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
(slode 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
(slides 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.
• 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
• 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
• 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
• 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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