

Tax Notes

Impact of Excess Business Losses on Fund Managers

By Alan S. Kufeld, CPA, Partner, Thomas J. Riggs, JD, CPA, Partner and Edward Poreba, CPA, Senior Manager

As we continue to examine specific provisions of the Tax Cuts and Jobs Act, it is becoming increasingly clear that numerous provisions will directly or indirectly impact investment management companies and/or their principals.

One such provision relates to the new limitation placed on a taxpayer's ability to deduct losses incurred in a trade or business. Since investment management activity constitutes a trade or business, and such activity often results in a net loss to the principals, without proper planning these new limitations could result in a significant negative tax consequence to certain fund managers.

Excess Business Loss Defined

For tax years beginning in 2018 and before January 1, 2026, if a non-corporate taxpayer incurs an "excess business loss," then this loss shall be disallowed and suspended and treated as a net operating loss, which is carried forward indefinitely to succeeding taxable years.

An excess business loss is defined as the excess of the taxpayer's aggregate deductions attributable to the taxpayer's trades or businesses for the year over the sum of the taxpayer's aggregate trade or business gross income or gain, plus an inflation-adjusted threshold amount of \$250,000 (\$500,000 in the case of a joint tax return).

As a practical matter, cash basis taxpayers would be forced to wait one year to recognize the tax benefit of their economic losses, even if there is other taxable income from interest, dividends or capital gains to absorb the loss.

Offset Limitations

This new rule will be applicable to losses generated from the management company entity and subject to limitations at the individual partner level. Therefore, it appears that excess business losses at the management company level cannot be used to offset investment income generated from a separate GP entity, even where the GP entity receives its allocation from a trader fund.

It is important to note that before a loss can be deductible by an individual who is a partner in a partnership or shareholder of an S corporation, they face various potential limitations or hurdles including rules governing tax basis, at risk and passive activity loss limitations.

As previously stated, a taxpayer's excess business loss becomes part of the individual's net operating loss, which the new law further limits to 80% of taxable income (calculated without the loss).

To Be Continued

As with many other provisions of the new tax law, the Section 461(l) loss limitation presents uncertainties and will require further guidance. As we continue to analyze this provision and search for ways to mitigate the burden caused by the excess business loss provisions, please reach out to us with any questions.

Contact Us

For more information, please contact either of the following partners or your PKF O'Connor Davies tax advisor:

Alan S. Kufeld, CPA

Partner

akufeld@pkfod.com | 646.449.6319

Thomas J. Riggs, CPA, JD

Partner

triggs@pkfod.com | 646.449.6317

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