2000 Income Tax School

LOSS LIMITATIONS

INTRODUCTION

The numerous limitations on loss deductions in the Internal Revenue code have been added in a piecemeal fashion over the years. To apply these rules, the tax preparer must understand the hierarchy of the various limitations.

There are two main areas in which loss limitations play a role:

- Losses on the sale or disposition of property
- Losses arising during the conduct of an ongoing business or investment activity

Within each of these two areas, there are four dimensions to be considered:

- Distinguishing **single-transaction** limitations from **combination** limitations
- Separating the **permanent** disallowance provisions from the **temporary** disallowance provisions
- Determining the hierarchy of the limitations
- Recognizing special treatment for the alternative minimum tax

This chapter covers the loss limitations that relate to **activities** and **dispositions of property.** The most visible and inherently complicated loss limits are the **passive activity** loss rules of I.R.C. §469, to which this chapter devotes considerable coverage. It is extremely important, however, to relate these limits to other loss restrictions. The limitations operate in a hierarchical sequence. A transaction must clear **each** of the following steps to eventually qualify as a deduction.

Order of Loss Limitations

The Ordering of Loss Limitations Follows These Steps

STEP 1. Single-transaction limits
STEP 2. Combined transactions within a single enterprise
STEP 3. Basis limits (partnership or S corporation)
STEP 4. Portfolio limits (not discussed)
STEP 5. At-risk limits
STEP 6. Passive activity loss limits
STEP 7. Capital loss limits, (not discussed)
STEP 8. Taxable income limit (not discussed)

An expenditure must clear each of these hurdles in turn in order to be allowed as a deduction. If it does not clear one of the steps, it may be either **permanently** or **temporarily** disallowed. A temporary disallowance results if a carryover is allowable in another taxable year.

Some transactions will skip some of the steps.

- If an individual owns an activity directly, rather than through a partnership or S corporation, Step 3 is irrelevant.
- Steps 4, 5, and 6 generally do not apply to sales of property.

The rest of the chapter discusses Steps 1, 2, 3, 5, and 6 shown in the preceding table. Steps 4, 7, and 8 are not discussed.

Observation. Throughout the chapter, it is assumed that a limited liability company has *not* elected to be treated as a corporation under the "check- the- box" regulations. [Treas. Reg. §301.7701-3] **Thus the terms "partnership" and "limited liability company (LLC)" will be used interchangeably unless the departure is clearly indicated.**

STEP 1: SINGLE TRANSACTIONS

If any transaction is subject to one of the single-transaction limitations, there is no need to proceed with Steps 2 through 8. No special rule will permit a taxpayer to deduct a loss if the loss is prohibited by Step 1.

Three of the single-transaction limitations discussed are:

1. Related-party losses
2. Related-party accruals
3. Disallowance of personal expenditures

1. RELATED-PARTY LOSSES

I.R.C. §267(a)(1) provides that no loss is allowed on a sale if the parties are related. The related parties are listed in I.R.C. §267(b). They include the following:

- Family members (brothers, sisters, spouse, ancestors, and lineal descendants)
- An individual and a corporation in which the individual owns more than 50% of the stock
- Two corporations that are members of the same controlled group
- Several relationships between fiduciaries, grantors, and beneficiaries of trusts.

I.R.C. §267 does **not** govern transactions between partners and partnerships. Thus, it does **not** apply to limited liability companies and their members, as long as the LLC has not elected to be treated as a corporation. However, I.R.C. §707(b)(1) causes the same result for sales of property between these taxpayers; it works in a similar manner to the loss disallowance rule of I.R.C. §267(a)(1). Thus:

- A loss on the sale of property between a partnership (or LLC) and a holder of a direct or indirect interest in partnership (or LLC) capital or profits is disallowed. (For indirect ownership, use the constructive ownership rules of I.R.C. §267.)

- The purchaser is allowed to offset any eventual gain on the ultimate sale of property by the loss that was disallowed to the seller.

Observation. The seller does not recognize the loss. The purchaser takes a cost basis that reflects the loss in the property. The only relief from the disallowed loss to the seller will arise if the related buyer later sells the property at a gain.

Example 1. John, Kathy and Lavern each own a 1/3 interest in capital and profits in the JKL Limited Liability Company. John sells property to JKL. The property had an adjusted basis of $100,000, but the sale price was $75,000, the fair market value of the property. If John is **not** treated as the constructive owner of the interests of Kathy or Lavern, **John will be allowed to deduct the $25,000 loss** (subject to the remaining limits in the other steps). However, if John were treated as the constructive owner of the interest of either of the other partners, the $25,000 loss would be disallowed. In that instance, the limited liability company's basis would be $75,000. If the company were to sell the property later at a gain, up to $25,000 of the gain would be offset by the loss that was disallowed to John. The same rules would govern if the sale had been from JKL to John.

Practitioner Note. The same disallowance rules apply to sales of property between two partnerships (including limited liability companies) if any combination of partners or members owns more than 50% of the capital or profits interests in both entities.

Example 2. Refer to Example 1. John, Kathy, and Marvin are equal partners in the JKM Partnership. Marvin is not related to any of the other partners in either partnership. JKL sells property to JKM for $50,000 that had a basis of $65,000. If John and Kathy are not treated as related parties, JKL recognizes the $15,000 loss at the time of sale. If John and Kathy **were** treated as related parties, JKL would **not** recognize the loss, but JKM could use the $15,000 disallowed loss to offset future gains.

Observation. An additional complication arises if the sale of property between related parties is for less than the fair market value. The "buyer's" basis is the greater of the amount paid or the "donor's" basis. Also, the "seller" may be treated as having made a gift, subject to the federal gift tax.

2. RELATED-PARTY ACCRUALS

This limit, defined in I.R.C. §267(a)(2), is important when a payor is using the accrual method of accounting and the payee uses the cash method. The result is that the payor receives no deduction until the payee reports the payment in gross income. In effect, this limitation forces the payor to use the cash basis. The most common applications are:

- The payor is a C corporation and the payee owns more than 50% of the outstanding shares.
- The payor is an S corporation and the payee owns any shares.
- The payor is a personal service corporation and the payee owns any shares.
- The payor is a partnership and the payee owns an interest in the partnership. (If the payment is classified as a "guaranteed payment," another rule governs.)

Example 3. Sam, a **cash method, calendar year taxpayer,** owns 1/3 of the stock of OPUS Corporation, a C corporation. His brother, Ed, owns 1/3 of the stock, and an unrelated party owns the other 1/3.

OPUS uses the **accrual method** of accounting and an **October 31 year end.** On October 31 it accrues bonuses to its employees/shareholders. It pays the bonuses on November 5. The corporation is not allowed to deduct the bonuses to Sam and Ed until November 5, which is in its next taxable year. The bonus to the third unrelated shareholder is allowed when accrued.

Observation. If OPUS were an **S corporation** or a **personal service corporation,** none of the bonuses to **any** shareholder, no matter how small the ownership, could be deducted until November 5.

3. DISALLOWANCE OF PERSONAL EXPENDITURES

The IRS has authority to limit or eliminate deductions of business entities for expenditures that are incurred for the personal use of owners. [I.R.C. §262] This disallowance can extend to proprietorships, partnerships, limited liability companies, S corporations, and C corporations. The following issues and related citations will help explain the disallowance or personal expenditures as defined in I.R.C. §262.

- **Legal expenses** can often be on the edge between business and personal. Legal fees paid by an S corporation were allowed as deductions when a shareholder fought successfully to retain control of corporate assets; such fees were incidental to a divorce of the controlling shareholder, but they were definitely tied to the corporation's business purpose. (*Liberty Vending Inc.,* T.C. Memo 1998-177)
- **No corporate trade or business.** The IRS has been successful in invoking I.R.C. §262 when the corporation was not involved in a trade or business except for provision of property to shareholders.
  - *Ray Clymer & Denison Poultry,* 47 T.C.M. 1576, T.C. Memo 1984-203
  - *International Trading Co. v. Commissioner,* 5 AFTR 2d 970, 275 F.2d 578, 1960-2 C.B. 435, 60-1 USTC ¶9335 (7th Cir. 1960)
- **Company car.** Similarly, the IRS has prevailed in disallowing expenses relating to a company car, when the use of the car was a constructive dividend to a shareholder-employee. (*Egan*, 43 T.C.M. 1284, T.C. Memo 1982-237.)
- **Property used by shareholders.** Corporate expenses related to corporate owned property used by shareholders (and not reported as compensation) have been disallowed.
  - *Magnon,* 73 T.C. 980 (1980) (electrical contracting services on shareholders' personal property)
  - *Nicholls, North, Buse Co,* 56 T.C. 1225 (1971) (use of corporate-owned yacht)
  - *Ashby,* 50 T.C. 409 (1968) (use of corporate-owned yacht)
  - *International Trading Co. v. Commissioner,* 275 F.2d 578 (7th Cir. 1960) (use of corporate-owned recreation property)

Deductions Allowed

Property rented to shareholders. A corporation may deduct expenses related to property used by shareholders if it rents the property to the shareholders or treats the value as compensation on the shareholders' W-2 [*Levy,* T.C. Memo 1984-306, 48 T.C.M. 293.]

Single-transaction limits that are not discussed in this book include the following:

- Capital expenditures
- Casualty losses
- Losses realized on like-kind exchanges
- Losses realized on contributions of property to a partnership or controlled corporation

- Losses sustained on worthless securities
- Losses realized on dividends and other corporate distributions
- Expenses paid to produce tax-exempt income

STEP 2: COMBINED TRANSACTIONS WITHIN A SINGLE ENTERPRISE

For a taxpayer to be able to deduct any loss from an enterprise, that enterprise must be either a business or another activity engaged in with a profit motive. If the requisite profit motive is lacking, the taxpayer will not be able to deduct any expenses relating to the venture, with few exceptions. Some of the more commonly encountered restrictions are the **hobby loss limits** of I.R.C. §183 and the **rental of vacation home limits** of I.R.C. §280A.

1. THE HOBBY LOSS RULES

Code §183 disallows any net loss from an activity conducted without a bona fide profit motive. By definition, the rules of I.R.C. §183 apply only to individuals and S corporations. Thus a C corporation is not subject to these restrictions. However, a C corporation may be subject to disallowance under the personal expense test of I.R.C. §262, discussed above.

The hobby loss rules do not include partnerships (including limited liability companies). However, these limits apply to individual partners or members of such entities with respect to any activities owned by those entities.

Since profit motivation is a subjective test of intent, a variety of factors must be considered as tests.

a. Factors in the Regulations. The regulations list nine tests that are used as indicators of a profit motive:

1. **The manner in which the taxpayer carries on the activity.** A taxpayer who does not keep books or records, or engage in normal business practices, will not likely be treated as having a profit motive.
2. **The expertise of the taxpayer or his advisors.** A taxpayer with little background and training may fail this test. This problem can be overcome if the taxpayer has recently shifted substantial time and effort into learning the business.
3. **The time and effort expended by the taxpayer in carrying on the activity.** Devoting substantial time to the activity is evidence that the taxpayer has the requisite profit motive. Occasional attention to the activity is evidence that the profit motive is lacking.
4. **Expectation that assets used in the activity may appreciate in value.** A long-term, rather than current, profit expectation may be acceptable. This factor, by itself, gives little support to the deduction of current expenses, unless the taxpayer can meet the presumption of a profit motive described below.
5. **The success of the taxpayer in carrying on other similar or dissimilar activities.** A taxpayer who has a history of turning losing enterprises into profitable ventures will be likely to demonstrate the profit motive.
6. **The taxpayer's history of income and losses with respect to the activity.** If the taxpayer has been engaged in the activity for many years, and has suffered a series of misfortunes, the profit motive may be present.
7. **The amount of occasional profits earned.** An occasional large profit indicates that there is a realistic profit motive.
8. **The financial status of the taxpayer.** A taxpayer who has little financial means other than the enterprise in question may demonstrate the profit motive.

9. **Elements of personal pleasure or recreation.** Activities such as collecting valuables, racing cars, boats, or motorcycles, raising animals, music, or artistic creation are ripe for suspicion as to a genuine profit motive. [Treas. Reg. §1.183-2]

b. Profit Motive Presumed. The nine factors listed above are **subjective.** Any one of the factors, if sufficiently strong, may be an indication of the motive. Alternatively, there is an **objective** presumption. I.R.C. §183(d) states that the profit motive is presumed when the activity has shown a profit in three of the last five years. In the case of horse breeding, training, racing, or showing, there must be profits in two of the last seven years.

Burden of Proof. If the presumption is met, then the IRS has the burden of proving that the activity is not engaged in for profit. However, it is not necessary to report a profit during the requisite period in order to have a legitimate trade or business. Several cases have been decided in favor of the taxpayer where there was a long period of losses but where the other subjective standards discussed above were adequate to show that the business was engaged in for profit. Conversely, in cases where a very small amount of profit is reported for the requisite period of time combined with large losses in the other years, the IRS could overcome the presumption.

c. Result of Disallowance. Deductions that are disallowed under I.R.C. §183 cannot be carried into any other tax year. This rule makes documentation of the profit motive extremely important. If possible, the activity should not show a loss for more than two consecutive years. If the taxpayer is able to prepay or postpone expenses, elect slower depreciation, or use any other legitimate device to help the activity show a profit, this may help the activity meet the profit presumption.

d. I.R.C. §183(b) Deductions Allowable. The hobby loss rule applies to any net loss (deductions in excess of gross income) incurred in connection with the particular activity. Thus, this rule may not provide a complete disallowance of all deductions incurred in connection with the activity. First, the owner is allowed to offset any gross income from the activity with otherwise allowable deductions, such as depreciation and other ordinary and necessary expenses, to bring the net income down to zero [I.R.C. §183(b)(2)].

Additionally, there may be certain itemized deductions, such as property taxes, that are specifically allowed under other code sections. These deductions are not disallowed by the hobby loss rule [I.R.C. §183(b)(1)].

Practitioner Note. However, the allowed expenses are reported as itemized deductions subject to the 2% of adjusted gross income floor.

e. Judicial Activity. The IRS has been fairly active in enforcing I.R.C. §183. Several cases involve activities owned by S corporations.

- In one case, an S corporation with certain farming activities was subjected to the hobby loss limits, and the loss was disallowed at the corporate level. [*Westbrook,* T.C. Memo 1993-634, 66 T.C.M. 1823, aff'd *Westbrook v. CIR,* 68 F.3d 868, 76 AFTR 2d 95-7397, 95-2 USTC ¶50,587 (5th Cir. 1993)]
- Other recent cases held that the requisite profit motive was missing from the S corporation's activities, and denied S corporations' deductible losses, based on the hobby loss rules. [*Ballard,* T.C. Memo 1996-68; *Hilliard,* T.C. Memo 1995-473, 70 T.C.M. (CCH) 898; *Lucid,* T.C. Memo 1997-247]

- Similarly, an S corporation was not able to claim research and experimentation expenses as deductible items. The S corporation was not involved in any trade or business and was thus disallowed a deduction for any expenses. [*Cook,* T.C. Memo 1993-581, 66 T.C.M. 1523]
- An attempt to deduct hobby losses, in which part of the deduction was rent paid to the shareholder, landed the shareholder in double jeopardy. An S corporation was prohibited from claiming a deduction for rent paid on pleasure boats to the sole shareholder. However, the shareholder was required to claim the rent received from the corporation as income. Note that the shareholder was claiming deductions with respect to the boats. [*Catalano,* T.C. Memo 1998-447]

2. RENTAL OF VACATION HOMES

Another set of rules that serves to disallow certain expenditures is found in I.R.C. §280A. This provision has the unwieldy title "Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Homes, Etc." Two of the more important rules in this provision are the vacation home limits and the restrictions on office in home deductions, discussed later.

The limits of I.R.C. §280A prevent a taxpayer from claiming a loss with respect to a particular activity. However, **unlike the hobby loss rules**, deductions that are limited by I.R.C. §280A **may be carried forward** to future years.

The rules of I.R.C. §280A apply only to individuals and S corporations. Thus **a C corporation is not subject to these restrictions**. However, a C corporation may be subject to disallowance under the personal expense test of I.R.C. §262, discussed above.

The **vacation home rules do not include partnerships** (including limited liability companies). However, the vacation home rules apply to individual partners or members of such entities with respect to any activities owned by those entities.

a. Special Rule for No More Than 14 Days Rental Use. If property used as a residence by the taxpayer is rented for 14 or fewer days annually, the rental receipts are excluded from gross income. Consistent with this special rule, no expenses are allowed as rental deductions. [I.R.C. §280A(g)]

Example 4. Paul and Mary Jane live near a NASCAR speedway that hosts four races each year. They rent three bedrooms in their home for each event. In total, each room is rented for 12 days per year. The rental income is completely excluded from their gross income. None of their expenses related to their home are deductible, except for mortgage interest and property tax, which are subject to the usual itemized deduction rules.

b. The Non-Personal Use Test

Details of test. If a dwelling meets the non-personal use test, it is not subject to the vacation home limits. A rental property meets the non-personal use test if the owner uses it personally for 14 or fewer days in the year. If he or she uses it for more than 14 days, it may pass the test only if the owner's use is fewer than 10% of the days for which it is rented to others at a fair market rate. If it passes the non-personal use test, it is treated as a rental activity. All deductions in connection with the property are allowed, subject to the at-risk and passive activity loss restrictions, discussed below.

Example 5. (from IRS Publication 17) Susan converted the basement of her home into an apartment with a bedroom, a bathroom, and a small kitchen. She rents the apartment to college students during the regular school year on a 9-month (273 days) lease. During the summer, her nephews stay for a month (30 days) and live in the apartment without payment of any rent. Susan's basement apartment is a dwelling unit (and not a hotel, motel, inn, or similar establishment) because she uses it as a home (that is, for personal purposes) for more than 14 days and more than 10% of the number of days for which it is rented. Thus the vacation home rules apply to this activity.

Example 6. Assume the same facts in Example 5, except that Susan does not let her nephews use the basement, and she never uses the apartment for personal purposes. Since there are fewer than 14 days personal use, the vacation home rules do not apply. However, she will be subject to the passive activity loss limits, described below.

Burden of proof. Although the test is apparently objective, it may be necessary for a taxpayer to prove that his or her personal use was low enough to meet the test. Rent receipts, guest books, and other documents are useful evidence. If an agent manages the property, the agent must submit the records of use to the owner. Days when not rented or used personally are ignored when computing the use test. (IRS position)

Use by relative. If a relative pays the owner a fair market rent for the days of use, it will not be considered personal use.

c. Operation of the Limits. If the rented property does not pass the non-personal use test (i.e., the owner's use exceeds the greater of 14 days, or 10% of the days the property was rented) the expenses may offset the gross income from the property. However, allowable deductions cannot exceed gross income from the property.

The statute prescribes that the gross income shall be offset in the following order:

1. Advertising, rental commissions, and such other expenses that can be associated only with rental income are applied first to offset gross income.
2. Interest, taxes, and casualty losses that are deductible without regard to the vacation home limits are applied next. If these expenses create a net loss, the loss may be deductible, subject to the passive activity loss limits. However, see the discussion on interest, below.
3. Repair and maintenance, utilities, and insurance are applied next, but only to the extent of the income remaining after the first two categories of expenses have been subtracted.
4. Depreciation can be deducted, but only to the extent of the income remaining after the first three categories of expenses have been subtracted. [Prop. Reg. §1.280A-3]

d. Allocation of Expenses to Rental and Personal Use

General rule. As a general rule, expenses, other than those directly identified with rental income, are allocated on the basis of the days used.

Controversy. The Tax Court, however, has held that interest and taxes may be allocated on the basis of the total days in the year [*Bolton,* 88-2 USTC ¶9699 (1988), affirming the Tax Court]. The IRS continues to oppose this allocation.

Example 7. (Tax Court position) G uses his vacation home for 20 days in the year (not a leap year). He rents the home out for 180 days. Since his personal use exceeds 10% of the rental days, the vacation home limits apply. His interest, which is allowed as qualified residence interest, was $7,300. Taxes on the property were $1,460. Maintenance and insurance were $2,700. His gross income from rent was $5,400.

He makes the following allocations:

Rent income	\$5,400
Less interest and taxes allocated to rent:	
Interest (\$7,300 × 180/365)	(3,600)
Taxes (\$1,460 × 180/365)	(720)
Income after interest and taxes	\$1,080
Maintenance and insurance allowed	
(\$2,700 × 180/200)	2,430
Limit	(1,080)*
Net income or loss	\$ -0-

* The remaining \$1,350 of expenses, disallowed for the current year due to the income limitation, may be carried forward to the subsequent year.

Observation. In most cases, a taxpayer is allowed to deduct all home mortgage interest on any loans secured by a principal residence, including first and second mortgages, home equity loans, and refinanced mortgages. However, the loans are limited to acquisition debt, and up to \$100,000 of home equity loans. Any taxpayer is also allowed to deduct interest on a second home as an itemized deduction. [I.R.C. §163(h)(3)]

3. BUSINESS USE OF HOME

If the taxpayer's principal residence, or other home, is not rented during the year, the vacation home rules are irrelevant. However, the taxpayer may conduct a business activity in the home and then may be permitted to deduct proportionate interest, taxes, maintenance, utilities, and depreciation as business expenses. The business itself must first pass the test as not being a hobby.

a. Qualification for Deductions. If the taxpayer uses a portion of the home for business, the expenses for that portion of the home can be deducted if **any one of five** tests is met. The tests are:

1. A portion of the home is used exclusively for business and is the principal place of business of the taxpayer.

Practitioner Note. The definition of "principal place of business" was liberalized for 1999 and later years by the Taxpayer Relief Act of 1997. Under the new rules, the home is the principal place of business if it is used by the taxpayer for the administrative or management activities of any business of the taxpayer and there is no other fixed location of such business where the taxpayer conducts substantial administrative or management activities of the business. Self-employed taxpayers who perform service outside of the home office but do all of their administrative work in the home office benefit from this new rule.

2. A portion of the home is used exclusively by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business.

Practitioner Note. This test does not require the home to be the principal place of business. Therefore, use of the home as a satellite office to meet with clients will qualify even though the taxpayer has a principal office in another location.

3. There is a separate structure that is used exclusively for business.

Practitioner Note. This test requires neither that the home be the principal place of business nor that it be used to meet with patients, clients, or customers.

4. The home is the sole fixed location of the business, and a portion of the home is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer for use in the business of selling products.

Practitioner Note. The test does not require that portion of the home to be used exclusively for business.

5. A portion of the home is used on a regular basis in the taxpayer's business of providing day care.

Practitioner Note. This test does not require exclusive use, but it allocates cost based on both the percentage of the home that is used for day care as well as the percentage of time it is used for day care.

b. Rental of a Portion of the Home to the Employer. A 1986 amendment to the office-in-home rule provides that no business deduction shall be allowed for any portion of the home rented to the taxpayer's employer [I.R.C. §280A(c)(6)].

Example 8. Meg is the sole shareholder/employee of Meg's Florist, Inc., an S corporation. In 2000, Meg performed administrative duties of the corporation in a room in her residence. There is not adequate office space in the building owned by the corporation to conduct such duties. Meg's Florist, Inc., paid her $300 a month for the use of her home office for corporate duties. The corporation and Meg signed a lease contract for this arrangement.

Question. How should Meg report her rental income and home office expenses on her 2000 Form 1040?

Answer. The $3,600 rental income is reported in Part I, Schedule E. Due to I.R.C. §280A(c)(6), Meg is entitled to no expense deductions for her home office expenses. Therefore, she will report a $3,600 net rental profit on her 2000 Schedule E.

Practitioner Note. Meg can deduct all of the taxes and mortgage interest on her residence if she itemizes deductions for 2000.

An employee may deduct office-in-home expenses if the office meets the above tests and is used for the convenience of the employer. However, the vast majority of employees use their home offices for their own convenience, not for their employer's convenience. An employee deducts allowable home office expenses on line 4, Form 2106. They are subject to the 2% AGI limitation for miscellaneous itemized deductions.

c. Limitation on the Office-in-Home Deduction. As was the case with hobby loss and rental of vacation home limitations, the office-in-home deduction cannot create or add to a net loss from the business. However, the allocable share of interest and taxes can create or increase a net loss. The limit on the deduction for the home expenses is the gross income from the business less interest and taxes attributable to the portion used as the office, and less the other expenses allowed as trade or business deductions. In a departure from the hobby rule, however, any office-in-home deductions that exceed the limit may be carried forward to a future year.

Example 9. Janet began her self-employed consulting business on January 1, 2000. In 2000, she used 10% of her home as the only place to perform administrative duties for her business. Her Schedule C and Form 8829 are shown on the following pages.

Observations Concerning Example 9 for Janet. Janet's deductible home office expenses for her 2000 tax year are limited to her tentative business profit of $500 shown on line 29, Schedule C.

If line 29 on her Schedule C (tentative profit or loss before considering any home office expenses) had been zero or had shown a loss, Janet would be entitled to only the interest and tax deductions of $260 on line 14 of Form 8829. The balance of $280 would be carried over to the year 2001

Janet's 2000 total home office expenses of $540 consist of:

Office portion (10%) of:	
Mortgage interest	$200
Real estate taxes	60
Utilities	168
Insurance	12
Office portion (10%) of depreciation	100
Total home office expenses for 2000	$540

Janet is allowed to deduct all but $40 of the depreciation on her 2000 Form 8829. The $40 excess depreciation amount shown on line 42, Form 8829, will be carried over to line 29 on her 2001 Form 8829.

Figure 1. Schedule C for Janet's Consulting Business

SCHEDULE C (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.
▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2000
Attachment Sequence No. 09

Name of proprietor: *Janet*
Social security number (SSN): *111 11 111*

A Principal business or profession, including product or service (see page C-1): *Consulting*
B Enter code from pages C-8 & 9 ▶

C Business name. If no separate business name, leave blank.
D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶ *1342 Magholia Ave.*
City, town or post office, state, and ZIP code: *Ft. Smith, AR*

F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2000? If "No," see page C-2 for limit on losses . ☒ Yes ☐ No

H If you started or acquired this business during 2000, check here . . . ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ▶ ☐	1	7,800
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	7,800
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	7,800
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	7,800

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising	8	1,200
9	Bad debts from sales or services (see page C-3)	9	
10	Car and truck expenses (see page C-3)	10	1,250
11	Commissions and fees	11	
12	Depletion	12	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	2,700
14	Employee benefit programs (other than on line 19)	14	
15	Insurance (other than health)	15	250
16	Interest:		
a	Mortgage (paid to banks, etc.)	16a	
b	Other	16b	300
17	Legal and professional services	17	
18	Office expense	18	
19	Pension and profit-sharing plans	19	
20	Rent or lease (see page C-4):		
a	Vehicles, machinery, and equipment	20a	
b	Other business property	20b	
21	Repairs and maintenance	21	
22	Supplies (not included in Part III)	22	600
23	Taxes and licenses	23	
24	Travel, meals, and entertainment:		
a	Travel	24a	700
b	Meals and entertainment	24b	600
c	Enter nondeductible amount included on line 24b (see page C-5)	24c	300
d	Subtract line 24c from line 24b	24d	300
25	Utilities	25	
26	Wages (less employment credits)	26	
27	Other expenses (from line 48 on page 2)	27	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	7,300
29	Tentative profit (loss). Subtract line 28 from line 7	29	500
30	Expenses for business use of your home. Attach **Form 8829**	30	500
31	**Net profit or (loss).** Subtract line 30 from line 29.	31	0

- If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
- If a loss, you **must** go to line 32.

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
- If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
- If you checked 32b, you **must** attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

7

Figure 2. Form 8829 for Janet's Business Use of Home

Form **8829**

Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

▶ See separate instructions.

OMB No. 1545-1266

2000

Attachment Sequence No. **66**

Name(s) of proprietor(s): *Janet*

Your social security number: *111 11 1111*

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples. See instructions			1	*175 sq. ft.*
2	Total area of home			2	*1,750 sq. ft.*
3	Divide line 1 by line 2. Enter the result as a percentage			3	*10* %
	• **For day-care facilities not used exclusively for business, also complete lines 4–6.**				
	• **All others, skip lines 4–6 and enter the amount from line 3 on line 7.**				
4	Multiply days used for day care during year by hours used per day	4	hr.		
5	Total hours available for use during the year (366 days × 24 hours). See instructions	5	8,784 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.		
7	Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶			7	*10* %

Part II Figure Your Allowable Deduction

			(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions				8	*500*
	See instructions for columns (a) and (b) before completing lines 9–20.					
9	Casualty losses. See instructions	9				
10	Deductible mortgage interest. See instructions	10		*2,000*		
11	Real estate taxes. See instructions	11		*600*		
12	Add lines 9, 10, and 11	12		*2,600*		
13	Multiply line 12, column (b) by line 7	13		*260*		
14	Add line 12, column (a) and line 13				14	*260*
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	*240*
16	Excess mortgage interest. See instructions	16				
17	Insurance	17		*120*		
18	Repairs and maintenance	18				
19	Utilities	19		*1,680*		
20	Other expenses. See instructions	20				
21	Add lines 16 through 20	21		*1,800*		
22	Multiply line 21, column (b) by line 7	22		*180*		
23	Carryover of operating expenses from 1999 Form 8829, line 41	23		*0*		
24	Add line 21 in column (a), line 22, and line 23				24	*180*
25	Allowable operating expenses. Enter the **smaller** of line 15 or line 24				25	*180*
26	Limit on excess casualty losses and depreciation. Subtract line 25 from line 15				26	*60*
27	Excess casualty losses. See instructions	27				
28	Depreciation of your home from Part III below	28		*100*		
29	Carryover of excess casualty losses and depreciation from 1999 Form 8829, line 42	29		*0*		
30	Add lines 27 through 29				30	*100*
31	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30				31	*60*
32	Add lines 14, 25, and 31				32	*500*
33	Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684,** Section B				33	*0*
34	Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶				34	*500*

Part III Depreciation of Your Home

35	Enter the **smaller** of your home's adjusted basis or its fair market value. See instructions	35	*46,000*
36	Value of land included on line 35	36	*5,370*
37	Basis of building. Subtract line 36 from line 35	37	*40,630*
38	Business basis of building. Multiply line 37 by line 7	38	*4,063*
39	Depreciation percentage. See instructions	39	*2.461* %
40	Depreciation allowable. Multiply line 38 by line 39. Enter here and on line 28 above. See instructions	40	*100*

Part IV Carryover of Unallowed Expenses to 2001

41	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-	41	*0*
42	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-	42	*40*

STEP 3: LOSSES INCURRED BY AN S CORPORATION, PARTNERSHIP, OR LIMITED LIABILITY COMPANY: THE BASIS LIMIT

When an activity is owned by a partnership (or limited liability company) or an S corporation, the tax benefit of a loss will be claimed by the owners. However, if the loss has not cleared the Step 1 and Step 2 limitations discussed previously, it will not be deductible by the owners in the current year. Instead, the partnership, limited liability company, or S corporation reports a nondeductible expenditure to the owners.

If the loss has cleared the Step 1 and Step 2 limits, it is reported in full and allocated to the owners. It is each owner's responsibility to determine his or her **basis** in the entity, which acts as the next limit on deductibility.

Although the pass-through rules are similar for partnerships and S corporations, the basis rules can be quite different. A discussion of the basis rules for each type of entity follows.

Losses incurred by a partnership or S corporation are deductible to the extent of the partner's (or shareholder's) basis. Losses in excess of basis are carried forward until basis is increased in the future. The basis rules are different for partnerships and S corporations.

See the appendix at the end of this chapter for worksheets to help determine basis for the owners of each of these entities.

I. BASIS LIMIT FOR S CORPORATION SHAREHOLDERS

An S corporation's distributed loss is not automatically deductible by the shareholders. To be deductible, the loss must not exceed the shareholder's basis in his or her stock, plus certain debt basis. [I.R.C. §1366(d)(1)]. A loss that is deductible reduces the shareholder's basis at the **close of that year.** Basis cannot be reduced below zero.

Any loss that, because of the basis limitation, is not deductible is carried forward to the next taxable year. [I.R.C. §1366(d)(2)]. It may be deducted when the shareholder gains sufficient basis to absorb it.

Practitioner Note. If the loss clears the basis hurdle, it may be subject to other limits, such as the amount-at-risk limit (I.R.C. §465) or the passive activity loss restriction (I.R.C. §469). None of those limitations apply, however, if the shareholder does not have sufficient basis to deduct the loss. The loss is merely carried forward. In a later year, if the shareholder gains basis, the loss will be subjected to the amount-at-risk and passive activity loss limits.

A. S Corporation Stock Basis Defined

Stock basis presents no particularly difficult interpretive problems. The shareholder finds a starting point, or initial basis at the time of acquisition. The shareholder then **adjusts** his or her basis **each year** for his or her share of the corporation's income, deductions, and losses, and reduces basis for distributions received (other than dividends from accumulated earnings and profits).

1. Basis at Time of Acquisition. Subchapter S provides few special rules for the starting point of basis calculations. **The key factor is how and when the stock (or debt) was initially acquired.**

1. If the stock and debt were received in a §351 incorporation, there is a substituted basis from the property given to the corporation. (I.R.C. §358)
2. If the shareholder purchased the stock (and debt), the initial basis is cost. It may have no relation to the book value on the corporate records. (I.R.C. §1012)
3. If the stock was received as a gift, it is important to know the date of the gift, the donor's basis, and the fair market value on the date of the gift. (I.R.C. §1015)

- If the gift was made prior to 1977, the holder's basis is the donor's basis increased by any gift tax; the total basis is limited to fair market value as of the date of the gift.
- If the gift was made after 1976, the holder's basis is the donor's basis increased by gift tax; the increase is limited to gift tax attributable to appreciation in the hands of the donor.
- If the fair market value of the stock was less than the donor's basis, there is a special loss limit. The starting point for any loss determination is the fair market value at the date of the gift.

Practitioner Note. In the author's experience, the upward adjustments to stock received as a gift are rare. They apply only when the donor has exhausted his or her applicable exclusion amount and actually pays a gift tax.

4. If stock was received as compensation, the basis is its imputed cost, or gross income reported by the shareholder [Treas. Reg. §1.83-4(b)]. This principle was applied to S corporation stock in Ltr. Rul. 8752006.
5. If the stock was received through an estate, the basis is fair market value on the date of the decedent's death or on the alternate valuation date. [I.R.C. §1014]. For persons who inherited S corporation stock **after August 20, 1996,** there is a **new rule.** The new shareholder must reduce basis in the stock for any **income in respect of a decedent** in the S corporation at the time of the first shareholder's death [I.R.C. §1367(b)(4)(B), as added by the Small Business Job Protection Act of 1996].

Practitioner Note. The most common items of income in respect of a decedent are:

- Accounts receivable of a cash basis taxpayer
- Deferred gains on installment receivables

The effect of the 1996 rule is that shareholders who inherit S corporation stock must reduce basis for their portions of these receivables.

Example 10. Julie inherits 1/3 of the stock in Jayco, a cash basis S corporation, from her father, Jake. The fair market value of the inherited stock at Jake's death is $100,000. The corporation had $45,000 of accounts receivable on the date of Jake's death.

Scenario 1 for Example 10. If Jake died **on or before** August 20, 1996, Julie's basis in the inherited stock would be $100,000, the fair market value of the stock at the time of Jake's death.

Scenario 2 for Example 10. If Jake died **after** August 20, 1996, Julie's basis in the inherited stock would be only $85,000 ($100,000 less the $15,000 accounts receivable attributable to Julie's inherited S corporation stock}.

2. Adjustments to S Corporation Stock Basis

Income and losses. Shareholders adjust their stock basis annually for the allocable portion of S corporation income and losses. When there is more than one shareholder during the tax year, the corporation must allocate each item of income or loss on a **per-day, per-share basis**. This allocation formula holds, even when there is a change in shareholdings, unless the corporation elects to split the year, discussed below.

Example 11. Threeco, an S corporation, had **three** shareholders in 2000. Teresa owned 100 shares all year. Uriah owned 100 shares from January 1 through March 14. Vinnie bought Uriah's shares and owned them from March 15 through the end of the year. During 2000 the corporation had $100,000 of ordinary income and $20,000 of long-term capital gains, and it made a charitable contribution of $10,000. It also received $12,000 of tax-exempt interest income and paid $3,600 of premiums on key employee life insurance. Each of these items would be allocated to the three shareholders as follows:

Teresa	100/200× 365/365 = 50%
Uriah	100/200× 73/365 = 10%
Vinnie	100/200× 292/365 = 40%

The 2000 Schedule K-1 information is as follows:

	Teresa	Uriah	Vinnie	Total
Ordinary income	$50,000	$10,000	$40,000	$100,000
Long term capital gain	10,000	2,000	8,000	20,000
Charitable contributions	(5,000)	(1,000)	(4,000)	(10,000)
Tax exempt income	6,000	1,200	4,800	12,000
Insurance premium	(1,800)	(360)	(1,440)	(3,600)
Total	**$59,200**	**$11,840**	**$47,360**	**$118,400**

Each shareholder would include this information on his or her Form 1040 as follows:

Item	Schedule on Form 1040
Ordinary income	E
Long-term capital gain	D
Charitable contributions	B (if itemizing deductions)
Tax-exempt income	Page 1, for information only
Insurance premium	Not applicable

The shareholders must adjust their stock basis to reflect their distributive items reported on the 2000 Schedule K-1.

- Teresa will **increase** her stock basis by $59,200.
- Uriah will **increase** his stock basis by $11,840 as of March 14, 2000, the day he sold his stock to Vinnie.
- Vinnie will **increase** his stock basis by $47,360.

Practitioner Note. The foregoing example pro-rated the income between buyer and seller without an interim closing of the books, as defined in I.R.C. §1377(b). In practice, the interim closing is usually the preferred method of allocating S corporation items in a year when a shareholder sells his or her interest.

Distributions and Basis Adjustments. For taxable years beginning **after 1996**, distributions are treated as reductions of basis before losses. **Thus, a shareholder must reduce basis for any S corporation distribution before** computing the amount available for deduction of losses.

Example 12. Jayco is an S corporation with one shareholder, Jay. Jay's stock basis at the beginning of 2000 was $110,000. In 2000 the corporation reported an ordinary loss of $60,000 and made a distribution of $70,000 to Jay. The corporation has no earnings and profits.

Jay's stock basis at beginning of 2000	$110,000	
Step 1: Add any current year income items (N/A)	-0-	
Step 2: Reduce for 2000 distribution	(70,000)	
Adjusted stock basis before applying the 2000 loss	$40,000	
2000 ordinary loss		
Amount that does not exceed basis (potentially deductible in 2000)	40,000	(40,000)
Amount that exceeds basis (carry forward to 2001)	20,000	
Jay's stock basis at end of 2000	$-0-	

3. S Corporation Debt Basis. A shareholder obtains debt basis by a **direct loan** to the corporation. The **guarantee** of an S corporation's loan does not immediately increase shareholder's stock basis. This problem has been litigated frequently, with the IRS prevailing in the vast majority of cases.

Adjustments to S corporation debt basis. If a shareholder's portion of an S corporation's losses do **not exceed** his or her stock basis, there will never be an adjustment to debt basis. If, however, the shareholder's portion of losses **exceeds** stock basis, debt basis must be adjusted as follows:

- In the year of the loss, after the stock basis is reduced to zero, the shareholder will reduce debt basis.
- In a subsequent year when the corporation reports income, the shareholder will restore debt basis before increasing stock basis.

Example 13. Updown, Inc., is an S corporation. In 2000 the corporation reports an ordinary loss of $100,000. In 2001 Updown reports ordinary income of $140,000. At the beginning of 2000, the sole shareholder has stock basis of $60,000 and debt basis of $50,000. The shareholder will adjust basis in the following order:

	Stock	Debt	Total
2000 Beginning Basis	$60,000	$50,000	$110,000
2000 loss. Decreases to:			
Stock basis (not below zero)	(60,000)		(60,000)
Debt basis (not below zero)		(40,000)	(40,000)
2000 Ending Basis	$0	10,000	10,000
2001 income. Increases to:			
Debt basis (not above original)		40,000	40,000
Stock basis (all remaining)	100,000		100,000
2001 Ending Basis	**$100,000**	**50,000**	**150,000**

B. Order of S Corporation Basis Adjustments

A shareholder must reduce basis for deductible and nondeductible expenses and losses. The following tables summarize the basis adjustments to both stock and debt.

Order	Stock Basis
1. Increase	Taxable income, separately reported gains, and tax-exempt income (If debt basis had been reduced in a prior year, apply income to debt basis first)
2. Decrease	Distributions (Other than dividends from accumulated earnings and profits from C corporation years)
3. Decrease	Nondeductible loss to the extent of stock basis, after adjustments 1 and 2 above*
4. Decrease	Deductible loss to the extent of stock basis, after adjustments 1, 2, and 3 above*

*Any shareholder can make an election to reverse 3 and 4.

Order	Debt Basis
1. Increase	Income in excess of distributions, but only after prior year's losses have reduced debt basis
2. Decrease	Nondeductible loss in excess of stock basis, after adjustment 1*
3. Decrease	Deductible loss in excess of stock basis, after adjustments 1 and 2, above*

*An election by a shareholder to reduce stock basis for deductible items before nondeductibles would also reverse the order of 2 and 3, above

If there is sufficient basis to absorb both types of reductions, the ordering is unimportant. The shareholder reduces basis for both the nondeductible and deductible losses, after considering income and distributions for the year.

Example 14. Disco Inc., an S corporation, has one shareholder, Diana. At the beginning of 2000 Diana's stock basis is $50,000. During 2000, Disco reports an ordinary loss of $40,000 and has nondeductible life insurance premiums of $5,000. Diana will **reduce** her stock basis by $45,000, to $5,000. She will be able to deduct $40,000 of ordinary loss, assuming that the loss meets the other tests for deductibility. She will receive no tax benefit for the insurance premiums.

When the total of nondeductible and deductible items **exceeds** the shareholder's basis, the ordering can become quite important. If the shareholder must reduce basis for nondeductible items first, it will limit the amount of potentially deductible losses in the current year.

Example 15. Refer to the previous example. Assume the same facts, except that Diana's basis in her stock was only $30,000 at the beginning of 2000. **If** she must reduce basis by the nondeductible items **first,** she will have only $25,000 basis remaining for the ordinary loss deduction purposes. If she need not reduce basis for the nondeductible items, she will be able to deduct $30,000 of the $40,000 ordinary loss in 2000.

Shareholders must generally reduce stock and debt basis for **nondeductible items first** [Treas. Reg. §1.1367-1(f)(1)]. The IRS allows any shareholder to make a **permanent, irrevocable election** to reduce basis for **nondeductible items after** taking the deductible losses and expenses into account [Treas. Reg. §1.1367-1(f)(2)]. The price to be paid for the elective rule is that the shareholder agrees to carry forward any nondeductible losses in excess of basis, and treat them as basis reductions in the future. Otherwise, there is no requirement to carry forward a nondeductible loss or expense.

Observation. In general, shareholders will benefit from the elective ordering rule, claiming their deductible losses before they run out of basis. On occasion, however, a shareholder may benefit from the general ordering rule. This is most likely to occur when the nondeductible items are extremely large in relation to the shareholder's basis.

II. BASIS LIMIT FOR PARTNERS OR LIMITED LIABILITY COMPANY MEMBERS

A. Acquisition of Interest by Contribution of Property

In general, neither the partnership nor the contributing partner recognizes any gain or loss when a partner acquires an interest in a partnership in exchange for property, including cash. [I.R.C. §721(a)]

The contributing partner's basis in the partnership interest (**"outside basis"**) is the same as the basis of the property contributed [I.R.C. §722]. The basis a partner receives upon a contribution of property is a substituted basis. The determination of a partner's basis may not be as simple as the statute implies, however, since the partner must **increase** basis for any **partnership liabilities.**

The contribution of property may be by an existing partner or a new partner. There is no requirement that the transferor of the property be in control of the partnership to avoid a taxable gain on contribution, as in the case of transfer of property to a corporation.

Example 16. Al and Bob decide to form the AB general partnership. Each partner contributes $88,000 in cash to the partnership. At the time of formation there are no other assets, no liabilities, and no other partners. The basis of each partner is $88,000. Immediately, Al and Bob decide to admit a new general partner, Ruth. Ruth contributes some equipment to the partnership, which is valued at $88,000. Ruth's book value and basis in the equipment is $60,000. Due to the value of the property, all parties agree that Ruth will be a 1/3 partner, and that the partnership will now be known as the ABR Partnership.

As equal partners, all three will have capital accounts of $88,000 for financial accounting purposes. However, Ruth will have a basis of $60,000, the same as the basis in the property she contributed. This is a clear example of **outside** basis.

When a partner receives an interest in a partnership, he or she may receive a shift in liabilities. This can have two effects.

1. If a partner **increases** his or her share of partnership liabilities, the partner is treated as if he or she made a contribution of cash. For basis purposes, this is treated in the same manner as an actual contribution of cash and will **increase** the partner's basis.
2. If the partner contributes property subject to liabilities, his or her personal liabilities may be reduced, since they are now shared among all of the partners. In this situation, the partner is treated as if he or she received a cash distribution simultaneously with the contribution of property.

The key to determining the impact of a liability shift is to determine the partner's share of liabilities. This concept is complicated and receives further discussion below.

B. Effect of Partnership Liabilities

In general, the tax law apportions a partnership's liabilities among the various partners. Thus any alteration in a partner's interest in a partnership may cause a reallocation of partnership liabilities.

1. When a partner's share of partnership liabilities increases, the partner is considered to have made a cash contribution in the amount of the increase and adjusts basis in his or her interest upward by the same amount. [I.R.C. §§752(a), 721(a)]
2. When a partner's share of partnership liabilities decreases, the partner is considered to have received a cash distribution in the amount of the decrease and adjusts basis in his or her interest downward (not below zero) by the same amount. [I.R.C. §§752(b), 733(1)]
3. There can be hypothetical contributions and distributions whenever any event causes the partners' relative shares of partnership liabilities to change.
4. Accordingly, it is extremely important to be able to measure every partner's share of partnership liabilities at any point in time.

1. Determination of Partners' Relative Shares of Liabilities. Each partner's share of partnership liabilities depends on the following factors:

- Is the liability in question a recourse liability or a nonrecourse liability?
- If it is a nonrecourse liability, what are the pre-contribution minimum gain, the minimum gain chargeback, and the partners' shares of partnership profits.
- If it is a recourse liability, what is each partner's relative economic risk, in the worst case?

2. Recourse Liability Defined. In the partnership context, a debt is a recourse liability when any partner or any person related to any partner bears the economic risk for payment of the debt. [Treas. Reg. §1.752-1(a)(1)]

Each partner's share of partnership recourse liabilities is his or her **risk of loss.** [Treas. Reg. §1.752-2(a)] Risk of loss is determined by the partner's obligation on an immediate hypothetical (constructive) liquidation. Constructive liquidation is accomplished in the following steps.

1. All properties secured by nonrecourse liabilities are sold for the amount of the liabilities. [Treas. Reg. §1.752-2(b)(2)(i)] Gain or loss on each of these sales is the difference between the amount of liability on each property and the book value of each property. [Treas. Reg. §1.752-2(b)(2)(i)]
2. All other properties are sold for zero. The loss on these properties is the book value on the date of constructive liquidation. [Treas. Reg. §1.752-2(b)(2)(ii)]

Practitioner Note. At this point, the partnership has no assets and still has all of its recourse liabilities to pay.

3. At this point, the obligation of each partner to make payments on partnership liabilities is determined using the following factors:
   a. Contractual obligations outside the partnership agreement, such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners or to the partnership. [Treas. Reg. §1.752-2(b)(3)(i)]
   b. Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership. [Treas. Reg. §1.752-2(b)(3)(ii)]
   c. Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. [Treas. Reg. §1.752-2(b)(3)(iii)]

Example 17. Refer to Example 16. Immediately after Ruth joins the partnership, the business acquires a new building. It uses $150,000 of its cash and borrows $750,000, for a total cost of $900,000. The building is carried as a partnership asset, and all of the partners have unlimited liability for the mortgage. The balance sheet now appears as follows:

Assets	
Cash	$26,000
Equipment (contributed by Ruth)	88,000
Building	900,000
Total	**$1,014,000**
Liabilities and Partners' Equity	
Mortgage on building	$ 750,000
Capital, Al	88,000
Capital, Bob	88,000
Capital, Ruth	88,000
Total	**$1,014,000**

The basis of the partnership and each partner is as follows:

Basis of the Partnership in Its Assets			
Cash		$ 26,000	
Equipment (contributed by Ruth)		60,000	
Building		900,000	
Total		**$986,000**	
Partners' Outside Bases			
Al	"Capital"	$ 88,000	
	Loan	250,000	
			$338,000
Bob	"Capital"	$ 88,000	
	Loan	250,000	
			338,000
Ruth	"Capital"	$ 60,000	
	Loan	250,000	
			310,000
Total			**$986,000**

Observation. The treatment of liabilities to a partner has no parallel in S corporation tax law. One of the attractive features of the partnership has been the ability of a partner to leverage basis by including a share of the liabilities of the partnership to outside lenders. Contrast this with the debt basis for S corporation shareholders, which can be obtained only by a loan from the shareholder to the corporation. **Thus it may be that the limited liability company provides the protection afforded by the S corporation with the basis treatment of the partnership.** However, as is demonstrated later in the chapter, the at-risk rules may have some unanticipated effects for members of limited liability companies.

Example 18. Refer to Example 17. Immediately after the partnership buys the building, the partners' shares of partnership liabilities are determined by calculating a constructive liquidation of the partnership.

First, all of the partnership property, including cash, is treated as if it became completely worthless. (A constructive liquidation is often called the "atom bomb test.") In this example, the total book value of the assets, $1,014,000, would be treated as a loss. Assuming the partners are sharing losses equally, as these examples have implied, the loss would be posted to each partner's capital account. The effect of the constructive liquidation on each partner's capital account would be as follows:

	Al	Bob	Ruth
Balance before constructive liquidation	$ 88,000	$ 88,000	$ 88,000
Share of $1,014,000 loss	(338,000)	(338,000)	(338,000)
Balance after constructive liquidation	**($250,000)**	**($250,000)**	**($250,000)**

Each partner would have a deficit of $250,000 in his or her capital account after the constructive liquidation. Thus, each partner would be obligated to contribute this amount to the partnership in order to satisfy the creditors. Note that the same result can be obtained by dividing the total debt by the number of partners. If the partners do not share losses equally, however, the constructive liquidation test becomes more important. If, for example, Al was to receive 50% of the partnership losses and Bob and Ruth were to each receive 25%, the effect of the constructive liquidation would be as follows:

	Al	Bob	Ruth
Balance before constructive liquidation	$ 88,000	$ 88,000	$ 88,000
Share of $1,014,000 loss	(507,000)	(253,500)	(253,500)
Balance after constructive liquidation	**($419,000)**	**($165,500)**	**($165,500)**

In this instance, Al's share of partnership liabilities would be $419,000, whereas Bob and Ruth would each have $165,500. Inclusion of liabilities under this alternative would yield the following:

Al	"Capital"	$88,000	
	Loan	419,000	
			$507,000
Bob	"Capital"	$88,000	
	Loan	165,500	
			253,500
Ruth	"Capital"	$60,000	
	Loan	165,500	
			225,500
Total			**$986,000**

3. Nonrecourse Liability Defined. A partnership debt is a nonrecourse liability only if no partner or person related to any of the partners bears economic risk for payment [Treas. Reg. §1.752-1(a)(2)].

Treas. Reg. §1.752-4(b) gives a special definition of related person for this purpose. If an affiliate of any partner or member, including family members, has any risk of loss for the debt, it is treated as recourse. In practice, nonrecourse liabilities are rarely encountered. See Treas. Reg. §1.752-3 for discussion of allocation of partnership nonrecourse liabilities.

Practitioner Note. Nonrecourse liabilities are the only partnership debts that can be allocated to limited partners (beyond any limited partner's obligation to contribute capital to the partnership), since limited partners bear no risk of economic loss.

C. Acquisition of Partnership Interest by Other Means

Subchapter K generally defers to other provisions of the Code when a partner acquires an interest in a partnership by means **other than a direct contribution of property**.

1. If the partner **purchased** the partnership interest, the initial basis is cost. It may have no relation to the book value on the corporate records (I.R.C. §1012).
2. If the partnership interest was **inherited,** the basis is fair market value on the date of the decedent's death or on the alternate valuation date (I.R.C. §1014).
3. If the partnership interest was **received as a gift,** it is important to know the date of the gift, the donor's basis, and the fair market value on the date of the gift (I.R.C. §1015).
   - If the gift was **prior to 1977,** the holder's basis is the donor's basis increased by any gift tax, limited to the fair market value on the date of gift.
   - If the gift was **after 1976,** the holder's basis is the donor's basis increased by gift tax, limited to gift tax attributable to appreciation in the hands of the donor.
   - If the **fair market value** of the partnership interest **was less than the donor's basis,** there is a special loss limit. The starting point for any loss determination is the fair market value on the date of the gift. The basis for loss is the holder's basis. The basis for gain is the donor's basis. The date of the gift does not change the application of this rule.
4. Partnership interest received as **compensation** is its imputed cost, or gross income reported by the partner, in addition to any amount that the recipient paid for his or her interest [Treas. Reg. §1.83-4(b)].
5. If a partner receives an interest in partnership profits, but not partnership capital, **in exchange for services,** the IRS has ruled that the partner takes a **zero basis** in such interest (Rev. Proc. 93-27).

D. Increases and Decreases in Partner's Basis

Any event that increases a partner's share of partnership assets will cause a similar increase in each partner's basis. Increases in the basis of partnership assets and the basis of a partner's interest will result from the following:

- Taxable income of the partnership
- Tax-exempt income of the partnership
- Purchase of an asset by an increased partnership liability
- A contribution of additional property or cash from the partner to the partnership

Conversely, any transaction that causes a partner's share of partnership assets to decrease will cause a simultaneous reduction in each partner's basis. **Such transactions include the following:**

- Any deductible expense or loss of the partnership
- Any nondeductible expense of the partnership (except for expenditures that must be capitalized)

- Use of partnership assets to pay off partnership liabilities
- Any distribution of cash or other property from the partnership to the partner

STEP 5: THE AT-RISK RULES

Once an activity has cleared the hurdles of the hobby loss, vacation home, office-in-home, or investment interest deduction limitations, the next obstacle to a deduction is the amount-at-risk [I.R.C. §465]. Any loss in excess of the taxpayer's amount-at-risk cannot be deducted in the current year. It is carried forward until there is an increase in the amount-at-risk.

Navigation of the rules of I.R.C. §465 is not a straightforward task. There are few regulations adopted to interpret these rules. There were numerous proposed regulations issued in 1980, which have not been adopted but are still in proposed form. Many of these proposed regulations interpret rules that have been modified by statutory changes, some nearly 20 years ago. However, a few definitions can be gleaned from the legislative history and the proposed regulations. Some of the more important definitions follow.

- **Activity**. The at-risk rules apply to limit deductions from certain activities. Neither the Code nor the Proposed Regulations give any comprehensive and unambiguous definition of the term "activity." However, it includes any income-producing venture, from passive investments to full-time trades or businesses.
- **Nonaggregation**. The amount-at-risk for each identifiable activity (see "Separate Activities" below) must be compared to the net loss from the same activity. In short, the taxpayer cannot commingle amounts at risk with respect to more than one activity and cannot use income from one activity to offset a loss from another activity where nonaggregation is required.
- **Aggregation**. The amount-at-risk for all activities is aggregated, and must be compared to the net loss from all of the activities in this category. In short, the taxpayer does commingle amounts at risk with respect to more than one activity, and uses income from one activity to offset a loss from another activity where aggregation is required.

I. IMPACT OF THE AT-RISK RULES

Deductions or losses from any activity are limited to the taxpayer's amount at-risk. Any losses in excess of that amount are suspended until there is an increase in the amount-at-risk. The suspension is another form of carryforward. The suspended losses cannot be carried back.

> **Practitioner Note.** The at-risk rules cover trade or business or investment activity. They are not limited to those investments that produce portfolio income or loss, or to those that produce passive income or loss.

A. Inconsistent Application to Investment Activities and Passive Activities. For **investment activities,** the expenses must **first** clear the general deduction criteria, or the **investment interest** limits. The allowable deductions at that point must be measured against the amount-at-risk. For **passive** activities, however, the at-risk rules apply **before** the limits on passive losses.

> **Practitioner Note.** There is no apparent rationale for this divergence in treatment.

B. Taxpayers Subject to the Rules. The at-risk limits cover individuals, estates, and trusts, as well as certain closely held corporations. **A corporation is subject to the rules if five or fewer individuals**

own more than 50% of the outstanding stock at any time during the last half of the corporation's taxable year. The ownership test uses the attribution rules of I.R.C. §544. An individual is considered to own any stock held by a family member, or by a partnership in which the individual owns an interest. The least number of shareholders allowed for a corporation to be exempt from the limits is eleven equal, unrelated persons. **Considering the indirect ownership rules, most closely held corporations are subject to the limits.** There are also exemptions for closely held corporations regularly engaged in the business of equipment leasing.

The limits do not apply directly to partnerships or S corporations. Instead, each individual partner or shareholder must determine his or her amount-at-risk in the partnership or corporation. In the case of an activity held by a partnership or S corporation, the at-risk test is applied to a net loss only after the basis limit.

In the case of a partnership, there can be distinctions between a general partner and a limited partner. There are some uncertainties regarding a member in a limited liability company. Also, there are some strange rules applicable to S corporation shareholders.

It is important is to realize that the at-risk limitations apply **after** the step 3 basis limits for partnerships and S corporations.

Example 19. Kevin is a partner in a partnership. At the end of 2000, his basis **before** accounting for the 2000 ordinary loss is zero. The amount-at-risk is irrelevant for 2000, as Kevin has no basis to allow deductibility of the loss. The same would be true if the business was an S corporation and Kevin was a shareholder.

C. Activities Subject to the Rules. The at-risk rules limit the deductibility of losses from any business or investment activity.

There are, however, **three** different sets of activities, **each** of which has its own special rules.

1. "Separate activities" for which nonaggregation is required. This set consists of any individual
   - Film or videotape
   - Section 1245 property held for leasing
   - Farm
   - Oil and gas property
   - Geothermal property
2. Any real estate activity.
3. Any business or investment not classified in (1) or (2). This is the aggregation group.

II. AMOUNT-AT-RISK DEFINED

The amount-at-risk includes money contributed to the activity as well as debts for which the taxpayer is personally liable.

If the taxpayer has no personal liability, but has pledged property as security for repayment of the debt, the amount-at-risk is the fair market value of the pledged property, less any superior liens.

If the taxpayer pledges property that is used in the activity as security, that property does not increase the amount-at-risk. A related rule provides that any loan from a co-venturer in the activity does not give the borrower any amount-at-risk [I.R.C. §465(b)(3)(A)].

In many cases the taxpayer's amount-at-risk is the same as his or her adjusted basis. The principal differences arise when basis is financed by nonrecourse debt, or by an obligation to a co-venturer.

Example 20. M is a general contractor with excellent credit. He is a regular customer of First National Bank. First National forecloses on some equipment owned by another customer. The bank offers the equipment to M if he will agree to make payments on a $100,000 note. The bank does not require M's personal liability, but only reserves the right to repossess the equipment if M defaults. **M has a basis of $100,000 in the equipment, but no amount-at-risk.**

Example 21. N is syndicating a movie. He offers investors the following terms:

1. Each investor contributes $10,000 cash.
2. Each investor signs a note to N for $40,000.
3. N will retain a 10% interest in the profits or losses of the movie. Each of the other nine investors will receive a 10% interest.

In this situation, each investor's basis is $50,000, **but the amount-at-risk of each is only $10,000.**

Observation. The amount-at-risk will be increased **if and when** an investor **actually pays** N on the note.

A. Special Rule for Real Estate

Until 1987, real estate activities were exempt from the at-risk rules. Any real estate placed in service before 1987 continues to be exempt.

For real estate placed in service **after 1986,** the at-risk rules apply, but with a significant modification. **A nonrecourse loan does give the taxpayer an amount-at-risk if it is "qualified nonrecourse financing"** [I.R.C. §465(b)(6)].

A nonrecourse loan **qualifies** as an amount-at-risk if it is made by a **commercial lender**. The lender may be related to the borrower if the terms of the loan are commercially reasonable. However, the lender may **not** be the **seller of the property,** or any party related to the seller.

Example 22. First National Bank repossesses an apartment house. It finances Jim's purchase of the building on a **nonrecourse** basis. Jim will **not** be at-risk and is not entitled to deduct any losses from the property.

B. Aggregation of Amounts-at-Risk

The original at-risk law was adopted in 1976 (I.R.C. §465). It applied only to:

- Films and videotapes
- Leased I.R.C. §1245 property
- Farms [as defined by I.R.C. §464(e)]
- Oil and gas properties

The original law required that the loss from each activity be measured against the amount-at-risk for each activity. **For these activities, as well as for geothermal properties,** which were added in 1978, **the non-aggregation rule still applies.**

Generally, the same non-aggregation rules apply to other activities that the taxpayer owns outright. If, however, a partnership or S corporation owns activities (other than the five types for which separation is generally required), each partner or shareholder may aggregate his or her amounts-at-risk for all of the activities [*Jackson*, 86 T.C. 492 (1986)]. To come under the aggregation rule, the partnership or S corporation must allocate at least 65% of the losses to persons who actively participate in the entity's management.

Partnerships and S corporations are also allowed to aggregate the separate items of leased §1245 property [I.R.C. §465(c)(2)(B)(i)]. As a practical matter, allocation of amounts-at-risk to separate oil and gas properties has proved so cumbersome that the IRS allows partnerships and S corporations to aggregate income, losses, and amounts-at-risk from all oil and gas investments [Temp. Reg. §1.465-1T].

C. Adjustments to Amounts-at-Risk

1. Increases in Amounts-at-Risk. A taxpayer's amount-at-risk is **increased** for additional contributions of cash or property. It is also increased for any income that the venture produces. These rules are the same as those governing increases in basis for an owner of a partnership or a shareholder in an S corporation.

In addition, a taxpayer can **increase** his or her amount-at-risk by **changing a loan from nonrecourse to recourse**. This type of refinancing wouldn't have any effect on the taxpayer's adjusted basis in his or her partnership interest. It is unlikely that it would affect the basis of a shareholder in his or her S corporation stock or debt.

Finally, a rule, which is a complete departure from the basis rules, **increases** a taxpayer's amount-at-risk **for any gain recognized on the disposition of the taxpayer's interest in the activity** [Prop. Reg. §1.465-12(a), Prop. Reg. §1.465-66(a)].

> **Practitioner Note.** In a recent case, a shareholder in an S corporation recognized gain on the disposition of his stock. He had zero basis in the stock, and had losses in excess of his basis. He properly reported the gain on the sale, and increased his amount-at-risk accordingly. However, he assumed that the increase in his amount-at-risk was also an increase in basis. The Court held that there was no increase in basis, and thus no opportunity to deduct the suspended losses [*Miller v. U.S.,* 83 AFTR 2d 99-1559 (DC WV)].

2. Decreases in Amounts-at-Risk. The amount-at-risk is **decreased** by an investor's withdrawal of cash or property. It is also **decreased** by an investor's share of losses. If a recourse loan is refinanced with a nonrecourse loan, the borrower's amount-at-risk is decreased accordingly. **The amount-at-risk cannot be decreased below zero. If a decrease in the amount-at-risk would create a deficit, the taxpayer must recapture losses deducted in earlier years to bring the amount-at-risk back up to zero** [I.R.C. §465(e)(1)].

Example 23. In prior years, Tom had deducted $40,000 worth of losses on a farm. He had $50,000 at risk, which included a $10,000 cash contribution and a $40,000 note with full recourse. The losses had reduced his amount-at-risk to $10,000. In 2000 he refinanced the loan with a $40,000 nonrecourse note.

Tom's amount-at-risk would be a negative $30,000 if not for the recapture rule. He must recapture $30,000 of his previously deducted losses as income on his 2000 return to bring the amount-at-risk back up to zero. This also creates $30,000 of suspended losses to be used up to the extent that the farm shows a profit; otherwise, the amount-at-risk is increased in the future.

3. Rules for Partners and Shareholders

a. Application to General Partners. In many cases, a general partner's amount-at-risk will be the same as his adjusted basis. However, there can be differences due to the following:

1. A general partner may have borrowed money from the partnership or from another partner to contribute to the venture. This amount is not treated as an amount-at-risk [I.R.C. §465(b)(3)(A)].

2. **The at-risk limit applies after the basis rule,** as illustrated in the following example:

Example 24. Linda's basis in her partnership interest, before deducting any 2000 losses, is $5,000. Her share of partnership ordinary loss for 2000 is $7,000. Her amount-at-risk at the beginning of 2000 is only $4,000.

The proper tax treatment of her 2000 partnership loss is:

Limits	Basis	At Risk
Loss, before application of basis limitation	$7,000	
Basis limitation	(5,000)	
Carryforward until basis is increased	$2,000	
Loss after application of basis limitation		$5,000
Limit to amount-at-risk		(4,000)
Carryforward until amount-at-risk is increased		$1,000
Amount of partnership loss Linda can deduct in 2000		**$4,000**

b. Application to Limited Partners. A limited partner has an amount-at-risk for his or her contributions of cash or property to the partnership.

Since a limited partner has no obligation to pay a share of partnership recourse debts, they do not give him or her an amount-at-risk.

No partner has any amount-at-risk for partnership nonrecourse debts, except for the special rule for qualified nonrecourse financing of real estate.

c. Application to Members of Limited Liability Companies. In general, no person has an amount-at-risk for any amount for which he or she is protected from risk of loss [I.R.C. §465(b)(4)]. This rule has been applied to treat a guarantor who is not the primary debtor as not being at risk.

In the S corporation context, that principle has been applied to deny a shareholder an amount-at-risk for guarantee of the corporation's debt. See discussion below.

It is indeed problematic whether the basic structure of limited liability company laws will treat members' protection from debts of the business as being at risk. There are no cases or rulings on this point as of July 2000. However, there is one Field Service Advice issued by the IRS that allows limited liability company members to be treated as at-risk for their portions of limited liability company debt, as allocated under the basis rules [FSA 200025018].

d. Application to Shareholders of S Corporations. The problem does not arise frequently for S corporation shareholders, since the basis rules are more strict than for partners. However, the at-risk rules occasionally apply to shareholders.

For a shareholder's amount at risk in **stock**, do not include money contributed if the money was borrowed from a co-venturer or any party related to the co-venturer [I.R.C. §465(b)(3)(A)]. For purposes of determining related parties to the co-venturer, the rules of I.R.C. §267 and I.R.C. §707)(b)(1) apply.

In *Riggs*, a 50% shareholder in an S corporation borrowed money from another corporation that was wholly owned by the other 50% shareholder. The borrowing shareholder was not treated as being at risk with respect to the borrowed amounts (*Riggs*, 63 T.C.M. 3107, T.C. Memo 1992-323). In that case, the IRS did not claim that the taxpayer lacked basis in her stock. Also see *Van Wyk*, 113 T.C. No. 29 (1999) for a similar result.

Example 25. In 2000, Jim bought 50% of J Corporation's stock, using $40,000 of his own funds. He pledged the stock to the bank for a loan of $42,000, which he used to purchase the other 50% of the shares. Jim's **basis** in J Corporation is $**82,000.** His **amount-at-risk,** however, **is only $40,000.**

For loans to an S Corporation, the amount-at-risk **can** include money borrowed from another shareholder or a party related to the shareholder [I.R.C. §465(b)(3)(B)]. **Therefore, the at-risk rules are more liberal for loans to S corporations than they are for investments in S corporation stock.**

Example 26. Refer to the previous example. After purchasing his stock, Jim borrows $20,000 from another shareholder and loans the amount to J Corporation. His debt basis is now $20,000. Since he has loaned the money to the corporation, rather than contributing it to capital, **his amount-at-risk is increased by the $20,000 loan.** Jim's **total** amount-at-risk in the J Corporation is **now $60,000,** consisting of the $40,000 cash he paid for the stock and the $20,000 he loaned directly to the S corporation.

In the *Van Wyk* case mentioned above, the borrowing shareholder tried to use the **debt** rules to establish an amount **at risk** for his stock. However, the Tax Court upheld the distinction and did **not** allow the two rules to be merged into one.

In the case of S corporations, a shareholder's amount-at-risk does not include any portion of corporate debt to other parties. This rule may appear to be redundant, since a shareholder would not receive basis for the guarantee of a loan and the basis limit would predominate the at-risk limit. In some situations, however, the at-risk rules could be important. In *Goatcher*, the court reasoned that the shareholders would have a claim against the corporation if they were required to perform on their guarantee. Therefore, they were protected by a stop-loss agreement and were not at risk with respect to their guarantee [*Goatcher v. U.S.*, 91-2 USTC 50,450 (10th Cir.)].

STEP 6: PASSIVE ACTIVITY LOSS LIMITS

I.R.C. §469 was a major provision of the Tax Reform Act of 1986 from two perspectives. First, it was the most significant revenue producer of the individual provisions of the 1986 act. Second, it has already spawned approximately 300 pages of complex regulations.

I. FRAMEWORK FOR STUDY

The passive activity loss rules are lengthy. A brief framework, or road map, will help the reader understand the direction of the rules. This portion of the chapter covers the following topics:

1. General rule: A brief description of the restrictions
2. Definitions
3. Categorization of income and expenses for purposes of the passive activity rules
4. Taxpayers affected by the rules
5. Material participation
6. Rental activities
7. Non-rental activities
8. Accounting for suspended losses
9. Disposition of an interest in a passive activity
10. Definition of Activity

II. GENERAL RULE

If the activity is passive, the loss from that activity cannot be deducted against any income of the taxpayer other than certain income from that passive activity or another passive activity. Credits from a passive activity cannot be used to offset the tax liability of the taxpayer other than tax liability from passive activities.

III. DEFINITIONS

A. Passive Activity

1. An activity that involves the conduct of a **trade or business** in which the taxpayer does not materially participate.
2. Any rental activity (whether or not the taxpayer materially participates).
3. However, the term "passive activity" does not include any working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to that interest.

B. Trade or Business. A trade or business includes any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under I.R.C. §212. I.R.C. §212 expenses are those paid for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.

C. Passive Activity Loss. This is the amount by which the aggregate losses from all passive activities exceed the aggregate income from all passive activities for the taxable year.

D. Passive Activity Credits. This is the amount by which the sum of allowable credits from all passive activities exceeds the regular tax for the year allocable to all passive activities.

E. Certain Types of Income and Expenses Not Treated as Passive Activity Income or Expense. In determining income or loss from any activity, do not take into account:

1. Gross income derived from interest, dividends, annuities, or royalties not derived in the ordinary course of the trade or business.
2. Expenses directly allocable to items in (1) above, including interest allocable to such gross income.
3. Gain or loss attributable to the disposition of property that produces income of a type described in (1), or which is held for investment.

Also, any income gain or loss derived from an investment of working capital is treated as not derived in the ordinary course of a trade or business.

Casualty losses are exempt from the limitation on passive activities [Temp. Reg. §1.469-2T(d)(2)(x)].

IV. CATEGORIZING INCOME AND DEDUCTIONS

A. Income by Type of Activity

1. Portfolio Income. Portfolio income is never passive. Examples include:

1. Interest
2. Dividends
3. Royalties
4. Annuities
5. Sale of property that produces income in (1)–(4)
6. Payments from retirement, pension, or deferred payment plans
7. Social security benefits

8. Income from a patent, copyright, or literary, musical, or artistic composition if taxpayer's personal efforts significantly contributed to creation of the property

2. Rental Income. Rental income is always passive, even if it is real estate rental and the taxpayer actively participates. There is an exception for certain real estate professionals.

3. Trade or Business Income. Trade or business income may be passive or not depending on the amount of participation.

- For the income to be classified as not passive, there must be material participation.
- However, some retired taxpayers are considered to be material participants.

B. Deductions by Type of Activity

1. Portfolio Expenses. Itemized deductions are subject to the 2% of adjusted gross income floor if they are not interest expense. Investment interest limitation rules apply to interest expenses. Deductions for certain rent or royalty expenses are allowed in arriving at adjusted gross income.

2. Rental Expenses. Rental expenses are allowed in arriving at adjusted gross income. They are subject to the passive loss limitations. There are special rules for rental real estate if active participation is involved.

3. Trade or Business Expenses. Trade or business expenses are allowed in arriving at adjusted gross income. They are subject to passive loss limitations, unless the taxpayer materially participates.

C. Other Rules

There are some other important rules to emphasize. **Activities that are subject to the hobby loss or vacation home rules are not subject to the passive activity loss rules.** Oil and gas investments are subject to special rules. As cumbersome and restrictive as the passive activity loss limits are, they are in fact more liberal than some of the limitations discussed previously in steps 1, 2, and 3. For instance, there are future events that will trigger suspended passive activity losses and allow their deduction in future years. By contrast, there is no such relief provision for hobby loss limitations.

D. Summary

Portfolio expenses are not subject to any of the passive activity loss restrictions. As a correlative, portfolio income cannot be treated as passive income and cannot be sheltered by losses from passive activities. Rental net profits and losses are passive by statute. The definition of rent, however, is subject to some rather complicated interpretations.

One of the primary goals of the complex I.R.C. §469 regulations is to prevent taxpayers from characterizing a profitable activity as a rental activity, or an unprofitable activity as a trade or business activity in which the taxpayer materially participates.

In contrast to rental activities, an oil or gas venture is not passive by statute **if** the taxpayer's ownership is through a **working interest**. A working interest is outright ownership or ownership through a general partnership interest. The form of ownership must not limit the taxpayer's liability for the venture's debts. The justification offered by Congress is that such ventures are so risky that they should **not** be subject to the passive activity loss limits.

Income or loss that is not portfolio, rental, or an oil or gas working interest is subject to the material participation tests. If the taxpayer materially participates in the trade or business, the income or loss is not passive. If the taxpayer does not materially participate, the profit or loss is passive.

V. TAXPAYERS AFFECTED BY THE RULES

The passive activity loss rules apply to:

- Individuals
- Estates
- Trusts
- Personal service corporations
- Closely held C corporations

Generally, regardless of whether an individual directly owns an interest in a **trade or business activity** (e.g., as a proprietorship), or owns an interest in an activity conducted at the entity level by a pass-through entity such as a general partnership or S corporation, he or she **must be involved in the operations of the activity on a regular, continuous, and substantial basis in order to be materially participating.**

Liberalization for Closely Held C Corporations. For all taxpayers **except** closely held C corporations, the passive activity loss deduction is limited to passive income. There is a significant liberalization for closely held C corporations. They may deduct passive losses to the extent of net active income. Net active income includes income and deductions from all activities except portfolio investments.

VI. MATERIAL PARTICIPATION

A. General Rules

In order to categorize income or loss from a trade or business as not passive, there must be material participation in the trade or business.

The General Explanation of the Tax Reform Act of 1986 includes the following helpful comments:

1. Since a **limited partner** generally is precluded from participating in the partnership's business if he or she is to retain limited liability status, **a limited partnership interest is treated as intrinsically passive** (except as provided in regulations).
2. Material participation of a taxpayer in an activity is determined separately for each taxable year. In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year.
3. 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.
4. **Material participation by a corporation subject to the passive loss rule.** Special rules apply in the case of corporations that are subject to the passive loss rule. A corporation that is subject to the passive loss provision is treated as materially participating in an activity with respect to which one or more shareholders, owning in the aggregate more than 50% of the outstanding stock of the corporation, materially participate.

Example 27. A corporation with five shareholders, each owning 20 shares of stock, is treated as materially participating in an activity if three or more of the shareholders so participate. If one of the three shareholders who so participate owns only five shares of the stock, and as a result the three participating shareholders own only 45 shares of the stock in the corporation, the corporation is not treated as materially participating in the activity.

5. **A closely held C corporation** subject to the passive loss provision that is **not** a personal service corporation may also be treated as materially participating in an activity if it meets the following standards.

- for the prior 12-month period, at least one full-time employee of the corporation provided sufficient services in active management with respect to the activity,
- during the prior 12-month period, at least three full-time non-owner employees provided sufficient services directly related to the activity, and
- the amount of business deductions by the taxpayer attributable to the activity exceeded 15% of gross income from the activity for the taxable year.

B. Specific Rules

A person is materially participating if the person is involved in the operations of the activity on a regular, continuous, and substantial basis. (This rule is applied considering services provided both by the taxpayer and by the taxpayer's spouse, whether or not such taxpayer and spouse file a joint return.) (A special **"active participation"** rule applies to certain rental real estate.) Treas. Reg. §1.469-5T adopts **mechanical tests** to determine material participation. **It** lists **seven** tests. A taxpayer who meets **any one** of these is deemed to materially participate in an activity (Treas. Reg. §1.469-5T). The first four tests are purely mechanical.

Test 1. The individual participates for more than 500 hours in the taxable year [Treas. Reg. §1.4695T(a)(I)].

Example 28. John and Elmer Robbins are brothers who have formed a computer software development company. John lives in Atlanta and Elmer lives in San Diego. Both have other full-time occupations. John is an engineer who designs and programs the software. Elmer is a CPA. He is the sales manager of the software company, which is located in San Diego. In 2000, the first year of operations, John spent approximately 500 hours developing products. Elmer spent about 600 hours calling on potential customers and arranging advertising.

Answer. Both John and Elmer are material participants.

Test 2. The individual is the sole participant in the activity for the year [Treas. Reg. §1.4695T(a)(2)].

Example 29. Phil Berry is a teacher who lives in a rural area of Illinois. He owns a truck with a snowplow. He contracts with some of his neighbors to plow roads. He maintains and drives the truck. In the winter of 2000 there is little snow and he operates the truck for only 10 hours.

Answer. He is nevertheless a material participant in the snowplowing business.

Test 3. The individual participates more than 100 hours and no other individual spends more time on the activity [Treas. Reg. §1.469-5T(a)(3)].

Test 4. The individual participates for less than 500 hours in each of several businesses, excluding rental operations. A person who participates for more than 500 hours in all of them and more than 100 hours in each of them is treated as a material participant in each [Treas. Reg. §§ 1.469-5T(a)(4) and 1.469-5T(c)]. These activities are known as **"significant participation"** activities, a term that has no legislative history, but materialized in the regulations.

Example 30. [Treas. Reg. §1.469-5T(k)(4)]. Bob Lewis is a full-time CPA. He owns interests in a restaurant and in a sporting goods store. In the current year he spends 400 hours working at the restaurant and 150 hours at the store. There are other participants who spend more time in each of these activities than Bob.

Answer. He is treated as a material participant in both the restaurant and the store.

Observation. A likely problem in meeting each of the first four tests will be substantiation of the hours spent on each activity. The next two tests are objective, but relate to **past,** rather than current, involvement.

Test 5. An individual who has materially participated (by tests 1 through 4) in an activity for five of the past ten years will be considered a material participant in the current year [Treas. Reg. §1.469-5T(a)(5)].

Example 31. Dale Williams is a partner in an automobile dealership. He retired in 1995 after forty years in the business. Since then his daughter has been the general manager, but Dale retains a 60% general partnership interest.

Answer. He is treated as a material participant for five years after retirement. By 2001 he will no longer be a material participant, since he will have participated in only four of the last ten years.

Test 6. An individual who has materially participated in a personal service activity for at least three years will be treated as a material participant for his life [Treas. Reg. §1.469-5T(a)(6)].

Example 32. Jim Scott is a retired physician, but retains a partnership interest in his former medical practice.

Answer. He will always be treated as a material participant in the medical partnership.

Test 7. An individual who participates in the activity for more than 100 hours may be treated as a material participant if, based on all the facts and circumstances, he or she participates on a regular, continuous, and substantial basis [Treas. Reg. §1.469- 5T(a)(7)].

The regulations set out the following rules regarding the facts and circumstances test listed in Test 7:

1. The fact that an individual satisfies a material participation test under **another section of the code,** such as I.R.C. §1402 (the self-employment test) or I.R.C. §2032A (special use valuation) has **no bearing** on the material participation test for these passive activity rules.

Exception. If an individual is treated as materially participating under I.R.C. §2032A(b)(1)(C)(ii) because he or she meets the requirements of I.R.C. §2032A(b)(4) or (5), he or she meets the material participation test for these rules. I.R.C. §2032A(b)(4) treats a retired or disabled farmer as materially participating if he or she materially participated for five of the last eight years preceding retirement or disability. I.R.C. §2032A(b)(5) treats the surviving spouse of a farmer as materially participating if the farmer met the requirements at the time of death and the surviving spouse actively participates in the farm business.

2. Management activities of the taxpayer are not counted if [Treas. Reg. §1.469-5T(b)(2)]:

   a. Anybody other than the taxpayer is compensated for management services
   b. Somebody provides more hours of management services than the taxpayer

3. If the taxpayer participates 100 hours or less, he or she cannot be treated as materially participating under the facts and circumstances test.

VII. RENTAL ACTIVITIES

All income and deductions from rental activities are characterized as passive. However, in one circumstance losses are deductible against non-passive income.

A. Active Participation in Rental Real Estate Activities

The passive activity loss and credit limitations **do not apply to up to $25,000 of passive losses** (or credit equivalents) **of rental real estate activities** if certain conditions are satisfied:

1. The taxpayer is a natural person. (There is no allowance for an estate, trust, personal service corporation, or closely held corporation.)
2. The individual **"actively participates"** in the rental real estate activity.
3. The $25,000 allowance is **reduced** 50 cents for each dollar by which the taxpayer's modified adjusted gross income exceeds $100,000 (phase-out at $150,000 of AGI). Adjusted gross income is determined without reference to net losses from passive activities, IRA contributions, and taxable social security benefits. (There is a special phase-in for low-income housing and rehabilitation credits.)
4. There are two special rules for married taxpayers filing separate returns:

   - If they live together at any time during the year, they are allowed no deduction.

   - If they do not live together at any time during the year, the maximum deduction is $12,500. It is phased out 50 cents for each dollar after MAGI exceeds $50,000.

1. Active Participation Defined. The difference between active participation and material participation is that **the active participation test can be satisfied without regular, continuous, and substantial involvement in operations,** so long as the taxpayer participates in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions" (Senate Finance Committee General Explanation).

2. Examples of Active Participation in Rental Real Estate Activities.

Example 33. A taxpayer owns and rents out an apartment that was formerly used as his primary residence. He hires a rental agent and uses a contractor to handle routine repairs.

Conclusion. The taxpayer is **likely** to meet the active participation test, as his main purpose is probably not the generation of tax losses (Senate Finance Committee General Explanation).

Example 34. A taxpayer purchases an undivided interest in a shopping mall. He bought it from a promoter, based on a prospectus describing the investment opportunity and stressing the tax benefits of the special $25,000 allowance for rental real estate. Since one of the taxpayer's main reasons for buying the property is to shelter income, he relies on a professional management company to make all significant management decisions. In order to create an evidentiary record purporting to show active management, the management company sends letters to the owner detailing operating expenses, changes in tenants, and new lease terms. The management company also informs the owner as to market trends, and requests approval of decisions to seek certain types of retailers as tenants. The owner ratifies such judgments without independently exercising judgment.

Conclusion. The owner of the shopping mall has **not** met the active participation test (Senate Finance Committee General Explanation).

3. Active Real Estate Trade or Business. Individual taxpayers who materially participate in active real estate trades or businesses do not treat losses from rental real estate as passive per se [I.R.C. §469(c)(7)]. To qualify for this classification, the taxpayer must meet two criteria:

1. More than 50% of the personal services performed by the taxpayer in all trades or businesses must be in active real estate [I.R.C §469(c)(7)(B)(i)].
2. The taxpayer must have participated in active real estate trades or businesses for at least 750 hours in the year [I.R.C. §469(c)(7)(B)(ii)].

An active real estate trade or business includes development or redevelopment of real estate, as well as construction, reconstruction, acquisition conversion, rental or leasing, operation, management, or brokerage [I.R.C. §469(c)(7)(C)].

> **Practitioner Note.** An active real estate professional is not entitled to deduct losses from real estate rents in all cases. This rule merely shifts the real estate rental to the trade or business category. If the active real estate professional then meets one of the material participation tests with respect to the activity in question, the income or loss from this activity will be treated as active.

An individual **cannot** be treated as actively participating if at any time during the applicable period his interest is **less than 10%** (by value) of all interests in the activity (interests of a husband and wife are combined for this purpose).

B. Allocation among Activities

1. Pro Rata Allocation

When there are excess losses (or credits from rental real estate activities), allocation is pro rata with respect to the amount of losses (or credits) from each loss activity.

Example 35. If a taxpayer who qualifies for the full $25,000 allowance has $10,000 of losses from the first activity and $40,000 of losses from a **second** activity, then $5,000 is treated as allowed from the **first** activity and $20,000 is treated as allowed from the **second** activity.

In order to determine the amount of losses potentially qualifying for the $25,000 allowance, it is necessary first to net income and loss from all of 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 in determining the amount eligible for the $25,000 allowance.

Example 36. Assume that a taxpayer has $25,000 of losses from a rental real estate activity in which she actively participates. If she also actively participates in another rental real estate activity from which she has $25,000 of gain, the result would be no net loss from rental real estate activities. Consequently, no amount is allowed under the $25,000 allowance for the year.

2. Real Estate Activities with Active Participation

All real estate rentals in which the taxpayer actively participates are grouped together. If any of the activities has net income, the income from that activity is first absorbed by real estate activities that produce losses. If there is a net loss from real estate, the income from real estate activities is allocated entirely to the real estate activities that produce losses. Only if there is net income from all of the real estate activities is any loss absorbed by other passive activities. The apparent purpose of this allocation formula is to minimize the allocation of carryforward deductions to real estate activities, thereby reducing the probability of claiming an active real estate deduction in future years.

Example 37. Charles has two real estate activities, A and B. He actively participates in both. He also has a passive activity C, which is a limited partnership interest and does not qualify for the real estate deduction. In the current year his income or loss from each activity is as follows:

Activity	Income (Loss)
A	$20,000
B	(55,000)
C	(15,000)

Assume that he qualifies for the active real estate deduction of $25,000.

Answer. His active real estate income of $20,000, as well as the rental real estate deduction of $25,000, is allocated to activity B. Activity B would carry forward a loss of $10,000 and activity C would carry forward a loss of $15,000.

C. Definition of a Rental Activity

1. General Rule

The general rule is that a **rental activity** is considered **passive even if there is material participation.** The regulations give a commonplace definition of rent as payment for the use of property. They then carve out numerous special rules. The special rules exempt certain rental operations from automatic classification as passive. In most cases exemption from rent classification subjects the activity to the material participation tests. In a few cases, it will create portfolio income.

However, see the exception for active real estate professionals, above.

2. Regulations Tests

The regulations provide **three tests,** based on **average length of customer use** of the property. These are likely to be the most important tests for most taxpayers.

Test 1. Income is not treated as rent if the average customer use is seven days or less. There is an inherent presumption that the customer is paying primarily for services rather than the property itself. This presumption cannot be rebutted [Treas. Reg. §1.469-1T(e)(3)(ii)(A)].

Test 2. If the average period of customer use exceeds seven, but not thirty days, the activity is rent unless the owner provides "significant personal services" [Treas. Reg. §1.469-1T(e)(3)(ii)(B)]. The regulations somewhat loosely describe significant personal services by stating that "all of the relevant facts and circumstances shall be taken into account." There are certain services, termed "excluded services," which will not be counted as significant.

These services are:

- Services necessary to permit the lawful use of the property
- Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers
- Services provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters) [Treas. Reg. §1.469-1T(e)(3)(iv)(A) and (B)]

Test 3. If the average period of customer use exceeds thirty days, the activity will generally be rental. There are some **general exceptions** to this rule. The first exception exists when the owner provides **"extraordinary personal services"** [Treas. Reg. §1.469-1T(e)(3)(ii)(C) and Treas. Reg. §1.4691T(e)(3)(v)]. There is little guidance to this exception. The regulations mention hospitals and boarding schools as examples of situations where the services are extraordinary.

Example 38. The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment **exceeds** 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50% of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the **customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services** (within the meaning of paragraph (e)(3)(v) of this section) **are not provided** in connection with making the photocopying equipment available for use by customers, **and the activity is a rental activity.**

VIII. NON-RENTAL ACTIVITES

Property held in connection with a non-rental activity is generally not treated as rent [Treas. Reg. §1.469-1T(e)(3)(ii)(D) and Treas. Reg. §1.469-1T(e)(3)(vi)]. But there are several exceptions. One occurs when the property is, or has recently been, used in the taxpayer's trade or business. The exact wording, from Treas. Reg. §1.469-1T(e)(3)(vi)(C), is:

1. The taxpayer owns an interest in such trade or business activity during the taxable year;
2. The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and,
3. The gross rental income from such property for the taxable year is less than two percent of the lesser of
   a. The unadjusted basis of such property; and
   b. The fair market value of such property.

There is one example that is applicable to farmers.

Example 39. A calendar year taxpayer owns a farming activity that is a trade or business activity and owns farmland that was used in the farming activity in 1995 and 1996. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1997, 1998, and 1999, the taxpayer continues to own the farming activity but does not use the land in the activity. In 1997 the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1998, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1999, the taxpayer again leases the land for $4,000 to the rancher.

Answer for 1997 and 1999. For 1997 and 1999, the taxpayer owns a trade or business activity, and the farmland that the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is **less than two percent** of the lesser of the fair market value and the unadjusted basis of the land (0.02 × $210,000 = $4,200). Accordingly, the taxpayer's rental of the land is treated as incidental to the taxpayer's farming activity, and **is not a rental activity.**

Answer for 1998. Because the taxpayer's gross rental income from the land for 1998 ($10,000) is not **less than two percent** of the lesser of the fair market value and the unadjusted basis of the land, the requirement of the regulations is **not** met. Therefore, the taxpayer's rental of the land in 1998 is not treated as incidental to the taxpayer's farming activity and **is a rental activity.**

A. Property Used by Partnership, S Corporation, or Joint Venture

There is a variant on the business use exception, which arises when the taxpayer owns an interest in a partnership, S corporation, or joint venture. If the owner of the property provides the property to the entity for use in the business, but does not charge the entity any rent, no part of the owner's income from the business will be considered as rental income. As a correlative, no portion of the owner's expenses in connection with the property will be considered as expenses relating to rent [Treas. Reg. §1.469-1T(e)(3)(ii)(F) and Treas. Reg. §1.469-1T(e)(3)(vii)].

B. Property Held for Sale

Income is **not** considered to be rent if it is received for property that the taxpayer holds for sale in the ordinary course of business [Treas. Reg. §1.469-1T(e)(3)(vi)(D)]. The amount of rent charged does not affect the classification in this case.

C. Property Used for Convenience of Employer

The income or loss from property rented to an employee for the convenience of the employer is not treated as rent [Treas. Reg. §1.469-1T(e)(3)(vi)(E)]. The real impact of this exception seems to be the classification of deductions, since the owner typically does not charge any rent.

D. Rental of Dwelling Unit

An activity involving the rental of a dwelling unit that is used as a residence by the taxpayer during the taxable year (within the meaning of I.R.C. §280A(c)(5)) is **not** a passive activity of the taxpayer for such year. This exception encompasses **two** circumstances. **First, when a taxpayer holds his or her principal residence out for sale and vacates before the sale, the taxpayer may rent the property until the sale closes.** The rent income and expenses in this situation will not be treated as in connection with a rental activity. **The second situation covered is the rental of a vacation home.** Remember that I.R.C. §280A will not permit a deductible loss, or carryover of excess expenses when the taxpayer has used a home for more than the greater of: 1) 14 days; or 2) 10 of the rental days. The only possibilities in this case are zero or positive income. **If the expenses exceed the income, there is no effect of excluding the vacation home from the passive activity loss rules. If, however, the income exceeds the expenses, the net income will not be passive.** Therefore, it **cannot** be sheltered by losses from other rental or passive activities.

E. Property Held Primarily for the Realization of Investment Gain

In this case, any incidental rent is not treated as rental income if the rent is less than two percent of the unadjusted basis (or fair market value, if less) of the property [Treas. Reg. §1.469-1T(e)(3)(vi)(B)]. The following example illustrates when rental income and loss might fall under the investment interest limits.

Example 40. The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year.

Answer. The gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (0.02 × $210,000 = $4,200). **Therefore, the rental of the land is not a rental activity because the rental is treated as incidental to an activity of holding the property for investment.**

Another example from the regulations illustrates a condition under which property **is not held for investment gain.** Pay special attention to the last sentence in the last paragraph.

Example 41. In 1998, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1999.

Answer. The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose of realizing gain from the appreciation of the property. Therefore, the rental of the property in 1998 is not treated as incidental to an activity of holding the property for investment. The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1998 is not treated as incidental to a trade or business activity. Since the rental of the land in 1998 is not treated as incidental to a non-rental activity of the taxpayer, it is a rental activity.

F. Property Subject to a Net Lease

Generally, being the lessor of property subject to a **"net lease" is a rental activity.** A net lease is defined, for purposes of determining whether leased property constitutes investment property under the investment interest limitation, as a lease of property if the I.R.C. §162 deductions (other than rents and reimbursed amounts) are less than 15% of the rental income produced by the property, or if the lessor is guaranteed a specified return. This test has not been embodied in the regulations.

G. Farm Operated on a Landlord-Tenant Crop Share Basis

Is a farm operated on a landlord-tenant **crop share basis** a rental activity?

The instructions to Form 4835 imply that a **share lease is a rental activity unless** it is a business that is **subject to self-employment tax.** That implication arises from the instruction that states, "Use this form only if the activity is a rental activity for purposes of the passive loss limitations." That instruction apparently requires a taxpayer to report income and expenses from a share lease on Schedule F (where it is subject to the self-employment tax) or treat the share lease as a rental activity that is subject to the passive loss rules.

The restrictions of the tax form instructions pose a problem for reporting income from a share lease in some circumstances, whether the taxpayer treats the share leases as a rental activity or not.

If the share lease is **treated as a rental activity,** there are three possible reporting scenarios depending on whether the owner materially participates for self-employment tax purposes and actively participates for passive loss purposes. They are:

Scenario	Facts of Each Scenario: Material Participation for SE Tax?	Facts of Each Scenario: Active Participation for Passive Loss Rules?	Conclusions for Each Scenario: Where to Report on Tax Return	Conclusions for Each Scenario: Subject to Passive Loss Limits?	Conclusions for Each Scenario: Qualifies for Rental Real Estate Exception?
1	Yes	Yes	Schedule F	Yes	Yes
2	No	Yes	Form 4835	Yes	Yes
3	No	No	Form 4835	Yes	No

If the loss qualifies for the rental real estate exception, it is reported on line 1 of Form 8582.

However, the temporary regulations indicate that it is possible for a share lease to avoid being treated as a rental activity. They state that an owner of land is not engaged in a rental activity if the taxpayer provides the property for use in a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture [Treas. Reg. §1.469-1T(e)(3)(vii)]. Treas. Reg. §1.469-1T(e)(3)(viii) includes the following example to illustrate that rule.

Example 42. The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop share lease." Under the arrangement, the tenant is required to make maximal efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50% of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50% of the crops produced (or 50% of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

A taxpayer who wants to take the position that a share lease is **not a rental activity** has four possible reporting scenarios depending on whether he or she materially participates for purposes of the self-employment tax and whether or not he or she materially participates for purposes of the passive loss rules. They are:

Scenario	Facts of Each Scenario: Material Participation for SE Tax?	Facts of Each Scenario: Active Participation for Passive Loss Rules?	Conclusions for Each Scenario: Where to Report on Tax Return	Conclusions for Each Scenario: Subject to Passive Loss Limits?	Conclusions for Each Scenario: Qualifies For Rental Real Estate Exception?
1	Yes	Yes	Schedule F	No	N/A
2	Yes	No	Schedule F	Yes	No
3	No	Yes	?	No	N/A
4	No	No	Form 4835	Yes	No

Notes

1. Reporting the share lease income and expenses for Scenario 3 presents a dilemma. One option is to report them on Schedule F, but omit the net income or loss from the amount carried from Schedule F to Schedule SE. Another option is to report the income and expenses on Form 4835 but not to report a net loss on Form 8582. While it is tempting to report on Form 4835 (that is, treat the share lease as a rental activity) for years in which there is net income from the share lease, and on Schedule F (that is, treat the share lease as a joint venture) for years in

which there is net loss from the share lease, such inconsistency makes it difficult to defend either position on an audit.

2. Reporting the income and expenses for Scenario 4 presents a similar dilemma. The income and expenses technically do not belong on Schedule F because the owner does not materially participate for SE tax purposes. According to the Form 4835 instructions, they do not belong on Form 4835 because the share lease is not a rental activity. However, reporting the share lease income and expenses on Form 4835 and carrying a net loss to Form 8582 achieves the right result since the share lease in Scenario 4 is a passive activity, due to lack of material participation, for purposes of the passive loss rules.

Practitioner Note. The tests for material participation for purposes of the self-employment tax rules are not the same as the tests for material participation for purposes of the passive loss rules. In most cases, if there is material participation for one, there is material participation for the other. However, it is possible to materially participate for one and not the other.

Example 43. Jack Pine bought a farm in 1998 and leases it to his daughter under a share lease that includes a provision requiring Jack to help with making management decisions. Jack meets with his daughter for one hour every week and takes an important part in making management decisions.

Jack meets the material participation requirements for purposes of the self-employment tax (see Test 2 on page 80 of IRS Publication 225, *Farmer's Tax Guide* (1999). He does not meet the material participation test for purposes of the passive loss rules because he does not participate for more than 100 hours.

Example 44. Sue Mack retired from farming in 1994 and rented her farm to her son under a share lease. From 1994 through 1999, Sue participated in her son's farming activity 500 or more hours each year. In 2000, Sue moved to Arizona and now only visits the farm occasionally.

Sue meets Test 5 of the material participation requirements for purposes of the passive loss rules but does not meet the material participation requirements for purposes of the self-employment tax.

IX. ACCOUNTING FOR SUSPENDED LOSSES

1. Suspended losses and credits (not available because of the limitations) are **carried forward** and treated as deductions and credits from passive trade or business activities in the **next** year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his or her entire interest in the activity.
2. If any passive losses are not deductible in any given year, the amount of the suspended losses from each passive activity is determined on a **pro rata basis**. This is actually a two-stage computation in some cases, requiring allocation both among and within the various passive activities.
3. With respect to each activity, the portion of the loss that is suspended, and the portion 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.** This allocation is necessary in order to determine the suspended losses for any particular activity, which are allowed in full upon a qualifying disposition. The allocation among activities is illustrated by **two** examples from the regulations:

Example 45. An individual holds interests in 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)

Answer. The taxpayer's $21,000 passive activity loss for the taxable year is disallowed. 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 × $ 9,000 ÷ $25,000 =	$ 7,560
B:	$21,000 × $16,000 ÷ $25,000 =	$13,440
Total	=	$21,000

[Treas. Reg. §1.469-1T(f)(2)(i)(D) Example 1]

Example 46. The facts are the same as in Example 45. The $7,560 of loss from activity A and the $13,440 of loss from activity B that are disallowed for the taxable year are allocated among the passive activity deductions from those activities for such year and are treated as deductions from activities A and B, respectively, for the succeeding taxable year [Treas. Reg. §1.469-1T(f)(4) Example (2)].

The two examples illustrate what would happen if the taxpayer disposed of Activity A in the next year. Although A had $9,000 of losses, only $7,560 would be allowed on the disposition. This is due to the fact that $1,440 of the loss was allowed in the previous year.

The allocation within activities can be illustrated by the following adaptation of the two preceding examples.

Example 47. Assume that the $9,000 of loss attributable to Activity A in the first year in the two preceding examples was composed of the following:

Ordinary deductions in excess of gross income	$4,000
I.R.C. §1231 loss	5,000
Total	$9,000
Amount disallowed	(7,560)
Amount allowed in year 1	$1,440
Apportioned to ordinary (1,440 × 4,000/9,000)	$640
Apportioned to §1231 (1,440 × 5,000/9,000)	800
Total	$1,440
The carryover to year 2 would be	
Apportioned to ordinary (7,560 × 4,000/9,000)	$3,360
Apportioned to §1231 (7,560 × 5,000/9,000)	4,200
Total	$7,560

Observation. The determination of whether a loss is suspended under the passive loss rules is made after the application of the at-risk rules. For an activity held by a partnership or S corporation, the passive activity loss limits apply **after** the basis limitations and the at-risk limitations, in that order.

4. In the case of the $25,000 allowance for passive losses from rental real estate activities in which an individual actively participates, a situation could arise in which losses would be allowable for the year under the passive loss rule, but the taxpayer has insufficient (or no) passive income against which to apply them. In such a case, the otherwise allowable rental real estate losses are thereupon treated as losses that are **not** from a passive activity. They may give rise to net operating losses (NOLs) treated as arising in that year, and may be carried forward and back in accordance with the rules applicable to NOLs (Senate Finance Committee General Explanation).

X. DISPOSITION OF AN INTEREST IN A PASSIVE ACTIVITY

A. Disposition of the Entire Interest in the Activity. Disposition of the taxpayer's **entire interest** in the activity allows the taxpayer to **recognize any loss** associated with the activity. That includes any loss **recognized** on the disposition, as well as losses **suspended** from prior years. The disposition must be a completely taxable transaction, and may not be made to a related party.

Loss on disposition. A **loss** recognized on the disposition is not treated as a passive activity loss. **It will not absorb any income from other passive activities.** Income from the other passive activities will be available for offset by losses on other passive activities.

Gain on disposition. A **gain** on the disposition will be treated as **gross income from a passive activity**. It will not, however, be available for offset by losses from other passive activities, unless it exceeds the suspended losses from earlier years.

Example 48. In 2000, Alvin disposes of a passive activity in a **completely taxable sale.** He recognizes $50,000 gain on the sale. He has $35,000 of losses allocated to that activity, which were suspended in 1998 and 1999.

The $35,000 of suspended losses can be deducted in 2000 to offset $35,000 of the recognized gain, leaving only $15,000 of passive income from the sale. This remaining $15,000 will provide an offset for up to $15,000 of **losses from other passive activities** in 2000.

Practitioner Note. If the disposition results in a capital loss, the loss is subject to the usual capital loss limits.

B. Gifts. A **gift** of all or part of the taxpayer's interest in a passive activity **does not trigger suspended losses.**

Gift of Entire Interest. If a taxpayer gives away his entire interest in passive activity property, he cannot make a future taxable disposition of it. Suspended losses are therefore **added to the basis** of the property immediately before the gift.

Gift of Partial Interest. Similarly, if the taxpayer gives away **less** than all of his or her interest, **an allocable portion of any suspended losses** is added to the donee's basis.

Suspended losses allocable to the activity given away **are eliminated when added to the donee's basis**, and the remainder of the losses allocable to the activities retained by the donor continues to be suspended in the donor's hands. The treatment of subsequent deductions from the activity, to the extent of the donee's interest in it, depends on whether the activity is treated as passive in the donee's hands.

C. Related Party Transactions. The taxpayer is **not** treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if he disposes of it in an otherwise fully taxable transaction to a **related party** (within the meaning of §§267(b) or 707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition of the activity for purposes of the passive loss rule, **suspended losses are not triggered, but rather remain with the taxpayer.** Such suspended losses may be offset by income from passive activities of the taxpayer. **When the related party who buys the passive activity sells it to an unrelated party, the original related seller may then deduct all of his or her suspended losses.** The original seller must have disposed of all of his or her interest in the activity.

D. Activity No Longer Treated as Passive Activity. Other circumstances may arise that do not constitute a disposition, but which terminate the application of the passive loss rule to the taxpayer generally, or to the taxpayer with respect to a particular activity. For example, an individual who previously was passive in relation to a trade or business activity that generates net losses might 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 was not a material participant, previously suspended losses remain suspended and continue to be treated as passive activity losses [General Explanation of the Tax Reform Act of 1986].

Such previously suspended losses, unlike passive activity losses generally, are allowed against income from the activity realized after it ceases to be a passive activity with respect to the taxpayer. As with tax-free exchanges of the taxpayer's entire interest in an activity, however, the taxpayer must be able to show that such income is from the same activity in which the taxpayer previously did not materially participate.

E. Transfer of Interest Due to Death. A transfer of a taxpayer's interest in an activity due to his death causes suspended losses to be allowed to the extent they exceed the amount, if any, by which the basis of the interest in the activity is increased at death under I.R.C. §1014. **Suspended losses are eliminated to the extent of the amount of the basis increase.** The suspended losses allowed would generally be deducted on the **final return** of the deceased taxpayer.

F. Installment Sale of the Entire Interest in the Activity. An **installment sale** of the taxpayer's **entire interest** in an activity in a **fully taxable transaction triggers the allowance of suspended losses.** The losses are allowed in the **ratio** that the **gain recognized in each year bears to the total gain on the sale.**

G. Sale of Partial Interests in Passive Activity

Gain on sale of partial interest. Gain recognized on a transfer of a partial interest in the passive activity, and gain (boot) on a tax-free transfer of an entire or partial interest, are treated as being from a passive activity. Gain on such transfers may be offset by losses and credits from passive activities, but such transfers are not treated as dispositions triggering all suspended losses from the activity.

Loss on sale of partial interest. Loss recognized on a transfer of a partial interest in the passive activity will be subject to the usual passive activity loss limits on deductibility. If the loss is a capital loss, it will be subject to the capital loss limits after application of the passive activity loss limits.

Example 49. Jerry owned a 1/3 interest in a partnership engaged in a rental activity. In 1999 Jerry had $40,000 of suspended losses with respect to the activity, under I.R.C. §469. In 2000 he sells 1/2 of his 1/3 interest in the partnership and recognizes a loss of $10,000. The disposition does not allow him to recognize any of his suspended losses from 1999. Assume that his total income from passive activities in 2000 is $20,000. He has no income or loss from the 1/6 interest he retains in the partnership.

His treatment of the losses from the partnership will be as follows:

Loss	Total Losses of Partnership	Portion Recognized	Allocation to Specific Losses
From 1999	$40,000	(25,000/50,000)	$20,000
From 2000	10,000	(25,000/50,000)	5,000
Allowed in 2000			$25,000

Observation. If Jerry has no capital gains in 2000, he can deduct only $3,000 of the capital loss. He will carry $1,000 forward as a capital loss carryover. He will carry the remaining $6,000 of the 2000 capital loss forward as a suspended passive activity loss until he either has passive income or disposes of his entire interest in the partnership.

XI. DEFINITION OF ACTIVITY

The term “activity” is not the same as “entity.” The regulations make frequent reference to “activities” held by “entities.” When a partnership or S corporation holds an activity, it may be treated as producing passive income or loss to the owners. There is no attribution of the passive, rental, or active characteristic of an activity conducted by a C corporation.

Example 50. A taxpayer investing in a single partnership might be investing in several activities for I.R.C. §469 purposes. If so, the complete taxable disposition of one activity by the partnership could trigger the release of suspended losses attributable to that activity.

Example 51. Conversely, if a taxpayer directly owns 30% of an apartment building and another 10% indirectly through a partnership, her sale to an unrelated party of her entire partnership interest would not release the losses suspended because the disposition would not be “complete.”

APPENDIX

Basis Worksheets

The S corporation worksheets are adapted from Robert W. Jamison, *S Corporation Taxation Guide,* published each fall by Harcourt Professional Publishing. Copies may be ordered at 1-800-831-7799, or at amazon.com.

Worksheet: Stock basis in post-1996 year. Keep a separate worksheet for each block of stock.

If the corporation has terminated a year under I.R.C. §1377(a)(2) or Treas. Reg. §1.1368-1(g), complete a separate worksheet for each portion of the year.

1. Basis at beginning of year, or at acquisition date if acquired during year $______

2. Additions to basis
(CAUTION: Make sure that any debt basis has been restored to extent of prior reductions.)

a. Add all taxable items from shareholder's K-1
(to the extent allocated to this block) $______

b. Add all tax-exempt income
(CAUTION: If including corporate cancellation of debt income, review current IRS position and consider disclosure.) $______

c. Add any deemed dividend allocated to this block ______

3. Subtotal (1 + 2a + 2b + 2c) $______

4. Reductions of basis $______

a. Distributions received by shareholder during year
(Do not include any dividend from earnings and profits or deemed dividend.) (Do not reduce basis below zero. If distributions exceed basis, check to see whether other block of stock has sufficient basis to absorb excess.) $______

b. Subtotal (3 – 4a)
(CAUTION: Determine whether prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is in effect. If such election is in effect, skip line 4c and go directly to line 4d.) $______

c. Nondeductible expenses, not capitalized
(Include any spillovers from other blocks of stock.)
(Do not reduce basis below zero. Check to see whether other block of stock has sufficient basis to absorb excess.)
(Check to see whether shareholder debt has sufficient basis to absorb excess.)
(Do not carry forward any excess expense to next year.) $______

d. Deductible expenses and losses
(Include any spillovers from other blocks of stock.)
(Include any amounts carried forward from last year.)
(Do not reduce basis below zero.)
(Check to see whether other block of stock has sufficient basis to absorb excess.)
(Check to see if shareholder debt has sufficient basis to absorb excess.)
(Carry forward any excess expense to next year.) $______

e. Subtotal (4b – 4c – 4d)
(CAUTION: If prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is not in effect, skip line 4f and go directly to line 4g.) $______

f. Nondeductible expenses, not capitalized
(Include any spillovers from other blocks of stock.)
(Include any amounts carried forward from last year.)
(Do not reduce basis below zero.)
(Check to see if other block of stock has sufficient basis to absorb excess.)
(Check to see if shareholder debt has sufficient basis to absorb excess.)
(Carry forward any excess expense to next year.) $______

g. Subtotal (4e – 4f) $______

5. Ending basis (4f – 4g) $______

Worksheet: Debt basis. Keep a separate worksheet for each debt instrument. If the corporation has terminated a year under I.R.C. §1.1368-1(g), complete a separate worksheet for each portion of the year.

1. Basis at beginning of year, or at loan date if loaned during year	$ ______
2. Additions to basis (CAUTION: Limit to extent of prior reductions. If debt basis has never been reduced, skip to line 3.)	
a. Add all taxable items from shareholder's K-1 (to extent allocated to this block)	$ ______
b. Add all tax exempt income (CAUTION: If including corporate cancellation of debt income, review current IRS position and consider disclosure. See discussion at 925.22.)	$ ______
c. Less distributions received by shareholder during year (do not include any dividend from earnings and profits or deemed dividend), limit to 2a + 2 b	$ ______
3. Subtotal (1 + 2a + 2b –2c)	$ ______
4. Reductions of basis (CAUTION: Determine whether prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is in effect. If such election is in effect, skip line 4a and go directly to line 4c.)	
a. Nondeductible expenses, not capitalized (to extent expenses exceed basis of stock) (Do not reduce basis below zero.) (Do not carry forward any excess expense to next year.)	$ ______
b. Subtotal (3 – 4a)	$ ______
c. Deductible expenses and losses (to extent expenses exceed basis of stock) (Include any amounts carried forward from last year.) (Do not reduce basis below zero.) (Carry forward any excess expense to next year.)	$ ______
d. Subtotal (4b – 4c) CAUTION: If prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is not in effect, skip line 4e and go directly to line 4f.)	$ ______
e. Nondeductible expenses, not capitalized (to extent expenses exceed basis of stock) (Include any amounts carried forward from last year.) (Do nor reduce basis below zero.) (Carry forward any excess expense to next year.)	$ ______
f. Subtotal (4d – 4e)	$ ______
g. Partial repayments received by shareholder during year	$ ______
5. Ending basis (4f – 4g)	$ ______

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Basis Worksheet 1, to be completed at the end of the year. For computing a partner's basis in a partnership. of a member's basis in a limited liability company.

Item	Amount
1. Basis, beginning of year	$
2. Add Income items from Form 1065, Schedule K-1	$
3. Add any increase in liabilities, comparing this year's Schedule K-1 with last year, Schedule K-1	$
4. Add any other contribution of property	$
5. Subtotal (lines 1 through 4)	$
6. Distributions of cash from the partnership	$
7. Reduction in partner's share of liabilities, comparing this year's Schedule K-1 with last year, Schedule K-1	$
8. Add 6 and 7. If the total distributions exceed bases, as computed in line 5, the partner must report gain.	$
9. Subtotal. Line 5 less line 8, but not less than zero.	$
10. Distributions of other partnership property, at partnership basis. Do not reduce basis below zero. If Line 10 exceeds line 9, apportion basis among assets received.	$
11. Subtotal. Line 9 less line 10, but not less than zero.	$
12. Less nondeductible items, such as 50% meal and entertainment, charitable contributions, foreign income tax, fines, penalties, etc. If line 12 exceeds line 11, excess disappears and is not carried forward.	$
13. Subtotal. Line 11 less line 12, but not below zero.	$
14. Less deductible losses, such as ordinary loss, capital loss, §1231 loss, investment interest, etc. If line 14 exceeds line 13, apportion among the categories of loss, and carry any excess forward.	$
15. Final basis. Line 13 less line 14, but not less than zero.	$

SALE OF A BUSINESS