What does the CARES Act mean for net operating losses and non-corporate business losses?

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The CARES Act temporarily suspends retroactively changes made to the treatment of net operating losses by the 2017 Tax Cuts and Jobs Act (the “2017 Tax Act”). It also suspends retroactively the limitation on excess business losses added to the Internal Revenue Code (the “Code”) by the 2017 Tax Act. These changes will result in some taxpayers receiving refunds on taxes previously paid for 2018 and 2019 taxable years.

For many years, the Code has contained a provision that allows business losses from one taxable year to be carried to one or more other taxable years to reduce taxable income in that other taxable year or years (Code Section 172). These are referred to as “net operating losses” or “NOLs.”

The CARES Act, which was signed by President Trump on March 27, 2020, amends the NOL provisions to allow for the carryback of losses arising in taxable years ending after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year of such loss. The CARES Act does not alter the indefinite carryforward of NOLs arising in those years. However, real estate investment trusts (REITs) are not permitted such carrybacks.

The CARES Act also amends the NOL provisions to remove the limitation that NOLs could be used to offset no more than 80% of taxable income (disregarding the NOL deduction itself). The amendment applies to taxable years beginning before January 1, 2021.

Before the 2017 Tax Act, taxpayers could carry back NOLs from a current taxable year to the two preceding taxable years (receiving a tax refund if the NOL could be used against income on which tax had been paid) in addition to carrying NOLs forward. The 2017 Tax Act eliminated the option to carry back NOLs, except for farming losses. NOLs only could be carried forward, but they could be carried forward indefinitely. The 2017 Tax Act also limited the NOL offset in any taxable year to 80% the amount of taxable income in such year.

In addition to the changes to NOLs, the 2017 Tax Act added a new limitation (Code Section 461(l)) on the amount of business losses noncorporate taxpayers (e.g., individuals, partners in partnerships, shareholders in S corporations, trusts, and estates) could use to offset nonbusiness income. This provision works together with other provisions that limit the ability of noncorporate taxpayers to deduct losses, such as the passive activity loss rules under Code Section 469 and the “at-risk” rules under Code Section 465.

The CARES Act removes the limitation on excess business losses for taxpayers other than corporations for tax years beginning after December 31, 2017, and before January 1, 2021. This will benefit noncorporate taxpayers by allowing them to fully offset taxable income by business losses for the 2018, 2019, and 2020 taxable years, even if those losses are not related to COVID-19. At this time, it is unclear whether IRS will require noncorporate taxpayers to amend their 2018 tax returns (and 2019 tax returns, if already filed) to obtain a refund of past taxes paid due to the limitation on excess business losses or if they will be able to receive a refund for past years when they file their current taxable year return.

Code Section 461(l) works by denying a deduction for “excess business losses.” An “excess business loss” is defined as the excess deductions of a taxpayer from all trades or businesses over any gain from the taxpayer’s trades or businesses plus $250,000 (or $500,000 if spouses file a joint return). For partnerships, S corporations, and other pass-through business entities, the loss limitation is applied at the partner or shareholder level – not the entity level. The effect of this provision is that regardless of the amount of business losses a noncorporate taxpayer may have, he, she, or they very likely could have taxable income subject to tax.

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