



Excess Business Loss limitation – Effective for 2021 - by Sandy Klein

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We have always heard that in life the only two things for certain are death and taxes. This may be true but the more accurate point regarding taxes is that there is constant change. In this article we will focus on a change impacting many and is effective for 2021. The change involves the Excess Business Loss (EBL) limitation.

EBL Background and Impact of Tax Changes on Effective Date

In summary, the EBL limitation, Internal Revenue Code section 461(l), was originally created by the Tax Cuts and Jobs Act of 2017 (TCJA) beginning in 2018. As a result of COVID its implementation was subsequently delayed. The delay has now expired, and the EBL limitation is now effective in 2021. The EBL limitation applies to non-corporate taxpayers including individual partners and S-Corp shareholders and does not allow a net “business” loss to exceed \$250,000 for single filers or \$500,000 for married joint filers with the limitations indexed annually. (For 2021 it is \$262,000 and \$524,000, respectively.) The EBL limitation was effective for tax years beginning after December 31, 2017, and before January 1, 2026. (EBL was therefore effective for years 2018 through 2025 tax filings).

After TCJA went into effect COVID hit and the Coronavirus Aid, Relief, and Economic Security (CARES) Act retroactively delayed implementation of the EBL limitation to 2021 (tax years beginning after December 31, 2020). Taxpayers who had already filed 2018 and 2019 tax returns with the EBL limitation were given the opportunity to amend those returns and fully claim business losses.

So for 2021 the EBL limitation is in full effect. Under the TCJA the tax years for which EBL limitations apply was through 2025. Subsequently under the American Rescue Plan Act EBL limitations were extended through 2026.

Claiming a Business Loss Deduction

Deducting a business loss is not a straightforward offset. Taxpayers need to go through specific steps in the specific order listed below - satisfying each of the limitation rules as required by the Internal Revenue Code before claiming the deduction. The Taxpayer's loss (or losses) are now subject to:

- Basis Limitations
- At-Risk Limitations
- Passive Activity Loss Limitations
- Excess Business Loss Limitations

Basis Limitations

A partner's distributive share of a loss (IRC 704(d)) or an S-Corp shareholder's pro rata share of losses/deductions (IRC 1366(d)) is allowable only to the extent of the adjusted basis in the interest or stock plus certain liabilities or indebtedness. A disallowed loss due to this limitation is carried forward indefinitely.

At-Risk Limitations

Business losses from an activity are limited to the amount the taxpayer is "at-risk." (IRC 465) The "at-risk" amount includes the taxpayer's own personal funds invested in the activity, the adjusted basis of contributed property, amounts borrowed to the extent personally liable and qualified non-recourse financing. A disallowed loss due to this limitation is carried forward indefinitely.

Passive Activity Loss Limitations

Passive activity loss rules (IRC 469) created a special category of income and loss called "passive income or loss." Passive income or loss comes from (1) businesses in which you don't materially participate (as specifically defined) and (2) all rental properties you own; except see tax code rules for real estate professionals. Income or loss from rental properties owned is straightforward. The "material participation" concept is more complicated. To be brief for purposes of this article "material participation" is if you are involved with its day-to-day operations on a regular, continuous and substantial basis (IRC 469(h)). Real Estate professional status & application is introduced by IRC 469(c)(7) and is beyond the scope of this article. The IRS has specific tests to determine "material participation." A disallowed loss due to this limitation is carried forward indefinitely.

Excess Business Loss Limitation - In Effect for 2021 through 2026

The EBL limitation is determined after the three prior limitations have been applied and is only considered once, in the year incurred. Note that disallowed losses are carried forward as net operating losses and are not subject to further EBL testing in future years.

A simple example of the EBL limitation may be illustrated as follows, a single individual that is a real estate professional is allocated a business loss of \$1 million in tax year 2021 and meets the first three criteria as described above. The individual has W-2 wages of \$800,000 and capital gains from stock sales of \$200,00 also in 2021. At first thought this individual may think their adjusted gross income would be \$0 for tax year 2021 after deducting the rental real estate losses. However, this is not the case; the actual adjusted gross income is \$738,000. The \$1 million business loss is

not fully deductible due to the EBL limitation. For 2021 a single taxpayer may only deduct \$262,000 of this loss (\$524,000 for married, joint taxpayers). The remaining \$738,000 will be carried forward as a net operating loss. This carryforward is deductible against any source of income during 2022 and beyond and is not limited to the real estate sector, (but will be subject to the 80% limitation for NOLs.)

EBL Limitations and Capital Gains

As we described above, an excess business loss is the amount by which the total deductions attributable to all of your trades or businesses exceed your total gross income and gains attributable to those trades or businesses including capital gains on the disposition of business property. Note an important nuance—that the allowable EBL is not available to offset capital gains from the taxpayer's non-business portfolio assets—it is only available for capital gains on the disposition of business property.

We suggest you discuss EBL limitations with your tax advisors as planning is always the best approach to taxes.

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