An Interview With David Kirk: Beware The New Excess Business Loss Limitation

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If you make your living in the tax world, you know David Kirk, even if you don't *think* you know David Kirk.

If you've ever applied for a late S corporation election, you know David Kirk. If you've ever computed a client's liability for the net investment income tax, you know David Kirk. And if you've ever been wowed by the acting chops on the guy who played Captain Kirk in that Star Trek-themed training video the IRS put out, well then, you know David Kirk.

IRS Star Trek Parody

OK, I made that last one up. But David Kirk is still one impressive dude.

After earning his undergraduate degree at Syracuse, Kirk added a law degree (University of Pittsburgh) and LLM (Georgetown) to his resume before joining the IRS as an attorney with the Office of the Chief Counsel. Within Chief Counsel, Kirk landed with the Passthroughs and Special Industries division, where he specialized in the treatment of partnerships, S corporations, estates and trusts.

While with the IRS, Kirk worked tirelessly to make our lives easier. He authored Revenue Procedure 2013-30 ??? which offers late relief from a missed S corporation, QSub, or entity classification election — sparing advisors from many a rough conversation with clients.

Kirk's magnum opus, however, was his work as the primary author of the regulations under Section 1411, the provision of the Affordable Care Act that imposes a 3.8% surtax on net investment income. At a time when practitioners were struggling to keep up with an abundance of new law – the repair regulations, the individual mandate, and the expiration of the Bush tax cuts, to name a few – Kirk's proposed and final regulations under Section 1411 provided much needed guidance in a way advisors could understand and implement.

In March of 2014, Kirk landed at Ernst & Young LLP, where he is now a National Tax Partner in the firm's Private Client Services group, and where he continues to focus primarily on the taxation of pass-through entities. While at EY, Kirk has continued to help the tax world make sense of the net investment income tax, authoring the Bloomberg-BNA Tax Management Portfolio on Section 1411.

But here's what's most impressive about David Kirk: he *cares* about this stuff. When Kirk published the proposed Section 1411 regulations five years ago, I endeavored to analyze and write about them for Forbes. I published a 4,000 word article, and the first piece of feedback I got was from….David Kirk. He reached out to me to offer his thoughts, letting me know what areas of the law I had interpreted correctly, and more importantly, where I may have been a bit misguided or misinterpreted his intent. Kirk viewed my article as a conduit between his work and the very people who would be

tasked with implementing it, and he wanted to make sure I got it right. It was a startling display of commitment to one's craft.

Kirk and I have stayed in touch over the years, and when the-bill-commonly-called-but-not-really-named The Tax Cuts and Jobs Act was passed on December 22, 2017, signifying the most comprehensive overhaul of the tax law in 31 years, I knew I wanted his take on what it all means.

In January, we got together and talked about everyone's least favorite tax reform topic: new Section 199A. Today, we take on something completely different, but just as confusing. Let's take a look…

Tony Nitti: DK, it's good to talk tax reform with you again. But before we jump into that, can we address the elephant in the room? How is it possible that of the THREE universities you attended — all of which were historically prominent basketball schools — it is more likely than not that NONE of them will will be participating in March Madness? I blame you.

David Kirk: Hey, don't blame me. Blame the fact that if you look at the recent reports alleging that college basketball programs are making illicit six-figure payments to procure top recruits, NONE of my schools are on the list. You've gotta' pay to play in today's NCAA, and my three alma maters prefer to invest in their accounting, tax, and law programs. I do not support this decision.

Nitti: Fair enough. Last time we got together, we beat up tax reform in general, but spent the bulk of the conversation on everyone's favorite topic: Section 199A. But while the new 20% deduction is garnering all of the headlines, I thought we could spend today talking about a less-publicized but potentially more painful provision of the new law: Section 461(l), the "excess business loss rules." In simple terms, under this new rule, a taxpayer will only be able to deduct net business losses of up to $250,000 ($500,000 in the case of a joint return), regardless of how much non-business income he or she might have. But as with all things in the TCJA, nothing is as simple as it seems. So…what are we really dealing with here?

Kirk: At its core, Section 461(l) it is a loss disallowance provision. It operates *after* the three limitation provisions that already stood between a taxpayer and the ability to use business losses: including…

Nitti: …Ooh, ooh, I know this one!…You mean the limitations based on 1) the owner's "tax basis" in the entity (Section 1366/Section 704), 2) "at-risk basis" (Section 465), and 3) the passive activity rules (Section 469), right?

Kirk: Your answer, while correct, isn't particularly impressive considering this interview was written, edited, and then published to the internet. Who's to say you didn't just Google the answers and plug them in there to make yourself look smart? I digress, and begrudgingly admit that, yes, you got it right. Now, we have a *fourth* limitation before we can use a business loss, which is fairly eye-opening when you consider than in The Last Crusade, Indiana Jones only had to overcome THREE gauntlets to obtain the grail. So if the movie is to be believed — and I have no reason to believe it isn't — in the current climate it is more difficult to use a business loss than claim the cup of Christ. Seems fair.

Nitti: Those Indiana Jones flicks were good watchin', or at least until Shia Lebouf managed to single-handedly undo three decades worth of cinematic goodwill with his performance in that Crystal Skulls abomination. Thinking back, the at-risk and passive loss limitations were used to kill off the tax shelters of their day. What shelter is this trying to shut down?

Kirk: If you read the committee report, it doesn't talk about shutting down a shelter. Honestly, I don't know why we needed this, but it does work differently that the others. As you described, it basically says that net losses in excess of $500,000 (for joint returns, $250,000 for everyone else) are disallowed in the current year. Any "excess business loss" (EBL) above those amounts is carried forward, and becomes a net operating loss in the following year.

Nitti: Why would this be so painful? If the EBL becomes a net operating loss, wouldn't it really just result in a one year deferral?

Kirk: In many cases, it is a deferral. If you have a loss of $900,000 and only $500,000 is allowed, $400,000 becomes an NOL in the next year. But don't forget, under the TCJA, newly created net operating loss carryforwards are now limited to offsetting only 80% of taxable income. And, of course, if you add a zero to all of the amounts in our example such that the disallowed amount is $4 million and the taxpayer needs to write a check for $1 million, the concept of "it's just timing" is of little consolation.

as eight years…because remember, all of the individual provisions of the TCJA, including Section 461(l), expire on December 31, 2025. The time value of money of $1 million in tax over eight years will make almost anyone cranky.

But in some cases, it is a permanent loss.

Nitti: Surely you can't be serious?

Kirk: I am serious, and don't call m…eh, you know how it goes.

OK, think about it, if you incur an EBL in the year of death, what happens? A decedent's NOL disappears after the filing of their last return and does not transcend death and land on the estate's income tax return. Of course, prior to the 80% NOL limit nonsense in effect for 2018 and forward, large losses incurred on the decedent final year return could be carried back to the preceding two years, so there was hope. But now there is none. So maybe the IRS could simply turn off the application of this provision in the year of death? Who's going to argue with that? The deceased surely won't. And if they do somehow, then we've got bigger problems, because now we're communicating with the dead about tax law rather than more important stuff, like who secretly murdered them.

I guess the other alternative is to have the NOL carryover show up on the first income tax return of the estate. That is a little more technically difficult because it would be the only situation where a deferred income tax attribute transcends death.

Of course, there exists the very real possibility that Congress intended all of this to be nothing more than a huge budget gimmick. Think about it: if the deferred loss is finally allowed in a year outside the 10 year budget window for TJCA (like in 2026 or after), the lost revenue doesn't count against the score of the bill. So is it really is just a congressional shell game? *Aaaahh! Turn it off man, turn it off! It's sucking my will to live! Oh, the humanity!* Sorry, it just seemed like an appropriate time for a line from Wayne's World.

Nitti: The only thing more depressing than Section 461(l) is the fact that neither you nor I appear capable of quoting a movie that was made after the turn of the century. OK, so maybe it's a deferral, maybe it's not. But there has to be more to it.

Kirk: As with many aspects of the TCJA, the toughest part of Section 461(l) is the definitional uncertainty. It appears that the limit applies on a net basis across all businesses of the taxpayer. But the difficulty is that we are stressing out over what is "business income" and what are "business losses," and how do they net?

Nitti: Give me an example: assume you had a loss from a Schedule C and income from a partnership K-1. It is only after netting the two that we look at whether we are at a loss in excess of the $500,000/250,000 threshold, right?

Kirk: Yes, but that's an overly simplistic example. It would be relatively easy if I could just say that if the sum of my Schedule C, E, and F have net losses of greater than $500,000, the excess turns into an NOL for the following year. But that's where we have to stretch our minds a bit into the outreaches of tax theory.

How do we think about this? In theory — and this helps my mind make sense of it all — we need to consider this new provision as a half-brother of the NOL.

First, we'll start off with a seemingly easy question. How should wages or guaranteed payments be treated? Are they gross business income that should be taken into account when netting losses? I mean, they have only been considered business income for a generation or two; why stop now? So I say they should, and business losses should be allowed against wages and guaranteed payments from the business generating the losses.

But if guaranteed payments and Schedule C income are business income, what do we do about the above-the-line deductions associated with those types of business income? For example, would deductions for ½ of self-employment tax, self-employed health insurance, and qualified plan

would think that other business deductions, like above-the-line interest expense allocable to a partnership or S corporation under Notice 89-35 would go into the calculation as well, as would other partner unreimbursed expenses. These seem like basic Tax-101 type questions, but they really have no answer at this stage.

Along those same lines, what about interest income reported on Schedule B : is that business income? If I was a partner in partnership that made bicycles, and the company earns $80 of interest on its checking account that is reported on Schedule K, is that business income for this purpose? If you asked a layperson, they'd say yes. If you ask a Section 469/1411 person; they'd say no, it's portfolio income.

What about itemized deductions? Most of the itemized deductions are probably not much of an issue, but even though state and local income taxes have been severely limited, up to $10,000 remain deductible. Ever since 1970, state income taxes allocable to a trade or business are business deductions for NOL computation purposes. So do I have to do the same here?

That was the easy part, so let's up the game. What about ordinary gains and losses reported on Form 4797? Now, the fact that they are on the Form 4797 seems to point to a business-connectivity. So the sale of "business assets" should probably generate business income for purposes of Section 461(l), no?

Nitti: I think I see where you're going with this, and yes, I would argue that if a business sells business assets, any resulting gain or loss should be included in business income for purposes of Section 461(l). But what about a gain or loss on the sale of the business itself? Should that be taken into account in the EBL calculation?

Kirk: Great question. When you sell a partnership interest, and that partnership has hot assets, the gain associated with your share of those assets is converted to ordinary income and the remainder is capital. If Section 751 assets, when triggered by the partnership itself would generate ordinary business income, then it would seems that any gain on the sale of a partnership interest that is recharacterized as ordinary income under the hot asset rules should be treated as business income. But what about the remaining capital gain or loss, or the gain or loss on the sale of S corporation stock, where the hot asset rules have no applicability? What do we do about gains and losses?

When Congress enacted Section 1411, it included Section 1411(c)(4), which allowed gain or loss from the sale of S corporations and partnerships to be excluded from net investment income. The reason I am bringing that up is that, theoretically, it may be used to support the default presumption that gain or loss on the sale of a partnership or S corporation is not business income because individuals are not in the business of holding these interests. And while Section 1411(c)(4) provided a rule that allowed a selling taxpayer to overcome that presumption, because there is no such rule — at least as of today — in Section 461(l), does that mean that the default presumption holds true, and gain or loss on the sale of a partnership interest or S corporation stock is not business income?

On the other hand, if we look at passive activity and at-risk rules, the gain or loss when a taxpayer disposes of their interest in the activity IS taken into account under these provisions as if they originated in the business. So which is the better approach? Personally, I think the latter provisions makes more sense, and gain or loss on the sale of an interest in a business SHOULD be included in business income for purposes of the EBL rules.

Nitti: I agree completely. Moving on…in the Section 199A world there has been much discussion about whether Section 1231 gains should be included in QBI. Is the same true here? Should Section 1231 gains be considered business income?

Kirk: Does the fact that they can toggle between ordinary and capital matter? I think that it is reasonable to include Section 1231 gains and losses into the EBL calculation. But what happens to the Section 1231 gains that are capital? If the Section 1231 losses that are ordinary are included, it make sense that the gain are included, regardless of whether they are capital or ordinary.

Nitti: But if capital gains can go into the EBL calculation, what about capital losses?

Kirk: Capital losses are really nasty to think about, so it's probably time for your readers to get a double bourbon if they haven't done so already.

We'll start with the simple question, can capital losses be business income? It is possible that capital losses can be business losses because they are expressly dealt with in the NOL context. So they must exist.

So assuming they do, let start with the easy example. Imagine that I am a married taxpayer who has $200,000 of Schedule C income and a short-term capital loss from a business of $800,000. What is my EBL? If I have no other capital gains, I am allowed $3,000 of my loss against my $200,000 of schedule C income. So do I even have an excess business loss? Maybe not.

But do I look at the capital loss before or after the $3,000 limitation? In theory, $797,000 is a short term capital loss next year; should that be tracked as a business related loss? That is what we did with the net investment income tax rules on capital losses in the 2013 proposed regulations. The rule made it relatively simple to track the loss rolling forward. It was maybe two sentences, but the example to illustrate the rule was like 4-5 pages single spaced. So maybe we don't want to do that all over again?

But what happens if we look at EBL before the $3,000 limit? So I have $200,000 of net business income and $800,000 of loss; so I have a net loss of $600,000 for the year. Does that mean I allow

Where the mind really bends is if the capital loss is long term. Assume the same facts, except the $800,000 loss is long term. Now, assume that I sold my beach house for a $950,000 long term capital gain.

Now this is where you look down into the abyss and it stares back. In this example, I have $200,000 of business income from Schedule C and $800,000 loss that is fully taken into account in computing taxable gain during the year. My net long term gain is $150,000. If the $800,000 loss is a business loss, I can only use $700,000 of the loss (because after netting with the $200,000 of Schedule C income, it brings my net business loss to $500,000), and I suspend $100,000. If I do that, my $950,000 gain on the beach house is offset by only $700,000 of business long term loss. That would make my taxable gain in the current year to be $250,000, not $150,000. Ok, but does my $100,000 EBL carry forward as a long-term capital loss, or as an NOL? If it's the latter, I just turned a long-term capital loss of $100,000 into an ordinary deduction in the form of an NOL. If so, I'd take an NOL over a long-term capital loss any day.

But I no longer have the power of the pen to create & implement tax systems. So someone else is going to make that call.

Nitti: They'll have to do it soon, no?

Kirk: That's the rough part. This provision is not on the revised guidance priority list. That doesn't mean the IRS is not doing anything with it; it just means that it is not a priority. But they probably have until late summer to do something about it.

Nitti: Why late summer?

Kirk: It's all about the forms. You probably need a new form for this. if that is the case, the software folks are going to need to start programming something – on both the IRS side and the commercial software vendor side.

this:

1	Enter Amount from Schedule C
2a	Enter Amount from Schedule E
2b	Enter amounts reported on Schedule E that are not associated with a trade or business
2c	Net Schedule E Business Income (Loss) [combine line 2a with 2b]
5	Enter Amount from Schedule F
6	Enter Amount from Form 4797
7a	Enter Amount from Schedule D
7b	Enter amounts reported on Schedule D that are not associated with a trade or business
7c	Net Schedule D Business Income (Loss) [combine line 7a with 7b]
8	Wages
9	Enter other business income or deductions not reported on Lines 1-8
10	Add lines 1-9
11	Enter ($500,000) or ($250,000)
12	Is the loss on Line 10 greater than the amount on Line 11? If no, then stop. You have no excess business loss. If yes, enter the difference between line 10 and line 11 here. Enter the amount from line 12 on your 2018 Form 1040, line 21 an increase to income. Enter the amount from line 12 on your 2019 Form 1040, line 21 as a Net Operating Loss

Nitti: That actually looks pretty straightforward. Couldn't you just have given me this at the start and saved 4,000 words?

Nitti: I really don't want to ask this question, but I fear I must: does Section 461(l) apply to trusts and estates, and if so, how?

Kirk: I think conventional wisdom would say that this does apply to estates and trusts because they compute taxable income in the same way as an individual, unless specifically directed to do otherwise. And I don't see a direction to do otherwise.

Once you think you have the general rule of engagement figured out for this beast, nongrantor trusts will test your patience, and the application to charitable remainder trusts may cause you to throw your computer out the window. So for simplicity, I just use "trust" as a proxy for simple trusts, complex trusts, and estates.

So if we start with the premise that this provision applies to trusts, then the general rule should apply to convert EBLs into NOLs that can be used by the trust. Not really rocket science. But what happens if a trust incurs an EBL in the final year? There is no next year to carry the NOL to. In my mind, there are three possible outcomes:

- The EBL disappears. Now that is really uncool.
- The EBL is treated as an NOL that succeed to the property under the mechanics of Section 642(h). That is a viable possibility, but the IRS would have to activate, for lack of a better word, that concept in guidance because I am not sure it happens naturally.
- The EBL rule could simply not apply in the final year. Although this sounds like a good idea, it would likely require the IRS to exercise some authority to bend the statute. But is this really a good idea? The potential problem with this, if the EBL is large enough to cause the entire trust to have a loss in the final year, that loss is passed out to the beneficiary under Section 642(h). But then that excess loss becomes a miscellaneous itemized deduction which is disallowed between 2018 and 2025. So after all of that, in some cases, the answer is functionally the same as the first outcome.

The other issue for trusts is what to do with Electing Small Business Trusts (ESBTs). These trusts are a little bizarre because they are treated as two separate trusts for income tax purposes. So the nature question is whether the trust tests for the $250,000 EBL limit on the S side and the non-S side? Or does the entire trust only get one $250,000 threshold. I think if you literally apply the existing legal fiction of ESBTs, you should get two separate thresholds. And by the way, I think the same logic applies to the $10,000 limit on state tax deductions – each side probably should get its own $10,000 limit, subject to the reasonable allocation rule.

The real head scratcher is what do with charitable remainder trusts (CRT). CRTs cannot have NOLs. They are really accumulation mechanisms where income is deferred and accumulated until money is distributed to the non-exempt beneficiary. Now, EBLs in a CRT will be really rare because EBL tend to be from businesses, obviously, and CRTs are subject to 100% tax on unrelated business taxable income. But it still could happen because a trust could hold trade or business assets that do not generate UBTI, such as rental real estate. So assume the CRT generates $800,000 of interest income and $600,000 of rental loss, what should happen (setting aside passive loss limitation)? In 2017, the trust would accumulate $200,000 of net ordinary income that could be distributed to the beneficiary? In 2018, is the answer the same? Or does it only have $300,000 of income and $100,000 next year? If the current year distributions are less than $200,000, then the excess income will be rolled forward and reunite with the NOL. But that is just silly. Complexity for the sake of complexity. Why not just turn off this Section 461(l) silliness for CRTs and move on with our lives?

Nitti: I have no idea. This whole thing is mind blowing to me. It⋯s as if Congress just inserted the bare minimum language into the legislative text in order to establish the limitation, but gave no additional thought to how the rule would be implemented or who it would impact. And yes, I'm just cynical enough to believe that this was all just a budgetary gimmick: push the losses down the road and you reduce the cost of the TCJA, allowing it to sneak under the $1.5 trillion budget reconciliation limit. Then, deal with the consequences later. The real loser here, however, is YOU, Mr. Kirk, because every time I have a question on Section 461(l), I'm calling you. Sound good?

Kirk: Sure, but do me a favor…give me a few weeks. I have three separate alma maters about to battle it out in the NIT, hoping to lay claim to being the 69th best college hoops team in the land. Can't miss that.

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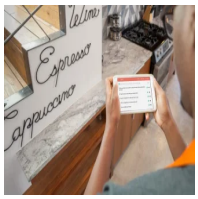

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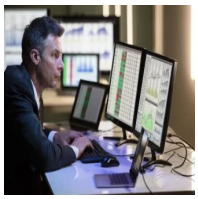

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