Tax Basis and At-Risk Loss Limitations for Individual Partners and S-Corp Shareholders

Taxpayers constantly feel entitled to deduct losses from their businesses and investments. However, taxpayers need to be aware of the multiple loss rules provided by the Internal Revenue Code that limit the ability to deduct these losses from their trade or businesses.

Taxpayers need to take their losses through four different loss limitations before one can claim the deduction:

1) Basis limitations
2) At-risk limitations
3) Passive activity loss limitations
4) The new limitation on excess business losses of non-corporate taxpayers enacted in the Tax Cuts and Jobs Act of 2017

In this article, we will go over two: the basis limitation rules and the at-risk limitation rules. Per IRC §704(d), a taxpayer will need to determine if they have enough basis to take the deduction; thereafter, the taxpayer should follow the IRC §465 at-risk rules to calculate any limitations. In 2018, the taxpayer will need their losses to satisfy all the requirements of each limitation to fully deduct their losses. If not, the losses will be suspended in their respective baskets. There are several planning strategies taxpayers may use to maximize their losses.

Basis Limitations

IRC § 704(d) explains that a partner's distributive share of partnership loss (including capital loss) is allowable only to the extent of the adjusted basis in his interest in the partnership at the end of the year in which the loss occurred. Any losses in excess of basis are disallowed and suspended pro rata per Treas. Reg. § 1.704-1(d) and are carried forward indefinitely until the partner exits the partnership. IRC § 705(a) generally provides that a partner's adjusted basis is increased by the sum of the capital contributions, distributive share for the current and prior taxable years of taxable and tax-exempt income, and decreased by distributions, distributive share of partnership losses, and nondeductible expenses. A partner's basis is further adjusted by its allocation of liabilities under the provisions of IRC § 752. Under IRC § 752(a), a partner's increase in its share of liabilities is considered as a contribution of capital to the partnership. IRC § 752(b) provides that a decrease in the partner's share of partnership liabilities is considered a distribution of capital to the partner.

IRC § 1366(d) similarly provides that an S corporation shareholder's pro rata share of losses and deductions are limited to the sum of the adjusted basis of stock and the adjusted basis of any S corporation indebtedness to the shareholder. Any disallowed losses by reason of the basis limitation rules are carried forward indefinitely and will be treated as incurred by the corporation in the succeeding taxable year with respect to the shareholder (IRC § 1366(d)(2)). Under the provisions of IRC § 1367, S corporation basis is increased for items of income, tax-exempt income, and the excess of deductions for non-oil and gas depletion over the basis of the property subject to depletion, and is decreased by items of distributions, losses & deductions flowed through to the shareholder, any non-separately computed losses, non-deductible expenses not charged to capital account, and depletion deductions for any oil and gas property that do not exceed the adjusted basis of such property allocated to the shareholder.

When a partner or S-corp shareholder has a suspended loss a later year and wants to be able to utilize it, they can either:

1) contribute additional money or property to the activity;
2) receive an allocation of partnership or S corporation income; and/or
3) increase his or her share of partnership or S corporation liabilities.

Even though the business may not be profitable during the year, it may be a good tax planning strategy to incur debt to increase the adjusted basis and be able to utilize those suspended losses. During a certain year, a taxpayer may also consider accelerating the recognition of income or deferring expenditures to a later year and generate enough income to offset the prior years' suspended losses.

At-Risk Limitations

A remarkable aspect of tax shelters prior to 1976 was that taxpayers were allowed to deduct losses that were greater than their investment in the activity. With the enactment of the IRC § 465 at-risk limitation rules effective for years beginning in 1976, individuals (partners of partnerships and shareholders of S corporations), estates, trusts, and closely held corporations (more than 50% ownership in C corps) that incur deductions of business or investment losses from an activity are now limited to the amount the taxpayer is "at-risk." To be considered "at-risk", the taxpayer must invest their own personal funds to the activity or they can incur a personal liability for borrowed funds. Per IRC § 465(b), the at-risk amount includes: the amount of money and the adjusted basis of property contributed to an activity, amounts borrowed to the extent the taxpayer is personally liable, and qualified non-recourse financing. A taxpayer can deduct loss amounts up to the at-risk limitations in any given tax year and any unused portion can be carried forward until there is enough positive at-risk income to allow the deduction.

These rules do not limit the deductibility of all deductible expense arising from an active, but rather they limit the deductibility of losses. The amount at-risk can go negative resulting in the recognition of previously deducted losses as income and is known as an at-risk recapture pursuant to IRC § 465(e). This can be a result of excess distributions to the taxpayer or changes in the status of loans from recourse to non-recourse.

There are a few tax planning ideas to get around the at-risk limitations. A taxpayer could aggregate their activities if he or she actively participates in the management of the trade or business or if such trade or business is carried on by a partnership or an S-corporation and 65% or more of the losses for the year is allocable to persons who actively participate in the management of the trade or business pursuant to IRC § 465(c)(3). One could potentially combine losses from one activity with the net profits from another and be treated as a single activity for purposes of the at-risk rules. The taxpayer may then have no net loss from the activity to be limited under IRC § 465. Congress left the IRS to decide whether all other business and income-producing activities should be segregated or aggregated depending on the tax shelter characteristics. Proposed regulations failed to address these issues and we are left to decide based on the facts whether certain activities should be aggregated.

Another strategy in navigating the at-risk rules is being aware of the taxpayer's tax basis and amount at-risk and then taking measures to increase these amounts prior to an anticipated event before the end of the taxable year. One notable action that can be taken is guaranteeing a portion of partnership or s corporation debt which will increase a partner's or shareholder's amount at-risk since he would be personally liable for his share of recourse debt.

Conclusion

Taxpayers need to go through the four types of limitation hurdles before being able to deduct their losses: basis limitations, at-risk limitations, passive loss rules, and the new excess business loss limitations. At the end of the day, these loss ordering rules are not always that straightforward because they can cause huge headaches for unsuspecting taxpayers when income recognition results. Proper tax planning and a close monitor of tax basis are some of the key ways in successfully getting over the Code's four hurdles.

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