Defending America's Small & Family Owned Businesses

September 24, 2024

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Chair, Main Street Tax Team
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U.S. House of Representatives
Washington, D.C. 20515

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Subject: Excess Business Loss Limitation under IRC §461(l)

Dear Chair Smucker and Members of the Main Street Tax Team:

The S Corporation Association (S-CORP) is grateful for the opportunity to submit the following comments to the Ways & Means Committee's Main Street Tax Team. These comments focus on the Excess Business Loss provision, which adversely affects S-CORP's member companies as well as the broader pass-through business community. We thank you for your attention to this critical issue and stand ready to work with you to address it.

Background

Under IRC §461(l), as enacted in the TCJA and amended by the CARES Act, for tax years beginning after 2020 and before 2029, an "excess business loss" from a trade or business of a noncorporate taxpayer cannot be deducted in the current year. This limitation does not apply to C Corporations, which are generally allowed to net losses against income broadly. However, any disallowed excess business loss is treated as a net operating loss (NOL) carryover. In TCJA, the provision was scored as raising $149.7B/10 years.

The excess business loss provision was originally enacted in the TCJA, then delayed by the CARES Act until 2021. The original expiration was extended twice, first by one year in ARPA ($31.008B/10 years JCT score), then again in the Inflation Reduction Act (IRA) for two additional years ($52.759B/10 years JCT score). As a result, the provision no longer aligns with

the expiration of most of the individual tax provisions in TCJA. The JCT recently scored extending the provision through 2034 as raising only $21.837B/10 years – though only six years of the extension are in the window. Note the dramatically reduced revenue estimate as compared to the original or two extensions. Given the fact the excess losses become NOLs, that reduction seems more reasonable and the original scores appear to have far exceeded the actual revenues.

An "excess business loss" is the amount by which the total deductions from a taxpayer's trades or businesses exceed the taxpayer's total gross income and gains from his or her trades or businesses, plus the threshold amount. A trade or business can include Schedules C and F activities and other business activities reported on Schedule E (passthrough income and losses from a partnership or S corporation). Business ordinary gains and losses reported on Form 4797, Sales of Business Property, can be included in the excess business loss calculation. The threshold amount is set at $289,000 ($578,000 MFJ) for tax years beginning in 2023 and $305,000 ($610,000 MFJ) for 2024.

The provision was also "clarified" in a technical amendment to resolve some ambiguities in the language, including reclassifying employee income as nonbusiness income meaning it cannot be offset by excess business losses. The original provision had no such limit, so a statutory change was required that expanded the reach of the provision; and as Prof. Hodasky observed in a paper "exacerbates the rule's onerous effects."[1] A second clarification creates an unequal treatment of capital gains. Trade or business capital gains are included in the computation of an excess business loss. Trade or business capital losses are excluded. When calculating the limitation, it is the lesser of 1) capital gain net income from business sources or 2) overall capital gain net income (which includes non-business losses). It is unclear what the policy is to reduce the amount of gains allowed by non-business losses which effectively increases the excess business loss where no other place are non-business losses or gains considered. (*See the fourth example below of how this treatment of non-business gains impacts a small business owner*).

The limitation of active business losses represents a significant departure from prior tax policy which focused on passive losses, or on farm losses in the narrow case where the taxpayer received farm subsidies. It has the potential to impact start-up businesses (generating early losses and needing capital), reduce investment incentives, and impact small and passthrough businesses only. Moreover, it departs from the basic tax policy premise that to determine income, a taxpayer should be allowed to net all costs of producing (or attempting to produce) business income against gross economic receipts. Income tax should be applied on actual or economic income, not phantom income. Section 461(l) results in tax being applied on amounts that are not income and distorts the income tax regime.

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[1] "Loss Cause: Developments in the Section 461(l) Excess Business Loss Rule as of Fall 2022," Prof. Steven Z. Hodasky, Assoc. Prof. of Taxation, Robert Morris Univ. (Accessed 5/2024 at: https://ssrn.com/abstract=3834513)

Excess Business Loss (EBL) Examples

General Example - In 2022, a married taxpayer has trade or business income from Business A of $5 million and trade or business losses from businesses B and C of $15 million in 2022. Instead of being able to deduct the entire $10 million loss against other income in 2022, the taxpayer is limited to deducting only $5.54 million of the losses in 2022 ($5 million of income from business A + $540,000 threshold amount). The excess ($9.46 million) is carried forward to 2023 as a net operating loss.

Continuing the example above, the taxpayer has a 2023 NOL of $9.46 million and 2023 taxable income of $10 million. The NOL can offset only 80% of the taxable income, which is $8 million. The remaining unused NOL ($1.46 million) would be carried forward to 2024.

Example Demonstrating Undercutting Access to Capital - A second example with the treatment of capital gains is as follows: A taxpayer owns an S corporation that generates $7 million in losses in 2022. In the same tax year, the taxpayer receives their regular $500,000 of annual compensation and to infuse the business with operating capital sells securities for a total gain of $9 million. In this scenario, the taxpayer may only deduct $270,000 of the $7 million business loss in 2022. As a result, the taxpayer will have $9.23 million of taxable income ($500,000 of compensation plus $9 million gain on the sale of stock less $270,000 allowable business loss deduction). The taxpayer will have a $6.73 million NOL carryover to 2023 ($7 million in business loss less the $270,000 allowed in the current year). However, in the case of the sale of capital assets generating capital gains, it is not necessarily likely that the taxpayer will have similar gains in 2023, so the NOLs may take many years to be applied.

Example Demonstrating Undercutting Investment Incentives in TCJA – A third example shows how Section 461(l) undermines the investment incentives enacted in TCJA (full expensing or Section 179 deduction). Consider a taxpayer who has $500,000 of investment income and is a 100% owner/operator of a business that usually generates $1 million of income a year. The business is seeking to expand and is expected to spend $2 million on new property, all of which can be immediately depreciated. This will result in $1 million of business losses, of which only $270,000 can be deducted in the tax year (using the 2022 threshold amount).

Example Demonstrating Inconsistent Treatment of Capital Losses vs. Gains – A final fourth example shows the unequal treatment of nonbusiness capital losses from Prof. Hodaszy. An unmarried individual operates a restaurant as a sole proprietorship. Assume that, for 2022, she has $200,000 of gross receipts from her restaurant, $570,000 of ordinary expenses attributable to the operation of her restaurant, $370,000 of salary from her job as an internal auditor for ACME Corporation, $100,000 of non-business-related capital losses from sales of gold bullion that she held for her personal investment, and $100,000 of business-related capital gain from the sale of an Andy Warhol print that was used as a decoration in her restaurant's dining room. Before the clarification, and had non-business losses not been netted against business gains, she would have $0 excess business losses as her business losses ($570,000) matched her gross receipts

($200,000) plus her business gain ($100,000) plus the threshold allowance in 2022 ($270,000). She could deduct her entire operating loss from her other income and her AGI would be $0.

Under the clarified rule, she has $100,000 in excess business losses because her non-business loss is netted against her business gains, and the net result is she would have $100,000 AGI and pay tax despite the fact she had $370,000 in real, operating losses. She would be paying tax on income she did not receive in real terms for the year.

Issue

The excess business loss provision is a dramatic departure from general tax policy principles that active losses can be applied to active income. In the corporate context, generally related companies may elect to file a return that consolidates all the businesses together and nets income and loss. Section 461(l) introduces a substantial new tax burden on small and closely-held business owners—in direct contradiction to Congress' broad goal of supporting small business.

What makes the new loss limitation even more perplexing is that it serves no useful policy purpose. Instead, Section 461(l)'s excess-business-loss limitation violates a foundational income tax precept by preventing a taxpayer from netting all of the costs of producing income against gross receipts. In so doing, the new rule causes such a taxpayer to be taxed on an amount greater than their income. Indeed, in some cases, it requires a taxpayer to pay federal income tax even though the taxpayer incurs a loss for the year. This accelerates negative economic impacts and slows economic recovery by delaying loss deductions at least a year.

In the passthrough or individual tax code, pre-2017 there were limits on passive losses reducing active income, and also a narrow loss for farming losses in cases where the taxpayer received farm subsidies; i.e., received a federal benefit.

One of the policy issues described informally as the driver for enactment of IRC Section 461(l) was the proverbial dentist with a side business that has active business losses, to prevent those losses from offsetting income from the taxpayer's dentist wage income or investment income. The JCT Blue Book and the TCJA Conference Report offer no official 'reason for change' for the dramatic expansion represented by Section 461(l). The Senate summary offered the following, after reciting changes to corporate NOLs and limits on an individual's personal casualty losses "[t]he Committee believes that excess business losses of taxpayers other than corporations should be carried forward rather than bunched in the year of loss. The provision is based on, and operates in a manner that is somewhat similar to, the current rule for excess farm losses."

In practice, in fact, this provision can prevent the deduction of losses against gains directly related the same business or undermine investment incentives enacted in TCJA like full expensing (now phasing out) or enhanced Section 179. For example, injecting capital in a business in a passthrough environment is very likely to come from a nonbusiness source – such as liquidating another investment to fund a capital injection.

The rationale for disallowing real economic (not paper) losses in the tax year they occur remains unclear. Unlike the farm loss rule, which had a corresponding benefit received for farm subsidies, there is no corresponding benefit to a passthrough business with excess business losses. Worse, the policy prevents the business from utilizing the 199A deduction and it would have to carryforward a negative 199A deduction into the following year (reducing the 199A benefit in future years).

Proposal – Eliminate or Mitigate Section 461(l) to Improve Access to Capital and Encourage Investment

Eliminate Section 461(l) – The best approach would be to eliminate Section 461(l). It departs from several core tax policy foundational principles of allowing active losses to be applied broadly to active income and accurately measuring income before applying tax and it creates obstacles to capitalizing a business or taking advantage of investment incentives for a business.

The second-best option is to allow Section 461(l) to sunset. As noted above, temporary extensions of Section 461(l) twice were used to offset other tax provisions, resulting in the current sunset at the end of 2028. These offsets were based on revenue estimates that grossly overstated the revenue impact of the policy. If the revenue estimates had been more accurate, the provision would almost certainly never been extended three additional years, as it would not have offset more than about $7-8 billion, instead of the $83.76 billion the JCT erroneously estimated the provision would be raised. Moreover, the CARES Act delay of three years might have been a $7-8 billion cost that would have potentially reversed itself in later years as opposed to the incomprehensible $135.028 billion ten year score the JCT assigned the delay in the CARES Act.[2]

Mitigate Section 461(l) To Improve Access to Capital and Encourage Investment– If the first two options are not possible, then Section 461(l) should be reformed to mitigate its negative impact on a business's access to capital and its ability to access the investment incentives enacted in the TCJA.

1) Gains related to either capital that is invested into the business (from outside the business), or generated from within the business such as portfolio income from business-related investments of operating cash, should be allowed to be netted against losses to reduce overall Section 461(l) losses. Capital investment in a passthrough business often comes from the owners(s) selling outside assets and contributing the proceeds to the business; that is a primary way that these businesses access capital to grow and invest, and in some cases stay in business. Capital gains related to funds invested back into the business should be netted against any losses in the business, as should capital gains from portfolio income generated from inside a business (for legitimate business purposes).

[2] The JCT originally scored the three year delay of Section 461(l) as reducing revenues by $169.609 billion over ten years in JCX-11-20 (March 26, 2020), and subsequently revised the score downward in JCX-11R-20 (April 23, 2020). Formal revenue estimate revisions by the JCT after enactment are a rare occurrence.

Nonbusiness losses are already factored into Section 461(l); allowing nonbusiness gains is a parallel treatment that would improve access to capital by these businesses.

2) To encourage investment incentives enacted in the TCJA and previously, Section 461(l) should be adjusted to exclude certain losses attributable to accelerated depreciation from the excess business loss calculation (to encourage capital formation and investment). The ordinary depreciation under the relevant MACRS table would be applied for the purposes of calculating the loss for the purposes of Section 461(l).

The S Corporation Association appreciates the opportunity to offer these suggestions and welcomes the chance to discuss these issues further.

Sincerely,

Brian Reardon
S Corporation Association