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The 2020 reboot of individual loss limitations

The third installment of the 2019 essential tax and wealth planning guide discussed the existing individual loss limitation rules, explored changes to the loss limitation rules brought about by the TCJA, and discussed new loss planning issues to consider as a result of such changes.

One significant change brought about by the TCJA was the enactment of the excess business loss limitation rules. These rules added an additional hurdle to the monetization of business tax losses for certain taxpayers by disallowing excess business losses. Excess business losses are defined as aggregate trade or business deductions in excess of the sum of (1) aggregate trade or business gross income or gain, plus (2) a threshold amount ($250,000, indexed annually for inflation, or 200% of that amount in the case of a joint return). Additionally, the TCJA modified the net operating loss (NOL) rule such that NOLs arising in tax years beginning after 2017 generally could not be carried back, but instead had to be carried forward. Lastly, utilization of an NOL generated after December 31, 2017, and carried forward was limited to 80% of regular taxable income (as opposed to 100% under prior law). The combined impact of the above changes delayed taxpayers’ ability to monetize business losses. Specifically, excess business losses cannot offset nonbusiness income, are carried forward to the next tax year, and are converted to NOLs.

The COVID-19 pandemic has had a significant impact on the economy, leading many taxpayers to incur significant losses in 2020.

Although it has only been a year since our last discussion of these rules, the COVID-19 pandemic has had a significant impact on the economy, leading many taxpayers to incur significant losses in 2020. In response to the economic stresses brought about by the pandemic, the government signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). In this installment, we examine the flexibility that has been provided to assist individuals with monetizing their 2020 business losses as a result of the temporary modifications to the loss limitation rules brought about by the CARES Act and consider those avenues best suited to utilize (and perhaps, in some cases, enhance) the loss deduction.
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The 2020 CARES Act

Signed into law on March 27, 2020, the CARES Act includes wide-reaching support for individuals, businesses, and other groups affected by the pandemic. The CARES Act contains several income tax provisions aimed at stimulating the economy and providing relief to businesses, including a temporary repeal of the excess business loss limitation rules, a temporary reinstatement of NOL carryback provisions, and a temporary repeal related to limiting NOL usage to 80% of taxable income. These changes to the loss limitation provisions and NOL rules were intended to temporarily relax those rules governing the timing of claiming business losses, generally allowing taxpayers to claim losses in the year incurred. Thus, the CARES Act provides taxpayers an opportunity for an immediate reduction in their tax liability and, in some cases, will allow taxpayers to further monetize business losses by filing a refund claim for an NOL carryback.

Specifically, the CARES Act included provisions that allow NOLs generated in tax years beginning after December 31, 2017, and before January 1, 2021, to be carried back to offset taxable income from the preceding five taxable years. Furthermore, the CARES Act suspended the provision in the TCJA that limited usage of NOLs to 80% of a taxpayer’s regular taxable income. The suspension of the 80% limitation applies to NOLs generated and utilized in taxable years beginning after December 31, 2017, and before January 1, 2021. However, an NOL generated after December 31, 2017, and carried forward into 2021 will be subject to the 80% limitation in 2021 and going forward. Note that the NOL change alone may not have much impact on monetizing business losses due to the addition of the excess business loss limitation rules by the TCJA. To address the interplay between the two provisions, lawmakers retroactively postponed the effective date of the excess business loss limitation provisions from tax years beginning after December 31, 2017, to tax years beginning after December 31, 2020. Accordingly, these changes now allow taxpayers the flexibility to carry forward or carry back NOLs created in 2020, and NOLs carried back are not subject to a taxable income limitation.
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Business losses

In general, an NOL is generated by an individual in a year in which current year business losses from a sole proprietorship and/or passsthrough entity exceed current year taxable income. Note that business loss limitation rules in existence before the enactment of the TCJA are still applicable. As such, only those losses not disallowed under the basis, at-risk basis, and/or passive business loss rules will contribute to the current year NOL.

Changes to the loss limitation provisions brought about by the CARES Act mean that excess business losses incurred in tax year 2020, which are allowable after considering the loss limitation rules above, will fully offset current-year taxable income, including nonbusiness income. Furthermore, to the extent allowable current-year business losses exceed other taxable income, an NOL will be generated that can be:
- Carried back five years;
- Utilized against 100% of taxable income in such years; and
- Then, to the extent any of the NOL remains after the carryback, be carried forward indefinitely.

Alternatively, taxpayers may choose to elect to bypass the carryback provisions and simply carry forward the loss. As discussed above, 2020 NOLs carried forward and used in taxable years beginning after December 31, 2020, are subject to the 80% regular taxable income limitation in the carryforward years.

The result of these changes allows business owners to more immediately monetize the tax benefit of their business losses. For those businesses that are in need of a cash infusion and already anticipating that 2020 will be a loss year, thought should be given to tax planning alternatives that may enhance their 2020 business loss. For example, consideration should be given to filing accounting method changes that would accelerate deductions and defer revenue. The acceleration of deductions and deferral of revenue can also be accomplished through actions that do not require a change in method of accounting. One such example is the acceleration of large planned business asset purchases into 2020. Note that if such purchases qualify for the additional depreciation allowance (bonus depreciation), the full cost of the asset will be deductible in the year purchased. Given the economic effects of the pandemic, this option may not be feasible for many taxpayers. However, some businesses and business owners may have significant assets that allow them to fund additional asset purchases.
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Business losses

It is highly recommended that taxpayers who anticipate business losses for 2020 reach out to their business and/or tax advisers to discuss possible planning considerations, as well as the interaction and impact of an increased business loss on not only basis, at-risk basis, and passive loss limitations, but also charitable deduction planning, the business interest expense limitation, and the qualified business income (section 199A) deduction. Note that this list is not all-encompassing; there are other issues to consider that have not been mentioned here.

The nontax concerns and challenges that taxpayers may face from COVID-19, coupled with the limited time frame available to utilize the taxpayer-friendly provisions of the CARES Act, have made the loss limitation rules even more complex. Tax planning should be considered in light of changing business concerns and changing tax laws. We encourage you to work closely with your business and/or tax advisers to understand the rules and to gain perspective on your income tax posture based on your specific facts and circumstances. Careful modeling through multiyear income tax projections can identify potential scenarios, assist you with understanding cash flow considerations, and arm you with the information needed to make tax-efficient decisions in an unprecedented time.

Weighing various factors related to 2020 versus 2021 NOLs

<table>
<thead>
<tr>
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<td>Legislative uncertainty around future ordinary and capital gains tax rates</td>
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<td>Time value of money</td>
<td>Ability to monetize loss via an NOL carryback</td>
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<td>Ability to monetize loss via an NOL carryback</td>
<td>Ability to fully offset AGI in 2020 with certain cash charitable contributions</td>
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<td>Excess business loss limitation NOT applicable</td>
<td>Excess business loss limitation IS applicable</td>
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Taxpayer has ordinary income in 2020 vs. preferential rate income in 2021

Taxpayer has preferential tax rate income in 2020 vs. ordinary income in 2021

Ability to enhance section 199A deduction in 2020 if losses taken in 2021
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Alternatives for filing an NOL carryback claim

The NOL carryback claim is filed by individuals with an NOL on Form 1045, Application for Tentative Refund, or Form 1040-X, Amended U.S. Individual Income Tax Return. While there are some instances in which filing Form 1040-X is required or favored, Form 1045 is most commonly used to claim a refund for an NOL carryback. The IRS must generally act on a claim filed on Form 1045 within 90 days of filing, and interest will be due to the taxpayer if the refund is not issued within 45 days of filing the claim. Thus, Form 1045 is often the preferred filing method because a taxpayer will typically receive a refund check from the carryback claim faster than when filing the claim on Form 1040-X. Also note that when a carryback claim is filed via Form 1040-X, an amended return is considered a claim for refund and subject to screening procedures in advance of issuing the refund. The IRS could audit the return before issuing the refund, which may cause a significant delay in the issuance of the refund check.

Form 1045 must be filed within the 12-month period following the year of loss. Therefore, for a calendar-year taxpayer with an NOL reflected on the 2020 income tax return, Form 1045 is required to be filed by December 31, 2021. Note that processing of the application for refund on Form 1045 and issuing a check to the taxpayer does not mean the IRS has accepted the application as correct. The refund claim can be audited after the refund is received. Additionally, the refund claim filed on Form 1045 may be rejected if it includes material omissions or math errors. If you generate an NOL in the current year, speak to your tax adviser regarding filing the carryback claim.

Form 1045 is often the preferred filing method because a taxpayer will typically receive a refund check from the carryback claim faster than when filing the claim on Form 1040-X.
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Investment losses

While many taxpayers are focused on business losses, others may have concerns regarding capital losses. There are many sectors of the market that have been negatively affected by COVID-19, and thus, taxpayers may find that certain investments in their portfolio are currently in a loss position. The difference in treatment between business losses and capital losses is that business losses may offset ordinary income with any excess creating an NOL, whereas capital losses may only be offset against capital gains plus up to $3,000 of ordinary income. Any excess capital loss is carried forward as a capital loss in future years.

As mentioned above, many taxpayers may find themselves in a position of owning capital assets that have fallen in value to the point that, if sold, would generate a capital loss. This may provide an opportunity for tax planning. If a taxpayer has capital gains, either from the direct sale of capital assets or indirectly from passthrough investments, “harvesting” capital losses prior to year-end can allow those losses to offset previously recognized capital gains. However, there are limitations to keep in mind when harvesting losses.

The first limitation to consider is whether the wash-sale rules will apply to the transaction. Losses subject to the wash-sale rules are disallowed. The wash-sale rules apply to a transaction that generates a loss on the sale or disposition of stock or securities and if, within a period beginning 30 days before and ending 30 days after the date of the disposition, the taxpayer acquires substantially identical stock or securities. As an example, if a taxpayer sells stock in a publicly traded security for a loss and then proceeds to repurchase the same security within 30 days, the wash-sale rules would result in the loss being disallowed.

The second limitation to consider is the overall limitation on net capital losses. As mentioned earlier, capital losses may be recognized to the extent the taxpayer has capital gains in the current year. Any excess loss can offset up to $3,000 of ordinary income, with the balance disallowed in the current year and carried over to future years to once again be offset against capital gains plus up to $3,000 of ordinary income.

In some situations, taxpayers may find that they are unable to sell or otherwise dispose of stocks in their investment portfolio, perhaps due to the stocks having very little to no value. A taxpayer may deduct the cost basis of stock in the year it...
Investment losses

Investment losses become completely worthless. Losses that are generated from worthless securities are treated as capital transactions and thus generate a capital loss. In some instances, such as when a taxpayer owns an investment in a partnership that becomes worthless, a taxpayer may be able to generate an ordinary loss. For example, assume that a taxpayer owns a partnership interest and that the value of the partnership has decreased to the point of having little to no value. If the taxpayer determines there is no opportunity for recovery and thus decides to abandon their interest in the partnership, such abandonment may result in either a capital or ordinary loss. The determination as to whether an abandonment will generate a capital or ordinary loss is a highly complex matter, the details of which are beyond the scope of this article. If you own a partnership interest that may be worthless, initiate a conversation with your tax adviser to discuss the potential outcome.

Finally, taxpayers who have made loans in either business or nonbusiness settings should consider whether the COVID-19 pandemic and its economic impacts will limit the ability of the debtor to repay the loan. For the purposes of this discussion, we will focus on the treatment of nonbusiness debt. If a taxpayer makes a nonbusiness loan and determines that the loan has become completely worthless, the taxpayer may be able to take a bad debt deduction. A debt becomes worthless when there is no longer any possibility that the amount owed will be repaid. This may occur on the date the debt is due or prior to that date. To demonstrate worthlessness, a taxpayer must show that they have taken reasonable steps to collect on the debt, but were unable to do so. If it is determined that the taxpayer has nonbusiness bad debt, a deduction is available as a short-term capital loss without regard to how long the debt was held. Taxpayers should note, however, that there are additional tax return reporting requirements with regard to nonbusiness bad debts, as detailed below.
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Conclusion

As a result of the COVID-19 pandemic, many individuals have incurred significant losses from their businesses and/or investments. While incurring a loss is never ideal, it does provide an opportunity for tax planning with the objective of either (1) reducing current or future income tax liabilities or (2) the carryback of losses to receive a refund of prior tax paid. In all instances, careful planning involving tax and investment advisers is recommended to determine what impact realizing losses will have and how to best move forward.
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