

Accountant

The Tax Cuts and Jobs Act (TCJA) and excess business loss limitations



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For taxable years beginning in 2018, the Tax Cuts and Jobs Act (TCJA) signed by the President last year added a new limitation on the ability of taxpayers other than C corporations to deduct business losses.

“Excess business losses” are defined as the excess (if any) of the taxpayer’s aggregate deductions for the taxable year that are attributable to the taxpayer’s trades or businesses over the sum of (1) the taxpayer’s aggregate gross income or gain attributable to such trades or businesses, plus (2) \$250,000 (\$500,000 for joint returns). These amounts are indexed for inflation after 2018. Any amount over the threshold is considered an “excess business loss” and is not deductible in the current taxable year. The excess business loss limitation is applied after the basis, at-risk and passive loss rules.

Excess business losses that are disallowed are treated as a net operating loss carryover in the following taxable year. In the case of a partnership or S corporation, the limitations of section

461(l) are applied at the partner or shareholder level. As a net operating loss carryover, the excess business losses become subject to the TCJA modifications that were made to the rules governing net operating loss deductions.

Net operating losses arising in 2018 can now only be used to offset up to 80% of the taxpayer’s taxable income and cannot be carried back to previous years. They can, however, be carried forward indefinitely. Prior to TCJA, net operating losses could be carried back two years and/or carried forward twenty years and could offset 100% of taxable income (see AMT rules for separate limitation).

A decedent’s unused net operating losses are lost after the filing of the decedent’s final tax return and cannot be used by the decedent’s estate or beneficiaries. Since excess business losses are treated as net operating losses, they also are lost.

The following is an example of how the limitation is applied:

David, an unmarried taxpayer, is an active member in ABC LLC and XYZ LLC. His share of 2018 distributive income (loss) from these entities is \$50,000 and \$600,000 respectively. His excess business loss is \$300,000. (\$50,000 – \$600,000 = \$550,000) – loss limitation of

\$250,000 = \$300,000. David will be allowed a loss deduction of \$250,000 on his 2018 income tax return and will

remaining \$20,000 net operating loss will be carried forward indefinitely to future years.

determine business income (loss)? There are other instances in the tax law where these items are considered

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have a \$300,000 net operating loss carry forward into his 2019 tax year. Assuming David has other income of \$1 million in 2018, he will reflect net income of \$750,000 (1 million – 250,000) for 2018 versus Pre-TCJA net income of \$450,000 (\$1 million + \$50,000 – \$600,000).

As suggested by the above example, the excess business loss limitation can have a big impact on tax liability even with the lower tax rates enacted by TCJA. Continuing with the example above, if David has net income of \$350,000 in 2019 (before considering his net operating loss carryover from 2018). His net operating loss deduction for 2019 will be limited \$280,000 (\$350,000 x 80%). The

In contrast, under Pre-TCJA rules, 100% of his 2018 loss would have been deducted on his 2018 return as his income (\$1 million) was greater than his net loss (\$550,000). As suggested by this example, the new rules essentially act as a deferral mechanism delaying a taxpayer’s ability to deduct losses until future years.

As with other parts of the TCJA there is uncertainty about the definition of the terms “business income” and “business losses.” Will wages and guaranteed payments paid to S-corporation owners or partners be considered business income? Will self-employment taxes and pension deductions based on business income be included in the calculation to

“business income or loss.”

Additional regulations and guidance from the Internal Revenue Service will need to be forthcoming to clarify what is business income (loss) under by Section 461(l).

It should be noted that the TCJA did not make any changes to the basis, at-risk, or passive activity loss rules governing the determination of allowable losses. Taxpayers must still pass the hurdles of these rules before they begin to consider whether their losses will be limited under the new excess business loss rules.

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