

# Loss Limitations Analysis: Basis, At-Risk, Passive, and NOLs

THURSDAY, OCTOBER 27, 2022, 1:00-2:50 pm Eastern

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October 27, 2022

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# Agenda

- i. Basis
- ii. At-Risk Limitations
- iii. Passive Activity Loss Limitations
- iv. Excess Business Losses and Net Operating Losses

# Sequence of Loss Limitations for Individuals

1. Disallowance provisions – Section 162, 163(d) and etc.
2. Section 1366 (S Corps) /Section 704 (Partnerships) – Basis Limitations
3. Section 465 – At-Risk Limitations
4. Section 469 – Passive Activity Losses Limitations
5. Section 461(l) – Excess Business Loss Limitations
6. Section 172 – Net Operating Losses



## Basis – Partnerships

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## TWO CONCEPTS OF BASIS

- First, the partnership has an adjusted basis in its assets.
  - This basis is sometimes referred to as “inside basis.”
  - Determines the amount of gain or loss realized by the partnership upon the sale of an asset.
- Second, each partner has an adjusted basis in its partnership interest.
  - This basis is sometimes referred to as “outside basis.”
  - Determines the amount of gain or loss recognized by the partner upon a distribution of property by the partnership and the deductibility of partnership losses by the partner.

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# RELATIONSHIP BETWEEN BASIS AND CAPITAL ACCOUNT

- Partnership allocations of income, gain, loss, or deduction are respected only if the allocations have “substantial economic effect.”
- In order for partnership allocations to have “substantial economic effect,” the partnership must establish and maintain “capital accounts” for the partners.
  - Capital accounts are referred to as 704(b) book capital
  - Capital accounts are intended to keep track of the partners' contributions, distributions, and allocations.
  - A partner's capital account does not reflect the partner's share of partnership liabilities.
  - Partnership property is accounted for at fair market value in the partners' capital accounts regardless of whether fair market value differs from basis.

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# PARTNER'S ADJUSTED BASIS

## *Increases and Decreases*

- A partner's basis is increased by the following items:
  - The partner's additional contributions to the partnership, including an increased share of, or assumption of, partnership liabilities.
  - The partner's distributive share of taxable and nontaxable partnership income.
- The partner's basis is decreased (but never below zero) by the following items:
  - The money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership.
  - The partner's distributive share of the partnership losses (including capital losses).
  - The partner's distributive share of nondeductible partnership expenses that are not capital expenditures.

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# EFFECT OF PARTNERSHIP LIABILITIES

- A partner's basis in a partnership interest includes the partner's share of a partnership liability only if, and to the extent that, the liability:
  1. Creates or increases the partnership's basis in any of its assets,
  2. Gives rise to a current deduction to the partnership, or
  3. Is a nondeductible, noncapital expense of the partnership.
- The term "assets" in (1) includes capitalized items allocable to future periods, such as organization expenses.
- A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership are not included in the adjusted basis of the partner's interest in the partnership.

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## PARTNER'S BASIS INCREASED

If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

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## PARTNER'S BASIS DECREASED

If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

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# PARTNER'S ADJUSTED BASIS

## *Liabilities Assumed by Partnership*

- If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners.
- This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner.
- The other partners' assumption of the liability is treated as a contribution by them of money to the partnership

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# PARTNERSHIP ADJUSTED BASIS LIMITATION

- A partner's distributive share of partnership losses may be deducted only to the extent of the adjusted basis of its partnership interest (before adjustment for losses) at the end of the partnership year in which the losses occurred.
- Losses that are disallowed are carried forward indefinitely until the partner has a sufficient basis in its partnership interest to permit their deduction.
- A subsequent increase in a partner's basis in the partnership enables the partner to deduct losses previously disallowed.



# Basis – S Corporations

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# S CORPORATION STOCK BASIS

The basis in an S corporation stock is used to determine:

- the deductibility of losses,
- the taxability of operating or liquidating distributions from the S corporation; and
- the gain or loss on the sale of the stock.

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# S CORPORATION BASIS

## *IRC Sec 1367*

- There are several ways to create basis in an S corporation to ensure that shareholders can utilize losses that pass through to them.
- Several ways to create basis in an S corporation:
  - contribution of cash or property to the corporation;
  - loans of additional cash;
  - shareholder payment of corporate debt guaranteed by the shareholder either using their own funds or funds borrowed from a third-party lender;
  - shareholders borrowing from lenders and relending proceeds to the corporation, i.e., back-to-back loans;
  - shareholders acquiring property with a mortgage and then selling the property to the corporation under a wrap-around mortgage transaction; or
  - accelerating corporate income or deferring corporate deductions.

*NOTE: Merely guaranteeing debt held by the S corporation does not generate stock basis*

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# INITIAL BASIS IN S CORP STOCK

- Purchase of shares
  - Basis is cost (IRC Sec 1012)
- Incorporation
  - Usually basis carries over from property transferred (IRC. Sec 358)
- C corporation electing S status
  - Basis is basis in C stock at the time of conversion
- Stock acquired by gift:
  - Basis in S corporation stock is donor's tax basis (IRC Sec. 1015)
- Stock acquired by inheritance:
  - Basis in S corporation stock is usually FMV (IRC Sec. 1014)

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# INCREASED SCRUTINY

## *IRS' Large Business and International Division*

- Taxpayer shareholder basis in stock and indebtedness is becoming more of an IRS exam issue for S corporations and their shareholders.
- IRS LB&I is educating its agents about S corporation stock and debt basis to make sure that shareholders are properly claiming excess losses on individual shareholder returns.
- LB&I has developed concept units on adjustments to S corporation stock basis and stock basis ordering rules.

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# EXAMPLES OF CREATING S CORPORATION BASIS

- Examples:
  - Matt contributes cash of \$20,000 and property with a tax basis of \$4,000 and FMV of \$10,000 to New Co in exchange for all the New Co stock. Under Section 358, Matt takes a basis in the New Co. stock of \$24,000, the \$20,000 of cash plus the \$4,000 adjusted tax basis of the contributed property.
  - Jill is a shareholder in All Co a C corporation. On 01/01/2017, when Jill has a basis in the All Co stock of \$20,000 All Co co elects S status. A's initial basis in her All Co stock is \$20,000.

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# INCREASES IN STOCK BASIS

## *IRC Sec. 1367(a)(1)*

- Basis increased by:
  - Capital contributions (cash and adjusted basis of property contributed),
  - Separately stated items of income,
  - Non-separately computed income,
  - Tax-exempt income

*NOTE: Separately and non-separately stated income items will adjust stock basis only if shareholders include these items in their gross incomes as reported on the shareholders' income tax returns*

- Basis is NOT increased by:
  - Section 332/337 liquidation of QSSS
  - Cancellation of Debt Income excluded under IRC Sec. 108
    - Planning Opportunity - Consider PPP Loan Forgiveness

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# DECREASES IN STOCK BASIS

## *IRC Sec. 1367(a)(2)*

- After all upward adjustments are completed, the stock basis of each shareholder is reduced by the following:
  - Distributions (cash and FMV of property)
    - Excludes dividends from earnings and profits
  - Separately stated loss and deduction items
  - Non-separately computed losses
  - Non-deductible expenses (*e.g.* M&E, illegal bribes, and penalties)

*NOTE: Shareholder's stock basis may not be reduced below zero*

- Basis is NOT decreased by:
  - Temporary M-1s (*i.e.* Bad debt allowance, inventory reserve, etc.)
  - Section 1374 or Section 1375 taxes

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# ORDERING OF ADJUSTMENTS TO STOCK BASIS

- The adjustments to stock basis are determined as of the close of the corporation's taxable year.
- Under Reg. Sec. 1.1367-1(f) stock basis is adjusted in the following order
  - Increased to income items
  - Decreased for distributions
  - Decreased by nondeductible expenses
  - Decreased for items of loss and deduction
- **NOTE:**
  - There is an election available to take deductible items first ahead of non-deductible items.
  - The election is permanent and must be followed every year.
  - Must agree to carry over unused non-deductible expenses to future years. Normally these don't carry over.

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# ELECTION TO CHANGE ORDERING RULES

## Example:

On 01/01/2019, Jeff has \$10,000 of basis in his S Co stock. During 2019, S Co. allocates to Jeff \$5,000 of income, \$17,000 of non-deductible expenses, and \$10,000 of losses. If Jeff does not make the election to reverse the ordering rules of Reg. Section 1.1367-1(f), Jeff will adjust his basis as follows.

Beginning Basis	\$10,000
Income	\$5,000
Non-deductible Expenses	(\$15,000)
Ending Basis	\$0
Carryover Losses	\$10,000
Carryover Non-Deductible Expenses	\$0

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# ELECTION TO CHANGE ORDERING RULES

Example:

If Jeff made the election under Reg. Sec. 1.1367-1(g) to deduct losses before non-deductible expenses. If the election is made, any non-deductible expenses that do not currently reduce basis must be carried over to future years.

Beginning Basis	\$10,000
Income	\$5,000
Losses	(\$10,000)
Non-Deductible Expenses	(\$5,000)
Ending Basis	\$0
Carryover Losses	\$0
Carryover Non-Deductible Expenses	\$12,000

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# CHARACTER OF LOSS DEDUCTED

- If losses are limited by basis, different characters of losses are deductible pro-rata up to the amount of available basis.
- Disallowed losses of each character of loss are carried forward and retain their character in future years.

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# BASIS IN INDEBTEDNESS

- A shareholder's initial basis in a loan to an S corporation is the face amount of the loan.
- Loan must be directly from the shareholder to the S corporation.
- Specifically, after stock basis has been reduced to zero, the basis in indebtedness may be reduced, but not below zero, by loss and deduction items that flow through to the shareholder.
  - If there are subsequent basis increases due to the pass-through of net income after the basis in indebtedness has been reduced to zero, these increases first restore basis in the indebtedness before increasing basis in stock.
  - This allows the repayment of low basis debt while minimizing any gain on repayment.
  - If reduced basis debt is repaid before its basis is restored, it generally generates capital gain.
- If taxpayer has multiple debts, reduce basis of each debt in proportion to each debt's basis as a percentage of total debt basis

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## BASIS IN DEBT

- Intercompany loans do not create debt basis
- Circular loans (from bank-shareholder S corp-related S corp-shareholder-bank) do not create basis
- Must be bona fide debt
  - True debtor-creditor relationship between the S corporation and the shareholder

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# UTILIZING DEBT BASIS

- A owns 100% of S Corp. On 01/01/2019, A had a stock basis of \$25,000 and a debt basis of \$50,000.
- During 2019, S corp had the following:
  - Non-separately stated loss (\$40,000)
  - Long Term Capital Gain \$5,000
  - 1231 Loss (\$6,000)
- How much loss can be absorbed?
- What is A's adjusted basis on 12/31/2019?

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# UTILIZING DEBT BASIS

	<b>Stock</b>	<b>Debt</b>
Beginning Basis	\$25,000	\$50,000
Increase Stock Basis for Income	\$5,000	
Decrease for Losses	(\$30,000)	
Ending Stock Basis	\$0	
Use Remaining Loss Against Debt Basis		(\$17,000)
Ending Debt Basis		\$33,000

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# RESTORING REDUCED BASIS DEBT

- The S corporation rules allow for restoration of debt basis first with S corporation earnings before applying repayments of shareholder loans in determining the amount of taxable gain on repayments.
- Must determine if there is a “net increase” or “net decrease”
  - Net increase:
    - income for the year exceed losses, deductions, non-deductible expenses, and distributions (except dividends)
  - Net decrease:
    - income for the year does not exceed the total of losses, deductions, non-deductible expenses and distributions
  - If “net increase”, increase debt basis before stock basis even if debt was repaid during the year
  - If “net decrease” adjust stock basis first. If the debt has been fully repaid during the year, no decrease to debt basis is permitted
- Note: capital contributions never increase debt basis only stock basis

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# UTILIZING DEBT BASIS

- Continuing Example:
  - When A has zero stock basis and has reduced its \$50,000 debt basis to \$30,000, the corporation repays the debt.
  - A has income of \$17,000 and a loss of (\$7,000) for year of repayment.
  - Since A has a net increase for the year, it increases debt basis by \$10,000 to \$43,000 immediately before repayment.
  - This result is only \$7,000 of capital gain.

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## EXAMPLE: RESTORING REDUCED BASIS DEBT

ABC, an S corporation, is wholly owned by J. J's stock basis in ABC at the beginning of the tax year is zero.

In addition, J has made one loan to ABC, which now has a basis of \$0. During the tax year, ABC incurs \$20,000 in net income and deduction items, and makes a \$18,000 distribution to J.

Therefore, the net of income, deduction and distribution items is \$2,000. Under the regulations, \$18,000 of the basis increase is allocated to stock, which is then offset by the \$18,000 distribution. The remaining \$2,000 in basis increase is allocated to the debt.

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# REPAYMENT OF DEBT

- Warning #1: If reduced basis debt is repaid before its basis is restored, it general generates capital gain.
- Warning #2: A shareholder will recognize gain on the partial repayment of reduced basis debt, even if the amount repaid is less than the shareholder's total basis in the debt.

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# PROPERTY DISTRIBUTIONS

Section 311(b) applies to an S corporation:

- If an S corporation distributes appreciated property, the S corporation recognizes gain as if it had sold the property for FMV
- The gain flows through and increases the shareholder's basis
- The amount of the distributions is the FMV of the property less any liabilities

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# STOCK BASIS VS ACCUMULATED ADJUSTMENTS ACCOUNT

- Note: stock basis and AAA may not be the same thing
- AAA is a corporate attribute
- Stock basis is personal to a shareholder
- Stock basis is increased for tax exempt income and decreased for expenses attributable to tax exempt expenses, AAA is not.
- AAA can go negative, stock basis cannot
- If a shareholder buys an interest in a S corporation for a premium, it has not effect on AAA.

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# DISTRIBUTIONS FROM AN S CORPORATION WITH NO E&P

## Taxability of distributions if no E&P

- Distributions are tax-free to the extent of stock basis and basis must be reduced
- Distributions in excess of basis generate capital gain to the shareholder.



# Section 465 - At-Risk Limitations

# Purpose of At-Risk Rules

Section 465 was adopted in 1976 as part of an effort to rein in excessive tax shelter activities. Although Section 465 was initially aimed at specific targets, the provision was later amended to cover almost all business activities. The purpose of IRC 465 is to deduct only losses that were “at-risk” and limit non-economic losses.

The amount you have at-risk is similar to basis in that you cannot deduct losses in excess of your “at risk” amount. The amount at-risk, however is not the same as basis.

In many cases a taxpayer can still have basis, but their losses are not deductible because they are limited by the amount “at-risk”.

# Who is subject to IRC 465?

- Individuals
  - S Corporation Shareholders
  - Partners of an LLC or Partnership
- Personal holding companies
- Estates
- Trusts
- Closely held C Corporations
  - 5 or fewer shareholders own greater than 50% of stock (applied the attribution rules under IRC 267)

# Reporting At-Risk On Partnerships or S Corp

## Partnership and S Corporation:

- Give separate statement of income, expenses, and deductions for each at-risk and not-at-risk activity

## Partners and S Corporation Shareholders:

- Use info on Schedule K-1 or equivalent
- Report at-risk items on Form 6198

# At-Risk Amount

Under Sec. 465(b)(1), a taxpayer is at risk for money and the adjusted basis of any property contributed to an activity *and* amounts borrowed for use in the activity, if the taxpayer is personally liable for repayment or the taxpayer pledged property (other than the property used in the activity) as security for the loan.

- ***Certain borrowed amounts excluded.*** A taxpayer may not be considered at risk if he or she borrowed money from a person with an interest in the activity or from someone related to a person with an interest in the activity (Sec 465(b)(3)(B)).

# At-Risk Amount

***Reduction of at-risk amounts.*** The amounts at risk in any activity may be reduced by any losses allowed in previous years. These amounts may also be reduced by:

- distributions received from that activity
- debts changed from recourse to nonrecourse
- the initiation of a stop-loss or similar agreement

If the at-risk amount is reduced below zero, any previously allowed losses are subject to recapture.

Unused losses carry forward indefinitely until activity is disposed.

- Special Rules apply for transfers and dispositions

# Special Rules for Transfers and Dispositions

Recognition of gain from the disposition of all or part of an activity, including gain from the disposition or liquidation of a partnership interest or a complete redemption by an S corporation of a shareholder's stock in that corporation, is treated as income from the activity, thereby increasing a partner's amount at-risk (Prop. Regs. Sec. 1.465-66). This provision enables a partner to deduct losses previously suspended under the at-risk rules to the extent gain is recognized.

This is an important distinction from the tax basis limitation under Sec. 704(d) and 1366, in which gain from the disposition of a partnership interest or stock does not increase a partner/shareholders' tax basis, and suspended losses therefore do not offset gain on disposition.

# S Corporation Shareholder Issues

- A shareholder's basis and at-risk amount may arise with regard to loans made by a shareholder to an S corporation. Under Secs. 1366 and 1367(b) and the applicable regulations, a shareholder's basis is increased by loans made to the S corporation.
- Under Sec. 465, these loans might not increase the shareholder's at-risk amount. Sec. 465(b)(2) states that an S corporation shareholder is at-risk only with respect to amounts borrowed for use in the corporation to the extent that the shareholder:
  - is personally liable for the repayment of such amounts; or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the fair market value of the taxpayer's interest in such property).

# S Corporation Shareholder Issues

- The terms of the note between the bank and the shareholder will determine the shareholder's liability. In the case of money borrowed from a related party, the substance of the transaction, and not the form, will govern whether the S corporation shareholder is at risk.
  - Exception for Qualified Nonrecourse Financing under Sec. 465(b)(6)
- When a shareholder borrows money from an unrelated party, pledges the property of an S corporation as security, and lends the funds to the S corporation, this loan from the shareholder to the S corporation gives the shareholder basis in debt but does not increase his or her at-risk amount.

# Partnership Liabilities

- Nonrecourse debt - Debt that no partner is personally liable for. (Examples include collateral pledged against the loan, such as Accounts Payable and Accrued Expenses.) This applies in an LLC but in a general partnership all partners would be liable.
- Qualified nonrecourse debt - Nonrecourse debt that is secured by real estate and used in an activity of holding real estate. The creditor needs to be a “qualified” person who is in the business of lending money, such as a bank.
- Recourse Debt - Direct loans and advances, personally guaranteed debt, etc.

# Partnership Liabilities

- A partner's share of partnership liabilities are reported on Schedule K-1, Part II, Item K.
  - Schedule K-1s should be reviewed and analyzed for proper reporting.

K Partner's share of liabilities:		Beginning	Ending
Nonrecourse . . . . .	\$		\$
Qualified nonrecourse financing . . . . .	\$	262,577.	\$
Recourse . . . . .	\$		\$
Check this box if Item K includes liability amounts from lower tier partnerships ► <input type="checkbox"/>			

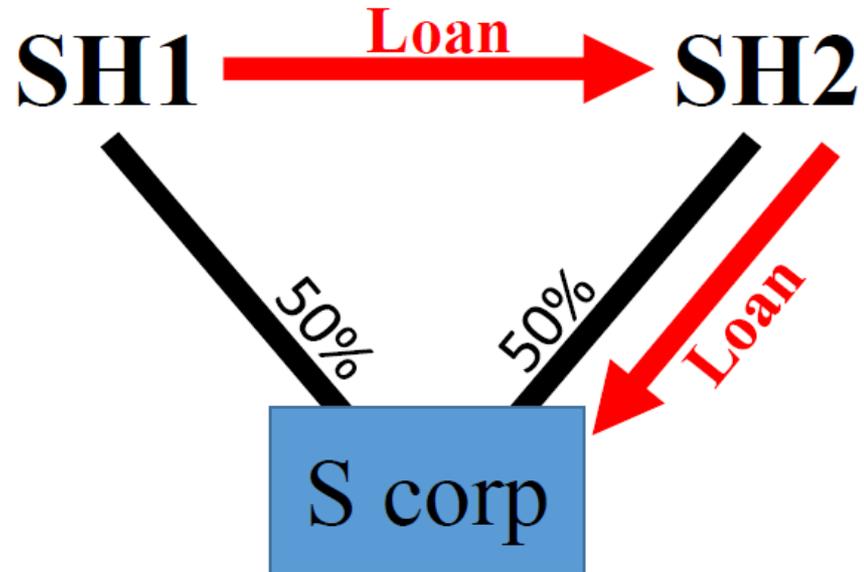
# At-Risk & Related Party

- Not at-risk if borrowed from:
  - Person with “interest in activity” OR
  - Related party (other than the borrower) with “interest in activity”
- Related party defined as:
  - Siblings, spouse, ancestors, etc. (Section 267(b) and 707(b)(1))
  - Corporation more than 10% ownership
  - S corps with common (more than 10%) owner

# Example - Related Party Not At-Risk

Shareholder 1 and 2 are **Related**

Shareholder 2 **not** At-Risk



# What is Not At-Risk

- Nonrecourse financing
- Guarantee by 3rd party
- Stop loss agreement
- Deficit restoration obligation (DRO).
  - Proposed. Reg. §1.465-22(a)

# Loss Recapture

If the amount you have at-risk in any activity at the end of any tax year is less than zero, you must recapture at least part of your previously allowed losses. You do this by adding certain amounts (discussed later) to your income.

## Reasons for Loss Recapture:

- Debt/Equity Classification
- Shift in partnership debt allocation
- Change in debt from recourse to nonrecourse
- Distributions
- Change in guarantor or contract modification

# Reporting – Form 6198

- Filing requirements - Required if during the tax year you, a partnership in which you were a partner, or an S corporation in which you were a shareholder incurred a loss that exceeded the amount at risk. (In other words, file Form 6198 if the at-risk rules cause a limitation of a loss.)
  - At-Risk Activities
    - Motion pictures and video tapes
    - Farming
    - Leasing 1245 property
    - Oil and gas
    - Geothermal deposits
    - Other trade or business
- Separate form for each activity
- Two methods
  - Simplified: If adjusted basis known
  - Detailed: May allow more at-risk

# At-Risk Aggregation

The at-risk rules apply on an activity by activity basis. There is no clear authority on what constitutes a separate activity.

Section 465(c)(3)(B) provides that activities can constitute a single trade or businesses if:

- Taxpayer actively participates, or
- S Corp, partnership – 65% of losses allocated to active members

Section 465(c)(3)(C) provides the IRS with authority to create regulations as to when activities should be aggregated or treated separately. No such regulations have been created.

# At-Risk Example #1

ABC, LLC is owned 50/50 by individuals Y and Z. Z has \$10,000 of tax capital and \$40,000 of recourse partnership liabilities at the beginning of the year. Z is allocated the following items : \$35,000 of recourse partnership liabilities, \$10,000 ordinary loss, and \$15,000 distribution.

What is Z's deductible loss?

# At-Risk Example #1

**Answer - \$10,000**

		<b><u>At-Risk</u></b>
BOY		50,000
Increases		
	Ordinary Income	-
	Increase in Recourse Liabilities	
Decreases		
	Distributions	(15,000)
	Decrease in Recourse Liabilities	(5,000)
Amount At-Risk		30,000
Deductible Loss		(10,000)

## At-Risk Example #2

Assumed the same facts as At-Risk Example #1. In the subsequent year ABC, LLC refinances the debt and it becomes a nonrecourse loan. ABC, LLC has no other income, deductions, or distributions.

What is Z's income or loss?

# At-Risk Example #2

**Answer - \$10,000 of At-Risk recapture income.**

## Recapture Rule

If the amount you have at-risk in any activity at the end of any tax year is less than zero, you must recapture at least part of your previously allowed losses. You do this by adding to your income from the activity for that year the lesser of the following amounts.

- The negative at-risk amount (treated as a positive amount), or
- The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts you previously added to your income from that activity under this recapture rule.

Don't use the recapture income to reduce any net loss from the activity for the tax year. Instead, treat the recaptured amount as a deduction for the activity in the next tax year.

# At-Risk Example #2

	<b>Year 1</b>	<b>Year 2</b>
	<b><u>At-Risk</u></b>	<b><u>At-Risk</u></b>
BOY	50,000	20,000
Increases		
Ordinary Income	-	-
Increase in Recourse Liabilities		
Decreases		
Distributions	(15,000)	-
Decrease in Recourse Liabilities	(5,000)	(35,000)
Amount At-Risk	30,000	(15,000)
Deductible Loss	(10,000)	-
Recapture of Loss		10,000

# At-Risk Planning Opportunities

- Aggregation of activities
- Be aware of the taxpayer's tax basis and amount at-risk and then take measures to increase these amounts prior to an anticipated event before the end of the taxable year



## Passive Activity Losses

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## OVERVIEW - PASSIVE ACTIVITY LOSS

- Section 469 disallows a “passive activity loss” for the year.
- A “passive activity loss” is the amount by which the aggregate losses from all passive activities exceed aggregate income from all passive activities
  - The purpose of section 469 is to prevent taxpayers from using losses from passive activities to offset salary and investment income
  - The limitation is applied by each partner, not at the partnership level

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## PASSIVE ACTIVITY - OVERVIEW

- A passive activity is—
  - A trade or business activity in which the taxpayer does not materially participate and
  - Most rental activities
- Each activity is tested annually under the rules of section 469.
- Grouping
  - Activities are considered single activity if the activities constitute an “appropriate economic unit”

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# PASSIVE ACTIVITY – TYPES OF INCOME

## Section 469 divides income into three categories:

1. Nonpassive:
  - Income from activities in which the taxpayer materially participates, including activities in which wages or salaries are earned.
2. Passive:
  - Income from activities in which the taxpayer does not materially participate, and
  - Income that is *per se* passive
3. Portfolio:
  - Investment income such as annuities, royalties, interest, dividend, capital gains/losses, guaranteed payments for interest on capital.

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# MATERIAL PARTICIPATION

- Regular, continuous, and substantial involvement
- Generally, any work in an activity done by an individual who owns an interest in the activity
  - Includes spouse's participation
- **Exceptions**
  - Work not customarily done by owners if principal purpose is avoidance of section 469
  - Work done as an investor, unless involved in daily operations
- Material participation tested annually
- Activity of agents not counted toward material participation

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# MATERIAL PARTICIPATION – SEVEN TESTS

There are seven tests for material participation for non-limited partners:

1. Taxpayer participated more than 500 hours
2. Taxpayer participation was substantially all of the hours
3. Participation was >100 hours and more than anyone else
4. Taxpayer's participation in "significant participation activities" exceeded 500 hours
5. "Nickel and dime test" (materially participated 5 of last 10 years)
6. Personal service activity (any 3 years)
7. Facts and circumstances test (and > 100 hours)

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# MATERIAL PARTICIPATION – SPPA

- Re-characterization of certain income – Significant participation passive activities
- Taxpayer participates more than 100 hours in each of several trade or business activities but does not materially participate in any of the trade or business activities and total hours do *not* exceed 500 hours.
- If passive gross income from all significant participation passive activities exceeds passive activity deductions from all such activities, a portion of the net passive income is treated as nonpassive.



# Excess Business Losses (EBL)

# Excess Business Losses (EBL) – Section 461(l)

- Passed into law as part of “The Tax Cuts and Jobs Act” of 2017 (TCJA)
- Applies to only non-corporate taxpayers (i.e., Individuals, Trusts)
- Effective for tax years after December 31, 2017, and before January 1, 2026. Repealed for 2018 and 2019 tax years.
- \$250,000 (\$500,000 MFJ) limit on business losses claimable as reduction of AGI.
  - \$270,000 (\$540,000 MFJ) for 2022 tax years
- Disallowed losses are reclassified as net operating losses (NOLs) and carried forward for use in the following tax year

# Excess Business Losses – Carryforwards

- Currently, any amounts limited in a tax year under § 461(l) are carried forward as a net operating loss (NOL)
  - Usable in the next tax year after the limitation occurs
  - Reminder: NOLs are not taken into account when determining the limitation under § 461(l)
  
- NOLs are more broadly applicable to a taxpayer's Adjusted Gross Income, since these losses have already passed tests for other income limitations
  - However, NOLs could be used to reduce capital gain income of a taxpayer, creating a situation in which business losses are being used to reduce income taxed at a lower rate

# Excess Business Losses – Example

Assume all tax years begin after 2022, the threshold amount is \$270k for single taxpayers and \$540k if married filing jointly (no inflation adjustments), and there are no standard or itemized deductions.

Example: In year 1, Taxpayer (T) wages of \$400,000 as well as gross business income of \$100,000 and deductions of \$600,000. T has an EBL of \$230,000 ( $\$600,000 - [\$100,000 + \$270,000]$ ), which is treated as an NOL and carried forward to year 2. Furthermore, T's taxable income in year 1 will be 130,000 (wages of \$400,000 – \$270,000 business loss).

# Excess Business Losses – Trade or Business Income

- Trade or business income is not defined within § 461(l), but we can assume it adopts the definition generally applied to § 162, which includes activities that the taxpayer is continuously and regularly engaged in for income or profit
- Taxpayer's own direct participation in a business activity should be within the scope of § 461(l)
- For activity engaged in by a partnership or S corporation, includes taxpayer's allocable share
- However, without additional guidance from the IRS, one could argue that a limited partner's allocable share is not trade or business activity unless that partner continuously and regularly participates in the partnership's activity

# Excess Business Losses – Trade or Business Income

## What is included?

- Trade or Business Income
- Net capital gains related to a trade or business
- Other limitations on deductibility of losses
- § 163(j) Limitation
- Limitation due to at-risk basis
- Passive loss limitations

## What is not included?

- Net Operating Losses (§ 172)
- § 199A Deductions (Qualified Business Income Deduction)
- Employee Wages
- Net capital losses related to a trade or business
- Net gains/losses from sale of capital assets if unrelated to a trade or business

# Net Operating Loss (NOL)

# NOL Provisions – Overview

A Net Operating Loss (NOL) generally results when a taxpayer's business expenses exceed income from all sources.

Per IRC section 172, a taxpayer who sustains this type of loss in one year can spread the loss over several years. This may generate refunds which can provide additional capital.

Prior to TCJA (pre-2018 tax years), NOLs ordinarily could be carried back two taxable years and forward 20 taxable years.

# NOL Provisions – Overview

NOL Generated in Tax Years	Eligible for Carryback	Carryforward period	Percent of Taxable Income to Offset
Beginning on or before December 31, 2017	2 tax years	20 tax years	100% of taxable income (Subject to AMT limitation)
Beginning after December 31, 2017 and beginning before January 1, 2021	5 tax years	Indefinite	100% of taxable income (prior to 2021) 80% of taxable income (after 2020)
Beginning on or after January 1, 2021	No carryback except for certain farming businesses	Indefinite	80% of taxable income

# NOL Provisions – Carryback

IRC section 172(b)(1)(A)(i) requires that the loss be carried to the earliest year first, unless an election is made in the year the NOL is generated to permanently forego the carryback.

Any amount not absorbed should be carried to each subsequent year and thereafter until fully absorbed.

In addition, a taxpayer may file claims resulting from several carryback loss years to the same gain year.

# Overview of NOL Carryback Claim

Two alternatives for carrybacks exist: Form 1045 and Form 1040X.

Form 1045 differs from Form 1040X:

1. Concerning the time to file,
2. Whether verification is before or after the issuance of the refund, and;
3. The method of making audit adjustments.

The background, documentation, research, and computations are the same.

# Form 1045

Form 1045 must be filed within one year of the loss year.

Applications generally are processed by the IRS within 90 days of receiving a taxpayer's properly completed application.

- Be sure to attach required forms listed in instructions to Form 1045 for the year of loss to avoid delays or disallowance of tentative refund.

# Form 1040X

Form 1040X may be filed anytime within the later of: 3 years after the due date (including extensions) of the loss year; or the date as extended by an IRC section 6501(c)(4) extension agreement for the loss year return; or other periods referred to in Rev. Rul. 65-281. (IRC sections 6511(c) and (d)(2)).

Refunds based on Form 1040X generally are not released to taxpayers before the Form 1040X enters the audit stream. Any adjustments would be made using the claim processing procedures outlined in Internal Revenue Manual (IRM) 4510.

# Election to Waive NOL Carryback

Waiver of 5 year carryback for applicable tax years (2018, 2019, and 2020)

- This is similar to other NOL carryback waivers under section 172(b)(3) and consists of a statement included with a timely filed, original return. The election is irrevocable.
  - An amended return may be filed within 6 months of the due date of the return (excluding extensions) to make this choice if election missed.
- However, for NOL arising in tax years beginning in 2018 and 2019, such election is due by the tax return due date (including extensions) for the tax year ending after March 27, 2020.
  - Rev. Proc. 2020-24 provides guidance on the manner of making such waiver. A separate statement for each tax year being waived.

Waiver of certain section 965 carryback years

- See guidance in Rev. Proc. 2020-24.

# Election to Waive NOL Carryback

If the taxpayer fails to assert the election under IRC 172(b)(3) to permanently forego carrying back the NOL, the IRS's default position procedurally is that any carryforward must be reduced by the amount of NOL that would have been diminished if the carryback had been filed. This can result in permanent loss of refunds, solely as a result of an overlooked election.

# Statute of Limitation on Claims

A claim for refund relating to an NOL carryback generally must be filed within the later of:

- 3 years after the due date of the return (including filing extensions) for the loss year; or
- The period set forth in IRC section 6511(c) as to the loss year (that is, 6 months after the extended date for assessment set forth in an IRC section 6501(c)(4) agreement concerning the loss year). IRC sections 6511(d)(2)(A) and 6511(c).

# Exception to the General Rule

The claim statute under IRC section 6511(a) for the carryback (gain) year expires either:

- 3 years from the date of filing of the carryback year return, or
- 2 years after the tax is paid, whichever is later.

This claim period can be extended by an IRC section 6501(c)(4) agreement as to the carryback year.

# Pre and Post 2018 NOL Utilization

- First use pre-TCJA NOL (tax years beginning before 12/31/2017)
- Then are allowed the lesser of:
  - NOLs arising after 12/31/2017 OR
  - 80% of taxable income (without section 199A [qualified business income] or section 250 deductions [FDII and GILTI]) minus pre-TCJA NOLs

# Pre and Post 2018 NOL Utilization - Example

Taxpayer has \$100 of 2017 NOL, \$100 of 2020 NOL, and \$200 of 2021 taxable income (breakeven for 2018 and 2019).

Taxpayer first offsets 2021 taxable income with pre-TCJA NOL (\$200 minus \$100). 80% limit applies to this amount (80% of \$100, or \$80). Therefore only \$80 of 2020 NOL is usable (\$80 < \$100). Taxpayer has revised taxable income of \$20.

# Alternative Minimum Tax (AMT) NOLs

Under Code Sec. 56(a)(4), taxpayers can take an alternative minimum tax (AMT) NOL deduction in calculating their alternative minimum taxable incomes (AMTI).

Under the AMT rules, use of an NOL is limited to 90% of a taxpayer's income (after the taxpayer has modified the NOL for the adjustments under IRC sections 56 and 57 and preference items under section 58). State tax laws frequently permit NOLs to be carried forward only and often for much shorter periods than the IRC allows. Indeed, some states make no provision at all for taxpayers to use NOLs.

# Calculating and Using NOLs for Individual Taxpayers

# Calculation of NOL

## STEP 1: Compute Negative Taxable income

To convert the taxpayer's taxable income per return (usually stated at zero) to true negative taxable income:

- Subtract the standard deduction or the itemized deductions from adjusted gross income.
- The net result is negative taxable income. This amount is also referred to as the “statutory” loss.

This step is necessary since the tax return will generally not show negative taxable income.

# Calculation of NOL

STEP 2: Make modifications to arrive at the NOL.

These modifications eliminate personal deductions. The net result is a loss resulting solely from business, casualty or theft.

In general, the following items are not allowed in computing an NOL:

- Capital losses in excess of capital gains.
- The section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.
- Nonbusiness deductions in excess of nonbusiness income.
- The NOL deductions from other years.
- The section 199A deduction for qualified business income.
- The section 199 deduction for income attributable to domestic production activities (DPAD).

# Calculation of NOL – Example

Example: Greer owns a candy store. She is single and has the following income and deductions on her Form 1040 for 2021.

INCOME		DEDUCTIONS	
Wages	\$15,000	Net Loss from business	\$50,000
Interest	500	LT Capital Loss	2,000
Section 1231 Gain	<u>10,000</u>	Standard Deduction	<u>12,550</u>
Greer's total income	<u>\$25,500</u>	Greer's total deductions	<u>\$64,550</u>

Greer's deductions exceed her income by \$39,050 (\$64,550 – \$25,500). However, to determine whether she has an NOL, certain deductions are not allowed.

# Calculation of NOL – Example

## Example #1 – Continued

The following deductions are not allowed:

Nonbusiness LT Capital Loss	\$ 2,000
Nonbusiness deductions (Standard Deduction less interest income)	<u>12,050</u>
Total adjustment to net loss	<u>\$14,050</u>

Greer's NOL for 2021 is \$25,000

Total Income	\$ 25,500
Total Deductions less adjustments	<u>(50,500)</u>
NOL (if Negative)	<u>\$(25,000)</u>

# The NOL Deduction

The deductions or exclusions, which may need to be recomputed because of the decreased adjusted gross income, include the following:

1. Deduction up to \$25,000 of passive activity losses from rental activities as per IRC section 469(i)
2. Exclusion of social security and Tier 1 railroad retirement benefits as per IRC section 86
3. Deductions for individual retirement accounts as per IRC section 219(g)
4. Exclusion of U.S. Savings Bond interest used for educational purposes as per IRC section 135(b)
5. Medical expense deductions as per IRC section 213(a)
6. Casualty loss deduction as per IRC section 165(h)
7. Miscellaneous itemized deductions as per IRC section 67(a)
8. Total itemized deductions as per IRC section 68(a)
9. Phase out of exemptions as per IRC section 151(d)(3)

Regarding items (1) through (4), above, if more than one applies, you re-compute them in the order listed above, using the recomputed AGI after applying the NOL deduction and any previous items on the list above.

# The NOL Deduction

The reduction in AGI due to an NOL carryback has no effect on the individual's deduction for charitable contributions.

IRC section 170(b)(1)(F) provides that the contribution base for determining percentage limitations is the AGI without regard to any NOL carrybacks.

An NOL carryback can also free up unclaimed federal tax credits and other tax attributes from closed tax years. If the NOL carryback results in credits no longer being used in the closed year, these items are eligible to be carried forward.

# NOL Documentation

For both the Form 1045 and the Form 1040X refund requests, records for the loss year and the carryback/carryover year(s) **MUST** be kept together.

Records should be kept for any tax year that generates an NOL for 3 years after the later of the NOL Year or the last year the carryforward was used.

- Keep in mind that post-2017 NOLs are carried forward indefinitely.
- IRS is may be permitted to re-compute taxable income in closed tax years to adjust NOL and charitable contribution carryovers to open years. Barenholtz, 784 F.2d 375 (Fed. Cir. 1986)
  - IRS Memorandum 20202501F (released on June 19, 2020) indicated that examining the NOL with respect to its composition when the NOL had previously been audited violated the repetitive audit bar of Code §7605(b) (in this case, a hobby loss issue).

# NOLs and a Change in Filing Status

Separate to joint return - Treat the separate carryback or carryover as a joint carryback or carryover.

Joint to separate returns - Figure each of your carryovers separately.

# NOLs and a Change in Marital Status

If the taxpayer and spouse were not married to each other in all years involved in figuring NOL carrybacks and carryovers, only the spouse who had the loss can take the NOL deduction. If you file a joint return, the NOL deduction is limited to the income of that spouse.

# NOL Carryovers When Taxpayer Dies

NOL carryovers are deductible only by the taxpayer who sustained the losses, and they cannot be transferred to or used by another taxpayer, including the surviving spouse.

NOLs generally can be traced to specific business interests, so unless both spouses have losses, the CPA should be able to attribute the carryover to the spouse who generated the loss.

Whatever amount of a decedent's NOL that remains unused in the year of death is lost. Rev. Rul. 74-175 specifically addressed NOL carryovers, providing that only the taxpayer who sustained the loss can use these carryovers.

# NOL Planning Opportunities

- Accounting method changes
- Timing and type of depreciation
  - Consider state tax impact
- Reporting of other deductions that normally get limited or phased out (i.e. medical expenses, student loan interest, and etc.)

# Accounting Method Changes Can Create EBLs/NOLs

Some changes are now available for any “small business taxpayer,” defined as a taxpayer that has average annual gross receipts of \$27 million or less (tax years after 2021) for the three prior tax years and is not a tax shelter. Options include the ability to:

- Use the cash method of accounting instead of the accrual method of accounting (Sec. 448(c));
- Currently deduct rather than capitalize additional uniform capitalization (UNICAP) costs to inventory (Sec. 263A(i));
- Treat inventories as non-incidental materials and supplies or use an inventory method that conforms to their financial accounting treatment of inventories (Sec. 471(c)); and
- Not account for long-term construction contracts using the percentage-of-completion method (PCM) of accounting (Sec. 460(e)(1)(B)).
- Qualified Improvement Property Corrections