

Tax Cuts and Jobs Act Excess Business Loss and Net Operating Loss (NOL)



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The Tax Cuts and Jobs Act is the biggest federal tax law change in over 30 years. Below are significant changes affecting excess business losses and net operating losses (NOLs) for noncorporate taxpayers. **Note:** Except where noted, the changes are effective for tax years 2018–2025.

New Excess Business Loss Limitation

Under the new law, certain excess business losses of noncorporate taxpayers are not allowed.

An excess business loss is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trade or business over the sum of the aggregate gross income or gain attributable to the trade or business of the taxpayer plus a \$250,000 (\$500,000 if Married Filing Jointly) threshold amount, indexed for inflation. Any excess loss that is disallowed is treated as part of the taxpayer's NOL carryforward.

Example: George has \$500,000 of gross income and \$800,000 of deductions from his retail furniture business. His excess business loss is \$50,000 [$\$800,000 - (\$500,000 + \$250,000)$]. George must treat his excess business loss of \$50,000 as an NOL carryover to 2019.

Pass-Through Entities

For pass-through entities (partnerships and S corporations), the excess loss limit applies at the partner and shareholder level. Each partner's or shareholder's share of the items of income, gain, deduction, or loss of the partnership or S corporation is taken into account by the partner or shareholder in applying the excess business loss limitation.

Passive Activity Loss Rules

The excess business loss limit is applied after the passive loss rules. Under the passive activity rules, losses and expenses attributable to passive activities may only be deducted from passive activities. Generally, passive activities are those in which a taxpayer may own an interest in the business, but does not materially participate. Some activities are considered passive by default, such as rental activities.

Net Operating Loss (NOL)

A net operating loss (NOL) generally means the amount by which a taxpayer's business deductions exceed gross income.

An individual, estate, or trust may have an NOL if deductions for the year exceed income. NOLs are caused by losses from the following:

- Trade or businesses (Schedules C and F losses, or Schedule K-1 losses from partnerships or S corporations),
- Deductions for work as an employee (Form 2106) prior to 2018,
- Casualty and theft losses (whether personal or business),
- Moving expenses, and
- Rental property (Schedule E).

Individual NOL

An individual may have an NOL if adjusted gross income (AGI) minus the standard deduction or itemized deductions is a negative amount, and the negative amount is due to business deductions exceeding business income.



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Estate or Trust NOL

An estate or trust may have an NOL if the taxable income line on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, is a negative amount, and the negative amount is due to business deductions exceeding business income.

Once the NOL has been calculated for the year, it is used to offset income from another tax year.

Prior Law

Under prior law, the default rule required an NOL to be carried back two years unless an election to waive the carryback was made. If the NOL was not used up in the carryback year, it was carried forward to the following year. If not used up in that year, it continued to be carried forward until it was used up. The longest it could have been carried forward is 20 years after the NOL year.

Different carryback periods apply with respect to NOLs arising in different circumstances, such as for farming losses (5-year carryback). Extended carryback periods are allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses. Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions.

New Law

Effective for losses arising in tax years beginning after 2017, the NOL deduction is limited to 80% of taxable income (taxable income for the year in which it is carried to, determined without regard to the NOL deduction), which means NOLs can no longer completely zero out taxable income. This 80% limitation does not apply to a property and casualty insurance company.

When computing a taxpayer's NOL, the new 20% qualified business income deduction is not taken into account.

Carryback. The new law repeals the 2-year carryback and other special carryback provisions. An exception provides a 2-year carryback in the case of certain losses incurred in the trade or business of farming.

Exception: Farming loss. Previously, farming NOLs were allowed a 5-year carryback. Under the new law, farming NOLs are allowed a 2-year carryback. The definition of farming NOLs remains unchanged and a taxpayer may still waive the carryback period.

Exception: Insurance company. The new law allows a 2-year carryback for NOLs of a property and casualty insurance company.

Carryforward. Any NOL carryover is adjusted to take into account the 80% of taxable income limitation, and may be carried forward indefinitely (until used up).

Exception: Insurance company. The new law provides a 20-year carryforward for NOLs of a property and casualty insurance company.

How to Calculate an NOL Carryover

If the NOL is more than taxable income for the year to which it was carried (figured before deducting the NOL), there may be an NOL carryover. Certain modifications must be made to taxable income to determine how much NOL will be used up in that year and how much may be carried over to the next tax year. The carryover is the excess of the NOL deduction over modified taxable income for the carryback or carryforward year. If the NOL deduction includes more than one NOL, apply the NOLs against modified taxable income in the same order they were incurred, starting with the earliest. Additionally, if an NOL consists of both a farming loss and a non-farming loss, the losses should be treated separately and the farming loss is treated as a separate NOL and taken into account only after the non-farming NOL is applied.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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