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It's All About That Basis: NOL Limitation Considerations for Noncorporate Taxpayers

As 2020 is coming to a rapid close and business losses are looming, noncorporate taxpayers should consider whether their businesses will generate net operating losses (NOLs), and whether any loss limitation rules will prevent them from utilizing these losses on their individual returns.

Several months ago, we alerted clients to the recent change in NOL rules. Under the CARES Act, NOLs generated in tax years beginning after December 31, 2017 and before January 1, 2021 (i.e., 2018, 2019 and 2020 for calendar year taxpayers), can be carried back five years, and carried forward indefinitely with no limitation.

For noncorporate taxpayers (such as individuals, estates or trusts that are partners, shareholders or members of a pass-through entity owner), there are three principle limitations on the deductibility of NOLs passed through to such owners: (1) basis limitations; (2) at-risk rules; and (3) passive activity rules.

Basis Limitations

The first limitation on the deductibility of a loss that is passed-through to a noncorporate taxpayer (e.g., a shareholder in an S corporation or a partner in a partnership) is adequate basis. In order to deduct a loss, an individual's basis must be equal to or in excess of the loss. An owner cannot deduct a loss in excess of basis. It is the owner's responsibility to adequately track their individual basis in a pass-through entity. Utilizing proper planning techniques, an owner may be able to increase their basis and thus take advantage of a loss that would otherwise be limited.

For partnerships, a partner can deduct a share of his or her partnership loss to the extent that such partner has sufficient outside basis immediately prior to the deduction of the loss. Outside basis can be increased through a contribution of cash or other property to a partnership or through an increase of such partner's share of the partnership liabilities. In other words, a partner obtains outside basis for debt of the partnership.

For S corporations, shareholders can also obtain both stock and debt basis. Stock basis can be increased by contributions of cash or other property to an S corporation. However, unlike the partnership context, a shareholder does not

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receive debt basis for debts owed by the S corporation to a third party. Rather, a shareholder only has debt basis to the extent he or she has personally lent money to the S corporation. A loan guarantee is not sufficient to obtain debt basis. In the event an S corporation shareholder has debt basis, and a loss that passes through to such shareholder exceeds his or her stock basis, the shareholder can deduct the loss to the extent of debt basis.

At the S corporation level, an NOL will result in a downward adjustment to the accumulated adjustments account (AAA), which measures the amount of previously taxed but undistributed earnings of an S corporation. Unlike shareholder basis, AAA can be negative but only due to a loss and deduction items. However, if AAA becomes negative, the S corporation must generate future income in an amount in excess of the negative balance before distributions can be made tax-free.

Partners and S corporation shareholders who have losses disallowed by reason of the basis limitation can carry forward such disallowed losses indefinitely. Disallowed losses will be allowed when the partner or shareholder has sufficient basis to take advantage of such loss.

Action Items:

- Noncorporate taxpayers should review their basis calculations to determine if they have sufficient basis to utilize any NOLs that will be generated in 2020.
- Noncorporate taxpayers who may not have sufficient basis should consult a Reinhart tax attorney about planning techniques that might be available to increase basis.

At-Risk Limitations

After considering whether there is adequate basis, a noncorporate taxpayer must consider the at-risk rules. The amount at risk is:

1. The money and adjusted basis of property an individual contributes to the activity; and
2. Amounts the individual borrows for use in the activity if the individual:
    1. Is personally liable for repayment; or
    2. Pledges property as security for the loan.

At-risk amounts are reduced by losses allowed in previous years, distributions received, a change in the character of debt from recourse to nonrecourse, and the initiation of a stop loss or similar agreement.

The amount at-risk is determined as of the end of each tax year with respect to each activity conducted by a partnership or S corporation. The at-risk rules then operate to limit the amount of loss an individual owner can deduct to an amount equal to that individual's amount at risk in the activity. Any disallowed loss is carried forward until the taxpayer has enough at-risk to allow the deduction. If losses are allowed, the losses are subject to recapture in later years if the individual's amount at-risk is reduced below zero.

Action Items:

- Noncorporate taxpayers should review their at-risk amounts and debt portfolios to determine if any changes have impacted their at-risk amounts.
- Noncorporate taxpayers who may not have sufficient basis should consult a Reinhart tax attorney about the planning techniques that might be available to increase their at-risk amount.

Passive Activity Loss Limitations

The third loss limitation that noncorporate taxpayers should evaluate is the passive activity rules. Generally, a loss generated by a passive activity for a tax year is not allowed unless there is corresponding passive activity income or the passive activity has terminated. A passive activity with respect to an individual generally includes (a) a trade or business in which the individual does not materially participate; and (b) rental activities unless the individual otherwise qualifies as a "real estate professional." A passive activity loss generated to the extent passive activity deductions exceed passive activity gross income. A passive activity loss may be utilized only to the extent of passive activity income; any remaining loss is disallowed. A disallowed passive activity loss is suspended and carried forward indefinitely. Suspended passive losses that have not been previously used are generally allowed in full in the tax year in which the individual disposes of their entire interest in the activity.

Action Items:

- Noncorporate taxpayers should evaluate whether they will have a loss subject to the passive loss rules.

If you have any questions regarding these NOL limitation considerations, please contact Michael Goller or another Reinhart tax attorney.