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At a Loss: Excess Business Loss and NOL Provisions of the TCJA

64th Annual William and Mary Tax Conference

Brian J. O’Connor and Stephen M. Sharkey

November 8, 2018
What’s New?

- New Section 461(1) Excess Business Loss Limitation.
- Changes to the Carryover and Carryback provisions under Section 172 for Net Operating Losses (“NOLs”).
- New income limitation on the ability to deduct NOLs under Section 172.
Before New Section 461(1)

• Subject to limitations due to lack of basis, the at-risk rules under Section 465, and the passive loss rules under Section 469, taxpayers could freely deduct their business losses against their salary and investment income.

• As a result, if a taxpayer had sufficient business losses, the taxpayer could fully avoid paying tax in a given year.
New Section 461(1)

- For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year.
- An excess business loss would equal
  - (1) the aggregate deductions of the taxpayers attributable to all trades or businesses over
  - (2) all business income and gain of the taxpayers plus $500,000 for married filing jointly or $250,000 for individuals (adjusted for inflation)
New Section 461(1) (cont’d)

• For partnerships and S corporations, this limitation will apply at the partner or shareholder level
  – Each partner’s distributive share and each S corporation shareholder’s pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder.

• Regulatory authority is provided to apply the provision to other pass-through entities and to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.
New Section 461(1) (cont’d)

• Rule applied after application of Section 469

• The deductibility of business losses for taxpayers who are not active participants in a business activity under Section 469 may be limited by Section 461(1).
  – For example, deferred losses taken into account upon disposition of a passive activity are taken into account in the calculation of excess business losses.

• Carryover of excess business losses treated as NOLs under Section 172 (as will be discussed in greater detail below, carryover losses do not appear to be treated as subject to the excess business loss limitation in future years).

• As a result of new Section 461(1), a taxpayer with business losses that are well in excess of the taxpayer’s salary and investment income still may have a tax obligation for a given year.
New Section 461(1) (cont’d)

EXCESS BUSINESS LOSS (“EBL”) – GENERAL OBSERVATIONS

• **GENERAL EFFECT:**
  Limits “active losses” of individuals to $500,000 ($250,000 filing separately).

• **INTENDED TARGET:** **REAL ESTATE PROFESSIONALS.** Generally believed that a primary target of EBL limitation was Section 469(c)(7) active losses:
  • Losses of real estate professionals from leveraged real estate generally active and available to offset portfolio income.

• **REACH OF EBL LIMITATION IS MUCH BROADER.**
  EBL limitation reaches much further, and will deny (or delay) benefits of losses to many typical non-abusive situations.
### New Section 461(1) (cont’d)

#### Excess Business Loss – Simple R/E Example

<table>
<thead>
<tr>
<th></th>
<th>w/o EBL Limit</th>
<th>w/EBL Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment (Portfolio)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>850,000</td>
<td>850,000</td>
</tr>
<tr>
<td>469(c)(7) Loss</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>EBL Limitation</td>
<td></td>
<td>(500,000)</td>
</tr>
<tr>
<td>Adj. Gross Income (Loss)</td>
<td>(150,000)</td>
<td>350,000</td>
</tr>
<tr>
<td>NOL Carry Forward</td>
<td>(150,000)</td>
<td>(500,000)</td>
</tr>
</tbody>
</table>
New Section 461(1) (cont’d)

**EXCESS BUSINESS LOSS – MULTI-YEAR R/E EXAMPLE**

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment (Portfolio)</td>
<td>850,000</td>
<td>850,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>469(c)(7) Loss</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>EBL Limitation</td>
<td></td>
<td>(500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Prior Year NOLs Applied</td>
<td></td>
<td>(150,000)</td>
<td>(280,000)</td>
</tr>
<tr>
<td>(w/80% limit)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adj. Gross Income (Loss)</td>
<td>(150,000)</td>
<td>200,000</td>
<td>70,000</td>
</tr>
<tr>
<td>NOL Carry Forward</td>
<td>(150,000)</td>
<td>(500,000)</td>
<td>(720,000)</td>
</tr>
</tbody>
</table>
EXCESS BUSINESS LOSS – OPEN QUESTIONS -- REAPPLICATION TO CARRIED FORWARD NOL?

• Statutory language is ambiguous whether an Excess Business Loss that is reported in a later year as an NOL carryforward is a deduction “attributable to trades or businesses of [the] taxpayer” and becomes subject to the Section 461(l) limitation again.

• Better view is EBL is “one and done” limitation, but guidance from the IRS would be helpful.

  • See 10/13/18 letter from AICPA to David Kautter, Dep’t. of Treasury, Ass’t Sec’y for Tax Policy.
### New Section 461(1) (cont’d)

**Excess Business Loss – Open Questions -- Example of Reapplication Interpretation**

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment (Portfolio) Income</td>
<td>850,000</td>
<td>850,000</td>
<td>850,000</td>
</tr>
<tr>
<td>469(c)(7) Loss</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>EBL Limitation</td>
<td></td>
<td>(500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Prior Year NOLs Applied (w/80% limit)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adj. Gross Income (Loss)</td>
<td>(150,000)</td>
<td>350,000</td>
<td>350,000</td>
</tr>
<tr>
<td>NOL Carry Forward</td>
<td>(150,000)</td>
<td>(650,000)</td>
<td>(1,150,000)</td>
</tr>
</tbody>
</table>
EBL limitation permits deductions “attributable to trades or businesses of [the] taxpayer” to offset fully gross income “attributable to such trades or businesses”.

**QUERY:** For purposes of the EBL limitation, is an individual considered to be engaged in the trade or business of being an employee, such that her/his W-2 income is attributable to the trade or business of being an employee?

- Consider Rev. Rul. 90-93 and Section 199A(d)(1)(B).
Excess Business Loss – Interactions with Other Loss Limitations

- Excess Business Loss provision applies after the Passive Activity Loss limitations.
- However, there may be some unexpected interactions between other loss limitations and EBL Limitation.
- Also, EBL provisions not necessarily disadvantageous as they may help taxpayers avoid using ordinary losses against capital gain income.
“Old” Section 172

- Under prior Section 172, NOLs were generally eligible for a 2-year carryback and a 20-year carryforward.

- In addition, under prior Section 172, NOL carrybacks and carryforwards could fully offset taxable income as long as they were not otherwise limited and the taxpayer was not subject to the alternative minimum tax ("AMT").

- NOLs were eligible to fully offset all of a corporation’s “regular” taxable income in a given year.

- For corporate AMT purposes, NOLs were eligible to offset only 90 percent of AMT taxable income.
“New” Section 172

- Under new Section 172, the carryback of NOLs is eliminated and the carryforward of NOLs is indefinite.

- As a result, on the one hand, NOLs lose some of their value to taxpayers. On the other hand, NOLs now never expire.

- AMT repealed for corporations but not repealed for individuals.

- These rules apply to any NOL arising in a taxable year ending after December 31, 2017.

- There has been some confusion about the effective date.
“New” Section 172

- Under new Section 172, the amount of NOLs that may be deducted in a single year is limited to the lesser of the available NOL carryover or 80% of the taxpayer’s taxable income before taking into account the NOL.

- The new provision applies only to losses from tax years beginning after December 31, 2017.

- Due to the effective date, NOLs from tax years that began before 2018 will not be subject to the 80% limit. Thus, taxpayers will have to track pre-2018 NOLs separately from post-2017 NOLs.
Example 1:

Taxpayer generates $500,000 in NOLs in 2018 followed by $200,000 of taxable income in 2019. Under the new law, taxpayer only would be eligible to offset 80% of its 2019 taxable income with its 2018 NOL. As a result, taxpayer still has $40,000 in taxable income in 2019 after applying its 2018 NOL. This effectively means that taxpayer ends up paying tax for 2019 even though it has NOL carryforwards in excess of its 2019 taxable income.
“New” Section 172

Example 2:
Taxpayer has a $2,000,000 cumulative NOL from years prior to 2018. Taxpayer then generates a $15,000,000 NOL in 2018 and subsequently produces $15,000,000 of taxable income in 2019. In 2019, Taxpayer can use the $2,000,000 NOL from before 2018 and $12,000,000 of the 2018 NOL (that is, 80% of $15,000,000 in income). This means that Taxpayer has net taxable income of $1,000,000 in 2019 and will have a $3,000,000 NOL carryforward.
What’s Not New

- Both before and after the new tax law, taxpayers could deduct business losses only to the extent such losses were not limited by:
  
i. lack of sufficient basis under Sections 704(d) or 1366(d);
  
ii. lack of sufficient at risk under Section 465; or
  
iii. lack of sufficient material participation under the passive loss rules of Section 469
Sections 704(d) and 1366(d)

• Under Section 704(d), a partner’s distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership at the end of the year.

• Under Section 1366(d), the aggregate amount of losses and deductions taken into account by an S corporation shareholder shall not exceed the sum of such shareholder’s adjusted basis in stock and any indebtedness of the S corporation.
Section 465

• For individuals and closely held corporations engaged in activities to which Section 465 applies, any loss from such activity shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year.

• Taxpayers are generally considered at risk with respect to (i) the amount of money and the adjusted basis of property contributed to the activity and (ii) certain amounts borrowed with respect to such activity.

• Upon the disposition of an activity to which Section 465 applies, any suspended losses become deductible subject to Section 469.
Section 469

• For individuals and certain corporations engaged in activities to which Section 469 applies, any passive activity loss from such activity shall be disallowed.

• For purposes of Section 469, a passive activity means any activity (i) which involves the conduct of a trade or business and (ii) in which the taxpayer does not materially participate.

• Upon the disposition of a activity to which Section 469 applies, any losses suspended under Section 469 become freely deductible.
What’s Not New (cont’d)

- The basis limitation rules of Section 704(d) and 1366(d) apply first to suspend business losses at the partnership or S corporation level to the extent that the partner or S shareholder has insufficient basis in its partnership interest or S corporation stock.

- To the extent that the partner or S corporation shareholder subsequently obtains basis, the suspended losses are “freed-up” and deductible subject to the limitations under Sections 465 and 469.
What’s Not New (cont’d)

- Suspended losses that become available due to the creation of basis must then satisfy the at risk rules of Section 465.

- As a result, to the extent that the partner or S corporation shareholder is sufficiently at risk, the taxpayer may deduct the loss subject to Section 469.

- If the partner or shareholder is not sufficiently at risk, the loss is suspended under Section 465 until the taxpayer either becomes sufficiently at risk or disposes of the activity.
What’s Not New (cont’d)

- Taxpayers may freely deduct the losses that are not restricted by the basis limitation rules of Sections 704(d) and 1366(d) or the at risk rules of Section 465 only to the extent that the losses are not suspended under Section 469 due to insufficient material participation.

- Thus, “active” taxpayers would qualify to freely deduct such losses under the passive loss rules of Section 469 while “passive” taxpayers would be required to suspend the losses until they qualified as materially participating or they disposed of the activity.
Case Studies

• Please refer to the newly-provided handouts for a review and discussion of the case studies.
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