The new individual loss limitation landscape

Familiar but different. Be prepared.

Owners of pass-through businesses that incur losses have a myriad of issues to contend with, not the least of which are financial and cash flow concerns. However, the financial challenge of these losses has historically been shared with the government through tax laws that allowed the business loss to offset other current year income of the owner. To the extent a loss exceeded current year taxable income, the owner could generate a net operating loss (NOL), which could create a refund of prior year tax paid. The result of these elements of the tax law allowed business owners to “monetize” the tax benefit of their tax loss and either reinvest it in their business or create additional liquidity to lessen their cash flow concerns.

The rules relating to utilization of an individual’s business losses are highly complex, having evolved over time. The passage of the 2017 Tax Act1 significantly altered the landscape of loss utilization for 2018 and beyond by adding new hurdles before a loss can be monetized. Examples of changes in the 2017 Tax Act include the new excess business loss rules and material modifications to the NOL rule set. These hurdles, coupled with the existing loss limitation provisions, may require owners of pass-through businesses to view the world of business losses through a different lens.

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1 P.L. 115-97, known informally as the Tax Cuts and Jobs Act and officially as An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.
Individual loss limitations

The evolution of loss limitation rules

To assist with understanding the impact of the 2017 Tax Act, we first need to review the evolution of the rules that have made it increasingly more difficult to monetize business losses.

Prior to the Tax Reform Act of 1986 (the “1986 Act”) there were few limitations in place preventing individual taxpayers from offsetting any form of income (for example, wage or portfolio income) with ordinary business losses. To the extent a taxpayer had sufficient basis in an activity, and the basis was at-risk, the losses were generally fully deductible to the extent of income. Further, to the extent the loss exceeded income, an NOL was created. The taxpayer could carry back the NOL and obtain a refund of tax paid in a prior year or elect to carry the loss forward to offset taxable income in a subsequent year. In fact, NOL carryback claims filed under the quick refund procedures were required to be processed by the Internal Revenue Service (IRS) within 90 days, which provided taxpayers the opportunity to carry back their losses to a prior year and obtain refunds swiftly to inject cash back into their businesses.

A new landscape for business losses was ushered in with the 1986 Act. The 1986 Act, a landmark piece of legislation that completely overhauled the income tax code, generally lowered income tax rates and offset the cost of doing so by modifying or eliminating certain tax benefits to broaden the tax base. One such base-broadening measure was the introduction of the passive activity loss rules. The creation of the passive activity loss rules established a roadblock between individuals with business losses from passive activities and their ability to monetize those losses.

To understand how the passive activity loss rules work, first note that they only apply to a passive activity, which is any trade or business in which a taxpayer does not actively participate. Generally, the passive activity loss rules operate by limiting the losses from passive activities to the extent of income from passive activities. To the extent passive losses exceed passive income, the passive losses are carried forward to the next tax year, and once again limited to passive income. As previously discussed, prior to the enactment of the passive activity loss rules, taxpayers could use losses from these types of activities to offset any other income.

The stated principal purpose for enacting the passive activity loss rules was to curb abusive tax shelters formed solely to avoid tax. Lawmakers stated that tax shelter activity was fueling the public belief that the tax system was unfair to the average American. The codification of these rules had a significant impact on the utilization of losses generated by passive activities and, in turn, broadened the tax base.

Although the passive activity loss rules made monetization of losses more challenging for many, taxpayers with losses from operating businesses in which they actively participated were generally not affected, as the passive activity loss rules do not apply when the owner actively participates in the business. Thus, in these situations, owners would continue to be able to deduct their business losses against any type of income.

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Individual loss limitations

The evolution of loss limitation rules

Fast forward to the close of 2017, which brought the most comprehensive tax reform of recent generations. Two significant changes enacted by the 2017 Tax Act—the new excess business loss rules and material changes to the NOL rule set—further complicate the loss utilization landscape and impact not only taxpayers already grappling with existing loss limitation provisions like the passive activity loss rules, but also extend to taxpayers with losses from businesses in which they actively participate.

Business loss limitation rules

A business loss encounters numerous limitation provisions before it is monetized. The enactment of section 461(l) adds yet another limitation for the loss to traverse through before arriving at a deduction.
Individual loss limitations

Loss planning in a post-tax reform world

As discussed throughout this chapter, loss limitation provisions such as the basis limitations and the passive activity loss rules have long existed as barriers for taxpayers with losses to overcome. The excess business loss rules create a new hurdle impacting a group of taxpayers unimpeded by the challenges of the passive activity loss rules: individuals with losses from trades or businesses in which they actively participate. Under newly-enacted section 461(l), an excess business loss arises when a taxpayer’s aggregate trade or business deductions exceed the sum of the taxpayer’s aggregate trade or business gross income and gain plus a threshold amount (for 2018, $250,000 or $500,000 for a married couple filing jointly). If an excess business loss exists, it is not allowed in the current year and is instead converted into an NOL that must be carried forward to a subsequent year.

In addition to the enactment of the excess business loss rules, the 2017 Tax Act modified the NOL rule set such that NOLs arising in tax years beginning after 2017 generally must be carried forward, not back. The inability to carry back NOLs means that taxpayers generally are no longer able to utilize the quick refund procedures, as discussed above, to generate cash flow that could be used to support their business operations. While it is true that an NOL can now be carried forward indefinitely and can still offset any type of income, under the new law an NOL can only be used to offset 80 percent of regular taxable income rather than 100 percent of regular taxable income under the prior law. To the extent the NOL carried forward to the next year exceeds 80 percent of the taxable income in that year, it will continue to be carried forward to a future year until it can be utilized. Thus, taxpayers who generate an NOL because of an excess business loss could find themselves in a position where the recognition of such a loss is deferred for greater than one year.

Further, an excess business loss is computed after applying the passive activity loss rules; thus, the recognition of a previously suspended passive loss may give rise to or increase the excess business loss for that year. The excess business loss rules apply for tax years beginning after December 31, 2017 and ending before January 1, 2026. The changes to the NOL rule set are permanent.

The combined impact of the new excess business loss limitation provisions and changes to the NOL rule set can have a significant impact on owners of businesses that incur losses. In any year where a taxpayer incurs a loss from an active trade or business that is limited by the excess business loss rules, an income tax liability may now occur if nonbusiness income exceeds the allowable loss. As a result, taxpayers with cash flow constraints inherent in a loss situation may be faced with financing a tax liability despite the absence of net income from their business or positive cash flow.

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Loss planning in a post-tax reform world

It is important to consider that excess business losses will create NOLs that would not have existed under prior law, likely resulting in more taxpayers with NOLs. Taxpayers who own businesses that incur losses for many years could be faced with the issue of perpetual NOLs and the challenge of utilizing them. Because of the potential for perpetual NOLs, it is now more likely that at a taxpayer's death, he or she may still have unutilized NOLs. Without further guidance clarifying otherwise, NOLs resulting from an excess business loss not utilized prior to a taxpayer's death appear to die with the taxpayer.

NOL in year of death

<table>
<thead>
<tr>
<th></th>
<th>2018 Tax Year</th>
<th>2019 Tax Year</th>
<th>2020 Tax Year</th>
</tr>
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<tbody>
<tr>
<td>Aggregate trade or business deductions</td>
<td>(3,000,000)</td>
<td>(3,000,000)</td>
<td>(3,000,000)</td>
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<tr>
<td>Aggregate trade or business income</td>
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<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Married filing joint threshold*</td>
<td>500,000</td>
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<td>500,000</td>
</tr>
<tr>
<td>Excess business loss</td>
<td>(2,500,000)</td>
<td>(2,500,000)</td>
<td>(2,500,000)</td>
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<tr>
<td>Allowed trade or business loss</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(500,000)</td>
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<tr>
<td>Portfolio income</td>
<td>10,000,000</td>
<td>10,000,000</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Trade or business income</td>
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<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Allowed trade or business loss</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Tentative taxable income</td>
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<tr>
<td>NOL allowed</td>
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<td>(2,500,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td>(up to 80% of taxable income)</td>
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<tr>
<td>Taxable income</td>
<td>9,500,000</td>
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<tr>
<td>NOL carryforward</td>
<td>(2,500,000)</td>
<td>(2,500,000)</td>
<td>(2,500,000)</td>
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</table>

*Does not reflect annual inflation adjustments to threshold amounts.

OBSERVATION:
See a pattern? Depending on a taxpayer's circumstances, the new loss limitation rules have the potential to increase the likelihood of a taxpayer dying with an NOL. Without further guidance clarifying otherwise, NOLs resulting from an excess business loss not utilized prior to a taxpayer's death appear to die with the taxpayer.
Individual loss limitations

Loss planning in a post-tax reform world

Unlike the stated reason for the enactment of the passive activity loss rules (curbing abusive tax shelters), we are not aware of a similar sentiment communicated by lawmakers providing a policy-related justification for the enactment of the excess business loss rules. Further, to date, there have been no regulations promulgated under section 461(l), which leaves many unanswered questions for taxpayers and their advisers to ponder.

As illustrated throughout this chapter, navigating the world of loss utilization is complex. The hurdles introduced over time have created challenges for taxpayers who incur business losses. Taxpayers must be aware that although they may incur true economic losses and, as a result have significant cash flow constraints, they still may be faced with the task of financing a tax liability. Careful modeling is critical to avoid unwelcome cash flow surprises. We recommend that you work closely with your tax adviser to understand the rules, how they interact with each other, and to model the impact on cash flow.

Working closely with your tax adviser can also result in uncovering some potential planning considerations that may exist to mitigate the negative impact of these provisions. For example, consider a married couple filing jointly for 2018 that has a $10 million long-term capital gain from the sale of an investment and a business loss in the amount of $7 million. The excess business loss rules will limit the deductible business loss in 2018 to $500,000 and create a $6.5 million excess business loss, which will be treated as an NOL and carried forward. Although the loss is no longer able to fully offset the capital gain in 2018, causing the individual to finance a larger tax liability than they would have under previous law, this situation may present planning considerations. If the loss had been fully utilized in 2018, it would have offset long-term capital gain income that is taxed at a preferential rate. Now, due to the excess business loss rules, the couple has a potential opportunity to generate ordinary income in 2019 and utilize the NOL against income that would otherwise be taxed at higher ordinary income tax rates. Careful modeling through multiyear income tax projections can uncover potentially beneficial scenarios, assist you with understanding cash flow considerations, and arm you with the information needed to make tax efficient decisions.

Now, more than ever, it is critical for taxpayers to understand the loss limitation rules and how they interact. We encourage you to work closely with your tax adviser to understand the rules and to model over multiple years to gain perspective on your income tax posture, to understand your cash flow requirements and to identify potential tax planning considerations available to ease the financial pain of an ordinary business loss.