REAL ESTATE OWNERS AND THE NEW LIMITATION FOR ACTIVE LOSSES UNDER THE TCJA

*New **Section 461(l)** creates an important new obstacle to the use of tax losses from a trade or business.*

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The Tax Cuts and Jobs Act of 2017 **1** (TCJA) added new **Section 461(l)** to the Code, which limits the ability of a noncorporate taxpayer to deduct net business losses against income from nonbusiness sources. The new rule is in addition to the preexisting limitation on the deductibility of passive activity losses under **Section 469** . This article examines the operation of **Section 461(l)** , including specifically its effect on real estate owners and the interaction with the preexisting rules of **Section 469** .

Excess business losses

Section 461(l) disallows a noncorporate taxpayer's "excess business loss." An excess business loss is

the excess of (1) the taxpayer's deductions for the tax year attributable to trades or businesses (determined without reference to **Section 461(l)**) over (2) the sum of (a) the taxpayer's gross income or gain for the tax year attributable to trades or businesses plus (b) $250,000 ($500,000 for a joint return). For partnerships and S corporations, the limitation is applied at the partner or shareholder level. **2**

The basic operation of **Section 461(l)** is illustrated by Example 1.

Example 1.

A is an individual who is married and files a joint tax return. He operates a business as a sole proprietor, which generates a $20 million loss in 2018. He also owns a significant portfolio of investments including marketable securities, hedge funds, and private equity funds. These investments generate $12 million of interest, dividends, and capital gains in 2018. A has no other items of income, loss, or deduction. In prior years, he was able to use his business loss to eliminate his federal tax liability. For 2018, under Section 4611(l), the business loss is an "excess business loss" that may be used against nonbusiness income only to the extent of the $500,000 threshold amount. A's taxable income for 2018 is $11.5 million.

Using business losses to offset employment income

Section 461(l) refers to the aggregate deductions and the aggregate gross income or gain "attributable to trades or businesses of the taxpayer." It does not specifically exclude from the definition of "trade or business" the provision of services as an employee. This is in contrast to the passive activity rules, under which a taxpayer's "earned income"

[pg. 40]

is not treated as income from a passive activity. **3** It is clear that, for purposes of many Code sections, an employee is treated as engaged in the trade or business of providing services as an employee. **4** Certain other Code sections explicitly exclude the trade or business of performing services as an employee from the scope of a trade or business for particular purposes, reinforcing the conclusion that, absent such an explicit exclusion, an employee is engaged in a trade or business. **5** At least without administrative guidance under **Section 461(l)** to the contrary, business losses can be used to offset compensation income of an employee.

Example 2.

The facts are the same as in Example 1 except that A has no investment income, but is an employee and has $12 million of compensation income. A is able to deduct $12 million of his business losses. Assuming no other items of income or deduction, A's taxable income for 2018 is $0, and A has a net operating loss (NOL) carryover under **Section 172** of $8 million in 2019.

Carryforward as NOL

Under **Section 461(l)(2)** , any loss disallowed by **Section 461(l)** "shall be treated as a net operating loss carryover to the following taxable year under section 172" ("NOL carryover"). Standing alone, the phrase "*to the following taxable year* under section 172" might lead one to wonder whether any disallowed loss that is not usable under **Section 172** in the first year may be further carried forward to future years under **Section 172** . Nevertheless, the Conference Report to the TCJA clarifies that losses disallowed under **Section 461(l)** do carry forward indefinitely under **Section 172** . **6**

Example 3.

The facts are the same as in Example 1. In 2019, A has business income of $25 million. A's excess business loss of $19.5 million in 2018 is treated as an NOL carryover in 2019. A is permitted to deduct the entire NOL carryover against his business income in 2019. Assuming no other items of income or deduction in 2019, A's taxable income for 2019 is $5.5 million.

Section 172 , as amended by the TCJA, limits a taxpayer's use of an NOL carryover in a tax year to 80%% of the taxpayer's income (computed without regard to the deduction for NOL carryovers). **7**

Example 4.

The facts are the same as in Example 3 except that A's business income in 2019 is $20 million. Although A has an NOL carryover of $19.5 million in 2019, he is able to deduct only

[pg. 41]

$16 million of the NOL carryover, assuming no other items of income or deduction. A's taxable income for 2019 is $4 million, and in 2020 he has an NOL carryover of $3.5 million.

There is nothing in **Section 172** or **Section 461(l)** that treats an excess business loss that has become an NOL carryover as a business loss for purposes of **Section 461(l)** . **8** As a result, it appears that the limitations of **Section 461(l)** no longer apply to the excess business loss after it is converted to an NOL carryover.

Example 5.

The facts are the same as in Example 4 except that instead of business income of $20 million, A has interest, dividends, and capital gains of $20 million in 2019. A's NOL carryover of $19.5 million is deductible to the extent of 80% of his investment income of $20 million. A's taxable income in 2019 is $4

million, and in 2020 he has an NOL carryover of $3.5 million.

Interaction with passive activity loss rules

The **Section 461(l)** limitation applies after the passive loss limitation of **Section 469** . **9 Section 469** disallows certain taxpayers' passive activity losses, **10** which are the excess of a taxpayer's losses from passive activities over the taxpayer's income from passive activities. **11** A passive activity is the conduct of a trade or business in which the taxpayer does not materially participate. **12** Subject to certain exceptions, a rental activity is per se a passive activity, regardless of whether the material participation standard is met. **13** Disallowed passive activity losses are generally treated as passive activity losses of the taxpayer arising in its next tax year. **14** When a taxpayer disposes of his entire interest in a passive activity in a fully taxable transaction to an unrelated person, prior-year passive activity losses are generally available to be deducted without limitation under **Section 469** (to the extent that they exceed passive income and gain for the year). **15**

The Tax Reform Act of 1986 added **Section 469** to the Code. **16** The rule was generally understood as targeting tax shelter investments, whereby taxpayers would acquire interests in trades or businesses in which they did not participate actively, which generated losses that were used to offset the taxpayers' income from other sources (e.g., wages or investment income). **17** Nonetheless, the rule has much broader effect.

Interaction with passive activity loss real estate professional rule

As noted above, a rental activity is generally treated as per se passive regardless of whether the taxpayer materially participates in the activity. However, **Section 469(c)(7)** contains an exception from this treatment for "real estate professionals" who meet certain more stringent participation standards. Specifically, the exception applies if (1) more than one-half of the personal services that the taxpayer performed in trades or businesses during the tax year are in real property trades or businesses in which the taxpayer materially participates ; and (2) the taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates. **18** The net effect is that for taxpayers who meet the "real estate professional" standard, rental real estate activities are generally not passive and, therefore, are not subject to the passive activity loss limitations.

As illustrated in Example 6, taxpayers who meet the "real estate professional" exception of **Section 469(c)(7)** now must also run the gauntlet of **Section 461(l)** .

Example 6.

C is an individual who is married and files a joint tax return. He owns rental real estate that generates a $20 million loss in 2018. C also owns a significant portfolio of investments including marketable securities, hedge funds, and private equity funds. These investments generate $12 million of interest, dividends, and capital gains in 2018. C qualifies as a "real estate professional" under **Section 469(c)(7)** so the loss from the rental real estate is deductible without restriction under the passive activity loss rules of **Section 469** . In prior years, C was able to use his rental real estate loss to eliminate his federal tax liability. For 2018, under **Section 461(l)** , the rental real estate loss is an "excess business loss" that may be used against nonbusiness income only to the extent of the $500,000 threshold amount. **19** Assuming no other items of income or deduction, C's taxable income for 2018 is $11,500,000.

"Stacking order" issues

The existence of different tax rates for types of income (e.g., 20% for long-term capital gain, 25% for unrecaptured **Section 1250** gain and 37% for ordinary income) can create "stacking order" questions under the **Section 461(l)** limitation. Example 7 illustrates the issue.

Example 7.

[pg. 42]

D is an individual who is married and files a joint tax return. He owns rental real estate that generates a $20 million loss from rental in 2018. D also has $10 million of interest income taxable at ordinary rates. He qualifies as a "real estate professional" under **Section 469(c)(7)** so the loss from the rental real estate is deductible without restriction under the passive activity loss rules of **Section 469** . Shortly before the end of 2018, D sells the rental real estate for a $20 million **Section 1231** gain, of which $8 million is attributable to straight-line depreciation on the property and, therefore, constitutes "unrecaptured section 1250 gain" taxable at a 25% rate under **Section 1(h)** . D does not have an excess business loss for 2018 because the $20 million loss from rental does not exceed the $20 million gain on sale of the rental property. **20** Assuming no other items of income or deduction, D's taxable income for 2018 is $10 million. How much of the $10 million of taxable income is subject to ordinary rates, how much is subject to the 25% rate for unrecaptured **Section 1250** gain, and how much is subject to the 20% rate on "regular" **Section 1231** gain?

As an initial matter, **Section 461(l)** should not be viewed as causing the $20 million rental loss to offset or eliminate the $20 million of gain on sale of the rental property, leaving the taxpayer taxable on $10 million of ordinary income. Rather, **Section 461(l)** is a loss limitation provision, and once it is applied-in Example 7 with the result that there is not a **Section 461(l)** limitation-other rules determine the character of income as capital gain, unrecaptured **Section 1250** gain, or "regular" **Section 1231** gain.

The IRS addressed a similar issue in the context of the passive activity loss rules of **Section 469** and

reached this conclusion:

> It is true that the gain from the disposition of property used in a passive activity is treated as passive income for purposes of applying the passive loss rules. See [Temp. Reg.] 1.469-2T(c)(2).... Passive activity loss is defined in [Section] 469(d)(1) as the amount (if any) by which (A) the aggregated losses from all passive activities for the taxable year, exceed (B) the aggregate income from all passive activities for such year. Accordingly, for the limited purpose of calculating the disallowed "passive activity loss" of the taxpayer for the taxable year under [Section] 469(d)(1) (for purposes of [Section] 469(a)(1)(A)), the gain on the disposition of property used in a passive activity will be allowed to offset passive losses from the same or other passive activities of the taxpayer. The character of such gain or loss as capital or ordinary has no relevance for applying the rules of [Section] 469, because the passive loss rules are only concerned with whether the relevant income and loss are from a passive activity. Instead, once it is determined that the passive losses of a taxpayer are no longer subject to disallowance under [Section] 469(a)(1)(A) for a taxable year because the losses are either offset with a corresponding amount of passive income under [Section] 469(d)(1) or are recharacterized as "not from a passive activity" under [Section] 469(g)(1)(A)), the tax rules that would otherwise apply to such gain or loss outside of [Section] 469 will control the extent to which those gains and losses must offset each other for tax reporting purposes and for calculating the amount of tax due. **Section 469** is merely a loss disallowance provision, and as such it does not change the character of any gain or loss once the loss is no longer subject to limitation under that provision. In this case, the rules under [Section] 1211 et seq. will determine whether the capital gain from the Ventura property must offset the ordinary losses produced by such property, and [Section] 469 will play no role in this determination. Moreover, there is no provision in [Section] 469 or the regulations thereunder requiring the offset of capital gain with ordinary losses for other tax purposes as apparently contemplated by the Tax Court in Anjum Sheikh v. Comm'r [TCM 2010-126]." **21**

Similarly, once **Section 461(l)** has been applied in Example 7 to determine that the $20 million rental loss is fully deductible, other rules should determine how much of D's taxable income is subject to which rate. Under those rules, it appears that the entire $10 million is subject to tax at the 20% rate applicable to "regular" **Section 1231** gains. Thus, a taxpayer favorable "stacking rule" applies, and the $20 million ordinary loss first offsets $10 million of interest income taxable at a 37% rate, then offsets $8 million of unrecaptured **Section 1250** gain taxable at a 25% rate, and then offsets $2 million of the $12 million of regular **Section 1231** gain taxable at a 20% rate. **22**

Interaction with passive activity loss rule for complete dispositions

[pg. 43]

Unlike the passive loss limitations, **Section 461(l)** does not appear to have been targeted at a perceived tax abuse, and the Conference Report to the Tax Cuts and Jobs Act does not suggest otherwise. **Section 461(l)** does, however, add a hurdle for disallowed passive activity losses that have been freed from the passive activity loss limitations because of a complete disposition of the activity in a fully taxable transaction to an unrelated person. This is illustrated in Example 8.

Example 8:

B is an individual who is married and files a joint tax return. He conducts a rental real estate activity that is treated as a passive activity under **Section 469** . B has a $20 million passive activity loss carryforward to 2018. In 2018, B sells the rental real estate activity in a transaction that qualifies as a disposition of the entire activity in a fully taxable transaction to an unrelated person within the meaning of **Section 469(g)** . He recognizes a $15 million gain on the sale, all of which is attributable to straight-line depreciation on the property and, therefore, constitutes unrecaptured **Section 1250** gain taxable at a 25 % rate under **Section 1(h)** . B also has $10 million of interest income taxable at ordinary rates. Under **Section 469(g)** , the $20 million passive activity loss carryforward is deductible to the extent of the $15 million passive gain on disposition, and the remaining $5 million amount is deductible as a loss not from a passive activity. Prior to the enactment of new **Section 461(l)** , assuming no other items of income or deduction, B would have $5 million of taxable income for 2018, all of which would be unrecaptured **Section 1250** gain taxable at a 25% rate. **23**

Under new **Section 461(l)** , the $5 million passive loss carryforward amount in excess of the $15 million passive gain on disposition is an excess business loss that may be used against nonbusiness income only to the extent of the $500,000 threshold amount. **24** Assuming no other items of income or deduction, B has $9.5 million of taxable income for 2018, all of which would be unrecaptured **Section 1250** gain taxable at a 25% rate.

Conclusion

New **Section 461(l)** creates an important new obstacle to the use of tax losses from a trade or business. Perhaps one measure of its significance is that its enactment was estimated to increase revenues for the period from 2018 through 2027 by $149.7 billion. **25** The total revenue estimate for the TCJA for the same period was a revenue loss (i.e., tax cut) of $1.456 trillion, **26** so the revenue raised by the enactment of Code Sec. 461(l) exceeded 10% of the overall loss from the legislation. That certainly is material. **27**

As discussed above, at least absent administrative guidance to the contrary, our view is that **Section 461(l)** does not prevent net losses from a trade or business from offsetting employment income. Thus,

the effect of **Section 461(l)** is to prevent net losses from a trade or business from offsetting investment income. Most importantly, the fact that a loss disallowed under **Section 461(l)** becomes an NOL carryover in the subsequent year reduces the provision's bite substantially compared with what it might have been otherwise. Under the NOL rules, a disallowed loss under **Section 461(l)** can offset all forms of income (including investment income) in the subsequent year, subject to the limitation that an NOL may not offset more than 80% of taxable income. Any unused portion of the NOL carries forward indefinitely from year to year, again subject to the 80% limitation in subsequent years. As a result, for many taxpayers, the net effect of the **Section 461(l)** limitation may be merely to postpone the ability to deduct an "excess business loss" for a year or two or three. **28**

1 P.L. 115-97, December 22, 2017. The short title of the legislation as the "Tax Cuts and Jobs Acts of 2017" was removed during the legislative process because of a "Byrd Rule" objection by Democrats that the short title provision did not have a revenue impact, which was required for the bill to be eligible for passage in the Senate under expedited budget reconciliation procedures. Nevertheless, the article will refer to the legislation by its former official short title.

2 Section 461(l)(4) .

3 Section 469(e)(3) . Earned income is defined by reference to **Section 911(d)(2)(A)** , generally to include wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered.

4 See, e.g., *Primuth*, 54 TC 3742 (1970), acq. 1972-2 CB 2 (treating an employee as engaged in the trade or business of performing services as an employee separate and apart from the performance of those services for his existing employer); *Trent*, 291 F. 2d 669 (CA-2, 1961) (treating employee as having made loan in connection with trade or business of being an employee for purposes of **Section 166**); **Rev. Rul. 81-194, 1981-2 CB 43** ("Although an employee is in the trade or business of being an employee, this fact does not convert all amounts withheld from wages, whether mandatory or nonmandatory, into deductible trade or business expenses under **section 162 of the Code** .").

5 See, e.g., **Sections 62(a)(1)** , 199A(d)(1)(B), 163(j)(7)(A)(i), 163(h)(2)(A), and 263A(h)(2)(A).

6 H. Rep't No. 115-466 (Dec. 15, 2017) ("Conference Report"), which says at page 57 that "excess business losses not allowed are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward *in subsequent taxable years* as determined under the NOL rules provided under the conference agreement." [Emphasis added.]

7 Section 172(a)(2) .

8 Compare, for example, **Section 469(b)** (discussed in more detail below) which says: "Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or credit allocable to such activity in the next taxable year."

9 Section 461(l)(6) .

10 The limitation applies to individuals, estates, trusts, closely held C corporations, and personal service corporations. **Section 469(a)(2)** .

11 Section 469(d)(1) .

12 Section 469(c)(1) .

13 Sections 469(c)(2) , (4).

14 Section 469(b) .

15 Section 469(g)(1)(A) .

16 P.L. 99-514 (1986).

17 See, e.g., Senate explanation in the Conference Report to the Tax Reform Act of 1986, which explained the reason for including personal service corporations as subject to the rules ("[T]he rule is designed to prevent the sheltering of income derived from an individual's personal services simply by incorporating as a personal service corporation and acquiring tax shelter investments at the corporate level." S. Rep. 99-13 at 721-722 (1986).).

18 Section 469(c)(7)(B) .

19 This assumes that the real property rental activity constitutes a trade or business, which is likely but not inevitable. See, e.g., *Curphey,* **73 TC 766** (1980) in which Judge Tannenwald said: "This Court has held repeatedly . . . that the rental of even a single piece of real property for production of income constitutes a trade or business. *Fegan v. Commissioner*, **71 TC 791** 814 (1979), on appeal (10th Cir., July 30, 1979); *Elek v. Commissioner*, **30 TC 731** (1958), acq. 1958-2 C.B. 5; *Lagreide v. Commissioner*, **23 TC 508** (1954); *Hazard v. Commissioner*, **7 TC 372** (1946), acq. 1946-2 C.B. 3. "Other courts have sometimes reached a contrary conclusion. See, e.g., *Grier*, 120 F. Supp. 395 (DC

CT, 1954), *aff'd. per cur.* 218 F. 2d 603 (CA-2, 1955) (rental of single family home that taxpayer inherited did not constitute a trade or business). Highly "passive" rental activities such as triple net lease rentals, grazing, antenna, and billboard leases may present close cases.

20 This again assumes the rental property activity constitutes a trade or business. See note 19.

21 CCA 201312041.

22 This result is imbedded in the convoluted drafting of **Section 1(h)** . It is also the way the IRS Form 1040 Schedule D Tax Worksheet operates.

23 See discussion above regarding "stacking order" issues.

24 This again assumes that the rental property activity constitutes a trade or business. See note 19.

25 Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act*, JCX-67-17 (December 17, 2017).

26 *Id.*

27 In addition, the modifications to the NOL rules (including limiting a taxpayer's use of an NOL carryover in a tax year to 80% of the taxpayer's income) was separately estimated to increase revenues by $201.1 billion over the same period. Id. Because disallowed losses under **Section 461(l)** become NOL carryovers in the subsequent year, some of this revenue increase may have been attributable to interaction with **Section 461(l)** .

28 While the authors are by no means expert in the arcane art of tax revenue estimation, we do find the revenue estimate for **Section 461(l)** surprising. Such revenue estimates do not incorporate present-value concepts, and to the extent that a loss is merely deferred from one year to a subsequent year within the revenue estimation period, no revenue pick-up would be scored. We also find the yearly pattern of the revenue estimate ($9.7 billion in 2018 and then roughly double that in subsequent years until sunset in 2025) counter-intuitive, as we would have expected a larger revenue pick-up in 2018 followed by lower revenue in later years because of the use of the previously disallowed loss under the NOL rules.