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A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part IV – Suspended Losses of an S Corporation

By Larry Brant on 3.6.24 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

This fourth installment of my multi-part series on Subchapter S is focused on suspended losses of an S corporation. While the rules seem straightforward, their application can be tricky, especially given legislative changes made in recent years.

Background

In general, S corporation shareholders, like the owners of entities taxed as partnerships, are allocated their share of the entity's losses for the taxable year. A number of rules, however, may limit the ability of the owners to deduct these losses.

For one, the aggregate amount of losses taken into account by an S corporation shareholder cannot exceed:

- the shareholder's adjusted stock basis; plus
- the shareholder's adjusted basis of any indebtedness owed by the corporation to the shareholder.[1]

Additionally, the losses being passed through to an S corporation shareholder must be tested under the at-risk[2] and then tested under the passive activity loss[3] rules before the losses may be used by the shareholder in determining his/hers/its taxable income.

Losses that are disallowed under either the at-risk or the passive activity loss rules are generally suspended and carried forward indefinitely until the shareholder has sufficient amounts at-risk, sufficient passive income or disposes of the shares of the S corporation. If a loss is not limited by these rules, however, it may be applied against the shareholder's other income.

TJCA Additional Limitation

The Tax Cuts and Jobs Act ("TCJA") imposed an additional limitation on an S corporation shareholder's ability to use losses passing through from the corporation.[4] To create this additional limitation, the TCJA amended Code § 461, which imposed certain limitations on the amount of any deduction allowable for the taxable year.

PRACTICE ALERT: These new rules equally apply to other non-corporate taxpayers, such as entities taxed as sole proprietorships and partnerships.

For taxable years beginning after December 31, 2017, Code § 461(l) disallows something called "excess business losses," which are passed through to an S corporation shareholder.[5]

For this purpose, an "excess business loss" for the taxable year in the case of an S corporation is the excess of the shareholder's aggregate deductions attributable to all of the shareholder's trades or businesses for the year, over the sum of the shareholder's aggregate gross income or gain for the year, plus $250,000 (or $500,000 in the case of a joint return).[6]

The limitation imposed by Code § 461(l) is applied after the passive activity loss limitations under Code § 469.[7] Further, it is applied at the shareholder level.[8]

PRACTICE ALERT: There is a trap lurking in the Code that may catch the unwary if they are not careful. An S corporation shareholder may have losses that have been historically suspended from use due to the application of the at-risk or the passive activity loss rules that are now (after December 31, 2017) available for use (no longer suspended) but may continue in suspension due to the application of Code § 461(l). Taxpayers planning for losses suspended by Code §§ 465 and 469 need to consider the limits arising from the application of Code § 461 (l). The moral to this story is simple – just because losses are no longer suspended under Code §§ 465 and 469 does not mean they are available for use against other income – Code § 461(l) needs to be considered. It cannot be ignored in tax planning.

While the loss limitation imposed by Code § 461(l) may put a monkey wrench in any S corporation shareholder's day, there is some relatively good news. Any loss disallowed as a

result of Code § 461(l) may be carried forward to the following taxable year under Code § 172.[9]

PRACTICE ALERT: Code § 172 imposes a limitation on the deductibility of loss carryovers of eighty percent (80%) of taxable income computed without regard of such losses.

QUERY: Do losses carried over to the next taxable year, subject to the eighty percent (80%) limitation of Code § 172, go through the gauntlet of Code § 461(l) again in such subsequent taxable year?

Unfortunately, the Code is not clear. Hopefully, Treasury will issue guidance on the matter in the form of Treasury Regulations to answer this query. We should assume the answer is "yes" absent guidance to the contrary.

QUERY: Are losses carried forward to future taxable years due to this new rule allowable in the taxable year in which the shareholder disposes of the shares of the S corporation without application of the Code § 461(l) limits?

Unfortunately, the Code in this second instance is also unclear. Hopefully, Treasury will issue guidance on the matter in the form of Treasury Regulations to answer this query.

Code § 461(l)(5) gives the Secretary authority to prescribe additional reporting requirements as it deems necessary to carry out the purposes of this new addition to the Code.

Good News

As a general rule, some good news (if we look hard and long enough) accompanies bad news. Code § 461(l) is **not** an exception to this general rule. Unless Congress acts, Code § 461(l) expires on December 31, 2025. **It is not a permanent provision of the Code.**

American Jobs Creation Act

Prior to the American Jobs Creation Act of 2004 (the "AJCA"), any loss or deduction that was disallowed to a shareholder of an S corporation because the loss exceeded the shareholder's basis in his or her stock and debt of the corporation owed to the shareholder was treated as incurred by the S corporation with respect to that shareholder in subsequent tax years when adequate basis existed.

Under pre-AJCA law, in accordance with IRC § 1366(d)(2), suspended losses were not transferred from a shareholder to a new shareholder upon the transfer of the shares (e.g., gift).

The AJCA amended IRC § 1366(d)(2) in one (1) respect. After the passage of the AJCA, suspended losses are transferred with the shares of an S corporation when the transfer of shares is being made by a spouse or a former spouse incident to divorce under Code § 1041.[10] This provision of the Code became effective in 2005.

PRACTICE ALERT: When advising a client relative to tax matters incident to a divorce, this provision could be a valuable negotiating tool. The tax benefit of the suspended losses that transfer with the shares of the S corporation could potentially be considered as an asset (i.e., the value of the tax attribute) in an equalizing property transfer pursuant to Code § 1041.

Conclusion

Subchapter S, due to numerous legislative changes, as well as cases, rulings and regulations, has become complex. The rules relating to suspended losses are no exception. These rules contain some tricky application nuances that may catch tax practitioners by surprise if they are not careful. I hope this blog post puts some light on some of the nuances with respect to suspended losses.

I will provide guidance on some of the other not-so-obvious aspects of Subchapter S in upcoming blog posts. Stay tuned!

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[1] Code § 1366(d). The rules applicable to entities taxed as partnerships are much more liberal.

[2] Code § 465.

[3] Code § 469.

[4] § 11012 of the TCJA. Public Law 115-97.

[5] These rules also apply to owners of entities taxed as partnerships.

[6] Code § 461(l)(3)(A). This amount is to be adjusted after 2018 for inflation. Code § 461(l)(3)(B).

[7] Code § 461(l)(6).

[8] Code § 461(l)(4).

[9] Code § 461(l)(2).

[10] § 235 of the AJCA. Public Law 108-357.

Tags: A Journey Through Subchapter S, American Jobs Creation Act of 2004, S corporation, shareholders, suspended losses, Tax Cuts and Jobs Act