Chapter 4: Passive Activities

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Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

Being able to identify passive activities and understanding the rules and limitations associated with passive activities is important due to numerous tax consequences. The passive activity rules may **limit the amount of losses** that a taxpayer can claim. Practitioners who fail to apply the rules properly may be subject to preparer penalties and/or other adverse consequences.

Note. Rules associated with passive activities are used to determine which income is subject to the net investment income tax (NIIT), which affects higher-income taxpayers.

For those unfamiliar with classifying and reporting passive activities, the nomenclature can be confusing. The word **active** is used in two different ways within this context.

1. **An activity** is a business endeavor.
2. The word **active** is used in contrast to **passive.** A passive activity is subject to limitations. An active endeavor is not. Also, in this context, the words **nonpassive** and **active** are used interchangeably.

Certain activities are by definition passive, and other activities are classified as passive or nonpassive based on the amount of time the taxpayer spends on the activity. For many activities, the taxpayer's participation varies from year to year. Because of this, an activity that is passive during one tax year may not necessarily be passive in others.

Activities reported directly on Form 1040, *U.S. Individual Income Tax Return* (Schedules C, E, and F) may be subject to passive activity limitations. Income and losses from **pass-through entities** are affected by the passive activity rules. These include the following.

- S corporations
- Partnerships
- Limited liability companies (LLCs)
- Limited partnerships
- Trusts
- Estates

Additionally, the following taxpayers are also affected by the passive activity rules.[1]

- Closely-held C corporations
- Personal service corporations

1. IRC §469(a)(2).

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For purposes of the passive activity rules, a **closely-held C corporation** is one in which not more than five individuals hold, directly or indirectly, more than 50% of the value of outstanding stock at any time during the last half of the tax year.[2] A **personal service corporation (PSC)** is defined as one whose principal activity is the performance of personal services that are substantially performed by employee-owners who own **any** of the outstanding stock.[3]

> **Note.** Stock ownership in the PSC may be owned directly by the taxpayer or indirectly through attribution. The attribution rules of IRC §318 apply if a party related to the taxpayer owns **any** stock.[4] Under §318(a)(1), stock owned by a spouse, child, grandchild, or parent is attributed to the taxpayer. See IRC §318(a)(2) for further information about stock ownership attribution from a partnership, estate, trust, or corporation.

Special reporting requirements may apply to a taxpayer with passive activities, and it may be necessary to track amounts suspended or used from year to year for each activity. In many cases, tax software relies upon the practitioner to properly classify and track activities affected by the passive activity rules.

Generally, passive activity loss (PAL) amounts and the PAL limitation for the taxpayer are reported using Form 8582, *Passive Activity Loss Limitations*. If there are limitations in connection with tax credits associated with the passive activities, Form 8582-CR, *Passive Activity Credit Limitations,* is used.

> **Note.** IRS Pub. 925, *Passive Activity and At-Risk Rules,* provides further guidance and a detailed example with completed forms for the practitioner.

MATERIAL PARTICIPATION

A passive activity is generally any trade or business activity engaged in by the taxpayer in which the taxpayer does **not materially participate.**[5] For purposes of these rules, a **trade or business** activity generally includes:[6]

- An activity considered a trade or business under IRC §162,
- An activity engaged in to start a business, or
- An activity that generates deductible research or experimental expenditures under IRC §174.

The concept of material participation is key to identifying activities as active or passive. Generally, the **nature of the activity** itself is **not** determinative of whether the activity is active or passive. Rather, the determining factor generally is whether the taxpayer's **degree of engagement** or involvement in the activity meets the definition of **material participation.**

However, by definition, **most rental real estate activities are passive,** regardless of the taxpayer's level of participation.[7] Rental real estate activities are discussed later.

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2. IRC §469(j)(1), referencing §465(a)(1)(B), which references the definition under §542(a)(2).
3. IRC §469(j)(2), referencing §269A(b) with modifications.
4. IRC §469(j)(2)(B), referencing §318(a)(2)(C) with modifications.
5. IRC §469(c)(1).
6. Treas. Reg. §1.469-4(b)(1).
7. IRC §469(c)(2).

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There are general rules that apply in order for the taxpayer's participation in an activity to constitute material participation. The conduct of the taxpayer in connection with an activity must be:[8]

1. Regular,
2. Continuous, and
3. Substantial.

This section discusses the various rules that can be used by the taxpayer to establish material participation in an activity.

Not all work or types of involvement in an activity count toward material participation. Under the seventh material participation test (facts and circumstances), the nature of the work or involvement must be the type customarily done by an owner of the activity, and it must have a principal purpose **other** than to meet the material participation test.[9] **Management duties** performed by a taxpayer **do not qualify unless both** of the following items apply.[10]

1. No person other than the taxpayer performs management services for the activity for compensation, and
2. The taxpayer spends more hours engaged in providing management services for the activity than anyone else.

Generally, investor functions do not qualify towards material participation. The **types of investment activities** that do **not** qualify include the following.[11]

- Studying and reviewing financial statements or reports regarding the activity's operations
- Preparing financial analyses or summaries for the taxpayer's own use
- Monitoring the finances or operations of the activity in a manner that is not managerial in nature

However, if the taxpayer is directly involved in the **day-to-day management** of the activity, time spent on such activities **does** qualify towards meeting the material participation test.[12]

> **Observation.** Although the regulatory guidance provides some insight on what type of activites qualify as material participation, there are many types of activities that a taxpayer can engage in that are unclear. Practitioners should review the guidance closely to properly advise clients on whether the nature of a taxpayer's participation in an activity is likely to qualify as material participation. Documentation of material participation is discussed later.

The determination of whether the taxpayer materially participates is made separately for each tax year. However, under certain circumstances, a taxpayer is deemed to have met the material participation standards in the current year based on prior years' activity.

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8. IRC §469(h)(1).
9. Temp. Treas. Reg. §1.469-5T(f)(2)(i).
10. Temp. Treas. Reg. §1.469-5T(b)(2)(ii).
11. Temp. Treas. Reg. §1.469-5T(f)(2)(ii).
12. Ibid.

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SEVEN TESTS FOR MATERIAL PARTICIPATION

The IRS provides **seven tests** under which a taxpayer can meet the material participation requirement **for an activity to be classified as active.**[13] This section discusses these seven tests.

Material Participation Test	Reference
Devoting more than 500 hours to the activity	Temp. Treas. Reg. §1.469-5T(a)(1)
Providing substantially all the participation	Temp. Treas. Reg. §1.469-5T(a)(2)
Devoting 100 hours to the activity	Temp. Treas. Reg. §1.469-5T(a)(3)
Significant participation activities	Temp. Treas. Reg. §1.469-5T(a)(4)
Five years of material participation	Temp. Treas. Reg. §1.469-5T(a)(5)
Three years of personal service activity	Temp. Treas. Reg. §1.469-5T(a)(6)
The facts and circumstances rule	Temp. Treas. Reg. §1.469-5T(a)(7)

These seven tests apply to a taxpayer regardless of **whether the taxpayer wants** to be treated as materially participating.[14] If the taxpayer's level of involvement in an activity meets the requirements of any of the seven tests, the taxpayer is deemed a material participant in that activity. For example, a taxpayer with substantial passive losses may try to categorize a profitable activity as passive in order to deduct passive losses. However, if the taxpayer's level of involvement in the profitable activity meets **even one** of the seven tests, the activity is treated as nonpassive and passive losses are not allowed against its income.

Test 1: Devoting More than 500 Hours to the Activity

A taxpayer is treated as materially participating in an activity if they participate in that activity for more than 500 hours during the tax year. The taxpayer and the taxpayer's spouse may aggregate their activity under these rules to determine whether material participation exists.[15] Such aggregation is permitted without regard to whether the spouse has an ownership interest or whether they file jointly.

Example 1. Martin and Rebecca are partners in a bakery business, Morning Muffins, LLP. Martin and Rebecca are not married. Martin works full-time for the bakery. With the exception of Sundays, when the shop is closed, Martin opens the kitchen at 5:00 a.m., bakes the muffins before 8:00 a.m., and manages the retail storefront each day until closing at 3:00 p.m. Accordingly, Martin works 60 hours per week.

Rebecca is a bookkeeper working full-time for a local accounting firm. She goes to the bakery after work each Thursday from 5:00 p.m. to 7:00 p.m. to complete the necessary bookkeeping and payroll duties. During 2014, each partner documented the following bakery hours.

Partner	Weekly Hours				Hours for 2014
Martin	60	×	52	=	3,120
Rebecca	2	×	52	=	104

In order to be considered a material participant, the taxpayer's activity must be regular, continuous, and substantial. It appears both Martin and Rebecca meet the standard. However, only Martin has devoted more than 500 hours to the bakery.

Martin materially participates because his activity is regular, continuous, and substantial, and he meets the 500-hour requirement (test 1). Rebecca does not meet the test 1 requirement.

13. Temp. Treas. Reg. §1.469-5T(a).

14. Ibid.

15. Temp. Treas. Reg. §1.469-5T(f)(3).

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Example 2. Use the same facts as **Example 1,** except Martin and Rebecca are married. Because a spouse must attribute the other spouse's activity to their own participation, Rebecca is considered a material participant. Martin's 3,120 hours are added to Rebecca's 104. As a result, both Martin and Rebecca meet the 500-hour requirement (test 1). This is true even if Rebecca and Martin file married filing separately (MFS).

Test 2: Providing Substantially All the Participation

This test is met if the taxpayer's participation for the year constitutes **substantially all the participation in that activity.** This includes all individuals involved, even those with no ownership interest.

Example 3. Lola, a lawyer, works full-time for a large law firm. The firm has a large number of construction company clients. Because of the contacts she developed through her casework, she decides to start an equipment leasing company. She buys expensive construction equipment and leases it to local construction companies.

The equipment is typically provided under long-term lease arrangements. During 2014, Lola spends a total of 44 hours executing new lease agreements and making cursory inspections of the equipment. No one assists Lola in these duties.

Arguably, Lola can meet test 2 because her efforts constitute substantially all the participation in the activity. However, she must also satisfy the regular, continuous, and substantial standard. This may be difficult to prove with only 44 hours devoted to the business in 2014.

Caution. Although test 2 may be easy for the taxpayer to meet, it may be the test most vulnerable to counterarguments by the IRS. There is little case law to interpret test 2 or illustrate its application to fact patterns.[16] Definition of the term **substantially all** appears to be largely an open question. Therefore, practitioners should use caution before relying on this test to prove material participation.

Test 3: Devoting 100 Hours to the Activity and Not Less than Any Other Person

The taxpayer is considered to materially participate if the taxpayer's participation exceeds 100 hours for the year and the taxpayer's participation is **not less** than the total hours worked by any other individual, including those without any ownership interest in the activity.[17]

Example 4. Wiley is one of 40 partners in a business that makes commercial start-up loans to new businesses. For the first year of operation, Wiley spends a total of 139 hours on partnership activities.

Wiley's time includes seven hours preparing federal and state tax forms for the operation, 20 hours of travel to the semi-annual partners' meetings, and 36 hours preparing for and attending the partners' meetings. Also included in the 139 hours is Wiley's time spent reviewing loans and related paperwork, reviewing and amending operating budgets, and preparing financial analyses of loan activity.

The partnership has a staff of two full-time loan officers; each works 40 hours per week handling the day-to-day partnership operations and loan administration. This staff oversees loan applications, interviews applicants, visits businesses of applicants, evaluates business ideas and business plans, and issues loan proceeds.

Most of Wiley's time can be characterized as investor activities. This does not qualify as material participation unless Wiley is also involved in the day-to-day operations of the partnership. However, Wiley is **not** involved in the day-to-day operations.

Even if Wiley spends more hours managing the business than any of the 39 other partners, the time spent by the two full-time employees exceeds his. **Therefore, he does not meet the 100-hours test.**

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16. See *Fred Misko et ux. v. Comm'r*, TC Memo 2005-166 (Jul. 6, 2005); *B. Theodore and Wendy Chapin v. Comm'r*, TC Memo 1996-56 (Feb. 14, 1996); and *Tom and Nancy Miller v. Comm'r*, TC Memo 2011-219 (Sep. 8, 2011). None of these cases provides in-depth clarification for the definition of "substantially all" for test 2.

17. Temp. Treas. Reg. §1.469-5T(a)(3).

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Note. In *Serenbetz v. Comm'r*,[18] the taxpayer was one of 40 condominium owners who participated in a partnership that managed renting the condos to outside parties. The taxpayer claimed that he met the 100-hours test because, with 40 properties to manage, none of the full-time staff members spent more time allocated to his condo than he did. The Tax Court was not swayed by this logic nor by the taxpayer's classification of investor-type activities as management duties.

Test 4: Devoting Over 500 Hours to Significant Participation Activities

Taxpayers are allowed to group time spent on significant participation activities (SPAs) in order to meet the material participation rule for the group. An SPA is characterized as follows.

1. The trade or business activity is **not** a rental real estate activity.[19]
2. The taxpayer **participates for more than 100 hours (significant participation)** during the year.[20]
3. The taxpayer would not be considered a material participant under any other rule.[21]

Because the taxpayer does not meet any other material participation rule with respect to an SPA, **SPAs are passive** in nature. However, under this test,[22] if the taxpayer's participation in **all** SPAs exceeds a total of 500 hours for the year, the taxpayer is considered as materially participating in **each** of the activities.

Example 5. Joni is a part-time employee working as a teller at the local bank. Along with several other individuals, she has ownership interests in three other businesses in which she is somewhat active. These are the only businesses in which Joni is involved.

These businesses consist of a shoe store, a small engine-repair shop, and a custom auto-painting shop. Joni does not materially participate in any of these activities under the requirements of any other material participation test. For example, she does not meet test 1, the 500-hour test, for any of the three businesses if each is considered individually.

Joni's co-owners work in these businesses on a full-time basis. Joni does not meet test 2, the **substantially all the participation** test, for any of them. Joni's participation in these activities may not even meet the regular, continuous, and substantial standard. Therefore, the three businesses are passive activities for Joni.

The hours during 2014 that Joni works in the three businesses are shown in the following table. These hours include only those that qualify for purposes of the material participation test.

	Shoe Store	Engine Repair	Auto Painting	Total
Material participation hours for 2014	135	233	142	510

Joni must use the SPA rule and aggregate the hours from those SPAs in which she has more than 100 hours. Because the total number of hours exceeds 500, the income or losses from her activities are grouped. Therefore, Joni is considered to have materially participated in the three businesses. Consequently, the activities **as a group** are treated as **nonpassive.**

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18. *Robert Serenbetz and Karen J. Serenbetz v. Comm'r*, TC Memo 1996-510 (Nov. 18, 1996).
19. Temp. Treas. Reg. §1.469-5T(c)(1)(i).
20. Temp. Treas. Reg. §1.469-5T(c)(2).
21. Temp. Treas. Reg. §1.469-5T(c)(1)(ii).
22. Temp. Treas. Reg. §1.469-5T(a)(4).

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The SPA Trap. Significant participation passive activities (SPPAs) are SPAs that do **not** meet the material participation tests, including the grouping exception. Under special regulatory rules,[23] if the total of the net profit and loss from all SPPAs is a **profit,** that profit is recharacterized as nonpassive. The allocation of the recharacterized amount is done proportionately between the profitable activities.

Example 6. Use the same facts as **Example 5,** except Joni's hours spent in the three activities are as follows. Her share of the income and deductions from each activity are shown in the second table. In addition to these businesses, Joni also owns a number of limited partnership interests in activities in which she does not participate at all. Her share of the limited partnership interest losses in 2014 is $50,000.

	Shoe Store	Engine Repair	Auto Painting	Total
Material participation hours for 2014	103	147	142	392

	Shoe Store	Engine Repair	Auto Painting	Total
Passive gross income	$22,000	$4,000	$12,000	$38,000
Passive deductions	(12,000)	(6,000)	(7,000)	(25,000)
Net passive income	$10,000	($2,000)	$ 5,000	$13,000

Because Joni **did not spend more than 500 hours** on the businesses as a group in 2014, she does **not** meet test 4, the SPA exception for material participation. However, because she spent more than 100 hours on each of them, they are SPPAs.

Because Joni realized a net profit from all her SPPAs combined, the $13,000 total net profit must be recharacterized as nonpassive income. This net profit is then allocated to the profitable activities as follows.

Profitable SPPAs	Shoe Store	Auto Painting	Total
Net passive income	$10,000	$ 5,000	$15,000
	÷ 15,000	÷ 15,000	
Percentage of total	66.67%	33.33%	
Net SPPA profit to allocate	× $13,000	× $13,000	
Income recharacterized as nonpassive	$ 8,667	$ 4,333	

None of the $50,000 in losses from her passive limited partnership interests can be used to offset the income from the SPPAs, because that income is now considered nonpassive.

Test 5: Five Years of Material Participation

If the taxpayer materially participated in the activity for **any five of the last 10 tax years** that immediately precede the tax year for which the material participation determination is being made, the taxpayer is considered a material participant.[24] The five years do not have to be consecutive.

A taxpayer **cannot** count a year as one of the five if the only reason the taxpayer was treated as materially participating in the activity was because they met the 5-year test for previous participation.

> **Observation.** The 5-year test may be used by a business retiree who was previously a material participant in the business and who still receives some income from the business that is now operated by others.

23. Temp. Treas. Reg. §1.469-2T(f).

24. Temp. Treas. Reg. §1.469-5T(a)(5).

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Example 7. Giacomo formerly worked full-time as a partner in a law firm partnership. There are three other partners in the firm. After 30 years of full-time practice, he retired in 2008. He continued to own 25% of the partnership after retirement.

Giacomo worked full-time until July 2008, therefore meeting the 500-hour requirement for that year. His tax advisor told him that he was considered a material participant because in the 10 years prior to 2008, he met the material participation standard in at least five years.

While preparing his 2014 return, his tax advisor notes that 2014 is the final year in which his share of the partnership's profit or loss can be considered nonpassive. This is the last year in which the 10-year period ending with 2013 includes five years of material participation in the business. For 2015 and later years, the partnership income or loss will be considered **passive** unless he meets one of the other material participation tests.

Test 6: Three Years of Personal Service Activity

If the taxpayer was a material participant in a **personal service activity** for **any three** previous tax years, the taxpayer is treated as a material participant for the current year.[25] The three tax years need not be consecutive.

Under this rule, a **personal service activity** involves providing personal services:

- In the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting; or
- In any other trade or business in which capital is **not** a material income-producing factor.

Example 8. Max is a partner with three others in a private investigation firm. The firm's income is generated by rendering personal services provided by the four private investigators who own the firm. The firm is a personal service activity.

Under this rule, a taxpayer with at least three years of material participation in a personal service business must permanently treat any income from that personal service activity as nonpassive.

Example 9. Otto and Franz each work full-time as investment bankers in New York City. They each have an advertising and marketing background. In early 2011, they start a 50/50 partnership to develop creative campaigns on a part-time basis for organic farms in upstate New York.

The partnership's only assets are two laptop computers and some art supplies. All of the income is generated by the creative services of Otto and Franz. Both partners consistently performed these services for the partnership on a part-time basis in 2011, 2012, and 2013, with a total of over 500 hours worked per partner per year.

In late 2013, Otto was promoted to regional vice president of his investment bank. He continues to own a 50% partnership interest in the advertising firm, but Franz now does all the creative work for the partnership. Franz receives guaranteed payments as compensation for his labor. The remaining net profit or loss is allocated 50/50 between Franz and Otto.

For 2014 and all subsequent years, Otto's share of the income or loss from the partnership is considered **nonpassive** because he previously spent three years materially participating in the personal service activities of the partnership.

> **Observation.** In **Example 9,** if Otto has passive losses from other sources, the personal service activity rule prevents him from using those passive losses to offset his share of nonpassive income from the partnership.

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25. Temp. Treas. Reg. §1.469-5T(a)(6).

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Test 7: The Facts and Circumstances Rule

If the individual participates in the activity on a regular, continuous, and substantial basis and the facts and circumstances support the conclusion, the taxpayer is treated as materially participating in the activity.[26] However, regardless of the facts and circumstances, the taxpayer must participate for more than 100 hours in the activity during the year.[27] In addition, purely managerial services performed for the activity are not taken into account unless: [28]

1. No other person (other than the taxpayer) performs such managerial services for compensation, and
2. The taxpayer spends more hours performing the managerial services than anyone else during the year.

DOCUMENTATION AND BURDEN OF PROOF

The taxpayer may establish the extent of participation in an activity by any reasonable means.[29] Accordingly, while contemporaneous journals, time sheets, or logs generally suffice, the extent of participation may be established by other reasonable means. For purposes of this rule, **reasonable means** includes any record identifying the services performed by the taxpayer over a period of time and the approximate number of hours spent performing those services within the activity. An appointment book, narrative summary, or calendar may be used for this purpose.[30]

> **Caution.** Income from passive activities is subject to NIIT.[31] Because the NIIT exclusion is based on the material participation rules, documentation by higher-income taxpayers is essential. Taxpayers who are depending on these rules to claim that an activity is nonpassive and therefore excludable from net investment income (NII) may face additional IRS scrutiny.

In Tax Court or other court proceedings, an initial determination by the IRS is presumed correct and the taxpayer has the burden of proving the IRS wrong.[32] Accordingly, the taxpayer generally has the burden of proof in establishing their material participation in an activity for the period subject to litigation. The taxpayer may be able to shift the burden of proof to the IRS if the taxpayer meets the requirements of IRC §7491(a).[33] Generally, under this Code section, the taxpayer can shift the burden of proof regarding any factual issue if the taxpayer meets **all** of the following requirements.[34]

1. The taxpayer provides credible evidence on the factual issue or issues relevant to determining the tax liability that is being disputed.
2. The taxpayer complies with any substantiation requirements under the Code.
3. The taxpayer maintains the records required under the Code.
4. The taxpayer cooperates with reasonable IRS requests for information, documents, meetings, interviews, and witnesses.

Accordingly, keeping and maintaining appropriate records regarding each activity's operations and properly recording and maintaining records regarding participation in each activity places the taxpayer in a much stronger position to shift the burden of proof to the IRS.

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26. Temp. Treas. Reg. §1.469-5T(a)(7).
27. Temp. Treas. Reg. §1.469-5T(b)(2)(iii).
28. Temp. Treas. Reg. §1.469-5T(b)(2)(ii).
29. Temp. Treas. Reg. §1.469-5T(f)(4) .
30. Ibid.
31. IRC §1411(c)(2)(A).
32. *Thomas H. Welch v. Comm'r,* 290 U.S. 111 (Nov. 6, 1933).
33. See *Delbert L. and Margaret J. Baker v. Comm'r*, 122 TC 143 (Feb. 19, 2004).
34. IRC §7491(a).

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RULES FOR SELECTED PASSIVE ACTIVITIES

Certain types of passive activities have special rules. This section covers some of these areas.

RENTAL ACTIVITIES

Generally, any **rental activity is considered passive** even when the taxpayer materially participates in that activity.[35] There are special rules for certain real estate rental activities.

An activity is a rental activity if:[36]

- During the tax year, tangible property held in the activity is used by customers or held for use by customers; and
- The income from the activity is from amounts paid by customers in exchange for the use of the tangible property.

However, there are several exceptions to this definition. If any of these exceptions apply to a taxpayer's rental activity, the activity is **not automatically** considered a passive rental activity. Instead, the activity is regarded as a trade or business for income tax purposes. If the taxpayer can **prove material participation** in that trade or business, its income and losses are considered active instead of passive.[37] The exceptions are as follows.[38]

1. The average period of the property's customer use is seven days or less.
2. The average period of the property's customer use is 30 days or less, and significant personal services are provided by or on behalf of the owner.
3. Extraordinary personal services are provided by or on behalf of the owner (without regard to any duration of customer use).
4. The property's rental is incidental to a nonrental activity.
5. The property is customarily made available during established business hours for the nonexclusive use of customers.
6. The taxpayer provides the property for use in an activity that is conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

> **Caution.** If a rental property meets one of these exceptions, the activity is also excluded from the definition of rental real estate under IRC §469(i). This provision provides a $25,000 special deduction allowance for qualifying rental real estate losses (discussed later). In particular, this often negatively affects taxpayers who own vacation rental property that is rented for **seven days or less** on average. In that case, exception 1 applies.

35. IRC §469(c)(2).
36. Temp. Treas. Reg. §1.469-1T(e)(3)(i).
37. *Aris Valdis Jende and Marilyn Jane Jende v. Comm'r,* TC Summ. Op. 2011-82 (Jul. 6, 2011).
38. Temp. Treas. Reg. §1.469-1T(e)(3)(ii).

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REAL ESTATE PROFESSIONALS

There are special rules for real estate professionals. Rental real estate activities for these taxpayers are not automatically classified as passive. If a real estate professional **materially participates in the rental activities,** the real estate professional may treat losses as active instead of passive.

A real estate professional is a taxpayer who meets **all of** the following qualifications.

1. The taxpayer owns **at least one interest in rental real estate.**[39]
2. **More than half of the personal services** the taxpayer performs in trades or businesses during the year are performed in real property trades or businesses in which the taxpayer **materially participates.**[40]
3. The taxpayer performs **more than 750 hours of service** during the tax year in real property trades or businesses in which the taxpayer **materially participates.**[41]

For purposes of qualification 1, any rental real estate that the taxpayer has grouped with a nonrental real estate trade or business activity does not constitute an interest in real estate unless the trade or business activity is insubstantial in relation to the rental real estate activity.[42]

A **real property trade or business** includes the following types of activities associated with the real property.[43]

- Development or redevelopment
- Construction or reconstruction
- Acquisition
- Conversion
- Rental, operation, or management
- Leasing
- Brokerage

A real estate professional may perform personal services in a real estate trade or business as an employee. Such service is not treated as personal services performed in that activity unless the taxpayer is at least a 5% owner of the employer.[44] If the real estate professional is a 5% owner for only part of the tax year, then only the personal services for that part of the year qualify as being performed in the real estate trade or business.[45]

It is important to note that the Tax Court has held[46] that the 750-hour requirement is not met by merely being on call. The Code[47] and underlying regulations[48] require that the taxpayer actually **perform** services that count toward the 750-hour requirement.

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39. Treas. Reg. §1.469-9(b)(6).
40. IRC §469(c)(7)(B)(i).
41. IRC §469(c)(7)(B)(ii).
42. Treas. Reg. §1.469-9(b)(3).
43. IRC §469(c)(7)(C).
44. IRC §469(c)(7)(D)(ii).
45. Treas. Reg. §1.469-9(c)(5).
46. *James F. and Lynn M. Moss v. Comm'r*, 135 TC 18 (Sep. 20, 2010).
47. IRC §469(c)(7)(B).
48. Treas. Reg. §1.469-9(b)(4).

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For married filing jointly (MFJ) taxpayers, the real estate professional requirements are considered met if either spouse separately satisfies the requirements.[49] However, for a real estate professional filing an MFS return, all the requirements must be separately satisfied.[50] In this regard, the requirements to be classified as a real estate professional are different than the requirements to determine material participation in the activity. A taxpayer filing MFS can use the time worked by the spouse as qualifying for material participation[51] even though they cannot use that same amount of time to qualify as a real estate professional.

Grouping Election for Real Estate Professionals[52]

Each real estate interest is regarded as a separate activity unless the real estate professional makes an election to treat all real estate interests as a single activity.[53] This election is made by filing a statement with the real estate professional's original income tax return. The statement must contain an indication that the real estate professional is making an election under IRC §469(c)(7)(A). The election may be revoked only if there is a material change in the real estate professional's circumstances.

> **Caution.** Without the grouping election, the taxpayer seeking real estate professional status must meet all three of the preceding professional status qualifications for **each** property. Grouping the properties together, which allows the taxpayer to treat **all** the properties as **one property,** eliminates this potentially onerous requirement. This can make the grouping election extremely important for the taxpayer seeking real estate professional status. Chief Counsel Advice Memorandum 201427016 issued April 28, 2014 appears to suggest real estate professionals may not need to meet professional status qualifications for each property.

> **Note.** For further information on this election, see Treas. Reg. §1.469-9(g). For further guidance on the limitations on which types of activities may be grouped, see Treas. Reg. §1.469-9(e)(3)(i).

In certain circumstances, a real estate professional may make **a late election to group rental activities** without the need to apply for a letter ruling. More information can be found in Rev. Proc. 2011-34. Real estate professionals who are not eligible under this revenue procedure may request permission to make a late election by requesting a letter ruling.

SPECIAL $25,000 ALLOWANCE

An individual taxpayer (or the taxpayer's estate for tax years ending less than two years after the taxpayer's date of death) may be able to deduct up to $25,000 of passive rental real estate losses against active income if certain qualifications are met.

Generally, in order to qualify, the taxpayer must be an active participant in one or more rental real estate activities from which the passive loss arises. **Active participation** does not require as high a level of involvement in the activity as material participation. The active-participation requirement may be met without the regular, continuous, and substantial involvement by the taxpayer that is necessary for material participation. However, active participation **does** require the taxpayer to participate in management decisions or arrange for others to provide necessary services such as repairs.[54] Activity that qualifies for active participation includes directly making the following types of decisions.

1. Approving new tenants
2. Deciding on rental terms
3. Approval of repair and capital expenditures

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49. IRC §469(c)(7)(B).
50. *Julie A. Oderio v. Comm'r,* TC Memo 2014-39 (Mar. 10, 2014).
51. Treas. Reg. §1.469-9(c)(4).
52. CCM 201427016 (Jul. 3, 2014).
53. IRC §469(c)(7)(A).
54. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, P.L. 99-514 (1986).

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Example 10. Marvin owns two apartment buildings that he rents to various tenants. He determines the rental rates for each unit, administers, and renegotiates mortgage financing arrangements on the buildings with the local bank. He also regularly inspects the buildings and decides what periodic maintenance and repairs are required.

He has a local realtor locate and interview prospective tenants, and he has local plumbers, roofers, painters, and other contractors perform the necessary repairs and maintenance. His level of involvement constitutes active participation. The delegation of the duties by him to the realtor and contractors does not constitute a significant delegation of management functions that would disqualify him from meeting the active-participation requirement. Therefore, Marvin meets the active participant requirement.

Example 11. Logan owns three rental residences. His activity for the year involves a monthly review of rental income. He also decides whether to renew the existing contract every six months with the current property management company that handles the day-to-day operations of the rental residences, such as approving tenants, setting the rental rates for the homes according to rates that are competitive in the local residential real estate market, and overseeing repairs. **Logan's participation is not sufficient to meet the active-participation requirement.**[55]

Services performed by a taxpayer's spouse are attributed to the taxpayer under the active-participation rule.[56] In addition to participation requirements, the taxpayer (along with the taxpayer's spouse) must own at least a 10% interest in the value of all ownership interests in the activity.[57]

> **Note.** The taxpayer may use the grouping rule to group two or more real estate activities together in order to meet the 10% ownership test.[58]

Special rules apply for calculating and using the $25,000 special allowance. These rules are as follows.[59]

1. The net income and losses from all of the taxpayer's active-participation rental real estate are aggregated to determine whether there is a net loss.
2. If there is a net loss from the active-participation rental real estate activities, that loss is netted against any net passive income for the year from other sources **before** using the special allowance. The $25,000 allowance only applies if the taxpayer does not have sufficient net passive income from other sources to absorb the rental real estate losses.
3. Loss amounts in excess of the $25,000 special allowance, if any, for the year are included in the suspended losses that the taxpayer may carry forward to subsequent years.
4. The $25,000 special allowance includes both the losses from active-participation rental real estate activities and any special tax credits that the taxpayer may qualify for related to real estate interests.[60]

> **Note.** The credits that may be included in the calculations when determining the amount of the $25,000 special allowance that the taxpayer is entitled to claim include the low-income housing credit and the rehabilitation credit. These credits that form part of the special allowance may be used by the taxpayer **whether or not** the taxpayer meets the active-participation requirement for the property to which the credits apply.[61]

55. See *James R. and Anita Madler v. Comm'r,* TC Memo 1998-112 (Mar. 18, 1998).
56. IRC §469(i)(6)(D).
57. IRC §469(i)(6)(A).
58. IRS Pub. 925, *Passive Activity and At-Risk Rules.*
59. IRC §469(i); and IRS Pub. 925, *Passive Activity and At-Risk Rules.*
60. IRC §469(i)(1).
61. IRC §469(i)(6)(B).

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Special Allowance Qualifications

Generally, deductions for losses from passive activities are limited to income from passive activities. However, most taxpayers who **actively participate** in rental real estate activities may deduct up to $25,000 of related passive losses against other types of income.[62]

Not all rental activities qualify for the special allowance. To qualify, **one** of the following two tests must be met.

1. The property must be rented for **more than seven days per customer on average during the year.**
2. The taxpayer must **materially participate** in operating the rental activity.

If the taxpayer does **not** meet at least **one** of these tests, deductible losses are limited to the amount of income from other passive activities.[63]

For the **average rental test,** the average period of customer use is calculated by dividing the total number of days in all periods of customer use during the year by the number of periods of customer use. Each period during which a customer has a continuous or recurring right to use the property is a separate period of customer use.

Example 12. Gomer earns $66,000 per year as a First Sergeant with the U.S. Marines. While on leave in Florida in December 2013, he bought a beach house. It will be a perfect place for him to live when he retires. In the meantime, he hired a local management company to oversee the property. He knows that the rental income will not be sufficient to cover the costs of owning the property, but he expects the value to increase substantially. He also expects substantial tax savings from deducting the operating losses.

In 2014, the beach house is rented to the following people.

Renter	Dates	Number of Days
Vince	February 13–26	14
Duke	May 25–31	7
Chuck	July 2–5	4
Duke	November 11–13	3
Total rental periods	4	28

Vince spends five days at Disney World during the period he rents the property. Although he does not use the beach house at all during those five days, they count as rental days because he paid for the right to use the property during that time. Duke's rentals count as two separate periods because the dates are not consecutive.

Gomer does not stay at the beach house in 2014. He spends about 60 hours total during the year paying bills and corresponding with the management company. His mortgage interest, real estate taxes, management fees, insurance, repairs, and depreciation **exceed** his 2014 rental income by $10,000. He has no other sources of income in 2014 except his Marine wages.

Gomer fails both qualifying tests for the special allowance. His average rental period per customer is only seven days (28 days ÷ 4 rental periods), and he does not materially participate in the operation of the rental activity. Therefore, he does not qualify for the $25,000 special allowance. **Gomer's $10,000 loss for 2014 is suspended until a future year** when he has sufficient passive income to absorb the loss.

Observation. If the property was rented for **more than seven days** on average per customer, he would qualify for the $25,000 special allowance for rental real estate activities. This is true even though he failed the material participation test.

Conversely, he would also qualify if he **materially participated** in the rental activity even though the property was rented for an average of only seven days per customer.

62. IRC §469(i).

63. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

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Note. In *Charles M. Akers, Jr. v. Comm'r,*[64] the Tax Court found that the taxpayer did not meet either test. The court also concluded that, based on the taxpayer's personal use of the property, the property was a personal residence and disallowed all the rental expenses reported on Schedule E, *Supplemental Income and Loss*.

Income Phaseout Rule

The $25,000 special allowance is also subject to an income phaseout rule that may negatively affect higher-income taxpayers. The maximum $25,000 allowance is reduced by half of the amount by which the taxpayer's AGI exceeds $100,000.[65]

Note. Although the maximum amount of the special allowance is usually $25,000, that amount is reduced to $12,500 for an MFS filer who lives apart from their spouse for the full tax year.[66] The phaseout begins when the MFS filer's AGI exceeds $50,000. In addition, for an MFS filer who lives with their spouse during **any part of the year,** the special allowance is zero.

For purposes of the income phaseout rule, adjusted gross income (AGI) is calculated **without** regard to the following items.[67]

- Deductible individual retirement account (IRA) contributions
- Taxable social security benefits
- Excludable adoption assistance payments
- Deductible interest on student loans
- Deductible higher education expenses
- The domestic production activities deduction
- Excludable U.S. savings bond interest used to pay higher-education expenses
- Any passive activity income or loss included on Form 8582
- Allowable rental real estate loss of qualified real estate professional

Note. This $25,000 special allowance applies only to individual taxpayers[68] and, to a limited extent, estates.[69] An estate qualifies for its tax years ending less than two years after the decedent's date of death if it holds an interest in which the decedent actively participated.

If the surviving spouse of the decedent is also deducting rental losses, the estate's $25,000 limit is reduced by the amount allowable to the surviving spouse. The amount allowable is determined without regard to the income phaseout rules for this purpose. The spouse's tax year that is used to determine the reduction amount is the one ending with or within the estate's tax year.[70]

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64. *Charles M. Akers, Jr. v. Comm'r,* TC Memo 2010-85 (Apr. 21, 2010).
65. IRC §469(i)(3).
66. IRC §469(i)(5).
67. IRC §469(i)(3)(F); and Treas. Reg. §1.469-9(j).
68. IRC §469(i)(1).
69. IRC §469(i)(4)(A).
70. IRC §469(i)(4)(B).

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LIMITED PARTNERS

A partnership interest is a **limited partnership interest** if either of the following applies.[71]

- The partnership agreement or certificate designates the interest as a limited partnership interest (without regard to how state law limits the limited partner's actual liability).
- The limited partner's liability is limited under state law by a determinable fixed amount.

> **Note.** In these two factors, the term **state law** refers to the state statute under which the limited partnership interest is created (usually the state's limited partnership statute).

Generally, income from a limited partnership interest is viewed as passive.[72] However, a limited partner may establish material participation in the limited partnership activity by meeting any of the following **three tests.** The other tests to qualify for material participation do not apply to limited partnerships.[73]

Material Participation Test	Reference
1. Devoting more than 500 hours to the activity	Temp. Treas. Reg. §1.469-5T(a)(1)
2. Five years of material participation	Temp. Treas. Reg. §1.469-5T(a)(5)
3. Personal service activity	Temp. Treas. Reg. §1.469-5T(a)(6)

If the taxpayer owns a limited partnership interest **indirectly** through another entity, the taxpayer is still considered to own the limited partnership interest **directly.**[74] Accordingly, if a taxpayer is an owner in a general partnership or an S corporation and the entity owns the limited partnership interest, the taxpayer is treated as the direct owner of the limited partnership interest for application of the passive activity rules.

The current IRS guidance pre-dates the creation of other types of limited liability entities, such as LLCs and limited liability partnerships (LLPs). The IRS drafted **proposed regulations** that address these new types of entities. These regulations[75] would change the definition of a limited partner. Generally, under these proposed regulations, an interest in a partnership, LLC, LLP, or other entity is treated as a **limited partnership interest** if **both** of the following items apply.

1. The entity is classified as a partnership under the check-the-box election[76] used to classify an entity for federal tax purposes.
2. The owner of the interest in the entity does not have rights to manage the entity at any time during its tax year under state law and the governing agreement for the entity.

> **Note.** For further details on these proposed regulations, see Prop. Treas. Reg. §1.469-5(e). These proposed regulations were issued November 28, 2011.

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71. Temp. Treas. Reg. §1.469-5T(e)(3).
72. Temp. Treas. Reg. §1.469-5T(e)(1).
73. Temp. Treas. Reg. §1.469-5T(e)(2).
74. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, PL 99-514 (1986).
75. Prop. Treas. Reg. §1.469-5(e)(3)(i).
76. See Treas. Reg. §301.7701-3.

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General and Limited Partnership Interests Held Simultaneously

A taxpayer's interest in a partnership is not considered a limited partnership interest for the year if the taxpayer is a general partner in the partnership at **all** times during the year. If the limited partnership interest was only owned for part of the year, the taxpayer must have also been a general partner during the entire time that they owned the limited partnership interest, both directly and indirectly.[77]

This rule is sometimes referred to as the **general partner exception** to the limited partnership rule. According to the Tax Court, this general partner exception applies to interests in LLPs and LLCs.[78] Because the Tax Court decided that LLP partners and LLC members should be treated as general partners under the IRS rules, such taxpayers can establish material participation under any of the seven material participation tests (rather than be limited to the three tests available to limited partners). Three subsequent cases have followed the Tax Court's approach in this application of the general partner exception.[79]

TRUSTS AND ESTATES

A trust may distribute or retain income based on the trust document. A trust that distributes all income is not affected by passive losses and NII. These issues are the beneficiary's responsibility. A trust that retains income may be subject to the new higher tax rate, capital gains tax, and the NIIT.

For a **grantor trust,** the trust's level of participation is determined by the activity of the grantor. If the grantor meets the tests for material participation in the activity, so does the trust.[80]

For **estates and other types of trusts**, material participation exists if the fiduciary, in the capacity of fiduciary, materially participates in the activity in which the estate or trust is involved.[81] The IRS has interpreted this provision narrowly. Therefore, few fiduciaries can meet one of the material participation tests.[82]

In *Frank Aragona Trust v. Comm'r*,[83] the Tax Court recently ruled that the participation of trustees **and** employees could be considered when determining whether the trust met one of the material participation tests. The trust in this case had trustees who served as employees of an LLC that was wholly-owned by the trust. The LLC managed the trust's rental properties. The trust also had trustees who served as employees of other entities in which the trust owned a greater percentage ownership than the trustees owned.

In this case, the court ruled that a trust can qualify as a real estate professional. The IRS had argued that **only an individual** may perform the personal services necessary to meet the requirements to be considered a real estate professional under the Code. Despite the IRS's use of the word **individual** in the regulations,[84] the Tax Court rejected the IRS's argument. The court noted that if Congress wanted to limit the exception to individuals, the term **natural person** would have been used (as it was for the $25,000 special allowance that applies to individuals only).

> **Observation.** When the regulations on material participation were issued in 1988, space was reserved for further guidance for trusts and estates.[85] However, additional guidance was never issued. The absence of clear guidance in this area may lead to additional judicial expansion of these rules.

77. Temp. Treas. Reg. §1.469-5T(e)(3)(ii).

78. *Paul D. and Alicia Garnett v. Comm'r,* 132 TC 19 (Jun. 30, 2009).

79. *Lee E. and Kathy H. Newell v. Comm'r,* TC Memo 2010-23 (Feb. 16, 2010); *Stephen A. and Kristina K. Gregg v. U.S.,* 186 F.Supp.2d 1123 (D.C. OR., Nov. 29, 2000); and *James R. Thompson v. U.S.*, 87 Fed.Cl. 728, *acq. in result* (Jul. 20, 2009).

80. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, PL 99-514 (1986).

81. Ibid.

82. See *The Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (Apr. 11, 2003). See also Ltr. Rul. 201020104 (Apr. 7, 2010).

83. *Frank Aragona Trust v. Comm'r*, 142 TC 9 (Mar. 27, 2014).

84. See Treas. Reg.§1.469-9(b)(4).

85. Temp. Treas. Reg. §1.469-5T(g).

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OIL AND GAS PROPERTY

An oil or gas activity **may** be considered active even if the taxpayer does not meet any of the material participation tests. Generally, a **working interest** in an oil or gas activity **is considered active** as long as the taxpayer owns that working interest either:[86]

- Directly, or
- Indirectly through an **entity that does not limit the owner's liability** in connection with the drilling or operation of the well.

For purposes of this rule, the following forms of ownership **limit** liability.[87]

- A limited partnership interest
- Corporate stock
- An interest in any entity for which state law limits the liability of the taxpayer for the entity's obligations to a fixed amount (such as the amount of capital contributed)

However, the following items (or any combination of these items or similar types of items) **do not limit** liability for purposes of this rule.[88]

- Indemnification agreements
- Stop-loss arrangements
- Insurance

A **working interest** is defined in the regulations as "a working or operating mineral interest in any tract or parcel of land (within the meaning of Treas. Reg. §1.612-4(a))."[89] Working interest is generally understood to mean an ownership interest in the **operations** of an oil well or mineral mine (including exploration and development). Such operations are typically done by a taxpayer specializing in such ventures. The taxpayer does not usually own the land being drilled or mined. The landowners only qualify for this exception to the material participation tests if they also own an interest in the entity operating the well or mine.

Example 13. Bob is a civil engineer who earns a salary of $220,000 annually. He is a single filer without any passive income. In late 2013, Bob's tax advisor, Vinny, suggested that Bob invest in a natural gas exploration partnership to give him losses to offset his high salary.

In 2014, Bob purchases a 15% **general partner** interest in Mooncrater Natural Gas Production LP (Mooncrater). Despite the fact that he does not participate in the operations of the partnership, his share of the 2014 loss is not subject to the passive activity limitations. **He is allowed to deduct his $22,000 partnership loss against his salary.**

Example 14. Use the same facts as **Example 13,** except Bob acquires a 15% interest as a **limited partner** in Mooncrater. As a limited partner, Bob's investment does **not** qualify for the exception to the passive activity limitations.

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86. Temp. Treas. Reg. §1.469-1T(e)(4)(i).
87. Temp. Treas. Reg. §1.469-1T(e)(4)(v)(A).
88. Temp. Treas. Reg. §1.469-1T(e)(4)(v)(B).
89. Treas. Reg. §1.469-1(e)(4)(iv).

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Example 15. Use the same facts as **Example 13.** In addition to Bob's general partnership interest, Bob and the other partners in Mooncrater sign an indemnification agreement that limits the liability of certain general partners, including Bob, from liability beyond the amount originally invested in the partnership. Bob's general partnership interest loss is a **nonpassive loss** that he can use against his salary. The indemnification agreement is not a sufficient means of limiting liability in order to characterize Bob's Mooncrater investment as a passive activity.

Note. Another tax benefit available to investors in oil and mineral operations is that they may elect to either deduct or capitalize expenses for **intangible drilling and development costs.**[90] The rules regarding this election are complex. For further details, see IRC §612 and the underlying regulations.

LIMITATIONS ON PASSIVE ACTIVITY LOSSES

Generally, PAL amounts and the PAL limitation for the taxpayer are reported using Form 8582. A PAL generally may not be deducted by the taxpayer in the year in which it occurs. Instead, that PAL is **suspended** and **carried forward** for possible deduction in later tax years.[91] The carryforward period is indefinite.[92] Generally, the PAL may only be deducted to the extent of passive income and cannot be used as a deduction against income from other nonpassive sources, such as wages, portfolio income, or income from an active trade or business.

Note. A suspended PAL may never be carried **back,** and is never used in computing a net operating loss (NOL).[93]

Note. The concept of material participation is central to the determination of whether an activity is passive. Understanding the definition of rental activity is also essential. These terms were discussed eaarlier.

A PAL exists when deductions from the passive activity exceed its income.[94] For taxpayers with multiple passive activities, total income from **all** passive activities is netted against total deductions from **all** passive activities to determine the taxpayer's current year PAL.[95]

Example 16. Riccardo is a full-time registered nurse at the local hospital. He acquired a partnership interest in a tavern in January 2011. Because Riccardo does not materially participate in the tavern business, it is a passive activity. This is his only passive activity.

Riccardo received a 2011 Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* reporting his share of the partnership loss as $15,000. Riccardo could not deduct this loss in 2011 because it is a PAL and he had no 2011 passive activity income to offset it. The $15,000 loss was suspended and carried forward to 2012.

In 2012, Riccardo's partnership interest generated a $10,000 profit. For 2012, Riccardo used $10,000 of the $15,000 PAL from 2011 to fully offset his 2012 partnership income. The $5,000 remainder of his 2011 suspended PAL carried forward to 2013.

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90. Treas. Reg. §1.612-4(a).
91. IRC §469(b).
92. Ibid.
93. Ibid.
94. IRC §469(d)(1).
95. Ibid.

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Example 17. Use the same facts as **Example 16,** except in 2011, in addition to his tavern partnership interest, Riccardo owned a passive interest in a bicycle shop.

The bicycle shop is an S corporation. Riccardo's share of the 2011 S corporation's net profit was $20,000.

On his 2011 return, Riccardo's passive S corporation income of $20,000 was partially offset by the $15,000 passive loss from the tavern partnership. Riccardo reported net passive income of $5,000 on his 2011 return. He had no suspended 2011 PAL to carry forward to 2012.

Note. Riccardo must also have sufficient basis and amounts at risk in order to deduct the partnership loss.

A taxpayer may be eligible for tax credits for certain qualifying passive activities. Such credits include the following.

- The low-income housing credit for qualified low-income housing projects[96]
- The rehabilitation investment credit for certain rehabilitation expenses on qualifying properties[97]

Note. For further details on the low-income housing credit, see IRC §42. For further information on the rehabilitation credit, see IRC §47.

Generally, passive activity credits are limited to the tax liability associated with passive activity income. Unused credits are suspended and carried forward to subsequent years to offset future tax liability related to passive income.

DISPOSITION OF THE PASSIVE ACTIVITY

When the taxpayer disposes of the **entire** passive activity **in a fully taxable transaction** with an unrelated party, any suspended PALs **associated with that activity** are allowed in full.[98] The previously suspended PALs may be used against any type of nonpassive income received in the year.

Disposition of a passive activity does **not** release suspended passive activity **credits.** However, any credit that decreased the taxpayer's basis in the activity's property may be used instead to increase the property's basis immediately before the disposition if the taxpayer elects to do so.[99]

Transactions that constitute a **fully taxable transaction** include the following.

- Sale of the taxpayer's interest to an unrelated party
- Abandonment of the passive activity property[100]
- A casualty or theft loss (but only if **all** the property used or created in the activity is lost)[101]

Caution. Because disposition releases only the suspended PALs arising from that activity, it is necessary to track the history of each passive activity separately.

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96. IRC §42(a).
97. IRC §47.
98. IRC §469(g)(1).
99. IRC §469(j)(9).
100. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, PL 99-514 (1986).
101. IRS Notice 90-21, 1990-1 CB 332.

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Transactions that **do not** qualify as a fully taxable transaction include the following.[102]

- A like-kind exchange under IRC §1031
- Conversion of the passive activity's property to personal use
- Change in the nature of the passive activity (such as changing the activity from construction to rental)[103]
- Gifting of the passive activity's property to another taxpayer or entity
- Transfer of the passive activity's property to the taxpayer's corporation, partnership, or LLC
- Transfer of the passive activity's interest or property incident to divorce

After the disposition of an entire passive activity interest in a fully taxable transaction, any suspended loss from the activity can be used in the year of disposition to offset reported income in the following order.

1. Recognized gain on the disposition of the passive activity
2. Other passive income of the taxpayer
3. Any other income of the taxpayer (e.g., wages, interest income, retirement income, etc.)

Observation. The IRS Passive Activity Loss Audit Technique Guide states that there is currently no guidance in connection with the use of suspended losses upon disposition of a passive activity interest other than IRC §469(g) and legislative history. Treas. Reg. §1.469-6 was reserved for the purpose of providing such guidance, but remains undrafted.

Installment Sales

An installment sale of an entire interest in a passive activity does not qualify as a fully taxable transaction. The amount of suspended losses that are deductible during the period of the installment sale is computed using a fraction. The numerator of the fraction is the amount of the installment sale gain recognized in the current tax year. The denominator is the total amount of the realized installment sale minus all gains recognized in prior tax years.

Note. See pages 11–12 of the 2013 IRS Pub. 925*, Passive Activity and At-Risk Rule*s, for an example of an installment sale and how it permits the deduction of suspended losses.

Note. In the case of a like-kind exchange, if all gain is deferred, any suspended losses remain suspended until the replacement property is entirely disposed of in a taxable transaction.

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102. IRS Passive Activity Loss Audit Technique Guide, Chapter 5, Dispositions Exhibit 5.2. Mar. 4, 2014. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-5-Dispositions#_ftn2]. Accessed on May 28, 2014.

103. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, PL 99-514 (1986).

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Partial Disposition

If the taxpayer makes a partial disposition of a passive activity instead of an entire disposition, the taxpayer may be entitled to treat the portion of the activity disposed of as a separate activity, but only if all of the following requirements are met.[104]

- The taxpayer has disposed of substantially all of the activity.
- The taxpayer can establish the amount of allocable deductions and credits carried forward that pertain to the partial disposition.
- The taxpayer can establish the allocable amount of gross income, deductions, and credits that pertain to the partial disposition in the tax year of the disposal.

> **Note.** Special rules regarding partial dispositions apply to real estate professionals who have grouped rental real estate activities. See Treas. Reg. §1.469-9 for more information.

CHANGE FROM PASSIVE TO ACTIVE

When a formerly passive activity becomes active, previously suspended losses **remain suspended** and continue to be treated as PALs. However, these PAL amounts (plus suspended credit amounts, if any) are allowed against income from the activity **after** it becomes active.[105] The taxpayer must establish that the present activity is the same activity that was previously passive.

In this situation, the suspended PAL is allowed because it is likely that the taxpayer would have benefitted from the suspended PAL amounts had the activity continued to be passive. Congress deemed that it would be unfair to deny the benefit of these PAL amounts to a taxpayer just because they began to materially participate in the activity.[106]

ALLOCATION FOR MULTIPLE PASSIVE ACTIVITIES

When a taxpayer has multiple passive activities, it is necessary to allocate the PALs to each activity. If one or more passive activities generate income that is offset by the activities generating losses, it is necessary to determine how much of the loss is from each activity. It is important that this allocation is done each year so that the carryforward amount is correct when an activity is disposed of or when the activity is converted from passive to active.

The allocation procedure generally is done using the following two steps.

1. A ratable portion of the total disallowed PAL for the year is allocated between those passive activities that generated a passive loss to the taxpayer for the year.[107]
2. The ratable portion of each PAL is then allocated to each of that activity's deductions. However, the taxpayer must only separately account for the disallowed deductions if such a separate accounting will affect tax liability.[108] Generally, the deductions that must be accounted for separately include the following.
   - Rental real estate activity deductions
   - Deductions relating to capital losses, losses on the sale or exchange of property used in a trade or business, and involuntary conversions

> **Note.** For further details on the deductions that must be accounted for separately, see Temp. Treas. Reg. §1.469-1T(f)(2)(iii). Special rules apply for the allocation of losses between significant participation activities (discussed earlier in the chapter) under Temp. Treas. Reg. §1.469-1T(f)(2)(i)(C).

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104. Treas. Reg. §1.469-4(g).
105. IRC §469(f).
106. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, PL 99-514 (1986).
107. Temp. Treas. Reg. §1.469-1T(f)(2)(i).
108. Temp. Treas. Reg. §1.469-1T(f)(2)(iii).

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Example 18. In 2014, Mariella owns an interest in three passive activities. None of the activites have deductions that must be accounted for separately. The income and deductions for the three passive activities are as follows.

	Bakery	Bookstore	Barbershop
Gross income	$22,000	$18,000	$19,000
Deductions	(28,000)	(34,000)	(15,000)
Net income/(loss)	($ 6,000)	($16,000)	$ 4,000

Mariella's 2014 PAL is calculated by aggregating her total net income and losses from all three of her passive activities. Her 2014 PAL is calculated as follows.

Activities with losses:		
Bakery	($ 6,000)	
Bookstore	(16,000)	
Aggregate PALs	($22,000)	($22,000)
Activities with profits:		
Barbershop	$ 4,000	
Aggregate passive activity profits	$ 4,000	4,000
2014 PAL		($18,000)

Mariella's 2014 PAL is $18,000. She cannot deduct this loss in 2014; it is suspended and carries forward to 2015.

Mariella must determine the amount of PAL attributable to each of the two passive activities that generated a net loss for the year (the bakery and the bookstore). This is calculated for each passive activity using the following formula.

$$\textbf{Individual PAL} = \textbf{Total PAL disallowed for year} \times \frac{\textbf{Loss for individual passive activity}}{\textbf{Total losses for all passive activities}}$$

The amount of PAL attributable to the bakery is calculated as follows.

$$\textbf{Bakery PAL} = \$18{,}000 \times \frac{\$6{,}000}{\$22{,}000}$$

$$= \$4{,}909$$

The amount of PAL attributable to the bookstore is calculated as follows.

$$\textbf{Bookstore PAL} = \$18{,}000 \times \frac{\$16{,}000}{\$22{,}000}$$

$$= \$13{,}091$$

The allocation of Mariella's 2014 PAL of $18,000 is summarized as follows.

PAL allocable to bakery activity	$ 4,909
PAL allocable to bookstore activity	13,091
Total 2014 PAL	$18,000

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GROUPING PASSIVE ACTIVITIES

GROUPING RULES

Two or more activities may be grouped together and treated as one single activity.[109] However, any grouped activities must form an **appropriate economic unit.** Whether activities form an appropriate economic unit is based on all the facts and circumstances. A taxpayer can use any reasonable method to determine whether grouped activities form an appropriate economic unit. However, factors given the greatest weight in making this determination are as follows.[110] These factors are not all-inclusive, and not all factors are considered in every grouping.

- Similarities and differences in types of trades or businesses
- Extent of any common control over the activities
- Extent of any common ownership of the activities
- Geographical location of the activities
- Degree of interdependency between the activities (including purchasing or selling goods, provision of products or services that are complimentary, existence of common customers or employees, and use of a single set of records for accounting)

If the taxpayer has two or more activities that form an appropriate economic unit and they elect to group them, all their grouped activities are treated as **a single activity** for material participation purposes. **Without grouping, the taxpayer would need to establish material participation separately for each individual activity.**

Prohibited Groupings

The regulations expressly prohibit certain groupings.[111] Several examples follow.

- Rental activities cannot be grouped with other trade or business activities unless the activities constitute an appropriate economic unit.
- Real property rentals cannot be grouped with personal property rentals.
- Activities conducted as a limited partner or limited entrepreneur cannot be grouped with other activities that are not the same type of business.

GROUPING PROS AND CONS

There are various benefits and drawbacks to grouping passive activities.

Benefits of Grouping

Grouping activities is a technique used to convert otherwise passive activities into nonpassive activities. Because grouping treats multiple activities as a single activity, participation hours are combined. This increases the likelihood that a taxpayer can attain the necessary hours required for material participation. Moreover, the taxpayer must meet the material participation requirement only for the combined single activity instead of each separate activity. Treas. Reg. §1.469-4 provides general rules and limitations for grouping activities and applies a facts-and-circumstances test to determine the appropriateness of a particular grouping. In general, under IRC §469, activities can only be grouped if they constitute an **appropriate economic unit** for measuring gain or loss (discussed earlier).

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109. Treas. Reg. §1.469-4(c)(1).

110. Treas. Reg. §1.469-4(c)(2).

111. Treas. Reg. §1.469-4.

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Grouping activities can provide significant tax advantages. An example of the benefits of the appropriate-economic-unit rule may be found in *Glick v. U.S.*[112] In this case, the Glicks (husband and wife) owned general partner and/or debt interests in 116 limited partnerships. Each limited partnership owned a specific low-income housing apartment project. One of their interests (GBG) was an S corporation. The Glicks owned 93.57% of this business, whose sole purpose was to manage the apartment projects for a fee. It also provided all of the required services either directly or by hiring third party vendors to supply them.

The District Court for southern Indiana found that GBG and the limited partnerships worked as an interrelated and integrated single-business unit, rather than as two distinct entities that happened to provide services to each other. The court found that this close operating relationship indicated that they were two parts of a single economic enterprise. The court analyzed the quantitative facts, and found that "GBG clearly had no role beyond providing services to the partnerships. It was subservient to and totally dependent upon the partnerships for its revenue as well as its existence." From this conclusion, the court ruled in favor of the taxpayer and allowed the passive losses generated from the Glicks' limited partnership interests to offset the fee income generated by their S corporation.

Other benefits of grouping include the following.

- Current losses that would otherwise be suspended can be utilized.
- The 3.8% NIIT can be minimized.
- The burden of meeting the material participation rules for each activity is eliminated.

> **Observation.** Generally, there is no advantage to only grouping separate rental real estate activities, because the activity is usually considered a passive activity. A separate set of rules (covered earlier) applies to real estate professionals.

Drawbacks of Grouping

Some of the drawbacks of grouping include the following.

- Suspended passive losses cannot be utilized until there is a complete disposition of the grouped activity.
- Passive losses may not be currently deductible due to previous groupings that eliminated passive income.

When making an election to group activities, future capital gains from the activity's disposition will not be treated as passive income. For tax planning purposes, the practitioner should consider the benefits and drawbacks of the grouping, taking into account the current loss deduction versus the smaller future passive income available to be offset by future passive losses.

REGROUPING ACTIVITIES

Impact of ACA

The grouping election available under the IRC §469 PAL rules was important **before** the passage of the Affordable Care Act (ACA). It is even **more important now** because the taxpayer's net income from a passive interest in a trade or business activity is subject to the 3.8% NIIT.

Beginning January 1, 2014, a taxpayer who becomes subject to the NIIT may, on a **one-time only basis**, elect to **regroup** (fresh-start election) and disregard the prior grouping election.[113] However, this special grouping opportunity must be made in the **first tax year** in which the taxpayer owes NIIT. More information on the fresh-start election is provided later.

> **Note.** Any regrouping of activities under this one-time regrouping election is still subject to the requirements for an appropriate economic unit and disclosure under §469, Treas. Reg. §1.469-4(e), and Rev. Proc. 2010-13.

[112] *Glick v. U.S.*, 96 F.Supp.2d 850 (2000).

[113] Treas. Reg. §1.469-11(b)(3)(iv).

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Regrouping in Subsequent Years

Once activities are grouped together, the taxpayer may generally not regroup them in subsequent taxable years.[114] Regrouping, however, is required when the taxpayer's original grouping is clearly inappropriate or if there is a material change in the taxpayer's circumstances that makes a current grouping inappropriate.[115]

The IRS has the authority to regroup a taxpayer's activities if the grouped activities do not form an appropriate economic unit and a principal purpose in using the grouping (or failing to group or regroup) is to circumvent the passive loss rules.[116]

DISCLOSURE STATEMENT

The taxpayer is required to disclose activity groupings and regroupings in a written statement that is filed with the taxpayer's original return.[117] This statement must be filed at the following times.

1. The first year that two or more activities are grouped together by the taxpayer
2. In any tax year during which the taxpayer adds a new activity to an existing grouping
3. In a tax year during which the taxpayer regroups activities

Note. For further information on grouping, see the following additional resources.

1. The 2012 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Individual Taxpayer Topics, contains extensive coverage of the grouping election for rental real estate activities. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**
2. The 2011 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Rulings and Cases, includes the *Miller* court case analysis that illustrates the importance of the grouping election for rental real estate activities. This can also be found at the above URL.
3. Rev. Proc. 2010-13 provides further guidance on the written statement required for grouping or regrouping, including special rules for S corporations and partnerships.
4. See Treas. Reg. §1.469-4 for information about grouping in general and Treas. Reg. §1.469-11(b)(3)(iv) for information about regrouping related to NIIT.

DISPOSITION OF GROUPED ACTIVITIES

Unless all activities in a group are disposed of, the disposition is treated as a partial disposition. However, in the year in which the taxpayer disposes of substantially all of the group, the part disposed of may be treated as a separate activity if the taxpayer can establish both of the following with reasonable certainty.[118]

1. The amount of deductions and credits allocable to the part of the activity disposed of for purposes of the PAL suspension and carry forward rules
2. The amount of gross income, other deductions, and credits allocable to the part of the activity disposed of

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114. Treas. Reg. §1.469-4(e)(1).
115. Treas. Reg. §1.469-4(e)(2).
116. Treas. Reg. §1.469-4(f).
117. Rev. Proc. 2010-13, 2010-4 IRB 329.
118. Treas. Reg. §1.469-4(g).

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PASSIVE ACTIVITY GROUPING ELECTIONS

There are various elections available for grouping passive activities. Treas. Reg. §1.469-4, Rev. Proc. 2010-13, and Chief Counsel Memorandum 201427016 provide guidance regarding grouping and regrouping activities.

General Grouping Election

A taxpayer uses guidance provided in **Rev. Proc. 2010-13** when making the election to **group two or more trade or business activities or rental activities as a single activity.** The taxpayer files a written statement with their original income tax return for the first taxable year of the grouping. This statement must identify the names, addresses, and federal employer identification number (FEIN), if applicable, for the grouped trade or business activities or rental activities. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469.

Adding New Activities to Existing Groupings. If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping, a written statement is required to be filed with the taxpayer's original income tax return for that taxable year. The same information is required in the new grouping election as provided in the original grouping election.

Regrouping Activities. Under Treas. Reg. §1.469-4(e)(2), if the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances occurred to make the original grouping inappropriate, the taxpayer must regroup the activities. If such a determination and regrouping is made, a written statement is required to be filed with the taxpayer's original income tax return for that taxable year. The same information is required in the regrouping election as provided in the first election.

The statement reporting a regrouping must also contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

Failure to Report. If a taxpayer is engaged in two or more trade or business activities or rental activities and they fail to report whether the activities were grouped as a single activity, the activity is treated as a separate activity for the PAL and credit limitation rules of §469. However, a timely disclosure is deemed to be made by a taxpayer who has filed all income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures.[119] Accordingly, Rev. Proc. 2010-13 provides alternative relief allowing a late filing of the disclosures otherwise required.

Although the default rule established by Rev. Proc. 2010-13 generally results in unreported activities being treated as separate activities, the IRS retains the authority to regroup a taxpayer's activities to prevent tax avoidance under Treas. Reg. §1.469-4(f).

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[119] Rev. Proc. 2010-13, 2010-4 IRB 329.

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Fresh-Start Regrouping Under ACA

As mentioned earlier, beginning January 1, 2014, a taxpayer who becomes subject to the NIIT may, on a **one-time-only basis,** elect to **regroup** and disregard the prior grouping election.[120] However, this special grouping opportunity must be made in the **first tax year in which the taxpayer is liable for the NIIT.**

When amending a return, a taxpayer may discover that they are liable for the NIIT for the first time. This situation makes them eligible for the regrouping election under the "fresh-start" provisions of Treas. Reg. §1.469-11(b)(3)(iv).

If a taxpayer already used the one-time regrouping rule and decides to amend a return for a year in which the regrouping election was in effect, the amended return **must** reflect the regrouped activities. If the amended return does not reflect the activities as regrouped, the regrouping is deemed invalid. However, the regrouping is not invalid if the taxpayer can establish under the general grouping rules of §469 (discussed previously) that there was a material change in facts and circumstances that support maintaining the regrouping in the year in which the activities were regrouped.

If the taxpayer discovers that they were not eligible to regroup because the amended return shows that the taxpayer is not subject to the NIIT for that year, the regrouping is deemed to have no effect for that year or subsequent years. Appropriate amended returns should be filed to reflect these changes for the affected years.

> **Observation.** Because the NIIT regrouping regulations became effective on January 1, 2014, the 2014 tax year is generally the first year a taxpayer may elect to regroup. However, the regrouping rule may be used for any taxable year that begins during 2013 as long as the eligibility requirement is met.

Special Election for Real Estate Professionals

As discussed earlier, there is a special election available to taxpayers who qualify as real estate professionals (qualifying taxpayers). Real estate professionals are not affected by the grouping election under Treas. Reg. §1.469-9(g). The election is relevant only after determining whether the real estate professional is a qualifying taxpayer.

Once the real estate professional is classified as a qualifying taxpayer, it must be determined whether they materially participated in the rental real estate activity. If the taxpayer did **not** make an election to group the properties, they are treated as separate rental properties and the nonelecting real estate professional must separately meet the tests for material participation for each property.

A qualifying taxpayer may elect to **treat all interests in rental real estate as a single real estate activity,** by filing a statement with the taxpayer's original income tax return for the year. The election must be made in a year in which the taxpayer is a qualifying taxpayer. The election is effective for the tax year in which it was made and all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening tax years in which the taxpayer is not a qualifying taxpayer. In such intervening years in which the taxpayer does not qualify, the election has no effect.

Although the election may be revoked, it may only be revoked in the year in which a material change to facts and circumstances occurs or in any subsequent year in which the material change in facts and circumstances continues to prevail. The fact that an election is not as advantageous to the taxpayer does not constitute a material change. In addition, loss of status as a qualifying taxpayer does not constitute a material change.

A statement is required to either make or revoke this election. Further guidance may be found in Chief Counsel Memorandum 201427016, which was released July 3, 2014, and Treas. Reg. §1.469-9(g)(3).

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120. Treas. Reg. §1.469-11(b)(3)(iv).

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Late Election. To obtain relief from an otherwise late election, the taxpayer must have reasonable cause for not making a timely election. The taxpayer must attach a statement to an amended return for the most recent tax year, along with the reason for the failure to file a timely election, and identify the year for which they are making a late election. Once the IRS approves the relief application, the taxpayer may treat all interests in rental real estate as a single activity for the year for which the election was made.

Mandatory Grouping by Partnerships and S Corporations

Partnership and S corporations must group their activities as required under **Treas. Reg. §1.469-4(d)(5).** These entities must comply with the disclosure instructions for grouping activities on Form 1065, *U.S. Return of Partnership Income,* and Form 1120, *U.S. Income Tax Return for an S Corporation*. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner/shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the Schedule K-1.

Grouping and Regrouping Examples

Example 19. Gilligan owns two partnership interests. In the Gilligan's Restaurant partnership, he is a general partner in a restaurant business. He works **50 hours per year** as a kitchen consultant. In CaterConsult partnership, he owns a catering consulting business. He works **50 hours per week** for the catering consulting business.

In 2014, Gilligan's restaurant activity had a loss. His 2014 Schedule K-1 reports $100,000 as his share of the loss. His 2014 Schedule K-1 for the catering consulting business reports a $130,000 profit.

Tax filing season arrives and Gilligan takes his tax information to his tax preparer, Ginger. She reviews returns from prior years and his 2014 tax information, including both Schedules K-1. She discovers that Gilligan never made an election to group the partnership activities.

Ginger notes that because Gilligan does not materially participate in the restaurant activity, the $100,000 loss is considered passive. She also notes that Gilligan has no passive income to offset this passive loss. Because the restaurant loss is passive, it cannot be used to offset any of the catering business's nonpassive income.

After researching the grouping election rules, Ginger recommends that Gilligan elect to group the two activities. She concludes that both activities represent an appropriate economic unit. If a grouping election is made, both partnership interests are treated as one activity for Gilligan. The benefits of making a grouping election are as follows.

1. Gilligan can offset the substantial income from the catering consulting activity with the large restaurant activity loss.
2. For 2014, Gilligan meets the material participation requirement for both activities because the election treats both activities as a single activity.

There are a few disadvantages to a grouping election for Gilligan.

1. The grouping decision is irrevocable without the IRS's consent. However, if Gilligan has a subsequent tax year that triggers the NIIT, he may regroup using the "fresh-start" one-time regrouping rule.
2. The election treats future income from the restaurant consulting activity as nonpassive.

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Gilligan agrees to the election and Ginger files the required statement with his 2014 tax return. A sample of this required statement follows.

Statement Filed in Accordance with Rev. Proc. 2010-13 and Election to Group Activities Under Treas. Reg. §1.469-4(c)

Taxpayer Name: **Gilligan Jones** Tax Yearend: **2014**

Taxpayer ID #: **999-99-9999**

New Groupings

The following activities were grouped as a single activity for the first time during the current tax year.

Activity	Address	EIN	Type of Activity
Gilligan's Restaurant	123 Island Dr., Oceanside, MD	39-5555555	Restaurant
CaterConsult Partners	125 Island Dr., Oceanside, MD	39-5456555	Consulting

Adding Activities to Existing Grouping

The following activities were added to an existing group during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

Regrouping Activities

The following activities were regrouped either due to an error or change in facts and circumstances during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

Example 20. Betty, who is single, had four separate businesses. She is also employed full time as a consultant. In 2010, she grouped the following four S corporations.

- Wedding Planner
- Flower Shop
- Catering Business
- Photographer

She typically **does not materially participate** in any one business because she has employees who perform the necessary work that generates the income.

In 2013, Betty started another business that provides escort services. She incorporates the business and elects S corporation status.

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Betty's wealthy aunt died in 2013 and Betty inherited her aunt's vast holdings. From this inheritance, Betty purchased a rental property in 2013.

In 2013, Betty's tax information is as follows.

		Income/Loss	Participation Hours
Wages		$230,000	
Interest income		11,000	
Ordinary dividends from estate		29,000	
Group 1: Wedding planner	$10,000		100 hours per year
Flower shop	(16,000)		450 hours per year
Catering	(8,000)		200 hours per year
Photographer	(18,000)		50 hours per year
Group 1 total	($32,000)	(32,000)	800 hours per year [a]
Escort service (passive activity)		(25,000)	80 hours per year
Real estate rental loss		(9,500)	

[a] Betty devoted more than 500 hours to the group 1 activity. Therefore, the group 1 activity is considered nonpassive, and the $32,000 loss is allowable in computing Betty's 2013 AGI.

Betty's tax professional Dianne provides the following tax information to Betty.

Wages	$230,000	
Interest income	11,000	$11,000
Ordinary dividends from estate	29,000	29,000
Passive loss from rental ($9,500)	0 [a]	
Escort service loss ($25,000)	0 [a]	
Group 1 nonpassive loss	(32,000)	
MAGI	$238,000	
Less: NII threshold	(200,000)	
A: Excess of MAGI over NII threshold	$ 38,000	
B: Total passive income		$40,000
Lesser of A or B	$ 38,000	
	× 3.8%	
NIIT	$ 1,444	

[a] Passive loss limitation.

Note. For more information about the NIIT, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

Dianne explains that because 2013 is the first year that Betty is subject to the NIIT, she is allowed to regroup her previous group 1 activities under the fresh-start provisions.

Betty regroups for 2013. She removes the wedding planner activity from group 1 and adds the escort service to it. **By doing this, she has created $10,000 of passive income to offset the $9,500 passive real estate rental loss.** By adding the escort service to group 1, she can increase her group 1 activity loss by the $25,000 escort service loss.

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After regrouping using the fresh-start election, Betty's relevant tax information is as follows.

Wages		$230,000	
Interest income		11,000	$11,000
Ordinary dividends from estate		29,000	29,000
Group 1: Flower shop	($16,000)		
Catering	(8,000)		
Photographer	(18,000)		
Escort service	(25,000)		
Group 1 total	($67,000)	(67,000)	
Wedding planner (passive activity)		10,000	10,000
Real estate rental (passive activity)		(9,500)	(9,500)
MAGI		$203,500	
Less: NII threshold		(200,000)	
A: Excess of MAGI over NII threshold		$ 3,500	
B: Total passive income			$40,500
Lesser of A or B	$ 3,500		
	× 3.8%		
NIIT	$ 133		

By regrouping using the fresh-start election, Betty saves $1,311 ($1,444 – $133) in NIIT.

PASSIVE ACTIVITY LOSSES AND CAPITAL GAINS AND LOSSES

A PAL is created when the excess of the taxpayer's aggregate passive activity deductions for the year exceed aggregate passive income.[121] However, for purposes of calculating a PAL, **deductions** include capital losses arising from the disposition of passive activity property.[122] In addition, **income** includes capital gains arising from such dispositions.[123]

Accordingly, current capital gains and losses from the disposition of passive activity property are taken into account along with other passive income and expense deductions in calculating a PAL for the year.

> **Example 21.** Theodore owns an interest in a boat repair shop. He also owns an interest in a movie theater. Both of these interests involve passive activities and they are the only passive activities he owned. In 2014, the boat repair shop sells equipment, generating a $10,000 capital gain for Theodore. In 2014, the theater generates an ordinary loss of $12,000. Therefore, he has a 2014 PAL of $2,000.[124]

As previously mentioned, PALs are deductible only to the extent of passive income for the year. Any excess loss constitutes a PAL, and it is suspended and carried forward. This rule is referred to as the **passive activity limitation.**

Net capital losses are generally deductible only to the extent of net capital gains during the year. However, individual taxpayers may deduct $3,000 of capital losses in excess of capital gains.[125] This limitation is referred to as the **capital loss limitation.**

The passive loss rules do not affect how any item of income, gain, or loss is categorized in any other section of the Code. Therefore, the passive loss limitation and the capital loss limitation both serve as **separate** limitations that apply to the taxpayer. The passive activity limitation is applied before the capital loss limitation.

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121. Temp Treas. Reg. §1.469-2T(b)(1).

122. Temp Treas. Reg. §1.469-2T(d)(5).

123. Temp Treas. Reg. §1.469-2T(c)(2).

124. See Temp Treas. Reg. §1.469-2T(d)(1).

125. IRC §1211.

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Example 22. Use the same facts as **Example 21.** In addition to the passive activities, Theodore is also a motivational speaker. He operates his motivational speaking business as a sole proprietorship in which he materially participates. The motivational speaking business has a 2014 profit of $25,000. He also sold stocks in 2014, resulting in a $9,000 short-term capital loss. His short-term capital loss carryforward to 2014 is $8,000. The following table summarizes his 2014 activities.

2014 Activity	Nonpassive	Passive
Motivational speaking net income	$25,000	
Boat repair equipment sale		$10,000
Movie theater operating loss		(12,000)
Net stock sale loss	(9,000)	
Capital loss carryforward	(8,000)	
Net PAL carryforward to 2015		($ 2,000)

Under the **passive activity limitation** rule, Theodore's two 2014 passive activities result in a $2,000 PAL, which is suspended and carried forward to 2015.

Under the **capital loss limitation** rule, Theodore can deduct capital losses to the extent of capital gains. Accordingly, he can combine the $9,000 stock sale loss with the $10,000 capital gain from the sale of the boat repair equipment, resulting in a net $1,000 capital gain.

Theodore is able to use $4,000 of the 2014 capital loss carryforward ($1,000 against the 2014 net capital gain plus the $3,000 maximum allowable against ordinary income).

2014 Activity	Noncapital	Capital
Motivational speaking net income	$25,000	
Boat repair equipment sale		$10,000
Movie theater operating loss	(12,000)	
Net stock sale loss		(9,000)
Net current year capital gain		$ 1,000
Capital loss carryforward		(8,000)
Net capital losses		($ 7,000)
Capital loss limitation (lesser of net capital losses or $3,000)		($ 3,000)

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As shown in these two tables, the $10,000 gain from the sale of the boat repair equipment is considered under both the capital loss limitation and passive loss limitation rules. Even though this $10,000 capital gain is passive income, it allows Theodore to deduct the $9,000 nonpassive stock sale loss. The amount of income and losses from each activity reported on Theodore's 2014 tax return follows.

2014 Activity	Income	Allowed Losses
Motivational speaking net income	$25,000	
Boat repair equipment sale	10,000	
Movie theater net operating loss		($10,000)
Net current year stock sale losses		(9,000)
Capital loss carryforward used		(4,000)
Totals	$35,000	($23,000)

Observation. A passive capital gain may provide the taxpayer with a double benefit. It allows the taxpayer to deduct passive losses up to that passive gain amount and also allows the deduction of a capital loss from a nonpassive source.

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