

Tax Cuts and Jobs Act: Excess Business Losses



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As we continue our analysis of the Tax Cuts and Jobs Act (TCJA), we will address a provision that has not been widely reported, but could have an immediate impact in 2018 to certain taxpayers.

Effective for tax years beginning after December 31, 2017, an excess business loss of a non-corporate taxpayer will be disallowed in the current tax year and converted into a net operating loss to be carried over to the following tax year. An excess business loss is the excess of the taxpayer's aggregated net active business losses over \$250,000 (\$500,000 MFJ). To illustrate:

H and W are married taxpayers filing a joint return. In 2018, H generates a net tax loss from his business of \$600,000 and W generates a net tax loss from her business of \$200,000. Both H and W actively participate in their businesses. Their aggregated net tax losses from trades or business is \$800,000. Their excess business loss for 2018 is \$300,000 (\$800,000 – \$500,000).

How does this limitation impact the taxable income of H and W?

Let's assume that, in addition to the losses generated from their businesses, H and W have other investment income totaling \$1,000,000. The following table illustrates how taxable income is calculated before and after the TCJA:

	Before TCJA	After TCJA
Investment income	\$1,000,000	\$1,000,000
H's active business loss	(600,000)	(600,000)
W's active business loss	(200,000)	(200,000)
Excess business loss (see above)	<u>0</u>	<u>300,000</u>
Net taxable income	\$200,000	\$500,000

While H and W cannot reduce their 2018 taxable income by the \$300,000 excess business loss, this loss is converted to a net operating loss and carried over to the following year. H and W can use the net operating loss in 2019 to offset up to 80% of their taxable income. To illustrate, let's assume that H and W have the exact same facts as above for 2019. Their 2019 taxable income would be calculated as follows:

	2019
Investment income	\$1,000,000
H's active business loss	(600,000)
W's active business loss	(200,000)
Excess business loss (see above)	<u>300,000</u>
Net taxable income before net operating loss carryover	<u>\$500,000</u>
Net operating loss carryover from 2018 (lesser of NOL of \$300,000 or 80% of taxable income before NOL (\$400,000))	<u>(300,000)</u>
Net taxable income after net operating loss	\$200,000

This illustrates that the excess business loss limitation is merely a timing issue. Affected taxpayers, however, may be in for a surprise in this first effective tax year if not aware of this provision.