Finance Essentials

Taxes on Negative Taxable Income

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Suppose a company has negative taxable income during a particular year as shown below:

Sales Revenues	\$3,000
Operating Expenses	−5,000
Operating Income	−\$2,000
Interest Expense	−500
Taxable Income	−\$2,500

To calculate the taxes, multiply the taxable income with the tax rate as you would if the taxable income were positive. Since the taxable income is negative, the taxes will turn out to be negative. Now subtract the taxes from the taxable income as you normally would, but keep in mind that you are subtracting a negative amount which means that you are adding it. The net income, therefore, will be less negative than taxable income.

Suppose the tax rate is 40% for the company in the example above, then the tax amount would be $-\$2{,}500 \times 40\% = \$1{,}000$. Now subtract the taxes of $-\$1{,}000$ from the taxable income of $-\$2{,}500$ as $-\$2{,}500 - (-\$1{,}000) = -\$2{,}500 + \$1{,}000 = -\$1{,}500$. Here is the completed income statement:

Sales Revenues	\$3,000
Operating Expenses	−5,000
Operating Income	−\$2,000
Interest Expense	−500
Taxable Income	−\$2,500
Taxes (40%)	−1,000
Taxable Income	−\$1,500

If you have a spreadsheet or a calculator programmed to calculate the taxes as a fixed percent of the taxable income and to subtract the taxes from the taxable income to get the net income, you will not need to make any changes. The process will work regardless of whether the taxable income is positive or negative.

This process might raise some questions: What does the negative tax amount mean? If a positive tax amount means the company pays the taxes, does a negative amount mean that the company gets money back? The answer basically is yes. Here is how the process works. Suppose a company has a positive taxable income of \$5,000 in year 1 so that it pays \$2,000 in taxes at the tax rate of 40%. In year 2, the company has a taxable income of −\$2,500. If we were to look at the company over the two-year period, the company has a taxable income of \$2,500, and it should pay \$1,000 in taxes. Since it paid \$2,000 in year 1, it will get a refund of \$1,000 in year 2 so that the net taxes over the two years are \$1,000. We can reverse the situation. Suppose the company has a taxable income of −\$2,500 in year 1. In year 1, the company will not pay any taxes. In year 2, the company has a taxable income of \$5,000. The company will use the losses from year 1 to offset \$2,500 of its income in year 2, and pay taxes on only \$2,500, which at 40% tax rate are \$1,000.

Losses—negative taxable income—during a year can be used to get a refund of taxes paid in the past or can be carried forward to shield future taxable income. Negative taxable income results in refund of taxes paid in the past or reduced taxes in the future, as long as the company has positive taxable income in the past or the future to offset the losses. There are some restrictions on the number of years the losses can be carried back or forward, and one should consult a qualified tax accountant or the tax department for details.