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Tax Notes

Changes to the Excess Business Loss Provisions in the CARES Act

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The CARES Act has made numerous changes to help individuals and businesses recover from the financial difficulties resulting from the COVID-19 pandemic. One welcome change is to IRC §461(l) which is referred to as the excess business loss (EBL) limitation. §461(l) was enacted as part of the Tax Cuts and Jobs Act (TCJA) and disallows the deduction of excess business losses by non-corporate taxpayers beginning in 2018. The CARES Act retroactively eliminates the loss limitation for tax years 2018 and 2019 and suspends this limitation for 2020. This, thereby, enables taxpayers to fully deduct business losses without limitation.

EBLs were calculated by applying the aggregate trade or business deductions over the aggregate trade or business gross income or gain. The resulting loss was limited to $250,000 for single filers ($500,000 for a joint return). All other loss limitation rules continue to apply (i.e., tax basis, at-risk, and passive activity loss limitations). The disallowed loss was carried forward to the succeeding year as a net operating loss (NOL).

One immediate benefit of the retroactive suspension of EBLs is the taxpayer's ability to amend their 2018 and 2019 returns. The amended return allows previously limited deductions to be utilized and included in the calculation of taxable income as originally reported, which can have the effect of generating immediate refunds of federal taxes paid in 2018 and 2019. If there was an EBL in 2018, the return has to be recomputed and amended to utilize the additional loss as there currently is no option to carry that forward. In addition, if a 2019 return was prepared utilizing the 2018 EBL as a NOL, the 2019 will also have to be amended, if it has already been filed.

Technical Corrections

The CARES Act also makes the following technical corrections to the calculation of EBLs which will be applicable when the limitations reappear for tax years beginning <u>after</u> December 31, 2020.

- Clarification on whether W-2 wages are business income for purposes of the excess business loss limitation. EBLs are "determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee."
- Deductions under §172 and §199A are not taken into account in determining the amount of a taxpayer's deductions.
- Net capital gains (but not losses) attributable to a trade or business are taken into account when calculating EBL but they will be limited to the taxpayer's overall capital gain net income

Additionally, the CARES Act suspends the TCJA's restrictions regarding NOLs. The CARES Act provisions are designed to increase the utilization of NOLs to provide additional relief to taxpayers.

- The CARES Act temporarily allows a 5-year carryback period for losses incurred in a tax year beginning after December 31, 2017 and before January 1, 2021. Accordingly, a loss arising in 2018 could be carried all the way back to 2013. Prior to the Act, NOLs could not be carried back, but carried forward indefinitely against 80% of taxable income.

- The Act temporarily eliminates the 80% of income limitation for tax years beginning before January 1, 2021.

One nuance under these rules involves taxpayers who were required to include the earnings and profits of a foreign subsidiary in income under §965 (toll charge income). Taxpayers cannot utilize NOLs to offset income from the §965 deemed repatriation. Taxpayers may elect to exclude §965 years (2017, and potentially 2018 and 2019 if the taxpayer chose to pay the §965 tax in installments) from the carryback period.

Recently released Revenue Procedure 2020-24 provides detailed clarity to the various elections in the implementation of these rules. In brief, taxpayers who want to waive the carryback period for NOLs arising in taxable years beginning in 2018 or 2019 must make such election by the federal extended due date for the first taxable years ending after March 27,2020. This election is irrevocable and must include a statement referencing Revenue Procedure 2020-24.

The suspension of the TCJA provisions is temporary. The effective date of these suspended provisions has been deferred to tax years beginning after December 31, 2020.

State Conformity – or Lack Thereof

The state impact of these changes will depend upon whether a state conforms or decouples from this CARES Act provision. Those states that conform will be easy to deal with as they will just follow the federal rules. As of the writing of this article, New York is the only state to indicate that they will not adopt this change under IRC §461(l). New York has said that any IRC changes made after March 1, 2020, will not apply for state and city personal income tax purposes. Further, the CARES Act NOL carryback amendment and temporary suspension of the NOL limitation are also not adopted for New York State and New York City personal income tax. It is not clear if other states will follow.

Contact Us

PKF O′Connor Davies is monitoring the situation in Washington, DC and as it changes we will keep you informed. For more information, contact your client tax engagement team or either of the following:

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