March 4, 2024

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RE: Updated Request for Guidance Related to Section 461(l) – Limitation on Excess Business Losses of Noncorporate Taxpayers

Dear Mr. Vance and Ms. Hanlon-Bolton:

The American Institute of CPAs (AICPA) is submitting updated recommendations related to the issuance of guidance under section 461(l),[1] also known as the limitations on excess business losses (EBLs) of noncorporate taxpayers, enacted under the Tax Cuts and Jobs Act (TCJA).[2] These comments are in addition to our April 3, 2019 prior comments on the 2018 Instructions for Form 461 – Limitation on Business Losses, as well as our June 22, 2020 prior comments on Request for Additional Guidance and Relief Regarding Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers, and supersede our prior comments submitted on February 28, 2019.[3]

We acknowledge the efforts of the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) in issuing Information Release 2018-254 (IR-2018-254) and Instructions for Form 461, Limitation on Businesses Losses. However, taxpayers need additional guidance on section 461(l).

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.
[2] P.L. 115-97.
[3] See AICPA prior comments that these attached comments are in addition to, "Recommendation for the 2018 Instructions for Form 461 – Limitation on Business Losses," April 3, 2019, and "Request for Additional Guidance and Relief Regarding Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers," June 22, 2020. These attached comments supersede AICPA prior comments "Request for Guidance Related to Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers," February 28, 2019.

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Our comments address the following areas and recommendations:

I. Operating Principles
   A. Follow Section 172 Principles for Business and Non-Business Income and Deductions
   B. Recognize Application of Section 461(l) When Calculating Adjusted Taxable Income for Section 163(j)
   C. Clarify Treatment of Net Earnings from Self-Employment (NESE)
   D. Provide Guidance on Applying Loss Disallowance Rule within Net Investment Income Tax (NIIT) Calculation
   E. Provide Guidance on Integrating Loss Disallowance Rule with Section 199A

II. Definitions Related to Business Income
   A. Allow Business Income to Include Cancellation of Debt (COD) Income
   B. Clarify that Business Income Does Not Include Interest and Dividends
   C. Clarify Treatment of Partner and Self-Employment Deductions by Providing Guidance Confirming that Partnership Guaranteed Payments Constitute Business Income under Section 461(l)

III. Definitions Related to Business Deductions and Losses
   A. Clarify Allocation of Itemized Deductions for Income Taxes
   B. Provide Guidance on a Claim of Right
   C. Clarify that Deduction Does Not Include Deposits to Capital Construction Funds (CCFs)

IV. Treatment of Gains and Losses
   A. Provide Guidance on the Classification of Business Gains and Losses
   B. Provide Guidance Regarding How to Account for Section 1231 Gains and Losses in Computing a Taxpayer's Overall EBL
   C. Provide Guidance Regarding How to Account for Gains and Losses in Computing a Taxpayer's Overall EBL in Cases Where the Gains and Losses from Capital Assets are Classified as Ordinary
   D. Provide Guidance on the Dispositions of Interests in Partnerships and S Corporations
   E. Clarify the Treatment of Pre-2018 Capital Loss and Gain Carryforwards

V. Treatment of Qualified Plans
   A. Clarify that Self-Employed Contributions to Retirement Plans are Non-Business Deductions for Section 461(l) Purposes
   B. Provide Guidance that Distributions from Qualified Retirement Plans, Including Income Inclusion from Roth Individual Retirement Account (IRA) Conversions, Are Non-Business Income Items Excluded from the Definition of Business Income

VI. Treatment of Industry Specific Issues
   A. Provide Guidance on Treatment of Traders in Financial Instruments and Commodities
   B. Provide Guidance on Exempt Organization Unrelated Business Taxable Income (UBTI)

VII. Application to Trusts and Estates
- A. Clarify the Treatment of Suspended PALs
- B. Provide Guidance on the Application of Section 461(l) to the Final Year of an Estate or Trust
- C. Clarify The Treatment of Electing Small Business Trusts (ESBTs)
- D. Clarify The Treatment of Charitable Remainder Trusts (CRTs)

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The AICPA is the world's largest member association representing the CPA profession, with more than 415,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We welcome the opportunity to discuss these comments or to answer any questions that you may have. If you have any questions, please contact; Peter Mills, AICPA Senior Manager, Tax Policy & Advocacy at (202) 434-9272, or Peter.Mills@aicpa-cima.com; Dana McCartney, chair of the AICPA Individual and Self-Employed Tax Technical Resource Panel at (512) 370-3275 or dmccartney@mlrpc.com; or me at (830) 372-9692 or Bvickers@alamo-group.com.

Sincerely,

Blake Vickers, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc: Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
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AMERICAN INSTITUTE OF CPAs

Updated Request for Guidance Related to Section 461(l) Limitations on Excess Business Losses of Noncorporate Taxpayers

March 4, 2024

These recommendations supersede the prior recommendations that the AICPA submitted on February 28, 2019, and are in addition to our prior comments on the 2018 Instructions for Form 461 – Limitation on Business Losses, as well as our prior comments on Request for Additional Guidance and Relief Regarding Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers.[1]

Background

The Tax Cuts and Jobs Act[2] (TCJA or "the Act") added section[3] 461(l), which disallows excess business losses (EBLs) for taxpayers other than C corporations for tax years beginning after December 31, 2017, and before January 1, 2029.[4] Eligible taxpayers may carry forward any such disallowed losses and treat them as part of the taxpayers' net operating loss (NOL) carryforward in subsequent tax years. The Act also allows NOL carryovers for a taxable year up to the lesser of the carryover amount or 80 percent of the taxable income (determined without regard to the deduction for NOLs). Any limitation calculated under this provision applies after the application of the excess passive activity loss (PAL) rules in section 469.

An EBL for the taxable year is equal to the excess of the aggregate deductions attributable to trades or businesses of the taxpayer over the sum of aggregate income or gain (plus a threshold) from those same trades or businesses. The threshold amount for a taxable year is $250,000, indexed for inflation using the Chained Consumer Price Index for All Urban Consumers (C-CPIU).[5] With regards to partnership or S corporation ownership interests, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation from trades or businesses attributable to the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or shareholder.

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[1] See AICPA prior comments that these comments supersede, "Request for Guidance Related to Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers," February 28, 2019; and see AICPA prior comments that these comments are in addition to, "Recommendation for the 2018 Instructions for Form 461 – Limitation on Business Losses," April 3, 2019, and "Request for Additional Guidance and Relief Regarding Section 461(l) – Limitations on Excess Business Losses of Noncorporate Taxpayers," June 22, 2020.

[2] P.L. 115-97.

[3] All references to "section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.

[4] TCJA provided that section 461(l) was effective for tax years beginning after December 31, 2017, and before January 1, 2026. The American Rescue Plan Act, P.L. 117-2, subsequently extended the section 461(l) one additional year through January 1, 2027, and the Inflation Reduction Act, P.L. 117-169, extended it for an additional two years through January 1, 2029.

[5] For married taxpayers filing jointly, the amount is $500,000, also indexed for inflation.

Our comments cover the following issues:

I. Operating Principles
II. Definitions Related to Business Income
III. Definitions Related to Business Deductions and Losses
IV. Treatment of Gains and Losses
V. Treatment of Qualified Plans
VI. Treatment of Industry Specific Issues
VII. Application to Trusts and Estates

I. Operating Principles

Recommendations

The AICPA recommends that Treasury and the IRS draft the operating principles for section 461(l) as follows:

A. Follow Section 172 Principles for Business and Non-Business Income and Deductions
B. Recognize Application of Section 461(l) When Calculating Adjusted Taxable Income for Section 163(j)
C. Clarify Treatment of Net Earnings from Self-Employment (NESE)
D. Provide Guidance on Applying Loss Disallowance Rule within Net Investment Income Tax (NIIT) Calculation
E. Provide Guidance on Integrating Loss Disallowance Rule with Section 199A

Analysis

A. *Follow Section 172 Principles for Business and Non-Business Income and Deductions*

An EBL creates an NOL that is carried forward to the next succeeding year. Treasury and the IRS should use the long-established computational principles embodied in section 172 for noncorporate taxpayers for all guidance under section 461(l). Adopting the NOL computational rules in determining the amount of business income and deduction will prevent the creation of an NOL carryforward under section 461(l) that would not have been created under existing law section 172 principles.

By adopting NOL computational principles, there is a body of law that will allow taxpayers to determine what differentiates business income from non-business income and business deductions from non-business deductions. The result would permit section 461(l) to disallow business deductions (plus the threshold amount) in excess of business income that is determined from established rules, and not create a new loss limitation system that requires a different definition of business for new Internal Revenue Code (IRC or "Code") sections. Given that the provision only has an eight-year effective life, the creation of a new definitional and computational system is inadvisable.

B. *Recognize Application of Section 461(l) When Calculating Adjusted Taxable Income for Section 163(j)*

In the case of a taxpayer that has business interest expense and has a potential for loss disallowance under section 163(j), rules are necessary to coordinate the two provisions in order to avoid circular calculations. For every dollar of section 461(l) disallowance, it creates the possibility of another 30 cents of interest expense allowed. But those 30 cents of interest expense become a deduction that goes into the calculation of section 461(l), and thus becomes converted from a section 163(j) disallowance into a section 461(l) disallowance which, in turn, becomes an NOL. Thus, rules are necessary to determine whether section 461(l) or section 163(j)'s adjusted taxable income is calculated first, because it is highly unlikely that Congress intentionally created circular calculations.

C. *Clarify Treatment of NESE*

Section 1402(a) provides, in relevant part, that the term "net earnings from self-employment" means the gross income "derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member."

Treasury Reg. § 1.1402-2(c) provides that "where an individual is engaged in more than one trade or business within the meaning of section 1402(c) and Treas. Reg. § 1.1402(c)-1, his NESE consists of the aggregate of the net income and losses (computed subject to the special rules provided in Treas. Reg. §§ 1.1402(a)-1 to 1.1402(a)-17 inclusive) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business."

Clarity is needed on the proper section 461(l) treatment when the taxpayer conducts multiple businesses, some with net income and some with net loss, but not all amounts are included in the taxpayer's NESE. To the extent a loss is disallowed, guidance should provide that this loss is attributed to businesses whose income is not included in NESE (such as that allocable to limited partnerships and S corporations). Allowing the non-NESE loss allocation to apply before the NESE loss allocation is an equitable approach because the resulting NOL created in the subsequent tax year is not allowed in the subsequent year's calculation of net earnings from NESE by reason of section 1402(a)(4).

D. *Provide Guidance on Applying Loss Disallowance Rule within NIIT Calculation*

Section 1411(c)(1)(B) provides that net investment income includes deductions allowed by subtitle A that are properly allocable to gross income or net gain described in section 1411(c)(1)(A). To the extent that section 461(l) disallows business deductions, the deductions may also affect the calculation of net investment income in section 1411(c)(1). Guidance is needed, under section 461(l), for applying the loss disallowance rule within the net investment income calculation regime

in Treas. Reg. § 1.1411-4. This is conceptually similar to the request in item C above (pertaining to self-employment tax).

E. *Provide Guidance on Integrating Loss Disallowance Rule with Section 199A*

Treasury Reg. § 1.199A-3(b)(1)(iii)(A) provides, in relevant part, that previously disallowed losses or deductions allowed in the taxable year (which includes losses disallowed by section 461(l) in a previous year) generally are taken into account for purposes of computing qualified business income (QBI) to the extent the disallowed loss or deduction is otherwise allowed by section 199A. The regulation goes on to state that these losses are used for purposes of section 199A and this section in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and are treated as losses from a separate trade or business.

Treasury Reg. § 1.199A-3(b)(1)(iii)(B) provides, in relevant part, that if a loss or deduction attributable to a trade or business is only partially allowed during the taxable year in which incurred, only the portion of the allowed loss or deduction that is attributable to QBI will be considered in determining QBI from the trade or business in the year the loss or deduction is incurred. The regulation provides taxpayers with a calculation method to determine this amount whereby the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction, the numerator of which is the portion of the total loss incurred during the taxable year that is attributable to QBI and the denominator of which is the amount of the total loss incurred during the taxable year.

As a general rule, the NOLs generated by a section 199A taxpayer (generally, individuals, estates, and trusts) after 2017 no longer have "vintages" because they are carried forward indefinitely. Additionally, an NOL deduction is, generally, devoid of character. Said differently, the tax identity of the income and losses that go into the calculation of a NOL are lost when resulting loss is allowed by section 172 in a later year.

Section 461(l) and section 172, unlike section 465 and section 469, are not traced on an activity-by-activity basis, but instead are an aggregate of all activities of the taxpayer. Specifically, guidance is needed in three principal areas. First, guidance is needed to assist in the determination of how the resulting section 172 deduction is bifurcated between QBI-NOLs and non-QBI-NOLs, as well as the annual vintages that Treas. Reg. § 1.199A-3(b)(1)(iii)(A) appears to require.

Second, guidance is needed in a situation where a taxpayer's loss is so large where they are subject to section 461(l) but also create a "natural" NOL even after section 461(l) is applied. In this case, the resulting NOL is actually the sum of the section 461(l) disallowance as well as a "natural" NOL calculated using the rules in section 172(d). Presumably, Treas. Reg. § 1.199A-3(b)(1)(iii) is implicated in the section 461(l) portion of the NOL, but there is some question about how the natural NOL is dealt with.

Finally, guidance is needed on the application of the rules in Treas. Reg. § 1.199A-3(b)(1)(iii) and the operation of section 170(d)(1)(B), which provides a special ordering rule for charitable deductions and NOL deductions. This is most acute in situations where a taxpayer has both section

170 and section 172 deductions in the same year and has both section 170 and section 172 carryovers coming out of that year.

II. Definitions Related to Business Income

Recommendations

The AICPA recommends that Treasury and the IRS draft the definitions related to business income for section 461(l) as follows:

A. Allow Business Income to Include Cancellation of Debt (COD) Income
B. Clarify that Business Income Does Not Include Interest and Dividends
C. Clarify Treatment of Partner and Self-Employment Deductions by Providing Guidance Confirming that Partnership Guaranteed Payments Constitute Business Income under Section 461(l)

Analysis

A. *Allow Business Income to Include COD Income*

Business income should include COD income to the extent it is not excluded from gross income by reason of section 108 guidance on income from discharge of indebtedness and is attributable to a trade or business.

B. *Clarify that Business Income Does Not Include Interest and Dividends*

As noted above, we believe that the existing NOL rules contain taxpayer guidance on this issue. Therefore, guidance should provide that business income does not include interest and dividends, except those that are derived in the ordinary course of a trade or business. [6] The guidance should also confirm that interest and dividend income on working capital is not income in the ordinary course of a trade or business. Additionally, it is reasonable to include self-charged lending rule, similar to Treas. Reg. § 1.163(j)-6(n), Treas. Reg. § 1.469-7, or Treas. Reg. § 1.1411-4(g)(5), allowing certain interest income to be treated as properly allocable to a trade or business.

C. *Clarify Treatment of Partner and Self-Employment Deductions by Providing Guidance Confirming that Partnership Guaranteed Payments Constitute Business Income under Section 461(l)*

Guidance is needed addressing the treatment of guaranteed payments as business income under section 461(l). Guaranteed payments, defined in section 707(c), are payments to a partner for services or the use of capital, determined without regard to the income of the partnership. The section 707 regulations state that guaranteed payments are "considered as made to one who is not

[6] For example, a partnership or S corporation that is engaged in the trade or business of lending is generally expected to generate interest income which is properly allocable to a trade or business, consistent with Treas. Reg. § 1.469-2T(c)(3)(ii) and Treas. Reg. § 1.199A-3(b)(2)(ii)(C).

a member of the partnerships only for purposes of section 61(a) a (relating to gross income) and section 162(a) (relating to trade or business expenses)… *[however], for the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income*."[7] To the extent a partnership is engaged in a trade or business, the guaranteed payments should also be attributable to the trade or business of the partnership.

The Bluebook on the TCJA states "in the case of a partnership or S corporation, [section 461(l)] applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of a partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder."[8] Given this explanation and the codified definition of guaranteed payments as "a partner's distributive share of ordinary income" noted above, it naturally follows that guaranteed payments would be included as business income; we find this to be consistent with our interpretation of the legislative intent of section 461(l).

We find additional support in the lack of a specific exclusion of guaranteed payments from the definition of section 461(l) business income. Under section 199A, guaranteed payments for services are expressly carved out from the definition of qualified business income (QBI).[9] Sections 199A and 461(l) were enacted concurrently as part of the TJCA. Congress made the conscious decision to exclude guaranteed payments from the QBI calculation but did not provide any such exclusion for section 461(l) business income. Furthermore, the Coronavirus Aid, Relief, and Economic Security (CARES) Act,[10] provided several technical corrections and clarifications relating to section 461(l) but did not specifically exclude guaranteed payments from the definition of business income.

We believe the basis for including guaranteed payments in section 461(l) business income is sound. We recommend Treasury and the IRS issue guidance affirming this position in order to aid in the administration of the provision.

Certain deductions are allowable against the adjusted gross income (AGI) of the taxpayer. These deductions include self-employed health insurance,[11] 50 percent of self-employment tax,[12] unreimbursed partner expenses, and business interest deductions for equity acquisition of partnerships or S corporations.[13] (We also provide additional discussion of deductions allowed for contributions to employee benefit plans in section V below.) Therefore, section 461(l) implementation guidance is needed with respect to the various items of individual income and deductions associated with a qualified business which generates EBLs.

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[7] See Treas. Reg. §1.707-1(c).
[8] General Explanation of Public Law 115-97 (JCS-1-18), page 40.
[9] Section 199A(c)(4)(B).
[10] P.L. 116-136.
[11] Section 162(l) (but not the above-the-line deduction for Health Savings Accounts (HSAs)).
[12] Section 162(f).
[13] IRS Notices 88-37 and 89-35.

III. Definitions Related to Business Deductions and Losses

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance on specific individual deductions, including:

A. Clarify Allocation of Itemized Deductions for Income Taxes
B. Provide Guidance on a Claim of Right Deduction
C. Clarify that Deduction Does Not Include Deposits to Capital Construction Funds (CCFs)

Analysis

A. *Clarify Allocation of Itemized Deductions for Income Taxes*

Revenue Ruling 70-40 allows the apportionment for state and local income taxes between business and non-business income for NOL purposes. If the AICPA's recommendation on NOL principles is adopted, Rev. Rul. 70-40 would likely require the same allocation to occur. However, given that section 164 limits the deduction for taxes under the TJCA, we encourage the IRS to choose a simplifying provision that would not require allocation of any of these relatively insignificant amounts as business deductions for section 461(l) purposes. Therefore, guidance should clarify that there is no apportionment for state and local income taxes between business and non-business income for section 461(l) while the cap imposed by section 164(b)(6) is in effect.

B. *Provide Guidance on a Claim of Right Deduction*

In the case of a claim of right deduction that is allowed in the current year by reason of section 1341(a), the taxpayer needs to determine the origin of the payment deduction for the section 461(l) calculation as business or non-business. The section 1341 tax credit alternative should also consider whether section 461(l) is applicable when a prior year tax is recomputed (assuming the recomputation year is 2021-2028). If section 461(l) is applied in the year(s) of recomputation, guidance is necessary to determine if an NOL is created in the recomputation year(s). In addition, guidance is requested with respect to the year(s) following the recomputation in order to determine the amount of credit that is available to the extent that it is not readily apparent from the existing NOL rules. Guidance is needed to address the interaction between sections 461(l) and 1341.

C. *Clarify that Deduction Does Not Include Deposits to Capital Construction Funds (CCFs)*

Section 7518(c)(1) provides that taxable income is reduced by the amount contributed to CCFs. Guidance should include that the term "deduction" in section 461(l) does not include amounts contributed to CCFs.[14]

[14] This interpretation is consistent with *Eades v. Commissioner*, 79 T.C. 985 (1982), and Rev. Rul. 79-413. These authorities conclude that the reduction in taxable income by reason of section 7518(c)(1) is not a deduction.

IV. Treatment of Gains and Losses

Recommendations

The AICPA recommends that Treasury and the IRS provide guidance on the application of section 461(l) to gains and losses. This area of section 461(l) is difficult for taxpayers to apply because the statute does not specifically address what gains and losses are attributable to a trade or business of the taxpayer. Specifically, Treasury and the IRS should:

A. Provide Guidance on the Classification of Business Gains and Losses
B. Provide Guidance Regarding How to Account for Section 1231 Gains and Losses in Computing a Taxpayer's Overall EBL
C. Provide Guidance Regarding How to Account for Gains and Losses in Computing a Taxpayer's Overall EBL in Cases Where the Gains and Losses from Capital Assets are Classified as Ordinary
D. Provide Guidance on the Dispositions of Interests in Partnerships and S Corporations
E. Clarify the Treatment of Pre-2018 Capital Loss and Gain Carryforwards

Analysis

A. *Provide Guidance on the Classification of Business Gains and Losses*

As originally drafted, section 461(l) did not address how gains and losses affected a taxpayer's EBL, although the Joint Explanatory Statement of the Committee of Conference (Conference Report) for the TCJA implied that section 461(l) was modeled after the then-existing farm loss rules embodied in section 461(j).[15] Section 2304 of the CARES Act, subsequently added several technical amendments to section 461(l), including the introduction of a new subparagraph[16] clarifying the treatment of capital gains and losses.

As amended by the CARES Act, section 461(l)(3)(B)(i) addresses the treatment of capital losses by providing that "*deductions for losses from sales or exchanges of capital assets shall not be taken into account*" under section 461(l)(3)(A)(i) as attributable to trades or businesses of a taxpayer. The Description of the Tax Provisions of Public Law 116-136, prepared by the Joint Committee on Taxation, explains that "because capital losses cannot offset ordinary income under the NOL rules,[17] any capital loss deductions are not taken into account in computing the section 461(l) limitation." Conversely, section 461(l)(3)(B)(ii) addresses the treatment capital gains by providing that "*the amount of gains from sales or exchanges of capital assets taken into account* [as gross income or gain attributable to a trade or business] *shall not exceed the lesser of (I) capital gain net income determined by taking into account only gains and losses attributable to a trade or business, or (II) capital gain net income*."

[15] See Conference Report 115-466, "Joint Explanatory Statement of the Committee of Conference," page 238.
[16] Section 461(l)(3) redesignated subparagraph (B) as subparagraph (C) and inserted after subparagraph (A) a new subparagraph, section 461(l)(3)(B).
[17] Section 172(d)(2)(A).

Although section 461(l)(3)(B) clarifies how capital gains and losses mechanically affect a taxpayer's EBL calculation, it remains unclear how taxpayers determine whether gains and losses are "attributable" to a trade or business.

Treasury Reg. § 1.172-3(a)(3)(ii) states in relevant part: "any gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business." Treasury Reg. § 1.172-3(b) also contains rules that address the characterization of capital loss carryovers between business and nonbusiness.[18]

Treasury and the IRS should provide that the concept of business gain and business loss for purposes of sections 461(l)(3)(A) and 461(l)(3)(B) is determined in the same manner as described in Treas. Reg. § 1.172-3(a)(3)(ii). Determining the character of business gains and business losses for EBL purposes in the same manner as such gains and losses are characterized for NOL purposes will simplify taxpayer compliance and provide consistency between both provisions.

B. *Provide Guidance Regarding How to Account for Section 1231 Gains and Losses in Computing a Taxpayer's Overall EBL*

Treasury and the IRS should provide guidance on how section 1231 gains and losses affect the calculation of a taxpayer's EBL, particularly when applying the provision of section 461(l)(3)(B). To the extent a taxpayer recognizes an overall net section 1231 gain on trade or business assets, we recommend that such gain be included in the taxpayer's EBL calculation as gross income or gain attributable to a trade or business as defined in section 461(l)(3)(A)(ii)(I), and is not considered gain from the sale or exchange of a capital asset as provided in section 461(l)(3)(B)(ii). Similarly, we recommend that any net section 1231 loss recognized on the sale or exchange of trade or business assets be included in the taxpayer's EBL calculation as a deduction of the taxpayer attributable to a trade or business as defined in section 461(l)(3)(A)(i), and not as loss or deduction from the sale or exchange of a capital asset under section 461(l)(3)(B)(i).

1. <u>Background on Section 1231 Gains and Losses</u>

Section 1231(a)(3)(A) defines a "section 1231 gain" as any gain recognized on the sale or exchange of property used in the trade or business, and any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of either (I) property used in the trade or business, or (II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction

[18] Treasury Reg. § 1.172-3(b) provides that taxpayers must determine the proportion of any net capital loss carryover attributable to business capital losses in excess of business capital gains, and the proportion attributable to nonbusiness capital losses in excess of nonbusiness capital gains.

entered into for profit." A loss from the sale or exchange of such property is defined as a "section 1231 loss."[19]

Section 1231(b)(1) defines the term "property used in the trade or business" as property used in the trade or business which is subject to the allowance for depreciation and held for more than one year, as well as real property used in the trade or business held for more than one year.[20]

Section 1231(a)(1) provides that if the aggregate of the taxpayer's section 1231 gains for the tax year exceed their section 1231 losses, then such gains and losses shall be treated as long-term capital gains or long-term capital losses. In effect, an overall net section 1231 gain on the sale of property used in a trade or business is generally characterized as a long-term capital gain, although in some instances such gain may be treated as ordinary income.[21] Conversely, section 1231(a)(2) provides that if the aggregate of the taxpayer's section 1231 gains for the tax year do not exceed their overall section 1231 losses, then the net section 1231 loss is characterized as ordinary.

2. Application of Section 1231 Gains and Losses to Section 461(l)

Section 461(l)(3)(B)(ii) limits the amount of overall gain from the sale or exchange of "capital assets" to the lesser of the taxpayer's "capital gain net income" attributable to a trade or business, or the taxpayer's overall "capital gain net income." It is unclear how taxpayers should interpret this provision if taxable income includes an overall net section 1231 gain. When a taxpayer sells or exchanges section 1231 property for an overall net gain, such gain is characterized as long-term capital gain under section 1231(a)(1). In this scenario, the net section 1231 gain will be included in a taxpayer's "capital gain net income" even though such gain is not attributable to the sale or exchange of a "capital asset."

In certain situations, this dynamic may cause a taxpayer with an overall net section 1231 gain from a trade or business to have an unexpected EBL limitation. For example, suppose a taxpayer has overall net income from their trade or business consisting of an ordinary business loss and a net section 1231 gain. If this same taxpayer also incurs a loss on the sale of nonbusiness capital assets, then the nonbusiness capital loss would offset the taxpayer's net section 1231 gain when figuring "capital gain net income" under section 461(l)(3)(B)(ii). This would either reduce or eliminate the amount of net section 1231 gain included in the taxpayer's EBL calculation. As a result, the taxpayer may incur an EBL even though they did not have an overall loss from their trade or business.

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[19] Section 1231(a)(3)(B).

[20] Exceptions include property which would be includible in inventory of the taxpayer, property held primarily for sale to customers, a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in section 1221(a)(3), or a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in section 1221(a)(5).

[21] Under section 1231(c)(1), a net section 1231 gain is treated as ordinary income (and not as long-term capital gain) to the extent the net section 1231 gain does not exceed the taxpayer's non-recaptured net section 1231 losses. Non-recaptured 1231 losses are defined in section 1231(c)(2) as the excess of the aggregate amount of the taxpayer's net section 1231 losses for the five most recent preceding tax years over the portion of such losses previously recaptured.

Although a net section 1231 gain is generally characterized as a long-term capital gain, such gain does not relate to the sale or exchange of a "capital asset." Accordingly, Treasury and the IRS should clarify that a net section 1231 gain (whether classified as a capital gain or ordinary income) is not included in the calculation of "capital gain net income" under section 461(l)(3)(B)(ii).

C. *Provide Guidance Regarding How to Account for Gains and Losses in Computing a Taxpayer's Overall EBL in Cases Where the Gains and Losses from Capital Assets are Classified as Ordinary*

Subparagraph (B) of section 461(l)(3) is titled "Treatment of *capital* gains and losses," and section 461(l)(3)(B)(ii) limits the amount of gain taken into account in calculating the EBL limitation to the lesser of "capital gain" net income from a trade or business or "capital gain" net income. Taken together, this implies that section 461(l)(3)(B) was intended to address how gains and losses affect a taxpayer's EBL calculation when such gains and losses are characterized as capital (not ordinary). However, sections 461(l)(3)(B)(i) and 461(l)(3)(B)(ii) explicitly reference gains and losses from the sale or exchange of *capital* assets, which implies that the provision affects gains and losses from capital assets regardless of whether such gains and losses are characterized as capital or ordinary.

Treasury and the IRS should clarify that ordinary gains and losses, particularly those recognized by a trader fund that has made a section 475(f) election, qualify as business income and loss under section 461(l)(3)(A) and are not considered gains and losses from the sale or exchange of capital assets under section 461(l)(3)(B).

1. Section 475(f) Election for Trader Funds

Section 475(f)(1)(A) permits a taxpayer engaged in a trade or business as a trader in securities to elect to recognize gain or loss on any security held in connection with such trade or business at the close of any taxable year as if such security were sold for its fair market value on the last business day of such taxable year, with any resulting gain or loss characterized as ordinary (rather than capital).[22]

Section 475(c)(2) defines a security to include stock, a partnership interest, a debt instrument, an interest rate, currency, or equity notional principal contract, an interest in or a derivative financial instrument in any security (including any option, forward contract, short position, and any similar financial instrument), and any hedge of a security that the dealer or electing trader identifies as such before the close of the day on which the dealer or electing trader enters into the hedge.

2. Application of Section 461(l) to Trader Funds with 475(f) Election

If a trader in securities does not make a section 475(f) election, then any gain or loss recognized on the sale of securities (such as stock) is generally considered capital in nature because the

[22] Section 475(d)(3)(A)(i).

securities do not meet any of the exceptions to capital asset treatment under section 1221.[23] Therefore, by making a section 475(f) election, the electing taxpayer converts what would have otherwise been a capital gain or loss on the sale of securities (i.e. capital assets) into ordinary income or loss, which creates a discrepancy between the character of the income being generated and the character of the underlying assets. For this reason, it is unclear how gains and losses stemming from a section 475(f) election impact an EBL.

Once a trader in securities makes a section 475(f) election, any losses from its trading business may trigger an NOL[24] and are uninhibited by the capital loss limitation under section 1211(b). For this reason, we recommend that any losses pursuant to a section 475(f) election are included as deductions of the taxpayer attributable to a trade or business under section 461(l)(3)(A)(i) and are not considered losses from the sale or exchange of capital assets as described in section 461(l)(3)(B)(i). Similarly, we recommend that net section 475(f) gains are characterized as income or gain attributable to a trade or business under section 461(l)(3)(A)(ii)(I) and not as "capital gain net income" under section 461(l)(3)(B)(ii).

D. *Provide Guidance on the Dispositions of Interests in Partnerships and S Corporations*

Currently, Treasury and the IRS have not provided guidance to address the treatment of gains and losses associated with the disposition of interests in S corporations and partnerships. Due to the lack of guidance in this area, it is difficult for taxpayers to apply these provisions because the Code does not specifically address what gains and losses, attributable to the trade or business of the taxpayer, are includable in EBL.

To the extent that a taxpayer disposes of an interest in an S corporation or partnership, we recommend that any gain or loss (regardless of the classification as ordinary or capital) is taken into account under section 461(l)(3)(A) or section 461(l)(3)(B) when that entity conducts a trade or business. Conversely, where the entity is not engaged in a trade or business, any gain or loss from the disposition of an S corporation or partnership interest should not be taken into account under section 461(l)(3)(A) or section 461(l)(3)(B). In the case of a disposition of an S corporation or partnership interest that conducts business and nonbusiness activities (*i.e.*, section 212 activities), guidance should provide for a proration of the gain or loss between the business and non-business activities.[25]

In this context, we can look at several analogous sources of the Code to provide additional clarification.

[23] See also *Hart v. Commissioner*, TC Memo 1997-11: "A trader does not have customers and is therefore not considered to fall within an exception to capital asset treatment."
[24] Section 172(b)(1).
[25] For an example of current guidance on the allocation of gains and losses between business and non-business activities, see Treas. Reg. § 1.469-2T(e)(3). However, taxpayers should not adopt the rules in Treas. Reg. § 1.469-2T(e)(3) in their entirety because the section 469 reclassification of various types of business activities as portfolio are not likely relevant for section 461(l) purposes.

1. Section 469

Section 469 defines a passive activity as "any activity which involves the conduct of a trade or business, and in which the taxpayer does not materially participate."[26] For PAL limitation purposes, the gain or loss from the sale of an asset or activity is classified in the same manner as income or loss previously generated therefrom.[27]

Under the PAL rules, the character of the gain or loss resulting from the disposition of an interest in an activity is determined by the nature of the activity in the year of disposition.[28] In the case of the disposition of a passthrough entity (such as a partnership or S-corporation), the regulations provide for a ratable allocation of any gain or loss from such disposition among each trade or business, rental, or investment activity in which the passthrough entity owns an interest.[29]

Any gain recognized upon the disposition of an interest in a partnership or s corporation, or an interest in an activity held thereunder, is treated as gross income from the activity. This means, for PAL purposes, the gain or loss on disposition is treated in the same manner as the income or loss in the year of disposition.

2. Section 172

Above, we concluded that, given the JCT report indicating that the section 461(l) was modeled after former section 461(j), that Treasury and the IRS should use the long-established computational principles embodied in section 172 for non-corporate taxpayers for all guidance under section 461(l).

The regulations under section 172 provide that "[a]ny gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposed of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business."[30]

3. Section 1411

Although section 1411 and the regulations thereunder are housed under U.S. Code Title 26, Chapter 2A (rather than Chapter 1), it provides recent guidance on the characterization of gain and loss on the disposition of partnership and S-corporation interests.

For NIIT purposes, gain or loss from the sale of an interest in a partnership or S-corporation is generally subject to the NIIT because, in most cases, the interest is not considered "property held

[26] Section 469(c)(1).
[27] Section 469(e)(1)(A)(2).
[28] See Treas. Reg. § 1.469-2T(c)(2)(i)(A), Treas. Reg. § 1.469-2T(d)(5)(i).
[29] See Treas. Reg. § 1.469-2T(e)(3).
[30] See Treas. Reg. § 1.172-3(a)(3)(ii).

in a trade or business."[31] However, an exception applies to certain gains that would not have been subject to the NIIT had the passthrough entity sold its assets immediately before the disposition.[32] The preamble to the section 1411 regulations affirms this treatment.[33] Consistent with this approach, Prop. Reg. § 1.1411-7(a)(3)(i) provides that the disposition of an interest in a passthrough entity is exempt from the NIIT if the passthrough entity is engaged in at least one section 162 trade or business (other than trading in financial instruments)[34] and the section 162 trade or business was a not a passive activity with respect to the taxpayer.

If a taxpayer's gain or loss on the disposition of a passthrough entity meets the requirements of Prop. Reg. § 1.1411-7(a)(3)(i), then the gain or loss is considered attributable to a trade or business and is exempt from NIIT. By extension, any such gain or loss should also be considered attributable to a trade or a business for section 461(l) purposes as described in section 461(l)(3)(A) and section 461(l)(3)(B). However, the characterization of gain or loss on the disposition of a passthrough entity may not always be consistent for NIIT purposes and section 461(l) purposes. For example, if a taxpayer's gain or loss on the disposition of a passthrough entity is not exempt from NIIT (because the passthrough entity is engaged in a trade or business that is a passive activity with respect to the taxpayer or a trader in financial instruments), then such gain or loss could still be attributable to a trade or business for section 461(l) purposes,[35] even though it would be subject to the NIIT.[36]

Accordingly, we recommend that Treasury and the IRS determine the character of gains and losses realized on the disposition of partnerships and S-corporations for section 461(l) purposes by using similar look-through rules as found in section 1411. This approach would simplify taxpayer compliance and, in some cases, create parity between the characterization of gains and losses for both NIIT and section 461(l) purposes. Consistent with this approach, we also recommend that the definition of "trade or business" under section 461(l) be consistent with the definition of "trade or business" found in the proposed section 1411 regulations, which relies on section 162 and the accompanying guidance thereunder.[37]

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[31] Section 1411(c)(1)(A)(iii).

[32] Section 1411(c)(4) provides that in the case of a disposition of an interest in a partnership or S-corporation, gain or loss from such disposition will be subject to NIIT only to the extent of the net gain which would be taken into account by the transferor if all property of the partnership or S-corporation were sold for fair market value immediately before the disposition of such interest.

[33] The preamble states "Congress intended Section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor)… in other words, the exception in section 1411(c)(4) is only applicable where property is held in a trade or business."

[34] For NIIT purposes, the trade or business of a trader trading in financial instruments is defined in Treas. Reg. § 1.1411-5(c)(1) and Treas. Reg. § 1.1411-5(c)(2).

[35] Section 469(c)(1).

[36] Treasury Reg. § 1.1411-5(a)(1) and Treas. Reg. § 1.1411-5(a)(2).

[37] The preamble to the proposed regulations states "Section 1411's statutory language and legislative history do not provide a definition of trade or business. The most established definition of trade or business is found under section 162(a), which permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. The rules under section 162 for determining the existence of a trade or business are well-established and there is a large body of case law and administrative guidance interpreting section 162's meaning of trade or business.

4. Other Guidance

There are several other underlying provisions under Chapter 1 that support the AICPA's recommendation on the treatment of gains and losses associated with the disposition of interests in S corporations and partnerships:

- Section 864 codifies the position that the aggregate theory applies to the sale of a partnership interest and that you look through the entity to the underlying assets to determine the appropriate treatment. [38]

- When determining adjusted taxable income for section 163(j) purposes, any gain resulting from the disposition of a passthrough entity that holds a mixture of non-excepted trade or business assets and investment assets, is allocated proportionately by reference to the entity's underlying assets.[39]

5. Application to Gains Recognized on Distributions

Distributions from passthrough entities are generally non-taxable to the recipient partner or shareholder. In certain circumstances, partners or shareholders may recognize either gain or loss on receipt of a distribution from a passthrough entity. Such gain or loss is generally treated as capital gain or loss from the sale or exchange of the passthrough entity interest.[40] Treasury and the IRS should confirm that the application of section 461(l) to capital gain or loss recognized on distributions from passthrough entities is governed by the same principles as the sale or exchange of interests in passthrough entities discussed above.

6. Section 751 Gains

Section 751 provides that a partner must recognize ordinary income or loss to the extent any money or the fair market value of any property received on the sale or exchange of their partnership interest is attributable to unrealized receivables or inventory ("hot assets"). If this provision applies, then the amount realized attributable to hot assets is considered to be from the sale or exchange of property "other than a capital asset."[41] The difference between the amount of capital gain or loss that the partner would have recognized in the absence of section 751, and the amount of ordinary income or loss actually recognized, represents capital gain or loss on the sale or exchange of their partnership interest.[42]

Treasury and the IRS should clarify that any ordinary gain or loss recognized by a partner upon the sale or exchange of a partnership interest under section 751 is included in the EBL calculation

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The proposed regulations incorporate the rules under section 162 for determining whether an activity is a trade or business for purposes of section 1411 and the proposed regulations. The use of the section 162 definition of trade or business facilitations administration of section 1411 and should simplify taxpayer compliance."

[38] Section 864(c)(8); Rev. Rul. 91-32.

[39] See Treas. Reg. § 1.163(j)-6(e)(3) and Treas. Reg. §1.163(j)-10(b)(4)(ii).

[40] See generally section 302(a), section 331(a), section 731(a), section 741, and section 1368(b).

[41] Treasury Reg. § 1.751-1(a)(1).

[42] Treasury Reg. § 1.751-1(a)(2).

under section 461(l)(3)(A) and is not considered gain or loss on the sale of a capital asset pursuant to section 461(l)(3)(B). Such treatment would be consistent with analogous guidance under Treas. Reg. § 1.199A-3(b)(1)(i), which provides that section 751 gain or loss is considered attributable to the trades or businesses conducted by the partnership for purposes of computing qualified business income.

7. Example – Interplay Between Section 461(l) and Gain on Disposition of S-Corporation Interest

In Year One, Shareholder A (an unmarried individual) contributes $4 million to ABC Corporation, an S-Corporation, in exchange for a 10% ownership interest. ABC Corporation is a start-up manufacturing company engaged in a section 162 trade or business. Shareholder A does not materially participate in the operations of ABC Corporation under section 469(h) and holds Shareholder A's interest in the activity as a passive investor. Throughout the life of Shareholder A's investment in the activity, Shareholder A is allocated ($2.5 million) of ordinary business losses from ABC Corporation. Shareholder A has sufficient stock basis under section 1366(d) and at-risk basis under section 465 to deduct Shareholder A's share of losses from the activity. However, because Shareholder A has no other sources of passive income (or passive losses) other than Shareholder A's ownership interest in ABC Corporation, Shareholder A is unable to deduct Shareholder A's distributive share of ordinary business losses from the activity under section 469 during the years at issue. At the end of Year Five, Shareholder A has a PAL carryover of $2.5 million.

At the beginning of Year Six, Shareholder A sells Shareholder A's entire 10% interest in ABC Corporation to Shareholder B, an unrelated party, for $4.4 million. At the time of sale, Shareholder A's stock basis in ABC Corporation is $1.5 million (i.e., $4 million original investment reduced by Shareholder A's ($2.5 million) allocable share of prior-year losses). Shareholder A both realizes and recognizes a long-term capital gain of $2.9 million on Shareholder A's disposition of ABC Corporation stock (i.e., $4.4 million sales proceeds less $1.5 million stock basis). In addition, because Shareholder A disposed of Shareholder A's entire interest in ABC Corporation in a fully taxable transaction to an unrelated party, his $2.5 million PAL carryover is treated as a loss not from a passive activity under section 469(g)(1). Shareholder A has no other sources of income or loss other than Shareholder A's $600,000 salary from XYZ Company, where Shareholder A works as an employee.

Based on the above fact pattern, it is unclear whether Shareholder A's $2.9 million long-term capital on the disposition of ABC Corporation is considered gross income or gain attributable to a trade or business under either section 461(l)(3)(A) or section 461(l)(3)(B). If the $2.9 million long-term capital gain is not considered gross income or gain attributable to a trade or business, then Shareholder A has an excess business loss of ($2,250,000), i.e. ($2.5 million) of prior year released PALs, plus $250,000. Shareholder A's $600,000 salary from XYZ Company is not considered trade or business income under section 461(l)(3)(A) and cannot be used to absorb any portion of the excess business loss. As a result, Shareholder A would report $2,650,000 of taxable income from Shareholder A's sale of ABC Corporation stock despite only having $400,000 of economic income from the sale. See Table 1 and Table 2 below.

Under section 461(l)(2), the ($2,250,000) excess business loss carries over to subsequent years as a section 172 NOL and is eligible to offset up to 80% of taxable income. If Shareholder A's sole source of income in the carry-forward years is Shareholder A's $600,000 salary from XYZ Company, then Shareholder A would effectively be limited to claiming ($480,000) of the excess business loss (now an NOL) in each carry-forward year, i.e. 80% of taxable income or $600,000 × 80% (ignoring standard and itemized deductions). As a result, it may take Taxpayer A over 5 years to receive the full benefit of Shareholder A's loss deduction from ABC Corporation.

Our recommendation to include any gain or loss from the disposition of an interest in an S corporation or partnership interest as business income under either section 461(l)(3)(A) or section 461(l)(3)(B) when the entity conducts a trade or business would prevent this inordinate result. If Shareholder A's $2.9 million gain on the disposition of ABC Corporation is considered gross income or gain attributable to a trade or business, then Shareholder A is no longer in an excess business loss position in Year Six; Shareholder A's $2.9 million gain offsets Shareholder A's ($2.5 million) released PAL, resulting in net business (and economic) income of $400,000. This result makes even more sense given that Shareholder A's ($2.5 million) distributive share of losses from ABC Corporation reduced Shareholder A's stock basis in the entity from $4 million to $1.5 million, which largely contributed to Shareholder A's $2.9 million long-term capital gain on disposition.

Characterizing gain or loss on the disposition of an S corporation or partnership interest as either business or nonbusiness income based on the underlying activity of the interest being disposed of would also create consistency with other provisions of the Code, specifically the passive activity (section 469), at-risk (section 465), and NIIT (section 1411) rules. For example, Treas. Reg. § 1.469-2T(c)(2)(i)(A) provides that any gain recognized upon the sale, exchange, or other disposition of an interest in an activity held through a partnership or S corporation is treated as gross income from the activity in the year in which such gain is recognized. Treasury Reg. § 1.469-2T(e)(3)(ii)(A) also provides that if a holder of an interest in a passthrough entity disposes of such interest, then a ratable portion of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in "each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date."

The at-risk rules provide similar guidance. Proposed Reg. § 1.465-12 states that income received or accrued from an activity includes "gain recognized upon the disposition of the activity or an interest in the activity in accordance with (Prop. Reg.) §1.465-66." Finally, both section 1411(c)(4) and Prop. Reg. § 1.1411-7(a)(3) provide that any gain or loss recognized on the disposition of an interest in a partnership or S corporation is not subject to the NIIT if the passthrough entity was engaged in at least one section 162 trade or business (other than trading in financial instruments) and the section 162 trade or business was a not a passive activity with respect to the taxpayer.

Thus, any gain or loss recognized on the disposition of a partnership or S corporation interest is generally characterized in the same manner in the passive activity (section 469), at-risk (section 465), and NIIT (section 1411) contexts. If the gain or loss recognized on the disposition of a partnership or S corporation is not characterized as either business or nonbusiness income for section 461(l) purposes by reference to the underlying activity (or activities) of the entity being

disposed, then it would represent a departure from established tax principles and create inconsistencies between several areas of the Code.

Table 1 – Taxable Income from Sale of ABC Corporation Stock

Taxable Income Calculation	Gain is Not Business Income	Gain is Business Income
Gain on Disposition of ABC Corp. Stock	$2,900,000	$2,900,000
PAL Carryover Allowed	($2,500,000)	($2,500,000)
Excess Business Loss Limitation*	$2,250,000	N/A
Taxable Income	**$2,650,000**	**$400,000**

Table 2 – Excess Business Loss Calculation

Excess Business Loss Calculation	Gain is Not Business Income	Gain is Business Income
Gain on Disposition of ABC Corp. Stock	$0	$2,900,000
PAL Carryover Allowed	($2,500,000)	($2,500,000)
Total Business Income / (Loss)	($2,500,000)	$400,000
Maximum Loss Allowed	$250,000	$250,000
Excess Business Loss Limitation*	**$2,250,000**	**N/A**

E. *Clarify the Treatment of Pre-2018 Capital Loss and Gain Carryforwards*

The instructions to Form 461 provide in relevant part that "if you had losses or deductions that were limited under other provisions of the Internal Revenue Code in prior tax years, those losses or deductions are included in figuring the amount, if any, of your excess business loss." Based on this guidance, a taxpayer who recognizes a business operating loss carried forward from pre-2018 years due to the passive loss, basis, or at-risk considerations (section 469, section 465, section 1366(d), or section 704(d)), or suspended losses of former passive activities (section 469(f)(3)) is required to include such losses in their EBL calculation in the current tax year.

Treasury and the IRS should clarify that all gains and losses from pre-2018 years that are recognized in the current tax year, including installment sale gains from pre-2018 business capital transactions, are included in the determination of an EBL. To the extent any pre-2018 gains and losses are excluded from the EBL calculation, guidance would be needed to provide for ordering rules when such amounts are co-mingled with business income, gains and losses occurring in 2018, and thereafter.

V. Treatment of Qualified Plans

Recommendations

The AICPA recommends that Treasury and the IRS:

A. Clarify that self-employed contributions to retirement plans are non-business deductions for section 461(l) purposes, following section 172 principles on the NOL deduction.[43]
B. Provide guidance that distributions from qualified retirement plans, including income inclusion from Roth Individual Retirement Account (IRA) conversions, are non-business income items excluded from the definition of business income.[44]

Analysis

The treatment of qualified plans should follow section 172 principles. This suggestion is consistent with our recommended adoption of the general NOL operating principles.

VI. Treatment of Industry Specific Issues

Recommendations

The AICPA recommends that Treasury and the IRS provide guidance on the treatment of the following industry specific issues under section 461(l):

A. Provide Guidance on Treatment of Traders in Financial Instruments and Commodities
B. Provide Guidance on Exempt Organization Unrelated Business Taxable Income (UBTI)

Analysis

A. *Provide Guidance on Treatment of Traders in Financial Instruments and Commodities*

Guidance is needed to address the section 461(l) treatment of trader funds.[45] Trader funds generate predominantly investment income (as defined in section 163(d)), but such income is earned in the ordinary course of the fund's trade or business. As discussed in the prior section, the determination of what constitutes business gains and the treatment of losses is of particular importance to this particular industry.

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[43] Treasury Reg. § 1.172-3(a)(3)(iv) provides that: "Any deduction allowed under section 404, relating to contributions of an employer to an employees' trust or annuity plan, … to the extent attributable to contributions made on behalf of an individual while he is an employee within the meaning of section 401(c)(1), shall not be treated, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business, but shall be treated as a non-business deduction."

[44] See Form 1045, *Application for Tentative Refund*, Schedule A, Line 7 (classifying IRA and pension income as non-business income).

[45] For this purpose, a "trader fund" in one described in section 1.469-1T(e)(6), regardless of whether such a fund makes a section 475(f) election. *See also* Rev. Rul. 2008-12.

Section 461(l) should provide guidance that business income includes items of income, gain and deduction generated from trader funds, regardless of whether the funds make section 475(f) elections.

Guidance should also include an example to illustrate that interest, dividends, and other types of investment income (within the meaning of section 163(d)) are included in a taxpayer's EBL calculation when originating from a trader business.[46]

B. *Provide Guidance on Exempt Organization UBTI*

As a result of TJCA's change to determining UBTI on a business-by-business basis, the business losses may not offset business income. Therefore, section 461(l) is unnecessary for exempt organizations subject to the business-by-business computations of the NOL. Treasury and the IRS should provide that the provisions of section 461(l) do not apply when calculating UBTI.

VII.Application to Trusts and Estates

Recommendations

The AICPA recommends that Treasury and the IRS provide guidance on the application of section 461(l) to trusts and estates as follows:

A. Clarify the Treatment of Suspended PALs
B. Provide Guidance on the Application of Section 461(l) to the Final Year of an Estate or Trust
C. Clarify The Treatment of Electing Small Business Trusts (ESBTs)
D. Clarify The Treatment of Charitable Remainder Trusts (CRTs)

Analysis

A. *Clarify the Treatment of Suspended PALs*

Treasury and the IRS should provide that suspended PALs, allowed solely by reason of death of a taxpayer, are exempt from the application of section 461(l). If there is no exception for the year of death for a taxpayer, previously suspended PALs that exceed the decedent's $250,000 limitation are disallowed. In a year other than the year of death, the EBL is considered part of the taxpayer's NOL under section 461(l). In the year of death, the newly created NOL would not carry over to the decedent's estate.[47] Further, due to the new NOL rules enacted by the Act, a taxpayer can no longer carry back an NOL to offset prior years' income. It appears under the Act, in the event that PALs are allowed on the decedent's final return – but get included in the EBL calculation that results in a suspension – they are essentially lost at death.

[46] For this purpose, the example should include both income and deduction from trader funds as well as individuals that are engaged in trading section 1256 contracts.
[47] Rev. Rul. 74-175.

As an alternative, if section 461(l) was to apply to suspended PALs in the year of death, guidance could also provide that the estate succeeds to the NOL created by reason of section 461(l).[48]

B. *Provide Guidance on the Application of Section 461(l) to the Final Year of an Estate or Trust*

Similar to the situation discussed above regarding the death of an individual, the application of the excess loss limitation in section 461(l) is important in the year of termination for a trust or estate. Based on the language under the Act, if an estate or trust has a loss in the final year that exceeds the $250,000 limit, any EBLs are added to the NOL carryforward. However, in the final year, there is no subsequent year for the NOL.[49]

Any NOLs remaining in the year of termination of an estate or trust are passed out to the succeeding beneficiaries.[50] Treasury and the IRS should apply section 461(l) in one of two ways during the final year of an estate or trust. One option is to provide that section 461(l) does not apply in the final year of an estate or trust. Alternatively, the other option is to offer guidance that the NOL created by section 461(l) is treated as arising in the beneficiary's succeeding year following the mechanics of section 642(h).

C. *Clarify the Treatment of ESBTs*

In the case of an ESBT, the provisions would likely apply on the S portion and the non-S portion independently. Given that the two portions of an ESBT are deemed separate trusts,[51] the S portion of the trust will compute the section 461(l) limitation separately at the shareholder level without regard to the income generated by the non-S portion of the trust. Guidance should specifically state that each portion of the ESBT will have separate $250,000 limitations and separate EBL calculations during each tax year.

D. *Clarify the Treatment of CRTs*

Section 461(l) should logically apply to a CRT, but it is unclear how the NOL provision would operate when a CRT cannot have an NOL.[52] Assuming that the definition of income or gain "attributed to trades or businesses" as defined in section 461(l) applies to the income a CRT receives and the trust is able to calculate a business loss under section 461(l), any losses in excess of the $250,000 limit is lost due to the disallowance of NOLs for CRTs. Further, it is unclear how the rules in section 461(l) will interact with the income tier rules applicable to CRTs.[53] Therefore, given this uncertainty, guidance is needed to clarify that section 461(l) does not apply to CRTs.

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[48] We appreciate that an estate succeeding to an NOL of the decedent is inconsistent with the general NOL operating rules that are recommended above.

[49] This same issue would arise in the final year of the S portion of an ESBT. Under section 641(c)(4), any EBLs limited under section 461(l) is added to the NOL carryforward of the S portion and allowed as a deduction for the non-S portion of the trust in future years.

[50] Section 642(h).

[51] Section 641(c).

[52] *See* Treas. Reg. § 1.664-1(d)(1)(iii)(a).

[53] Section 664; Treas. Reg. § 1.664-1(d)(1).