

Trump's NOL Lasts 20 Years, But Audits Last 3?

By Robert W. Wood

Brilliant or not, Donald Trump had big losses in 1995. And that means a big pot of losses than he could—and probably did—use to offset other income across many years. That's the system, one that makes everyone file tax returns annually, but that can allow losses to span many years. A net operating loss or NOL is the excess of a taxpayer's deductions over gross income.

Under the Tax Code, an NOL results when certain of your deductions exceed your income. The NOL exists so that you can use the loss in one year to lower your taxable income and reduce your tax burden in another year. Losses can be passed through from other entities, like partnerships, limited liability companies and S corporations.

But actually, you don't have to run a business to take advantage of an NOL. Some nonbusiness deductions can still result in an NOL, including losses due to moving expenses, rental real estate expenses, or casualty and theft losses. Of course, these aren't going to be big dollars.

You count income and expenses in only one year. After all, our tax system is annual, but the NOL rules essentially break that mold. If you have an NOL, you first carry back the entire NOL amount to the two prior tax years. If you still have an NOL remaining after you carry those losses back, you can carry the loss forward.

You can also opt not to carry back an NOL and only carry it forward for up to 20 years. A carry forward means that you can apply the loss towards your income in a future year. When taxpayers are involved in passive activities, the rules are tricky.

The Internal Revenue Service defines passive activities as trade or business activities in which you do not "materially participate." You "materially participate" if you are involved "on a regular, continuous, and substantial basis." If you do not actively participate, you have a passive loss.

When losses from passive activities exceed income from passive activities, those losses are disallowed for the current year. Fortunately, you can carry them forward to the next tax year. If you have more income than losses that year, you can offset the income with the carry forwards.

Defining trade or business activity is generally straightforward, with one exception. As a rule, rental activities are considered passive activities by the IRS even if you materially participate. There are some exceptions, including those who qualify as a "real estate professional" and certain dollar limitations. As has been widely said after the Trump tax return leak, the fact that an NOL can carry forward to up to 20 years can allow someone to legally not pay taxes for up to 20 years. You apply a portion of the NOL every year to your current year income. You can thereby immunize the current year income from tax.

Normally, the IRS statute of limitations allows the IRS to audit for three years. In some cases, the IRS gets six years. A few things are unlimited, with no limit on how long the IRS can go back. Curiously, though, there is not a special statute of limitations for NOLs. And that might make you think. For example, suppose that Trump made a mistake in calculating his \$916 million NOL?

Does that mean that after three years, the IRS can't touch him, even if it later learns that the \$916 million NOL is overstated? Not exactly. The IRS has rules for what it regards as mistakes in the calculation of the NOL. The statute of limitations can be quirky in this context, and the rules can seem downright inconsistent. The IRS generally does not allow you to go back beyond the statute of limitations to add to an NOL that you failed to claim properly. Conversely, the IRS can try to adjust your NOL, even if the statute of limitations on that year has expired.

If the IRS discovers mistakes in a closed tax year, the IRS can try to prevent you from using the losses based on that error many years later. Thus, in one case, a company had an NOL for 1945 that it was trying to use. A few years later, the IRS tried to reduce the use of the NOL, even though the year of the actual NOL was closed.

The company and the IRS went to court, and the IRS won. The court agreed with the taxpayer that the tax year for *calculating* the NOL was closed. But the court said the year in which the NOL is *used* is really what matters. See *Phoenix Coal Co.*, 231 F.2d 420 (2d Cir. 1956).

In another case, *Barenholtz*, 784 F.2d 375 (Fed. Cir. 1986), the IRS did something similar. There, the tax year for the NOL (like Trump's big loss year of 1995) was already closed. Even so, when the taxpayer went to use the NOL, the IRS said it could adjust the NOL *then*.

Once again, when the IRS and the taxpayer went to court, the IRS won. These rules suggest that the IRS could conceivably have been chipping away at Trump's NOL for up to 20 years after he claimed it. But without tax returns, we don't know.



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