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Congress Extends Limitation on Deduction of Business Losses

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On Aug. 16, 2022, President Joe Biden signed P.L. 117-169 into law, which is commonly known as the “Inflation Reduction Act.” The act made significant changes to the tax law, including by expanding various clean energy-related tax incentives and introducing a stock buyback tax and a new corporate minimum tax.

In addition, the act extended the limitation on the deduction of certain business losses under Section 461(l) of the Internal Revenue Code to Jan. 1, 2029 from its prior expiration date of January 1, 2027. Although this particular provision was much less publicized than the other aspects of the Inflation Reduction Act, it could have a significant effect on businesses that have tax losses, including many rental real estate businesses.

Prior to the enactment of the Tax Cuts and Jobs Act in 2017, there was no general limitation in the Internal Revenue Code on the deductibility of losses from an active business. If a taxpayer is considered to be passive with respect to an activity, then Section 469 limits the use of losses from such an activity to the taxpayer’s income from passive activities, and the taxpayer cannot use the losses to offset income from an active business or certain portfolio income.

Although rental real estate activities are generally considered passive, rental real estate activity may be considered active if the taxpayer qualifies as a real estate professional (i.e., if at least half of the taxpayer’s business activities are performed in real estate businesses in which he materially participates, and such services amount to at least 750 hours per year) and certain other requirements are met.

Thus, taxpayers that were not subject to the passive loss rules (including real estate professionals) could potentially use losses from business activities to completely eliminate their income tax liabilities from portfolio income and wages.

In 2017, Section 461(l) was added to the Code, although the provision’s effective date was later delayed until 2021. The provision was originally set to expire at the end of 2025, but was extended by one year in 2021, and has now been extended by another two years such that it will continue to apply through the end of 2028. The provision currently limits the use of net losses from a trade or business to \$270,000 of other income (or \$540,000 in the case of married couple filing a joint return), with such dollar amounts adjusted each year based on inflation. Thus, taxpayers cannot use active business losses to offset portfolio income (such as interest, dividends, and certain capital gains) or wage income in excess of these thresholds.

If a taxpayer has deductions that are limited by Section 461(l) for any year, those losses are treated as net operating loss carryforwards in subsequent years. Under separate rules, deductions for net operating loss carryforwards are limited to 80% of the taxpayer's taxable income in any given year, but can be carried forward indefinitely. The interaction of these two provisions means that if a taxpayer has losses that are limited under Section 461(l), the unused losses are not subject to Section 461(l) in subsequent years and are instead subject to the 80% net operating loss carryforward limitation in subsequent years.

To illustrate, assume that an unmarried taxpayer recognizes a \$1 million loss from an active trade or business in 2022, recognizes a \$1 million capital gain from the sale of stock in the same year, and has no other income or deductions. Under Section 461(l), the taxpayer could use only \$270,000 of the loss against his capital gain, with the remaining \$730,000 of the loss to be carried forward as a net operating loss in subsequent years.

Now instead, assume that the taxpayer recognizes the same \$1 million loss in 2022 but recognizes the \$1 million capital gain in 2023 instead of 2022 and has no other income or deductions for either year. The taxpayer cannot use the loss in 2022, and the entire deduction will be treated as a net operating loss carryforward in 2023.

The result is that the taxpayer will be able to use \$800,000 of the loss against the capital gain in 2023 (i.e., 80% of the gain) with the remainder of the loss carried forward to future years. Thus, a bizarre situation is created whereby the timing of gains and losses can sometimes have a dramatic effect on a person's tax liability.

In sum, for taxpayers with net losses from active businesses, Section 461(l) has the potential to create strange results that can sometimes be improved with careful planning. Given that Section 461(l) has already been extended twice, it seems increasingly likely that it will remain a permanent part of the tax law.

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