

CHAPTER 10
PASSIVE ACTIVITY LOSSES
SOLUTIONS TO PROBLEM MATERIALS

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	General purpose and effect of the at-risk and passive activity loss rules	New	
2	At-risk amount	Unchanged	2
3	Changes in at-risk amount	Unchanged	3
4	At-risk and passive loss limits	Modified	4
5	Descriptions of active, portfolio, and passive income	Unchanged	5
6	Preference as to active or passive classification	Unchanged	6
7	Preference as to active or passive classification	Unchanged	7
8	Disposition of passive activity	Unchanged	8
9	Treatment of suspended losses and credits on disposition of an activity	Unchanged	9
10	Taxpayers subject to passive loss rules	Unchanged	10
11	Corporate passive activity loss deduction	Unchanged	11
12	Appropriate economic unit	New	
13	Nature of passive activity	Unchanged	13
14	IRS regrouping of passive activities	Unchanged	14
15	Material participation significance	Unchanged	15
16	The 500-hour standard for material participation	Unchanged	16
17	Passive or active loss determination	New	
18	Issue ID	Unchanged	18
19	Work that qualifies for material participation standard	Unchanged	19
20	Issue ID	New	
21	Limited partnership interest and material participation standard	Unchanged	21

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
22	Extraordinary personal services: nature and importance	New	
23	Passive activity definition	Unchanged	23
24	Rental business: active versus passive	Unchanged	24
25	Real estate professional classification	Unchanged	25
26	Issue ID	Unchanged	26
27	Issue ID	New	
28	Determination of passive activity status	Unchanged	28
29	Real estate activity exceptions	Unchanged	29
30	Deduction equivalent: definition and computation	New	
31	Issue ID	Unchanged	31
32	At-risk rules	New	
33	At-risk rules	Unchanged	33
34	At-risk rules	Unchanged	34
* 35	Passive loss offsets passive income	Unchanged	35
36	Passive activity loss rules: general application	New	
37	Passive activity loss rules: general application	Unchanged	37
* 38	Passive activity loss rules: general application	Unchanged	38
39	Treatment of suspended losses	New	
* 40	Sale of passive activity and suspended losses	Unchanged	40
* 41	Sale of passive activity and suspended losses	Unchanged	41
* 42	Sale of passive activity	Unchanged	42
43	Passive losses of personal service corporation	New	
44	Passive losses of corporations	Unchanged	44
45	Passive, active, portfolio income of closely held corporation	Unchanged	45
46	Planning for material participation status	New	
* 47	Interaction of at-risk and passive loss rules	Unchanged	47
48	Interaction of at-risk and passive loss rules	Unchanged	48
49	Interaction of at-risk and passive loss rules	Unchanged	49
50	Interaction of at-risk and passive loss rules	Unchanged	50
* 51	Passive loss deduction amounts	Unchanged	51
52	Rental loss: active participation	Modified	52
53	Rental loss: nonactive participation	Modified	53
54	Active income and passive income: real estate activities	Unchanged	54
55	Joint or separate return: real estate rental exception	New	
* 56	Real estate rental exception	Unchanged	56
57	Real estate rental exception	Unchanged	57
* 58	Passive activity loss allowed, suspended losses and credits	Unchanged	58
* 59	Real estate rental loss deduction	Unchanged	59
* 60	Death and suspended losses	Unchanged	60
61	Gift of a passive activity	New	
* 62	Installment sale of passive activity	Unchanged	62

*The solution to this problem is available on a transparency master.

CHECK FIGURES

- 32. \$35,000 loss deduction in 2002; \$15,000 loss deduction in 2003.
- 33. \$40,000 loss deduction in current year; \$20,000 loss deduction next year.
- 34. Total present value of Alternative 1 \$53,142; total present value of Alternative 2 \$55,059.
- 35. No deduction in 2002 or 2003.
- 36. No deduction in 2002; \$15,000 deduction in 2003.
- 37. \$245,000.
- 38. Total present value of Option A \$14,431; total present value of Option B \$21,629.
- 39. \$16,000.
- 40. Defer sale until next year.
- 41. Net gain of \$6,500 can be used to absorb passive losses from other activities.
- 42.a. Taxable gain (passive) \$25,000.
- 42.b. Deductible loss \$15,000.
- 42.c. Deductible loss \$15,000.
- 43. \$260,000.
- 44.a. Taxable income \$436,000.
- 44.b. Taxable income \$396,000.
- 45. \$60,000.
- 46. Work at least 31 hours in the convenience store activity.
- 47. Invest in Rocky Road Adventures.
- 48. 2003 \$0; 2004 \$40,000.
- 49. \$40,000 deductible in current year.
- 50.a. \$218,000.
- 50.b. \$173,000.
- 51. No loss deductible in 2002 or 2003.
- 52. \$120,000.
- 53. \$120,000.
- 54. \$18,000 loss from development business is deductible; \$25,000 of rental loss is deductible.
- 55. Should file jointly.
- 56. \$6,800 net positive cash flow before mortgage payments.
- 57. \$25,000 deductible.
- 58. Use \$20,000 of losses and \$1,350 of credits.
- 59. Suspended loss \$23,000.
- 60. \$6,000.
- 61. Leon loses suspended losses; Lucy adds suspended losses to basis.
- 62. Gain \$40,000; deductible suspended losses \$4,800.

DISCUSSION QUESTIONS

1. In general, the purpose of the at-risk rules and the passive activity loss rules has been to reduce or eliminate abusive tax shelters. Such tax shelters essentially enabled taxpayers to “buy” deductions and credits for use on their income tax returns that cause a reduction or deferral of income tax liabilities. In some cases, taxpayers were able to claim multiple write-offs for each dollar invested. In response to these abuses, Congress enacted the at-risk provisions, which limit tax shelter deductions to the amount of the taxpayer’s actual economic loss. Later, Congress followed with the passive loss provisions. These provisions prohibit specified taxpayers from offsetting passive losses against other types of income (active and portfolio). p. 10-3
2. Alice is at-risk for the \$100,000 of cash invested plus her \$50,000 share of the recourse debt. Thus, her at-risk amount is \$150,000. p. 10-4
3. A taxpayer’s at-risk amount is *increased* by the following items:
 - The amount of cash and the adjusted basis of property contributed to the activity.
 - Amounts borrowed for use in the activity for which the taxpayer is personally liable or has pledged as security property not used in the activity.
 - Taxpayer’s share of amounts borrowed for use in the activity that is qualified nonrecourse financing.
 - Taxpayer’s share of the activity’s income.A taxpayer’s at-risk amount is *decreased* by the following items:
 - The amount of cash and the adjusted basis of property withdrawn from the activity (i.e., withdrawals).
 - The taxpayer’s share of losses from the activity.
 - Reductions of amounts borrowed for use in the activity for which the taxpayer is personally liable or reductions for qualified nonrecourse debt.

If a taxpayer is facing disallowances of deductions because of the at-risk limitation, it is possible to increase the amount at-risk by investing additional funds or property or having the business increase recourse or qualified nonrecourse debt.

pp. 10-4, 10-5, and Concept Summary 10-1

4. Roberto can deduct only \$18,000 currently because that is all he has at risk. Assuming further he is not a material participant, this deduction will be suspended under the passive loss rules if he does not have passive income from other investments of at least \$18,000. If, in the future, his at-risk amount increases sufficiently, he will then be able to deduct the remainder (i.e., \$8,000), again subject to the passive activity limitations. pp. 10-5, 10-6, and 10-20
5. Active income includes, but is not limited to, the following:
 - Wages, salary, commissions, bonuses, and other payments for services rendered by the taxpayer.

- Profit from a trade or business in which the taxpayer is a material participant.
- Gain on the sale or other disposition of assets used in an active trade or business.
- Income from intangible property if the taxpayer's personal efforts significantly contributed to the creation of the property.

Portfolio income includes, but is not limited to, the following:

- Interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business.
- Gain or loss from the disposition of property that produces portfolio income or is held for investment purposes.
- Passive income is generally income arising from the following activities:
 - Any trade or business or income-producing activity in which the taxpayer does not materially participate.
 - Subject to certain exceptions, any rental activity, whether the taxpayer materially participates or not.

p. 10-6

6. Manuel would generally prefer to have the loss activity classified as active. An active loss can offset income from any of the three categories of income: active, passive, and portfolio. If an activity is classified as passive, a loss from that activity can offset only passive income. pp. 10-6 and 10-7
7. Kim would generally prefer to have the activity classified as passive. Passive income can be offset by passive losses, active losses, and portfolio losses. Active income can be offset only by active and portfolio losses. pp. 10-6 and 10-7
8. The losses not previously deducted will be deductible when Felicia disposes of the activity. pp 10-7 and 10-8
9. Disagree. Upon disposition of a passive activity, a taxpayer's suspended losses may be offset against passive income, gain on disposition of the activity, or nonpassive (active or portfolio) income. However, suspended credits may be used only to offset tax on passive income. Credits that cannot be used in this manner are lost to the taxpayer. pp. 10-6 to 10-9 and Examples 12 and 13
10. The Code specifically states that the passive loss rules apply to individuals, closely held C corporations, and personal service corporations. However, in the case of closely held corporations, passive losses can be used to offset active income. For the flow-through entities, such as partnerships and S corporations, the passive loss rules apply at the partner and shareholder levels, not at the entity level. pp. 10-9 and 10-10
11. The loss is not deductible if Gray Corporation is a personal service corporation. However, the loss is deductible if Gray is a closely held C corporation that is not a personal service corporation. pp. 10-9 and 10-10

12. The following five factors are given the greatest weight in determining whether activities constitute an appropriate economic unit. It is not necessary to meet all of these conditions in order to treat more than one activity as a single activity.
- Similarities and differences in types of business conducted in the various trade or business or rental activities.
 - The extent of common control over the various activities.
 - The extent of common ownership of the activities.
 - Geographical location of the different units.
 - Interdependencies among the activities.
- p. 10-12
13. The question of what constitutes a passive activity is complicated when an activity has several parts. Is each part to be counted as a separate activity or as a component of a single activity? Regulations have been issued to provide guidelines for determining what constitutes an activity. See Examples 16 to 22 for illustrations of these guidelines.
14. The IRS may regroup activities when both of the following conditions exist.
- The taxpayer's grouping fails to reflect one or more appropriate economic units.
 - One of the primary purposes of the taxpayer's grouping is to avoid the passive loss limitations.
- pp. 10-12, 10-13, and Example 21
15. The term *material participation* is significant from the taxpayer's perspective because losses from an activity in which the taxpayer materially participates can offset active and portfolio income. Material participation is determined by the level of participation of the taxpayer in the activity. The underlying theory is that a high enough level of participation indicates that the taxpayer has an interest in the activity other than as an investment. The taxpayer who materially participates in the activity has both an economic interest in the activity and an interest in the activity as an ongoing source of livelihood. p. 10-13
16. The more-than-500-hour standard for material participation was adopted for two reasons. First, few investors in traditional tax shelters devote more than 500 hours a year to such investments. Second, the IRS believes that income from an activity in which the taxpayer participates for more than 500 hours a year should not be treated as passive. p. 10-15
17. Keith is entitled to an ordinary loss deduction if his participation in the activity constitutes substantially all of the participation in the activity of all individuals (including nonowner employees) for the year. As the information given in the question suggests that Keith is the only individual who participates in the activity, he would be entitled to an ordinary loss deduction. Example 25 and related discussion
18. • The amount of Rene's at-risk basis in the hardware business and whether the losses flowing from the entity are limited by the at-risk rules.

- Whether the profits and losses from the public accounting firm are classified as passive or active.
- Whether Rene is a material participant in the hardware business.
- Whether Rene is subject to the passive loss rules.

pp. 10-3, 10-4, and 10-14 to 10-17

19. As a general rule, participation includes work done by an individual in an activity that he or she owns. Such participation includes supervising employees, selling goods, providing services to customers, and any other activity associated with the day-to-day operations of a business. However, participation does not include work of a type not customarily done by owners if one of the principal purposes of such work is to avoid the disallowance of losses or credits. In addition, participation does not include activities of the owner which are really investor types of activities. Investment activities include examination of financial statements in a non-managerial capacity. Example 31 and related discussion
20. How can Alan best allocate the time he devotes to his various businesses in order to minimize the negative impact of the material participation rules? In carrying out this objective, several points need to be identified and resolved.
- How are the various businesses grouped together to form activities and how many hours does Alan spend working in each activity?
 - How many employees are working at each of the businesses and how many hours have they worked?
 - What type of work can Alan's wife do to ensure that her participation will be treated as being his?
 - Is Alan a limited partner in any of the businesses? (If so, this causes the rules to be applied differently.)

pp. 10-12 to 10-18

21. Generally, a limited partner is not considered a material participant. However, Kevin may be considered a material participant if he qualifies under Test 1, 5, or 6. p. 10-17
22. Extraordinary personal services are services provided by individuals where the customers' use of the property is incidental to their receipt of the services. If extraordinary personal services are provided, the activity is not treated as a rental activity, without regard to the average period of customer use. p. 10-19
23. The Code defines the following activities as passive:
- Any trade or business or income-producing activity in which the taxpayer does not materially participate.
 - Subject to certain exceptions, all rental activities, whether the taxpayer materially participates or not.

Reg. § 1.469-4 provides rules that are used to delineate what constitutes an activity for purposes of the passive loss limitations. Temp. Reg. § 1.469-5T(a) provides guidelines for determining what constitutes material participation. In addition, Temp. Reg. § 1.469-1T(e)(3) describes various rental activities that are not *treated* as rental activities for purposes of classifying the activities as passive.

pp. 10-11, 10-14, and 10-18

24. The average rental period for the video cassette business is seven days or less; thus, the business is not treated as a rental activity. Laura is a material participant with respect to the videotape business, so it is active. Real estate rental operations are passive, unless the taxpayer participates more than 750 hours as a real estate professional and that participation constitutes more than half of her personal services for the year. pp. 10-18, 10-19, 10-21, and Examples 33 and 42
25. If Hilda is a real estate professional who performs more than 750 hours of service in the real estate rental activity as a material participant and that participation constitutes more than half of her personal services for the year, she can treat the entire \$60,000 as nonpassive. p. 10-21 and Example 42
26.
 - Whether the at risk rules apply or whether Charles's at-risk basis is sufficient to support any losses that may be attributed to him. pp. 10-3 to 10-5.
 - How will these investments be grouped as activities (e.g., aggregating all businesses as one retail activity, treating the software, bagel, and rental businesses as three separate activities, or categorizing each location as a separate activity)? pp. 10-11 to 10-13.
 - Will Charles's involvement in any one or more of the activities be sufficient to support the classification of these businesses as active or will they be treated as passive? pp. 10-13 to 10-17
 - Will the mountain bike and ski rental shops be classified as rental activities or will they qualify for one of the exceptions involving rentals of personal property that are not treated as rental activities? pp. 10-18 to 10-20
 - Assuming the passive activity rules apply, what is the best combination of grouping the ventures as one or more activities, given the projected profits and losses, and Charles's willingness to stay with these investments without selling them for an extended period of time? pp. 10-3 to 10-5 and 10-11 to 10-13
27. Losses from real estate rental activities are not treated as passive losses for certain real estate professionals. Relevant to the applicability of this provision are the following points:
 - Because Rick works full-time as a real estate professional, undoubtedly more than half of his personal services are performed in real property trades or businesses.
 - Also, as a real estate professional, it is very likely that he performs more than 750 hours of service in real property trades or businesses.
 - Not clear from the facts is whether he materially participates in this S corporation venture or other investments that may be aggregated with this venture.

If Rick materially participates in the rental activity, he qualifies for the exception relating to real estate professionals. This allows him to offset the \$5,000 of active income (i.e., salary) with the \$5,000 loss. If he is not a material participant in the real estate activity, the \$5,000 of income is fully taxable and the \$5,000 loss is passive and deductible only against passive income.

pp. 10-21 and 10-22

28. Jane does not meet the 500-hour material participation requirement for the dress shop. Unless Jane's participation satisfies one of the other material participation tests, the dress shop is a passive activity. As to the apartment, real estate rental activities are generally treated as passive activities. However, Jane participates for more than 750 hours in the apartment building and may qualify as a real estate professional. If so, the apartment building is *not* a passive activity. The significant participation activities material participation test cannot be relied on to classify the dress shop activity as active in these circumstances because the apartment complex activity cannot be considered a significant participation activity. See Temp. Reg. § 1.469-5T(c), pp. 10-13 to 10-16 and 10-21
29. Matt might be allowed to deduct up to \$25,000 of the passive loss from the apartment building against active or portfolio income. To qualify for the deduction under the real estate rental exception, Matt must actively participate in the activity and own 10% or more of all interests in the activity for the entire taxable year.

Even if Matt qualifies for the real estate rental exception, the potential \$25,000 deduction will be reduced if his AGI exceeds \$100,000. The reduction is equal to 50% of AGI in excess of \$100,000. The deduction will be phased out completely if AGI reaches \$150,000.

Matt also could deduct the loss if he works more than 750 hours as a material participant in connection with the apartment and qualifies as a real estate professional.

pp. 10-21 and 10-22

30. A deduction equivalent is the deduction necessary to reduce one's tax liability by an amount equal to the credit. A taxpayer's deduction equivalent is calculated by dividing the credit by the taxpayer's marginal income tax rate. For example, the deduction equivalent of a \$6,000 credit for a taxpayer in the 30% tax bracket is \$20,000 ($\$6,000 \div .30$). p. 10-23
31.
 - On the properties held both for personal and rental use, what is the applicability of the vacation home rules? Chapter 5
 - To the extent losses flow through to the taxpayers, are they restricted by the passive loss rules? pp. 10-6 and 10-7
 - How are the rental cottages grouped as activities? p. 10-12
 - If the passive loss rules apply to losses flowing from the rental properties, does the rental real estate activities exception apply to grant some tax relief to the taxpayers? pp. 10-21 and 10-22

PROBLEMS

32. The at-risk rules limit Fred's deductions. He can deduct \$35,000 in 2002, and his at-risk amount will be reduced to \$15,000 (\$50,000 original investment – \$35,000 deducted). He will be limited to a \$15,000 deduction in 2003 unless he increases his amount at-risk. For example, if Fred invests an additional \$10,000 in 2003, his at-risk amount would be \$25,000 (\$15,000 balance + \$10,000 additional investment), and he would be able to deduct the entire \$25,000 loss in 2003. Fred's share of the partnership losses is not subject to the passive loss restrictions because Fred's interest is not a passive activity. Examples 4 and 5

33. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 5, 2003

Mr. Bill Parker
54 Oak Drive
St. Paul, MN 55162

Dear Mr. Parker:

This letter is in response to your inquiry regarding the tax treatment of losses that you could expect this year and next year from an investment in Best Choice Partnership. As I understand the facts, you would invest \$60,000 in the partnership with the expectation that your share of the partnership losses in the current and succeeding years would be \$40,000 and \$25,000, respectively.

Even though your investment would not be subject to the passive activity limitations, the amount of the deduction that you may claim in any one year is subject to the at-risk rules. Essentially, these rules provide that your deductions are limited to the amount that you have invested in the venture or the amount that you could lose if the investment were to be unsuccessful. Consequently, in your case, the initial amount that you would have at risk would be \$60,000. Therefore, you would be able to deduct \$40,000 in the current year, which would cause your at-risk basis to be reduced to \$20,000 (\$60,000 – \$40,000). Because your at-risk basis at the end of next year would be only \$20,000, your share of the partnership loss that would be deductible would be limited to \$20,000. The amount not deducted under this scenario would be deductible later when your at-risk basis increases, for example by additional investments you may make in the partnership or because of income generated by the partnership.

If you have additional questions or need further clarification, please call me.

Sincerely,

John J. Jones, CPA

Examples 4 and 5

34. Based on the following, Alternative 2's benefit exceeds Alternative 1's by \$1,917 (\$55,059 – \$53,142), primarily because of the flow of the benefits and the effect of the at-risk rules on those benefits.

Alternative 1

	<u>Income</u>	<u>Tax cost/ benefit</u>	<u>After-tax benefit</u>	<u>8% PV factor</u>	<u>Present value</u>
Yr. 1	(\$24,000)	\$ 6,480 ¹	\$ 6,480	0.92593	\$ 6,000
Yr. 2	(24,000)	4,320 ²	4,320	0.85734	3,704
Yr. 3	72,000	(17,280)	54,720	0.79383	<u>43,438</u>
Total present value					<u>\$53,142</u>

Alternative 2

	<u>Income</u>	<u>Tax cost/ benefit</u>	<u>After-tax benefit</u>	<u>8% PV factor</u>	<u>Present value</u>
Yr. 1	(\$48,000)	\$10,800 ³	\$10,800	0.92593	\$10,000
Yr. 2	32,000	(6,480) ⁴	25,520	0.85734	21,879
Yr. 3	40,000	10,800	29,200	0.79383	<u>23,180</u>
Total present value					<u>\$55,059</u>

¹ Because of the at-risk rules, Amanda's tax deduction in year 2 is limited to her remaining at-risk basis of \$16,000. The \$8,000 loss that is not deductible in year 2 is suspended until her at-risk basis increases. Therefore, her tax benefit from the deduction is \$4,320 (\$16,000 X 27%).

² Amanda's \$72,000 share of income increases her at-risk basis and provides the opportunity to claim the \$8,000 suspended loss from the previous year. Therefore, her taxable income for year 3 from this investment is \$64,000 (\$72,000 – \$8,000) and the tax cost is \$17,280 (\$64,000 X 27%).

³ Because of the at-risk rules, Amanda's tax deduction in year 1 is limited to her at-risk basis of \$40,000. The \$8,000 loss that is not deductible in year 1 is suspended until her at-risk basis increases. Therefore, her tax benefit from the deduction is \$10,800 (\$40,000 X 27%).

⁴ Amanda's \$32,000 share of income increases her at-risk basis and provides the opportunity to claim the \$8,000 suspended loss from the previous year. Therefore, her taxable income from this investment in year 2 is \$24,000 (\$32,000 – \$8,000) and the tax cost is \$6,480 (\$24,000 X 27%).

pp. 10-3 to 10-5

35. In 2002 and 2003, Tina may deduct none of the passive losses that remain after offsetting the passive income in both years. In 2002, the \$20,000 of passive income is used to absorb \$20,000 of the \$200,000 passive loss, leaving \$180,000 of passive loss suspended. In 2003, the \$40,000 of passive income is used against the \$280,000 passive loss [\$180,000 (suspended loss from 2002) + \$100,000 (loss in 2003)], leaving a \$60,000 passive loss suspended for that year. Thus, a total of \$240,000 of passive losses are suspended at the end of 2003. Examples 3 and 6
36. In 2002, Kay cannot deduct any of the passive loss. The \$35,000 loss is suspended and carried forward to 2003. The 2003 income of \$15,000 is offset by \$15,000 of the suspended passive loss from 2002. After deducting \$15,000 of the passive loss in 2003, \$20,000 of the 2002 passive loss remains suspended. Examples 3 and 6

37. Bob cannot deduct the passive loss against active or portfolio income. Therefore, his net income after considering the passive investment is \$245,000 (\$200,000 active income + \$45,000 portfolio income). Example 6
38. Option B's benefit exceeds Option A's by \$7,198 (\$21,629 – \$14,431), primarily because of the flow of the benefits and the ability to benefit from the passive loss deductions in years 1 and 2.

Option A

	<u>Income</u>	<u>Tax cost/ benefit</u>	<u>After-tax benefit</u>	<u>8% PV factor</u>	<u>Present value</u>
Yr. 1	\$8,000	(\$2,400)	\$5,600	0.92593	\$ 5,185
Yr. 2	8,000	(2,400)	5,600	0.85734	4,801
Yr. 3	8,000	(2,400)	5,600	0.79383	4,445
Total present value					<u>\$14,431</u>

Option B

	<u>Income</u>	<u>Tax cost/ benefit</u>	<u>After-tax benefit</u>	<u>8% PV factor</u>	<u>Present value</u>
Yr. 1	(\$ 8,000)	\$ 2,400	\$ 2,400	0.92593	\$ 2,222
Yr. 2	(2,000)	600	600	0.85734	514
Yr. 3	34,000	(10,200)	23,800	0.79383	18,893
Total present value					<u>\$21,629</u>

pp. 10-6 and 10-7

39. Hazel can deduct none of the loss from either passive activity during the current year. Therefore, her suspended loss at the end of the current year is \$16,000 (\$10,000 loss + \$6,000 loss). pp. 10-6 and 10-7
40. If Activity A is sold in the current year, the following results:

Gain from Activity A	\$100,000
Less: Suspended losses from Activity B (\$35,000 + \$35,000 + \$5,000)	<u>(75,000)</u>
Taxable gain	<u>\$ 25,000</u>
Federal income tax (at 27%)	<u>\$ 6,750</u>

In addition, the \$20,000 loss (and the corresponding tax benefit of \$5,400) from Activity B expected to be incurred next year would be suspended until passive income is generated. The prospects of gaining the use of the tax benefit at this time are nil.

If Activity A is sold next year, the following results:

Gain from Activity A	\$ 95,000
Less: Suspended losses from Activity B (\$35,000 + \$35,000 + \$5,000 + 20,000)	<u>(95,000)</u>
Taxable gain	<u>\$ -0-</u>
Tax (at 27%)	<u>\$ -0-</u>

Therefore, by deferring the sale until next year, Wade is able to avoid the current payment of a \$6,750 Federal tax liability. In addition, the expected gain from the sale can be offset by all of the suspended passive loss from Activity B (including the expected \$20,000 loss from next year). By deferring the sale, Wade's short-term cashflow increases by \$1,750.

Reduced sales price	(\$5,000)
Reduced Federal income tax	<u>6,750</u>
Increase in cash flow	<u>\$1,750</u>

Examples 6, 8, and 52

41. Last year, Sandra could deduct nothing against nonpassive income, and was required to allocate the \$20,000 net loss among the three loss activities.

Income (loss):	
Activity A	\$30,000
Activity B	(30,000)
Activity C	(15,000)
Activity D	<u>(5,000)</u>
Net passive loss	<u>(\$20,000)</u>

Net passive loss allocated to:	
Activity B (30/50 X \$20,000)	(\$12,000)
Activity C (15/50 X \$20,000)	(6,000)
Activity D (5/50 X \$20,000)	<u>(2,000)</u>
Total suspended losses	<u>(\$20,000)</u>

In the current year, Sandra has a net gain of \$10,000 from the sale of Activity D. She can offset the \$2,000 suspended loss from the activity and the current year's loss of \$1,500 from the activity against the \$10,000 gain. In addition, the remaining net gain of \$6,500 (\$10,000 – \$2,000 – \$1,500) from the sale may be used to absorb passive losses from the other activities.

pp. 10-7, 10-8, and Examples 9 and 10

42. a.

Net sales price	\$100,000
Less: Adjusted basis	<u>(35,000)</u>
Total gain	\$ 65,000
Less: Suspended losses	<u>(40,000)</u>
Taxable gain (passive)	<u>\$ 25,000</u>

Example 7

b.

Net sales price	\$100,000
Less: Adjusted basis	<u>(75,000)</u>
Total gain	\$ 25,000
Less: Suspended losses	<u>(40,000)</u>
Deductible loss	<u>(\$ 15,000)</u>

Example 8

c.	Net sales price	\$100,000
	Less: Adjusted basis	<u>(75,000)</u>
	Total gain	\$ 25,000
	Less: Suspended losses	<u>(40,000)</u>
	Deductible loss	<u>(\$ 15,000)</u>

The suspended passive losses are fully deductible. The suspended credits are lost forever because the sale of the activity did not generate any tax.

Example 12

43. A personal service corporation cannot offset passive losses against active or portfolio income. Therefore, Brown's income is \$260,000 (\$200,000 active income + \$60,000 dividend income) and the \$45,000 passive loss is suspended. Example 14 and related discussion
44. a. A personal service corporation is not allowed to offset passive losses against active or portfolio income. Therefore, White's taxable income based on the facts given is \$436,000 (\$400,000 income from operations + \$36,000 portfolio income). Example 14
- b. A closely held, non-personal service corporation is allowed to offset passive losses against active income, but not against portfolio income. Therefore, White's taxable income based on the facts given is \$396,000 (\$400,000 income from operations – \$40,000 passive loss + \$36,000 portfolio income). Example 15
45. A closely held, non-personal service corporation can offset passive losses against active income, but not against portfolio income. Green's net income is \$60,000 (\$50,000 active income + \$60,000 dividend income – \$50,000 passive loss deducted to extent of active income). Green will have a suspended passive loss of \$30,000 (\$80,000 passive loss incurred – \$50,000 passive loss used). Example 15
46. If Suzanne can incur an additional 31 hours in the convenience store activity, she will have more than 500 hours in all of her significant participation activities. Consequently, she would be considered a material participant in the ventures and the losses expected would be deductible against her active and portfolio income. Example 27
47. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

January 23, 2004

Ms. Kristin Bailey
123 Baskerville Mill Road
Jamison, PA 18929

Dear Kristin:

This letter is in response to your request for assistance in analyzing the tax consequences resulting from two investment alternatives. One alternative is to make an additional investment of \$10,000 in Rocky Road Adventures in which you have an at-risk basis of \$0, suspended losses under the at-risk rules of \$7,000, and suspended passive losses of \$1,000. If you were to make this investment, your share of the expected profits this year

would be \$8,000, while if your investment stayed at the same level, your share of profits would be \$1,000. Your other choice is to invest \$10,000 as a limited partner in the Ragged Mountain Winery, which would produce passive income of \$9,000 this year. I have prepared the following analysis based on these facts.

Invest \$10,000 in Rocky Road Adventures:

Expected profit from investment		\$8,000
Beginning at-risk basis	\$ -0-	
Increase due to profit	8,000	
Increase to at-risk basis due to investment	<u>10,000</u>	
	\$18,000	
Use of loss suspended by at-risk rules	<u>(7,000)</u>	
Ending at-risk basis	<u>\$11,000</u>	
Beginning suspended passive loss	(\$1,000)	
Reclassified suspended passive loss	<u>(7,000)</u>	
Use of suspended passive losses—revised		<u>(8,000)</u>
Current taxable income		<u>\$ -0-</u>
Current tax liability		<u>\$ -0-</u>

Invest \$10,000 in Ragged Mountain Winery:

Expected profit from investment—Ragged Mountain Winery	\$9,000
Expected profit from investment—Rocky Road Adventures	1,000
Use of suspended passive losses from Rocky Road Adventures	<u>(1,000)</u>
Current taxable income	<u>\$9,000</u>
Current tax liability (\$9,000 X 30%)	<u>\$2,700</u>

As you can see, the tax effects of the two options vary significantly and the differences relate to the interplay of the at-risk rules and the passive activity loss rules. I hope that this analysis will help you make a more informed investment decision. If you need any further explanation, please contact me.

Sincerely,

Libba Eanes, CPA
Partner

Examples 38 to 41

48. Lee’s share of ABC’s loss in 2003 is \$80,000 (\$400,000 X .20 ownership interest), and the entire loss is suspended under the passive loss rules. His share of the passive income in 2004 is \$40,000 (\$200,000 X .20 ownership interest). At the end of 2004, his at-risk amount is \$80,000 (\$120,000 – \$80,000 passive loss in 2003 + \$40,000 share of income in 2004). In 2004, he may deduct \$40,000 of his \$80,000 suspended loss against the passive income. This leaves a \$40,000 suspended passive loss at the end of 2004. Examples 38 to 41

49. Ann is allowed a \$40,000 deduction. Because her at-risk basis is only \$40,000, \$10,000 of the \$50,000 loss is suspended. The available \$40,000 loss is not subject to the passive activity loss rules because she was a material participant. The loss is treated as an active loss. Therefore, Ann’s AGI is \$100,000 (\$140,000 – \$40,000). Examples 23 and 38 to 41

50. a. If Soong is not a material participant, \$45,000 of his \$60,000 loss is reclassified as a passive loss and disallowed under the passive loss limits. The remaining \$15,000 is disallowed by the at-risk limits. Therefore, Soong's AGI is \$218,000 (\$200,000 salary + \$18,000 portfolio income).
- b. If Soong is a material participant, \$45,000 of his \$60,000 loss is deductible as an active loss. The remaining \$15,000 is disallowed by the at-risk limits. Therefore, Soong's AGI is \$173,000 (\$200,000 salary + \$18,000 portfolio income – \$45,000 active loss).

Examples 39 to 41

51. If losses were limited only by the at-risk rules, Gerald would be able to deduct the following amounts in 2002 and 2003.

<u>Year</u>	<u>Loss</u>	<u>Allowed*</u>	<u>Disallowed</u>
2002	\$40,000	\$30,000	\$10,000
2003	30,000	-0-	30,000

*Allowed under the at-risk rules, reclassified as a passive loss subject to the passive loss limitations.

However, the losses also are limited by the passive loss rules as follows:

<u>Year</u>	<u>Passive</u>	<u>Deductible</u>	<u>Suspended</u>
2002	\$30,000	\$-0-	\$30,000
2003	-0-	-0-	-0-

In 2004, the \$50,000 income increases Gerald's at-risk amount to \$50,000 enabling him to deduct the \$40,000 of disallowed losses. The \$50,000 is passive income that can be offset by \$50,000 of suspended losses, leaving a suspended loss of \$20,000. At the end of 2004, Gerald has no unused losses under the at-risk rules, \$20,000 of suspended passive losses, and a \$10,000 adjusted basis in the activity [$\$30,000$ (adjusted basis on 1/1/2002) – $\$40,000$ (loss in 2002) – $\$30,000$ (loss in 2003) + $\$50,000$ (income in 2004)].
Examples 4, 5, and 39 to 41

52. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

March 5, 2003

Mr. Joe Cook
125 Hill Street
Charleston, WV 25311

Dear Joe:

This letter is in response to your inquiry regarding the \$60,000 loss you incurred this year in conjunction with your investment in the apartment building, which I have assumed is not low-income housing given that it is located in an exclusive part of the city. As I understand your situation, you anticipate that your current AGI, exclusive of the loss flowing from the real estate rental activity, will be \$130,000 and you wish to determine whether the loss is either partially or fully deductible.

As you are aware, the apartment rental activity is considered a passive activity and, in general, is subject to the passive activity rules. However, because you are an active participant in the investment, you will be able to deduct \$10,000 under a real estate rental exception to the passive activity rules. More specifically, the law allows losses of up to \$25,000 from certain real estate rental activities to be deducted each year. However, if a taxpayer's AGI exceeds \$100,000, the amount deductible in the current year is reduced by 50% of every dollar of AGI over \$100,000. Once a taxpayer's AGI reaches \$150,000, no current loss deduction is allowed. Because your AGI is expected to be \$130,000, the maximum allowable loss of \$25,000 is reduced as follows: [$\$25,000$ (maximum allowable) $- .50(\$130,000$ AGI $- \$100,000)$]. Therefore, your AGI would be \$120,000 after the allowable \$10,000 loss ($\$130,000 - \$10,000$). The remaining \$50,000 loss that would not be deductible in the current year is suspended under the passive loss rules and would be available in future years.

If you have any additional questions or would like further clarification of this matter, please call me.

Sincerely,

John J. Hudgins, CPA

pp. 10-21 to 10-23

53. The activity is an apartment building (i.e., a passive activity) and Beth is not an active participant. Therefore, no deduction is allowed under the real estate rental exception. The \$35,000 loss is suspended under the passive loss rules, and Beth's AGI is \$120,000. pp. 10-22 and 10-23
54. Donald does not satisfy both requirements for certain real estate professionals that allow nonpassive treatment for losses. Of the 2,300 hours Donald worked during the year, only 1,100 hours, or less than half, involved real estate trades or businesses in which he materially participated. Therefore, his real estate rental activities are passive activities.

However, the 600 hours Donald devoted to his real estate development business satisfies the 500-hour material participation requirement. Therefore, the \$18,000 loss is fully deductible.

Under the rental real estate exception, Donald can deduct \$25,000 of his \$26,000 of losses given that his AGI is less than \$100,000. The remaining \$1,000 of losses are suspended passive losses.

pp. 10-14, 10-22, and 10-23

55. Ruth and Mike are much better off filing jointly (a tax liability based on the 2003 rate schedules of \$5,975 compared to \$10,563). The decrease in medical deductions [(\$6,500 – \$2,318) versus (\$6,500 – \$4,635)] is more than offset by the fact that they lose their rental loss deduction if they file separately because they live together.

	<u>Ruth</u>	<u>Mike</u>	<u>Joint</u>
Income:			
Salaries	\$30,000	\$50,000	\$80,000
Dividends and interest	900	900	1,800
Rental loss	<u>-0-</u>	<u>-0-</u>	<u>(20,000)</u>
AGI	\$30,900	\$50,900	\$61,800
Itemized deductions:			
Medical expenses	\$ 6,500	\$ -0-	\$ 6,500
Less: 7.5% of AGI	(2,318)	-0-	(4,635)
All other	<u>2,000</u>	<u>8,000</u>	<u>10,000</u>
Total itemized deductions	(\$ 6,182)	(\$ 8,000)	(\$11,865)
Personal exemptions	<u>(3,050)</u>	<u>(3,050)</u>	<u>(6,100)</u>
Taxable income	<u>\$21,668</u>	<u>\$39,850</u>	<u>\$43,835</u>
Tax (rounded)	<u>\$ 2,950</u>	<u>\$ 7,613</u>	<u>\$ 5,975</u>
Tax filing separately:			
Ruth's tax			\$ 2,950
Mike's tax			<u>7,613</u>
			\$10,563
Tax filing jointly			<u>(5,975)</u>
Tax savings filing jointly			<u>\$ 4,588</u>

p. 10-22

56. The incremental tax impact of renting the property would be that Mary and Charles would have a \$5,000 deductible loss. The total deductible loss, including the real estate tax and interest expenses, would be \$13,000 (\$5,000 + \$8,000). The real estate tax and interest expenses would be deductible whether or not Mary and Charles convert the cottage to rental status. Even though the rental cottage would be considered a passive activity, it would qualify for the real estate rental exception. This allows taxpayers to deduct up to \$25,000 per year against active and portfolio income. Therefore, converting the property to rental status would produce an incremental \$5,000 tax deduction and a tax benefit of \$1,800 (\$5,000 X 36%). The cash flow position before the mortgage payments would be:

Rent Income	\$20,000
Tax benefit from passive loss deduction	1,800
Less:	
Rental commissions	(3,000)
Maintenance expenses	<u>(12,000)</u>
Net positive cash flow before mortgage payments	<u>\$ 6,800</u>

Under the facts given, the cash flow from renting the cottage would not be sufficient to cover the \$12,000 mortgage payment. Nonetheless, other factors might be relevant that could lead Mary and Charles to decide to rent the cottage. Chapter 5 and pp. 10-21 to 10-23

57. Gene is considered a material participant in the tax practice but not in the apartment leasing operation. However, because he actively participates in the real estate rental activity and owns at least 10% in the activity, \$25,000 of the \$30,000 loss is deductible in the current year against his tax practice income. The remaining \$5,000 loss from the rental activity is suspended as a passive activity loss. pp. 10-22 and 10-23

58. Ida can utilize \$20,000 of losses and \$1,350 of credits as follows:

Income (Loss):	Activity A	(\$12,000)
	Activity B	(18,000)
	Activity C	<u>10,000</u>
Net loss		(\$20,000)
Utilized loss		<u>20,000</u>
Suspended loss		\$ -0-
Utilized credit		<u>\$ 1,350</u>
Suspended credit		<u>\$ 750</u>

After deducting the loss of \$20,000, Ida has available a deduction equivalent of \$5,000 [\$25,000 (maximum loss allowed) – \$20,000 (utilized loss)]. Therefore, the maximum amount of credits Ida may claim is \$1,350 [\$5,000 (deduction equivalent) X 27% (marginal tax bracket)]. Examples 44 and 45

59. Rental loss	(\$105,000)
Rental income	25,000
Other passive income	<u>32,000</u>
Net passive rental loss	(\$ 48,000)
Deductible against other income	<u>25,000</u>
Suspended rental loss	<u>(\$ 23,000)</u>

Example 43

60. On Lucile’s final income tax return, a deduction of \$6,000 is allowed as follows:

FMV of property at death	\$170,000
Adjusted basis of property	<u>(160,000)</u>
Increase (step-up) in basis	<u>\$ 10,000</u>
Suspended loss	(\$16,000)
Increase in basis	<u>10,000</u>
Suspended loss allowable on Lucile’s final income tax return	<u>(\$ 6,000)</u>

Example 47

61. In a disposition of a taxpayer’s interest in a passive activity by gift, the suspended losses are added to the basis of the property. Therefore, Lucy’s basis in the property received by gift is \$16,000 (\$13,000 basis in Leon’s hands + \$3,000 suspended passive losses). Leon is not allowed to deduct the suspended losses in the year of disposition. Example 48

62. In the current year, Tonya has a gain of \$40,000 and can deduct \$4,800 of suspended losses as follows:

Sale price	\$150,000
Adjusted basis	<u>(50,000)</u>

Total gain	<u>\$100,000</u>
Proceeds received this year	\$60,000
Gross profit ratio (\$100,000/\$150,000)	<u>X 2/3</u>
Gain recognized this year	<u>\$40,000</u>
Suspended losses	\$12,000
Ratio of gain recognized to total gain (\$40,000/\$100,000)	<u>X 40%</u>
Current deductible loss	<u>\$ 4,800</u>

Example 49