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NEW RULES ON SECTION 461(l) – LIMITATIONS ON EXCESS BUSINESS LOSSES (EVERYONE PAYS!)

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IRS Form 461 – Limitation on Business Losses

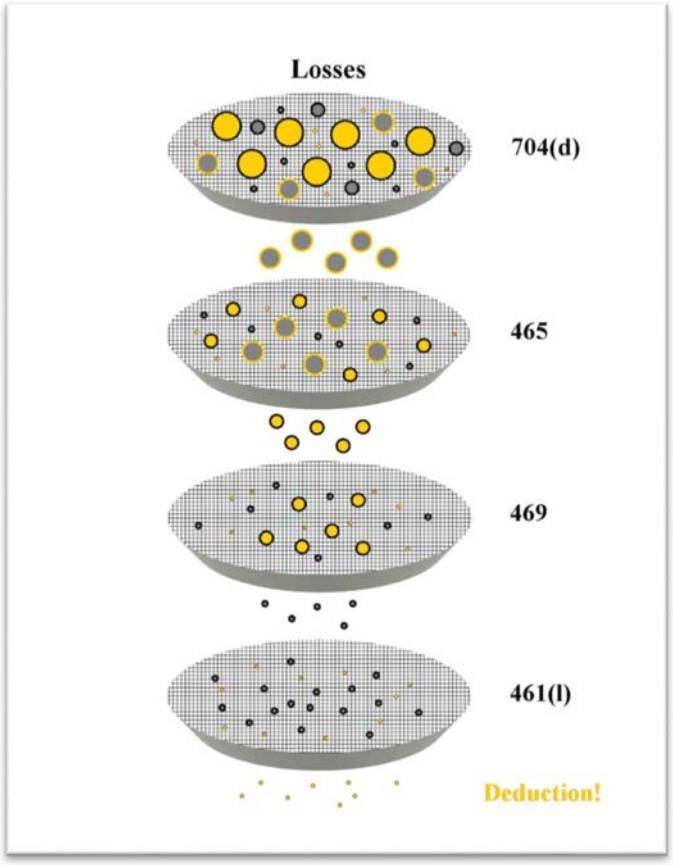
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I. INTRODUCTION

The Tax Cuts and Jobs Act ("TCJA")[1] introduced a new loss limitation rule in § 461(l)[2] for "excess business losses" and modified the net operating loss rules under § 172 to permit only carryforwards and limit deductibility to 80% of taxable income. These loss limitation provisions operate after applying the loss limitation provisions of § 704(d) (partnership basis limitation), § 465 (at risk rules) and § 469 (passive loss rules) in that order. Said differently, these provisions operate as a series of filters, filtering losses through different screens until the last viable deduction dribbles through the maze of screens and rules.



This paper is an updated version of a paper originally presented at the 53rd Southern Federal Tax Institute, October 23, 2018.

[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[2] § references are to the Internal Revenue Code of 1986, as amended.

Sections II through VII of this paper discuss those filters, starting with a quick refresher on how a partner's basis in the partnership is determined under § 705 since that amount must be known in order to apply the first loss filter of § 704(d).

Sections II through V are not exhaustive treatments of §§ 705, 704(d), 465 or 469. Rather, they are more primers to establish the basic rules and points of comparison between the various loss limitations before addressing the "excess business loss" concept under new § 461(l) and the modifications of § 172 relating to net operating losses.

Section VI is more detailed in its examination of new § 461(l) and provides a number of examples illustrating how the various loss limitation rules work in conjunction with § 461(l) and the modifications to § 172.

Section VIII touches on new § 199A which provides a deduction against taxable income equal to 20% of qualified business income. Inclusion of § 199A here is provided because various rules relating to the § 199A deduction will be affected by the loss limitation provisions discussed herein. For example, the definition of a "trade or business" is different under § 199A than under § 469 or § 461(l). Likewise, § 199A and § 469 differ in allowable grouping or aggregation approaches for netting separate trade or business income and losses.

There is little question that the "simplification" touted for the TCJA has not benefitted the maze of filters and limitation provisions that must be perused in order to determine whether and how certain losses are deducted. Although significant tax benefits may result with proper planning and structuring for the 20% deduction under § 199A, the watchword for the new loss limitation provisions of §§ 461(l) and 172 may be "estimation." Current estimation of income and losses throughout the year is more important than ever. Because a large non-deductible loss under § 461(l) may be limited in future years to 80% of taxable income by § 172, it is critical to estimate and forecast the amount and timing of income and losses where possible between taxable years.

II. PARTNER'S BASIS IN PARTNERSHIP INTEREST

Because § 704(d) limits the losses a partner[3] may deduct from a partnership, a partner must first determine its basis in the partnership interest.

A. Initial Basis

A partner's initial basis in a partnership interest, whether acquired by contribution of money or property to a partnership or by purchasing the partnership interest, is determined under § 705.

1. Contribution

a. Under § 722, a partner contributing money or property to a partnership has initial basis equal to (i) the amount of the money contributed to the partnership, or (ii) the adjusted basis of the partner in property other than money contributed to the partnership. The adjusted basis of property contributed to a partnership will generally be the partner's adjusted basis in the property as determined under § 1012.

b. Although not referenced in § 705, a partner's initial basis in its partnership interest also will be affected by the liabilities allocable to the partner or the liabilities of the partner assumed by the partnership in connection with a contribution of property. § 752(a), (b).

(1) A partner's basis in its partnership interest will be increased by the liabilities of the partnership assumed by the partner as if the partner had contributed money equal to the liabilities assumed by the partner. § 752(a). Liabilities assumed include both recourse liabilities to the partner as

[3] References to "partner" throughout also refers to a member of a limited liability company treated as a partnership for federal income tax purposes, and "partnership" similarly refers to a limited liability company unless otherwise specifically noted.

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