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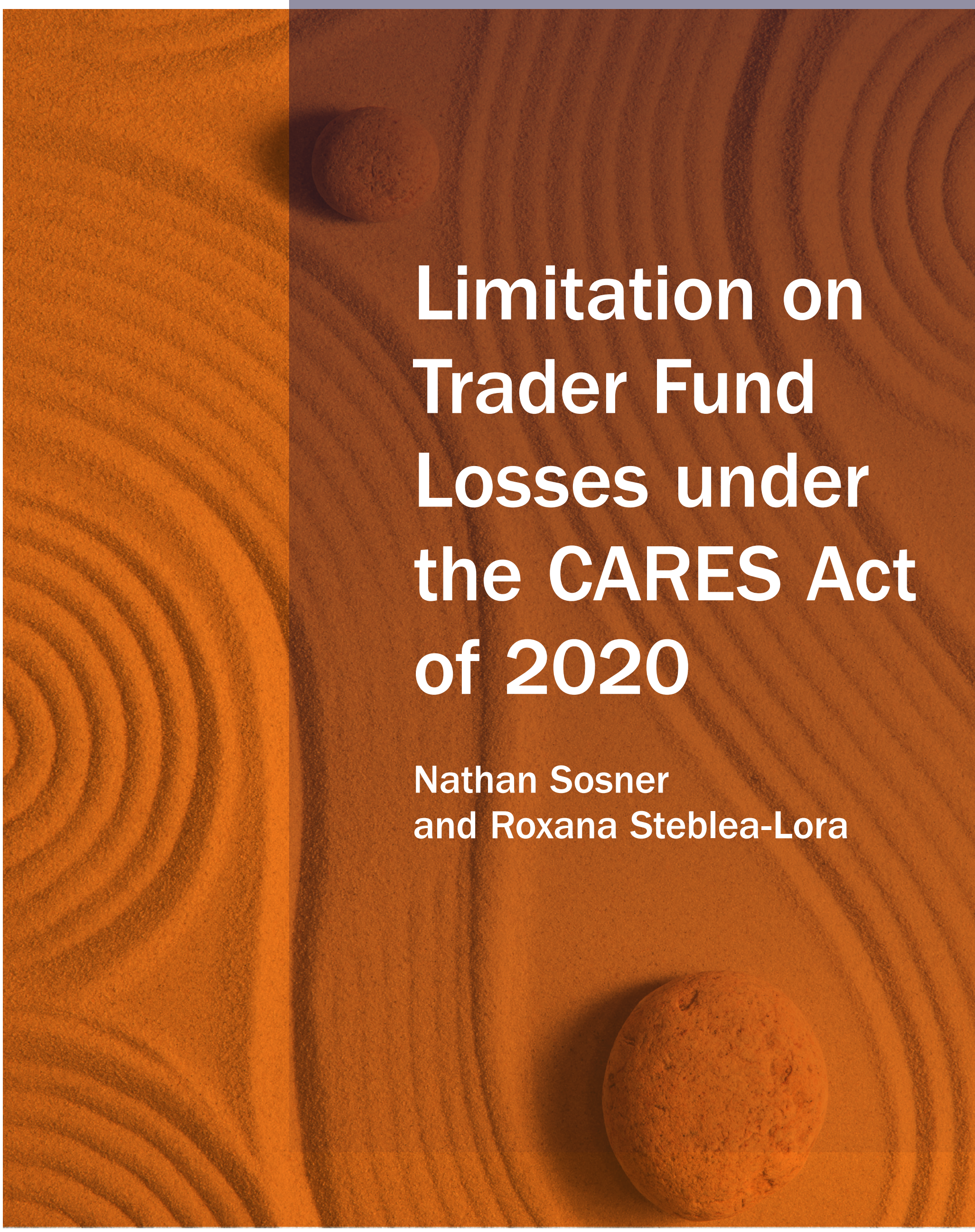

Limitation on Trader Fund Losses under the CARES Act of 2020

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KEY FINDINGS

- Hedge funds that engage in frequent, substantial, and regular trading activity and intend to derive profit from short-term changes in security prices, rather than from interest, dividends, and long-term price appreciation, often make a determination that they are trader funds. However, trader fund losses might be subject to a limitation on excess business losses introduced by the TCJA.
- The CARES Act provided some much-needed clarifications of the excess business loss limitation introduced by the TCJA. On one hand, it excluded capital losses from the calculation of excess business loss, which is good news. On the other hand, it specifically disallowed using trade or business losses, including trader fund losses, to offset income from employment, which is bad news.
- Trade or business losses, including trader fund losses, can still offset employment income and income from investor activities up to a safe harbor amount. The CARES Act also clarified that excess business losses are carried over to future years when they can offset employment income and income from investor activities, this time without the excess business loss limitation.

ABSTRACT

Hedge funds are characterized by the significant complexity of their tax attributes. In this article, the authors explain how hedge fund investors might be affected by a *limitation on excess business losses* codified in a new IRC Section 461(l), introduced as a part of the TCJA of 2017 and later amended by the CARES Act of 2020. In order to allocate business losses, a hedge fund must be a trader fund. They thus discuss what makes a hedge fund a trader fund, whether management and performance fees of a trader fund are deductible as a trade or business loss, and whether trader fund losses constitute passive activity losses. After explaining the relationship between hedge fund losses and business losses, they illustrate with simple examples how the new provisions of the CARES Act under Section 461(l) may affect hedge fund investors. They find that compared to the TCJA some of these new provisions are beneficial while others are detrimental to investors. On balance, Section 461(l) remains punitive, uneconomical, and unnecessary.

Whereas hedge funds are best known for their uniquely complex investment strategies, their other distinguishing characteristic is the significant complexity of their tax attributes. The goal of this article is not to provide a comprehensive overview of taxation of hedge funds and their investors—this has been done elsewhere (see, for example, Miller and Bertrand 2012)—but rather to discuss and illustrate with examples how hedge fund investors might be affected by a *limitation on excess business losses* codified in a new Internal Revenue Code (IRC) Section 461(l), which was introduced as a part of the Tax Cuts and Jobs Act (TCJA) of 2017 and later amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020.

Why should hedge fund investors and their advisors be concerned with the excess business loss limitation? Typically, hedge funds are perceived as tax-inefficient investments (see, for example, Lucas and Sanz 2017) that allocate large amounts of realized capital gains and income to their investors. But what if a hedge fund realizes a loss? In the presence of the excess business loss limitation, can hedge fund investors still benefit from realized losses and deductions by symmetry to the costs they incur from realized gains and income? If yes, then to what extent? And does it make a difference whether the loss is capital or ordinary?

In this article, we will shed light on these issues by contrasting the CARES Act of 2020 with the TCJA of 2017 and the pre-TCJA regime, with the latter set to return starting with tax year 2026 when the TCJA and CARES Act provisions are scheduled to sunset. However, before we compare and contrast these different tax regimes, we must clarify what a business loss is in the context of hedge fund investing. We do that in the first two sections.

The penultimate section reviews the main implications of the changes to excess business loss limitation rules under the CARES Act for investors' ability to utilize trader fund losses as deductions. The CARES Act repealed the excess business loss limitation for years 2018–2020, such that the new provisions apply only to a five-year period from 2021 to 2025. For this latter period, some of the changes can be viewed as good news for taxpayers investing in hedge funds and some as bad news. The good news comes from the exclusion of net operating loss (NOL) carryovers and capital losses from the calculation of excess business loss. The bad news relates to the clarification that income from employment cannot be offset by business losses and a potentially unintentional interaction between investor activity capital loss and excess business loss, whereby investor activity capital loss can increase the excess business loss limitation. We show that some of the punitive effects of the latter can be remedied by a strategic realization of capital gains.

The last section provides summary and conclusions.

TRADER FUND VERSUS TRADER IN SECURITIES ELECTION

The terms "trader fund" and "trader in securities election" (the latter also known as a "Section 475(f)" election) are sometimes mistakenly viewed as synonymous. Indeed, the two terms are related to the idea that a taxpayer "is engaged in a trade or business as a trader in securities."[1] In addition, in order to be able to make a trader in securities election, a fund needs to be a trader fund. However, the process for the *trader determination* and the *trader in securities election* is quite different, and the resulting tax treatment is very different as well. In this section, we clarify important differences and similarities between the two concepts.

[1] "A person who is engaged in a trade or business as a trader in securities" is the language used in the IRC Section 475(f)(1)(A).

Trader Funds and Their Tax Treatment

Trader Determination. On an annual basis, after completion of a tax year, a hedge fund partnership will take a position whether it is a trader or an investor. The position can be changed by the fund from one year to the next without a need for consent from the tax authorities. As we discuss further in this section, although the trader position has no effect on the fund's accounting method, it affects the deductibility of the fund's management fees. In addition, it might have other significant implications for the fund investors' tax returns, as we explain in great detail below. As a result, the fund clearly states its position as a trader in the footnotes to the Schedule K-1 issued to its investors.

What specifically allows a fund to make a trader determination? In the context of securities taxation, a trader is engaged in a "trade or business," while an investor is not. However, neither the IRC nor Treasury regulations define what constitutes trade or business, and the determination of whether a fund is engaged in a trader or investor activity depends on the facts and circumstances of each case. This position has been affirmed by the Supreme Court on several occasions.[2]

Based on case law, substantial, regular, and continuous trading activity is a necessary condition for being a trader. However, in some court cases this necessary condition has not been deemed as sufficient.[3] The courts opined that, in addition to substantial, regular, and continuous trading activity, a trader must have an intent to derive profit from short-term changes in security prices, whereas investors intend to derive their profits from interest, dividends, and long-term price appreciation.

Thus far, numerous court cases surrounding the complexity of trader-versus-investor determination have involved individual investors trading in their personal accounts rather than hedge funds and professional managers.[4] Nonetheless, in light of past legal challenges to individual traders, fund managers should exercise caution and prudence and consult with tax experts before taking a trader position for any one year for any one of their funds.[5] Moreover, as we explain shortly below, tax law changes introduced by the TCJA of 2017 made trader funds even more tax-advantageous than investor funds, thus increasing both the incentives for managers to treat their funds as traders and the risks of legal challenge by the IRS to the trader position.

Tax Treatment of Trader Fund Income, Gains, Deductions, and Losses. Although the trader fund determination relies on analysis of multiple factors and potentially carries a risk of legal challenge by the IRS,[6] this determination does not lead to any changes in the tax treatment of the fund's income, gains, deductions, and losses because there are no changes to the fund's accounting method. Thus, for example, a gain (or loss) on a stock held by a trader fund will not be recognized and passed through as a taxable gain to the fund investors until the stock is liquidated by the fund and the

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[2] *Higgins v. Commissioner*, 312 U.S. 212 (1941), and *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[3] For example, *Liang v. Commissioner*, 23 T.C. 1040 (1955), *Purvis v. Commissioner*, 530 F.2d 1332 (1976), and *Levin v. U.S.*, 597 F.2d 760 (1979).

[4] Trader position is advantageous because it allows traders to deduct against income various expenses associated with "trade or business" of trading securities. Investors, on the other hand, cannot deduct expenses associated with their investment activities.

[5] Losing an IRS challenge could result in disallowance of past deductions and, therefore, an increase in taxable income for the years when such deductions were applied. This could lead to back taxes on the additional income, plus applicable interest and penalties.

[6] Trader position has been advantageous for individuals trading for their own accounts because it allowed them to deduct various expenses associated with the "trade or business" of trading securities. Individuals who are investors, on the other hand, do not engage in a "trade or business" and thus could not deduct expenses associated with their investment activities. Therefore, the IRS is incentivized to challenge trader position and has done so on numerous occasions.

gain (or loss) becomes realized. This realized gain (or loss) will be long-term or short-term capital gain (or loss) depending on whether the fund held the stock for more or less than one year and will be passed through to the fund investors in its respective character.[7] Similarly, if a trader fund receives a dividend on a stock that, based on the stock's holding period, would be treated as qualified (and thus taxed at the lower long-term capital gains rate), the qualified character of the dividend will be passed through to the fund's investors.

While the character of the pass-through income, gains, deductions, and losses is unaltered by the position of a fund to treat itself as a trader, Section 461(l), newly added to the IRC as a part of the TCJA of 2017, introduced an excess business loss limitation that which created significant complexity and confusion as to how losses passed through by a trader fund can be used by its investors to offset their income and gains from various other sources.[8] Some of this confusion has been addressed by changing the language of Section 461(l) upon the introduction of the CARES Act of 2020. However, many complexities related to the excess business loss limitation remain. We treat these complexities in detail later in the article.

Tax Treatment of Trader Fund Management Fees. Although, as we just discussed, the trader determination does not change either the timing or the character of tax items realized by a fund, whether a hedge fund is treated as a *trader* or an *investor* does affect the deductibility of its management fees.[9] For an investor fund, management fees are treated as miscellaneous itemized deductions.[10] These deductions were already limited prior to the TCJA under what is known as a "2% of AGI" limitation,[11] and became fully disallowed under the TCJA for the years 2018 to 2025.[12] For a trader fund, management fees are considered expenses incurred in carrying on a trade or business.[13] Such expenses are ordinary trade or business expenses that prior to the TCJA could be deducted without limitation. The TCJA, by adding Section 461(l) to the Code, introduced a limitation on such losses that has been temporarily repealed by the CARES Act, as we explain in more detail below. For now, it suffices to say that from the management fee deductibility perspective the TCJA made trader funds more appealing for taxable investors than investor funds.

Tax Treatment of Fund Manager's Performance Compensation. Since trader fund fees are deductible, albeit with some limitations, managers of trader funds seeking to improve the tax efficiency of their funds might choose to treat their performance compensation as a fee. What do we mean by that? Typically, hedge fund manager performance compensation is an allocation of profits interest[14] from limited partners (LPs) to the general partner (GP), which from a tax perspective results in allocation of income, gains, deductions, and losses realized by the fund. For example, if in any given year the fund only realized long-term capital gains, an *allocation* of profits interest to the GP would result in long-term capital gain to the GP and a reduction in long-term capital gains to the LPs. If, on the other hand, the fund treated the performance compensation as a *fee*, the performance-related payment to the manager would be an

[7] Under the IRC Section 702(a).

[8] See, for example, Hodaszy (2019).

[9] Gordon (2005) also discusses the topic of management fee deductibility.

[10] To be precise, investor fund fees are considered the IRC Section 212 portfolio deductions, treated as miscellaneous itemized deductions under the IRC Section 67.

[11] The IRC Section 67 titled "2-percent floor on miscellaneous itemized deductions."

[12] The new IRC Section 67(g) introduced as a part of the TCJA states that "no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026."

[13] These expenses are considered the IRC Section 162(a) expenses and therefore are treated as an adjustment to AGI under the IRC Section 62.

[14] Rev. Proc. 93-27.

ordinary trade or business income to the manager and an ordinary trade or business expense to the investors treated exactly like the management fee.[15]

Let's illustrate the concept of fee-versus-allocation with a simple example. Imagine a trader fund realizes an economic profit, in excess of management fee, of $100, of which $50 is taxable as long-term capital gain and the remaining $50 is deferred to future periods. The fund manager is entitled to a $20 performance compensation. Economically, LP investors in the fund receive $80 and the GP manager receives $20. The $20 can be structured as either an allocation or a fee. When structured as an *allocation*, the manager and the investors are allocated $10 and $40 of long-term capital gains, respectively. When structured as a *fee*, the manager is allocated $20 of ordinary income and the investors are allocated $50 of long-term capital gain and $20 of ordinary deduction for a total of $30 net taxable income. Again, the $20 fee is available to the fund investors as an ordinary deduction because the fund is a trader fund. Clearly, the latter case would be preferred by the investors who could benefit in two ways. First, their total taxable amount is reduced from $40 (of long-term capital gain) to $30 ($50 of long-term capital gain less $20 of ordinary deduction) giving them a timing benefit. Second, the ordinary deduction of $20 can be utilized (although potentially subject to the Section 461(l) limitation) as an offset against highly taxed ordinary income thus giving them a beneficial mix of tax characters.

Trader in Securities Election and the Resulting Tax Treatment

Section 475(f) Trader in Securities Election. Trader funds can make a trader in securities election. A trader in securities election operates quite differently from a fund taking a trader position described above. First, while the trader position is guided by case law, the trader in securities election is provided by the IRC under Section 475(f)(1). In fact, the trader in securities election is widely known simply by its Code section as a "Section 475(f)" election.

Second, in contrast to the trader fund position that does not lead to recognition of unrealized gains or losses and does not change the character of realized income, gains, deductions, and losses of the fund, a Section 475(f) election changes the fund's accounting method such that all the gains and losses of the fund during the tax year, whether realized or not, are recognized as ordinary income.[16] There is one exception to the application of this method as we describe in more detail shortly.

Finally, the trader position is taken by a fund retroactively each tax year based on the fund's assessment of its activity in that year. In contrast, the trader in securities election needs to be made early in the year and applies to the tax year in which it is made and all the future years.[17] Until 2015 the election could only be revoked with consent of the Secretary of the Treasury. In 2015, the IRS allowed taxpayers to revoke the election without such consent (by symmetry with election, revocation must be done early in the year); however, if revoked, the election cannot be reinstated for the next five years.[18]

Tax Treatment under a Section 475(f) Election. A Section 475(f) election can be made for an entire fund or for a specific activity, for example, a strategy within a

[15] Deductible under the IRC Section 162(a).

[16] In fact, in addition to making the election, the fund will also be required to file a Form 3115, "Application for Change in Accounting Method."

[17] Rev. Proc. 99-17. For example, to make the Section 475(f) mark-to-market election for 2021, the fund must have filed an election statement no later than the due date for its 2020 tax return, without regard to extensions.

[18] Both the requirement to make or revoke the election early in the year and the five-year restriction on reelection after revocation are designed avoid abuses where the fund switches the election on and off with the goal of tax optimization for its investors.

fund.[19] For the years in which a Section 475(f) election is in place, that is, the year in which the election is made and all the subsequent years until revoked, all the gains (and losses) from all the securities held by the fund, whether realized or not, will be treated as an ordinary income (and losses), instead of capital gains (and losses). This is often referred to as mark-to-market ordinary treatment.

An exception to this rule is the IRC Section 1256 contracts. That includes regulated futures contracts, non-equity options, and foreign currency contracts, including foreign currency forwards in major currencies for which a valid election under the IRS Section 988(a)(1)(B) is made.[20]

Why elect a seemingly punitive ordinary tax treatment? The main reasons are reduction in tax reporting complexity, elimination of tax timing distortions, and character alignment with income and loss from other investments.[21] Let us clarify. Without a Section 475(f) election in place, the fund would have to test for, and possibly make, numerous tax adjustments related to wash sales, straddles, and constructive sales. Not only these tests and adjustments increase the administrative costs of tax compliance, but in some circumstances, they could also lead to accelerated recognition of gains and deferred recognition of losses, thus increasing taxable income above the economic profit of the fund. A Section 475(f) election eliminates the need for complex tax adjustments and aligns taxable income (or loss) of the fund with its economic profit (or loss). In addition, fund investors who tend to experience ordinary income and losses from other business activities could benefit from the fact that the fund's losses could offset their business income from other sources, and vice versa, the fund's income could be offset by losses from other businesses.[22]

Finally, because Section 475(f) funds are trader funds, their management fees were deductible without limitation prior to the TCJA and are still deductible with some limitations under the TCJA, as we have covered at length in our trader fund discussion above. Before we proceed, we summarize the discussion above in Exhibit 1.

DO TRADER FUND LOSSES CONSTITUTE PASSIVE ACTIVITY LOSSES?

Do trader fund losses constitute passive activity losses? The answer is a definitive *no*. Now, if the answer is so unambiguous, why spend time on it here? The reason is because too often we see confusion on this subject. We suspect that the confusion might be coming from attempts to interpret the language of the IRC Section 469. Section 469(c)(1) states that "the term 'passive activity' means any activity: (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." Since hedge fund investors do not manage the fund's investments, it might look like they do not "materially participate" in the conduct of the trade

[19] We refer to "a fund" with the understanding that the same tax treatment applies to a specific activity of a fund if only that activity is specifically elected under Section 475(f).

[20] Flush language in the IRC Section 475(c)(2) excludes from the definition of "security," for the purposes of this election, any contract to which section 1256(a) applies. We note that a symmetrical flush language carving out the IRC Section 1256 contracts does not exist in Section 475(e)(2) where "commodities" are defined, potentially leaving commodities futures and commodity futures options in scope for the 475(f) election. See Freindenberg and Wilber (2015) for further details and nuances related to the interaction of the IRC Sections 1256 and 475(f).

[21] See Freindenberg and Wilber (2015) for further details and nuances related to this general statement.

[22] Subject to limitations explained below, trader fund ordinary losses can also offset employment income and ordinary income from investor activities.

EXHIBIT 1

Summary of Similarities and Differences between Trader Position and Trader in Securities Election

	Trader Position	Section 475(f) Trader in Securities Election
Fund Must be a Trader Fund	Yes	Yes
Fund Must Make a Section 475(f) Election	No	Yes
Change in Accounting Method	No	Yes, a Form 3115, "Application for Change in Accounting Method," must be filed
Unrealized Capital Gains and Losses Are Recognized (Marked to Market)	No	Yes
Tax Treatment of Recognized Capital Gains and Losses	Capital gains (or losses)	Ordinary income (or loss)
Fees Are Deductible as Ordinary Expense	Yes	Yes
Means by Which Determination/ Election Is Made	Fund manager's determination	Election made on a prescribed statement filed with the IRS
When the Determination/Election Is Made	Every year, after the year is over	Early in the year for the current and all future years
Process for Revoking	No need to revoke, the determination is made anew every year	Early in the year for the current and all future years; if revoked, can reelect only after 5 years
Method of Reporting to Investors	Footnote on Schedule K-1	Detail statement on Schedule K-1

or business of the fund, thus seemingly making the fund's losses "passive activity" losses like, for example, net losses from depreciation in certain real estate activities.

The problem with passive activity losses is that under the IRC Section 469, passive activity losses and deductions do not offset gains and income from business or investor activities. For example, if hedge fund capital losses were indeed passive activity losses, they would not be able to offset capital gains realized by investors in their investment portfolios. Similarly, hedge fund ordinary deductions, for example, management fees or losses of the funds making a Section 475(f) election discussed in the previous section, would not be able to offset investors' income from operating businesses that they run. Clearly, if investors view hedge funds as economic diversifiers to their other investments and business ventures, such inability to deduct hedge fund losses from income and gains from those activities that hedge funds are intended to diversify would create timing distortions between economic and tax outcomes for the investors.

Fortunately, Treasury regulations issued in 1988 resolve this issue. Treas. Reg. Section 1.469-1T(e)(6) states that an activity of trading personal property (for example, stocks, bonds, derivatives, and other financial instruments) for the account of owners of interests in the activity (in our case, hedge fund investors) is *not* a passive activity. It further provides a clarifying example in which an activity of a partnership that uses capital of its partners and borrowed funds to trade stocks, bonds, and other securities, and thus derives income from interest, dividends, and capital gains, is *not* considered a passive activity. Furthermore, to avoid any confusion, some hedge funds add a footnote on their Schedule K-1 stating that the amounts on the schedule do not arise from passive activity under Treas. Reg. Section 1.469-1T(e)(6).

To summarize, losses allocated by hedge funds are not limited by the passive activity loss limitation under Section 469 and thus in principle can offset income and gains from investment activity and trade or business activity. However, rules for such offsets have been changed recently by the TCJA of 2017 and then again by the CARES Act of 2020. We discuss these statutory changes in the next section.

THE CARES ACT AND LIMITATION ON EXCESS BUSINESS LOSSES OF NONCORPORATE TAXPAYERS

Until the tax year 2017, capital losses and ordinary deductions allocated by trader funds could offset trade or business income and gains, including wages, and investment income and gains without limitation. The TCJA, by introducing a new IRC Section 461(l), changed this paradigm for tax years 2018 to 2025 in several important ways. First, the TCJA created uncertainty regarding the ability of trade or business losses to offset wages. Second, income from investor activities was clearly put out of scope for trade or business loss offsets. These disallowed trade or business losses, that is, losses that cannot be used as a deduction in the current tax year, are defined under Section 461(l)(3) as *excess business losses*. In addition, the TCJA introduced significant confusion as to how to incorporate trade or business *capital* gains and losses for the purpose of calculating the excess business loss limitation and how to treat excess business loss carryovers. Hodaszy (2019) provides a detailed discussion of both the distortive nature of the limitation, due to its tendency to increase taxable income above economic income, and the multiple ambiguities that it created.[23]

The CARES Act retroactively revoked the operation of Section 461(l) for tax years 2018 to 2020 and provided some much-needed clarity for its application for tax years 2021 to 2025. In the remainder of this section, we review the changes that took effect under the CARES Act that we view as particularly relevant to trader funds.

To clarify, the limitation on excess business losses is a limitation on aggregate loss from *all* trade or business activities not on a loss from an individual trade or business activity. Such that if, for example, in a given year the taxpayer has a $1,000,000 ordinary income from operating businesses and a $1,500,000 ordinary loss from various trader hedge fund investments, the trader hedge fund loss fully offsets the operating business income, and the aggregate excess business loss is only $500,000.

Before we continue, we would like to point out that the limitations of Section 461(l) do not apply to the first $250,000 ($500,000 for married filing jointly) of excess business loss. This safe harbor amount of $250,000 ($500,000 for married filing jointly) can be utilized toward employment income or income from investor activities. It is adjusted annually for inflation such that, for example, in 2019 it was increased by $5,000 to $255,000 ($510,000 for joint returns). For simplicity, in the examples below we ignore the inflation adjustment and use a $500,000 safe harbor amount for all the years when the Section 461(l) limitation applies.

Bad News: Wages Can Be Netted with Trade or Business Losses Only up to a Safe Harbor Amount

The original language of Section 461(l) made no reference to income and gains attributable to "performing services as an employee," which led to a seemingly clear interpretation that they were a part of the total income and gains from all the trade or

[23] In the concluding section of the article, Hodaszy (2019) says that, in light of all the problems with Section 461(l), the only positive thing that one can say about it is that it, mercifully, sunsets in 2025.

business activities of the taxpayer.[24] Simply put, if in a given year a taxpayer received $1,000,000 salary and was allocated an ordinary deduction of $1,000,000 by a trader fund, the taxpayer's adjusted gross income for the year would be $0.

The TCJA Blue Book[25] threw a wrench into this straightforward interpretation by stating that income or gains from performing services as an employee should not be taken into account when calculating excess business loss. The Blue Book continues to clarify: "For example, assume married taxpayers filing jointly for the taxable year have a loss from a trade or business conducted by one spouse as a sole proprietorship as well as wage income of the other spouse from employment. The wage income is not taken into account in determining the amount of the deduction limited under section 461(l)."

The inconsistencies between the language of Section 461(l) and that of the TCJA Blue Book resulted in uncertainty as to whether income or gains from employment could be considered trade or business income or gains for the purpose of excess business loss limitation. Unfortunately, the guidance from the IRS in conjunction with its new Form 461 ("Limitation on Business Losses") did not provide much clarity (see Hodaszy (2019) for further discussion).

Congress has finally resolved this uncertainty in the CARES Act by adding to Section 461(l)(3)(A), which defines the term "excess business loss," the following flush language: "Such excess shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee."

Unfortunately, as of the time of this writing, the resolution of uncertainty through this newly added language did not lead to a sensible result from the perspective of economic risk sharing where a taxpayer reduces the risk of her business venture by having a stable income from wages, or where one spouse is able to assume the risk of running a business because the other receives a stable salary as an employee.

In addition, excess business loss limitation, which, under the CARES Act, was not only retained but also made more onerous for some taxpayers by excluding wages from the definition of business income, also penalizes diversification of investments. If an investor diversifies among direct investments in securities, such as, for example, stocks and bonds and hedge funds treated as trader funds, beyond the safe harbor amount, trader fund losses cannot offset income from the investment account.

Fortunately, excess business loss limitation leading to exaggeration of taxable income relative to economic earnings applies to only a five-year period from 2021 to 2025. It is slated to sunset after 2025 and has been retroactively revoked for the tax years 2018 to 2020 by the CARES Act.

The example in Exhibit 2 illustrates the operation of the Section 461(l) excess business loss limitation as it relates to wages. As we mentioned earlier, to make the results more comparable across scenarios, we ignore the inflation adjustment to the $500,000 safe harbor amount available to married filing a joint return. Suppose that, in a given year, a married couple filing jointly has $400,000 of income derived from employment, a $600,000 ordinary deduction allocated to them by trader funds, and $200,000 in interest and dividends from their investment portfolio.

[24] Indeed, the IRC is generally consistent in treating the activity of performing services as an employee as a trade or business activity, unless specifically called out on certain occasions. For example, the IRC Section 162 treats "salaries or other compensation for personal services actually rendered" as deductions incurred in carrying on a trade or business, the IRC Section 62 refers to "trade or business deductions of employees," and the IRC Section 864 states that "the term 'trade or business within the United States' includes the performance of personal services within the United States."

[25] A Blue Book is a general explanation of tax law prepared by the Joint Committee on Taxation (JCT) and commonly relied upon by the IRS for interpreting the law. The TCJA Blue Book refers to the General Explanation of Public Law 115-97 prepared by the staff of the JCT in December 2018.

EXHIBIT 2

Income from Employment and the Excess Business Loss Limitation

	Pre-TCJA	TCJA Section 461(l)		CARES Act
	Year 2017 and Earlier	Literal Reading of the Section	Blue Book Clarification	Years 2021–2025
Trade or Business Income/(Loss)				
Employee Income/(Loss)	$400,000	$400,000	$400,000	$400,000
Non-Employee Income/(Loss)	($600,000)	($600,000)	($600,000)	($600,000)
Investor Income/(Loss)				
Interest and Dividend Income	$200,000	$200,000	$200,000	$200,000
Net Trade or Business Amount, (I)		($200,000)	($600,000)	($600,000)
Safe Harbor Amount, Joint Return, (II)		$500,000	$500,000	$500,000
(I) + (II)		$300,000	($100,000)	($100,000)
Excess Business Loss	N/A	$0	($100,000)	($100,000)
Income	$600,000	$600,000	$600,000	$600,000
Deductions, Reduced by Excess Business Loss	($600,000)	($600,000)	($500,000)	($500,000)
Adjusted Gross Income	$0	$0	$100,000	$100,000

Exhibit 2 models the adjusted gross income (AGI) of the couple depending on the tax regime of the year in which they receive the tax items. The top panel of the table in the exhibit summarizes the facts of the example. The bottom panel derives the AGI. The first column models the pre-TCJA regime: the $600,000 ordinary deduction simply offsets ordinary income resulting in a $0 AGI for the family.

The next two columns show two possible interpretations of Section 461(l) under the TCJA, before clarity was provided by the CARES Act. First, let's consider the column titled "Literal Reading of the Section." Under a literal reading of the section as it was originally worded, income from employment is not excluded from the calculation of aggregate income and gain attributable to trade or business. Therefore, we compute the net trade or business amount as the net of the $400,000 income from employment and the $600,000 loss from trader funds, which adds up to a $200,000 net loss. This aggregate trade or business loss is smaller than the safe harbor amount of $500,000 for married filing jointly, therefore, excess business loss under Section 461(l)(3)(A) is $0. As a result, the couple can utilize the full amount of $600,000 losses from trader funds to offset the aggregate $600,000 income from employment ($400,000) and investor activity ($200,000).

However, as we saw above, the TCJA Blue Book specifically instructed not to include employment income in the total trade or business income for the purpose of calculating excess business loss under Section 461(l). In this case, as we show in the column titled "Blue Book Clarification," the $400,000 employment income is disregarded, and the net trade or business amount is only the $600,000 loss from trader funds. This loss exceeds the safe harbor amount of $500,000 by $100,000 resulting in a $100,000 excess business loss under Section 461(l)(3)(A). The allowed deduction is, therefore, not the full trader fund loss of $600,000 but only $500,000 due to $100,000 of that loss being disallowed under excess business loss limitation. As a result, the couple ends up with adjusted gross income of $100,000 and a net operating loss (NOL) carryover of $100,000.

The CARES Act enacted the Blue Book interpretation for years 2021 to 2025. This is the example we show in the last column. The column shows that under the

EXHIBIT 3

NOL Carryovers and Excess Business Loss Limitation

	Pre-TCJA		A Potential Reading of the TCJA Section 461(l)		Section 461(l) under the CARES Act	
	2021	2022	2021	2022	2021	2022
Trade or Business Income/(Loss)						
Income/(Loss)	($600,000)	($500,000)	($600,000)	($500,000)	($600,000)	($500,000)
Investor Income/(Loss)						
Interest and Dividend Income	$700,000	$700,000	$700,000	$700,000	$700,000	$700,000
Aggregate Trade or Business Deduction, (I)			($600,000)	($500,000)	($600,000)	($500,000)
NOL Carryforward from Previous Years, (II)				**($100,000)**		
Safe Harbor Amount, Joint Return, (III)			$500,000	$500,000	$500,000	$500,000
(I) + (II) + (III)			($100,000)	($100,000)	($100,000)	$0
Excess Business Loss	N/A	N/A	($100,000)	($100,000)	($100,000)	$0
Income	$700,000	$700,000	$700,000	$700,000	$700,000	$700,000
Deductions, Reduced by Excess Business Loss	($600,000)	($500,000)	($500,000)	($400,000)	($500,000)	($500,000)
NOL Carryforward from Previous Years				($100,000)		($100,000)
Net Income/(Loss)	$100,000	$200,000	$200,000	$200,000	$200,000	$100,000
NOL Carryforward			($100,000)	($100,000)	($100,000)	$0
Adjusted Gross Income	$100,000	$200,000	$200,000	$200,000	$200,000	$100,000

CARES Act, the couple has an AGI that is $100,000 greater than under the pre-TCJA tax regime and, at the same time, has a $100,000 NOL carryover (treatment of which is illustrated in our next example). This is the tax timing distortion created by the TCJA and the CARES Act.

To summarize, after two years of uncertainty introduced by the TCJA (and the accompanying Blue Book) about the ability of business losses to offset wages, the CARES Act has specifically disallowed this offset, only leaving a safe harbor amount of $250,000 ($500,000 for married filing jointly, adjusted for inflation) of wages that could be offset with current year's net business losses. Any remaining net business loss is carried over to future years as an NOL. Despite the unfortunate outcomes just described, the CARES Act also brought some good news to taxpayers with NOL carryovers. We discuss this next.

Good News I: NOL Carryovers Are Excluded from Excess Business Loss Calculation

As we saw in the previous example, excess business loss is carried over to the next tax year as an NOL. Whether such NOL should be included in the calculation of excess business loss next year or not, remained ambiguous under the initial TCJA language of Section 461(l). As we show in our next example, different treatments of the NOL can give rise to large differences in tax results. Fortunately, the CARES Act clarified, in paragraph 461(l)(3)(A)(i), that NOL carryovers should *not* be included in the calculation of excess business loss. Exhibit 3 sets up an example that shows why this clarification is beneficial to the taxpayer.

The top panel of Exhibit 3 contains the facts of our example. In years 2021 and 2022, a married couple filing jointly receives trader fund losses of $600,000 and $500,000, respectively, and interest and dividend income of $700,000 in both years. In the bottom panel of Exhibit 3, the first two columns show the results if such income and losses would have occurred in two consecutive years prior to the TCJA: The trader fund losses would have offset the interest and dividend income and the family would have had an AGI of $100,000 and $200,000 in the two years, respectively.

The two middle columns of Exhibit 3 show a potential reading of the original language of TCJA where an NOL carryover is included in excess business loss calculation and the last two columns show the CARES Act treatment where it is not. The important result is that under the potential TCJA interpretation the AGI is $200,000 in both years, whereas under the CARES Act the AGI is $200,000 in the first year but is $100,000 in the second. Compared to the pre-TCJA result, shown in the first two columns, both treatments create a timing distortion by accelerating income recognition, but the distortion is smaller under the CARES Act: Although $100,000 of AGI is accelerated from year two to year one, the total two-year result is still $300,000 as before the TCJA.

Let's see what gives rise to these differences. The two middle columns show a potential interpretation of Section 461(l)—before the CARES Act clarification—applied to years 2021 and 2022. As before, we will ignore the inflation adjustment to the safe harbor $500,000 amount. In 2021, the trader fund loss is $100,000 greater than the safe harbor amount. This excess amount is treated as excess business loss and is carried over as an NOL to the next year, 2022. Because $100,000 is an excess business loss, only $500,000 out of the $600,000 trader fund loss is available as a deduction in 2021, resulting in the 2021 AGI of $200,000.

In 2022, the trader fund experiences a $500,000 loss, which is just within the limits of the safe harbor amount. However, if the $100,000 NOL carryover is *added* to this trader fund loss, there is again an excess business loss of $100,000 in 2022. For the purposes of the 2022 deduction, the trader fund loss is reduced by $100,000 to $400,000. Thus the 2022 income of $700,000 is reduced by the $400,000 trader fund loss and a $100,000 NOL carryover, resulting in an AGI of $200,000 in 2022.

The last two columns show how the situation is changed by the CARES Act clarification. The year 2021 is the same, however, in 2022 the NOL carryover is *not added* for the purposes of the excess business loss calculation. As a result, because the trader fund loss is equal to the safe harbor amount, there is no excess business loss, and the full $500,000 trader fund loss is a deduction. Combined with $100,000 NOL carryover, the deductions amount to $600,000, thus resulting in the 2022 AGI of $100,000.

Good News II: Capital Losses Attributable to Trade of Business Are Excluded from Excess Business Loss Calculation

The CARES Act added the following sentence to Section 461(l) as subparagraph 461(l)(3)(B)(i): "Deductions for losses from sales or exchanges of capital assets shall not be taken into account under subparagraph (A)(i)." The "subparagraph (A)(i)" here refers to Section 461(l)(3)(A)(i), which defines the aggregate deductions attributable to trade or business. The example in Exhibit 4 illustrates the importance of this new provision in the Code.

Exhibit 4 shows the pre-TCJA outcome in the first column, two alternative interpretations of the TCJA rules in the next two columns, and the outcomes under the CARES Act in the last column. The top panel of Exhibit 4 shows the facts of the example. In a given year, a couple filing jointly has a $600,000 ordinary deduction and a $400,000 capital loss from trader funds. From its investor activities, the couple receives $700,000 in interest and dividend income and recognizes $300,000 in capital gains.

Before the TCJA, income and gains from trader and investor activities could be netted, as we show in the first column. The couple has a net capital loss across trader and investor activities, and under the IRC Section 1211(b), up to $3,000 of

EXHIBIT 4

Trade or Business Capital Losses and Excess Business Loss Limitation

	Pre-TCJA	TCJA Section 461(l)		CARES Act
	Year 2017 and Earlier	A Potential Reading	An Alternative Reading	Years 2021–2025
Trade or Business Income/(Loss)				
Income/(Loss)	($600,000)	($600,000)	($600,000)	($600,000)
Capital Gain/(Loss)	($400,000)	($400,000)	($400,000)	($400,000)
Investor Income/(Loss)				
Interest and Dividend Income	$700,000	$700,000	$700,000	$700,000
Capital Gain/(Loss)	$300,000	$300,000	$300,000	$300,000
Net Trade or Business Amount, (I)		**($903,000)**	**($603,000)**	($600,000)
Safe Harbor Amount, Joint Return, (II)		$500,000	$500,000	$500,000
(I) + (II)		**($403,000)**	**($103,000)**	($100,000)
Excess Business Loss	N/A	($403,000)	($103,000)	($100,000)
Ordinary Income Items				
Interest and Dividend Income	$700,000	$700,000	$700,000	$700,000
Deductions, Reduced by Excess Business Loss	($600,000)	($197,000)	($497,000)	($500,000)
Section 1211(b) Deduction	($3,000)	($3,000)	($3,000)	($3,000)
Net Income/(Loss)	$97,000	$500,000	$200,000	$197,000
NOL Carryforward		**($403,000)**	**($103,000)**	($100,000)
Capital Gain Items				
Trade or Business Capital Gain/(Loss)	$300,000	$300,000	$300,000	$300,000
Investor Activity Capital Gain/(Loss)	($400,000)	($400,000)	($400,000)	($400,000)
Section 1211(b) Deduction	$3,000	$3,000	$3,000	$3,000
Capital Loss Carryforward	($97,000)	($97,000)	($97,000)	($97,000)
Current Year Net Income	$97,000	$500,000	$200,000	$197,000
Current Year Net Capital Gain	$0	$0	$0	$0
Adjusted Gross Income	$97,000	$500,000	$200,000	$197,000

this loss can be used as a deduction. As a result, the couple has $97,000 of ordinary income—$700,000 from income and dividends less $600,000 in trader fund ordinary deductions and $3,000 of net capital loss deduction allowed by Section 1211(b). $97,000 of capital gains—$100,000 net capital loss across trader and investor activities reduced by $3,000 deductible from ordinary income in the current year—are carried over indefinitely to be used against future capital gains under the IRC Section 1212(b).[26] The last three rows of the table in Exhibit 4 show the couple's net income, net capital gains, and an AGI of $97,000. Although, the items of income, gain, and loss in the current year sum to $0, due to character mismatch, the couple ends up with $97,000 of taxable income and a matching carryover capital loss.

The next two columns in Exhibit 4 deal with the Section 461(l) excess business loss limitation. Whether or not Congress intended to include capital losses for the purpose of the business loss limitation was unclear from the language of Section 461(l) and was a subject of much uncertainty and debate among tax professionals. In 2018, in order to assist taxpayers with calculating and reporting excess business losses under Section 461(l), the IRS issued a new form—Form 461, "Limitation on Business Losses." Unfortunately, the logic of the form, as well as the accompanying

[26] Losses from the IRC Section 1256 contracts can be carried back under the IRC Section 1212(c), which also describes limitations on such carrybacks.

instructions, left a door open for different interpretations, which as we show in our example in Exhibit 4, could lead to vastly different tax results.

First, we should say that under both interpretations, the amount of trade or business capital loss available to offset ordinary income under the IRC Section 1211(b)—$3,000 ($1,500 for a married individual filing separately)—was added to other trade or business losses. The ambiguity, leading to alternative interpretations, arose with respect to trade or business capital losses in excess of the $3,000 Section 1211(b) amount.[27]

Under one interpretation, shown in Exhibit 4 in the column titled "A Potential Reading," a trade or business capital loss is considered a trade or business loss to the extent it offsets capital gains from investor activities. In our example, the $300,000 capital gain from investor activities can be offset by $300,000 out of a $400,000 trader fund loss. Therefore, the amount counted for the purpose of the business loss limitation under this interpretation is $300,000. The couple thus has the net trade or business amount as a $903,000 loss. The loss is composed of a $600,000 trader fund loss, a $3,000 Section 1211(b) deduction, and a $300,000 (out of $400,000) trader fund capital loss. After applying the $500,000 safe harbor amount, the couple is left with an excess business loss of $403,000.[28]

After accounting for excess business loss, the deduction applicable to the $700,000 income from interest and dividends is $200,000. It consists of a $197,000 trader fund loss (computed as a $600,000 trader fund loss reduced by a $403,000 excess business loss) and a $3,000 Section 1211(b) deduction due to net capital loss. The couple's net income is thus $500,000. In addition, the couple has a $97,000 capital loss carryover—a net capital loss of $100,000 reduced by a $3,000 deduction applied to ordinary income.

To summarize, under the first interpretation of Section 461(l), the couple has an ordinary income of $500,000, an AGI of $500,000, an NOL carryover of $403,000, and a capital loss carryover of $97,000. One can see that, although the ordinary loss of the trader fund is merely $100,000 greater than the Section 461(l) safe harbor amount of $500,000, the presence of a trade or business capital loss creates a large excess business loss, which is carried over as an NOL, and a correspondingly high level of AGI in the current year. Cleary, under this interpretation, a trade or business capital loss leads to significant and burdensome timing distortions. Due to such potentially punitive results, tax professionals proposed an alternative interpretation.

The column titled "An Alternative Reading" in Exhibit 4 shows the net trade or business amount as a $603,000 loss composed of a $600,000 trader fund loss and a $3,000 Section 1211(b) deduction. Compared to the previous result, $300,000 out of the $400,000 of the trade or business capital loss are not included in this amount.[29] Without going into complexities of filling out the Form 461, we'll just mention

[27] A note in the draft instructions to Form 461 clarifies the interaction of Section 1211(b) and Section 461(l). The note states the flowing: "For amounts reported on Schedule D, if line 3 is a loss limited to ($3,000), determine the amount of the loss not from a trade or business as follows: if the loss from your trade or business is less than ($3,000), enter the difference between ($3,000) and your trade or business loss. Do not enter any loss amount on this line from Schedule D if the loss from your trade or business is equal to or greater than ($3,000)."

[28] Although inclusion of the $3,000 amount in excess business loss and therefore in the NOL carryover might look like double-counting, it must be included if the instructions to form 461 are correctly followed.

[29] Said differently, once capital gains and losses are netted on Schedule D (in our example, to a $100,000 loss), they will not be grossed up again (in our example, to a $400,000 loss and a $300,000 gain) for the purposes of separating capital losses and subjecting them to Section 461(l) limitation. This interpretation is consistent with the plain reading of Section 461(l)(3)(A), which defines "excess business loss" as excess of "the aggregate *deductions* [emphasis added] […] over the sum of the aggregate gross *income or gain* [emphasis added]." One can notice that whereas "gains" are listed explicitly in the second part of the definition of excess business loss, losses are not listed in the first part.

that difference in the interpretation fall out from how one chooses to follow the lines of that form given a lack of clarity in either the instructions to the form or the Section 461(l) itself.

The rest of the calculations follow the same mechanical steps we described for the first potential reading. The $603,000 trade or business loss is reduced by the $500,000 safe harbor amount, leaving the couple with a $103,000 excess business loss. The ordinary deduction applicable to the $700,000 income from interest and dividends is thus $500,000, which is composed of a $600,000 trader fund loss reduced by a $103,000 excess business loss, or $497,000, and a $3,000 Section 1211(b) deduction. The net income is thus $200,000 and the NOL carryover, resulting from the excess business loss, is $103,000. The capital gains results are the same as before—a $97,000 carryover capital loss.

To summarize, under the alternative interpretation, the couple ends up with a substantially less punitive tax outcome than under the first interpretation: only a $200,000 ordinary income, a $200,000 AGI, a $103,000 NOL carryover, and a $97,000 capital gain carryover.

Fortunately, the CARES Act, by adding Section 461(l)(3)(B) ("Treatment of Capital Gains and Losses") explicitly excluded capital losses from calculation of excess business loss. Importantly, the exclusion of capital losses solidified the alternative less punitive interpretation of Section 461(l) we just discussed. We consider this good news.

The last column of Exhibit 4 shows the results under the CARES Act. The excess business loss calculation now completely excludes anything related to capital losses, leading to a $100,000 excess business loss—a $600,000 trade or business loss reduced by the $500,000 safe harbor amount. The ordinary income is now $197,000, computed as the $700,000 from interest and dividends minus the $500,000 trader loss deduction (a $600,000 trader fund loss reduced by a $100,000 excess business loss) minus a $3,000 Section 1211(b) deduction.

The couple now has a $197,000 ordinary income and AGI, a $100,000 NOL carryover, and a $97,000 capital gain carryover. This result is not as beneficial as the pre-TCJA treatment and it gets progressively more punitive as the levels of income from investor activities and trader fund losses increase thus making the $500,000 safe harbor amount less valuable in relative terms. However, the new tax result is at the very least not as burdensome as one of the interpretations of the TCJA where capital losses were included in the excess business loss calculation.

Unfortunately, Section 461(l) has become so convoluted that, although capital losses attributable to trade or business have been excluded from the excess business loss calculation, capital losses from *investor activity* might now increase the excess business loss and thus limit the amount of business loss deductible in the current year. We explain this strange result next.

And Some More Bad News: Investor Activity Losses Increase Excess Business Loss

As we just discussed, the new paragraph 461(l)(3)(B) added under the CARES Act excludes trade or business capital loss from the calculation of excess business loss. However, it brings investor activity losses into the calculation. The paragraph requires calculating net capital gain attributable to *only trade or business* and net capital gain across *all activities* and uses the smaller of the two in the excess business loss calculation. Exhibit 5 sets up an example that shows how investor activity capital losses might adversely affect the taxpayer under this new rule. As a preview, Exhibit 5 will show that under the CARES Act, oddly enough, capital gains from investor activity may increase the amount of ordinary deduction stemming from trade

EXHIBIT 5

Effect of Investor Activity Capital Loss on Excess Business Loss Limitation

	Investor Activity Capital Gain		Investor Activity Capital Loss	
	Pre-TCJA	CARES Act Years 2021–2025	Pre-TCJA	CARES Act Years 2021–2025
Trade or Business Income/(Loss)				
Income/(Loss)	($600,000)	($600,000)	($600,000)	($600,000)
Capital Gain/(Loss)	$400,000	$400,000	$400,000	$400,000
Investor Income/(Loss)				
Interest and Dividend Income	$700,000	$700,000	$700,000	$700,000
Capital Gain/(Loss)	$300,000	$300,000	($400,000)	($400,000)
Aggregate Trade or Business Deduction, (I)		($600,000)		($600,000)
Aggregate Gain from Trade or Business, (II)		$400,000		$0
Safe Harbor Amount, Joint Return, (III)		$500,000		$500,000
(I) + (II) + (III)		$300,000		($100,000)
Excess Business Loss	N/A	$0	N/A	($100,000)
Ordinary Income Items				
Interest and Dividend Income	$700,000	$700,000	$700,000	$700,000
Deductions, Reduced by Excess Business Loss	($600,000)	($600,000)	($600,000)	($500,000)
Net Income/(Loss)	$100,000	$100,000	$100,000	$200,000
NOL Carryforward				($100,000)
Capital Gain Items				
Trade or Business Capital Gain/(Loss)	$400,000	$400,000	$400,000	$400,000
Investor Activity Capital Gain/(Loss)	$300,000	$300,000	($400,000)	($400,000)
Capital Gain/(Loss)	$700,000	$700,000	$0	$0
Current Year Net Income	$100,000	$100,000	$100,000	$200,000
Current Year Net Capital Gain	$700,000	$700,000	$0	$0
Adjusted Gross Income	$800,000	$800,000	$100,000	$200,000

or business ordinary loss, while investor activity capital losses may decrease this deduction. Since, in our opinion, trade or business ordinary loss should be used without limitation as a deduction against investor activity ordinary income, as was the case before the TCJA, we view this result where investor activity capital losses can indirectly reduce the trade or business ordinary loss deduction as bad news. This also suggests that by strategically realizing capital gains an investor can increase the amount of ordinary deduction resulting from a trade or business ordinary loss. We discuss this further below.

Let's start with the facts previously used in Exhibit 4—a $600,000 trader fund loss, a $700,000 income from interest and dividends, and a $300,000 gain from investor activities—but instead of a $400,000 trader fund capital loss, let's assume a $400,000 trader fund capital gain. Pre-TCJA, see the first column, the couple nets the $700,000 of interest and dividend income with the $600,000 of trader fund loss to obtain $100,000 of ordinary income, and has an aggregate $700,000 capital gain from its trader funds and investor activities. The AGI is $800,000.

Under the CARES Act, the couple computes a $400,000 capital gain from trade or business, a $700,000 capital gain from all activities, takes the smaller of the two, that is, $400,000, and uses it for the purpose of the business loss limitation. The second column of Exhibit 5 shows that this capital gain amount is combined with a $600,000 trader fund loss and the $500,000 safe harbor amount to yield a positive a $300,000. As a consequence, the couple doesn't have excess business loss under Section 461(l), and the result for ordinary income, capital gains, and AGI is the same as before the TCJA.

Now, however, let's assume that the investor activity capital result is a loss and not a gain. The third column in Exhibit 5 shows the pre-TCJA results. The last column shows the key result of this example—capital losses from investor activity indirectly trigger a business loss limitation. Let's look at the details. Using the rules of paragraph 461(l), we first compute the net capital gain from trade or business, which amounts to $400,000. We then compute net capital gain from all activities: The trader fund capital gain of $400,000 is netted with the investor activity capital loss of $400,000, resulting in a $0 net loss. Finally, we take the smaller of the trade or business net capital gain and the total net capital gain, which is $0. This is the amount of capital gain added when we compute the business loss limitation. This amount, together with the $600,000 trader fund loss and a $500,000 safe harbor amount, results in a $100,000 excess business loss.

After we have determined the amount of excess business loss, the rest of the calculations flow through as before. The trader fund loss reduced by excess business loss offsets the income from interest and dividends, resulting in a $200,000 ordinary income. The $100,000 excess business loss is carried over as an NOL. The net amount of capital gain or loss across all the activities is $0 and the AGI is $200,000.

The unexpected interaction between the ordinary business loss limitation and investor activity capital loss raises the question whether taxpayers could potentially improve their tax results through strategically reducing the capital loss amount when expecting large trade or business deductions. We believe that in some circumstances they can. Let's look at how this can be done.

Strategic Investor Activity Gain Realization Might Help Improve Tax Results. Let's continue with the facts presented in the last two columns of Exhibit 5. Suppose the couple faces a lower effective tax rate on capital gains than on ordinary income. For example, it can have capital loss carryovers or face a lower long-term capital gains tax rate. Moreover, the couple has assets in their investment portfolio on which they know they will be realizing capital gains at some point during the next few years. In such a case, the couple can strategically realize capital gains on these investment assets in a year when they might be subject to excess a business loss limitation due to capital losses from investor activities, as described in Exhibit 5. We show such an example of strategic capital gain realization in Exhibit 6.

Exhibit 6 compares two scenarios with and without capital gain realization. The first column of the exhibit replicates the last column of Exhibit 5, whereas the second column shows the results where the couple realizes a $100,000 gain on its investment assets in a targeted way. In the latter case, the couple only has a $300,000 net loss from investor activities. This capital loss only partially offsets the $400,000 capital gain from trade or business, thus leaving the couple with a $100,000 net capital gain across all activities. When this net capital gain (which is the smaller of the trade or business net gain and the total net gain) is included in the calculation of excess business loss along with a $600,000 trader fund loss and a $500,000 safe harbor amount, the amount of excess business loss is $0. As a result, the couple can fully utilize the $600,000 trader fund loss against the $700,000 interest and dividend income. The end result is still a $200,000 AGI but now composed of $100,000 of ordinary income and $100,000 of capital gain. Since, as mentioned above, the couple finds capital gains less tax burdensome than ordinary income, strategic realization of capital gains reduces their tax burden.

EXHIBIT 6

Strategic Capital Gain Realization in the Presence of Investor Activity Capital Loss

	CARES Act Years 2021–2025	Strategic Gain Realization
Trade or Business Income/(Loss)		
Income/(Loss)	($600,000)	($600,000)
Capital Gain/(Loss)	$400,000	$400,000
Investor Income/(Loss)		
Interest and Dividend Income	$700,000	$700,000
Intial Capital Gain/(Loss)	($400,000)	($400,000)
Strategically Realized Capital Gain/(Loss)		$100,000
Capital Gain/(Loss)	($400,000)	($300,000)
Aggregate Trade or Business Deduction, (I)	($600,000)	($600,000)
Aggregate Gain from Trade or Business, (II)	$0	$100,000
Safe Harbor Amount, Joint Return, (III)	$500,000	$500,000
(I) + (II) + (III)	($100,000)	$0
Excess Business Loss	($100,000)	$0
Ordinary Income Items		
Interest and Dividend Income	$700,000	$700,000
Deductions, Reduced by Excess Business Loss	($500,000)	($600,000)
Net Income/(Loss)	$200,000	$100,000
NOL Carryforward	($100,000)	$0
Capital Gain Items		
Trade or Business Capital Gain/(Loss)	$400,000	$400,000
Investor Activity Capital Gain/(Loss)	($400,000)	($300,000)
Capital Gain/(Loss)	$0	$100,000
Current Year Net Income	$200,000	$100,000
Current Year Net Capital Gain	$0	$100,000
Adjusted Gross Income	$200,000	$200,000

CONCLUSION

To summarize, the IRC Section 461(l) excess business loss limitation applies to investors in trader funds that may or may not have the IRC Section 475(f) trader in securities election in place. There is no bright line between trader and investor activity, and funds make a trader determination annually based on facts and circumstances. In addition, a trader fund may make a Section 475(f) election for the current and all future years. This election, if repealed, cannot be reinstated for a period of five years.

An important advantage of trader funds is that their fees are still tax deductible under the TCJA and the CARES Act, whereas investor fund fees are not. Trader fund fees, as well as other expenses and ordinary losses, can offset income from trade or business and, up to a safe harbor amount, income from wages and investor activities. Moreover, if a trader fund makes a Section 475(f) election for some of its activities, net economic losses from such activities are marked-to-market and become an ordinary deduction as well.

Next, we clarify that under Treasury regulations, trader fund losses do not constitute a passive activity loss. This means that trader fund ordinary losses can offset ordinary income from trade or business without limitation (and, up to a safe harbor amount, income from wages and investor activities).

Finally, we discuss and illustrate with simple examples the implications of an excess business loss limitation introduced by the TCJA of 2017 and amended by the CARES Act of 2020. We find that, compared to the TCJA, some of the amendments of the CARES Act might be viewed as beneficial from a tax perspective and some as detrimental. Among the disadvantages introduced by the CARES Act are (1) a clarification that income from providing services as an employee cannot be netted with ordinary deductions from trade or business activities such as, for example, trader fund losses, and (2) an indirect adverse effect of investor activity losses on the excess business loss limitation (we provide an example of how in some circumstances the latter can be potentially alleviated by a strategic capital gain realization). At the same time, some of the provisions of the CARES Act can be viewed as beneficial. We discuss two of those—clarity that (1) NOL carryovers and (2) trade or business capital losses are excluded from the computation of excess business loss.

On balance, the provisions of Section 461(l) remain punitive, uneconomical, and unnecessary. Therefore, we hope that due to all its uncertainties and inconsistencies this section will be either allowed to sunset in 2025 or repealed earlier.

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