Passive Loss and At-Risk Rules

SPIDELL
A CeriFi Company
TAX • ANALYSIS • EDUCATION

www.spidell.com | E-mail: cpe@spidell.com | Phone: 800-277-2257

This publication is distributed with the understanding that the authors and publisher are not engaged in rendering legal, accounting or other professional advice and assume no liability in connection with its use. Tax laws are constantly changing and are subject to differing interpretation. In addition, the facts and circumstances in your particular situation may not be the same as those presented here. Therefore, we urge you to do additional research and ensure that you are fully informed before using the information contained in this publication. Federal law prohibits unauthorized reproduction of the material in Spidell's **Passive Loss and At-Risk Rules** manual. All reproduction must be approved in writing by **Spidell Publishing, LLC®**

This is not a free publication. Purchase of this electronic publication entitles the buyer to keep one copy on his/her computer and to print out one copy only. Printing out more than one copy — and any electronic distribution of this publication — is prohibited by international and United States copyright laws and treaties. Illegal distribution of this publication will subject the purchaser to penalties of up to $100,000 per copy distributed.

Passive Loss & At-Risk Rules

With the adoption of the passive loss limitation rules, taxpayers are looking to CPAs for guidance related to what deductions are allowed, disallowed, or suspended. Updating practitioners on the practical aspects of §469, this course addresses the needed skill to handle these pragmatic issues. Fundamentals are reviewed, planning opportunities are identified, and creative strategies are discussed and evaluated along with remaining traditional approaches. The goal of this instructive course is to understand and solve client problems under §469, with emphasis on tax savings ideas. Participants will learn to master the proper administration of these complex and often cumbersome provisions.

Course Level: Overview. This program is appropriate for professionals at all organizational levels.

Field of Study: Taxes

Prerequisite: General understanding of federal income taxation.

Advanced Preparation: None

Recommended CPE Hours: CPAs — 3 Tax
EAs and CRTPs — 3 Federal Tax

Expiration Date: July 2024

Learning Assignment & Objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

ASSIGNMENT

At the start of the materials, participants should identify the following topics for study:

* Passive loss rules
* Material participation
* Activity definition
* Passive & nonpassive activities
* Passive activity loss
* Rental activities
* Recharacterization of passive income
* Passive activity credits
* Passive activity audit guide
* At-risk limits

Learning Objectives

After reading the materials, participants will be able to:

1. Identify affected taxpayers, categories of income and loss, and passive losses under §469 and necessary §469 calculation steps and specify the §469 & §1211 limits and the ordering and suspension of any disallowed losses.

2. Recognize a taxpayer's material participation in an activity by:

a. Identifying the material participation tests and their application to entities such as partnerships and corporations;

b. Specifying the activity grouping rules and exempt activities;

c. Determining passive activity particularly, the treatment of rental activity as passive; and

d. Identifying "nested" activities.

3. Identify special passive loss rules and calculations by:

a. Determining alternating use effects on amount realized and adjusted basis and citing additional loss limitations outside of §469;

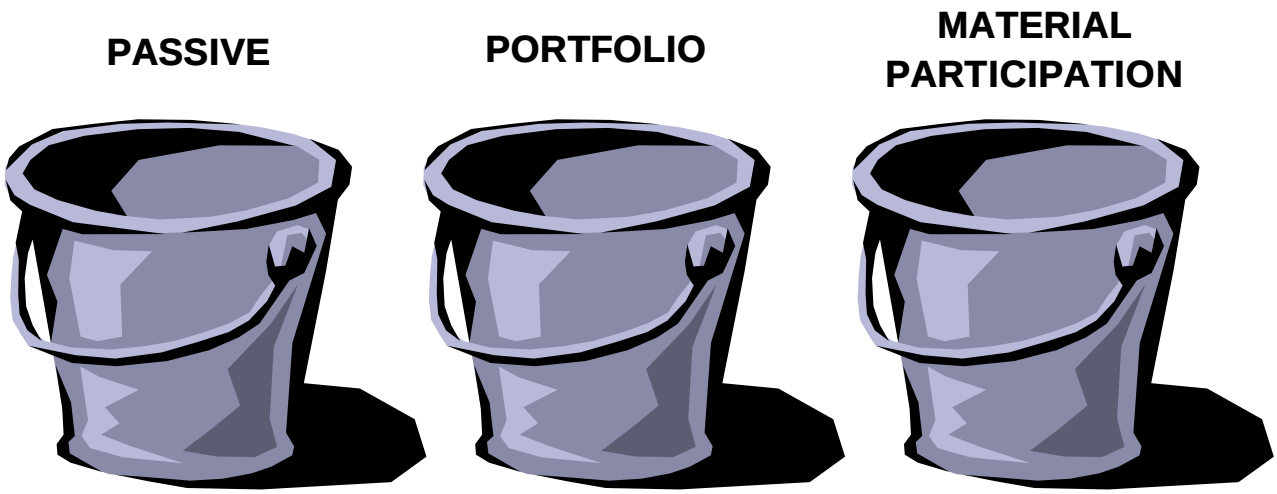
b. Recognizing requirements for the special $25,000 allowance; and

c. Specifying recharacterization rules and their purpose.

4. Recognize the passive activity audit guidelines identifying audit issues, determine the real estate rental activity credit exception, and cite the at-risk limit rules as they relate to §469.

Notice

This course and test have been adapted from materials and information contained in the above text and any supplemental material provided. This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.



Passive Loss & At-Risk Rules

By

Danny C. Santucci

The author is not engaged by this text, any accompanying electronic media, or lecture in the rendering of legal, tax, accounting, or similar professional services. While the legal, tax, and accounting issues discussed in this material have been reviewed with sources believed to be reliable, concepts discussed can be affected by changes in the law or in the interpretation of such laws since this text was printed. For that reason, the accuracy and completeness of this information and the author's opinions based thereon cannot be guaranteed. In addition, state or local tax laws and procedural rules may have a material impact on the general discussion. As a result, the strategies suggested may not be suitable for every individual. Before taking any action, all references and citations should be checked and updated accordingly.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert advice is required, the services of a competent professional person should be sought.

—-From a Declaration of Principles jointly adopted by a committee of the American Bar Association and a Committee of Publishers and Associations.

Copyright February 2023

Danny Santucci

Table of Contents

Passive Loss Rules 1
- Application 1
  - Active Losses 1
  - Credits 2
- Calculating Passive Loss - The "Fish" Rules 2
- Categories of Income & Loss 2
  - Passive 2
  - Portfolio 3
  - Material Participation 3
- Suspension of Disallowed Losses 6
  - Fully Taxable Disposition 6
    - Abandonment & Worthlessness 6
    - Related Party Transactions 6
    - Credits 6
      - Disallowance 7
      - Increase Basis Election 7
  - Other Transfers 7
    - Transfer By Reason Of Death - §469(g)(2) 7
    - Transfer By Gift - §469(j)(6) 7
    - Installment Sale - §469(g)(3) 8
    - Activity No Longer Treated As Passive Activity - §469(f)(1) 8
    - Closely Held To Nonclosely Held Corporation - §469(f)(2) 8
    - Nontaxable Transfer 9
  - Ordering of Losses 9
    - Capital Loss Limitation - §1211 10
  - Carryforwards 11
  - Allocation of Suspended Losses 11
- Taxpayers Affected 11
  - Noncorporate Taxpayers 11
  - Regular Corporations 11
  - Personal Service Corporations 11
    - Definition - Temp. Reg. §1.469-1T(g)(2)(i) 13
    - Personal Services 13
    - Principal Activity - 50% Test 13
    - Substantially Performed by Employee-Owners - 20% Test 13

Material Participation 14
- "Trade or Business" Definition 14
- February 19, 1988 Regulations 14
  - General Rule for Individuals 14
  - Record keeping 17

Meaning of Participation 17
Exceptions to Definition - The "Unwork" Rules 17
Husband & Wife Counted as One 18
Annual Test 18
Pre-'87 Participation - 500 Hours 19
Special Rules for Entities 21
Limited Partnership Interests Presumption 21
Exceptions to Presumption 21
Trusts and Estates 22
Retired & Disabled Farmers 22
Corporations 22
Activity Definition 24
Final Regulations 26
Relevant Factors 26
Rental Activities 26
Limited Partnership Activities 27
Partnership & S Corporation Activities 27
Consistency 27
Regrouping 28
Partial Dispositions 28
Passive & Nonpassive Activities 28
Trade or Business 29
Characterization Based on Participation 29
Rental Activity 29
Exceptions 29
Non-Passive Activities 30
Rental Activities of Real Estate Professionals 30
Eligibility Standards 30
Working Interests in Oil & Gas 32
Entities That Limit Liability 32
Activities within Activities 32
Passive Activity Loss 33
Husband & Wife 33
Special Rule for Closely Held Corporations 33
Net Active Income 33
Carryover of Disallowed Losses 36
Treatment of Carryover Losses 36
Allocation Process 36
Significant Participation Activities ..... **Error! Bookmark no**
Income from Dispositions of Property Used in Passive Activities 38
Mixed Use of Property 38
Alternating Use 38
De Minimis Use Rule - 10/10 Test 39
Disposition of Appreciated Property Formerly Used in a Nonpassive Activity 39
Rental Activities 39
Special Rule for Rental Real Estate 39
Five Conditions 40
Active Participation 42
Change in Participation 42
Application of $25,000 Allowance Rule 42
Aggregation & Ordering: 42

Net Operating Loss 43
Net Leases 43
Definition 43
Recharacterization of Passive Income 43
Active Business Recharacterization 43
Significant Participation Income Rules 43
Ratable Portion of Income 44
Formula 44
Significant Participation Losses 44
Rental of Property Developed by Taxpayer 44
Self-Rented Property 45
Portfolio Income Recharacterization Rules 45
Rental of Nondepreciable Property 45
Equity Financed Lending Activities 45
Limitation on Recharacterization 45
Passive Activity Credits 46
Regular Tax Liability Allocable to Passive Activities 46
Formula 46
Exception for Real Estate Rental Activity Credits 46
Application 47
Credits Subject to Passive Activity Limits 47
Allocation of Disallowed Credits 48
Treatment of Carryover Credits 48
Passive Activity Audit Guide 48
Indicators of Audit Issues 48
Investment Interest 49
Material Participation 49
Significant Participation Activities 50
Active Participation 50
Net Lease Properties 50
Vacation Rentals 51
Self-Charged Expenses 51
Rental & Nonrental Activity Grouping 51
Divorce 52
At-Risk Limits 52
Amount At Risk 52
Taxpayers Affected 52
Closely Held Corporation 52
Qualified Corporation Exception 54
Qualifying Business Requirements 54
Loss Defined 55
Disallowed Losses 55
Form 6198 55
Partnership & S Corporation Limits 55
Activities Covered by the At-Risk Rules 56
Equipment Leasing 56
Real Property 57
Grouping of Activities 57
Partners & S Corporation Shareholders 58
At-Risk Amounts 58
Borrowed Amounts 58

Related Persons 59
Subsequent Years 60
Amounts Not At Risk 60
Nonrecourse Financing 61
Other Loss Limiting Arrangements 61
Reductions of Amounts At Risk 62

Learning Objectives

After reading the materials, participants will be able to:

1. Identify affected taxpayers, categories of income and loss, and passive losses under §469 and necessary §469 calculation steps and specify the §469 & §1211 limits and the ordering and suspension of any disallowed losses.

2. Recognize a taxpayer's material participation in an activity by:

a. Identifying the material participation tests and their application to entities such as partnerships and corporations;

b. Specifying the activity grouping rules noting exempt activities;

c. Determining passive activity particularly, the treatment of rental activity as passive; and

d. Identifying "nested" activities.

3. Identify special passive loss rules and calculations by:

a. Determining alternating use effects on amount realized and adjusted basis and citing additional loss limitations outside of §469;

b. Recognizing requirements for the special $25,000 allowance; and

c. Specifying recharacterization rules and their purpose.

4. Recognize the passive activity audit guidelines identifying audit issues, determine the real estate rental activity credit exception, and cite the at-risk limit rules as they relate to §469.

PASSIVE LOSS & AT-RISK RULES



Passive Loss Rules

Section 469 provides that a taxpayer's income and losses for each tax year must be categorized into *passive* and *nonpassive*[1]. Losses from *passive* trade or business activities in excess of income from *passive* trade or business activities may not be deducted against other income (§469(a)(1)(A)).

The passive loss rules provide that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may *not* be deducted against other income (§469(a)(1)(A)). Similarly, *credits* from passive activities generally are limited to the tax due to the *passive* activities[2] (§469(a)(1)(A)). Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the *next* tax year[3] (§469(b)). Suspended losses from an activity are allowed in full when the taxpayer disposes of his or her entire interest in the activity. However, the ordering of recognized losses is determined under §469(g)(1).

Application

The passive loss rule applies to *all* deductions from passive activities, including deductions allowed under §162, §163, §164, and §165.

Active Losses

Section 469 is a passive loss limitation and does *not* affect *active* losses. Active losses may offset any type of income.

---

[1] Nonpassive is further subdivided into portfolio and material participation.

[2] Thus, if there is no net passive activity income for the year, passive credits will generally not be allowed. However, when the $25,000 allowance for rental real estate is not fully used, passive credits can sometimes be converted to deductions and used under the allowance.

[3] The carryforward has no time limit.

Credits

There are limits on credits and losses from passive activities. Credits from a passive activity are generally limited to the income tax allocable to the net passive activity income (§469(a)(1)(B)).

Calculating Passive Loss - The "Fish" Rules

The annual computation of passive losses can be summarized as a series of several basic steps:

1. Determine all the separate activities of the taxpayer ("catch the fish");

2. Categorize all activities ("put fish in buckets") as either:

(a) Passive,

(b) Portfolio, *or*

(c) Material participation;

3. Take the passive activities and net ("fish against fish") income against loss:

(a) First, netting the income of *each* activity solely against the losses of that activity[4], *then*

(b) Next, offsetting all net income activities against *all* net loss activities;

4. If a loss still exists, it is a passive activity loss and §469 applies.

Categories of Income & Loss

Section 469 annually divides a taxpayer's income and losses into two basic categories, passive and non-passive. Non-passive is further subdivided into portfolio and material participation. The result is three categories or "buckets" of income and loss.

Passive

Sections 469(c)(1), (c)(2), and (h)(2) define passive items to be any of the following:

1. Any activity involving the conduct of a trade or business in which the taxpayer does *not* materially participate;

2. Any rental activity; *and*

3. Any limited partnership (but *not* publicly traded partnerships that are classified as portfolio).

[4] This first netting will be important for allocating suspended losses among net passive loss activities.

Portfolio

While the term "portfolio income" is not used in the Code, the following items (which make up "portfolio income") are deemed to be non-passive under §469(e)(1)(A) and (B):

1. Interest (other than qualified residence interest that is nonpassive (§469(j)(7)));

2. Dividends (net of dividend received deduction) from:

(a) "C" corporations,

(b) REITs, REMICs, and RICs (Conference Report, II-146, note 3);

(c) Regulated investment companies;

3. Annuities (except pension plan annuities);

4. Royalties (not derived in the ordinary course of a trade or business - e.g., royalties from the licensing of property);

5. Expenses (other than interest) clearly and directly allocable to items 1 through 4 (Conference Report H7636);

6. Interest expense properly allocable to items 1 through 4 (Conference Report H7636);

> **Note:** The Conference Agreement stated that regulations related to appropriate interest expense allocation be issued before 12/31/86. The Service responded on July 1, 1987, with an intricate set of "tracing" regulations.

7. Gain or loss from the sale of property generating such income or held for investment[5];

8. Income, gain, or loss attributable to an investment of working capital[6]; *and*

9. Income[7] from a publicly traded partnership (§469(k)).

Material Participation

Section 469(h)(1) defines material participation as an activity in which the taxpayer is involved:

1. Regularly;

2. Continuously; *and*

3. Substantially.

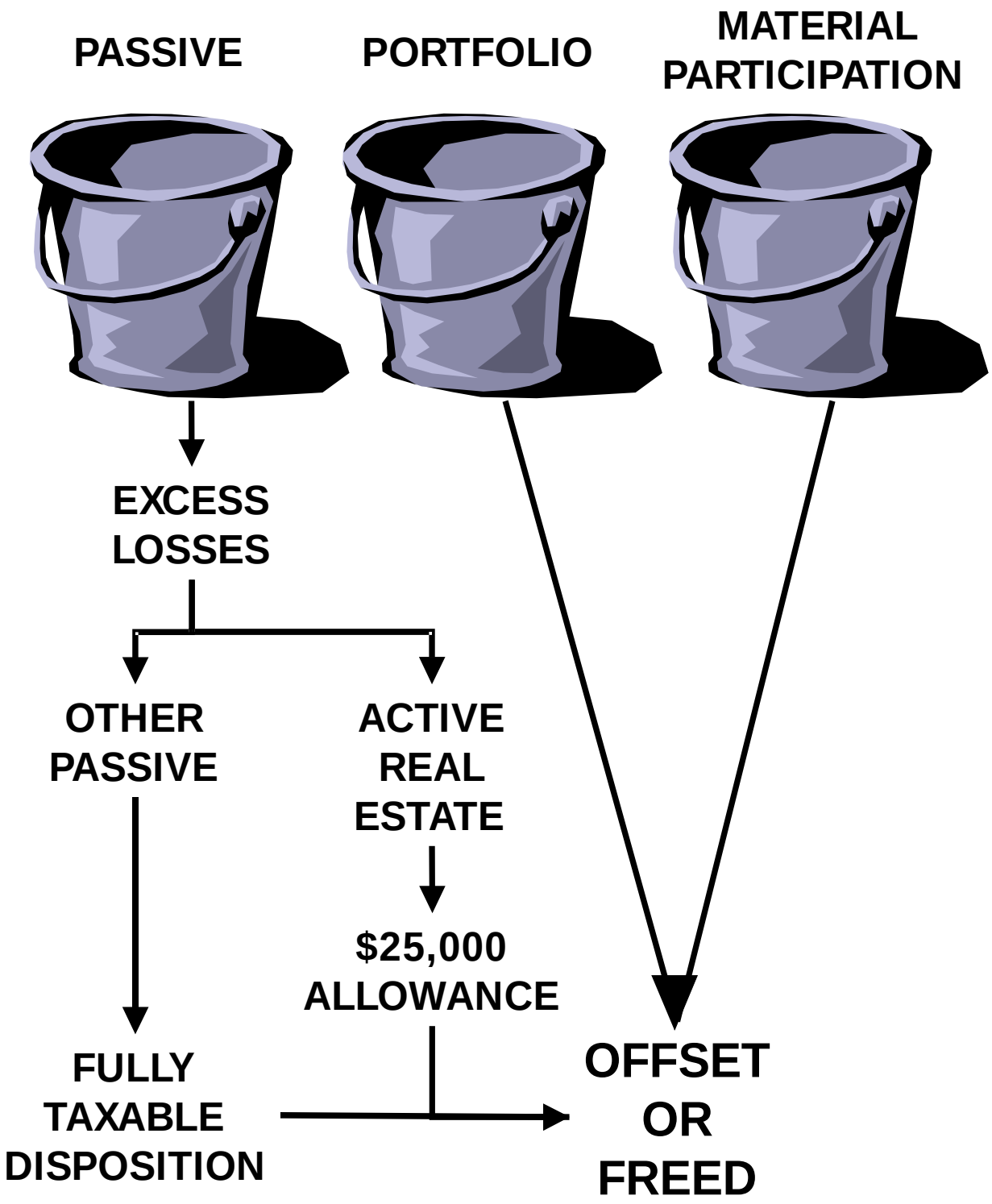
---

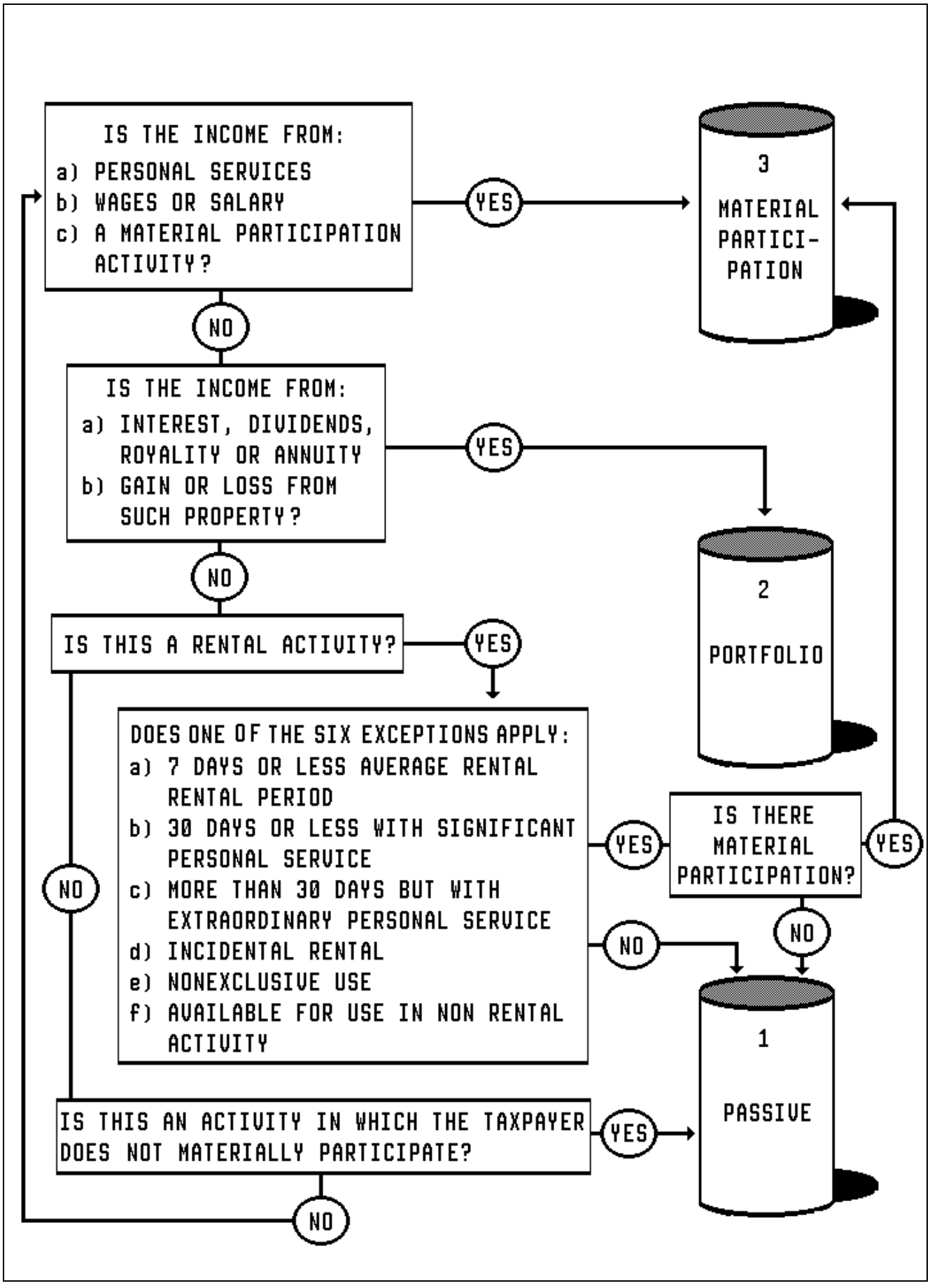
[5] For purposes of this clause, any interest in a passive activity shall not be treated as property held for investment (§469(e)(1)(A)(ii)).

[6] Although setting aside such amounts may be necessary to the trade or business, earnings on such amounts are investment related and not a part of the business itself.

[7] Net losses and credits from a publicly traded partnership can only be suspended and carried forward for use against income from that same partnership (Senate Report to RA '87 p. 161).

Passive Loss Big Picture




IS THE INCOME FROM:
a) PERSONAL SERVICES
b) WAGES OR SALARY
c) A MATERIAL PARTICIPATION ACTIVITY?
YES
3
MATERIAL PARTICI-PATION
NO
IS THE INCOME FROM:
a) INTEREST, DIVIDENDS, ROYALITY OR ANNUITY
b) GAIN OR LOSS FROM SUCH PROPERTY?
YES
2
PORTFOLIO
NO
IS THIS A RENTAL ACTIVITY?
YES
DOES ONE OF THE SIX EXCEPTIONS APPLY:
a) 7 DAYS OR LESS AVERAGE RENTAL RENTAL PERIOD
b) 30 DAYS OR LESS WITH SIGNIFICANT PERSONAL SERVICE
c) MORE THAN 30 DAYS BUT WITH EXTRAORDINARY PERSONAL SERVICE
d) INCIDENTAL RENTAL
e) NONEXCLUSIVE USE
f) AVAILABLE FOR USE IN NON RENTAL ACTIVITY
YES
IS THERE MATERIAL PARTICIPATION?
YES
NO
NO
NO
1
PASSIVE
IS THIS AN ACTIVITY IN WHICH THE TAXPAYER DOES NOT MATERIALLY PARTICIPATE?
YES
NO

Suspension of Disallowed Losses

Suspended losses and credits are deemed to be unrealized (i.e., suspended) and only converted to realized losses and credits when:

1. Passive activity income occurs in future tax years (§469(b)); *or*

2. Taxpayer disposes of his or her *entire* interest in a passive activity in a *fully* taxable transaction (§469(g)(1)).

Fully Taxable Disposition

When a taxpayer disposes of his or her entire interest in a passive activity, the actual economic gain or loss on his or her investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the taxpayer is recognized. This result is accomplished by triggering suspended losses upon disposition.

Suspended losses are triggered on a fully taxable disposition, and any overall loss determined is then allowed against income whether passive or active. A fully taxable disposition includes a bona fide and arm's length sale of the property to a third party for a price equal to its value (Senate Report p. 725).

Abandonment & Worthlessness

The scope of a disposition triggering suspended losses under the passive loss rules includes an abandonment, constituting a fully taxable event under §165(a), of the taxpayer's entire interest in a passive activity (Conference Report H7635).

Similarly, to the extent that the event of worthlessness of a security is treated under §165(g) as a sale or exchange of the security, and the event otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition.

Related Party Transactions

Under §469(g)(1)(B), a taxpayer is *not* treated as having disposed of an interest in a passive activity, for triggering suspended losses, if he or she disposes of it in an otherwise fully taxable transaction to a related party (under §267(b) or §707(b)(1), including applicable attribution rules).

Credits

A purpose of the passive loss rules is to allow losses only when real economic loss has occurred. Congress believed that credits do not represent such true economic loss. Credits are creatures of statute. They are not directly related to real gain or loss.

Disallowance

As a result, disallowed credits are *not* allowable on a fully taxable disposition. In general, credits are only[8] allowed when sufficient passive income is realized.

Increase Basis Election

However, §469(j)(9) provides an election to increase the basis of property immediately before the transfer by an amount equal to the portion of any unused credit that reduced the basis of such property for the tax year in which the credit arose. The increase in basis cannot exceed the amount of the original basis reduction of the property.

Other Transfers

The following are not deemed to be fully taxable dispositions and are subject to special rules:

Transfer By Reason Of Death - §469(g)(2)

Under §469(g)(2), a transfer of a taxpayer's interest in an activity on death allows suspended losses to the decedent[9] to the extent they *exceed* the amount by which the basis of the interest in the activity is increased at death under §1014[10].

Transfer By Gift - §469(j)(6)

Section 469(j)(6) provides that a gift of all or a part of the taxpayer's interest in a passive activity does not trigger suspended losses. However, the statute does allow suspended losses to be added to the basis of the property immediately before the gift.

Example

Ralph gifts a duplex that is passive property to his son. The duplex has an adjusted basis of $65,000, suspended losses of $15,000, and a fair market value of $110,000. Ralph can't deduct the suspended losses but his son's basis in the duplex is $80,000 (65,000 plus 15,000).

[8] In some instances they can be added to basis before a fully taxable disposition.

[9] Suspended losses are not available to decedent's transferee. The losses allowed would be reported on the final return of the decedent.

[10] Suspended losses are eliminated to the extent of the basis increase.

Installment Sale - §469(g)(3)

Under §469(g)(3), when an activity is disposed of in a transaction in which the gain is reported under the installment sale method, the entire suspended loss attributable to the activity is not triggered all at once. The losses are allowed in each year of the installment obligation, in the ratio that the gain recognized in each year bears to the total gain on sale. The installment gains are reported using the gross profit percentage and then offset by the proportionate amount of carryforward losses.

Activity No Longer Treated As Passive Activity - §469(f)(1)

Circumstances may arise that are not a disposition but terminate the application of the passive loss rules to the taxpayer generally, or to the taxpayer for a particular activity.

For example, an individual who previously was passive in relation to a trade or business activity that generates net losses may begin materially participating in the activity. When a taxpayer's participation in an activity is material in any year after a year (or years) during which he or she was not a material participant, previously suspended losses *remain* suspended and continue to be treated as passive activity losses.

Such previously suspended losses, however, unlike passive activity losses generally, *are* allowed against income from the activity realized after it *ceases* to be a passive activity for the taxpayer.

Closely Held To Nonclosely Held Corporation - §469(f)(2)

A similar situation arises when a corporation (such as a closely held corporation or personal service corporation) subject to the passive loss rules ceases to be subject to the passive loss rules because it no longer meets the definition of an entity subject to the rules.

For example, if a closely held corporation makes a public offering of its stock and no longer meets the stock ownership criteria for being closely held, it ceases to be subject to the passive loss rules.

So as not to encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation. Deductions arising in years after the year in which the corporation's status changes are not subject to limitation under the passive loss rules.

Nontaxable Transfer

An exchange of the taxpayer's interest in an activity that is a nonrecognition transaction, such as an exchange governed by §351, §721, or §1031 in which no gain or loss is recognized, does not trigger suspended losses (Senate Report p.726).

The suspended losses not allowed upon such a nonrecognition transaction continue to be treated as passive activity losses of the taxpayer, except that in some circumstances they may be applied against income from the property received in the tax-free exchange that is due to the original activity[11].

Such suspended losses may not be applied against income from the property due to a different activity from the one that the taxpayer exchanged[12]. Therefore, unless the taxpayer can show that income against which suspended losses are offset is clearly from the passive activity, his or her interest in which he or she exchanged for a different form of ownership, no such offset is permitted.

Ordering of Losses

The ordering of the recognized losses is determined under §469(g)(1). In the tax year the interest is disposed of, the unused losses and any current year losses for the activity are allowed to offset income in the following order:

1. Income or gain (including any gain recognized upon disposition) for the tax year *from* the passive activity disposed of;

2. Net income or gain for the tax year from *all other* passive activities; then

3. *Any other* income or gain.

Example from Pub 925

Ray earned a $60,000 salary and owned one passive activity through a 5% interest in the B Limited Partnership. He sold his entire interest in the current tax year to an unrelated person for $50,000. His adjusted basis in the partnership in-

[11] This rule does not apply, however, to permit the offset of suspended passive losses against dividends or other income or gain otherwise treated as portfolio income. In addition, following some transactions such as a §1031 like-kind exchange, for example, the taxpayer may no longer have an interest in the original activity. Therefore, there is no special rule permitting suspended losses from the prior interest to be offset by income from the new activity, unless it, too, is a passive activity.

[12] For example, suspended passive activity losses cannot be applied against portfolio income of a pass-through entity.

terest was $42,000, and he had carried over $2,000 of passive activity losses from the activity. He realized an $8,000 gain from the sale but can offset it by the $2,000 carryover loss. This offset occurs under the general passive loss rules without applying the special rules for dispositions. His $6,000 net gain is computed as follows:

Sales Price	*$50,000*
Minus: adjusted basis	*$42,000*
Gain	*$8,000*
Minus: carryover losses allowable	*2,000*
Net gain	*$6,000*

If Ray sold his interest for $30,000, instead of $50,000, his deductible loss would be $5,000, computed as follows:

Sales Price	*$30,000*
Minus: adjusted basis	*42,000*
Capital loss	*$12,000*
Minus: capital loss limit	*3,000*
Capital loss carryover	*$9,000*
Allowable capital loss on sale	*$3,000*
Carryover losses allowable	*2,000*
Total current deductible loss	*$5,000*

Ray deducts the $5,000 total current deductible loss in the current tax year. He must carry over the $9,000 capital loss, which is not subject to the passive activity loss limit. He will treat it as any other capital loss carryover.

Capital Loss Limitation - §1211

Upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the passive loss rules provide that any deductions previously suspended for that activity are allowed in full.

However, under §469(g)(1)(C), to the extent that any loss recognized upon such a disposition is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 for individuals (§1211). This limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule.

Conference Report Example

If a taxpayer has a capital loss of $10,000 upon the disposition of a passive activity and is also allowed to deduct $5,000 of previously suspended ordinary losses as a result of the disposition, the $5,000 of ordinary losses are allowed, but the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capi-

tal loss from the disposition is carried forward and allowed under the provisions determining the allowance of such capital losses.

Carryforwards

Disallowed losses and credits are carried forward in full and treated as passive losses and credits in the latter tax years. There is *no* time limit on the carryforward (§469(b)). The application of a passive loss or credit carryforward to a later tax year isn't limited to passive income generated by the particular activity that caused the loss or credit. They apply to the taxpayer's net passive income (if he or she has any) based on the aggregate income and losses from all the interests in passive activities owned by him or her.

Allocation of Suspended Losses

If any passive losses are not deductible in any given year, the amount of the suspended losses and credits from each activity is determined on a prorata basis. For each activity, the portion of the loss or credit that is suspended, and carried forward, is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year (§469(j)(4)).

Taxpayers Affected

Under §469(a)(2), the passive loss limit applies to:

Noncorporate Taxpayers

All noncorporate taxpayers, including individuals, estates, and trusts, are subject to the passive loss rules (§469(a)(2)(A)). The limitations are imposed at the taxpayer level. Thus, allocations and distributions from pass-through entities such as partnerships and S corporations are limited at the taxpayer level.

Regular Corporations

Any "C" corporation in which over 50% in value of its outstanding stock was owned (directly or indirectly) by five or fewer individuals at any time during the last half of its taxable year (§469(a)(2)(B)).

Personal Service Corporations

Any personal service corporation (§469(a)(2)(C)).

Taxpayers Subject to the Passive Loss Rules



- **Taxpayers subject to passive loss rules include:**
  - **Individuals,**
  - **Estates,**
  - **Trusts, and**
  - **Closely-held corporations**
- **S Corp and partnership passive losses flow through to owners and limits applied at the owner level**

Definition - Temp. Reg. §1.469-1T(g)(2)(i)

A corporation is a personal service corporation if all the following conditions[13] are met:

(a) It is a C corporation for the year;

(b) Its principal activity for the testing period is the performance of personal services;

Comment: The testing period for a taxable year normally is the taxable year preceding such taxable year.

(c) Those personal services are "substantially" performed by "employee-owners"; and

(d) Employee-owners, in aggregate, own more than 10% of the stock of the corporation.

Personal Services

The term "personal services" is restricted to services in one of the following fields:

(a) Health;

(b) Law;

(c) Engineering;

(d) Architecture;

(e) Actuarial science;

(f) Performing arts; *or*

(g) Consulting.

Principal Activity - 50% Test

The principal activity of a corporation for a taxable year will be personal services if the compensation cost of the corporation for its *preceding* taxable year that is attributable to the performance of personal services by the corporation under §441 is greater than 50% of the corporation's total compensation cost for such *preceding* taxable year.

Substantially Performed by Employee-Owners - 20% Test

Personal services are substantially performed by employee-owners of the corporation if more than 20% of the corporation's cost for such period attributable to its activities that are treated as the performance of personal services is attributable to personal services performed by employee-owners.

---

[13] Temp. Reg. §1.469-1T(g)(2)(i) adopts the definition of Temp. Reg. §1.441-4T(d)(1).

Material Participation

Except for rental activities and oil and gas working interests, the taxpayer must materially participate in a trade or business activity to avoid the activity being subject to the passive loss limits. This material participation requirement applies at the level of the actual taxpayer, not at the level of a pass-through entity.

"Trade or Business" Definition

Under §469(c), an activity is considered a trade or business activity when:

(a) The activity's research or experimental expenditures are deductible under §174 (§469(c)(5)); or

(b) To the extent provided in regulations[14], the activity is:

(1) Connected to a trade or business, *or*

(2) Generating expenses allowable as a deduction under §212 (§469(c)(6)).

A taxpayer materially participates if he or she is involved in the activity's operations on a *regular, continuous,* and *substantial* basis throughout the year (§469(h)(1)). For limited partnership interests, §469(h)(2) presumes that a limited partner cannot materially participate in the activity[15].

February 19, 1988 Regulations

February 19, 1988 regulations provided a series of seven tests. The first four tests are quantitative and based on hours spent participating in the activity. Participation in prior years is the basis of the fifth and sixth tests. The seventh test is a facts and circumstances test.

General Rule for Individuals

Under Reg. §1.469-5T(a), a taxpayer is treated as materially participating in an activity only if he or she meets *one* of the following seven[16] tests:

1. The individual participates in the activity over 500 hours[17] during the year (Reg. §1.469-5T(a)(1));

---

[14] Such regulations are still being studied and have yet to be adopted.

[15] However, the February '88 regulations provide three exceptions to this presumption.

[16] The first four tests are quantitative, and are based on the number of hours spent participating in the activity during the tax year. The fifth and sixth tests are based on material participation by the taxpayer in prior years. The seventh test is a fact and circumstances test.

[17] This rule restricts deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote over 500 hours of time to their investment.

Material Participation Tests Reg. §1.469-5T(a)



1. Over 500 Hours of Participation
2. Substantially All of the Participation
3. Over 100 Hours of Participation & None Better
4. Significant Participation Totals 500+ Hours
5. Material Participation For Any 5 Out of 10 Preceding Years
6. Material Participation in a Personal Service Activity For Any 3 Preceding Years
7. Regular, Continuous, & Substantial Participation Based on Facts

2. The individual's participation in the activity for the taxable year makes up substantially all of the participation in the activity of all individuals (including individuals who are not owners of an interest in the activity) for the year in issue (Reg. §1.469-5T(a)(2));

3. The individual participates in the activity over 100 hours during the taxable year, and the individual's participation in the activity for the taxable years is *no less* than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for the year at issue (Reg. §1.469-5T(a)(3));

4. The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during the year *exceeds* 500 hours (Reg. §1.469-5T(a)(4));

Significant Participation Activity

Under Reg. §1 .469-5T(c), a "significant participation activity" is a trade or business activity in which the individual participates over 100 hours during the tax year, but in which the individual does not materially participate for the year (without regard to this rule).

5. The individual materially participated in the activity for any 5 taxable years (whether or not consecutive) during the 10 taxable years that *immediately preceded* the tax year (Reg. §1.469-5T(a)(5));

6. The activity is a personal service activity, and the individual materially participated in the activity for *any* three taxable years (whether or not consecutive) preceding the taxable year[18] (Reg. §1.469-5T(a)(6)); *or*

Personal Service Activity

An activity is a personal service activity if it principally involves the performance of personal services in:

Health,

Law,

Engineering,

Architecture,

[18] As a result of tests 5 and 6, withdrawal from a longstanding active business or from a personal service business may not convert the earnings from that business to passive income. However, note that for longstanding active businesses (other than a personal service business), a continuing interest is a passive activity if the individual has not materially participated for a significant period of time during the 10-year period immediately preceding the tax year.

Accounting,

Actuarial science,

Performing arts,

Consulting, or

Any other trade or business in which capital is not a material income-producing factor.

---

7. Based on all of the *facts and circumstances*, the individual participates in the activity on a regular, continuous, and substantial basis during the year (Reg. §1.469-5T(a)(7)).

Record keeping

Under Reg. §1.469-5T(f)(4), the extent of an individual's participation in an activity may be established by any reasonable means. Despite the quantitative nature of the regulation tests, taxpayers do not need to keep contemporaneous daily time reports, logs, or similar documents[19]. Taxpayers are allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calendars, and narrative summaries.

Meaning of Participation

Reg. §1 .469-5T(f)(1) generally provides that all work done in an activity by an individual *who owns an interest in the activity* (other than an interest owned *through* a C corporation) is considered participation by the individual in the activity, *without regard to the capacity* in which the individual does such work.

Exceptions to Definition - The "Unwork" Rules

Reg. §1.469-5T(f) provides the following *two* exceptions to the above definition of what work counts toward material participation:

1. Under Reg. §1.469-5T(f)(2)(i), work that is *not* customarily done by an owner is *not* considered when a principal purpose for the performance of such work is to avoid the disallowance of a passive activity loss or credit; *and*

2. Under Reg. §1 .469-5T(f)(2)(ii), work done by an individual in connection with an activity in the individual's capacity as an investor in the activity is not taken into account.

---

[19] The IRS states in it's summary of the regulations that, "The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records."

Work Done As an Investor

Under Reg. §1 .469-5T(f)(2)(ii)(B), work done as an investor includes: (1) studying and reviewing financial statements or reports on operation of the activity; (2) preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and (3) monitoring the finances or operations of the activity in a nonmanagerial capacity.

Husband & Wife Counted as One

The material participation rules are applied by considering services provided by the taxpayer and spouse *whether or not* they file a joint return (§469(h)(5)). Thus, under Reg. §1 .496-5T(f)(3), the participation of the taxpayer's spouse is counted in determining whether a taxpayer materially participates in an activity. The spouse's participation is counted:

(1) Even though the spouse may own no interest in the activity,

(2) Regardless of whether the participation of the spouse is material in its own right, *and*

(3) Regardless whether a joint return is filed by the taxpayer and spouse.

Application

The husband and wife rule applies to the:

1. Material participation test when determining if an activity is passive or active;

2. Significant participation test when recharacterizing passive income as nonpassive;

3. Determination of whether an activity is nonrental because of significant personal services; *and*

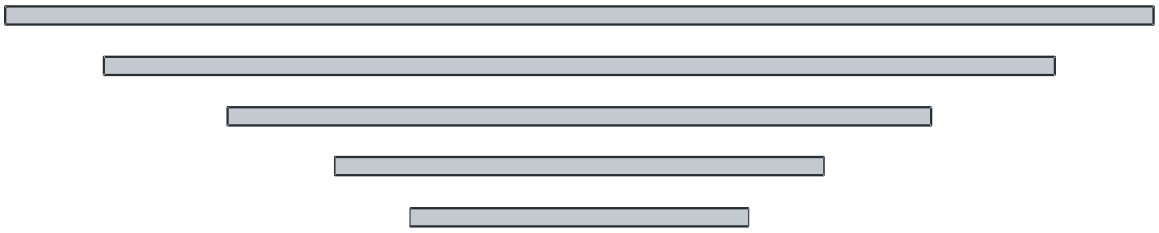
4. Active participation test for the $25,000 allowance on rental real estate activities.

Annual Test

The material participation of a taxpayer in an activity is determined separately for *each* taxable year. Thus, a taxpayer may materially participate one year, and not materially participate in the same activity the following year. However, note that under regulation tests 5 and 6 early material participation may have *lasting effects* on the characterization of the taxpayer's involvement in subsequent years.

Pre-'87 Participation - 500 Hours

An individual's participation in an activity for a tax year before 1987 can be relevant under rules such as those relating to the longstanding participation under regulation tests 5 and 6. Under Reg. §1.469-11T(a)(4), a taxable year beginning before January 1, 1987 (other than a tax year of a partnership, S corporation, estate, or trust ending after 1986), is taken into account for this purpose, but *only* if the individual participated in the activity for more than 500 hours during such taxable year.



Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

1. When calculating passive loss under §469, taxpayers must follow four basic steps. What is the initial step that must precede all others in the calculation?

a. categorize all activities as passive, portfolio, or material participation.

b. determine all of the taxpayer's separate activities.

c. offset all net income activities against all net loss activities.

d. offset all passive activities and net income against loss.

2. Under §469, a taxpayer's income and losses for each tax year are separated. What is classified as a passive item?

a. any dividend.

b. any activity involving the conduct of a trade or business in which the taxpayer materially participates.

c. any incidental rental in which the taxpayer materially participates.

d. losses from a limited partnership interest.

3. If you were advising a client who had disposed of his or her entire interest in a passive activity and the transaction was fully taxable, what would you inform your client concerning this transaction?

a. Any losses or credits would be deemed unrealized.

b. Any suspended losses or credits would be converted to realized losses or credits.

c. Any losses or credits would be suspended.

d. Any passive activity income would be treated as occurring in future tax years.

4. Upon the disposition of a passive activity, you experience $12,000 in capital losses and you are allowed to deduct $6,000 of previously suspended ordinary losses as a result of the disposition. If §1211 applied, what would your capital losses be limited to?

a. $3,000.

b. $5,000.

c. $6,000.

d. $12,000.

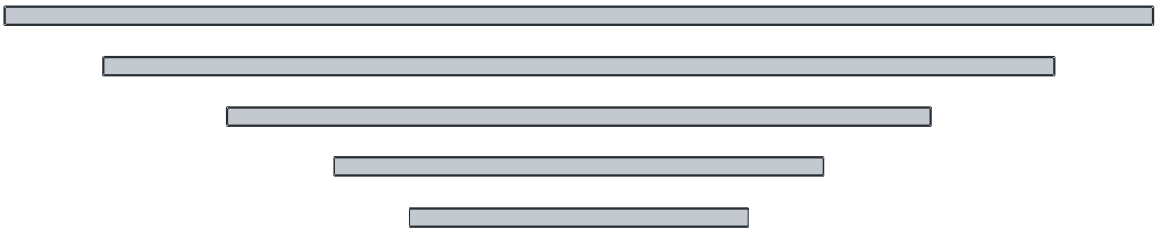
5. Several factors are considered in determining whether the taxpayer materially participates in an activity. What must the taxpayer's involvement relate to in order to satisfy the material participation standard?

a. operations.

b. the activity.

c. the individual's hobby.

d. the individual's location.





Special Rules for Entities

Special rules apply when activities are conducted by entities. These rules are complex, especially in the corporate area, and demand careful study.

Limited Partnership Interests Presumption

In general, limited partners[20] are not deemed to materially participate in partnership interests. Under §469(h)(2), a taxpayer that directly or indirectly owns any interest in any activity as a limited partner automatically fails the material participation test.

Exceptions to Presumption

Reg. §1.469-5T(e) provides three exceptions, under which a limited partner *can* materially participate:

1. The limited partner participates in the activity for more than 500 hours during the taxable year (Reg. §1.469-5T(e)(2) and Reg. §1 .469-5T(a)(1));

2. The individual materially participated in the activity for any 5 taxable years (whether or not consecutive) during the 10 taxable years that immediately preceded the tax year (i.e., test 5); *or*

3. The activity is a personal service activity, and the individual materially participated in the activity for *any* three taxable years (whether or not consecutive) proceeding the taxable year[21] (i.e., test 6).

Reg. §1.469-5T(e)(3)(ii) specifies a fourth exception. A limited partnership interest held by an individual who was a general partner in the partnership at all times during the partnership's taxable year ending with or

---

[20] See Reg. §1.469-5T(e)(3)(i) for a definition of a limited partner.

[21] As a result of tests 5 and 6, withdrawal from a longstanding active business or from a personal service business may not convert the earnings from that business to passive income. However, note that for longstanding active businesses (other than a personal service business), a continuing interest is a passive activity if the individual has not materially participated for a significant period of time during the 10-year period immediately preceding the tax year.

within the individual's taxable year is not treated as a limited partnership interest.

Trusts and Estates

Material participation rules for trusts and estates will be included in future regulations providing rules for the application of §469 in such cases. Reg. §1.469-5T(g) has been reserved for this purpose.

In the meantime, the only discussion of material participation for estates and trusts is in the committee reports. The Senate Report at page 735 states:

> *"An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating [Footnote 21]."*

Footnote 21 to the above quote is interesting. It states that "In the case of a grantor trust, however, material participation is determined at the grantor rather than the entity level." A literal application of this provision could be a significant "escape hatch" for *non*-grantor trusts. For example, a deceased taxpayer's heirs devoting full-time to an estate owned business might be able to have the income treated as passive if the *executor* did not materially participate in the business.

Retired & Disabled Farmers

Reg. §1.469-5T(h)(2) provides that to the extent §2032A(b)(4) or (5) treats retired or disabled farmers (or their surviving spouses) as still materially participating, that person will also be treated as materially participating for §469.

Corporations

The passive loss rules do not apply to C corporations unless they are closely held or personal service corporations.

Definition: Personal Service Corporation

Under Reg. §1 .441-4T(d), a personal service corporation is a C corporation in which, during a testing period, the principal activity is personal services[22] that are substantially performed by employee-owners. Personal services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. These services are deemed the principal activity of the corporation if the compensation paid for those services exceeds 50% of the corporation's total compensation for the testing period. The

[22] Note that this definition of personal service is more limited than that in the material participation tests.

services are substantially performed by employee-owners if more than 20% of the compensation due to personal service activities is paid to employee-owners (Reg. §1 .469-1T(g)(2)(i)).

Definition: Closely Held Corporation

A closely held corporation is a C corporation that isn't a personal service corporation and meets the stock ownership requirements of §542(a)(2) for the tax year (taking into account modifications under the at-risk rules of §465(a)(3)). This includes a corporation where more than 50% in value of its stock is owned, directly or indirectly, by five or fewer individuals. Individuals include employee pension, profit-sharing, stock bonus, supplemented unemployment benefit trusts, all private foundations under §509(a), and trusts dedicated to charity under §642(c).

Under §469(h)(4) and Reg. §1.469-1T(g)(3), *closely held C corporations* and *personal service corporations* are treated as materially participating in an activity only if *one* of the following conditions is met:

1. One or more individuals treated as materially participating in the activity for the tax year, under the requirements of Reg. §1.469-5T (the seven tests) as modified below, holds directly or indirectly over 50% in value of the corporation's outstanding stock[23]; *or*

Modifications to the Seven Tests

The requirements of Reg. §1.469-5T are modified in that:

(a) All activities of the corporation are treated as activities in which the individual holds an interest in determining if the individual participates under Reg. §1.469-5T(f) in an activity of the corporation;

(b) The individual's participation in all activities other than corporate activities is disregarded in determining if the individual's participation in a corporate activity is treated as material participation under test 4; and

(c) A corporate activity is treated as a significant participation passive activity only if:

(i) The corporation is not treated as materially participating in the activity for that taxable year; and

(ii) One or more individuals who directly or indirectly hold (in aggregate) more than 50% in value of the corporation's out-

[23] This condition applies to both closely held and personal service corporations.

standing stock are treated as significantly participating in the particular activity.

2. For closely held corporations[24], the "qualifying business" requirements of §465(c)(7)(C)[25] and (D) are met.

"Qualifying Business" Requirements - 12:3:15

The "qualifying business" standard of §465(c)(7)(C) is generally satisfied if:

(a) During the entire 12-month period ending on the last day of the taxable year, the corporation had at least one full-time employee substantially all the services of whom were in active management with respect to the activity (§465(c)(7)(C)(i)),

(b) During the same period, the corporation had at least 3 full-time nonowner employees substantially all of the services of whom were services directly related to the activity, and

(c) The amount of business deductions attributable to the activity which are allowable to the corporation pursuant to §§162 and 404 exceeded 15% of gross income from the business for the taxable year.

Activity Definition

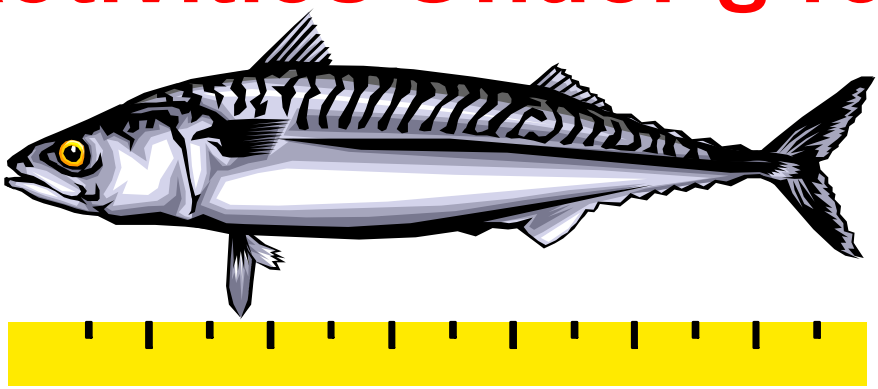
On May 11, 1989, the Service issued complicated temporary regulations governing how separate activities were to be determined. These activity rules applied to tax years ending before May 11, 1992. However, if a tax year includes May 10, 1992, and ends after that date, taxpayers may use the old rules or the new activity rules that are discussed below.

On May 15, 1992, the IRS issued proposed regulations that would shorten and simplify the rules for identifying activities and would replace Reg. §1.469-4T (Prop. Regs. §1.469-4 and §1.469-11). These regulations became final in 1994. The final regulations are shorter and more flexible.

[24] This condition does not apply to personal service corporations.

[25] Without regard to clause (iv).

Activities Under §469



- An activity is an economic unit appropriate to measure gain or loss
- Whether activities are a single activity depends on all facts and circumstances giving weight to:
  - Similarities & Differences
  - Common Control
  - Common Ownership
  - Geographical Location, and
  - Interdependencies
- Once activities are grouped, they can't be regrouped unless:
  - Original groups were clearly inappropriate, or
  - Material change in circumstances

Final Regulations

Whether activities are treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer can use any reasonable method of applying such factors when grouping activities.

Relevant Factors

The following factors are given the greatest weight in determining whether activities constitute an appropriate economic unit for the application of the passive loss rules:

(a) Similarities and differences in types of business,

(b) Extent of common control,

(c) Extent of common ownership,

(d) Geographical location, *and*

(e) Interdependencies between the activities[26] (Reg. §1.469-4(c)(2)).

Note: All of the above factors do not have to be present for a taxpayer to treat more than one activity as a single activity

Example

Dan has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. Here reasonable methods of applying the facts and circumstances test may, depending on other relevant facts and circumstances, result in grouping the movie theaters and bakeries into a single activity, into a movie theater activity and a bakery activity, into a Baltimore activity and a Philadelphia activity, or into four separate activities. (Prop. Reg. 1.469-4(c)(3), Example 1)

The example in the proposed regulations doesn't say whether or not the Baltimore bakery and the Philadelphia movie theater could be claimed as a single activity (or the Philadelphia bakery and the Baltimore movie theater).

Rental Activities

Under Reg. §1.469-4(d), a rental activity couldn't be grouped with a nonrental trade or business activity *unless* either:

(i) The rental activity is insubstantial in relation to the trade or business activity, *or*

[26] For example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records.

(ii) The trade or business activity is insubstantial in relation to the rental activity.

Under Reg. §1.469-4(e), an activity involving the rental of *real* property and an activity involving the rental of *personal* property (other than personal property provided in connection with the real property) could *not* be treated as a *single* activity.

Limited Partnership Activities

A taxpayer who is a limited partner or "limited entrepreneur[27]" in certain activities is not allowed to group that activity with any other activity. Activities subject to this rule include:

(1) Films,

(2) Videotapes,

(3) Farming,

(4) Oil and gas,

(5) Geothermal deposits, *and*

(6) Renting depreciable personal property.

However, such an activity can be grouped with another activity in the same type of business if the taxpayer is a limited partner or limited entrepreneur in *both*.

Two activities in the same type of business can also be grouped if the taxpayer is a limited partner or limited entrepreneur in only one of the two activities if the facts-and-circumstances test is satisfied (Reg. §1.469-4(f)).

Partnership & S Corporation Activities

A partnership or S corporation is required to group its activities under the proposed regulations. Once a partnership or S corporation determines its activities, a partner or shareholder groups those activities with activities conducted directly by the partner or shareholder or with activities conducted through other partnerships or S corporations under the proposed regulations (Reg. §1.469-4(j)).

Consistency

Under Reg. §1.469-4(g), once a taxpayer has grouped activities in accordance with the proposed rules, they are not permitted to regroup them in later tax years unless:

(1) The original grouping was clearly inappropriate, *or*

---

[27] A "limited entrepreneur" would be defined as a person other than a limited partner who doesn't actively participate in the management of an activity.

(2) There has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.

Regrouping

When the taxpayer's grouping fails to "reflect one or more appropriate economic units" and one of the primary purposes of the taxpayer's grouping is to circumvent the passive loss rules, IRS can regroup a taxpayer's activities (Reg. §1.469-4(h)).

Partial Dispositions

Under the regulations, a taxpayer is allowed to treat the disposition of a *substantial* part of an activity as a *complete* disposition in which suspended losses are allowed.

Under Reg. §1.469-4(k), taxpayers are permitted, for a tax year in which they dispose of a substantial part of an activity, to treat that part of the activity as a separate activity, but only if they can establish:

(1) The amount of deductions and credits allocable to that part of the activity for the tax year under the rules governing the carryover of disallowed deductions and credits from earlier years, *and*

(2) The amount of gross income and any other deductions and credits allocable to that part of the activity for the tax year.

Passive & Nonpassive Activities

Under §469(c)(1), an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate is a passive activity. In addition, §469(c)(2) provides that any rental activity is deemed a passive activity.

The regulations restate these rules. Under Reg. §1.469-T(e)(1), an activity is deemed to be passive if it is:

(a) A trade or business activity in which the taxpayer doesn't materially participate; *or*

(b) A rental activity[28].

[28] While a trade or business activity may be passive depending on the taxpayer's participation, a rental activity is automatically deemed passive regardless of the taxpayer's degree of participation.

Trade or Business

Passive activities must be trade or business activities. Reg. §1.469-1T(e)(2) generally defines the term "trade or business activity" to mean an activity that involves the conduct of a trade or business under §162.

Characterization Based on Participation

The taxpayer's relationship to the particular trade or business activity will determine whether that business is treated as passive or active. A business activity generally is a passive activity if the taxpayer does not materially participate in the activity[29]. A taxpayer, who is an individual, materially participates in an activity only if he or she is involved in the operations of the activity on a regular, continuous, and substantial basis.

Rental Activity

Under §§469(c)(2) and (4), a rental activity is treated as a passive activity *whether or not* the taxpayer materially participates in the activity. Section 469(j)(8) provides that the term "rental activity" means any activity where payments are principally for the use of tangible property[30].

However, Reg. §1 .469-1T(e)(3)(ii) provides several exceptions to the general rule that *all* rental activities are passive.

Exceptions

Regulation §1.469-1T(e)(3)(ii) provides *six* exceptions to the general rental active definition when:

1. The *average period of customer use* for such property is seven days or less (Reg. §1.469-1T(e)(3)(ii)(A));

2. The average period of customer use for such property is 30 days or less (but more than 7 days), and *significant* personal services are provided (Reg. §1.469-1T(e)(3)(ii)(B));

3. *Extraordinary* personal services are provided by or for the property owner in making property available for customer use without regard to the average period of customer use[31] (Reg. §1.469-1T(e)(3)(ii)(C));

4. The rental is treated as *incidental* to a taxpayer's nonrental activities (Reg. §1.469-1T(e)(3)(ii)(D));

---

[29] A rental activity is deemed passive without regard to participation (§469(c)(4)).

[30] This would include net leases and ground leases.

[31] Thus, this exception applies even if the average customer use exceeds 30 days

5. The taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers (Reg. §1.469-1T(e)(3)(ii)(E)); *or*

6. The property is provided for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest (Reg. §1.469-1T(e)(3)(ii)(F)).

Non-Passive Activities

Rental Activities of Real Estate Professionals

OBRA '93 makes an exception to the general rule that all "rental activities" must be treated passively, no matter what the level of the owner's personal participation might be (§469(c)(2)). For tax years beginning *on or after January 1, 1994*, a taxpayer's rental real estate activities in which he or she materially participates may *not* be subject to the passive loss limitations discussed above. Under these revised rules, if the taxpayer meets certain eligibility requirements relating to "real property trades or businesses" in general, then losses from "rental real estate activities" (which had *automatically* been "passive" in the past) are deductible (§469(c)(7)). As a result, certain real estate investors who qualify are now permitted to deduct their real estate losses from both their *active* and *portfolio* income.

> **Note:** This relief provision does *not* apply to estates, trusts, or limited partnerships owning real estate rentals. It only grants relief to individuals and closely held C corporations. Thus, how a taxpayer decides to hold a "real estate trade or business," including "rental activities," may now have to be re-examined.

Eligibility Standards

An individual satisfies the eligibility requirements when:

(1) *More than 50%* of the individual's personal services during the tax year are performed in *real property trades or businesses* in which the individual *materially participates*, *and*

> **Note:** Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Will this inclusion of "rental" activities with other "real estate trades or businesses" cause any net rental income to be subject to *self-employment* tax? The answer would appear to be "no" unless it was found that "significant services" were also being provided to the tenants involved.

Real Estate Professionals

- **When a real estate professional materially participates in a rental real estate activity, it is nonpassive provided:**
  - **More than half of the personal services they performed in trades or businesses during the tax year were performed in real property trades or businesses in which they materially participated, and**
  - **They performed more than 750 hours of services during the tax year in real property trades or businesses in which they materially participated**
- **Each interest in rental real estate is a separate activity, unless an election has been made to treat all interests in rental real estate as one activity**

(2) The individual performs *more than 750 hours* of service in those *same* trades or businesses.

Working Interests in Oil & Gas

Section 469(c)(3)(A) provides that the term "passive activity" does not include any working interest[32] in any oil or gas property which the taxpayer holds directly or through an entity that does not limit the taxpayer's liability with respect to the drilling or operation of such interest. Reg. §1.469-1T(e)(4)(i) applies this rule on a well-by-well basis.

Entities That Limit Liability

Reg. §1.469-1T(e)(4)(v) provides that an entity *is* deemed to limit the liability of the taxpayer if the taxpayer's interest in the entity is in the form of:

1. A limited partnership in a partnership in which the taxpayer is not a general partner[33];

2. Stock in a corporation that owns the interest; *or*

3. An interest in any entity that, under State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a *determinable fixed amount*[34].

Activities within Activities

An activity may contain other separate activities within it that must be separated and treated independently. Thus, according to the Conference Report, portfolio income of a passive activity is taken into account separately from other items relating to the activity. The result is that for purpose of the passive loss rules, legal entities are often disregarded and ignored.

Example

An accounting firm operating as a partnership has its office on the top floor of a three-story building that it owns. The other two floors are rented out to tenants. The partnership is treated as engaged in two separate activities - an accounting firm activity and a rental real estate activity.

[32] Reg. §1.469-1T(e)(4)(iv) defines the term "working interest" means an operating mineral interest within the meaning of §614(d).

[33] If the taxpayer is both a general and a limited partner, his or her entire interest qualifies

[34] If state law only limits the holder's liability to a percentage of the entity's obligations, that is not considered a determinable fixed amount and the exemption may still be available

Passive Activity Loss

In general, a taxpayer's passive loss for the taxable year is not allowed (§469(a)(1)(A)). Under §469(d)(1) and Reg. §1.469-2T(b), a passive activity loss is the amount by which a taxpayer's *passive activity deductions* for the taxable year exceeds all the taxpayer's *passive activity gross income* for the taxable year from all the taxpayer's passive activities[35].

Husband & Wife

Under Reg. §1.469-1T(j)(1), married couples filing *joint returns* are generally treated as one taxpayer for the passive loss rules. Thus, the passive activity loss from an activity is computed as if husband and wife were one individual (Reg. §1.469-2T). When husband and wife cease filing a joint return, disallowed deductions and credits due to the respective interests of each spouse in any activity must be accounted for separately (Regs. §§1.469-T(j)(2)(i), 1.469-1T(f)(2)(iii) and (3)(iii)).

Special Rule for Closely Held Corporations

A closely held C corporation, *other* than a personal service corporation, can apply passive activity deductions against passive activity income and net *active* income, but not against portfolio income (§469(e)(2)(A)). As a result, Reg. §1.469-1T(g)(4)(i) provides that a closely held corporation's passive activity loss for a tax year is the amount by which the corporation's passive activity deductions for such year exceed the sum of the corporation's passive activity gross income and the corporation's net active income for such year.

Net Active Income

For this special rule for closely held corporations, Reg. §1.469-(g)(4)(ii) defines net active income for the tax year as the corporation's taxable income determined without regard to:

(1) Passive activity gross income;

(2) Passive activity deductions;

[35] A number of important items are missing in this definition. The 2/19/88 regulations do not contain a definition of what is an activity, nor how to allocate shared expenses among activities. While an activity-by-activity breakdown of income and deductions is not necessary for determining passive loss, such a breakdown will be crucial when allocating disallowed losses and dealing with income recharacterization.

(3) Portfolio income[36];

(4) Gross income treated as not from a passive activity under Reg. §1.469-2T(c)(6) relating to gross income from certain oil or gas properties;

(5) Gross income and deductions from trade or business under Reg. §1.469-1T(e)(6), generally relating to activities of trading personal property, but only when the corporation did not materially participate in the activity for such year;

(6) Deductions due to portfolio income under Reg. §1.469-2T(d)(2)(i), (ii) and (iv); *and*

(7) Interest expense allocated under Reg. §1.163-8T to a portfolio expenditure.

Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

6. If you owned an interest in a particular activity, under which of the following circumstances would you be said to have failed the material participation test?

a. You participate in the activity for more than 500 hours during the taxable year even though you are a limited partner.

[36] Here the definition in Reg. §1.469-2T(c)(3)(i) is used and any gross income treated as portfolio income under any other provision of the regulations is included (e.g., Reg. §1.469-2T(c)(2)(iii)(E) and Reg. §1.469-2T(f)(10))

b. You participated in the activity as a limited partner for six consecutive years but have not participated for the last four years.

c. You paid for a limited interest in an architecture firm three years ago and participated in its activities during just the first year.

d. You directly own an interest in a limited partnership as a limited partner.

7. Under §469(h)(4) and Reg. §1.469-1T(g)(3), if one of two conditions is met, closely held C corporations and personal service corporations are treated as materially participating in an activity. What is one of these conditions?

a. During a 2-year period, the corporation had at least 1 part-time employee substantially all the services of which were in active management.

b. During a 2-year period, the corporation had at least 5 full-time owner-employees substantially all of the services of which were directly related to the activity.

c. One materially participating individual for the tax year holds directly or indirectly over 50% in value of the corporation's outstanding stock.

d. The amount of business deductions attributable to the activity exceeded 30% of gross income from the business for the taxable year.

8. An activity is an economic unit that is used to measure gain or loss. Under Reg. §1.469-4(e), what had to be treated as a separate activity?

a. activities in different states.

b. an activity involving the rental of real property and an activity involving the rental of personal property.

c. an activity involving the rental of real property and an activity involving the rental of personal property provided in connection with the real property.

d. 2 activities in the same type of business if the taxpayer was a limited partner in only 1 of the 2 activities and if the facts-and-circumstances test was satisfied.

9. Under which of the following scenarios would rental activities be treated non-passively and would, therefore, be deductible?

a. You have set up a trust that owns and manages real estate rentals.

b. You own an interest in a limited partnership that owns and manages real estate rentals

c. You and your spouse combined to produce 780 hours of personal service time in a real estate brokerage business.

d. 60% of your personal services were performed in a rental management business in which you materially participated for 760 hours.

10. Amazingly, passive activity deductions of a closely held C corporation may be applied against passive activity income and net active income. For

this special rule, what is included in the corporation's net active income for the tax year?

a. gross income from trading personal property if the corporation materially participated in the activity.

b. the corporation's deductions resulting from portfolio income.

c. the corporation's gross income from an active activity in oil or gas properties.

d. the interest expense allocated to a portfolio expenditure.

Carryover of Disallowed Losses

Under §469, any passive activity loss in a given tax year can be carried forward indefinitely and deducted from passive activity gross income in later years. However, disallowed passive activity losses must be allocated among all the taxpayer's activities producing a loss during the tax year. Allocation is necessary to determine:

(1) The taxpayer's gain or loss on the disposition of a passive activity;

(2) The treatment of disallowed losses when an activity ceases to be a passive activity; and

(3) The proper application of loss limitations other than §469.

Treatment of Carryover Losses

Any disallowed deduction is treated as a deduction from the activity to which it is allocated for the taxpayer's following tax year (Reg. §1.469-1T(f)(4)).

Allocation Process

Under Reg. §1.469-1T(f)(2)(i) and (ii), the allocation of disallowed passive activity losses is a two-step process[37]:

1. *First*, the amount of disallowed loss is allocated ratably among all the taxpayer's passive activities that have net losses for the year[38]; *and*

[37] See Reg. §1.469-T(h)(5) for special allocation rules applicable to affiliated groups filing consolidated returns. Under these rules, the disallowed loss or credit is first allocated among the members of the group and is then allocated among the activities of the members.

Ratable Allocation among Passive Activities

The ratable portion of a loss is determined by multiplying the disallowed passive activity loss by the following fraction:

$$\frac{\text{Loss from the specific activity}^{39}}{\text{Sum of losses for the tax year from all loss activities.}}$$

2. *Second*, any disallowed passive loss allocated to an activity is then allocated ratably among all deductions from that passive activity for the year.

Ratable Allocation among Deductions

The ratable portion of a passive activity deduction is the amount of the disallowed portion of the taxpayer's loss from the activity multiplied by the following fraction:

$$\frac{\text{The amount of such deduction}}{\text{The sum of all passive activity deductions}^{40}}$$

Significant Participation Activities

Under Reg. §1 .469-1T(f)(2)(C), when a taxpayer's passive activity gross income from significant participation passive activities *exceeds* his or her passive activity deductions from such activities, these significant passive activities are treated as a single activity that does not have a loss for the taxable year[41].

Example (1) From Reg. §1.469-1T(f)(2)(i)(D)

An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows:

	A	*B*	*C*	*Total*
Gross income	*$7,000*	*$4,000*	*$12,000*	*$23,000*
Deductions	*($16,000)*	*($20,000)*	*($8,000)*	*($44,000)*
Net income (loss)	*($9,000)*	*($16,000)*	*$4,000*	*($21,000)*

[38] In the case of credits, this first step is omitted; the disallowed passive activity credit is allocated ratably among all the taxpayer's credits from passive activities

[39] A loss from an activity is the amount by which the passive activity deductions from the activity for the year exceed the passive activity gross income from the activity for the year, reduced by any part of that amount that is allowed under §469(i) relating to the $25,000 allowance for rental real estate.

[40] Other than excluded deductions under Reg. §1.469-1T(f)(2)(B).

[41] This aggregation of significant passive activities only applies for allocating loss

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows:

A:	*$21,000 x $9,000/$25,000 =*	*$7,560*
B:	*$21,000 x $16,000/$25,000 =*	*$13,440*
Total		*$21,000*

Income from Dispositions of Property Used in Passive Activities

Characterization of gain from the exchange, sale, or other disposition of an interest in property used in an activity or held through a partnership or S corporation[42] follows the characterization of the activity (Reg. §1.469-2T(c)(2)). Thus, gain from the disposition of property used in a passive activity at the time of the disposition is deemed to be passive activity gross income (Reg. §1.469-2T(c)(2)(i)(A)(2)). Likewise, where the activity is not passive, the gain is not passive (Reg. §1.469-2T(c)(2)(i)(A)(3)).

Mixed Use of Property

Where only a portion of the property is used in the passive activity, gain on the disposition of the property must be allocated between the portion of the property used in the passive activity and the portion that is not so used. Thus, when a material portion of the property is used in an activity, while the remainder is not used in that activity, that portion is treated as a separate interest. The regulations provide that the amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

Alternating Use

Reg. §1.469-2T(c)(2)(ii) provides that in a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period.

[42] However, Reg.§1.469-2T(c)(2)(i)(B) states that dispositions of partnership interests and S corporation stock are not deemed dispositions of property.

De Minimis Use Rule - 10/10 Test

The amount realized and the adjusted basis may be allocated solely to one activity in which the interest in property is predominantly used if the fair market value of such interest in property does not exceed the lesser of:

(i) $10,000; *and*

(ii) 10% of the value of all property (including the property in question) used in such activity immediately before the disposition (Reg. §1 .469-2T(c)(2)(ii)).

Disposition of Appreciated Property Formerly Used in a Nonpassive Activity

Under Reg. §1.469-2T(c)(2)(iii), if an interest in property used in an activity is substantially appreciated[43] at the time of its disposition, any gain from the disposition is treated as *not* from a passive activity *unless* such interest in property was used in a passive activity for either:

1. 20 percent of the period during which the taxpayer held such interest in property; *or*

2. The entire 24-month period ending on the date of the disposition.

When the interest in property is used in more than one activity during the 12-month period before the sale, the allocation of the amount realized and the adjusted basis among the activities is done first. As a result, the disposition of substantially appreciated property rules apply only to the part of the gain due to the passive activity after allocation (Reg. §1.469-2T(c)(2)(iii)(D)).

Rental Activities

Under §469(c)(2), rental activity is generally treated as a passive activity whether or not the taxpayer materially participates in the activity.

Special Rule for Rental Real Estate

If a taxpayer meets five conditions up to $25,000[44] per year of losses and credits (after being converted to deduction equivalents[45]) related to the passive activity may be offset against nonpassive income (§469(i)).

---

[43] An interest in property is substantially appreciated if the fair market value of such interest in property exceed 120 percent of the adjusted basis of such interest (Reg. §1.469-2T(c)(2)(iii)(D)).

[44] Married taxpayers filing separately and living apart at all times during the year get $12,500 each. If married individuals filing separately, live together at any time during the taxable year, the amount of the $25,000 is reduced to zero (§469(i)(5)(B)).

Five Conditions

The five necessary conditions are:

1. The taxpayer[46] must be a natural person[47], although a partner or "S" corporation shareholder will qualify (§469(i)(1));

2. The activity must be pure real estate rental (i.e., no substantial services are provided);

3. The taxpayer's AGI (determine without regard to any passive activity loss) must be $100,000 or less ($200,000 or less if deductions are based on low-income housing or rehabilitation credits[48]);

Phase Out of $25,000 Exemption

The annual $25,000 exemption is reduced (but not below zero) by 50% of the taxpayer's adjusted gross in excess of $100,000 (§469(i)(3)(A)). For a married individual not filing a joint return, no more than $12,500 of the exemption is available, reduced by 50% of adjusted gross income in excess of $50,000.

4. The taxpayer must own 10% or more of the property (§469(i)(6)(A)); *and*

5. The taxpayer actively participates in the rental activity (§469(i)(1)).

---

[45] Under §469(j)(5), the deduction equivalent of a passive activity credit from a passive activity for any tax year is the amount of deductions that would reduce the tax liability for the tax year by an amount equal to the credit.

[46] Estates are only entitled to the special deduction for their first two years, and then only for rental real estate in which the decedent actively participated (§469(i)(4)).

[47] A trust does not qualify for the $25,000 allowance (Conference Report H7635).

[48] Section 469(i)((3)(B) provides that for the rehabilitation and low-income housing credits, the phaseout range for offsetting tax on up to $25,000 of nonpassive income is increased to between $200,000 and $250,000 of adjusted gross income. In addition, §469(i)(6)(B) states that such credits are allowed under the $25,000 rule regardless of whether the taxpayer actively participates in the activity generating the credits. As a result, no such credits are allowed if AGI exceeds $250,000.

Active Participation Exception



- **Certain taxpayers can deduct up to $25,000 of losses on real estate rental activities against active or portfolio income**
  - **$25,000 is reduced by 50% of taxpayer's AGI in excess of $100,000**
- **To qualify for this exception the taxpayer must:**
  - **Actively participate in rental activity, and**
  - **Own at least 10% of all interests in activity**
- **Active participation requires participation in making management decisions in a significant and bona fide sense**

Active Participation

Active participation should not be confused with material participation. The difference between active participation and material participation is that active participation can be satisfied without regular, continuous, and substantial involvement in operations. The active participation standard is satisfied so long as the taxpayer participates in a significant and bona fide sense, such as by making management decisions or by arranging for others to provide services such as repairs.

Change in Participation

If a taxpayer begins to actively participate in a rental real estate activity which in prior years he or she did not actively participate, the $25,000 allowance rule does not apply to losses from the activity carried over from such prior years (Conference Report H7634). The same rule applies to credits, to the extent that active participation is relevant to their allowance.

By contrast, losses (or credits) carried over from a year in which the taxpayer did actively participate, but that were not allowed against nonpassive income in such year because they exceeded $25,000 (as reduced by the applicable AGI phaseout), are deductible (or allowable) under the $25,000 rule in a later year, but *only* if the taxpayer is actively participating in the activity in such later year.

Application of $25,000 Allowance Rule

The $25,000 allowance is applied by first netting income and loss from all the taxpayer's rental real estate activities in which he or she actively participates. If there is a net loss for the year from such activities, net passive income (if any) from other activities is then applied against it, any remaining amount is eligible for the $25,000 allowance. Thus, in effect, the $25,000 allowance relief provision applies to *net* rental real estate activities.

Aggregation & Ordering:

Under §469(i)(3)(C), a single $25,000 amount (and phaseout thereof) applies on an aggregate basis to credits (including the low-income housing credit) and to deductions, as opposed to allowing a $25,000 amount for each. If the total net rental real estate losses and credits (in deduction equivalents) exceed the $25,000 amount allowable against other income, the taxpayer generally must allocate pro-rata first among all the losses (including real estate rental activity losses suspended in prior years), and then the credits, due to each separate activity, in determining which are treated as allowed. This allocation is necessary to determine the total sus-

pended losses attributable to each activity, which are allowable in full upon a disposition of the taxpayer's entire interest in the activity.

Net Operating Loss

If the allowance determined for passive rental real estate activities *exceeds* nonpassive income for a taxable year, an NOL is generated which may be carried back and forward under the applicable NOL rules.

Net Leases

Generally, being the lessor of property subject to a net lease is a rental activity. However, a net lease will generally not meet the active participation test (Senate Report p.738).

Definition

A net lease is defined, using the investment interest limitation rules, as a lease of property, if:

(a) The §162 deductions are less than 15% of the rental income produced by the property, *or*

(b) The lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

Recharacterization of Passive Income

There are two types of recharacterization rules under the regulations:

1. Active business income recharacterization rules designed to prevent conversion of active business income into passive activity income; *and*

2. Portfolio income recharacterization rules designed to prevent the conversion of portfolio income into passive income.

Active Business Recharacterization

Significant Participation Income Rules

Reg. §1.469-2T(f)(2) provides that an amount of the taxpayer's gross income from each significant participation passive activity equal to a ratable portion of the taxpayer's net passive income from such activity is recharacterized as active business income[49]. Under Reg. §1.469-5T(c)(2), a significant participation passive activity is an activity (other than a rental activity) in which the

[49] The significant participation rules apply to tax years after December 31, 1986 (Reg.§1.469-11T(a)(1)).

taxpayer participates over 100 hours, but does *not* materially participate for the tax year.

Ratable Portion of Income

The ratable portion of the net passive income from a significant passive activity is determined by multiplying the amount of such income by the fraction obtained by dividing:

(A) The excess of passive activity gross income over passive activity deductions from all such activities; by

(B) The excess of passive activity gross income over passive activity deductions considering only such activities from which the taxpayer has net passive income for the tax year.

Formula

$$\frac{\text{Passive Active Gross Income - Passive Activity Deductions (from all significant participation passive activities)}}{\text{Passive Active Gross Income - Passive Activity Deductions (from significant participation activities with net income)}}$$

Significant Participation Losses

The active business recharacterization rule can result in treating the taxpayer's net income, but not his or her net losses, from significant participation activities as nonpassive. The Service did not believe such treatment was appropriate *where* the taxpayer's involvement in *all* such activities is substantial. Accordingly, Reg. §1.469-5T(a)(4) provides that a taxpayer is considered to materially participate in activities that would otherwise be significant participation passive activities if the taxpayer's participation in all such activities exceeds 500 hours for the taxable year. If the 500-hour test is not met, the net loss remains passive and subject to §469.

Rental of Property Developed by Taxpayer

Reg. §1.469-2T(f)(5) provides a 12-month test. If the developed rental property is sold or exchanged under a binding contract entered into less than 12 months after initiating the rental, the gain is recharacterized as nonpassive. If the sale or exchange contract is 12 months or more after commencing the rental, the gain is passive. The general effect of this rule is that property developed by the taxpayer must be rented for at least 12 months before selling the property or contracting for its sale or the taxpayer's gain will be treated as nonpassive.

Self-Rented Property

Reg. §1 .469-2T(f)(6) provides that an amount of the taxpayer's gross income from renting an item of property equal to the taxpayer's net passive income from such rental is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year[50].

In a surprise move, the Service made the related party rule inapplicable to income from leases signed before 2/19/88 (Reg. §1 .469-11T(a)(2)(ii)).

Portfolio Income Recharacterization Rules

A risk similar to converting active business income into passive is the conversion of portfolio income into passive. The 2/19/88 regulations adopt a series of measures to prevent this conversion.

Rental of Nondepreciable Property

Reg. §1.469-2T(f)(3) provides that an amount of the taxpayer's gross income from an activity of renting nondepreciable property (e.g., land) equal to the taxpayer's net passive income from the activity is nonpassive. Income from a rental activity is subject to this recharacterization if the unadjusted basis of the depreciable property rented in the activity is less than 30% of the unadjusted basis of all property rented in the activity (Reg. §1 .469-2T(f)(3)).

Equity Financed Lending Activities

Reg. §1 .469-2T(f)(4) recharacterizes income from an equity financed lending activity as nonpassive if the average balance of debt[51] incurred in the activity (determined at the entity level) does not exceed 80% of the average balance of interest-bearing assets held in the activity.

Limitation on Recharacterization

If an activity is covered by one or more recharacterization rules, only the one that produces the largest nonpassive income applies (Reg. §1 .469-2T(f)(8)).

---

[50] Special rules apply when property is rented incidental to development activity (Reg.§1.469-2T(f)(5)

[51] Under Reg.§1.469-2T(f)(4)(iii)(B), debts incurred principally for increasing this percentage are not counted.

Passive Activity Credits

Passive credits may only be used to offset tax liability due to net passive income (§469(d)(2)). Otherwise, a taxpayer's passive credit for the taxable year is generally not allowed (§469(a)(1)). Under §469(d)(2) and Reg. §1 .469-3T(a), a passive activity credit is an amount (if any) by which:

(a) The sum of all the taxpayer's credits subject to §469 for such year; *exceeds*

(b) The taxpayer's regular tax liability allocable to all passive activities for such year.

Regular Tax Liability Allocable to Passive Activities

Reg. §1 .469-3T(d) defines regular tax liability allocable to passive activities as the excess of:

(a) The taxpayer's regular tax liability[52] of such tax year; *over*

(b) The amount of such regular tax liability determined by reducing the taxpayer's taxable income for such year by the excess of the taxpayer's passive activity gross income over the passive activity deductions for such year.

Formula

A simplified formula to determine regular tax liability allocable to passive activities is:

Regular tax (before credits) including net passive income

Minus: Regular tax (before credits) without including net passive income

Exception for Real Estate Rental Activity Credits

The $25,000 offset allowance is a combination of both passive deductions and credits (converted into their deduction equivalent). Section 469(i)(3)(C) provides that when the qualifying deductions and credit equivalents exceed the permitted $25,000 allowance, the deduction losses (including real estate rental activity losses suspended in earlier years) are used first against the allowance and thereafter the credits are applied.

Example

Ralph actively participates in a real estate rental activity that generates $10,000 of income, $30,000 of passive deductions, and $2,000 in credits. Ralph has a net passive loss of $20,000 ($10,000 less $30,000) which is usable under the

[52] The term "regular tax liability" has the same meaning given such term in §26(b).

$25,000 allowance. This still leaves $5,000 available which can be absorbed by a portion of the deduction equivalent of the $2,000 credit. If Ralph is in the 28% bracket then the maximum credit that can be used under the $25,000 is $1400 ($5,000 x 28%). The remaining portion of the credit ($600) is suspended and carried forward.

Passive credits from low-income housing and substantial rehabilitation of older structures are allowed to offset income other than passive income under the $25,000 allowance provision for real estate rental activity (Senate Rept, p.724). Under this exception, such credits can offset tax on the portion of the $25,000 allowance that the taxpayer has not been able to offset by deductions.

Application

A credit is subject to the passive activity limitations if the credit is attributable to the tax year and arises from the conduct of a passive activity[53]. In addition, a credit attributable to qualified progress expenditures under §46(d) is deemed connected with a passive activity, if it is reasonable to believe that such property will be used in a passive activity when it is placed in service.

For example, a credit attributable to qualified rehabilitation expenditures which is allowed for the taxable year under §46(d), is treated as a credit from a passive activity of the taxpayer if either:

(a) The activity in which the qualified rehabilitation expenditures are paid is a passive activity, *or*

(b) It is reasonable to believe that the rehabilitated property will be used in a passive activity of the taxpayer.

Credits Subject to Passive Activity Limits

Reg. §1.469-3T(b) provides that the following credits are subject to the passive activity limitations:

(a) General business credit, and its component credits[54] (§38(1) - (5));

(b) Puerto Rico and possession tax credit (§27(b));

(c) Orphan drugs credit (§28); *and*

(d) Nonconventional fuels credit (§29).

---

[53] A credit is not subject to §469 if it is attributable to a tax year beginning before 1987 (Reg. §1.469-3T(b)(4)). A credit is attributable to the tax year in which the credit would be (or would have been) allowed if the credits were determined without regard to §§26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

[54] Components include the following credits: investment credit, targeted jobs credit, alcohol used as fuel, employee stock option, low income housing, and research and experimentation..

Allocation of Disallowed Credits

Under Reg. §1.469-1T(f)(3)(i), if all or any portion of a passive activity credit is disallowed for the tax year, a ratable portion of each credit from each passive activity of the taxpayer is disallowed.

The ratable portion of a credit is computed by multiplying the disallowed passive credit by the following fraction:

$$\frac{\text{The amount of the credit}}{\text{The sum of all credits from passive activities}}$$[55]

Treatment of Carryover Credits

Any disallowed credit is treated as a credit from the activity to which it is allocated for the taxpayer's following tax year (Reg. §1.469-1T(f)(4)).

Passive Activity Audit Guide

The IRS has released to its examiners a 200+ page passive activity audit guide under its Market Segment Specialization Program (MSSB). The guide offers both revenue agents and taxpayers information on potential audit issues related to passive activity losses.

> **Note:** The guide is based on pre-OBRA '93 law and does not reflect the new rules under which certain real estate professionals can deduct losses from material participation rental activities after 1993.

The guide specifically addresses the following:

(1) Preparation of Form 8582,

(2) Material participation for businesses,

(3) Active participation in rentals,

(4) Improper grouping of rental and business activities,

(5) Misclassification of interest expense as investment rather than passive,

(6) Misclassification of portfolio income as passive income, *and*

(7) Rental real estate activities reported on Schedule C as "real estate management."

Indicators of Audit Issues

According to the guide, potential audit issues are indicated where *no* Form 8582 has been filed and the taxpayer's:

---

[55] Credits from a passive activity do not include any credits that: (i) are allowed under §469(i) relating to the $25,000 allowance, or (ii) increase the basis of property under §469(j)(9) involving the election to increase the basis of property by disallowed credits (Reg. §1.469-1T(f)(3)(ii)).

(1) Schedule C shows equipment or vehicle rentals;

(2) Schedule C shows "Real Estate Management" as the principal business;

> **Note:** The Service believes that some taxpayers may have moved losses from Schedule E to Schedule C to avoid passive activity limitations.

(3) Schedule E shows large nonpassive losses from a partnership or S corporation, especially if the entity is out-of-state;

(4) Schedule E shows that rental real estate losses in excess of $25,000 have been deducted; *and*

> **Note:** Active participation rental real estate losses are limited to $25,000.

(5) Adjusted gross income exceeds $150,000 and rental real estate losses are claimed.

> **Note:** The $25,000 active participation rental real estate amount is phased out at that level.

Audit issues are also indicated where a Form 8582 *is filed* and it shows large amounts of income offsetting large passive losses, especially if the income:

(1) Is possibly from a nonpassive activity,

(2) Is not reflected elsewhere on the return,

(3) May be portfolio income,

(4) Is from self-rented property, *or*

(5) Is installment sale income.

Investment Interest

IRS personnel are warned to watch for returns with Form 8582 and Schedule A showing a large investment interest deduction. Such interest expenses from limited partnership trade or business activities, rentals, or any other passive activity are not deductible as investment interest.

Material Participation

The guide devotes a great deal of attention to the material participation standard. It points out that large amounts of wages reported on Form W-2 may be an indication that the taxpayer did not devote the required hours to an activity, especially if significant distances between home, job, and activity are involved. Agents are advised to scrutinize partnership Schedules K-1 for indicators of passive investor status, such as an out-of-state address or a small ownership percentage. For S corporations, agents are to review corporate minutes and documents for clues as to a taxpayer's level of involvement.

The guide refers extensively to *Toups*, T.C. Memo 1993-359, calling it the first court case to discuss material participation. The *Toups* case involved the rental of a vacation cottage through a developer who managed and marketed the prop-

erty. The cottage was not a rental activity because average rentals were 7 days or less. Thus, taxpayers had to show material participation in order to use losses from the activity to offset other nonpassive income. The taxpayers devoted over 300 hours each year to their cottage and submitted to the Court an outline of 13 specific activities they performed. Nevertheless, the Tax Court held that material participation was not established since virtually all of this work related to the taxpayers' investment. The taxpayers were not involved in the day-to-day operations of the cottage or in its management.

Significant Participation Activities

The guide tells IRS personnel to look for returns where the taxpayer has many trade or business (nonrental) entities that appear to be in different lines of business. This may indicate that the taxpayer has significant participation activities (SPA).

> **Note:** A significant participation activity is one in which the taxpayer participates more than 100 hours during the tax year but less than 500 hours. If a taxpayer's aggregate participation in all his or her SPAs exceeds 500 hours, the SPAs are treated as nonpassive activities and losses generated by them may be used to offset nonpassive income. However, if aggregate participation in SPAs does not exceed 500 hours, then any overall *income* from those activities is treated as *nonpassive* income and any overall *loss* is treated as a *passive* loss.

Active Participation

According to the guide, many real estate management firms are automatically issuing letters to their clients stating the client is *actively* involved in managing the rental property, by approving tenants, arranging for repairs, etc. As a result, IRS personnel are advised that a better picture of the relationship between the client and the management firm can be obtained by inspecting the contract with the management firm. This document specifies the exact responsibilities of the management firm.

Net Lease Properties

The $25,000 allowance for active participation rental real estate does not apply to properties subject to a net lease. While the term "net lease" is not defined in the code, the guide refers IRS personnel to old §163(d)(4)(A). Under that definition, a net lease exists where:

(1) Deductions allowed the taxpayer with respect to the leased property (other than interest, taxes, or depreciation) are less than 15% of gross rents, *or*

(2) The lessor is guaranteed a specific return or guaranteed in whole or in part against loss of income.

The guide states that a Schedule E that does not show interest or taxes or expenses points to a net lease arrangement.

Vacation Rentals

Since many vacation rentals have an average period of customer use that is seven days *or less*, the activity falls outside the definition of a rental and the $25,000 offset is not available. Instead, the more stringent material participation test must be met. The same is true where the vacation property has an average period of customer use of *30 days or less* and significant services are provided.

> **Note:** The passive loss rules do not apply if a vacation home is used for personal purposes for more than the greater of 14 days or 10% of the days the home is rented at a fair rental during the tax year. Instead, the rental income is subject to §280A(a). Section 280A(a) limits the deduction of rent-related expenses to the amount of rental income, however, it does allow the deduction of real estate taxes and qualified residence interest not allocable to the rental use.

The guide reminds IRS personnel that:

(1) The involvement of a management firm makes it hard to meet the material participation test;

(2) The primary purpose of any travel must be business, not pleasure; *and*

(3) Hours spent reading reports and otherwise monitoring operations in a nonmanagerial capacity do not count since these are investor activities.

Self-Charged Expenses

The guide provides that the proposed regulations governing situations where taxpayers lend money (or borrow it from) pass-through entities in which they own an interest apply only to interest and *not* to other kinds of self-charged items.

Rental & Nonrental Activity Grouping

Generally, the grouping of rental and nonrental activities into a single activity is barred. Proposed regulations applying to tax years ending after May 10, 1992, provide that a rental activity cannot be grouped with a nonrental activity unless one of the activities is "insubstantial" in relation to the other. Noting that "insubstantial" is not defined and that the proposed regulations are intended to replace the old 80% 20% rule, the Guide says that the old rule is a good starting point when analyzing this issue.

> **Note:** In particular, the guide alerts IRS personnel that persons in the entertainment industry often mix a personal service activity with the rental of equipment.

Divorce

Section 469(j)(6) provides that if an interest in a passive activity is disposed of by gift, the basis of the interest is increased by the amount of any undeducted passive activity losses attributable to the property. The gift does not trigger the deduction of passive losses. The increase in basis will generally benefit the donee only on the sale, exchange, or abandonment of the interest.

Section 1041(b) treats transfers of property between divorcing spouses as *gifts*. According to the guide transfers of passive activities incident to a divorce should also be treated as gifts under §469. Thus, unused losses are added to basis under §469(j)(6).

At-Risk Limits

The at-risk rules limit losses from most activities to the loss or amount at risk, whichever is less. The at-risk rules must be applied before the passive activity rules.

Amount At Risk

A taxpayer is at risk in any activity for:

(1) The money and adjusted basis of property contributed to the activity, and

(2) Amounts borrowed for use in the activity if the taxpayer:

(a) Is personally liable for repayment, *or*

(b) Pledges property (other than property used in the activity) as security for the loan.

Taxpayers Affected

The at-risk limits apply to individuals and to certain closely held corporations (other than S corporations).

Closely Held Corporation

For the at-risk rules, a corporation is a closely held corporation if, at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals.

At-Risk Limits - §465



The at-risk rules limit losses from certain activities to the lesser of:

(1) the loss, or

(2) the amount at-risk

A taxpayer is at-risk in any activity for:

(1) the money & basis of property contributed to the activity, and

(2) amounts borrowed for use in the activity if the taxpayer:

(a) is personally liable, or

(b) pledges property as security for the loan

The following rules apply to figure if five or fewer individuals own more than 50% in value of the stock:

(1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries;

(2) An individual is considered to own the stock owned directly or indirectly by or for his or her family;

> **Note:** Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.

(3) If a person holds an option to buy stock, he or she is considered to be the owner of that stock;

(4) When applying rules (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person; *and*

> **Note:** Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.

(5) Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

Qualified Corporation Exception

A qualified corporation is not subject to the at-risk limits for any *qualifying business* carried on by the corporation. Each qualifying business is treated as a separate activity. A qualified corporation is a closely held corporation, defined earlier that is *not*:

(1) A personal holding company,

(2) A foreign personal holding company, *or*

(3) A personal service corporation (defined in §269A(b), but determined by substituting 5% for 10%).

Qualifying Business Requirements

A qualifying business is any active business if *all* of the following apply:

(1) During the entire 12-month period ending on the last day of the tax year, the corporation had at least:

(a) One full-time employee whose services were in the active management of the business, and

(b) Three full-time nonowner employees whose services were directly related to the business,

> **Note:** A nonowner employee does not own more than 5% in value of the outstanding stock of the corporation at any time during the tax year. The rules for constructive ownership of stock apply. However, in apply-

ing these rules, an owner of 5% or more, rather than 50% or more, of the value of a corporation's stock is considered to own a proportionate share of the corporation's stock.

(2) Deductions due to the business that are allowable to the corporation as business expenses and as contributions to certain employee benefit plans for the tax year exceed 15% of the gross income from the business, *and*

(3) The business is not an excluded business.

Note: Generally, an excluded business involves leasing §1245 equipment and any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, videotapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

Loss Defined

A loss is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable, disregarding the at-risk limits) over income received or accrued from that activity during the year. Income does not include income from the recapture of previous losses that is required because the amount at risk was less than zero.

Disallowed Losses

Any loss from an activity that is not allowed in a tax year because of the at-risk limits is treated as a deduction for the activity in the next tax year.

Form 6198

Form 6198, *At-Risk Limitations*, is used to figure how much loss from an activity can be deducted. Form 6198 must be filed if the taxpayer:

(1) Has a loss from any part of an activity that is covered by the at-risk rules, *and*

(2) Is not at risk for some of their investment in the activity.

Partnership & S Corporation Limits

Three separate limits apply to a partner's or shareholder's distributive share of a loss from a partnership or S corporation. The limits determine the amount of the loss each partner or shareholder can deduct on its own return. These limits and the order in which they apply are:

(1) The adjusted basis of:

(a) The partner's partnership interest, *or*

(b) The shareholder's stock plus any loans the shareholder makes to the corporation,

(2) The at-risk rules, *and*

(3) The passive loss rules.

Activities Covered by the At-Risk Rules

The following activities are subject to the at-risk rules:

(1) Farming,

(2) Exploring for, or exploiting, oil and gas as a trade or business or for the production of income,

(3) Holding, producing, or distributing motion picture films or videotapes,

(4) Equipment leasing, that is, leasing §1245 property, including personal property, and certain other tangible property that is depreciable or amortizable,

> **Note:** If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules. A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing.

(5) Exploring for, or exploiting, geothermal deposits (for wells started after September 1978),

(6) Holding real property placed in service after 1986,

> **Note:** However, if the taxpayer is a partner in a partnership, a shareholder in an S corporation, or has an interest in any other pass-through entity that they acquired after 1986, the at-risk rules apply no matter when the entity placed the real property in service.

(7) Holding mineral property, *and*

(8) Any other activity not included in (1) through (7) that is carried on as a trade or business or for the production of income.

Equipment Leasing

Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is §1245 property. Section 1245 property is any depreciable or amortizable property that is:

(1) Personal property,

(2) Other tangible property (other than a building or its structural components) that is:

(a) Used in manufacturing, production, or extraction, or in furnishing transportation, communications, energy, water, or sewage disposal,

(b) A research facility used for the activities in (a), *or*

(c) A bulk storage facility used for the activities in (a),

(3) A single purpose agricultural or horticultural structure, *or*

(4) A storage facility (other than a building or its structural components) used for the distribution of petroleum.

However, equipment leasing does not include leases of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs of artwork, or musical tapes. Thus, a closely held corporation cannot exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.

The equipment leasing exclusion is not available for leasing activities related to other at-risk activities, such as motion picture films and videotapes, farming, oil and gas properties, and geothermal deposits. Thus, if a closely held corporation leases a videotape, it cannot exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

> **Note:** A controlled group of corporations is subject to special rules for the equipment leasing exclusion (§465(c)).

Real Property

Holding real property is treated as a separate activity to which the at-risk limits apply after 1986.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property. For example, making personal property available, such as furniture and services, when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.

Grouping of Activities

Each film or videotape, item of leased §1245 equipment, farm, oil and gas property, or geothermal property is generally treated as a *separate* activity.

> **Note:** For a partnership or S corporation, all leasing of section 1245 property that is placed in service in any tax year of the partnership or S corporation is treated as one activity.

Activities that are a trade or business or are for the production of income are treated as *one* activity if:

(1) The taxpayer actively participates in the management of the trade or business, *or*

> **Note:** Active participation depends on all the facts and circumstances. Factors that indicate active participation include making decisions involving the operation or management of the activity, performing services for the activity, and hiring and discharging employees. Factors that indicate a lack of active participation include lack of control in managing and operating the activity,

having authority only to discharge the manager of the activity, and having a manager of the activity who is an independent contractor rather than an employee.

(2) The trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

Partners & S Corporation Shareholders

Partners or shareholders may aggregate certain activities their partnership or S corporation engages in. These activities are:

(1) Films and videotapes,

(2) Farms,

(3) Oil and gas properties, *and*

(4) Geothermal properties.

For example, partners and S corporation shareholders can treat all of the partnership's or S corporation's films and videotapes as one activity.

At-Risk Amounts

A taxpayer is considered at risk in an activity to the extent of cash and the adjusted basis of other property contributed to the activity. The at-risk amount also includes the taxpayer's share of partnership net income that they do not withdraw and certain amounts borrowed for use in that activity. However, if the borrowed amounts are from nonrecourse financing or loss limiting arrangements, such amounts are generally not at-risk.

Borrowed Amounts

Taxpayers are at risk for amounts borrowed to use in the activity if they are *personally liable* for repayment. Taxpayers are also at risk if the amounts borrowed are secured by property *other* than property used in the activity. In this case, the amount considered at risk is the net fair market value of the taxpayer's interest in the pledged property. The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it is subject. However, no property will be taken into account as security if the property pledged is directly or indirectly financed by debt that is secured by property the taxpayer contributed to the activity.

If a taxpayer borrows money to finance a contribution to an activity, they cannot increase their amount at risk by the contribution *and* the amount borrowed to finance the contribution. The at-risk amount is only increased *once*.

If a corporation borrows from its shareholder, the corporation will be considered at risk for that amount.

Even though the taxpayer is personally liable for the repayment of a borrowed amount or they secure a borrowed amount with property other than property used in the activity, the taxpayer is not considered at risk if they borrowed the money from a person having an interest in the activity (other than as a creditor) or from someone related to such a lender.

Taxpayers are not considered at risk for their share of any nonrecourse loan used to finance the activity or to acquire property used in the activity unless the loan is secured by property not used in the activity. If a taxpayer borrows money to contribute to the activity and the lender's recourse is only to the taxpayer's interest in the activity or to the property used in the activity, the loan is nonrecourse and does not increase the amount at risk.

Related Persons

Related persons include:

(1) Members of the family, but only brothers and sisters (both whole- and half-blood), spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),

(2) Two corporations that are members of the same controlled group of corporations determined by applying a 10% ownership test,

(3) The fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,

(4) Certain educational or charitable organizations and a person who directly or indirectly controls one of these organizations,

(5) A corporation and an individual who owns, directly or indirectly, more than 10% of the value of the outstanding stock of the corporation,

(6) A trust fiduciary and a corporation of which more than 10% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust,

(7) The grantor and fiduciary, or the fiduciary and beneficiary, of any trust,

(8) A corporation and a partnership if the same persons own over 10% in value of the outstanding stock of the corporation and more than 10% of the capital interest or the profits interest in the partnership,

(9) Two S corporations if the same persons own more than 10% in value of the outstanding stock of each corporation,

(10) An S corporation and a regular corporation if the same persons own more than 10% in value of the outstanding stock of each corporation,

(11) A partnership and a person who owns directly or indirectly more than 10% of the capital or profits of the partnership,

(12) Two partnerships, if the same persons directly or indirectly own more than 10% of the capital or profits of each, *and*

(13) Two persons who are engaged in business under common control.

The following rules apply to determine the direct or indirect ownership of the outstanding stock of a corporation:

(1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) Stock owned directly or indirectly by or for an individual's family is considered owned by the individual;

> **Note:** The family of an individual includes only brothers and sisters (both whole- and half-blood), a spouse, ancestors, and lineal descendants.

(3) Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned directly or indirectly by the individual's partner; *and*

(4) When applying rules (1), (2), or (3), stock considered owned by a person under rule (1) is treated as actually owned by that person.

> **Note:** However, when applying rules (2) or (3), stock considered owned by an individual under those rules is not again treated as owned by that individual to consider another the owner of that stock.

Subsequent Years

To apply the at-risk limits, any loss that is allowable in a particular year reduces a taxpayer's at-risk investment (but not below zero) as of the beginning of the next tax year and in all succeeding tax years for that activity. Thus, if a taxpayer has a loss that is more than their at-risk amount, the loss disallowed will not be allowed in later years unless they increase their at-risk amount.

Losses that are suspended because they are greater than a taxpayer's investment that is at risk are treated as a deduction for the activity in the following year. Consequently, if a taxpayer's amount at risk increases in later years, they may deduct previously suspended losses to the extent that the increases in their amount at risk exceed their losses in later years. However, a taxpayer's deduction of suspended losses may be limited by the passive loss rules.

Amounts Not At Risk

Taxpayers are not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Nonrecourse Financing

Taxpayers generally are not considered at risk for amounts protected against loss through nonrecourse financing. Nonrecourse financing is financing for which the taxpayer is not personally liable. However, this does not apply to *qualified nonrecourse financing* secured by real property used in the holding of real property.

Qualified nonrecourse financing is financing for which no one is personally liable for repayment and is:

(1) Borrowed by the taxpayer in connection with the activity of holding real property,

(2) Secured by real property used in the activity,

(3) Not convertible from a debt obligation to an ownership interest, *and*

(4) Loaned or guaranteed by any federal, state, or local government, or borrowed by the taxpayer from a *qualified person*.

A *qualified person* actively and regularly engages in the business of lending money. The most common example is a bank.

A qualified person is *not*:

(1) A person related to the taxpayer,

> **Note:** However, a person related to the taxpayer may be a qualified person if the nonrecourse financing is commercially reasonable, and on the same terms as loans involving unrelated persons.

(2) A person from which the taxpayer acquired the property, or a person related to such a person, *or*

(3) A person who receives a fee due to the taxpayer's investment in the real property, or a person related to that person.

Other Loss Limiting Arrangements

A taxpayer's capital, including any equity capital they have contributed, is not at risk in the activity if the taxpayer is protected against economic loss by an agreement or arrangement for compensation or reimbursement. For example, a taxpayer is not at risk if they will be reimbursed for part or all of any loss because of a binding agreement between the taxpayer and another person.

Example

Dan is personally liable for a mortgage but he separately obtains insurance to compensate him for any payments he must actually make because of his personal liability. Dan is considered at risk only to the extent of the uninsured portion of the personal liability to which he is exposed. Dan can include in

the amount he has at risk the amount of any premium that he paid from his personal assets for the insurance. However, if Dan obtains casualty insurance or insurance protecting him against tort liability, it does not affect the amount Dan is otherwise considered to have at risk.

Reductions of Amounts At Risk

It is possible for a taxpayer to place an amount at risk in an activity, deduct losses from the activity until the at-risk amount is reduced to zero, and then, in a later tax year, withdraw the amounts initially placed in the activity. This withdrawal (which could be by direct distributions to the taxpayer, by converting a recourse debt to a nonrecourse debt, or by initiating a stop loss agreement) would reduce the taxpayer's at-risk amount to less than zero.

If the amount a taxpayer has at risk in any activity at the end of any tax year beginning after 1978 is less than zero, they must add (recapture) that negative at-risk amount (but not more than the recapture limit, discussed next) to their gross income for that tax year as income from that at-risk activity. The amount the taxpayer includes in their gross income is treated as a deduction allocable to that at-risk activity in the next tax year.

Note: The amount that a taxpayer includes in their gross income cannot be more than the total amount of losses deducted in prior tax years beginning after 1978 for that at-risk activity, reduced by any amounts the taxpayer previously included in gross income for that activity under this recapture rule.

Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

11. Allocation of disallowed passive activity losses among all of a taxpayer's activities producing a loss during the tax year is required under §469. What does this required allocation determine?

a. the appropriate application of loss limitations other than §469.

b. the taxpayer's gain or loss on the acquisition of another passive activity.

c. the treatment of allowed losses when an activity ceases to be a passive activity.

d. the treatment of disallowed losses before an activity begins to be passive.

12. Under §469(i), a taxpayer must meet five conditions in order to offset up to $25,000 per year of losses and credits related to the passive activity against nonpassive income. What is one of these five required conditions?

a. The taxpayer must be either a partner or an S corporation.

b. The taxpayer must own 10% or more of the property.

c. The taxpayer must provide substantial services with the rental activity.

d. The taxpayer's AGI must be $80,000 or less.

13. Suppose you rented some land and the unadjusted basis of the depreciable property rented in the activity was 25% of the unadjusted basis of all property rented in the activity. In this case, which of the following would apply?

a. The gain from the sale would be considered passive since you did not meet the material participation test.

b. The gain would be considered active since the unadjusted basis of all the property was less than 80% of all property rented.

c. The gain from the sale is passive since it derives from self-rented property.

d. The gain from the sale of the property is recharacterized as nonpassive.

14. The passive activity audit guide indicates possible audit issues where the taxpayer fails to file Form 8582. In this situation, IRS personnel are advised to check whether the taxpayer's:

a. adjusted gross income exceeds $150,000 and rental real estate losses are claimed.

b. Schedule C shows large nonpassive losses from a partnership.

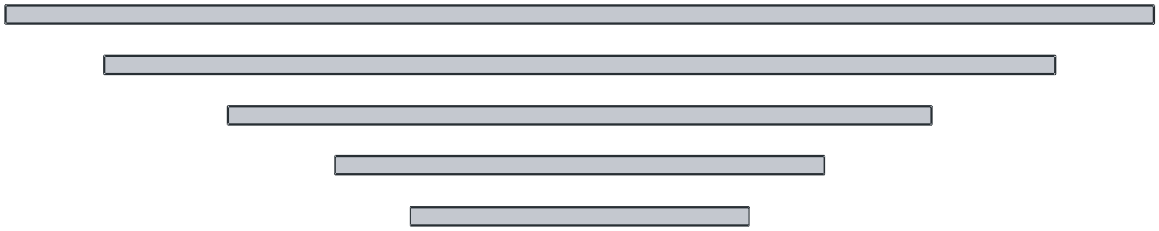
c. Schedule C shows rental real estate losses in excess of $25,000 have been deducted.

d. Schedule E shows equipment or vehicle rentals.

15. Leasing §1245 equipment is an activity subject to the at-risk rules. Which of the following is considered §1245 property?

a. a multiple purpose agricultural or horticultural structure.

b. intangible property.
c. a storage facility used to distribute petroleum.
d. real property.



Answers & Explanations

1. When calculating passive loss under §469, taxpayers must follow four basic steps. What is the initial step that must precede all others in the calculation?

a. Incorrect. When calculating passive loss, the second step is to categorize all activities as passive, portfolio, or material participation. Determine your activities first then characterize them as passive portfolio or material participation.

b. Correct. The first step, in calculating passive loss, is to determine all the separate activities of the taxpayer. Taxpayers must first determine how many separate activities they have. Later, this will become extremely important in determining hours of participation and whether a later fully taxable disposition may have occurred.

c. Incorrect. Part of the third step is to offset all net income activities against all net loss activities. There's lots of work to do before getting to this step.

d. Incorrect. The third step is to take the passive activities and net income against loss. Taxpayers must first determine the scope and breadth of activities for their net losses in income can be determined.

2. Under §469, a taxpayer's income and losses for each tax year are separated. What is classified as a passive item?

a. Incorrect. Dividends are characterized as portfolio items, based on the buckets produced.

b. Incorrect. Section 469 defines passive items to be any activity involving the conduct of a trade or business and in which the taxpayer does not materially participate. This material participation standard has now been made quantitative by the IRS.

c. Incorrect. Section 469 defines passive items to be any rental activity. However, there is an exception that applies to incidental rentals in which the taxpayer materially participates. These activities are classified as non-passive material participation activities.

d. Correct. Section 469 defines passive items to be any income or loss from a limited partnership interest. Because of the restricted management rights and limited liability, partnership interests are presumed to be passive in nature. [Chp. 1]

3. If you were advising a client who had disposed of his or her entire interest in a passive activity and the transaction was fully taxable, what would you inform your client concerning this transaction?

a. Incorrect. Unrealized losses or credits would be realized for the very reason that your client had disposed of the passive activity in a fully taxable transaction.

b. Correct. You would inform your client that, under §469(g)(1), suspended losses and credits are deemed to be unrealized and only converted to realized losses and credits when the taxpayer disposes of his or her entire interest in a passive activity in a fully taxable transaction.

c. Incorrect. Suspended losses and credits are other terms for unrealized losses and credits. In the particular case of your client, these losses and credits would be realized.

d. Incorrect. This is not a consequence of a disposition of a passive activity. Rather, suspended losses and credits are converted to realized losses and credits when passive activity income occurs in future tax years.

4. Upon the disposition of a passive activity, you experience $12,000 in capital losses and you are allowed to deduct $6,000 of previously suspended ordinary losses as a result of the disposition. What is the capital loss deduction you are allowed?

a. Correct. According to §469(g)(1)(C), to the extent that any loss recognized upon a disposition of a passive activity is a loss from the sale or exchange of a capital asset, the deduction is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 for individuals.

b. Incorrect. $5,000 is in excess of the allowable deduction of up to $3,000.

c. Incorrect. You are not allowed a deduction of up to 50% of the capital losses, although you are allowed to deduct the previously suspended ordinary losses.

d. Incorrect. You are not allowed to deduct the full amount of the capital losses.

5. Several factors are considered in determining whether the taxpayer materially participates in an activity. What must the taxpayer's involvement relate to in order to satisfy the material participation standard?

a. Correct. In order to satisfy the material participation standard, the individual's involvement must relate to operations. The taxpayer must make a significant contribution to the business.

b. Incorrect. To materially participate, the taxpayer must provide services that are integral to the activity. Merely providing legal, tax, or accounting services as an independent contractor generally fails to show material participation in an activity.

c. Incorrect. If the involvement relates to a hobby, he or she is not considered to have materially participated in the activity. Knowledge, education, or experience in the activity is a factor in material participation. If the taxpayer's

involvement relates to a hobby, it is likely that he or she materially participates in a different activity.

d. Incorrect. The taxpayer's involvement does not have to relate to the self-employment tax in order to satisfy the material participation standard. Based on the original committee reports, §1402(a), relating to the self-employment tax, and §2032A, relating to the valuation of farm property under estate tax, were to be the basis of the material participation standard. However, these provisions were not controlling.

6. If you owned an interest in a particular activity, under which of the following circumstances would you be said to have failed the material participation test?

a. Incorrect. One exception to the limited partnership presumption is when the limited partner participates in the activity for more than 500 hours during the taxable year.

b. Incorrect. An exception to the limited partnership presumption is when an individual has materially participated in the activity for any 5 taxable years, whether or not consecutive, during the 10 taxable years that immediately preceding the tax year.

c. Incorrect. Another exception to the limited partnership presumption is when an individual materially participated in a personal service activity for any three taxable years, whether or not consecutive, preceding the taxable year

d. Correct. Under §469(h)(2), if you directly or indirectly own any interest in any activity as a limited partner, you automatically fail the material participation test.

7. Under §469(h)(4) and Reg. §1.469-1T(g)(3), if one of two conditions is met, closely held C corporations and personal service corporations are treated as materially participating in an activity. What is one of these conditions?

a. Incorrect. Closely held C corporations are treated as materially participating in an activity if the "qualifying business" requirements are met including, during the entire 12-month period ending on the last day of the taxable year, the corporation had at least one full-time employee substantially all the services of which were in active management with respect to the activity.

b. Incorrect. Closely held C corporations are treated as materially participating in an activity if the "qualifying business" requirements are met including, during the entire 12-month period ending on the last day of the taxable year, the corporation had at least 3 full-time nonowner employees substantially all of the services of whom were services directly related to the activity.

c. Correct. Closely held C corporations and personal service corporations are treated as materially participating in an activity when one or more individuals

are treated as materially participating in the activity for the tax year, under the requirements of Reg. §1.469-5T as modified, holds directly or indirectly over 50% in value of the corporation's outstanding stock.

d. Incorrect. Closely held C corporations are treated as materially participating in an activity if the "qualifying business" requirements are met including, the amount of business deductions attributable to the activity which are allowable to the corporation pursuant to §§162 and 404 exceeded 15% of gross income from the business for the taxable year.

8. An activity is an economic unit that is used to measure gain or loss. Under Reg. §1.469-4(e), what had to be treated as a separate activity?

a. Incorrect. In the example provided in the course material, Dan had a significant ownership interest in a bakery and a movie theater in both Baltimore and Philadelphia. Depending on other relevant facts and circumstances, he could group the activities into a movie theater activity and a bakery activity, into a Baltimore activity and a Philadelphia activity, or into four separate activities. However, such activities were not required to be treated as separate four activities even though located in different states.

b. Correct. Under Reg. §1.469-4(e), an activity involving the rental of real property and an activity involving the rental of personal property could not be treated as a single activity. Normally, certain factors would be considered in making the determination, but the regulations explicitly forbid these activities from being treated as one activity. They were required to be treated as separate activities.

c. Incorrect. Under Reg. §1.469-4(e), an activity involving the rental of real property and an activity involving the rental of personal property provided in connection with the real property could but, was not required to, be treated as a single activity. This is where the factor of interdependencies between the activities would be considered.

d. Incorrect. Two activities in the same type of business can be grouped if the taxpayer is a limited partner or limited entrepreneur in only one of the two activities and if the facts-and-circumstances test is satisfied. The relevant factor in determining whether activities constitute an appropriate economic unit for passive loss purposes is the interdependencies between the activities.

9. Under which of the following scenarios would rental activities be treated non-passively and would, therefore, be deductible?

a. Incorrect. The relief provision permitting the deduction of losses from the rental activities of real estate professionals does not apply in the case of trusts.

b. Incorrect. The relief provision does not apply in the case of limited partnerships owning real estate rentals.

c. Incorrect. The relief provision does not apply to combined personal services, only to combined material participation. Therefore, either you or your spouse or both would each need to put in more than 750 personal service hours in a real property trade or business such as a real estate brokerage.

d. Correct. You would satisfy the eligibility requirements relating to real property trades or businesses for deducting losses if more than 50% of your personal services during the tax year are performed in real property trades or businesses in which you materially participate, and you perform more than 750 hours of service in those same trades or businesses.

10. Amazingly, passive activity deductions of a closely held C corporation may be applied against passive activity income and net active income. For this special rule, what is included in the corporation's net active income for the tax year?

a. Correct. Under Reg. §1.469-(g)(4)(ii), net active income for the tax year is determined without regard to gross income from a trade generally relating to activities of trading personal property, only when the corporation did not materially participate in the activity for such year. Thus, when the corporation does materially participate in the activity, such gross income is included in net active income. As a result, passive activity deductions could be applied against this income.

b. Incorrect. Under Reg. §1.469-(g)(4)(ii), net active income for the tax year is determined without regard to the corporation's deductions due to portfolio income under Reg. §1.469-2T(d)(2)(i), (ii) and (iv).

c. Incorrect. Under Reg. §1.469-(g)(4)(ii), net active income for the tax year is determined without regard to the corporation's gross income treated as not from a passive activity under Reg. §1.469-2T(c)(6), relating to gross income from certain oil and gas properties. Thus, passive activity deductions could not be applied against this income.

d. Incorrect. Under Reg. §1.469-(g)(4)(ii), net active income for the tax year is determined without regard to the interest expense allocated under Reg. §1.163-8T to a portfolio expenditure.

11. Allocation of disallowed passive activity losses among all of a taxpayer's activities producing a loss during the tax year is required under §469. What does this required allocation determine?

a. Correct. Allocation of disallowed passive activity losses among all the taxpayer's activities producing a loss during the tax year is necessary to determine the proper application of loss limitations other than §469. Separating the disallowed losses allows the portion of losses that are not subject to §469 to be allocated to those loss limitations.

b. Incorrect. Allocation of disallowed passive activity losses among all the taxpayer's activities producing a loss during the tax year is necessary to de-

termine the taxpayer's gain or loss on the disposition, not acquisition, of a passive activity.

c. Incorrect. Allocation of disallowed passive activity losses among all the taxpayer's activities producing a loss during the tax year is necessary to determine the treatment of disallowed losses. Allocating disallowed losses would not be needed to determine the treatment of allowed losses - i.e., nonpassive.

d. Incorrect. The passive loss rules only limit and require the suspension of disallowed passive losses. If the activity is a nonpassive activity to begin with, §469 treatment of disallowed losses will not apply to such nonpassive losses.

12. Under §469(i), a taxpayer must meet five conditions in order to offset up to $25,000 per year of losses and credits related to the passive activity against nonpassive income. What is one of these five required conditions?

a. Incorrect. One of the five conditions is that the taxpayer must be a natural person. While a partner or S corporation shareholder can qualify, the taxpayer must be an individual, not an entity.

b. Correct. One of the five necessary conditions is that the taxpayer must own 10% or more of the property. If this and all other conditions are met, the taxpayer could offset this amount against nonpassive income.

c. Incorrect. One of the conditions is that the activity must be pure real estate rental with no substantial services provided. If substantial services are provided with the rental activity, the taxpayer would disqualify for the special rule for rental real estate under §469(i).

d. Incorrect. One of the conditions is that the taxpayer's AGI (determine without regard to any passive activity loss) must be $100,000 or less. However, the AGI may be $200,000 or less if deductions are based on low-income housing or rehabilitation credits. Thus, if the taxpayer's AGI is more than $200,000, he or she would be unable to offset the $25,000 per year of losses and credits related to a passive activity against nonpassive income.

13. Suppose you rented some land and the unadjusted basis of the depreciable property rented in the activity was 25% of the unadjusted basis of all property rented in the activity. In this case, which of the following would apply?

a. Incorrect. The material participation test does not apply to portfolio income. It applies to active business income. Reg. §1.469-5T(a)(4) provides that a taxpayer is considered to materially participate in activities that would otherwise be significant participation passive activities if the taxpayer's participation in all such activities exceeds 500 hours for the taxable year. If the 500-hour test is not met, the net loss remains passive and subject to §469.

b. Incorrect. The 80% figure confuses rental of nondepreciable property with equity financed lending. Reg. §1 .469-2T(f)(4) recharacterizes income from an equity financed lending activity as nonpassive if the average balance of

debt incurred in the activity as determined at the entity level does not exceed 80% of the average balance of interest-bearing assets held in the activity.

c. Incorrect. This would not apply in your case since the property is not rented for a business activity in which you materially participated. Reg. §1 .469-2T(f)(6) provides that an amount of a taxpayer's gross income from renting an item of property equal to the taxpayer's net passive income from such rental is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year.

d. Correct. This would apply in your case. Reg. §1.469-2T(f)(3) provides that an amount of the taxpayer's gross income from an activity of renting nondepreciable property (e.g., land) equal to the taxpayer's net passive income from the activity is nonpassive. Income from a rental activity is subject to this recharacterization if the unadjusted basis of the depreciable property rented in the activity is less than 30% of the unadjusted basis of all property rented in the activity.

14. The passive activity audit guide indicates possible audit issues where the taxpayer fails to file Form 8582. In this situation, IRS personnel are advised to check whether the taxpayer's:

a. Correct. A potential audit issue is indicated where no Form 8582 has been filed and the taxpayer's adjusted gross income exceeds $150,000 and rental real estate losses are claimed. It is at that level that the $25,000 active participation rental real estate amount is phased out. Further, by not filing Form 8582, a taxpayer does not appear to report any passive activity loss limitations.

b. Incorrect. One potential audit issue to be aware of is where no Form 8582 has been filed and the taxpayer's Schedule E shows large nonpassive losses from a partnership or S corporation, especially if the entity is out-of-state. A Schedule C is the form that a sole proprietorship uses to report profit or loss from a business and its use here would appear to be a misreporting.

c. Incorrect. A potential audit issue is indicated where no Form 8582 has been filed and the taxpayer's Schedule E shows that rental real estate losses in excess of $25,000 have been deducted. Rental real estate losses are shown on a Schedule E, not a Schedule C. The reason this is an indicator is that active participation rental real estate losses are limited to $25,000.

d. Incorrect. A potential audit issue for revenue agents is where no Form 8582 has been filed and the taxpayer's Schedule C shows equipment or vehicle rentals and its use here would appear to be a misreporting. Schedule E shows supplemental income and loss from royalties, partnerships, S corporations, estates, trusts, etc.

15. Leasing §1245 equipment is an activity subject to the at-risk rules. Which of the following is considered §1245 property?

a. Incorrect. Section 1245 property is any depreciable or amortizable property that is a single purpose agricultural or horticultural structure. Thus, a multiple-purpose agricultural or horticultural structure would not qualify.

b. Incorrect. Section 1245 property is any depreciable or amortizable property that is other tangible property (other than a building or its structural components) that is: (a) used in manufacturing, production, or extraction, or in furnishing transportation, communications, energy, water, or sewage disposal; (b) a research facility used for the activities in (a); or (c) a bulk storage facility used for the activities in (a). Thus, intangible property would not qualify as §1245 property.

c. Correct. Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is §1245 property. Section 1245 property is any depreciable or amortizable property that is a storage facility (other than a building or its structural components) used for the distribution of petroleum.

d. Incorrect. Section 1245 property is any depreciable or amortizable property that is personal property. Thus, real property would not qualify as §1245 property.

Glossary

Active participation: Sufficient activity to treat a taxpayer as being engaged in a trade or business.

Activity grouping: The aggregation of activities under the passive loss rules.

Adjusted basis: The original basis of property increased by improvements and reduced by depreciation.

Adjusted gross income (AGI): Total income reduced by allowable adjustments, such as for an IRA, student loan interest, alimony, and Keogh deductions. The AGI is important in determining whether various tax benefits are phased out.

At-risk rules: Rules limiting loss deductions to the amount of cash investment and personal liability.

Capital loss: Loss from the disposition or exchange of a capital asset.

Consolidated return: A federal income tax return filed by an affiliated group of corporations.

Fully taxable disposition: A sale of an entire activity that frees any suspended losses.

Grantor trust rules: Rules that tax the grantor of a trust on the trust income.

Gross income: Money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits.

Material participation rules: Rules for determining whether a person is active in a business activity for passive activity will purposes.

Net lease: A lease or rental where the tenant pays most of the expenses.

Ordinary loss: A loss from the sale or exchange of property that is not a capital asset.

Passive activity: An activity for which the taxpayer does not materially participate.

Passive loss: A loss from a passive activity.

Portfolio income: Income from interest, dividends, royalties, and gains from the sale of stocks and bonds.

Real estate professional: An individual who, because of their involvement in certain real estate activities, is not subject to the passive loss rules.

Recharacterization rules: Passive loss rules that can recharacterize passive income as nonpassive.

Tax year: An annual accounting period for reporting income and keeping records.

Keywords & Phrases

A

abandonment, 6, 52
active income, 33
active participation, 42, 43, 49, 50, 57
adjusted basis, 7, 9, 10, 38, 39, 52, 55, 58
adjusted gross income, 40
affiliated group, 36
agents, 49
AGI, 40, 42
allowed or allowable, 55
amortization, 55
amount at risk, 52, 55, 58, 59, 60, 62
amount realized, 38, 39
appreciated property, 39
at-risk rules, 23, 52, 55, 56, 57
attribution, 6
attribution rules, 6
audit, 48
audit issues, 48

B

business expenses, 55

C

C corporation, 13, 17, 22, 23, 30, 33
capital asset, 10
capital interest, 59
capital losses, 10, 11
children, 59
compensation, 13, 22, 61
consolidated return, 36
constructive ownership, 54
controlled group, 57, 59

D

depreciable property, 45
dividends, 9
drugs, 47

E

equipment leasing, 56, 57

F

fair market value, 7, 39, 58
Form 8582, 48, 49
Form W-2, 49
fully taxable disposition, 6, 7, 10

G

grandparents, 59
grantor trust, 22
grants, 30
gross income, 24, 28, 33, 34, 36, 37, 38, 43, 44, 45, 46, 49, 55, 62
gross profit percentage, 8
guarantees, 60

I

intangible asset, 55, 57
interest expense, 3, 48, 49
investment interest, 43, 49

J

joint returns, 33

L

leases, 29, 45, 57
like-kind exchange, 9
limited partnerships, 30
low-income housing, 40, 42, 47

M

material change, 28
material participation, 1, 2, 3, 14, 17, 18, 21, 22, 23, 42, 48, 49, 51

N

net active income, 33
net income, 2, 44, 58
net lease, 29, 43, 50, 51
net loss, 2, 8, 11, 36, 42, 44
nonpassive activity, 49
nonrecourse financing, 58, 60, 61

O

oil and gas property, 57
ordinary losses, 10
original basis, 7

P

passive activity, 1, 2, 3, 6, 7, 8, 9, 10, 16, 17, 21, 23, 28, 29, 32, 33, 34, 36, 37, 36, 37, 38, 39, 40, 39, 43, 44, 45, 46, 47, 48, 49, 52
passive activity losses, 8, 9, 10, 36, 48, 52
passive income, 7, 11, 16, 18, 21, 42, 43, 44, 45, 46, 47, 48
personal holding company, 54
personal property, 27, 34, 56, 57
personal service corporation, 8, 11, 13, 22, 23, 24, 33, 54
placed in service, 47, 56, 57
points, 49, 51
portfolio income, 1, 3, 8, 9, 30, 32, 33, 34, 43, 45, 48, 49
principal purpose, 17
private foundation, 23
publicly traded partnerships, 2

Q

qualified person, 61
qualified residence interest, 3, 51

R

real estate professionals, 48
real estate taxes, 51
recapture, 55, 62
recharacterization, 33, 43, 44, 45
rehabilitation credit, 40
rental activities, 14, 29, 30, 48
rental income, 30, 43, 51
rental real estate losses, 42, 49
royalties, 3

S

S corporations, 11, 27, 49, 52, 59
self-employment tax, 30
significant participation, 16, 23, 37, 43, 44, 50
suspended losses, 2, 6, 7, 8, 9, 11, 28, 60

T

targeted jobs credit, 47
tax shelters, 14
tax year, 1, 6, 7, 9, 10, 11, 14, 16, 19, 21, 23, 24, 27, 28, 30, 33, 36, 37, 39, 43, 44, 46, 47, 48, 50, 51, 52, 54, 55, 56, 57, 58, 60, 62
taxable event, 6
taxable income, 33, 46
taxable year, 11, 13, 16, 18, 19, 21, 23, 24, 33, 37, 38, 39, 43, 44, 45, 46, 47
testing period, 13, 22

U

unadjusted basis, 45

W

worthlessness, 6

Passive Loss & At-Risk Rules

Mini-Course Description & Study Guide

With the adoption of the passive loss limitation rules, taxpayers are looking to CPAs for guidance related to what deductions are allowed, disallowed, or suspended. Updating practitioners on the practical aspects of §469, this course addresses the needed skill to handle these pragmatic issues. Fundamentals are reviewed, planning opportunities are identified, and creative strategies are discussed and evaluated along with remaining traditional approaches. The goal of this instructive course is to understand and solve client problems under §469, with emphasis on tax savings ideas. Participants will learn to master the proper administration of these complex and often cumbersome provisions.

Completion Deadline & Exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Course Level: Overview. This program is appropriate for professionals at all organizational levels.

Field of Study: Taxes

Prerequisite: General understanding of federal income taxation.

Advanced Preparation: None

Recommended CPE Hours: CPAs — 3 Tax
EAs and CRTPs — 3 Federal Tax

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement.

CPE sponsor information: Spidell Publishing, LLC (Registry ID: 104931)

Expiration Date: July 2024*
*Exam must be completed within one year of the date of purchase

Learning Assignment & Objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

ASSIGNMENT

At the start of the materials, participants should identify the following topics for study:

* Passive loss rules
* Material participation
* Activity definition
* Passive & nonpassive activities
* Passive activity loss
* Rental activities
* Recharacterization of passive income
* Passive activity credits
* Passive activity audit guide
* At-risk limits

Learning Objectives

After reading the materials, participants will be able to:

1. Identify affected taxpayers, categories of income and loss, and passive losses under §469 and necessary §469 calculation steps and specify the §469 & §1211 limits and the ordering and suspension of any disallowed losses.

2. Recognize a taxpayer's material participation in an activity by:

a. Identifying the material participation tests and their application to entities such as partnerships and corporations;

b. Specifying the activity grouping rules and exempt activities;

c. Determining passive activity particularly, the treatment of rental activity as passive; and

d. Identifying "nested" activities.

3. Identify special passive loss rules and calculations by:

a. Determining alternating use effects on amount realized and adjusted basis and citing additional loss limitations outside of §469;

b. Recognizing requirements for the special $25,000 allowance; and

c. Specifying recharacterization rules and their purpose.

4. Recognize the passive activity audit guidelines identifying audit issues, determine the real estate rental activity credit exception, and cite the at-risk limit rules as they relate to §469.

After studying the materials, answer the exam questions 1 to 15.

Notice

This course and test have been adapted from materials and information contained in the above text and any supplemental material provided. This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

Course Evaluation for Spidell Publishing, LLC®

Program title: **Passive Loss and At-Risk Rules (2023)**

If applicable, program instructor: _____

Program date: _____ Participant name (optional): _____

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? _____
2. If applicable, were prerequisite requirements appropriate and sufficient? _____
3. Were the program materials accurate? _____
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? _____
5. Was the time allotted to the learning activity appropriate? _____
6. If applicable, were the individual instructors knowledgeable and effective? _____
7. Were the facilities and/or technological equipment appropriate? _____
8. Were the handout and/or advanced preparation materials satisfactory? _____
9. Were the audio and visual materials effective? _____

IRS Course Number (if applicable): CRA7E-T-00641-23-S

TTP (CTEC) Course Number (if applicable): 1019-CE-1241

Date course completed: _____

Number of hours it took to complete the course: _____

P. O. Box 61044 • Anaheim, California 92803-6144 • *e-Mail:* cpe@spidell.com
***Phone:* (714) 776-7850 • *Fax:* (714) 776-9906 • *Web site:* http://www.caltax.com**

SPIDELL
A CeriFi Company
TAX • ANALYSIS • EDUCATION

Examination for Spidell's Passive Loss and At-Risk Rules

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (11 of 15) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. One of your tax clients, Edward, has experienced a loss resulting from land he held for investment and seeks your advice. You would want to let him know that he:

   a) Would not apply §469 to these losses
   b) Would not be able to deduct any of this loss against income
   c) Must limit the credits from this activity to the tax due on this activity
   d) Would carry the loss forward and treat it as a deduction in the following tax year

2. Jared gifts his daughter a townhouse that is passive property. The property has an adjusted basis of $275,000, suspended losses of $23,000, and a fair market value of $310,000. Which of the following applies in Jared's case?

   a) Jared can deduct $23,000
   b) His daughter's basis in the property is $275,000
   c) Jared can convert the passive losses into realized losses
   d) His daughter's basis in the property is $298,000

3. Brett earned a $90,000 salary and owned one passive activity through a 5% interest in a limited partnership. During the tax year, he sold his entire interest to Rick for $81,000. His adjusted basis in the partnership interest was $64,000, and he had carried over $4,500 of passive activity losses. What is Brett's net gain on the sale?

   a) $8,000
   b) $9,500
   c) $12,500
   d) $15,000

4. Over a year ago, Beth organized her architectural firm, Open Space Designs, as a C corporation. She is the sole shareholder and employee. Under the IRC, her firm would be classified as a:

   a) Nonpassive activity
   b) Personal service corporation
   c) Personal holding company
   d) Small business investment company

5. Sharon wants to avoid the passive loss rules by claiming that she materially participates in an activity. As Sharon's advisor, you should explain to her that, based on the February 19, 1988 regulations, you would need to sit down with her and analyze:

   a) Three tests
   b) Five tests
   c) Seven tests
   d) Six tests

6. Marty owns an interest in a partnership with two other partners and participates in some of its activities. He is concerned about meeting the §469 material participation requirement and seeks your advice. You would point out that, in order to materially participate, he would need to have:

   a) Given 100 hours of his time to work related to his capacity as an investor in the activity
   b) Already participated in the activity for three of the last 10 years prior to the current tax year
   c) His two partners materially participate for 400 hours each and have materially participated himself for 125 hours
   d) Participated in a number of different significant activities related to the principal activity for an aggregate total of over 500 hours

7. Erik is a limited partner in several partnerships and wants to know whether any of the activities he has participated in are exempted from the rules prohibiting limited partners from grouping certain activities with other activities. As his advisor, you would explain to him that the one exempted activity is:

   a) Warehousing
   b) Farming
   c) Geothermal deposits
   d) Rental of depreciable personal property

8. Max rents commercial space in the buildings he owns and wants to know if he can avoid the passive loss rules by devoting more time to the activity. You would inform him that, under §469(c)(2), his rental activity is presumed a passive activity:

   a) Only if he participates less than 500 hours
   b) If the average rental is less than 3 days
   c) Whether or not he materially participates
   d) Only if he participates less than 100 hours

9. In an attempt to reduce the impact of §469, Gary combines his rental and investment activities using several entities. You warn Gary that §469 may require the separate and independent treatment of such activities and that this separation process may often result in:

   a) A disregard for and ignoring of legal entities
   b) The sheltering of portfolio income
   c) The transfer of portfolio assets to passive activity entities
   d) The combination of rental activities with nonrental activities

10. Arthur sold some alternating use property subject to §469. His tax advisor informs him that the primary activity for which the property was used is allocated the amount realized and the adjusted basis. However, for this to be true, a tax advisor should note that the property's fair market value must be equal to or less than the lesser of 10% of all property value directly prior to its disposition and:

    a) $5,000
    b) $7,500
    c) $10,000
    d) $12,250

11. Christine sold some property she used in a passive activity, which she treated as passive activity gross income. However, Christine's tax advisor points out that the IRS finds it inappropriate to automatically treat gain from a rental property sale in this manner. As a result, for her gain to be considered passive, the property she sold would, according to Reg. §1.469-2T(f)(5), need to be subject to the:

    a) 10/10 test
    b) 12-month test
    c) 500-hour test
    d) Active participation test

12. You are discussing the nature of passive activity tax credits with your tax client, Elton. He wants to know when passive credits are allowable. You explain to him that, under §469(d)(2), passive credits are:

    a) Generally allowable in most situations
    b) Allowable to offset tax liability resulting from net passive income
    c) Allowable if they represent the sum of all his credits subject to §469 for the taxable year
    d) Allowable if his regular tax liability is allocable to all active activities

13. Greg actively participates in a real estate rental activity that generates income and has passive credits from rehabilitating older homes and turning them into rental units. If you were advising Greg, you would want to point out to this that:

    a) His deduction losses are used first against the allowance and thereafter the credits are applied
    b) He can only use real estate rental activity losses suspended in earlier years against the allowance before the credits are applied
    c) He can use these credits to offset tax on the portion of the $25,000 allowance that he has not been able to offset by deductions
    d) He may not use passive credits to offset tax liability due to net passive income

14. You are the internal auditor for a fast-growing computer systems company and are reading the IRS passive activity audit guide in order to be aware of the kinds of items IRS personnel are looking for. Searching for circumstances that would trigger audit problems with the IRS, you would want to look for large amounts of income that offset large passive losses, particularly if the income is:

    a) Definitely from a passive activity
    b) From rented property
    c) Reflected elsewhere on the return
    d) Portfolio income

15. Ethan is the owner of a closely held business and wants to know how §465 at-risk limits apply to him. You would point out that he would be at risk if:

    a) He was personally liable for repayment of the amounts he borrowed to use in a business
    b) He borrowed money protected by stop-loss agreements
    c) He borrowed money secured by nonrecourse financing
    d) Nobody was personally liable for money he borrowed from the federal government

SPIDELL
A CeriFi Company
TAX • ANALYSIS • EDUCATION

Answer Sheet for Spidell's Passive Loss and At-Risk Rules

Name: _____ Signature: _____

Company: _____

Address: _____

City/State/ZIP: _____

Phone: _____ Fax: _____

E-mail: _____

License/Registration No.: _____ ☐ CPA ☐ EA ☐ CRTP (CTEC) ☐ Atty

PTIN: _____

If you are an EA or CRTP (CTEC), we must have your PTIN in order to report your hours to the IRS.

Deadline to Complete the Course: *In accordance with NASBA and IRS requirements, you have one year from the date of purchase to complete the examination and submit it to our office for grading.*

This examination is designed to test your knowledge on the content of **Spidell's Passive Loss and At-Risk Rules**. We will grade the answer sheet, and if you answer 70% or more of the questions correctly you will be sent a certificate of completion. Passing CPAs will be recommended for three hours of continuing education credit, and passing EAs and CRTPs will be recommended for three federal tax hours of continuing education.

* Attorneys will be recommended for 2.5 hours of General MCLE/Tax Specialization credit.

To complete your exam: Go to https://cpe.spidell.com/ and login with your e-mail address and license number to complete your exam. Click on "view courses to be completed" then "start exam". When you are finished click "submit".

Or, fax your answer sheet to (714) 776-9906.

Final Exam Questions

1. ☐ **a)** Would not apply §469 to these losses
   ☐ **b)** Would not be able to deduct any of this loss against income
   ☐ **c)** Must limit the credits from this activity to the tax due on this activity
   ☐ **d)** Would carry the loss forward and treat it as a deduction in the following tax year

2. ☐ **a)** Jared can deduct $23,000
   ☐ **b)** His daughter's basis in the property is $275,000
   ☐ **c)** Jared can convert the passive losses into realized losses
   ☐ **d)** His daughter's basis in the property is $298,000

3. ☐ **a)** $8,000
   ☐ **b)** $9,500
   ☐ **c)** $12,500
   ☐ **d)** $15,000

4. ☐ **a)** Nonpassive activity
   ☐ **b)** Personal service corporation
   ☐ **c)** Personal holding company
   ☐ **d)** Small business investment company

5. ☐ **a)** Three tests
   ☐ **b)** Five tests
   ☐ **c)** Seven tests
   ☐ **d)** Six tests

6. ☐ **a)** Given 100 hours of his time to work related to his capacity as an investor in the activity
   ☐ **b)** Already participated in the activity for three of the last 10 years prior to the current tax year
   ☐ **c)** His two partners materially participate for 400 hours each and have materially participated himself for 125 hours
   ☐ **d)** Participated in a number of different significant activities related to the principal activity for an aggregate total of over 500 hours

7. ☐ **a)** Warehousing
   ☐ **b)** Farming
   ☐ **c)** Geothermal deposits
   ☐ **d)** Rental of depreciable personal property

8. ☐ **a)** Only if he participates less than 500 hours
   ☐ **b)** If the average rental is less than 3 days
   ☐ **c)** Whether or not he materially participates
   ☐ **d)** Only if he participates less than 100 hours

9. ☐ **a)** A disregard for and ignoring of legal entities
   ☐ **b)** The sheltering of portfolio income
   ☐ **c)** The transfer of portfolio assets to passive activity entities
   ☐ **d)** The combination of rental activities with nonrental activities

10. ☐ **a)** $5,000
    ☐ **b)** $7,500
    ☐ **c)** $10,000
    ☐ **d)** $12,250

11. ☐ **a)** 10/10 test
    ☐ **b)** 12-month test
    ☐ **c)** 500-hour test
    ☐ **d)** Active participation test

12. ☐ **a)** Generally allowable in most situations
    ☐ **b)** Allowable to offset tax liability resulting from net passive income
    ☐ **c)** Allowable if they represent the sum of all his credits subject to §469 for the taxable year
    ☐ **d)** Allowable if his regular tax liability is allocable to all active activities

13. ☐ **a)** His deduction losses are used first against the allowance and thereafter the credits are applied
    ☐ **b)** He can only use real estate rental activity losses suspended in earlier years against the allowance before the credits are applied
    ☐ **c)** He can use these credits to offset tax on the portion of the $25,000 allowance that he has not been able to offset by deductions
    ☐ **d)** He may not use passive credits to offset tax liability due to net passive income

14. ☐ **a)** Definitely from a passive activity
    ☐ **b)** From rented property
    ☐ **c)** Reflected elsewhere on the return
    ☐ **d)** Portfolio income

15. ☐ **a)** He was personally liable for repayment of the amounts he borrowed to use in a business
    ☐ **b)** He borrowed money protected by stop-loss agreements
    ☐ **c)** He borrowed money secured by nonrecourse financing
    ☐ **d)** Nobody was personally liable for money he borrowed from the federal government