

IRC Section 461(1) Business Loss Limitations: New Form 461

THURSDAY, DECEMBER 12, 2019, 1:00-2:50 pm Eastern

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IRC Section 461(l) Business Loss Limitations: New Form 461

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IRC Section 461(I) Business Loss Limitations: New Form 461

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December 12, 2019 Strafford Presentation

Outline

- Overview and Basic Structure of Section 461(I)
- Effect of Loss Carryover
- Defining Trade or Business
- Capital Gains and Losses
- Completing Form 461
- Questions Surrounding Section 461(I)

Section 461(I)

- Added by P.L. 115-97 (formerly known as Tax Cuts and Jobs Act)
- Applies to all non-corporate taxpayers in 2018 through 2025
- Business losses (generally deductions minus income and gain from trades or businesses) can offset only up to \$500,000 of non-business income for married couples 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 (2018-2027)
- 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



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 704(d) partner basis limitation
4. Section 465 at risk limitation
5. Section 469 passive activity loss limitation
6. Section 461(l) EBL limitation

Example 1: Material Participant in Non-Passive Activity

- Unmarried individual has \$800,000 tax loss from business activity in 2018 in which she materially participated
 - Such as rental business of section 469(c)(7) real estate professional
 - Previously all \$800,000 was deductible against any income
- \$800,000 net business loss limited by section 461(l) in 2018
 - Can offset only \$250,000 of 2018 non-business income
 - Potentially has \$550,000 of net taxable income in 2018 and \$550,000 EBL-related NOL carryover to 2019

Example 2: Full Taxable Disposition of Passive Activity

- 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: Net Lease versus Trade or Business

- 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 (compare safe harbor solely for section 199A purposes in Notice 2019-07 and Rev. Proc. 2019-38)

Example 4: Trading Business

- Married investor owns 75% of a partnership engaged in a commodities trading business. The investor does not materially participate. The investor separately has \$600,000 of investment interest income.
- The partnership trading business has a \$1,200,000 ordinary loss (all interest expense), which is reduced to a \$1,000,000 ordinary loss due to the section 163(j) business interest limitation.
- The \$750,000 (75%) ordinary loss (interest expense) allocated to the investor is subject to the section 163(d) investment interest deduction limitation.
- Does section 163(d) apply before or after section 461(l)?
 - If before, the investor has \$600,000 of allowed investment interest exp. and a \$150,000 investment interest expense carryforward. The \$600,000 allowed investment interest exp. becomes \$500,000 deductible expense and a \$100,000 EBL.
 - If after, the investor has \$500,000 allowed loss and a \$250,000 EBL.

Carryover to Next Year as Net Operating Loss (NOL)

- 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
 - can offset only up to 80% of pre-NOL taxable income

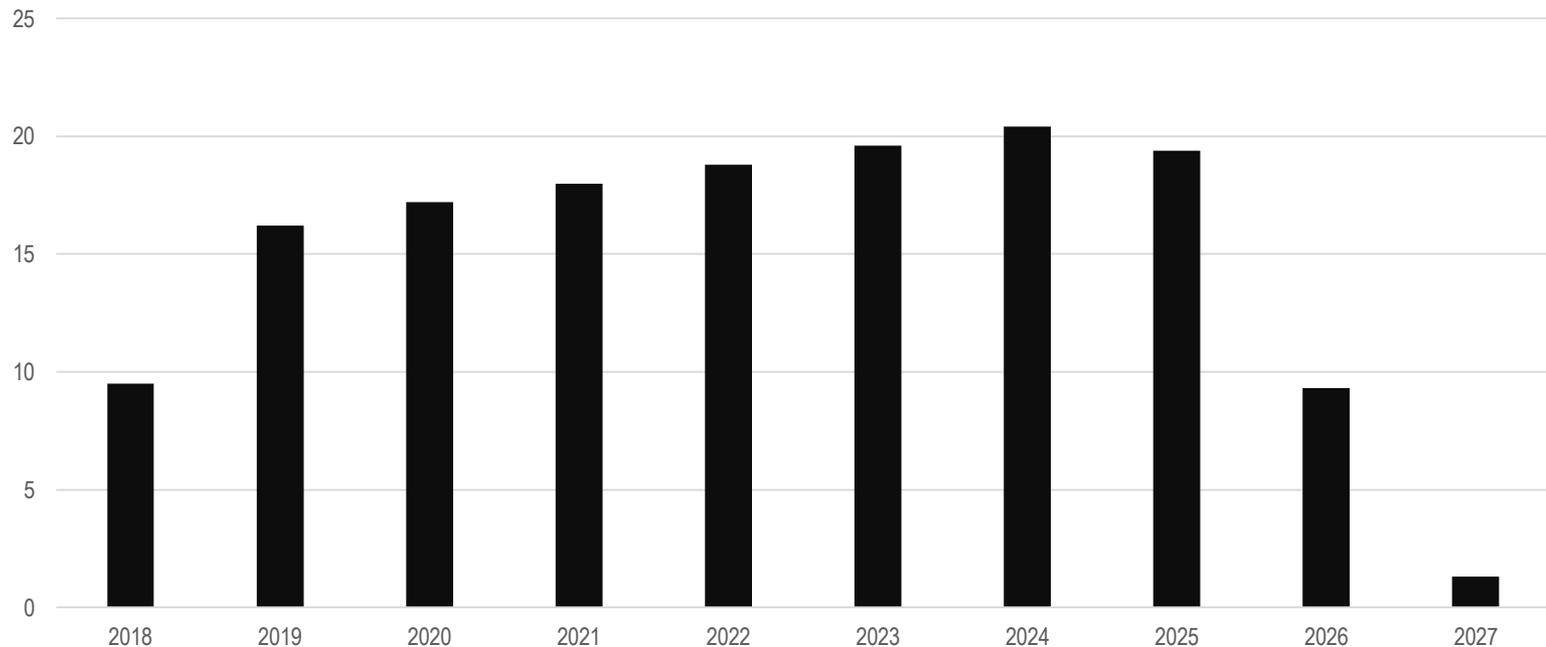
Carryover (cont'd)

- 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 a technical correction according to JCT)
- 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 according to JCT)

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 income.

Section 461(l) federal revenues according to JCT (\$ billions)



Example 4: EBL and NOL

- Married individual sells a Basquiat painting for \$10 million of gain and has \$10 million loss from his restaurant business, both in 2018
- Individual has \$9.5 million of capital gain in 2018, with \$9.5 million EBL-related NOL carryover to 2019
- If individual sells a second Basquiat painting for \$10 million in 2019, the gain generally can be offset by \$8 million of the EBL-related NOL carryover (NOLs can offset up to 80% of taxable income).

Planning Idea:

- Consider recognizing capital gains in a year after recognizing business losses.

Section 199A Deduction

- Section 199A generally provides a 20% deduction for certain pass-through business income (qualified business income, or QBI).
- **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 199A (may require technical correction).
- **Does EBL reduce section 199A QBI?** Not in the year when the EBL is generated, but when the EBL-related NOL carryover is used. Treas. Reg. 1.199A-3(b)(1)(v).

Example 5: Section 461(I) and QBI

- In 2018, married taxpayer has \$800,000 business loss and \$100,000 non-business income
 - \$500,000 business loss allowed under 461(I)
 - \$100,000 allowed loss reduces 2018 taxable income to zero
 - \$400,000 remaining allowed loss is non-EBL NOL carryover to 2019
 - \$300,000 EBL NOL carryover to 2019
- The 199A QBI is negative \$500,000 in 2018, equal to the allowed business loss including \$400,000 non-EBL NOL carryover
- The \$300,000 EBL NOL carryover reduces QBI in 2019 or later when the NOL is used. Taxpayer should track NOL usage between EBL and non-EBL portions each year.

Alternative Minimum Tax

- TCJA repealed the corporate alternative minimum tax, but the individual alternative minimum tax continues on
 - Note 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
 - Taxpayers may use up AMT NOLs more quickly and have positive AMT liability in later years
 - There is a minimum tax credit generally available if a taxpayer has AMT liability in early years and regular tax liability in later years, **but not vice versa**

Example 6: AMT NOLs

- Individual taxpayer has a \$600,000 NOL carryover (both regular tax and AMT) from 2018 to 2019
- Individual's 2019 pre-NOL taxable income is \$400,000
 - Offset by \$320,000 regular tax NOL carryover, to result in \$80,000 regular tax income (with \$280,000 carryover remaining)
 - Offset by \$360,000 AMT NOL carryover, to result in \$40,000 AMT income (with \$240,000 carryover remaining)
 - Individual pays tax on \$80,000 regular tax income in 2019
- Individual's 2020 pre-NOL taxable income is \$400,000
 - Offset by \$280,000 regular tax NOL carryover, to result in \$120,000 regular tax income
 - Offset by \$240,000 AMT NOL carryover, to result in \$160,000 AMT income
 - Individual pays tax on \$160,000 AMT income in 2020

State/Local Tax Conformity (or lack thereof)

- Consider differences in state-level regular tax and AMT NOLs
- Example: California law signed by Governor Newsom on July 1, 2019:
 - Conforms to section 461(I) for 2019 (not 2018)
 - Applies forever (no expiration in 2026)
 - EBL carryover is not a California NOL and continues to be subject to section 461(I) in later years as a business loss

Defining Trade or Business

- **Form 461 definition:** An activity qualifies as a trade or business if your primary purpose for engaging in the activity is for income or profit and you are involved in the activity with continuity or regularity.
- Profit motive vs. actual profit, but production of income is important element
- "Trade or business" in the tax law necessitates continuity, constant repetition, and regularity of activities (*Higgins*, 312 U.S. 212 (1941)); however, investment activities alone, regardless of quantity or frequency, do not constitute a trade or business (*Whipple*, 373 U.S. 193 (1963)).
- **IRS Alert definition last updated on 11-6-19:** A "trade or business" can include, but is not limited to, Schedule F and Schedule C activities, the activity of being an employee, an activity reported on Form 4835, and other business activities reported on Schedule E. Business gains and losses reported on Form 4797 and Form 8949 can be included in the excess business loss calculation. They also include pass-thru income and losses attributable to a trade or business. This includes farming losses from casualty losses or losses by reason of disease or drought. (Form 461 Instructions referenced for further details)

Defining Trade or Business

- There is a distinction between "trader" and "investor" funds in the fund universe
- For trader funds, a partner in such a fund may be able to treat this income as trade or business income or loss when calculating any individual excess business loss under Sec. 461(l).
- As items derived from trading activities are considered trade or business income, the fact that those items are separately stated on a partner's Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, should not affect the ultimate reporting on Form 461 as trade or business income.
- Partnership Consideration: Schedule K-1 presentation to advise ultimate owners of flow-through entities of their allocable share of "trade or business" income will also become increasingly important, especially in the instance of a fund of funds.

Defining Trade or Business

- Important to distinguish between trade or business income and material participation, such as in the case of a real estate fund investment. Material participation is not needed to establish the presence of a Sec. 162 "trade or business" that would qualify for inclusion in the excess business loss calculation.
- For investor funds, separately stated items of income and expense would not be deemed to be "trade or business" items of income and expense.

Completing Form 461

Form 461 **Limitation on Business Losses** OMB No. 1545-2283

Department of the Treasury Internal Revenue Service **2018** Attachment Sequence No. 461

▶ 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 | | |

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 16654I Form 461 (2018)



- LINE 10 – enter the combined amount of income or gain you reported on lines 1-8 above that is not from a trade or business
- LINE 11 – enter the combined amount of losses or deductions you reported on lines 1-8 above that is not from a trade or business

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)
 - Rev. Rul. 82-178 (repayment of severance is a business loss)
 - JCT Blue Book says no, wages do not count as business income (may require technical correction). But IRS Alert (see December 19, 2018 IRS Alert) says yes.

Other Income and Loss Items

- Guaranteed payments for capital or services
- COD income (note AICPA Comments dated 2/28/19 made recommendation that Treasury and the IRS draft definitions related to business income for 461(I) and allow business income to include COD income)
- Income from working capital
- Self-charged items
 - Compare self-charged interest rules for:
 - Section 469 passive activity loss rules (good)
 - Section 1411 net investment income tax (good)
 - Section 163(j) business interest limitation (pending new regulations, but likely good)
 - Section 199A pass-through business income deduction (bad!)

Losses from Property Disposition

- Ironically unclear how to treat losses from sale of business property
- Note AICPA Comments dated 2/28/19 requested guidance on the dispositions of interests in partnerships and S corporations

- 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).

Losses from Property Disposition

- If a shareholder sells his or her S corporation stock, the application of the rules is not as straightforward as with an asset sale. Guidance does not currently exist in the statute that defines "gross income or gain of [the] taxpayer for the tax year which is attributable to such trades or businesses" (Sec. 461(l)(3)(A)(ii)(I)).

Parallel Guidance from other provisions:

- Sec. 1411 - While uncertainty exists as to whether a shareholder may consider a gain from the sale of his or her S corporation stock as part of the computation of excess business loss, Sec. 1411 regulations employ a look-through approach to determine whether the gain or loss is part of an individual's net investment income, primarily as a result of Sec. 1411(c)(4), which provides certain exceptions to the application of the net investment income tax to active individuals on the sale of their interests in an underlying partnership or S corporation.

Losses from Property Disposition

- Sec. 163(j) (Prop. Regs. Sec. 1.163(j)-3(a)(4)) - provide that a taxpayer's adjusted taxable income includes gain from the sale of S corporation stock to the extent it is attributable to the S corporation's assets used in a "non-excepted" trade or business under Prop. Regs. Sec. 1.163(j)-6(l)(4)(ii).
- The proposed regulations for Sec. 163(j) refer to Sec. 461(l) in the context of Sec. 163(j) applying before the application of Secs. 461(l), 465 (at-risk rules), and 469 (passive activity rules) (*Also note this reference wrt ordering rules wrt 163(d) mentioned earlier in Slide 9*)

Q&A – K-1 Reporting

Potential question from a partnership client:

- Q: I notice that we have not disclosed anything under Line 20AH. Note 12 of the K-1 instructions for this item says this line item is to be used for (amongst other things) :

“12. Any information you may need to comply with the limitation on excess business losses of certain taxpayers under section 461. See section 461 and Form 461 and its instructions.”

Was there a reason we did not include a disclosure under 20AH?

- A: Any Section 461(l) limitation is determined at the individual level. Section 461(l)(3) allows business income or gains to offset businesses losses for purposes of this new limitation. Section 461(l)(5) delegates reporting responsibilities to the regulations for which guidance has not been issued as yet so there doesn't seem to be an absolute requirement at this stage nor does there appear to be guidance as to what constitutes a business gain. It would seem that the argument that character shouldn't matter in determining business versus non-business for these purposes can be made, but absent guidance for that position, query whether it should be up to the reporting entity to provide that guidance to a taxpayer without having the guidance needed to support that position.

Q&A

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QUESTIONS???

Select Other Resources

- Lydia Vercelli, *New Limitations on Excess Business Losses*, *The Tax Adviser* (May 1, 2019)
- 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)