KPMG

What's News in Tax

Analysis that matters from Washington National Tax

Excess Business Losses: The CARES Act Sequel

March 16, 2022

by Rob Keller and Debbie Fields, Washington National Tax[*]

The excess business loss regime, which takes effect *again* for tax years beginning in 2021, may disallow losses for individuals, trusts, and estates. New tax rules often create uncertainty, especially if there is a lack of guidance. This article considers how section 461(l) applies, explores the ambiguous areas, and contemplates possible solutions.

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

---

* *Robert S. Keller is a partner with the Passthroughs group of Washington National Tax ("WNT"). Deborah A. Fields is the partner-in-charge of the WNT Passthroughs group.*

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").

that disallows "excess business losses."[3] Non-corporate taxpayers, such as individuals, trusts, and estates, may be significantly (and adversely) affected by the loss limitation contained in section 461(l).

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

(i) The ***aggregate***[4] ***deductions***[5] 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).[6]

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.[7]

Prior to enactment of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), the excess business loss limitation applied to any tax year beginning after December 31, 2017, and before January 1, 2026. However, the CARES Act amended section 461(l) so the excess business loss limitation would only apply for tax years beginning *after* December 31, 2020, and before January 1, 2026.[8] The American Rescue Plan Act of 2021 ("ARPA") later extended the application of section 461(l) for one additional year, through tax years beginning before January 1, 2027.[9] Taken together, under current law—post-CARES Act and post-ARPA—the excess business loss regime applies for tax years beginning after December 31, 2020, and before January 1, 2027.

To date, no regulations have been promulgated under section 461(l).[10]

---

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

[4] 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.

[5] 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).

[6] Emphasis added. Limitation amounts are indexed for inflation. For 2021, the threshold amount is $262,000 ($524,000 for joint returns). *See* section 3.32 of Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[7] 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**.**

[8] Section 2304(a) of the CARES Act.

[9] American Rescue Plan Act, Pub L. No. 117-2 (March 11, 2021).

[10] 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).

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.[11] Although a partnership or an S corporation may be treated as a taxpayer under section 7701, section 461(l)(4) applies section 461(l) 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 definition (and associated body of case law) of a trade or business under section 162. In general, an activity qualifies as a trade or business if the taxpayer's primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity.[12]

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, 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).[13]

CARES ACT Impact

As discussed above, the CARES Act amended the excess business loss limitation regime under section 461(l) to apply for any tax years beginning after December 31, 2020, and before January 1, 2026. Prior to the amendment, the regime was applicable for any tax years beginning after December 31, 2017, and before January 1, 2026. Accordingly, the CARES Act amendment to section 461(l) retroactively repealed the TCJA loss limitation provision for tax years beginning prior to January 1, 2021. This affected calendar years 2018, 2019, and 2020.

The temporary repeal of section 461(l) created the potential for several different opportunities, allowing individual taxpayers to access a refund of cash, or to pay a reduced tax liability, for tax years 2018, 2019, and 2020. The repeal of the excess business loss regime may have also resulted in the possibility of increased "ordinary" NOLs for the tax year, including by extension, the possibility of

---

[11] 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*.

[12] *See* Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[13] 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.

increasing the amount of losses available for the taxpayer to carry back to a prior year.[14] In some cases, this might have included the possibility of carrying back a loss to a tax year prior to January 1, 2018, during which the taxpayer may have maintained a higher effective tax rate (i.e., when the highest individual rate was still 39.6 percent).

Note, the retroactive repeal of section 461(l) also carried with it the retroactive repeal of the excess business loss NOL established under section 461(l). Accordingly, a failure to amend the taxpayer's return in situations in which the excess business loss otherwise would have been utilized against non-business income of the taxpayer may have likewise implicated a potential loss of the taxpayer's section 461(l) NOL carryforward in a subsequent year.[15]

The repeal of section 461(l) through the CARES Act was further coupled with a few technical corrections to the TCJA. The section 461(l) calculation now excludes items that are attributable to the trade or business of performing services as an employee. In addition, NOL deductions under section 172 and qualified business income deductions under section 199A are not taken into account in determining the taxpayer's excess business losses.

Significantly, the CARES Act also amended section 461(l) to provide that losses from the sale or exchange of capital assets are not to be taken into account in increasing a section 461(l) limitation. However, the CARES Act provides that certain ***net*** capital gains attributable to a taxpayer's trade or business may be taken into account in reducing a potential section 461(l) limitation (as discussed further below).

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

Section 461(l)(6) provides that section 461(l) limits 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
- The loss must not be suspended under the passive activity loss rules of section 469

If the ordering rules above are satisfied, then the taxpayer must consider the impact of section 461(l).[16]

---

14 The TCJA generally eliminated the carryback of NOLs (except for certain farm losses). However, the CARES Act grants taxpayers (including individual taxpayers) a five-year carryback period for NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021.

15 See FAQs below on a discussion of the potential for an underpayment of estimated taxes as a result.

16 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.

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 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.[17]

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

---

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

changed unless there is a material change in facts and circumstances or the grouping is clearly inappropriate.[18]

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), 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 of an excess business loss in the initial year and potentially only 20 percent (or less) of the loss in a subsequent year.[19]

As a result of section 461(l), an individual may be surprised to find that while business losses of the individual could formerly offset income from other than a trade or business (such as certain portfolio or investment income), beginning in 2021, the losses can offset only income or gain attributable to the taxpayer's trade or business (plus either $250,000 / $500,000, approximately). As a result, individuals with significant investment or portfolio income may be subject to tax on the income in 2021 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 2021. 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 (approximately) of the ordinary losses as a result of section 461(l). The $1.25 million (approximately) limited under section 461(l) will become an NOL that is potentially available to offset other items of income beginning in 2022 (and subsequent tax years to the extent the NOL carryover remains unused).

---

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

[19] The CARES Act included a technical correction to the TCJA with respect to section 461(l) that both NOL deductions under section 172 and qualified business income deductions under section 199A would not be taken into account in determining excess business losses.

Form 461

The eponymous Form 461, *Limitation on Business Losses*, calculates the section 461(l) excess business loss.[20] Through Form 461 (for 2021) the IRS employs a unique computational adjustment to arrive at the limitation of excess losses. Specifically, Form 461 directs an applicable taxpayer to derive income and deduction items—on a net basis—and then to add back or to subtract items of income, gains, losses, or deductions that are not attributable to the taxpayer's trade or business, or are otherwise exempt capital losses from a trade or business. 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 prior to requiring a positive or negative adjustment to the same.

After adjusting for the non-business items (and net capital losses) in Part II, Form 461 computes the portion of the business deduction that exceeds the statutory amount (i.e., $250,000 / $500,000, approximately). This excess amount is then reported as an income addback on line 8(o) of Schedule 1 of the Form 1040. The calculation effectively creates an income "offset" against the excess business losses in arriving at a properly deductible net amount.

While the Form 461 strives to create the proper "buckets" for assessing whether or not a taxpayer has an excess business loss limited by section 461(l), 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 income allocation, as is presently adopted through Form 461.

Ordering Rules and Netting Ambiguities

The TCJA left open several ambiguities with respect to ordering and netting. For example, under the TCJA, it was unclear whether the amount of net capital gain or loss should be taken into account for the taxpayer's section 461(l) calculation, or whether an individual must apply an aggregate view of these gains and losses.

To this end, as briefly noted, the CARES Act made two significant changes. First, the CARES Act provided that deductions for ***losses*** from the sale or exchange of capital assets shall not be taken into account for purposes of section 461(l). Second, the CARES Act provides that certain ***gains*** from the sale or exchange of capital assets—which are attributable to a trade or business—shall be taken into account for purposes of section 461(l), but such trade or business capital gains are capped at the lesser of the taxpayer's net capital gain or loss from trade or business income (i.e., including gains and losses attributable to a trade or business) or overall capital gain net income (i.e., including all capital gains and losses, regardless of whether or not attributable to a trade or business activity).

Taken together these modifications essentially create an ordering rule through which the taxpayer's capital gain and loss netting effectively comes before the application of section 461(l). This ordering avoids the possibility that a capital loss might be converted into an ordinary deduction (as an excess

---

[20] http://www.irs.gov/pub/irs-pdf/f461. The IRS created Form 461 for the 2018 and 2019 tax years to account for section 461(l) under the TCJA, before removing such Form 461 for the 2020 tax year due to the retroactive repeal of section 461(l) under the CARES Act.

business loss NOL). In addition, the new CARES Act modification favorably creates circumstances in which taxpayers may still benefit from trade or business capital gains to reduce the amount of trade or business deductions and losses that may otherwise be subject to limitation under section 461(l).

Example of Capital Gains and Losses under Section 461(l)

Assume that for 2021 Taxpayer B has $10 million of portfolio interest income on Schedule B (Form 1040) and $10 million of ordinary trade or business losses on Schedule E (Form 1040). In addition, Taxpayer B also has $20 million of capital gain from a trade or business and $10 million of capital losses from a trade or business (both from a trader fund). In total, assuming no other loss limitation applies, the taxpayer would reflect a net capital gain of $10 million for the year (i.e., $20 million of capital gain and $10 million of capital loss) and the ordinary items would offset (i.e., $10 million of interest income and $10 million of Schedule E losses). For purposes of section 461(l), the taxpayer does not have an amount limited under section 461(l). This outcome results from the fact that the net $10 million of trade or business capital gain is included to “free up” the $10 million of ordinary losses.

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

Certain reporting issues arise with respect to the interaction between the ordinary income addback under the historical 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 operation of Form 461, which, as noted, applies a curious “offset” approach to applying the limitation of section 461(l) as compared with 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—and the need for regulatory guidance discussing this ambiguity sooner rather than later.

Changes to Net Operating Loss Deduction

As discussed above, any loss that is disallowed under section 461(l) is treated as an NOL carryover to the following tax year under section 172. The TCJA modified the NOL provisions under section 172(a) to take away the ability for taxpayers to carry back losses (but instead provided for losses to be carried forward indefinitely). The TCJA also limited the deduction for any particular year to 80 percent of taxable income for losses arising in tax years beginning after 2017.[21]

The CARES Act temporarily modified the TCJA-imposed rules above and established a five-year carryback period for NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021 (i.e., tax years 2018, 2019, and 2020).[22] The CARES Act also temporarily suspended the TCJA-imposed 80 percent of taxable income limitation on the use of NOLs for tax years beginning before January 1, 2021 (again, implicating tax years 2018, 2019, and 2020).

For tax years beginning after December 31, 2020, the CARES Act re-imposes the 80 percent limitation with respect to the use of post-TCJA NOLs (i.e., NOLs arising in tax years beginning after December 31, 2017). Further, for tax years beginning after December 31, 2020, taxpayers are once again unable to carry back losses (but instead carry forward such losses indefinitely).

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 $12.5 million of gain on the sale of the painting. Taxpayer C is also projecting $10 million in deductible losses from several partnership ventures in 2021 (i.e., losses allowed under sections 704(d), 465, and 469). Taxpayer C has no other sources of income or loss in 2021.

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 a significant portion of the gain from the sale of the artwork. However, under section 461(l), if Taxpayer C sells the artwork in 2021, the taxpayer will be able to utilize only $500,000 (approximately) of losses to offset the gain. As a result, the taxpayer will need to remit a sizeable tax payment for the 2021 tax year which is largely driven by the disallowed $9.5 million. 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 2022. By delaying the sale of the painting, Taxpayer C may be able to reduce taxable income in 2022 by $9.5 million since Taxpayer C would be able to potentially use the 2021 carryforward of section 461(l) NOLs to offset the gain on sale of art in 2022. In this situation, the tax payment required for 2021 would be significantly reduced as a result of properly "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 number of considerations that must be factored into the taxpayer's

---

[21] 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.

[22] *See* section 172(b)(1)(D)(i).

analysis—such as character and marginal tax rate of such income—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.[23]

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.[24] 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 2021. But, assume also that Taxpayer C realizes $10 million of qualified business income in 2022 from the partnership ventures. Because $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 2022 by $9.5 million in computing Taxpayer C's section 199A deduction for 2022.

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.

---

23 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.

24 *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)?

Prior to the CARES Act, it was believed that wages attributable to the trade or business of providing services as an employee would be included in the taxpayer's section 461(l) calculation.[25] However, as part of the technical corrections made to section 461(l) through the CARES Act, the following sentence was added to the definition of excess business loss: "Such excess shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee."[26]

As such, for tax years beginning after December 31, 2020, it is clear that wage gross income and gains attributable to the trade or business of providing services as an employee will no longer be included in the taxpayer's section 461(l) calculation. However, it is less clear how wage *deductions* attributable to a trade or business may likewise be excluded from the taxpayer's section 461(l) calculation.

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 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).[27] 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. 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).

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.

---

[25] 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, and informal guidance from the IRS, it appeared reasonable to include an employee's wage income in the definition of trade or business income under section 461(l) of the TCJA. 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) stated 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, but noted that a technical correction may be required to carry out the intent. Bluebook, at 40. The CARES Act makes the requisite technical correction to align with such Bluebook intent.

[26] *See* section 2304(a) of the CARES Act.

[27] Section 707(c).

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.[28] 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 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).[29] 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).

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

Investment income of a trader fund is generally earned in the ordinary course of the fund's trade or business.[30] 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).[31]

Are gains 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 are generated, the gain should be included in the definition of aggregate gross gain of the taxpayer under section 461(l). As discussed above, this would include circumstances in which the section 1231 results in a net capital gain. The gain should be treated as "attributable to the taxpayer's trade or business," notwithstanding the fact that the gain may be taxed at

---

[28] Section 1.707-1(c).

[29] 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.

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

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

favorable rates. Note, however, the special rules under the CARES Act with respect to the sale or exchange of capital assets (i.e., when certain *net* capital gains attributable to a trade or business—but not capital losses outside of their effect on the taxpayer's net gain calculation—may influence the taxpayer's section 461(l) computation).

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.

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). While the CARES Act generally addressed the application of trade or business capital gains and losses, unfortunately, the CARES Act did not address whether a capital gain on the sale of a partnership interest or S corporation stock could be considered attributable to the taxpayer's trade or business.

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.[32]

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.[33] 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.[34]

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

---

[32] *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).

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

[34] 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.

S corporation.[35] 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.[36] 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.[37]

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. Commissioner,*[38] 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.

Finally, the definition of excess business loss is very similar to the definition of an excess farm loss in former section 461(j),[39] 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.[40]

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 and gain 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

---

35 *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).

36 Rev. Rul. 91-32, 1991-1 C.B. 107.

37 Section 864(c)(8).

38 79 T.C. 541, 558 (1982), *action on dec.*, 1984-07 (Jan. 3, 1984), *acq.*, 1984-2 C.B. 1.

39 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)."

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

assets would have entered into the section 461(l) calculation if the entity had sold all of its assets directly.

Are deductions and losses that are "suspended" before 2021 subject to 461(l) if they are "released" between January 1, 2021, and January 1, 2027?

Section 461(l) does not provide an exception for deductions and losses that were incurred prior to January 1, 2021. 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, 2021, but subsequently released between January 1, 2021, and January 1, 2027, the loss may be subject to section 461(l).

What if the retroactive repeal of section 461(l) for 2018 resulted in a reduction of the taxpayer's NOL for 2019, and caused the taxpayer to owe additional estimated taxes as a result?

In certain cases, prior to the enactment of the CARES Act, an individual may have been relying on an NOL for the 2019 tax year to reduce overall taxable income, as a result of section 461(l) applying to limit a loss for their 2018 tax year. In such a case, an individual may have been remitting estimated taxes with the expectation of this NOL deduction before finding out that the NOL was no longer available. The taxpayer may have underpaid one or more installments of their estimated income tax for the tax year, incurring unexpected penalties. On January 19, 2021, Treasury and the IRS released Notice 2021-8 providing for potential, non-automatic relief from all or a portion of the underpayment of estimated taxes penalty that may have resulted from the retroactive increase in tax from the CARES Act changes to section 461(l).

Actions

Several years have passed since the initial introduction and enactment of the excess busines loss regime under TCJA, without the issuance of regulations on this statute, and with very little guidance on the provision from Treasury and the IRS. The retroactive repeal of section 461(l) for the first three years of its existence arguably reduced the early-on necessity for immediate guidance. However, with the retroactive repeal now in the rear-view mirror, for those taxpayers who are once again forced to grapple with the post-CARES Act "sequel" to the excess business loss regime, there are essentially just as many questions (if not more) than those presented to the same group of taxpayers on day one. Indeed, the CARES Act addressed a few open questions to section 461(l), but not all. Unfortunately, further guidance may be delayed until Treasury and the IRS first address guidance on several other items from the TCJA and CARES. In the interim, tax professionals must carefully navigate the complexities of the section 461(l) excess business loss limitation.

□□□□

The information in this article is not intended to be "written advice concerning one or more federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.