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Excess Business Losses—One More Hurdle to Clear

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Introduction and Overview

The law referred to as the Tax Cuts and Jobs Act ("TCJA")[1] replaced a somewhat obscure and limited provision that disallowed "excess farm losses"[2] with a much broader (but similarly worded) provision that disallows "excess business losses"[3] for tax years beginning after December 31, 2017, and before January 1, 2026. Non-corporate taxpayers, such as individuals, trusts, and estates, may be significantly (and adversely) affected by the loss limitation contained in new section 461(l).[4]

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1 An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

2 Section 461(j) previously applied to taxpayers other than C corporations that received any applicable subsidy. The General Explanation of Public Law 115-97 (the "Bluebook"), prepared by the staff of the Joint Committee on Taxation, describes the eliminated excess farm loss provision as follows: "*Excess farm loss rules:* A limitation on excess farm losses applies to taxpayers other than C corporations. If a taxpayer other than a C corporation receives an applicable subsidy for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year." Bluebook, at 39. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

3 Section 461(l) applies to taxpayers other than C corporations generally.

4 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Section 461(l) defines the term "excess business loss" as the excess (if any) of:

(i) The ***aggregate***[5] ***deductions***[6] of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer (determined without regard to whether or not such deductions are disallowed for such taxable year under this provision), over

(ii) The sum of (I) the ***aggregate gross income*** or ***gain*** of such taxpayer for the taxable year which is attributable to such trades or businesses, plus (II) $250,000 (or 200 percent of such amount in the case of a joint return).[7]

Losses disallowed under section 461(l) are treated as part of the taxpayer's net operating loss ("NOL") and carried forward to the next tax year.[8]

To date, no regulations have been promulgated under section 461(l), leaving uncertainty in how to comply with this new loss limitation provision.[9] This article discusses the general application of section 461(l), and explains areas of ambiguity and offers possible solutions.

Who Is Subject to Section 461(l)?

Section 461(l)(1) applies "in the case of a taxpayer other than a corporation." This includes individuals, trusts and estates.[10] While a partnership or an S corporation may be treated as a taxpayer under section 7701, section 461(l)(4) provides that in the case of a partnership or S corporation, section 461(l) is applied at the partner or shareholder level.

Which Items Are Attributable to a Trade or Business for Purposes of Section 461(l)?

Although section 461(l) does not provide clear parameters for what constitutes an item that is "attributable to a trade or business," it is presumed that section 461(l) largely adopts the general

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[5] Emphasis added. It is important to note that the statutory language refers to "aggregate" deductions and "aggregate" gross income or gain; therefore, this computation is *not* computed on an activity by activity or entity by entity basis.

[6] Emphasis added. Note, the statute only references "deductions" and does not specifically reference "losses" in the definition under section 461(l)(3)(A)(i) in a manner that mirrors the subsequent references to "gross income" and "gain" included in section 461(l)(3)(A)(ii).

[7] Emphasis added. Limitation amounts are indexed for inflation. For 2019, the threshold amount is $510,000 for married individuals filing jointly and $255,000 for other individuals. *See* Rev. Proc. 2018-57, section 3.32.

[8] The TCJA modifies existing NOL carryforward usage rules limiting the usage of NOL carryovers for a tax year to the lesser of the carryover amount or 80 percent of the taxable income determined without regard to the deduction for NOLs. *See* section 172(a)(2). A further discussion is provided below.

[9] On January 18, 2019, Treasury and the IRS noted in the preamble to the final regulations under section 199A that future guidance under section 461(l) may be forthcoming, but no timetable was provided. T.D. 9847, 84 Fed. Reg. 2952, 2961 (Feb. 8, 2019). To the extent a regulation package had been finalized prior to the 18-month period contained in section 7805(b) (i.e., June 22, 2019), the regulations could have been effective back to the enactment of the TCJA (i.e., December 22, 2017).

[10] For simplicity, the article will use the term "individual" when referring to an individual, trust, or estate. The Instructions to Form 461 indicate that Form 461 may be included with the following returns: (1) Form 1040, *U.S. Individual Income Tax Return*; (2) Form 1040NR, *U.S. Nonresident Alien Income Tax Return*; (3) Form 1041, *U.S. Income Tax Return for Estates and Trusts*; (4) Form 1041-QFT, *U.S. Income Tax Return for Qualified Funeral Trusts*; and 5) Form 1041-N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts*.

definition (and associated body of case law) of a trade or business under section 162. The Instructions to Form 461 (discussed below) confirm this approach by providing that an activity qualifies as a trade or business if the taxpayer's primary purpose of engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity, which is the general definition of a section 162 trade or business.

For activities conducted directly by an individual, items will be included in the section 461(l) computation to the extent attributable to a trade or business at the individual's level. In contrast, and as noted above, for trades or businesses conducted by a partnership or an S corporation, section 461(l)(4) takes into account the taxpayer's allocable share of entity-level items of income, gains, losses, and deductions at the partner or shareholder level when applying section 461(l).[11]

Review of Certain Limitations Leading up to Section 461(l)

Section 461(l)(6) provides that section 461(l) applies to limit the excess business loss of individuals after application of section 469. Thus, as described in more detail below, section 461(l)(6) effectively provides the following ordering rules for a business loss sustained by a passthrough entity: the partner or S shareholder must have sufficient basis in the entity for the loss to pass through; the partner or S shareholder must have sufficient at-risk basis for the loss to be allowed under section 465; and the loss must not be suspended under the passive activity loss rules of section 469. Thereafter, the taxpayer must consider the impact of section 461(l).[12]

Passthrough Entity Basis Limitation

Generally, a taxpayer can deduct losses allocated from a passthrough entity only to the extent of the taxpayer's adjusted tax basis in the entity pursuant to sections 704(d) and 1366(d). This first hurdle is computed and tracked on an entity-by-entity level. There is no ability to aggregate entities at the partner or shareholder level for this purpose. To the extent losses are disallowed in the current year due to a basis limitation, these losses are carried forward indefinitely and are generally released as the taxpayer's basis in the entity increases.

At-Risk Basis Limitation

If a taxpayer has adequate adjusted tax basis in the passthrough entity to allow the taxpayer's allocable share of loss items to pass through to the taxpayer, an additional hurdle is the section 465 at-risk basis limitation. Section 465 applies to trade or business activities of individuals, trusts, estates, and closely

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[11] It is less clear as to whether the trade or business of the passthrough entity itself should be attributed to the owner of the entity. Although a general partner is generally considered to be in the trade or business of his partnership, it is less likely that a limited partner would have traditionally been considered to be in the trade or business of his partnership. *See, e.g.*, Rev. Rul. 2008-39, 2008-2 C.B. 252. This raises the question of whether the sale of an interest in a passthrough entity should be considered to be attributable to the trade or business of the owner, which is discussed in greater detail below.

[12] It is important to note that there are other potential limitations on a taxpayer's ability to deduct a loss, such as the related party rules of section 267 or the interest expense limitations rules under section 163(j). A full discussion of all loss limitations is beyond the scope of this article.

held C corporations and generally allows a taxpayer to deduct losses only to the extent the taxpayer is "at risk" for the activity. A person is at-risk in an activity to the extent of money or property the taxpayer has contributed to the activity, income and gain from the activity, and borrowed funds for use in the activity for which the taxpayer has personal liability, or to the extent the liability is a qualified nonrecourse liability under section 465. Certain activities may be aggregated based on rules that are unique to section 465. Losses suspended under section 465 are generally carried forward until the at-risk basis amount increases sufficiently to allow use of the loss.

Passive Activity Limitation

Section 469 applies to individuals, trusts, estates, closely held C corporations, and personal service corporations and disallows net passive losses from a taxpayer's passive activities. A passive activity is defined as a trade or business activity in which the taxpayer does not materially participate, as well as most rentals.

To determine whether there is a net passive loss, the taxpayer aggregates all passive income, gains, losses, and deductions from the taxpayer's passive activities at the taxpayer level. Only if the resulting net amount is negative is there a disallowance under section 469. If a net passive loss is disallowed, the character and amount of the loss must be determined and allocated back among all of the taxpayer's loss-producing passive activities. Passive activity losses that are not allowable in the current year are carried forward and may be deducted in a year during which the activity generates passive income or upon the complete taxable disposition of the passive activity. Note that the passive loss rules apply to rentals regardless of whether the rental activity is a trade or business.[13]

To determine whether a taxpayer materially participates in a trade or business activity, section 469 allows taxpayers to group trades or businesses if the grouping forms an appropriate economic unit and meets certain other requirements. Once activities are grouped together, the grouping cannot be changed unless there is a material change in facts and circumstances or the grouping is clearly inappropriate.[14]

Excess Business Loss Limitation

Under section 461(l), to the extent aggregate "allowed" deductions attributable to a taxpayer's trade or business exceed aggregate gross income and gain attributable to a taxpayer's trade or business, plus $500,000 for married filing jointly (or $250,000 for other taxpayers)[15], then the resulting loss is disallowed and is treated as an NOL carryover to the following tax year under section 172. As an NOL, a deduction generally would be allowed in the subsequent year equal to the lesser of the NOL or 80 percent of the taxpayer's total taxable income. Thus, section 461(l) effectively acts to defer 100 percent

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[13] Section 469(c)(2).

[14] *See* Rev. Proc. 2010-13, IRB 2010-4.

[15] The amount is adjusted annually for inflation under section 461(1)(3)(B). For 2019, the threshold has been raised to $510,000 for married filing jointly (or $255,000 for other taxpayers). *See* Rev. Proc. 2018-57, section 3.32.

of an excess business loss in the initial year and potentially only 20 percent (or less) of the loss in a subsequent year.[16]

As a result of section 461(l), an individual may be surprised to find that while during 2017 the business losses of the individual could offset income from other than a trade or business (such as certain portfolio or investment income), beginning in 2018, the losses can offset only income or gain attributable to the taxpayer's trade or business (plus either $250,000 / $500,000). As a result, individuals with significant investment or portfolio income may be subject to tax on the income in 2018 with a carryover of the excess business loss to the following year as an NOL.

Example of the Loss Limitation Hurdles

Taxpayer A, an individual who files married filing jointly, contributes $1.75 million to Fund A for a partnership interest in 2018. Taxpayer A is also allocated *nonrecourse* debt of $10 million. For the same year, Fund A allocates a total amount of $2 million in ordinary losses to Taxpayer A. Taxpayer A has sufficient basis under 704(d) to take the full loss of $2 million. However, the loss is limited to $1.75 million under section 465. Assuming the taxpayer is not subject to a section 469 loss limitation in the investment (i.e., as the taxpayer materially participates in the activity), then the entire $1.75 million loss will enter the taxpayer's excess business loss limitation calculation. If the taxpayer only has other items of portfolio income (which are not attributable to a trade or business), the married taxpayer will only be able to deduct $500,000 of the ordinary losses as a result of section 461(l). The $1.25 million limited under section 461(l) will become an NOL that is potentially available to offset other items of income beginning in 2019 (and subsequent tax years to the extent the NOL carryover remains unused).

Form 461

The eponymous Form 461, *Limitation on Business Losses*, calculates the section 461(l) excess business loss. The Form 461 applies a unique computational adjustment to arrive at the limitation of losses under section 461. Although not entirely clear, Form 461 appears to direct the taxpayer to derive income and deduction items—on a net basis—and then to add back / subtract items of income, gains, losses, or deductions that are not attributable to the taxpayer's trade or business.[17] That is, instead of first limiting the excess business loss on the particular schedule through which the loss was derived (i.e., such as the way Form 8582, *Passive Activity Loss Limitations*, operates to limit losses under section 469), Form 461 looks to the net components of each loss to then add back / subtract any non-business items to the amounts.

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[16] *See* Bluebook, at 40. While noting that a technical correction may be required to achieve this effect, the Bluebook provides that: "The aggregate deductions taken into account to determine the excess business loss of the taxpayer for the taxable year that are attributable to trades or businesses of the taxpayer are determined without regard to the deduction under section 172 or 199A."

[17] The Instructions to Form 461 provide little guidance on computing such adjustments, other than to note that the taxpayer should adjust for the "combined amount of income or gain" and the "combined amount of losses or deductions" that are "not from a trade or business." However, the Instructions to Form 461 provide a special rule for losses limited to $3,000 on Schedule D, which is discussed more fully below.

After adjusting for the non-business items in Part II, Form 461 computes the portion of the business deduction that exceeds the statutory amount (i.e., $250,000 or $500,000, for 2018). This excess amount is reported as an income addback on line 21 of Schedule 1 of the Form 1040. This peculiar calculation appears to effectively create a "plug" or "offset" against the excess business losses in arriving at a properly deductible net amount. This income inclusion is presumably taxable at ordinary income tax rates. However, there does not appear to be any support for this approach in the statute. That is, there is no mention of allowing a deduction or loss, followed by an offsetting ordinary income allocation, as is presently contemplated by the operation of Form 461.

To the extent that all of the taxpayer's excess business loss is ordinary in nature, then the ordinary income addback may not generally affect the tax rate that would have been derived had the excess loss simply been limited at its source. However, Form 461 presents an unexpected result in tax rate to the extent that the taxpayer includes items that would have been considered capital in nature but for section 461(l), as discussed below.

Ordering Rules and Netting Ambiguities

Section 461(l) does not provide guidance on ordering (other than to note that section 461(l) shall be applied after section 469).[18] In addition, section 461(l) does not provide guidance as to whether or not items may be limited on a "gross" or "net" basis.[19] Further, it is unclear if Congress intended for "losses" which are incurred at the individual level to be included for purposes of section 461(l), given the fact that the statute only references "deductions" and does not specifically reference a limitation to "losses", other than in the context of losses from a partnership or S corporation.[20] This lack of direction leaves unanswered a number of important questions, as explored further in the section below.

Section 1211 and Section 1221 Considerations

Under section 1211, if a taxpayer has capital losses which exceed capital gains, the amount of the net capital loss may be limited to $3,000 (or $1,500 if married filing separately).[21] Further, in general, if a taxpayer has a capital gain, a preferential tax rate under section 1(h) may apply to such gain.[22] Schedule D (Form 1040) addresses both of these elements by classifying and netting various capital gains and losses (regardless of whether the gain or loss is attributable to a taxpayer's trade or business). While Schedule D nets such capital gains and losses, it is unclear whether the amount of net capital gain or loss should be used for the section 461(l) calculation, or whether the individual must apply an aggregate view of these gains and losses for purposes of section 461(l). To this end, the instructions to Form 461 provide little guidance, and where guidance is provided, the application

18 Section 461(l)(6).

19 Section 461(l).

20 Section 461(l)(4) provides that in the case of a partnership or S corporation, each partner's or shareholder's allocable share of the items of income, gain, deduction, or *loss* at the entity level shall be taken into account by the partner or shareholder (emphasis added).

21 Section 1211(b)(1).

22 Section 1221.

appears to provide conflicting results. To explain, the instructions seem to suggest that if a taxpayer has an overall capital loss in excess of $3,000, the taxpayer should not make any further addback to the Form 461 to modify the net amount (i.e., $3,000) which is flowing from Schedule D if the capital loss from the taxpayer's trade or business is at least $3,000.[23] Under such a fact pattern, by not adjusting the net output from Schedule D, the Form 461 appears to apply section 1211 before section 461(l) and also appears to adopt a netting approach, notwithstanding the potential for the offsetting of trade or business capital items with non-trade or business capital items. Said differently, the wording of the instructions does not simply provide a limit to the amount of trade or business loss which exceeds $3,000, but, rather, the wording has the potential to impact all of the taxpayer's trade or business capital losses incurred during the year. Now, to the contrary, the instructions do not appear to provide the same result when a taxpayer is not otherwise limited by $3,000. That is, the instructions seem to suggest that when a taxpayer is not limited by section 1211, then the taxpayer may be required to look through Schedule D to identify loss items which are not attributable to the taxpayer's trade or business (i.e., without the benefit of the aforementioned netting). If this reading of the Form 461 is correct, a taxpayer may find themselves with dramatically different results under section 461(l), under potentially similar facts. This seems to be an inappropriate outcome.[24]

For example, assume that a taxpayer has $5 million of long-term capital gain from a trade or business and $5 million of long-term capital losses from a portfolio investment and ($5,000) of long-term capital loss from a trade or business. In total, the taxpayer would reflect a loss of ($3,000) on Schedule D of the taxpayer's return, with a loss carryover of ($2,000). When following the instructions to Form 461, the taxpayer will simply reflect ($3,000) with no further addback, effectively netting long-term capital gain from a trade or business against portfolio losses. Now, assume the same facts as above (i.e., $5 million of long-term capital gain from a trade or business and $5 million of long-term capital losses from a portfolio investment), but now assume there is no additional capital losses from a trade or business. In total, the taxpayer would reflect $0 on Schedule D, with no loss carryover limited by section 1211. This time, as the taxpayer is not limited to $3,000, when computing Form 461, the taxpayer would add back $5 million of long-term capital losses which are not from a trade or business, resulting in $5 million of long-term capital gain from a trade or business which will be available to potentially free-up other non-capital deductions on the taxpayer's return.

As noted, section 461(l) states that any excess business loss "shall not be allowed." If section 461(l) is determined to apply before section 1211, then the excess capital loss should not enter the Schedule D computation in the first place. This could have the effect of accelerating the timing of the benefit for

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23 Form 461 Instructions provide: "For amounts reported on Schedule D, if line 3 is a loss limited to ($3,000), determine the amount of the loss not from a trade or business as follows.
- If the loss from your trade or business is less than ($3,000), enter the difference between ($3,000) and your trade or business loss.
- Do not enter any loss amount on this line from Schedule D if the loss from your trade or business is equal to or greater than ($3,000)."

24 Note, the special section 1211 rule cited in the footnote above is not likewise referenced with respect to the potential subtraction required for aggregate income and gain which are not attributable to a taxpayer's trade or business.

certain capital losses, and potentially convert such capital losses into an NOL in a manner which would not have been allowed under section 172. However, to the extent that section 1211 is determined to apply before section 461(l), then a “tentative” calculation may be required to compute the portion of the excess loss which is otherwise allowed under section 1211, but may nevertheless be disallowed under section 461(l). Under this latter approach, there is no longer the concern of circumventing section 1211, but there remains a question of character on the conversion of a capital loss into an ordinary loss item (i.e., in the form of an NOL in the subsequent year). Hopefully, future guidance will address these significant ordering and netting ambiguities.

Example of Form 461(l) / Schedule D Mechanics

Taxpayer B, an individual who files married filing jointly, has $20 million of long-term portfolio capital gains and $20 million of long-term capital losses from a trader fund. The long-term capital losses are attributable to the trade or business of Taxpayer B and are potentially subject to limitation under section 461(l). Taxpayer B is eligible for a threshold loss amount of $500,000, as a result of married filing jointly status. $20 million of long-term capital losses are “tentatively” allowed through Schedule D (i.e., with $20 million of long-term capital gain as an offset).

While unclear, one application of Form 461 would appear to suggest that Taxpayer B would flow the net zero from Schedule D and then record $20 million as an addback on line 11 as there is $20 million included on Schedule D which is not attributable to the taxpayer’s trade or business, resulting in a bottom line amount of loss of $20 million. After allowing for the threshold amount of $500,000, Taxpayer B would record $19.5 million of “addback” income on Form 1040, Schedule 1 (all of which will be taxable at ordinary income rates). The addback generates a $19.5 million NOL under section 172 that is carried forward to the next year.

This result is to be contrasted with an approach that may be more consistent with a literal read of section 461(l)—a disallowance on Schedule D of all but $500,000 of the long-term capital business losses resulting in $19.5 million of capital gain income subject to preferential tax rates, and a $19.5 million NOL that is carried forward to the following year.

Interaction of Section 461(l) with Sections 199A, 1402 and 1411

Additional issues arise with respect to the interaction between the ordinary income addback under Form 461 and section 199A (i.e., the qualified business income “QBI” deduction), section 1402 (i.e., the self-employment tax), and section 1411 (i.e., the net investment income tax). Sections 199A, 1402 and 1411 are all presumably computed after section 461(l). Other than limited guidance on how section 461(l) NOLs may reduce QBI under section 199A (discussed below), there is no additional direction on how to apply section 461(l) with respect to these sections. In the absence of guidance to the contrary, we believe one approach may be to reasonably apportion the components of the section 461(l) loss limitation among the various trades or businesses and activities that comprise the section 199A, 1402 and 1411 computations. Accordingly, when considering apportioning the allowed and disallowed losses for these provisions, the section 461(l) calculation must consider that different items of income, deduction, gain, or loss will enter into the section 461(l) limitation than the items that will enter into the analysis for purposes of sections 199A, 1402 and 1411. This mismatch potentially creates considerable complexity and uncertainty.

The necessity to engage with this complexity further underscores some of the challenges with the current operation of Form 461, which, as noted, applies a curious “offset” approach to applying the limitation of section 461(l) as compared to an approach which may have applied section 461(l) at the source of the loss, before proceeding to other elements of the taxpayer’s return.

Changes to Net Operating Loss Deduction

As discussed above, under the TCJA, any loss that is disallowed under section 461(l) is treated as an NOL carryover to the following tax year under section 172. In addition, the new tax law modified the NOL provisions under section 172(a). The new law limits the deduction for any particular year to 80 percent of taxable income for losses arising in tax years beginning after 2017. Further, for losses incurred in tax years ending after 2017, taxpayers are no longer permitted to carry back the losses, but can carry forward the losses indefinitely.[25] Due to the interaction of the excess business loss and NOL provisions, taxpayers should carefully consider the timing (to the extent possible) of realizing items that implicate section 461(l).

Example of Timing Consideration

Taxpayer C, an individual who files married filing jointly, has been contemplating the sale of a Renoir painting (Taxpayer C is not a trader or dealer in artwork) and has received an offer that would result in a $10 million gain on the sale of the painting. Taxpayer C is also projecting $10 million in deductible losses from several partnership ventures in 2018 (i.e., losses allowed under sections 704(d), 465 and 469). Taxpayer C has no other sources of income or loss in 2018. Before the enactment of section 461(l), if the taxpayer had sold the artwork in the same period as the deductible losses, the deductible losses likely would have been available to offset the gain from the sale of the artwork. However, under section 461(l), if Taxpayer C sells the artwork in 2018, the taxpayer will be able to utilize only $500,000 of losses to offset an equal amount of capital gain. In addition, the taxpayer will need to remit a significant tax payment on the income equal to the disallowed losses (which is treated as ordinary income under the Form 461 addback) for the 2018 tax year. None of the suspended $9.5 million in NOLs generated under section 461(l) would be available to carry back, and must instead be carried forward.

Now, assume the artwork is instead sold in 2019. By delaying the sale of the painting, Taxpayer C may be able to reduce taxable income in 2019 by $8 million (assuming 80 percent of $10 million) since Taxpayer C would be able to potentially use the 2018 carryforward of section 461(l) NOLs to offset the

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25 In the year of a taxpayer’s death, the newly created NOL would not carryover to the decedent’s estate. Rev. Rul. 74-175, 1974-1 C.B. 52.

$10 million in gain in 2019. In this situation, the payment required for 2019 would be significantly reduced, as a result of matching the NOL utilization with the recognition of income.

Note, the above represents a simple example to illustrate timing considerations inherent in the section 461(l) analysis. There are a myriad of considerations that must be factored into the taxpayer's analysis—such as character of income and the availability of the 20 percent deduction under section 199A—before ultimately making a determination as to the best course of action.

Regular NOLs and Section 461(l) NOLs under Section 199A

Section 199A provides a potential deduction of up to 20 percent of qualified business income (QBI deduction). If a deduction is limited under sections 704(d), 1366(d), 465, 469 or 461(l), it will not be taken into account for purposes of computing the QBI deduction in the year the item is limited. Rather, the previously disallowed losses or deductions are generally taken into account for purposes of computing the QBI deduction in the year that the item is fully released.[26]

In general, items giving rise to an NOL are allowed when computing taxable income in the year incurred and, as a result, are generally taken into account in computing the QBI deduction in the year that the item is incurred. As a result, an NOL is generally not treated as part of the QBI deduction calculation in a subsequent tax year. However, as noted above, losses disallowed by section 461(l) give rise to an NOL without ever having been allowed in computing taxable income. Therefore, a special rule exists for NOLs that have been created under section 461(l) for purposes of the QBI deduction.[27] Specifically, to the extent an NOL consists of amounts attributable to a trade or business that were disallowed under section 461(l), then the NOL may be included in the taxpayer's QBI calculation in a subsequent tax year.

To illustrate, assume the same facts as in the previous example in which Taxpayer C sells the painting in 2018. Assume also that Taxpayer C realizes $10 million of qualified business income in 2019 from the partnership ventures. Since $9.5 million of Taxpayer C's NOL consists of amounts attributable to a trade or business that were disallowed under section 461(l), Taxpayer C must reduce the $10 million of QBI realized in 2019 by $9.5 million in computing Taxpayer C's section 199A deduction for 2019.

Frequently Asked Questions

To date, taxpayers have received only limited points of reference to consider with respect to section 461(l), and there is presently no clear timetable for the issuance of further regulatory guidance. In the absence of future guidance to the contrary, the section below provides a deeper dive into a few frequently raised questions, and possible solutions.

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[26] However, losses or deductions that were disallowed, suspended, limited, or carried over under sections 704(d), 1366(d), 465, and 469 from tax years ending before January 1, 2018, are not taken into account in a later tax year for purposes of computing QBI.

[27] *See* section 1.199A-3(b)(1)(v).

Are employee wages attributable to the trade or business of the taxpayer for purposes of section 461(l)?

Individuals may be in the trade or business of being an employee under the Code. For example, contemporaneously enacted section 199A refers to the "trade or business of performing services as an employee." [28] Further, additional guidance in regulations supports this position. For example, when calculating a taxpayer's NOL carryover, section 172 regulations state that wages and salary constitute income attributable to the taxpayer's trade or business.[29] Guidance in section 179 regulations also support the treatment of wages as trade or business income. In the context of determining section 179 expensing limits, the regulations consider employees to be engaged in the active conduct of the trade or business of their employment. Thus, wages, salaries, tips, and other compensation derived by a taxpayer as an employee are included in the aggregate amount of taxable income of the taxpayer for purposes of determining the taxpayer's section 179 expensing limit.[30]

Furthermore, although informal with respect to guidance standards, the IRS has indicated on its website that a "trade or business" can include, but is not limited to "the activity of being an employee."[31] Moreover, the Form 461 provides a space for the taxpayer to include wage, salary, and tip income from Form 1040, line 1 in the calculation for computing excess business loss.[32]

Given the historical position in the Code and regulations that an individual may be in the trade or business of performing services as an employee, the recent affirmation of this position through section 199A, and informal guidance from the IRS, it appears reasonable to include an employee's wage income in the definition of trade or business income under section 461(l).[33]

Are guaranteed payments for services considered attributable to the trade or business for purposes of section 461(l)?

Section 707(c) provides that, to the extent determined without regard to the income of the partnership, payments to a partner for services are considered to be made to one who is not a member of the

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[28] Section 199A(d)(1)(B). In the case of section 199A, the trade or business of performing services as an employee is specifically *excluded* from the benefit of section 199A, but this policy treatment should not change the fact that Congress views an individual employee to be in a trade or business.

[29] Section 1.172-3(a)(3)(i). As with above, this section 172 regulation might be particularly influential for purposes of interpreting section 461(l), given the fact that the losses suspended under 461(l) are automatically converted to section 172 NOLs.

[30] Section 1.179-2(c)(6)(iv).

[31] *See* https://www.irs.gov/newsroom/excess-business-losses (Dec. 19, 2018).

[32] *See* Form 461 and accompanying Instructions. There is also a line on Form 461 to reverse any income or gain that is included on Form 461, but which is not attributable to a taxpayer's trade or business.

[33] However, on December 20, 2018, the Joint Committee of Tax released their Bluebook containing language that is in contradiction to above. The Bluebook explanation on section 461(l) states that items relating to the trade or business of the performance of services as an employee were not intended to be included in the section 461(l) calculation. However, it should also be noted that the Bluebook acquiesces to the fact that a technical correction may be required to carry out the intent. Bluebook, at 40. To the extent such a technical correction is enacted—potentially with retroactive effect back to the enactment of the TCJA—income from the trade or business of performing services would no longer be included in the section 461(l) calculation.

partnership, but only for the purpose of section 61(a) (relating to gross income) and for the purpose of section 162(a) (relating to trade or business expenses).[34] Section 1.707-1(c) goes on to provide that—with respect to other areas of the law—guaranteed payments are regarded as a recipient partner's distributive share of ordinary income.

The TCJA also enacted section 199A. Section 199A generally excludes from qualified business income reasonable compensation and guaranteed payments for services under section 707(c) paid to a partner for services rendered with respect to the trade or business.[35]

As guaranteed payments are considered rendered with respect to a trade or business, it would seem reasonable to conclude that guaranteed payments for services may be included in the computation of the recipient partner's trade or business income for purposes of section 461(l). However, it should also be noted that any guaranteed payment deduction may also be attributable to the trade or business of the partnership and could give rise to a deduction that is limited by section 461(l) at the partner level.

Are guaranteed payments for the use of capital considered attributable to the trade or business for purposes of section 461(l)?

The case for including guaranteed payments for use of capital as trade or business income for purposes of section 461(l) is less clear. This is largely a result of (1) a lack of formal guidance specifically defining or describing the nature of guaranteed payments for the use of capital, and (2) their disparate treatment in different areas of the Code.

As noted above, the guaranteed payment regulations regard a guaranteed payment as a recipient partner's distributive share of ordinary income for most purposes of the Code.[36] This would suggest that the guaranteed payment could retain the treatment of the income as considered at the partnership level.

Although not free from doubt, in the absence of guidance to the contrary, we believe that given the regulations under section 707(c) and that the income or deduction for section 461(l) merely needs to be "attributable to" the trade or business, it may be appropriate to include a guaranteed payment of income for use of capital in the determination of a taxpayer's excess business loss to the extent the partnership is in a trade or business.

Is portfolio income generated from a business considered attributable to the trade or business for purposes of section 461(l)?

In general, under section 469, income from interest, dividends, royalties, and annuities is classified as portfolio income, unless the income is derived in the ordinary course of a trade or business. An open

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[34] Section 707(c).

[35] Section 199A(c)(4).

[36] Section 1.707-1(c).

question remains, should all of the same principles of section 469 also apply in the context of section 461(l), in assessing whether an item is attributable to the taxpayer's trade or business?

As a simple matter, notwithstanding section 469, it would seem that if the asset is attributable to the trade or business—such as working capital or trade receivables—a reasonable argument could be made that the earnings on the assets are attributable to the trade or business of the taxpayer under section 461(l).[37] However, if the asset is held for investment, it is unlikely that the earnings on the assets would be considered to be attributable to the trade or business of the taxpayer under section 461(l).

It is worth noting that trader funds generate predominantly investment income (as defined in section 163(d)), but the income is earned in the ordinary course of the fund's trade or business.[38] To this extent, the items from a trader fund would presumably be considered to be attributable to the taxpayer's trade or business under section 461(l).[39]

Are gains and losses from the sale of business assets considered attributable to the trade or business for purposes of section 461(l)?

Section 1231 covers the treatment of gains or losses that are used in the trade or business of the taxpayer. To the extent section 1231 gains or losses are generated, the gain or loss should be included in the definition of aggregate gross gain or loss of the taxpayer under section 461(l). As discussed above, this would include circumstances where the section 1231 results in a net capital gain. The gain will be treated as "attributable to the taxpayer's trade or business," notwithstanding the fact that the gain may be taxed at favorable rates.

Are section 751 gains considered attributable to the trade or business for purposes of section 461(l)?

Section 751 provides that the amount of any money (or the fair market value of any property), received by a selling partner in exchange for all or a part of the partner's interest in certain "hot assets" will be considered as an amount realized from the sale or exchange of property other than a capital asset. Inclusion under section 751 likely should be considered trade or business income for purposes of section 461(l) to the extent attributable to the partnership's trade or business.

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[37] The passive activity loss rules of section 469 and net investment income tax rules of section 1411 provide that income, gain, or loss that is attributable to an investment of working capital is not treated as derived in the ordinary course of a trade or business. Sections 469(e)(1)(B), 1411(c)(3). However, specific statutory provisions were arguably needed to reach that result.

[38] *See* Rev. Rul. 2008-39, 2008-2 C.B. 252.

[39] This conclusion is true regardless of whether the taxpayer materially participates in the underlying activity.

Are capital gains and losses recognized upon disposition of an interest in a partnership or S corporation considered attributable to the trade or business of the taxpayer for purposes of section 461(l)?

There is no guidance on whether capital gains or losses that are recognized upon the disposition of an interest in a partnership or S corporation should be considered trade or business income for purposes of section 461(l). In general, other than in the context of a general partner (or equivalent), an owner is not treated as being in the business of his partnership or S corporation ("passthrough entity or entities") and a partnership interest and S corporation stock are not treated as assets held in a trade or business, unless the owner is a dealer.[40]

As mentioned above, however, section 461(l) applies more broadly to the extent items are "attributable to" the trade or business of the taxpayer. Provisions such as section 469 treat the sale of a partnership (or S corporation) interest as a sale of the underlying asset.[41] Similarly, section 1411(c)(4) provides that the sale of an interest in a partnership or S corporation is subject to the net investment income tax to the extent sale of the entity's assets would generate net investment income.[42]

This aggregate approach has also been applied in other areas of the Code and regulations for determining the nature and character of gain from the sale of an interest in a partnership or S corporation.[43] For example, the TCJA effectively codified Revenue Ruling 91-32, which required a foreign partner to recognize effectively connected income ("ECI") upon the sale of a partnership interest to the extent a sale of underlying partnership assets would give rise to an allocation of ECI to the transferor partner.[44] As a result, section 864(c)(8) now provides that if a nonresident alien individual or foreign corporation owns an interest in a partnership that is engaged in any trade or business within the United States, gain or loss on the sale or exchange of the interest shall be treated as effectively connected with the conduct of the trade or business to the extent the gain or loss does not exceed the portion of the partner's distributive share of the amount of gain that would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of the interest.[45]

In the context of section 172, whether something is capital gain or loss does not answer the question (i.e., character is not relevant) of whether it is attributable to the taxpayer's trade or business. In *Crow v.*

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[40] *See, e.g.*, Ward v. Commissioner, 20 T.C. 332, 342 (1953) ("By reason of being a partner in a business petitioner was individually engaged in business…"), *aff'd*, 224 F.2d 547 (9th Cir. 1955), *acq.*, 1956-2 C.B. 4. *See also* Zahler v. Commissioner, T.C. Memo. 1981-112; Smith v. Commissioner, T.C. Memo. 1994-640; *but cf.* Boone v. United States, 374 F. Supp. 115 (D.N.D. 1973).

[41] Section 1.469-2T(e)(3)(ii)(a).

[42] Proposed section 1.1411–7(b). Section 1411 generally provides for a 3.8 percent tax on certain "net investment income" of individuals, trusts and estates.

[43] *See, e.g.,* section 512(e)(1) (providing that gain or loss on the disposition of S corporation stock shall be taken into account in computing the unrelated business taxable income of the corporation); section 1373(b) (providing that the making or termination of an election to be treated as an S corporation shall be treated as a disposition of the underlying business).

[44] Rev. Rul. 91-32, 1991-1 C.B. 107.

[45] Section 864(c)(8).

Commissioner,[46] the Tax Court concluded that a capital loss on the sale of certain corporate stock had a sufficient nexus to the taxpayer's trade or business activities to be included in the calculation of the taxpayer's NOL. As the law that has developed under section 172 may allow inclusion of certain capital gains and losses in the calculation of an NOL, perhaps the conclusions lend insight under section 461(l), as well.

Finally, the definition of excess business loss is very similar to the definition of an excess farm loss in former section 461(j),[47] and the rules that the government developed to apply section 461(j) may provide insight to our understanding of the excess business loss provision of section 461(l) for purposes of determining whether gain or loss from sale of an interest in a passthrough entity is included in the excess business loss calculation. Under guidance issued by the IRS on section 461(j), gains and losses related to sales of interests in a partnership involved in farming appear to have been "attributable to" the farming business.[48]

While not free from doubt, we believe that until there is guidance that clarifies the issue, it may be reasonable for the taxpayer to include income, gain, deduction, and loss from the sale of an interest in a passthrough entity, in certain situations. In those circumstances, the inclusion under section 461(l) would be limited to the extent the passthrough entity held assets in a trade or business activity, and the sale of such assets would have entered into the section 461(l) calculation if the entity had sold all of its assets directly.

Are capital losses in excess of $3,000 included in the section 461(l) limitation?

Assume a taxpayer has an overall net long-term capital loss that is limited to $3,000 under section 1211. Assume further that the overall loss consists of a combination of long-term capital gain from the sale of portfolio stock and long-term capital loss from a trader fund. If the taxpayer uses an aggregate approach, the taxpayer might end up with a section 461(l) trade or business limitation applied against a loss that exceeds the amount otherwise deductible under section 1211 (and, in so doing, effectively convert an item limited by section 1211 into an NOL). The instructions to Form 461 provide that any loss that exceeds the $3,000 shall not be subject to section 461(l). However, this rule does not further clarify whether the capital gains or losses in the analysis should otherwise be determined on a "net" or "aggregate" basis, as reviewed above—particularly when certain gains or losses are considered attributable to the taxpayer's trade or business.

46 79 T.C. 541, 558 (1982), *action on dec.*, 1984-07 (Jan. 3, 1984), *acq.*, 1984-2 C.B. 1.

47 Section 461(j)(4)(A) defines an excess farm loss as the excess of— the aggregate deductions of the taxpayer for the taxable year which are *attributable to farming businesses of such taxpayer* (determined without regard to whether or not such deductions are disallowed for such taxable year under paragraph (1)), over the sum of (I) the aggregate gross income or gain of such taxpayer for the taxable year which is *attributable to such farming businesses*, plus (II) the threshold amount for the taxable year—which is the greater of $300,000 (or $150,000 in the case of married taxpayers filing separately) or the taxpayer's total net farm income for the prior 5 taxable years).

48 See page F-10 of the 2017 Instructions for Schedule F, Profit or Loss from Farming.

Are losses that are "suspended" before 2018 subject to 461(l) if they are "released" between January 1, 2018, and December 31, 2025?

Section 461(l) does not provide an exception for losses that were incurred prior to January 1, 2018. Instead, the statute provides that the section 461(l) limitation may apply against "the aggregate deductions of the taxpayer *for the taxable year* that are attributable to trades or businesses of such taxpayer." As a result, to the extent a loss was formerly suspended prior to January 1, 2018, but subsequently released between January 1, 2018, and December 31, 2025, the loss may be subject to section 461(l).

Actions

As with many new provisions enacted by the TCJA, section 461(l) contains some inherent uncertainty, and there are presently limited points of reference from which to make determinations with respect to this new loss limitation. Unfortunately, further guidance may be delayed until Treasury and the IRS first address guidance on several other items from the TCJA. In the interim, tax professionals must carefully navigate the complexities of this provision.

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