

Section 461(l) Excess Business Loss Limitations for Non-Corporate Taxpayers

WEDNESDAY, MAY 15, 2019, 1:00-2:15 pm Eastern

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FOR LIVE PROGRAM ONLY

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May 15, 2019

Libin Zhang, Partner

Fried, Frank, Harris, Shriver & Jacobson LLP

New York NY

libin.zhang@friedfrank.com

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Libin Zhang
Fried, Frank, Harris, Shriver & Jacobson LLP
libin.zhang@friedfrank.com
New York NY
May 15, 2019 Strafford Presentation

Outline

- Basic Structure and Overview
- Effect of EBL Carryover
- Ordering Rules
- Types of Business Income and Losses
- Items Awaiting IRS Guidance

Section 461(l)

- Added by P.L. 115-97 (Tax Cuts and Jobs Act of 2017)
- Applies to all non-corporate taxpayers in 2018 through 2025
- Business losses (generally the excess of deductions over income and gain attributable to trades or businesses) can offset only up to \$500,000 of non-business income for married couple filing jointly in 2018 (\$250,000 for single taxpayer, adjusted for inflation annually)
- Disallowed loss (aka excess business loss, or EBL) is treated as net operating loss (NOL) carryover to the following year under section 172

Federal Revenue Effect

- Joint Committee on Taxation (JCT) estimated that section 461(l) will increase revenues by **\$149.7 billion** over ten years (2018 through 2027)
- For comparison:
 - Section 163(j) business interest limitation -- \$253.4 billion
 - Base erosion and anti-abuse tax (BEAT) -- \$149.6 billion
 - GILTI -- \$112.4 billion
 - Parking and transportation fringe changes -- \$17.7 billion
 - Section 451(b) book-tax income conformity -- \$12.6 billion
 - Repeal of partnership technical termination -- \$1.6 billion

Inspiration

Section 461(j) was enacted in 2006 to limit excess losses from farming businesses that receive certain federal subsidies

Section 461(l) supersedes section 461(j) in 2018-2025

Section 461(l) differences with section 461(j):

- applies to all non-corporate taxpayers and their businesses
- no carryforward of excess income capacity
- very different carryover rules
- applies after section 469 (instead of before)

Ordering Rules

According to the transitive property of deduction limitation rules:

1. Capitalization rules and deduction limitations, such as section 267
2. Section 163(j) business interest limitation
3. Section 465 at risk limitation
4. Section 469 passive activity loss limitation
5. Section 461(l) EBL limitation

Example 1

- Unmarried individual has \$800,000 tax loss from material participation business activity in 2018
 - Such as rental business of section 469(c)(7) real estate professional
- \$800,000 net business loss limited by section 461(l)
 - Can offset only \$250,000 of 2018 non-business income
 - Potentially has \$550,000 of net taxable income and \$550,000 EBL-related NOL carryover to next year

Example 2

- Married investor in real property rental business has \$200,000 of rental tax losses each year
- After 5 years, sells property for \$150,000 gain
 - \$1,000,000 passive activity loss carryforward allowed as ordinary loss under section 469(g)
 - \$850,000 net business loss, subject to section 461(l)
 - Can offset only \$500,000 of non-business income
 - Potentially has \$350,000 of net taxable income and \$350,000 EBL-related NOL carryover to next year

Example 3

- Married investor has \$800,000 rental income from net leased real property (not a trade or business) and \$800,000 rental loss from commercial building (rental trade or business) in 2018
- \$800,000 rental loss can offset only \$500,000 of non-business rental income in 2018
 - \$300,000 net taxable income in 2018 and \$300,000 EBL-related NOL carryover to 2019
- Raises the question of what is a trade or business

Carryover to Next Year

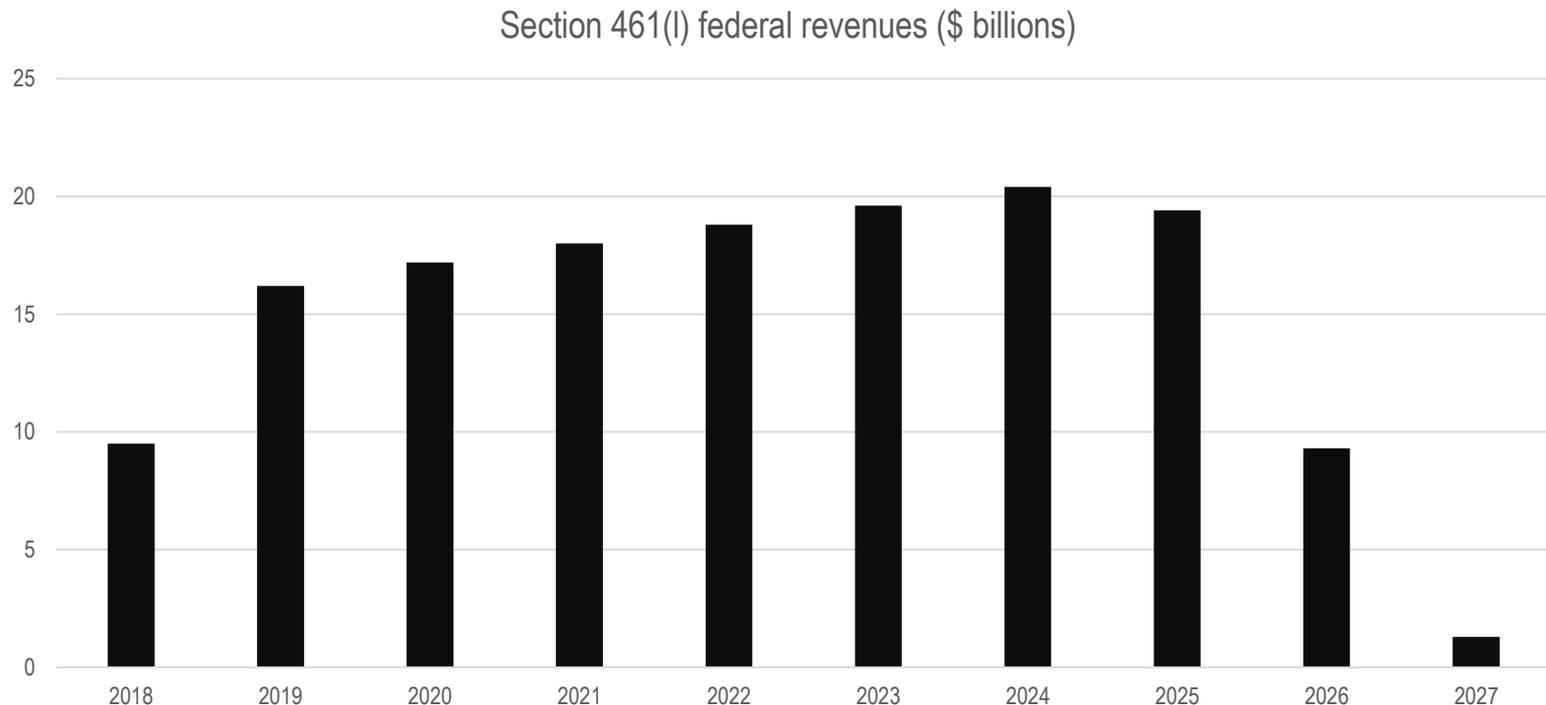
- Section 461(l)(2): any disallowed excess business loss “shall be treated as a net operating loss carryover to the following taxable year under section 172”
- TCJA modified section 172 for NOLs generated in 2018 and later: no carryback (except for farm businesses, etc.), unlimited carryforward, and can offset up to 80% of pre-NOL taxable income

Carryover (cont'd)

- The \$300,000 EBL is treated as NOL generated in 2018.
- The \$300,000 NOL is carried forward to 2019 and can offset up to 80% of the taxpayer's 2019 pre-NOL taxable income, without being further limited by section 461(l) in 2019 (may require technical correction)
- If a farm-related EBL, the NOL can be carried back 2 years under 172(b)(1)(B) and offset up to 80% of 2016 and 2017 taxable income (may require another technical correction)

Carryover (cont'd)

- Effective result is one year deferral of most or all of the EBL, because the next year's NOL carryover can offset up to 80% of pre-NOL taxable income, whether business or non-business.



Excess Business Losses

- EBL equals
 - the taxpayer's aggregate **deductions** for the tax year which are attributable to taxpayer's trades or businesses, minus
 - the taxpayer's aggregate **gross income or gain** for the tax year which is attributable to **such** trades or businesses, plus \$250,000 (or \$500,000 for a joint return).

- What if the trade or business has no deductions?

Losses from Property Disposition

- Ironically unclear how to treat losses from sale of business property,
- Taxpayer-favorable precedent in section 461(j) excess farm loss Schedule F worksheets:
 - When ordinary and capital gains exceed losses, the net gains are taken into account under section 461(j).
 - But when ordinary and capital losses exceed gains, the net losses are **not** taken into account under section 461(j).

Example 4

- Single taxpayer has \$400,000 dividend income from investments and \$600,000 ordinary loss from commodities trading trade or business
 - No section 461(I) limitation?
 - \$0 taxable income
 - \$200,000 NOL carryover to next year
 - Ordinary loss can offset only \$250,000 of dividend income?
 - \$150,000 taxable income
 - \$150,000 EBL-related NOL carryover to next year
 - \$200,000 other NOL carryover to next year
- What if \$600,000 **capital** loss from trading business?
 - If section 461(I) applies, unclear whether it applies before or after section 1211(b) capital loss limitation, which may result in an EBL-related NOL carryover to the next year

Wages

- Are wages business income?
 - If yes, business losses can offset unlimited wages.
 - See sections 62(a)(1), 163(h)(2), 164(f)(2), 199A(d)(1)(B), 264(f)(5)(A)(iii)(I) (each carving out trade or business of performing services as an employee), Treas. Reg. 1.179-2(c)(6)(iv) (wages count as trade or business income for section 179 expensing limitation); Treas. Reg. 1.172-3(a)(3)(i) (same for NOL purposes)
 - JCT Blue Book says no (may require technical correction).

Form 461 (2018)

Form 461 **Limitation on Business Losses**

Department of the Treasury
Internal Revenue Service

► Attach to your tax return.
► Go to www.irs.gov/Form461 for instructions and the latest information.

Name(s) shown on return _____ Identifying number _____

Part I Total Income/Loss Items
See instructions if you are filing a tax return other than Form 1040.

1	Enter amount from Form 1040, line 1	1
2	Enter amount from Schedule 1 (Form 1040), line 12	2
3	Enter amount from Schedule 1 (Form 1040), line 13	3
4	Enter amount from Schedule 1 (Form 1040), line 14	4
5	Enter amount from Schedule 1 (Form 1040), line 17	5
6	Enter amount from Schedule 1 (Form 1040), line 18	6
7	Enter amount from Schedule 1 (Form 1040), line 19	7
8	Enter other income, gain, or losses from a trade or business not reported on lines 1 through 7	8
9	Combine lines 1 through 8.	9

Part II Adjustment for Amounts Not Attributable to Trade or Business
See instructions if you are filing a tax return other than Form 1040.

10	Enter any income or gain reported on lines 1 through 8 that is not attributable to a trade or business	10
11	Enter any losses or deductions reported on lines 1 through 8 that are not attributable to a trade or business. See instructions.	11
12	Subtract line 11 from line 10	12

Part III Limitation on Losses

13	If line 12 is a negative number, enter it here as a positive number. If line 12 is a positive number, enter it here as a negative number	13
14	Add lines 9 and 13	14
15	Enter \$250,000 (or \$500,000 if married filing jointly)	15
16	Add lines 14 and 15. If less than zero, enter the amount from line 16 as a positive number on Schedule 1 (Form 1040), line 21. See instructions if you are filing a tax return other than a Form 1040. If zero or greater, do not attach this form to your tax return	16

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- Form 1040 line 1 = wages, salaries
- Schedule 1 line 12 = business income or (loss) (Schedule C)
- Schedule 1 line 13 = capital gain or (loss) (Schedule D)
- Schedule 1 line 14 = other gain or (loss) (Form 4797)
- Schedule 1 line 17 = rents, royalties, S corporations, partnerships (Schedule E)
- Schedule 1 line 18 = farm income or (loss) (Schedule F)
- Schedule 1 line 19 = unemployment compensation

Partnerships and S Corporations

- Section 461(l) applies at the partner or S corporation shareholder level
- Each partner or shareholder takes into account his allocable share of the partnership's or S corporation's items of income, gain, deduction, or loss from trades or businesses attributable to the partnership or S corporation

Partnerships and S Corporations (cont'd)

- Gain/loss from the sale of a partnership interest or S corporation stock
 - Compare look-through rules in section 1411(c)(4) (3.8% section 1411 Medicare tax) and Treas. Reg. 1.469-2T(e)(3) (passive activity loss rules)
- Interest allocable to acquisition of partnership interest or S corporation stock, or debt-funded distributions
 - Compare tracing rules in Notice 88-20, 1988-1 C.B. 487; Notice 89-35, 1989-1 C.B. 675

Section 199A Deduction

- Section 199A generally provides a 20% deduction for certain pass-through business income (qualified business income).
- **Is the section 199A deduction considered a deduction subject to section 461(I)?** Yes under the statute, but JCT Blue book says no (may require technical correction).
- **Does an NOL carryover offset 80% of taxable income before or after the section 199A deduction?** After 199A under the statute, but JCT Blue Book says before (may require technical correction).
- **Does EBL reduce section 199A qualified business income?** Not when the EBL is generated, but when the EBL-related NOL carryover is used. Treas. Reg. 1.199A-3(b)(1)(v).

Income and Loss Items

- Possible analogy to NOL rules:
 - Wages (business)
 - Personal casualty loss (business)
 - Deduction for $\frac{1}{2}$ of self-employment taxes (business)
 - State/local income tax (allocable to business for NOL purposes, though always nonbusiness for AGI purposes)
 - IR and self-employed retirement plan contributions (nonbusiness)
 - Alimony (nonbusiness)
- Taxpayers prefer business deductions under NOL rules (opposite motivation for section 461(l))

Other Income and Loss Items

- COD income
- Self-charged items
- Guaranteed payments for capital or services
- Working capital

Items Awaiting IRS Guidance

- What goes into business or nonbusiness income or loss and EBL
- Carryovers from pre-2018 years
 - Compare section 163(j) and BEAT treatment of pre-2018 carryovers
- Interaction with AMT adjustments
 - Differences between regular tax EBL and AMT EBL
 - AMT NOLs can offset 90% of pre-AMTNOL AMT income, whereas regular tax NOLs can offset only 80% of pre-regular-tax-NOL taxable income

More Items Awaiting IRS Guidance

- Using non-grantor trusts to multiply the \$250,000 exemption
 - Compare anti-abuse rules in section 199A final regulations
- Final year issues
 - Suspended passive activity losses in year of decedent's death
 - Last year of non-grantor trust or estate
- Interaction with self-employment tax and 3.8% section 1411 tax
- Effect on nonresident aliens and foreign business income/loss
- Really anything would be helpful!

The Future

- H.R. 6760 (Protecting Family and Small Business Tax Cuts Act, or Tax Reform 2.0) would make all TCJA individual tax reform permanent, including section 461(I)

- See also state/local tax conformity (or lack thereof)
 - Consider differences in state-level regular tax and AMT NOLs

Other Resources

- Libin Zhang, *More Losses, More Problems: Excess Business Loss Rules*, 163 Tax Notes 695 (April 29, 2019)
- John C. Zimmerman, *Issues Involving Disallowance of Excess Business Losses Under Code Section 461(l)*, Taxes Magazine (April 3, 2019)
- Christopher W. Hesse, *Questions Remain About the Excess Business Loss Rule*, The Tax Adviser (March 7, 2019)
- American Institute of CPAs, *Request for Guidance Related to Section 461(l)* (Feb. 28, 2019)
- Blake D. Rubin, Andrea M. Whiteway, Maximilian Pakaluk, *New Limitation on Active Losses Under Tax Cuts and Jobs Act*, Journal of Passthrough Entities (July 2, 2018)

Questions?

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