

Apply a net operating loss to a Roth IRA conversion

What is a net operating loss?

A net operating loss (NOL) may occur during a tax year in which business deductions exceed income, resulting in negative income. Historically, taxpayers could apply this NOL deduction to prior tax returns, at least two years prior, and in some cases as many as five years. This was referred to as an NOL “carryback.” Alternatively, the taxpayer could apply the loss to future tax returns for a maximum of 20 years. This was referred to as an NOL “carryforward.”

NOLs and small businesses

Small-business owners who operate as pass-through entities may take advantage of an NOL. In the case of a sole proprietor, business income and expenses are reported on Schedule C, which is used to calculate net business profit or loss. This figure is then carried over to the taxpayer’s 1040 form and combined with other income (spousal income, unearned income from investments, etc.). Generally, if the business loss being reported on Schedule C exceeds all other income reported on the 1040, an NOL deduction may be available, depending on the circumstances.

For other pass-through business entities, such as an S Corp, partnership, or LLC, the calculation of an NOL is more complicated. In these cases, a business loss for a particular year is first applied to the taxpayer’s cost basis in the business. Once the basis in the entity is reduced to zero, an NOL may apply. Additionally, entities generating passive income (from real estate activities, for example) are subject to the passive loss rules and may be limited when calculating a deduction for NOL.

Tax reform introduces changes to NOLs

The Tax Cuts and Jobs Act (TCJA) introduced major changes to the tax treatment of NOLs.

- Beginning in 2018, taxpayers are no longer able to carry back NOLs, but instead may carry forward NOLs for an unlimited number of years
- Taxpayers are allowed to deduct NOLs only up to 80% of taxable income in that year
- New limits are imposed on deducting “excess business losses”*

* The TCJA introduces a limitation on “excess business losses,” meaning pass-through business owners are restricted from deducting business losses in excess of \$250,000 per taxpayer (individuals) or \$500,000 (married couples filing a joint return). Business losses above this limit must be carried forward to the following tax year. For 2023, the limit on excess business losses is \$289,000 for single filers and \$578,000 for married couples filing a joint tax return.

Important CARES Act update: A net operating loss (NOL) arising in a tax year beginning in 2018, 2019, or 2020 can be carried back a maximum of five years and applied to prior tax returns. Tax law changes in 2017 disallowed the carry-back of NOLs. The provision also temporarily removes the taxable income limitation to allow an NOL to fully offset income, and suspends limits on “excess business losses” for individuals and pass-through business entities. Prior to this change from the CARES Act, taxpayers were limited to applying an NOL against 80% of taxable income. The 80% restriction and limit on “excess business losses” applies again beginning in 2021.

How to apply a Roth IRA conversion to an NOL deduction

Unlike net capital losses, where taxpayers are limited to only \$3,000 annually to offset any ordinary income, there are fewer restrictions on how an NOL can be used to offset ordinary income. For example, taxpayers carrying forward NOLs may use those losses to offset a portion of additional income from a Roth IRA conversion.* The rules on calculating and utilizing NOLs are complicated, so it is critical to consult with a qualified tax professional.

Consider this example:

- John is a sole proprietor reporting an NOL of \$200,000 after figuring business income and losses on Schedule C
- He also owns a SEP-IRA with a current value of \$500,000
- John and his spouse report \$100,000 in taxable income from her employment earnings and income from investment accounts
- As a result of the new rules, the taxpayers must carry forward any unused NOL deductions and are limited to offsetting 80% of their taxable income

Consult with a tax professional

Rules for calculating and utilizing NOLs are complicated and require expertise from a qualified tax professional. For additional information, refer to IRS publication 536, “Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.”

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions. Putnam does not provide tax or legal advice.

* Taxpayers are allowed to deduct NOLs up to 80% of taxable income in that year.

For informational purposes only. Not an investment recommendation.

Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative (or call Putnam at 1-800-225-1581). Read the prospectus carefully before investing.

Scenario 1: No Roth IRA conversion

Taxable income	\$100,000
NOL deduction limit	x 80%
Maximum NOL deduction for current tax year	\$80,000

NOL	\$200,000
NOL deduction	(\$80,000)
NOL carryforward to future tax years	\$120,000

In this case, they would report \$20,000 in taxable income after applying the NOL of \$80,000 and must carry forward the excess NOL to future tax years.

What if John converted \$150,000 of his SEP-IRA to utilize the entire NOL deduction for the current tax year instead of having to carry it forward?

Scenario 2: Partial Roth conversion of the SEP-IRA

Taxable income	\$100,000
Income realized by converting a portion of the SEP-IRA to a Roth	\$150,000
Total taxable income	\$250,000

Total taxable income	\$250,000
NOL deduction limit	x 80%
Maximum NOL deduction for current tax year	\$200,000

In this case, the taxpayers are able to utilize the entire \$200,000 NOL and would report \$50,000 in taxable income (\$250,000 taxable income reduced by the \$200,000 NOL). Although they report more taxable income in this case (\$50,000 vs. \$20,000), they have converted \$150,000 in pretax SEP-IRA assets to a tax-free Roth IRA while avoiding a carry forward of the NOL.