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COVID-19 TAX UPDATE

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CARES Act Retroactively Postpones Limit on Excess Business Losses

The Coronavirus Aid, Relief, and Economic Security (CARES) Act allows for the retroactive postponement of, and changes to, the limits on excess business losses. The provision applies to individuals, trusts, and estates who own (or may own in the future) a business directly or as a partner or shareholder in an S corporation.

Deferral of the Excess Business Loss Limits

On March 27, 2020, the CARES Act introduced a variety of income tax relief measures targeting both businesses and individuals that have suffered economic hardship as a result of the coronavirus. While the legislation was intended to put cash back into taxpayers' pockets, at least one provision, unfortunately, presents a trap for the unwary.

The CARES Act temporarily repeals a provision in the 2017 Tax Cuts and Jobs Act (TCJA), Section 461(l), that limits the amount of business losses a non-corporate taxpayer can use to offset non-business income. The TCJA provided that net tax losses from active businesses in excess of an inflation-adjusted $500,000 for joint filers, or an inflation-adjusted $250,000 for other covered taxpayers, are to be treated as net operating loss (NOL) carryforwards in the following tax year. The covered taxpayers are individuals (or estates or trusts) that own businesses directly or as partners in a partnership or shareholders in an S corporation.

The $500,000 and $250,000 limits, which are adjusted for inflation for tax years beginning after calendar year 2018, were scheduled under the TCJA to apply to tax years beginning in calendar years 2018 through 2025. But the CARES Act retroactively postponed the limits so that they now apply to tax years beginning in calendar years 2021 through 2025.

Benefits of the temporary repeal are potentially two-fold: (1) 2020 returns and 2019 returns not yet filed will not be subject to the limitation (potentially decreasing taxable income); and (2) 2018 and 2019 returns already filed are eligible for amendment (potentially generating an immediate refund). The temporary repeal may be particularly significant to real estate professionals who are owners of, and investors in, real estate as well as active traders with a trader tax status.

The repeal of Section 461(l) is not elective. As a consequence, if a taxpayer who is subject to limitation in a prior year does not amend, the IRS could adjust downward the amount of that taxpayer's loss carryforward. If the taxpayer's statute of limitation for the relevant year (i.e., 2018 or 2019) is closed at the time of the adjustment, then the taxpayer would lose the relevant benefit.

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Any excess loss that, absent these new rules, could have been utilized in the year it was disallowed (2018 or 2019 if filed pre-CARES act) is potentially at risk of forfeiture. The importance of filing an amended return therefore cannot be understated. Filing an amended return may not only provide the taxpayer with a refund (a timing issue) but, perhaps more significantly, may prevent a loss from being disallowed (a permanent difference).

The postponement means that the following tax returns might need to be amended:

- Any filed 2018 returns that reflected a disallowed excess business loss (to allow the loss in 2018)
- Any filed 2019 returns that reflect a disallowed 2019 loss and/or a carryover of a disallowed 2018 loss (to allow the 2019 loss and/or eliminate the carryover).

Note that the excess business loss limits also don't apply to tax years that begin in 2020. Thus, such a 2020 year can be a window to start a business with large up-front-deductible items (for example, capital items that can be 100% deducted under bonus depreciation or other provisions) and be able to offset the resulting net losses from the business against investment income or income from employment.

A taxpayer should also consider whether losses freed as a result of this temporary repeal are suitable for carryback under the legislation's new NOL provisions. The CARES Act loosens the TCJA restrictions by allowing NOLs arising in 2018, 2019, or 2020 to be carried back five years. It also temporarily removes the taxable income limitation for years beginning before 2021, so that NOLs can fully offset income.

Note that the taxpayer applies the limitations for passive activities, at-risk, and basis before application of the rules for excess business losses.

Changes to the Excess Business Loss Limits

Also of note are several technical corrections that will impact Section 461(l) when it becomes effective in the 2021 tax year:

- Net business losses subject to limitation are calculated without regard to NOLs or qualified business income deductions
- W-2 wage income will not be considered trade or business income and therefore may only be offset by business losses to the extent of the threshold
- Net losses from the sale of capital assets are excluded from the Section 461(l) computation.

California Conformity

California does not conform to the:

- Retroactive suspension of the excess business loss limitation for non-corporate taxpayers
- Five-year NOL carrybacks for 2018–2020 NOLs and temporary suspension of the 80% taxable income NOL carryover limitation.

Please don't hesitate to contact us if you want more details or have any questions or concerns.

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