Chapter 10

Passive Activity Losses

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Passive Losses Rules (slide 1 of 2)

- Require income and losses to be separated into three categories:
  - Active
  - Portfolio
  - Passive
- Generally, disallow the deduction of passive losses against active or portfolio income

Passive Losses Rules (slide 2 of 2)

- In general, passive losses can only offset passive income
- Passive losses are also subject to the at-risk rules
  - Designed to prevent taxpayers from deducting losses in excess of their economic investment in an activity

At-Risk Limits

(slide 1 of 4)

- At-risk defined
  - The amount of a taxpayer's economic investment in an activity
    - Amount of cash and adjusted basis of property contributed to the activity plus amounts borrowed for which taxpayer is personally liable (recourse debt)

At-Risk Limits

(slide 2 of 4)

- At-risk defined
  - At-risk amount does not include nonrecourse debt unless the activity involves real estate
    - For real estate activities, qualified nonrecourse debt is included in determining at-risk limitation

At-Risk Limits

(slide 3 of 4)

- At-risk limitation
  - Can deduct losses from activity only to extent taxpayer is at-risk
  - Any losses disallowed due to at-risk limitation are carried forward until at-risk amount is increased
  - At-risk limitations must be computed for each activity of the taxpayer separately

At-Risk Limits

(slide 4 of 4)

- Interaction of at-risk rules with passive loss rules
  - At-risk limitation is applied FIRST to each activity to determine maximum amount of loss allowed for year
  - THEN, passive loss limitation applied to ALL losses from ALL passive activities to determine actual amount of loss deductible for year

Passive Loss Limits
(slide 1 of 7)

- Active income
  - Wages, salary, and other payments for services rendered
  - Income/losses from self-employed trade or business activity in which taxpayer materially participates
  - Gain from sale or disposition of assets used in an active trade or business
  - Income from intangible property created by taxpayer

Passive Loss Limits
(slide 2 of 7)

- Portfolio income
  - Interest, dividends, annuities, and certain royalties not derived in the ordinary course of business
  - Gains/losses from sale of assets that produce portfolio income or held for investment

Passive Loss Limits
(slide 3 of 7)

- Passive losses defined
  - Losses from trade or business activities in which taxpayer does not materially participate, and
  - Certain rental activities

Passive Loss Limits

(slide 4 of 7)

- Limitations on passive losses
  - Generally, passive losses can only offset passive income, i.e., they cannot reduce active or portfolio income
  - Disallowed losses are suspended and carried forward
    - Suspended losses must be allocated to specific activities

Passive Loss Limits

(slide 5 of 7)

- Suspended losses are deductible in year related activity is disposed of in a fully taxable transaction

Passive Loss Limits
(slide 6 of 7)

- Passive credits
  - Credits from passive activities are subject to loss limitation
  - Utilize passive credits to the extent of tax attributable to passive income
  - Credits disallowed are suspended and carried forward similar to losses
    - Suspended credits can be used to offset tax from disposition of activity but any credits left after activity is disposed of are lost forever

Passive Loss Limits
(slide 7 of 7)

- Taxpayers subject to rules
  – Individuals, estates, trusts, personal service corporations
  – Closely-held corporations
    - Can deduct passive losses against active income
  – S Corp and partnership passive losses flow through to owners and limits applied at the owner level

Passive Loss Issues

- Passive losses are losses from trade or business *activities* in which taxpayer does not *materially participate* and certain *rental activities*
- What constitutes an activity?
- What is "material participation?
- When is an activity a rental activity?

Identification of Activities

(slide 1 of 3)

- Taxpayers with complex business operations must determine if segments of their business are separate activities or entire business is treated as a single activity

Identification of Activities
(slide 2 of 3)

- Regs allow grouping multiple trade or businesses if they form an *appropriate economic unit* for measuring gain or loss
  - Once activities are grouped, can’t regroup unless:
    - Original groups were clearly inappropriate, or
    - Material change in circumstances

Identification of Activities
(slide 3 of 3)

- Factors given greatest weight in determining an appropriate economic unit include:
  - Similarities and differences in types of businesses
  - Extent of common control and ownership
  - Geographic location of different units
  - Interdependencies among the activities

Material Participation Tests
(slide 1 of 8)

- An activity is treated as active rather than passive (thus, not subject to the passive loss limits) if taxpayer meets one of 7 material participation tests
- Participation is generally defined as work performed by an owner

Material Participation Tests

(slide 2 of 8)

- Test 1
  - Taxpayer participates in the activity more than 500 hours during the year

Material Participation Tests
(slide 3 of 8)

- Test 2
  - Taxpayer’s participation in the activity is substantially all of the participation in the activity of all individuals for the year

Material Participation Tests

(slide 4 of 8)

- Test 3
  - Taxpayer participates in the activity more than 100 hours during the year and not less than the participation of any other individual in the activity

Material Participation Tests
(slide 5 of 8)

- Test 4
  - Taxpayer's participation in the activity is significant and taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours
  - Significant participation is more than 100 hours

Material Participation Tests
(slide 6 of 8)

- Test 5
  - Taxpayer materially participated in the activity for any 5 years during the last 10 year period

Material Participation Tests
(slide 7 of 8)

- Test 6
  - The activity is a personal service activity in which the taxpayer materially participated for any 3 preceding years

Material Participation Tests
(slide 8 of 8)

- Test 7
  - Based on the facts and circumstances, taxpayer participated in the activity on a regular, continuous, and substantial basis
    - Regular, continuous, and substantial are not specifically defined in the Regulations

Rental Activities

(slide 1 of 7)

- Rental of tangible (real or personal) property is automatically passive activity unless it meets one of the 6 exceptions (Regs)
- If exception applies, activity is subject to the material participation test

Rental Activities

(slide 2 of 7)

- Exception 1
  - The average period of customer use of the property is 7 days or less

Rental Activities

(slide 3 of 7)

- Exception 2
  - The average period of customer use of the property is 30 days or less, and the taxpayer provides significant personal services
    - Significant services are only services performed by individuals

Rental Activities

(slide 4 of 7)

- Exception 3
  - Taxpayer provides extraordinary personal services
  - Average period of customer use is of no consequence
    - Extraordinary personal services occur when the customer's use of the property is incidental to the services provided

Rental Activities

(slide 5 of 7)

- Exception 4
  - Rental of the property is incidental to a nonrental activity of the taxpayer

Rental Activities

(slide 6 of 7)

- Exception 5
  - Taxpayer customarily makes the property available during business hours for nonexclusive use by customers

Rental Activities

(slide 7 of 7)

- Exception 6
  - Property is provided for use in an activity conducted by a partnership, S corporation, or joint venture in which taxpayer owns an interest

Interaction of At-Risk and Passive Loss Limits

- Passive loss rules are applied after the at-risk rules
  - Losses not allowed under the at-risk rules are suspended under the at-risk rules, not the passive loss rules
  - Basis is reduced by deductions even if not currently usable due to passive loss rules

Real Estate Passive Loss Limits
(slide 1 of 4)

- Generally, losses from real estate are treated like other passive losses
- There are two significant exceptions to the general rule

Real Estate Passive Loss Limits
(slide 2 of 4)

- Exception 1: Real estate professionals
  - Rental real estate losses are not treated as passive if the following requirements are met:
    - Taxpayer performs more than half of his/her personal services in real property businesses in which the taxpayer materially participates, and
    - Taxpayer performs more than 750 hours of services in these real property businesses as a material participant

Real Estate Passive Loss Limits
(slide 3 of 4)

- Exception 2: Rental real estate activities
  - Taxpayer can deduct up to $25,000 of losses on real estate rental activities against active or portfolio income
  - Benefit is reduced by 50% of taxpayer's AGI in excess of $100,000

Real Estate Passive Loss Limits
(slide 4 of 4)

- Exception 2: Rental real estate activities
  - 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 defined:
    - Requires only participation in making management decisions in a significant and bona fide sense

Suspended Losses

- Losses can be suspended due to the passive loss limits or the at-risk limits
- Losses suspended due to at-risk limitations are investment specific, thus no allocation of suspended losses is necessary
- Suspended at-risk and passive losses can be carried forward indefinitely

Disposition of Passive Interests
(slide 1 of 3)

- Disposition at death: suspended loss deductible on decedent's final tax return to extent of excess over any step-up in basis
- Disposition by gift: suspended loss increases donee's basis in activity

Disposition of Passive Interests
(slide 2 of 3)

- Disposition by installment sale: portion of suspended loss deductible is same as percentage of total gain recognized in year

Disposition of Passive Interests
(slide 3 of 3)

- Nontaxable exchange: if activities involved are same, suspended losses can be deducted against income from acquired activity
  - Otherwise, suspended loss generally deductible in year new activity disposed of in taxable transaction

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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