenses</td>
<td>(40,000)</td>
<td>(21,250)*</td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td></td>
<td></td>
<td>158,750</td>
</tr>
</tbody>
</table>
Year 2: S1 and S2 divorce. Both file a separate return reporting positive taxable income and a tax liability.

Year 3: S2 incurs a NOL of $210,000. S2 does not elect to forego the carryback of the NOL and thus must carry the NOL to Year 1. The NOL carryback may only offset S2's income in the carryback year. Thus, unlike other NOL situations, the carryback amount is not the entire NOL but only the amount of S2's income computed as if S2 filed a separate return. The amount of the carryback and, thus, S2's NOL deduction in Year 1 is computed as follows:

Step 1: Determine the amount of S2's NOL that may be carried back

\[
\begin{align*}
&\text{S2} \\
&\text{Gross income} \quad 150,000 \\
&\text{AGI} \quad 150,000 \\
&\text{Personal exemption} \quad (10,000) \\
&\text{Mortgage interest deduction} \quad (15,000) \\
&\text{Real estate taxes deduction} \quad (10,000) \\
&\text{Medical expense deduction (100%)} \quad (28,750)* \\
&\text{Taxable income} \quad 86,250 \\
&\text{NOL carryback allowable/NOL deduction} \quad 86,250 \\
\end{align*}
\]

* The $28,750 medical expense deduction is the extent to which the expense ($40,000) exceeds 7.5% of AGI ($11,250).

Step 2: Recompute S1’s and S2’s joint tax liability with the $86,250 NOL
deduction to determine the amount of overpayment.

Gross income $250,000
Net operating loss deduction (86,250)
Adjusted gross income 163,750
Personal exemption deduction (20,000)
Mortgage Interest deduction (30,000)
Real estate tax deductions (20,000)
Medical expense deduction (limited to 7.5% of AGI) (27,719)*
Taxable income $66,031
Recomputed joint tax liability (rounded) $13,206 (20% rate)

* The $27,719 (rounded amount) medical expense deduction is the extent to which the expense ($40,000) exceeds 7.5% of AGI ($12,281).

Step 3: Determination of overpayment for year 1:

Year 1 tax liability per original return $31,750
Year 1 tax liability after NOL carryback $13,206
Overpayment $18,544

Step 4: Who is entitled to the refund of the overpayment?

a) Compute each spouse’s separate tax liability as if the spouses filed married filing separate returns:

<table>
<thead>
<tr>
<th></th>
<th>S1</th>
<th>S2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$100,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>NOL deduction</td>
<td>(86,250)</td>
<td></td>
</tr>
<tr>
<td>AGI</td>
<td>100,000</td>
<td>63,750</td>
</tr>
<tr>
<td>Personal exemption</td>
<td>(10,000)</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>
Mortgage interest                          (15,000)                            (15,000)
Real estate taxes                             (10,000)                            (10,000)
Medical expense ded                        ______                            (35,219)*
Taxable income                               $ 65,000                              (6,469)
Tax liability (assume a 25% rate)           $16,250                                   0

* The $35,219 medical expense deduction is the extent to which the expense ($40,000) exceeds 7.5% of AGI ($4,781)

b) Allocate of the joint tax liability based on separate tax liability

\[
\begin{align*}
S1's \text{ separate tax liability} \times \text{ recomputed joint tax liability} \\
S1 \text{ and S2 separate tax liability} \\
16,250 \times 13,206 = 13,206 \\
16,250
\end{align*}
\]

\[
\begin{align*}
S2's \text{ separate tax liability} \times \text{ recomputed joint tax liability} \\
S1 \text{ and S2 separate tax liability} \\
0 \times 13,206 = 0 \\
16,250
\end{align*}
\]

Thus, in this example, all of the joint tax liability is attributable to S1.

c) Determine how much tax each spouse paid.

In this example, each spouse paid $15,875, which was 1/2 of the original tax liability.

d) Calculate the refund to each spouse

S2 is entitled to a refund of $15,875 because S2 had no tax liability after the carryback of S2’s NOL. Since the overpayment was $18,544, S1 is entitled to a refund of $2,669 ($18,544 minus S2's refund of $15,875).

**Step 5: Absorption computation**

The NOL amount absorbed in Year 1 is equal to S2's Year 1 modified taxable income computed as if S2 filed a separate return for Year 1. (Note that the NOL would be absorbed only to the extent of the joint modified taxable income if, unlike in this example, the joint modified taxable income is less than the loss spouse's separate
modified taxable income). As discussed in Part 1 of this document, the personal exemption deduction and the NOL are ignored for purposes of computing modified taxable income.

Absorption computation:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>S2</td>
<td></td>
</tr>
<tr>
<td>Gross income</td>
<td>$150,000</td>
</tr>
<tr>
<td>AGI</td>
<td>$150,000</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Medical expense deduction</td>
<td>(28,750)*</td>
</tr>
</tbody>
</table>

Modified taxable income 96,250

Amount of NOL absorbed in Year 1 96,250

NOL to be carried to Year 2 $210,000 minus $96,250 = $113,750

* The $28,750 medical expense deduction is the amount by which the expenses ($40,000) exceed 7.5% of adjusted gross income ($11,250)

Note: Had S1 and S2 not divorced and simply filed separate returns for Years 2 and 3, the above calculations would not have been necessary since S2’s individual NOL would have become a joint NOL carryback to the joint return year. See § 1.172-7(b).

If we may be of further assistance, please do not hesitate to contact the undersigned at...
This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

WILLARD N. TIMM, JR.
Associate Area Counsel
(Small Business/Self-Employed)

By:________________________

TRAVIS VANCE, III
Senior Attorney (SBSE)

Approved:

___________________________________________       Date

Cc:     Stephen Toomey
        Senior Counsel
        Office of Chief Counsel
        Income Tax and Accounting
        Washington, DC

        GL Legal Files