

Tax Aspects of Claims for Theft and Fraud in Bankruptcy

Presented by

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Income Tax Consequences of a Fraud

- Failure to pay taxes to IRS
- Failure to report income
 - Statute of limitations on assessment (26 U.S.C. 6501)
 - 3 years
 - 6 years
 - No SOL
 - Pros/cons of amended return
 - Qualified amended returns
- Failed 1031 – incorrect rules on requirements; improper usage of proceeds to personal property
 - Facts raise potential tax issues concerning the amount and timing of gain or loss to be recognized by the taxpayer on the disposition of the relinquished property.

IRS Relief?

1031 Failure – Rev. Proc. 2010-14 – QI Bankruptcy

- IRS relief on timing of income event when Qualified Intermediary goes bankrupt during the 180 day replacement window. Gain relating to the failed 1031 will not be recognized until the year in which cash recovery is received by the taxpayer
 - Relief **solely applies** to when a taxpayer is unable to complete deferred like-kind exchange solely due to QI who defaults on its obligation to acquire and transfer replacement property by reason of its entering bankruptcy or receivership under federal or state law.
 - Additional conditions:
 - Properly transferred relinquished property to a QI
 - Properly identified replacement property within the identification period (unless the QI default occurred during that period);
 - Did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI before the time the QI entered bankruptcy or receivership

IRS Relief?...continued...

Ponzi Scheme Relief - Rev. Rul. 2009-9 Published in response to Bernie Madoff Ponzi scheme regarding proper treatment of losses incurred by investors.

- Is ordinary loss, not capital, as long as had the intent to deprive the investor of \$ by criminal acts
- Held that taxpayers had profit motive qualifying as a theft loss under 165(c)(2) and not (c)(3)
- The amount of the theft loss is the amount invested, less withdrawals, reduced by reimbursements or recoveries or other compensation
- If taxable income was previously reported prior to the discovery of the theft, the investment is increased by the purportedly reinvested amount.
 - Amend prior years returns?
- Any a theft loss allowable under 165(c)(2) or (c)(3) is treated as a business deduction, and thus not limited to nonbusiness gain
- Theft loss by an individual (not a corporation or a partnership) is a loss from a “sole proprietorship” under 172(b)(1)(F)’s then favorable NOL carryback rule
- SOL mitigation provisions in 1311-1341 not applicable, so cannot adjust tax liability in years otherwise barred
- Alternative computation in 1341 n/a

IRS Relief?...continued...

Ponzi-type Scheme Loss Relief - Rev. Proc. 2009-20 – loss procedure when investment is discovered to be criminally fraudulent

- Allows uniform procedure for theft loss reporting from a Ponzi scheme to be claimed without independent proof of the theft and a safe-harbor method for computing the amount of the deduction.
 - **Fraudulent Investment defined as an arrangement where takes \$ from investors, income amounts are reported to investors that are partially or wholly fictitious, payments, if any, of purported income or principal are made to some investors from amounts that other invested in the fraudulent arrangement, and some or all of the investors' cash or property is appropriated.**
- Addresses wholly or partially fictitious earnings, but only if the income was included in the investor's tax return
- Requires lead figure to be criminally charged or be subject to a criminal complaint and admission or a receiver or trustee is appointed with respect to the arrangement or the assets were frozen.
- Qualified investor that did not know of the sham and investment was is not a listed tax shelter
- If follow the procedure, then the IRS will not challenge the loss as a theft loss, the year in which the loss is taken, and the amount of the deduction
- **Amount of deduction is (i) the amount invested * 95% if no third party recovery is pursued OR 75% if a third-party recovery is pursued, (ii) less actual or potential recovery from insurance/SIPC recovery. If the actual recovery is greater, the investor will have income in the subsequent year.**

Taxation - Potential Recoveries

- Origin of the Claim Doctrine
 - In lieu of what are the damages awarded?
 - If multiple types of recovery – income/gain, recovery of investment/basis, interest income, then the recovery is reasonably allocated
- Proof of Claim Effects on Origin of Claim doctrine
 - For taxpayers who may eventually seek to claim theft loss deduction, keep in mind that *personal* casualty and theft loss deductions are currently suspended unless related to federally-declared disaster
 - Theft loss still available for trade or business
 - Profit motive for 165(c)(2) and bona fide 1031 intent?
 - COVID-19 and 165(c)(3)

Casualty and Theft Losses

- Casualty losses are treated differently depending on whether the loss occurred to property used in your trade or business, to generate investment income, or for personal or family purposes.
- Regardless of the type of property, the loss must first be reported on IRS Form 4684, Casualties and Thefts.
- Fact and amount of loss must be proven.
 - Loss cannot exceed the adjusted basis of the damaged asset. 26 U.S.C. 165(b); Treas. Reg. 1.165-1(c)
- Deductible in the year in which the loss is closed, completed, and “fixed by identifiable events” (discussed later)

Casualty and Theft Losses

Effects of TCJA

- Loss Rules
 - 165(c)(1) – losses incurred in a trade or business
 - 165(c)(2) – loss incurred in any transaction entered into for profit
 - 165(c)(3) – subject to (h), losses of property not connected to a trade or business or transaction entered into for profit, if such losses arise from fire, storm, shipwreck or other casualty, or theft
- For tax years 2018 through 2025, individuals can no longer claim deductions for *personal* casualty and theft losses under 165(c)(3), unless “attributable to” a federally-declared disaster
 - For personal casualty loss attributable to federally-declared disaster, can claim the deduction in current year or the previous year
 - COVID-19

Casualty and Theft Losses of Income-Producing Property

IRS Publication 529:

You can deduct a casualty or theft loss as an itemized deduction on your Schedule A (Form 1040), if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First report the loss on Form 4684. You may also have to include the loss on Form 4797, Sales of Business Property, if you are otherwise required to file that form. To figure your deduction, add all casualty or theft losses from this type of property included on Form 4684, or Form 4797. For more information on casualty and theft losses, see Pub. 547.

2021 Form 1040

irs.gov/pub/irs-pdf/f1040.pdf

2021 Form 1040

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Form 1040 Department of the Treasury—Internal Revenue Service (99) **2021** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial Last name Your social security number

If joint return, spouse's first name and middle initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code

Foreign country name Foreign province/state/county Foreign postal code

Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.
☐ You ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☐ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind

Dependents (see instructions):
If more than four dependents, see instructions and check here ▶ ☐

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

1 Wages, salaries, tips, etc. Attach Form(s) W-2 **1**

2a Tax-exempt interest **2a** **b** Taxable interest **2b**

3a Qualified dividends **3a** **b** Ordinary dividends **3b**

4a IRA distributions **4a** **b** Taxable amount **4b**

5a Pensions and annuities **5a** **b** Taxable amount **5b**

6a Social security benefits **6a** **b** Taxable amount **6b**

7 Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐ **7**

8 Other income from Schedule 1, line 10 **8**

9 Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶ **9**

10 Adjustments to income from Schedule 1, line 26 **10**

11 Subtract line 10 from line 9. This is your **adjusted gross income** ▶ **11**

12a **Standard deduction or itemized deductions** (from Schedule A) **12a**

b Charitable contributions if you take the standard deduction (see instructions) **12b**

c Add lines 12a and 12b **12c**

13 Qualified business income deduction from Form 8995 or Form 8995-A **13**

14 Add lines 12c and 13 **14**

15 **Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0- **15**

Attach Sch. B if required.

Standard Deduction for—
• Single or Married filing separately, \$12,550
• Married filing jointly or Qualifying widow(er), \$25,100
• Head of household, \$18,800
• If you checked any box under Standard Deduction, see instructions.

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☰ **2021 Schedule A (Form 1040)** 1 / 1 | - 75% + | ⏴ ⏵

**SCHEDULE A
(Form 1040)**

Department of the Treasury
Internal Revenue Service (IRS)

Name(s) shown on Form 1040 or 1040-SR

Itemized Deductions

▶ Go to www.irs.gov/ScheduleA for instructions and the latest information.
▶ Attach to Form 1040 or 1040-SR.

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074
2021
Attachment
Sequence No. **07**

Your social security number

Medical and Dental Expenses	<p>Caution: Do not include expenses reimbursed or paid by others.</p> <p>1 Medical and dental expenses (see instructions) 1</p> <p>2 Enter amount from Form 1040 or 1040-SR, line 11 2</p> <p>3 Multiply line 2 by 7.5% (0.075) 3</p> <p>4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0- 4</p>
Taxes You Paid	<p>5 State and local taxes.</p> <p>a State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box <input type="checkbox"/> 5a</p> <p>b State and local real estate taxes (see instructions) 5b</p> <p>c State and local personal property taxes 5c</p> <p>d Add lines 5a through 5c 5d</p> <p>e Enter the smaller of line 5d or \$10,000 (\$5,000 if married filing separately) 5e</p> <p>6 Other taxes. List type and amount ▶ 6</p> <p>7 Add lines 5e and 6 7</p>
Interest You Paid	<p>8 Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box <input type="checkbox"/></p> <p>a Home mortgage interest and points reported to you on Form 1098. See instructions if limited 8a</p> <p>b Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address 8b</p> <p>c Points not reported to you on Form 1098. See instructions for special rules 8c</p> <p>d Mortgage insurance premiums (see instructions) 8d</p> <p>e Add lines 8a through 8d 8e</p> <p>9 Investment interest. Attach Form 4952 if required. See instructions . 9</p> <p>10 Add lines 8e and 9 10</p>
Gifts to Charity	<p>11 Gifts by cash or check. If you made any gift of \$250 or more, see instructions 11</p> <p>12 Other than by cash or check. If you made any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500 12</p> <p>13 Carryover from prior year 13</p> <p>14 Add lines 11 through 13 14</p>
Casualty and Theft Losses	<p>15 Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions 15</p>
Other Itemized Deductions	<p>16 Other—from list in instructions. List type and amount ▶ 16</p>

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☰ **2021 Form 4684**

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Form 4684

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

► Go to www.irs.gov/Form4684 for instructions and the latest information.
► Attach to your tax return.
► Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2021
Attachment
Sequence No. **26**

Name(s) shown on tax return _____ Identifying number _____

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes. For tax years 2018 through 2025, if you are an individual, casualty or theft losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. You must use a separate Form 4684 (through line 12) for each casualty or theft event involving personal-use property. **If reporting a qualified disaster loss, see the instructions for special rules that apply before completing this section.**)

If the casualty or theft loss is attributable to a federally declared disaster, check here ☐ and enter the DR- _____ or EM- _____ declaration number assigned by FEMA. (See instructions.)

1 Description of properties (show type, location (city, state, and ZIP code), and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. If you checked the box and entered the FEMA disaster declaration number above, enter the ZIP code for the property most affected on the line for Property A.

	Type of Property	City and State	ZIP Code	Date Acquired
Property A				
Property B				
Property C				
Property D				

	Properties			
	A	B	C	D
2 Cost or other basis of each property				
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions) Note: If line 2 is more than line 3, skip line 4.				
4 Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year				
5 Fair market value before casualty or theft				
6 Fair market value after casualty or theft				
7 Subtract line 6 from line 5				
8 Enter the smaller of line 2 or line 7				
9 Subtract line 3 from line 8. If zero or less, enter -0-				
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D				

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Casualty and Theft Losses

- I.R.C. § 165(a) allows "as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."
- I.R.C. § 165(e) provides "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." See also Treas. Reg. § 1.165-8(a)(2).
- If a reasonable prospect of recovery exists, the theft loss shall not be sustained until such prospect no longer exists, based on all facts and circumstances. See Treas. Reg. §§ 1.165-8(a)(2); -1(d)(2)(i).
- Theft – defined in Treas. Reg. §§ 1.165-8(d) to include, but not limited to, embezzlement, larceny, and robbery.
 - Theft - it must be an illegal taking under state criminal law and with criminal intent to deprive the taxpayer of the money or property.

Theft Losses...continued...

In *Urtis v. Comm 'r*, T.C. Memo 2013-66, at *15-*16, the U.S. Tax Court explained:

"A reasonable prospect of recovery exists when the taxpayer has a bona fide claim for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in the taxpayer's favor." (citing *Premji v. Comm 'r*, T.C. Memo. 1996-304, at *22). However, claims with only remote or nebulous potential for success will not postpone the deduction. Whether a reasonable prospect of recovery exists is a question of fact, determined by examining all facts and circumstances. "The standard to be applied is primarily objective, but the taxpayer's subjective attitude and beliefs are not to be ignored." (citing *Premji*, at *23).

Theft Losses...continued...

In *Halata v. Comm'r*, T.C. Memo 2012-351, at *27-*28 the U.S. Tax Court held that Ms. Halata's attorney's investigation was sufficient to determine with reasonable certainty in 2009 that Ms. Halata could not recover her loss where the attorney concluded that a lawsuit was impractical given the cost of the lawsuit, the perpetrator's lack of recoverable assets, and the perpetrator's possible defenses.

Theft Losses...continued...

In *Urtis v. Comm 'r*, T.C. Memo 2013-66, *10-*11, the Tax Court provided the following guidance with respect to thefts deductible under I.R.C. § 165:

“As used in the statute, theft is intended to incorporate any criminal taking of another's property, including the crime of false pretenses. The factual existence of the theft must be established by reference to the law of the jurisdiction where the loss occurred. Although a criminal conviction in a state court may conclusively establish the existence of a theft, the deduction does not depend upon whether the thief is convicted, prosecuted, or even whether the taxpayer chooses to move against him. Moreover, the taxpayer must prove a theft occurred under the relevant state statute only by a preponderance of the evidence.”

Theft Losses...continued...

Texas Penal Code Ann. § 31.03(a) defines theft as follows:

THEFT. (a) A person commits an offense if he unlawfully appropriates property with intent to deprive the owner of property.

Subsection (b) of the statute provides that an "Appropriation of property is unlawful if: (1) it is without the owner's effective consent". "Consent is not effective if [] induced by deception or coercion."

Theft Losses...continued...

Texas Penal Code Ann. § 31.01(2)

To "Deprive" means:

- (A) to withhold property from the owner permanently or for so extended a period of time that a major portion of the value or enjoyment of the property is lost to the owner;
- (B) to restore property only upon payment of reward or other compensation; or
- (C) to dispose of property in a manner that makes recovery of the property by the owner unlikely.

Theft Losses...continued...

Texas Penal Code Ann. § 31.01(1)

"Deception" means:

- (A) creating or confirming by words or conduct a false impression of law or fact that is likely to affect the judgment of another in the transaction, and that the actor does not believe to be true;
- (B) failing to correct a false impression of law or fact that is likely to affect the judgment of another in the transaction, that the actor previously created or confirmed by words or conduct, and that the actor does not now believe to be true;
- (C) preventing another from acquiring information likely to affect his judgment in the transaction;
- (D) selling or otherwise transferring or encumbering property without disclosing a lien, security interest, adverse claim, or other legal impediment to the enjoyment of the property, whether the lien, security interest, claim, or impediment is or is not valid, or is or is not a matter of official record; or
- (E) promising performance that is likely to affect the judgment of another in the transaction and that the actor does not intend to perform or knows will not be performed, except that failure to perform the promise in issue without other evidence of intent or knowledge is not sufficient proof that the actor did not intend to perform or knew the promise would not be performed.

DEDUCTIBILITY OF LEGAL FEES

- “Above the Line” Deductions
 - Partnership & LLC/S Corp/C Corp – IRC 162
 - Schedule C
 - Schedule E, F
 - Certain employment & whistleblower cases
 - If they fall under one of the above categories, legal fees incurred in attempt to recover stolen property are deductible as part of the theft loss. *Ander v. Comm’r*, 47 TC 592 (1967).
- “Below the Line” Deductions
 - Prior Law – Attorneys fees generally deductible but subject to 2% haircut
 - Current Law – NO miscellaneous itemized deductions, but may be able to claim as other itemized deduction if incurred in attempt to recover stolen income producing property or the casualty/theft loss is “attributable to” a federally declared disaster

IRS Collections Overview

- IRS Collection Notices
- Private Debt Collections
- IRS Revenue Officers
- Collection Alternatives
 - Installment Agreements
 - Currently Not Collectible (CNC)
 - Offer in Compromise (OIC)
 - Collateral Agreements
 - Additional Time

IRS Collection Appeals

- Collection Appeals Program (CAP)
- Collection Due Process (CDP) Requests
- IRS Appeals (Settlement) Officers
- File Petition with U.S. Tax Court

Federal Suits

- Employment Tax Suits
- Temporary Injunction
- Reduce Federal Tax Lien to Judgment
- Post-Judgment Collection
- Foreclosure of Homestead

IRS VOLUNTARY DISCLOSURE PRACTICE

- Informal – an issue to be considered in decision re criminal prosecution referral by IRS to the Department of Justice
- No substantive or procedural rights for taxpayers
- Cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution
- Requires truthful, timely and complete disclosure
- IRS practice since 1952 - encourage voluntary compliance
 - Legal source income
 - Timely – disclosure before IRS has initiated an examination or otherwise has information re taxpayer (Informant?)
 - Truthful and complete
- Taxpayer must
 - Fully cooperate with IRS
 - Make good faith arrangements to pay any tax, interest, and penalties determined by the IRS to be due
- Disclose every aspect of noncompliance
- Will not automatically guarantee immunity from prosecution - however, a voluntary disclosure may result in prosecution not being recommended by IRS (no “referral” to the Department of Justice for prosecution)
- IRS representatives to refrain from offering opinions or discussing hypothetical investigations with anonymous taxpayers or his/her representatives – may inquire as to reasons why they are making the voluntary disclosure

Basic NOL Rules

Pre-TCJA

- Before the TCJA, NOLs could be carried back two years and carried forward 20 years.
- Before the TCJA, it was necessary to calculate the alternative minimum tax (“AMT”) NOL.

Basic NOL Rules

Effects of TCJA

- Tax Cuts and Jobs Act (TCJA; P.L. 115-97). Current permanent law
- After TCJA, NOLs arising after 2017 can no longer be carried back, but may be carried forward indefinitely. (The CARES Act, discussed below, temporarily allowed some post-2017 NOLs to be carried back.)
- Can be viewed as favoring start-up companies, and disfavoring more established companies with fluctuating income, whereas both types of companies benefitted from the pre-TCJA rules.
- Provides that post-2017 NOLs can only offset 80% of a company's taxable income.
- Abolished the corporate AMT, so no longer necessary to calculate AMT NOL.
- Introduced "BEAT," "GILTI," and "FDII": new tax regimes that use some or all of NOL carryovers to calculate tax.
 - BEAT partially disallows NOLs based on a percentage; GILTI and FDII allow a deduction, calculated based on taxable income reduced by NOLs, reducing the benefit created by these NOLs.

Basic NOL Rules

2020 CARES Act

- Allows a five-year carryback for NOLs that arose in years 2018–2020
- Companies may recover estimated tax payments via a Form 4466 and get “quickie refunds” with Form 1139.
- Eliminated 80% limitation for 2018 through 2020.
- While the 20-year carryforward still applies to pre-TCJA NOLs, the repeal of the corporate AMT, and the fact that post-2017 NOLs can now offset 100% of corporate taxable income pursuant to the CARES Act (for NOLs arising in 2018-2020), means that the value of these NOLs has increased for some corporations.

Basic NOL Rules

2020 CARES Act

- Suspended for 2018-2020 the provision in the TCJA (Section 461(l)) that limited the amount of NOLs that individuals could use to offset other income.
- Clarified that “other income” included wages from the business for purposes of the limitation in future years.
- Included a technical correction to the TCJA, allowing certain firms whose fiscal years are not based on calendar years to use the pre-TCJA rules for losses in the year spanning 2017 and 2018.
- Allows taxpayers to disregard years in which a tax was paid under the TCJA’s transition tax (Section 965) on previously accumulated earnings abroad.

Basic NOL Rules

COVID-Related Tax Relief Act

- Allows farmers who elected a two-year NOL carryback before the CARES Act to elect to retain that two-year carryback rather than claim the five-year carryback provided in the CARES Act.
- Also allows farmers who previously waived an election to carry back an NOL to revoke the waiver.
- Applies retroactively as if included in the CARES Act.

Basic NOL Rules

Looking Forward

- Although no changes in the treatment of losses were included in the Consolidated Appropriations Act, 2021 (P.L. 116-260), enacted in December 2020, the limit on individual losses, which was originally scheduled to expire after 2025, was extended through 2026 by the American Rescue Plan Act of 2021 (P.L. 117-2) enacted in March 2021.

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