Do you have an excess business loss?

If an individual taxpayer has substantial business losses, unfavorable federal income tax rules can potentially come into play. Here's what you need to know as you assess your 2024 tax situation.

Disallowance rule

The tax rules can get complicated if your business or rental activity throws off a tax loss — and many do during the early years. First, the passive activity loss (PAL) rules may apply if you aren't very involved in the business or if it's a rental activity. The PAL rules generally only allow you to deduct passive losses to the extent you have passive income from other sources. However, you can deduct passive losses that have been disallowed in previous years (called suspended PALs) when you sell the activity or property that produced the suspended losses.

If you successfully clear the hurdles imposed by the PAL rules, you face another hurdle: You can't deduct an *excess business loss* in the current year. For 2024, an excess business loss is the excess of your aggregate business losses over $305,000 ($610,000 for married joint filers). For 2025, the thresholds are $313,000 and $626,000, respectively. An excess business loss is carried over to the following tax year and can be deducted under the rules for net operating loss (NOL) carryforwards explained below.

Deducting NOLs

You generally can't use an NOL carryover, including one from an excess business loss, to shelter more than 80% of your taxable income in the carryover year. Also, NOLs generally can't be carried back to an earlier tax year. They can only be carried forward and can be carried forward indefinitely. The requirement that an excess business loss must be carried forward as an NOL forces you to wait at least one year to get any tax-saving benefit from it.

Example 1: Taxpayer has a partial deductible business loss

David is unmarried. In 2024, he has an allowable loss of $400,000 from his start-up AI venture that he operates as a sole proprietorship.

Although David has no other income or losses from business activities, he has $500,000 of income from other sources (salary, interest, dividends, capital gains and so forth).

David has an excess business loss for the year of $95,000 (the excess of his $400,000 AI venture loss over the $305,000 excess business loss disallowance threshold for 2024 for an unmarried taxpayer). David can deduct the first $305,000 of his loss against his income from other sources. The $95,000 excess business loss is carried forward to his 2025 tax year and treated as part of an NOL carryover to that year.

Variation: If David's 2024 business loss is $305,000 or less, he can deduct the entire loss against his income from other sources because he doesn't have an excess business loss.

Example 2: Taxpayers aren't affected by the disallowance rule

Nora and Ned are married and file tax returns jointly. In 2024, Nora has an allowable loss of $350,000 from rental real estate properties (after considering the PAL rules).

Ned runs a small business that's still in the early phase of operations. He runs the business as a single-member LLC that's treated as a sole proprietorship for tax purposes. For 2024, the business incurs a $150,000 tax loss.

Nora and Ned have no income or losses from other business or rental activities, but they have $600,000 of income from other sources.

They don't have an excess business loss because their combined losses are $500,000. That amount is below the $610,000 excess business loss disallowance threshold for 2024 for married joint filers. So, they're unaffected by the disallowance rule. They can use their $500,000 business loss to shelter income from other sources.

Partnerships, LLCs and S corporations

The excess business loss disallowance rule is applied at the owner level for business losses from partnerships, S corporations and LLCs treated as partnerships for tax purposes. Each owner's allocable share of business income, gain, deduction, or loss from these pass-through entities is taken into account on the owner's Form 1040 for the tax year that includes the end of the entity's tax year.

The best way forward

As you can see, business losses can be complex. Contact us if you have questions or want more information about the best strategies for your situation.