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**Please note.** Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

### About the Author

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Other chapter contributors and reviewers are listed at the front of this volume.

# 2020 Workbook

Throughout the 2020 *University of Illinois Federal Tax Workbook*, there are topics affected by recent major legislation, notably the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, and the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. For the reader's convenience in locating these issues, there are icons in the left margin highlighting areas of impact and their source.



CARES Act



SECURE Act

Taxpayers report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in real estate mortgage investment conduits on Schedule E, *Supplemental Income and Loss*. The income or losses from these activities flow from the Schedule E to an individual's Form 1040, *U.S. Individual Income Tax Return*, or a fiduciary's Form 1041, *U.S. Income Tax Return for Estates and Trusts*. A taxpayer is only required to complete the relevant section(s) of the Schedule E.<sup>1</sup>

**Note.** Partnerships and S corporations with rental real estate activities report income and deductible expenses on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*.<sup>2</sup> C corporations do not report rental real estate activities on a separate form. Gross rents are reported on line 6 of Form 1120, *U.S. Corporation Income Tax Return*. Related expenses for rental activities are not reported separately from other ordinary and necessary business expenses.<sup>3</sup>

## RENTAL REAL ESTATE AND ROYALTIES

Income and losses from rental real estate and royalties are reported in part I on Schedule E.

### INCOME OR LOSS FROM RENTAL REAL ESTATE<sup>4</sup>

Income from rental real estate includes land rental, self-rental, and rental of other real estate property. Rental income includes any payment for the use or occupation of property and is not limited to normal rental payments. Common types of rental income include the following.

- Advance rent
- Amounts paid by a tenant to cancel a lease
- Expenses paid directly by a tenant (e.g., real estate taxes)
- Property or services in lieu of rent (valued at the fair market value (FMV) of the property or service)
- Security deposit retained because tenant did not live up to terms of lease
- Payments from a lease with an option to buy before the option is exercised

**Caution.** Taxpayers sometimes do not differentiate between pre-option payments and payments received after the option is exercised. Practitioners must be careful to report the rental income on Schedule E.

A taxpayer with a partial interest in rental real estate property reports only their part of the income and expenses on Schedule E. Expenses related to personal use of rental real estate are not deductible on Schedule E and the rental deductions may be limited.

<sup>1</sup> Instructions for Schedule E.

<sup>2</sup> Instructions for Form 8825.

<sup>3</sup> See Instructions for Form 1120.

<sup>4</sup> Instructions for Schedule E; IRS Pub. 527, *Residential Rental Property*.

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When there is both personal and rental use, the property can be considered one of the following based on the amount of personal use and rental use. The following tax consequences apply.<sup>5</sup>

- **Personal-Use Property.**<sup>6</sup> When personal-use property is rented less than 15 days and the taxpayer uses it more than 14 days, the rental income is not taxable. Real estate taxes and qualified mortgage interest are reported on Schedule A, *Itemized Deductions*. Other expenses related to the property are generally nondeductible.
- **Rental Property.** When rental property is utilized for personal use no more than 14 days or 10% of the days the property is rented, the rental activity is reported on Schedule E with expenses allocated to rental and personal use.<sup>7</sup> Only real estate taxes are deductible as both personal and rental expenses. The personal portion is deducted on Schedule A. The personal portion of mortgage interest is not deductible on Schedule A, because the property is not considered used as the taxpayer's home, but it may be deductible on Schedule A as investment interest. Rental activity is subject to passive-activity loss limits.
- **Hobby Rental Property.** When the personal-use test for rental property is not met and the home is rented for more than 14 days, rental activity is reported on Schedule E with expenses allocated to rental and personal use. Rental expenses are limited to gross rental income. The personal-use portions of real estate taxes and mortgage interest are deductible on Schedule A. The taxpayer is deemed to have used the property as a home or residence. Mortgage interest is deductible if the taxpayer elects to treat this property as a second home under mortgage interest rules.<sup>8</sup>

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## Personal-Use Days<sup>9</sup>

A taxpayer who personally uses a dwelling unit that they rent to others must divide expenses between rental and personal use. A **dwelling unit** has basic living accommodations such as a space for sleeping, toileting, and cooking (e.g., house, apartment, condominium, mobile home, boat, or vacation home). A single structure may contain more than one dwelling unit if each unit has basic living accommodations (e.g., a basement with basic living accommodations within a house is a separate dwelling unit). Dwelling units do not include property that is used solely as property regularly available for occupancy by paying customers and not used as a home during the year by the owner.

As mentioned previously, a taxpayer is considered to use a dwelling unit as a residence if their personal use exceeds the greater of **14 days or 10% of the number of days during the year for which the unit is rented at fair rental**.

A **day** is considered to be the 24-hour period for which a normal rental is calculated. Personal use of a dwelling unit is determined for any day if for any part of a day the unit is used:<sup>10</sup>

- For personal purposes by the taxpayer or other person with an interest in the unit, or any member of their family (includes taxpayer's brother, sister, spouse, ancestor, or lineal descendant);
- By any individual using the unit under an arrangement that enables the taxpayer to use a different dwelling unit; or
- By any individual unless the unit is rented at a fair rental based on the facts and circumstances.

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<sup>5</sup>. See Instructions for Schedule A.

<sup>6</sup>. IRC §280A(g).

<sup>7</sup>. IRC §280A(d)(1).

<sup>8</sup>. IRC §280A(c)(5).

<sup>9</sup>. Prop. Treas. Reg. §1.280A-1.

<sup>10</sup>. IRC §280A(d)(2); Prop. Treas. Reg. §1.280A-1.

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A taxpayer is not required to spend the night in the dwelling to be counted as a personal-use day.<sup>11</sup>

Days spent primarily on repair or maintenance are not considered personal use.<sup>12</sup> If the taxpayer is not engaged in repair and maintenance on a substantially full-time basis, the facts and circumstances determine whether the primary purpose was to perform repairs and maintenance. Relevant facts include:<sup>13</sup>

- Amount of time dedicated to repair and maintenance,
- Frequency of the use for repair and maintenance during the year, and
- Presence and activities of companions.

**Example 1.** Colton owns a cottage on a lake that he rents out every summer. Colton and his wife, Winnie, arrive at the cottage Thursday night to get the cottage ready for renters. They eat dinner and go to bed. Colton spends the majority of Friday and Saturday fixing the deck, replacing a broken window, and updating some plumbing. Winnie spends a couple hours each day painting the kitchen but mostly relaxes by the lake. All the necessary repairs are done by Saturday night. Sunday morning the couple enjoys breakfast by the lake and leaves by noon. Because the principal purpose for using the unit from Thursday to Sunday is to perform repairs and maintenance, none of those days are considered personal use.<sup>14</sup>

Expenses are allocated based on a ratio of the total number of days the unit was rented at a fair rental price to the total number of days during the year the dwelling unit is used.<sup>15</sup>

**Example 2.** Frank and Sandy own a condo in Orlando, Florida. They use the property for their 4-week winter vacation in March each year. The remainder of the time they allow the condo association to rent it on a monthly basis. Frank and Sandy receive the rental income minus a 25% handling fee the condo association charges for managing the rental and preparing the condo for the next tenant.

In 2019, the association rented the condo for a total of 250 days. The net rental income was \$12,000 (\$62,500 gross rental income – \$50,500 gross rental expense).

Frank and Sandy used the property for personal purposes 27 days. The following illustrates the allocation to Schedule E.

Rental portion	$250 \text{ days} \div 365 \text{ days} = 68.49\%$
Residential portion	$115 \text{ days} \div 365 \text{ days} = 31.51\%$

**Any day that the property is available for rent but not actually rented is not a day of rental use.<sup>16</sup>**

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<sup>11</sup> *Catherine Chacon v. Comm’r*, TC Memo 1992-632 (Oct. 27, 1992).

<sup>12</sup> See *C.R. Cooke v. Comm’r*, TC Memo 2017-74 (May 1, 2017); Prop. Treas. Reg. §1.280A-1.

<sup>13</sup> Prop. Treas. Reg. §1.280A-1(e)(6); IRC §280A(d)(2).

<sup>14</sup> Adapted from Example 3 in Prop. Treas. Reg. §1.280A-1(e)(6).

<sup>15</sup> IRC §280A(e)(1).

<sup>16</sup> IRS Pub. 527, *Residential Rental Property*.

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Item	Total	Rental Portion	Residential Portion
Rental income	\$62,500	\$62,500	\$ 0
Expenses			
Utilities	\$ 3,000	\$ 2,055	\$ 945
Condo fees	1,000	685	315
Rental fee	15,625	15,625	0
Real estate tax	5,000	3,424	1,576
Mortgage interest	16,875	11,558	5,317
Depreciation	9,000	6,164	N/A
Total expenses	\$50,500 (50,500)	\$39,511 (39,511)	\$8,153 (8,153)
Net rental	\$12,000	\$22,989	\$ 0

The rental portion of the income and deductions are reported on the couple's Schedule E. If Sandy and Frank itemize their deductions, they can claim the residential portion of the mortgage interest and real estate tax on Schedule A, assuming they otherwise qualify.

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## Practitioner Planning Tip

The *Bolton*<sup>17</sup> method (also known as the Tax Court method) allocates the expenses based on total days in the year instead of days in use. This may be helpful if there are high operating costs. For more information on the allocation of personal use of rental real estate using the Tax Court method and a detailed example, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

## Limitation on Business Interest

Generally, for tax years beginning after December 31, 2017, taxpayers are allowed a deduction for business interest not to exceed the sum of the amount of business interest income for the year, plus 30% of the adjusted taxable income (ATI) for the year, plus the floor plan financing interest for the year.<sup>18</sup> **For tax years beginning in 2019 and 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act increases the 30% of ATI to 50%.<sup>19</sup>**

**Caution.** The limitation on business interest **only applies to taxpayers with more than \$26 million** (for 2019 and 2020) of average annual gross receipts for the prior three years. The small business taxpayer exemption is explained in detail later in this section.

<sup>17</sup> *Bolton v. Comm'r*, 694 F.2d 556 (9th Cir. 1982), *aff'g* 77 TC 104 (1981).

<sup>18</sup> IRC §163(j)(1)(A); Prop. Treas. Reg. §1.163(j)-1.

<sup>19</sup> IRC §163(j)(10)(A).

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For these purposes, business interest expense is any interest paid or accrued on debt properly allocable to a trade or business of the taxpayer.<sup>20</sup> Business interest expense does not include investment interest. Similarly, business interest income is the amount of the taxpayer's includable interest income properly allocable to a trade or business and does not include investment income.<sup>21</sup> **Floor plan financing interest** is interest incurred to finance the acquisition of a motor vehicle held for sale or lease and secured by the acquired inventory.<sup>22</sup> **ATI** is the taxable income of a taxpayer **without regard** to the following.<sup>23</sup>

- Any item of income, gain, deduction, or loss not properly allocable to a trade or business
- Any business interest or business interest income
- Any net operating loss (NOL) deduction
- The qualified business income deduction (QBID) under IRC §199A
- Deductions for depreciation, amortization, or depletion for tax years beginning before January 1, 2022

**Note.** For more information on floor plan financing interest, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation and the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: New Legislation — Business Concerns. The 2018 chapter can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

Interest paid as part of rental real estate activities is **exempt** from the limitation on business interest **unless** the rental real estate activity is a trade or business.<sup>24</sup> A rental real estate activity that is considered a trade or business calculates the limit on its interest expense on Form 8990, *Limitation on Business Interest Expense Under Section 163(j)*, before completing lines 12 and 13 on Schedule E. Any interest the taxpayer cannot deduct in the current year is carried forward to the next year.<sup>25</sup>

Small business taxpayers without excess business interest expense from a partnership are not required to file Form 8990. A business that is not a tax shelter and has average annual gross receipts for the prior three tax years that does not exceed \$26 million (in 2019 and 2020<sup>26</sup>) is considered a **small business taxpayer**. Additionally, a taxpayer that only has interest expense from any of the following trades or businesses that are considered **excepted trades or businesses** are not required to file Form 8990.<sup>27</sup>

- Trade or business of providing services as an employee
- Electing real property trade or business<sup>28</sup>
- Electing farm business<sup>29</sup>
- Certain utilities

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<sup>20</sup> IRC §163(j)(5).

<sup>21</sup> IRC §163(j)(6).

<sup>22</sup> IRC §163(j)(9).

<sup>23</sup> IRC §163(j)(8).

<sup>24</sup> Instructions for Schedule E; Prop. Treas. Reg. §1.163(j)-1(b)(38).

<sup>25</sup> Instructions for Schedule E.

<sup>26</sup> Rev. Proc. 2019-44, 2019-47 IRB 1093.

<sup>27</sup> Instructions for Form 8990.

<sup>28</sup> See IRC §163(j)(7)(B).

<sup>29</sup> See IRC §163(j)(7)(C).

A taxpayer with both excepted and non-excepted trades or businesses must allocate the interest income, expense, and other tax items based on the relative amounts of the taxpayer's adjusted basis in the assets. The adjusted basis is determined as of the close of each determination date during the year. The **determination date** is the last day of each quarter of the taxpayer's tax year. Those amounts are averaged to determine the relative basis in the assets for the excepted and non-excepted trades or businesses.<sup>30</sup>

There is a de minimis exception for taxpayers with 90% or more of their basis in a tax year allocable to either excepted or non-excepted trades or businesses. In this situation, all of the taxpayer's interest income and expense for the year that is allocable to a trade or business is treated as allocable to either excepted or non-excepted trades or businesses, respectively.<sup>31</sup>

The basis for an asset that is used in both an excepted and non-excepted trade or business is allocated to each trade or business using a permissible method that most reasonably reflects the use of the asset during the determination period. Once selected, a taxpayer must apply the same allocation method consistently. A taxpayer may change its method of allocation with the consent of the IRS. To obtain consent, a taxpayer must submit a request for a letter ruling. Consent is granted only in extraordinary circumstances.<sup>32</sup>

The taxpayer's basis in an asset used in two or more trades or business can be allocated based upon the following.<sup>33</sup>

- Relative amounts of gross income the asset generates with respect to the trades or businesses
- Relative amounts of physical space used by the trade or business (for land and permanent structures)
- Relative amounts of output if the trade or business generates the same unit of output

**Note.** A taxpayer making such an allocation must attach a statement to their timely filed federal income tax return for the tax year. Details on what information must be included in the statement is found at Prop. Treas. Reg. §1.163(j)-10(c)(6)(iii).

Any carryforward of disallowed business interest expense that was treated as allocable to a non-excepted trade or business in a prior year continues to be treated as allocable to a non-excepted trade or business.<sup>34</sup>

**Note.** For more information on the business interest limitation, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Agricultural Issues and Rural Investments.

## Basis for Depreciation<sup>35</sup>

Basis as defined in IRS Pub. 551, *Basis of Assets*, is the amount of the taxpayer's investment in property for tax purposes. A taxpayer's basis in purchased property is usually its cost, which includes the amount paid in cash, debt obligations, and other property or services. For taxpayers constructing business, rental, or investment property, the basis computation is expanded to include construction period interest and taxes under IRC §263A.<sup>36</sup>

<sup>30</sup> Prop. Treas. Reg. §1.163(j)-10(c).

<sup>31</sup> Prop. Treas. Reg. §1.163(j)-10(c)(1).

<sup>32</sup> Prop. Treas. Reg. §1.163(j)-10(c)(3).

<sup>33</sup> Ibid.

<sup>34</sup> Prop. Treas. Reg. §1.163(j)-10(c)(4).

<sup>35</sup> IRS Pub. 527, *Residential Rental Property*.

<sup>36</sup> IRC §263(A)(f)(1).

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Certain closing costs, fees, and other expenses paid when purchasing real property are included in the basis of the property. Real estate taxes the buyer pays that were owed by the seller and that are not reimbursed by the seller are added to basis. Any amounts the seller owes that the buyer agrees to pay (i.e., recording fees, mortgage fees, back taxes or interest, charges for improvements or repairs, and sales commissions) are added to basis. Basis also includes the following costs.

- Abstract fees
- Charges for installing utility services
- Legal fees
- Recording fees
- Surveys
- Transfer taxes
- Title insurance

Certain settlement fees and closing costs are **not** included in the basis for the property. These include the following.

- Fire insurance premiums
- Rent or other charges relating to occupancy of the property before closing
- Charges connected with obtaining or refinancing a loan (i.e., points, mortgage insurance premiums, loan assumption fees, costs of a credit report, and fees for a required appraisal)
- Amounts placed in escrow for any future payments of items such as taxes and insurance

The basis for a taxpayer who purchases property and becomes liable for an existing mortgage is the amount paid for the property plus the remaining amount to be paid on the mortgage.

The basis for purchased property that includes the price of the land on which the building stands must be divided between the land and the building to determine the basis for depreciation of the building. Each asset is allocated the part of the cost based on the ratio of the FMV of the asset to the FMV of the whole property at the time of purchase. If the FMV of the land or the buildings is not evident, the cost can be divided based on their assessed values for real estate tax purposes, or other reasonable method to determine FMV.

**Example 3.** Hank is expanding his business and buys two office buildings in 2020. He buys an office building and land on Main Street for \$750,000. He pays \$50,000 in cash and assumes a mortgage of \$700,000 on the property. His total basis is \$750,000. Based on an appraisal performed for the lender, the purchase price is allocated \$680,000 for the building and \$70,000 for the land.

Hank pays \$600,000 for land and an office building on First Street. The purchase contract does not itemize how much of the price is for land and how much is for the building. The most recent real estate tax assessment for the First Street property was based on an assessed value of \$575,000, of which \$500,000 was for the building and \$75,000 was for the land. Hank can allocate 87% ( $\$500,000 \div \$575,000$ ) of the purchase price to the building. Therefore, his basis in the building is \$522,000 ( $\$600,000 \text{ cost} \times 87\%$ ). The remaining basis of \$78,000 is allocated to land and is not depreciable.

Hank calculates depreciation on a basis of \$680,000 for the Main Street building and \$522,000 for the First Street building on Form 4562, *Depreciation and Amortization*. The amount is then reported on line 18 of Schedule E.





## Practitioner Planning Tip

Hank may benefit from a cost segregation study on both properties to determine if any accelerated depreciation may be claimed. Cost segregation studies are discussed in the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Selected Real Estate Topics.

**Note.** For more information about depreciation, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation.

**Basis Other than Cost.** Taxpayers cannot use cost to determine basis for property they receive in the following manner.

- In return for services the taxpayer performed
- In exchange for other property
- As a gift from a spouse, or former spouse as the result of a divorce
- As an inheritance

**Note.** For information on how to determine basis for property received in each of the preceding manners, see IRS Pub. 551. For information on how to determine adjusted basis in order to calculate an asset's depreciation, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis.

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## IRC §481(a) Adjustment

When a taxpayer corrects depreciation errors from a prior year return, an amended return is required. If the taxpayer corrects depreciation errors from multiple prior years, an IRC §481(a) adjustment is required. The adjustment is the aggregate amount of income or expense that would have been reported in prior tax years if the new or correct method had been used in those years. To calculate the §481(a) adjustment, the amounts on prior year returns (ignoring the statute of limitations<sup>37</sup>) are compared with the correct amounts for those years.

To report the adjustment, the following rules apply.

- For a **decrease** in income, the entire deduction is claimed in the year the error is discovered.<sup>38</sup>
- For an **increase** in income, the §481(a) adjustment period is four years (add one-fourth of the adjustment to income each year). If the entire adjustment is less than \$50,000, the taxpayer can elect to include the entire adjustment in the year the error is discovered.<sup>39</sup>
- For an applicant under IRS audit, the §481(a) adjustment period is two tax years for a positive adjustment (increase in income).<sup>40</sup>
- If the taxpayer has discontinued the trade or business, the remaining balance of the §481(a) adjustment is taken into account in the tax year the business ceased or terminated.<sup>41</sup>

The §481(a) adjustment is reported on Form 3115, *Application for Change in Accounting Method*, part IV, line 26, and the same form or schedule on which the original error was reported.

**Example 4.** Tony purchased a building on June 15, 2016, for \$100,000 that he uses as residential rental real estate. He forgot to claim depreciation on his Schedule E for 2016, 2017, and 2018. As a result, Tony claimed a §481(a) adjustment for missed depreciation on Form 3115 of \$9,242, which is calculated as follows.

	Depreciation
2016	\$1,970
2017	3,636
2018	3,636
Total	\$9,242

Tony reports the adjustment on his 2019 Schedule E as follows.

**Note.** For more information on Form 3115 and examples of completed forms, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation, and the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues.

<sup>37</sup> Under §481, “if income escapes taxation because of a change in accounting method, the Commissioner may make an adjustment by including the omitted income in the year of the change.” *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568, 570 (5th Cir. 1965).

<sup>38</sup> Rev. Proc. 97-27, 1997-21 IRB 10, as modified by Rev. Proc. 2002-19, 2002-13 IRB 696 and Rev. Proc. 2007-67, 2007-35 IRB 467.

<sup>39</sup> Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

# 2020 Workbook

## For Example 4

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. <b>13</b>
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Department of the Treasury  
Internal Revenue Service (99)

Name(s) shown on return: **Tony T. Iger**

Your social security number: **999-99-9999**

**Part I** **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099?  Yes  No

**B** If "Yes," did you or will you file required Forms 1099?  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)

**A** **888 Pine Road, Champaign, IL 61801**

**B**

**C**

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>1</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>	<b>365</b>	<input type="checkbox"/>
<b>B</b>			<b>B</b>		<input type="checkbox"/>
<b>C</b>			<b>C</b>		<input type="checkbox"/>

- Type of Property:**
- 1 Single Family Residence
  - 2 Multi-Family Residence
  - 3 Vacation/Short-Term Rental
  - 4 Commercial
  - 5 Land
  - 6 Royalties
  - 7 Self-Rental
  - 8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>	<b>20,000</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>	<b>122</b>		
<b>17</b> Utilities. . . . .	<b>17</b>			
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>3,636</b>		
<b>19</b> Other (list) ▶ <b>Section 481(a) adjustment</b>	<b>19</b>	<b>9,242</b>		
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>13,000</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file <b>Form 6198</b> . . . . .	<b>21</b>	<b>7,000</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on <b>Form 8582</b> (see instructions) . . . . .	<b>22</b>	( )	( )	( )
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>20,000</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>3,636</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>13,000</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. <b>Do not</b> include any losses . . . . .	<b>24</b>			<b>7,000</b>
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>	( )	( )	( )
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>7,000</b>



# 2020 Workbook

## Qualified Business Income Deduction<sup>42</sup>

Taxpayers with rental activities may be eligible for the QBID under IRC §199A. To qualify, taxpayers must prove that their rental activity is a trade or business. This can be established through an analysis of the facts and circumstances or through the safe harbor rules.

**Note.** Although QBID is not calculated on Schedule E, the discussion is relevant for taxpayers who file a Schedule E to determine if they qualify for the deduction on their Form 1040.

An analysis of **the facts and circumstances** examines whether the taxpayer is actively involved in the activity with continuity and regularity with the primary purpose to make income or profit.<sup>43</sup> To further clarify what activities rise to the level of a trade or business and how to apply that requirement to real estate activities, the Treasury Department issued Rev. Proc. 2019-38, which contains a **safe harbor**.

Rev. Proc. 2019-38 finalized the safe harbor rules for rental real estate enterprises (RREE) for years ending after December 31, 2017. The safe harbor allows an RREE to be treated as a single trade or business for purposes of the QBID, including the application of the aggregation rules in Treas. Reg. §1.199A-4.

For the purposes of the safe harbor, an RREE is defined as an interest in real property held for the production of rents. It may consist of an interest in a single property or interests in multiple properties.

Taxpayers can hold an interest in an RREE either directly or through a relevant pass-through entity (RPE). A taxpayer can treat each RREE as a separate enterprise or treat interests in similar RREEs as a single enterprise. Commercial and residential real estate may **not** be part of the same RREE.

Once a taxpayer or RPE treats similar properties as a **single RREE** under the safe harbor, they must continue to treat interests in all similar properties, including newly acquired properties, as a single RREE as long as they rely on the safe harbor. However, a taxpayer or an RPE that treats each property as a **separate RREE** may choose to treat its interests in all similar commercial properties or all similar residential properties as a single RREE in a future year.

Rev. Proc. 2019-38 also addresses treatment of **mixed-use property** as a single RREE or as separate residential and commercial interests. Mixed-use property is defined as a single building with both residential and commercial units. An interest in mixed-use property that is treated as a single RREE may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.

The safe harbor election must be made annually. The following requirements must be met for the §199A safe harbor to apply to an RREE.

1. Separate books and records must be maintained to reflect income and deductions of the RREE. If the RREE contains more than one property, this requirement may be satisfied if the income and expense statements for each property are maintained and then consolidated.
2. For RREEs that have been in existence less than four years, at least 250 hours of **rental services** are performed in the tax year with respect to the RREE. For RREEs that have been in existence for at least four years, at least 250 hours of rental services are performed in any three of the five consecutive tax years that end with the tax year.

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<sup>42</sup> Rev. Proc. 2019-38, 2019-42 IRB 942.

<sup>43</sup> *Tax Cuts and Jobs Act, Provision 11011 Section 199A — Qualified Business Income Deduction FAQs*. Q17. Jan. 10, 2020. IRS. [www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs] Accessed on Jul. 6, 2020.

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3. The taxpayer maintains contemporaneous records regarding **all** services performed for the RREE. These records include time reports, logs, or similar documents regarding the following.
  - a. Hours of **all** services performed
  - b. Description of **all** services performed
  - c. Dates on which such services were performed
  - d. Who performed the services

These records must be kept available for inspection at the request of the IRS. The final regulations delay the effective date for the contemporaneous records requirement. The contemporaneous records requirement does **not** apply to tax years beginning **before January 1, 2020** (the date was January 1, 2019 in the proposed revenue procedure<sup>44</sup>).

4. The taxpayer attaches a statement to a timely filed original return (or an amended return for the 2018 tax year only) for each tax year in which the taxpayer or RPE relies on the safe harbor. If the taxpayer has multiple RREEs relying on the safe harbor, a single statement is sufficient but it must list all the required information separately for each RREE. The statement must include the following information.
  - a. A description (including the address and rental category) of all properties in the RREE
  - b. A description (including the address and rental category) of rental real estate properties acquired and disposed of during the tax year
  - c. A representation that the requirements of the revenue procedure were satisfied

The revenue procedure clarifies what rental services qualify for the safe harbor. The list includes, but is **not limited to**, the following.

- Advertising to rent or lease the real estate
- Negotiating and executing leases
- Verifying information contained in prospective tenant applications
- Collection of rent
- Daily operation, maintenance, and repair of the property, including the purchase of materials and supplies
- Management of the real estate
- Supervision of employees and independent contractors

The revenue procedure modifies the language of activities that are not included as rental services to include improving property under Treas. Reg. §1.263(a)-3(d). The proposed safe harbor<sup>45</sup> used the term, “planning, managing, or constructing long-term capital improvements.”

The types of rental real estate arrangements that **may not be included in an RREE and are therefore excluded from the safe harbor** were modified and expanded under the revenue procedure. The final list of excluded arrangements includes the following.

- Real estate used by the taxpayer as a residence under IRC §280A(d)
- Real estate rented or leased under a triple net lease

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<sup>44</sup> IRS Notice 2019-07, 2019-09 IRB 740.

<sup>45</sup> Ibid.



## Practitioner Planning Tip

In order to avoid having a lease classified as a triple net lease, the lease agreement should be modified to require the landlord to pay the real estate taxes, fees, insurance, or maintenance.<sup>46</sup>

- Real estate rented to a trade or business conducted by a taxpayer or RPE that is commonly controlled under Treas. Reg. §1.199A-4(b)(1)(i)
- The entire rental real estate interest if any portion of the interest is treated as a specified service trade or business under Treas. Reg. §1.199A-5(c)(2)

**Note.** For more information about the rental real estate safe harbor, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update and Volume B, Chapter 4: Selected Real Estate Topics.

## ROYALTIES

Payments for the right to use intangible property (including trademarks, trade names, service marks, or copyrights) are classified as **royalties**.<sup>47</sup> Royalty income is generally associated with items that constitute passive income<sup>48</sup> and do not include payments for services.<sup>49</sup> Royalties are reported to the taxpayer on Form 1099-MISC, *Miscellaneous Income*, or similar statement.<sup>50</sup> The taxpayer reports royalty income on Schedule E unless they are in business as a self-employed writer, inventor, artist, etc.<sup>51</sup>

Being engaged in a trade or business is not defined in the Code or regulations, but is taken to mean that a taxpayer who regularly and continuously engages in the activity for the primary purpose of income or profit is likely considered engaged in a trade or business.<sup>52</sup> Any royalties resulting from a trade or business are considered self-employment (SE) income and reported on Schedule C (explained in further detail later in this chapter). The classification of royalty income as business or nonbusiness income is made at the time the intellectual property upon which the royalties are related was created.<sup>53</sup>

**Example 5.** Miranda is a high school chemistry teacher. In 1999, she wrote a manual on how to prepare for Y2K, which was unrelated to her duties as a teacher. In subsequent years, Miranda has never updated the materials and has no plans to do so. She is not considered regularly engaged in the profession of writing. In 2019, Miranda received royalties of \$800. Her royalties are reported on the following Schedule E and are not subject to SE tax.

<sup>46</sup> Rev. Proc. 2019-38, 2019-42 IRB 942.

<sup>47</sup> Rev. Rul. 81-178, 1981-2 CB 135; *Jones v. Comm'r*, TC Memo 1998-354 (Oct. 5, 1998).

<sup>48</sup> See *Disabled American Veterans v. U.S.*, 650 F.2d 1178 (Cl. Ct. 1981).

<sup>49</sup> *Jones v. Comm'r*, TC Memo 1998-354 (Oct. 5, 1998).

<sup>50</sup> See Instructions for Form 1099-MISC.

<sup>51</sup> Instructions for Schedule E.

<sup>52</sup> *Comm'r v. Groetzinger*, 480 U.S. 23 (1987); Rev. Rul. 58-112, 1958-1 CB 323.

<sup>53</sup> See Treas. Reg. §1.1402(a)-1(c); *Tax Issues for Individuals Who Create Intellectual Property*. Kelley, Claudia L. and Kowalczyk, Tamara. Nov. 30, 2013. The Tax Advisor. [www.thetaxadviser.com/issues/2013/dec/kelley-dec2013.html] Accessed on Jul. 1, 2020.

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## For Example 5

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <span style="font-size: 2em; font-weight: bold;">2019</span> Attachment Sequence No. <b>13</b>
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Department of the Treasury Internal Revenue Service (99)

Name(s) shown on return: **Miranda Doom**      Your social security number: **012-31-1999**

**Part I** **Income or Loss From Rental Real Estate and Royalties**      Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . .  Yes  No

**B** If "Yes," did you or will you file required Forms 1099? . . . . .  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)

**A** **678 First Street, Minneapolis, MN 55415**

**B**

**C**

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>6</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>		<input type="checkbox"/>
<b>B</b>			<b>B</b>		<input type="checkbox"/>
<b>C</b>			<b>C</b>		<input type="checkbox"/>

- Type of Property:**
- 1 Single Family Residence      3 Vacation/Short-Term Rental      5 Land      7 Self-Rental
  - 2 Multi-Family Residence      4 Commercial      6 Royalties      8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>			
<b>4</b> Royalties received . . . . .	<b>4</b>	<b>800</b>		
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>			
<b>17</b> Utilities. . . . .	<b>17</b>			
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>			
<b>19</b> Other (list) ▶	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>0</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>800</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	( )	( )	( )
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>			
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>		<b>800</b>	
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>			
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>		<b>0</b>	
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. <b>Do not</b> include any losses . . . . .	<b>24</b>			<b>800</b>
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>	( )		
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>800</b>

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**Example 6.** Dr. Harvey is a professor of chemistry at a respected university. During his summer break from lecturing, he authors a chemistry text book for use in his class. Every four years, Dr. Harvey updates and revises the text book. A publisher pays Dr. Harvey annual royalties based on the sales of the textbook. Because Dr. Harvey is considered regularly engaged in the business of writing, the royalties are included in his net earnings from self-employment and are reported on Schedule C.<sup>54</sup>

**Example 7.** Use the same facts as **Example 6.** In 2019, Dr. Harvey retires from the university. The professor who replaces him continues to use Dr. Harvey's text book. The royalties that Dr. Harvey earns in 2020 and future years are considered income from a trade or business even though Dr. Harvey is not currently engaged in the activity on a regular and continuous basis.

## Practitioner Planning Tip

An advanced royalty must be included in income for the year in which a cash-method taxpayer received the payment.<sup>55</sup> Advanced royalties as compensation for services performed by a writer, musician, vocalist, or producer are reported in box 1 of Form 1099-NEC, *Nonemployee Compensation*, or on Form W-2, *Wage and Tax Statement*, depending on whether the person performing the services is an independent contractor or an employee.<sup>56</sup> It is important to review the employment contract to determine the appropriate tax treatment as either compensation income or royalty income.

A taxpayer who earns royalties of \$10 or more from a single payor during the year should receive a Form 1099-MISC or a similar statement, with the amount reported in box 2. The amount in box 2 is reported on Schedule E, line 4. Each royalty property is reported in a separate column.<sup>57</sup>

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.<sup>58</sup> Royalty income is also subject to the net investment income tax (NIIT).<sup>59</sup>

**Note.** For information on the NIIT, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Unexpected Issues for Individual Taxpayers.

<sup>54</sup> Ibid.

<sup>55</sup> *Holbrook v. U.S.*, 194 F.Supp. 252 (D. Or. 1961); IRS Pub. 525, *Taxable and Nontaxable Income*.

<sup>56</sup> Ltr. Rul. 9725037 (Mar. 25, 1997).

<sup>57</sup> Instructions for Schedule E.

<sup>58</sup> IRS Pub. 525, *Taxable and Nontaxable Income*.

<sup>59</sup> IRC §1411(c)(1)(A)(i).



## Oil, Gas, and Mineral Property

The amount received when natural resources are extracted from a taxpayer's property is royalty income from oil, gas, and mineral properties. The royalties are generally based on production or revenue (based on units such as barrels, tons, etc.) and are paid to the taxpayer by a person or company who leases the property from the taxpayer.<sup>60</sup>

**Oil and Gas Overview.** An oil and gas lease is created when the owner of an operating right (referred to as a working interest) assigns all or a portion of the right to another person and retains a continuing nonoperating interest in production. The owner may assign the right for no immediate consideration or for cash or its equivalent.

The income from the oil and gas property is commonly divided between the mineral interest owner (the **royalty owner**) and the operator (the **working interest owner**). In a typical lease arrangement, the royalty owner retains one-eighth (12.5%), and the working interest owner holds the other 87.5%. (This comprises the balance of the production or income that remains after the royalty interest owner's share has been satisfied.)<sup>61</sup>

The **working interest owner** bears the entire cost of exploration for minerals, plus the development and production costs. The **royalty owner** bears none of the exploration, development, or operational costs.

There are other types of oil, gas, and mineral property payments that are reported on Schedule E, including the following.

- Bonus payments
- Delay rentals
- Landowner royalty
- Advance royalties
- Advance minimum royalties
- Shut-in royalties

**Note.** For more information on oil and gas taxpayers, including details on the various types of payments that are reported on Schedule E, see the 2015 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 6: Special Taxpayers. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

Unless the taxpayer has a working interest in the extraction operation of the oil, gas, or minerals, the payments are reported on part I of Schedule E on line 4. The gross amount of royalty income is reported on line 4, even if state or local taxes are withheld from oil or gas payments received. Any taxes withheld by the producer are reported on line 16.<sup>62</sup>

The payments are generally not subject to SE tax. Payments that result from a working interest are reported on Schedule C and are generally subject to SE tax. A taxpayer who holds a working interest in an oil or gas well directly or through an entity that does not limit the taxpayer's liability (i.e., general partnership) **is not a passive activity**, even if the taxpayer did not materially participate. Royalty income that is not derived in the ordinary course of a trade or business reported on Schedule E is generally not considered income from a passive activity.<sup>63</sup>

<sup>60</sup> IRS Pub. 525, *Taxable and Nontaxable Income*; IRS Pub. 17, *Your Federal Income Tax*.

<sup>61</sup> See, for example, *Mineral Rights*. King, Hobart. Geology.com. [[geology.com/articles/mineral-rights.shtml](https://geology.com/articles/mineral-rights.shtml)] Accessed on Mar. 19, 2020.

<sup>62</sup> Instructions for Schedule E.

<sup>63</sup> *Ibid.*

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**Depletion.** Owners of an economic interest in mineral deposits or oil and gas wells can recover their investment through a depletion allowance.<sup>64</sup> The depletion deduction accounts for the reduction of the property's value or basis from extracting the natural resource by mining, drilling, quarrying stone, or cutting timber. An economic interest exists if:<sup>65</sup>

- The taxpayer acquired any interest in mineral deposits or standing timber by investment; and
- The taxpayer has a legal right to income from the extraction of the mineral or cutting of the timber as a return of their capital investment.

The taxpayer's basis in the property is reduced (but not below zero) by the depletion allowed or allowable, whichever is greater.<sup>66</sup>

Depletion is reported on line 18 of Schedule E.<sup>67</sup>

**Example 8.** Raul has a nonworking royalty interest in P.U. Gas & Oil. For 2019, he receives a Form 1099-MISC from P.U. with \$5,600 of royalties reported in box 2. Raul is entitled to depletion of \$840.<sup>68</sup> He files the following Schedule E.

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<sup>64</sup> IRS Pub. 17, *Your Federal Income Tax*.

<sup>65</sup> IRS Pub. 535, *Business Expenses*.

<sup>66</sup> *Ibid.*

<sup>67</sup> Instructions for Schedule E.

<sup>68</sup> See IRC §613.

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## For Example 8

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. 13
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Department of the Treasury Internal Revenue Service (99)

Name(s) shown on return: **Raul Slick**      Your social security number: **888-88-8888**

**Part I** **Income or Loss From Rental Real Estate and Royalties**      Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099?  Yes  No

**B** If "Yes," did you or will you file required Forms 1099?  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)

**A** **493 Derek Drive, Dallas, Texas 75001**

**B**

**C**

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>6</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>		<input type="checkbox"/>
<b>B</b>			<b>B</b>		<input type="checkbox"/>
<b>C</b>			<b>C</b>		<input type="checkbox"/>

**Type of Property:**

1 Single Family Residence      3 Vacation/Short-Term Rental      5 Land      7 Self-Rental

2 Multi-Family Residence      4 Commercial      6 Royalties      8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>			
<b>4</b> Royalties received . . . . .	<b>4</b>	<b>5,600</b>		
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>			
<b>17</b> Utilities. . . . .	<b>17</b>			
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>840</b>		
<b>19</b> Other (list) ▶	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>840</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>4,760</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	( )	( )	( )
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>			
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>		<b>5,600</b>	
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>		<b>840</b>	
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>		<b>840</b>	
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. <b>Do not</b> include any losses . . . . .	<b>24</b>			<b>4,760</b>
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>	( )	( )	( )
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>4,760</b>



# 2020 Workbook

## FARM RENTAL INCOME AND EXPENSES FOR ESTATES AND TRUSTS<sup>69</sup>

For an estate or trust, farm rental income and expenses based on crops or livestock produced by a tenant is reported on part I of Schedule E. Estates and trusts do not use Form 4835, *Farm Rental Income and Expenses*, or Schedule F, *Profit or Loss From Farming*, for this purpose.

## LOSS LIMITATIONS

A loss on Schedule E from rental real estate, royalties, partnerships, S corporations, or estates or trusts may be limited. Three different sets of rules may limit the amount of losses deductible by an investor in a pass-through entity. These limitations, in the order in which they are applied, are as follows.

1. The basis limitations (IRC §704(d) for partners and IRC §1366(d) for S corporation shareholders)
2. The at-risk rules under IRC §465
3. The passive activity loss rules under IRC §469

## BASIS LIMITATION

An individual may not deduct losses in excess of their basis. Basis limitations for S corporations and partnerships are discussed later in the chapter.

**Note.** For more information on items that can increase or decrease basis, see IRS Pub. 551. For information pertaining to basis calculations for S corporation shareholders and partners in a partnership, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Schedule K-1. For information on variations of basis applicable to individual taxpayers, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis.

## AT-RISK RULES<sup>70</sup>

The at-risk rules apply to any trade or business or income-producing activity. Under the at-risk rules, a taxpayer can only claim a loss up to the amount for which they are at risk. Taxpayers are at risk for the following.

1. The amount of money plus the adjusted basis of property contributed to the entity
2. The amounts the individual borrowed for use in the entity's activity as long as the individual either:
  - a. Is personally liable for repayment, or
  - b. Has pledged property as security for the debt

In applying the at-risk rules:

*...substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid [the at-risk rules of] section 465.<sup>71</sup>*

<sup>69</sup> Instructions for Schedule E.

<sup>70</sup> IRC §465.

<sup>71</sup> Prop. Treas. Reg. §1.465-1(b).

Generally, transactions that add to the basis also add to the amount of financial risk investors bear from their investment in the entity. However, if the individual does not bear any true economic risk, the transaction is disregarded under the at-risk rules. One example is shares purchased with borrowed funds when the shares are used as collateral for the loan.<sup>72</sup> Money borrowed from someone who also holds an interest in the entity's profits or equity does not qualify as an amount at risk for the investor who uses the loan to purchase the ownership interest.<sup>73</sup>

Certain debts do not increase the at-risk amount.<sup>74</sup> In most cases, nonrecourse debts or debts with a guarantee or stop-loss provision are not considered to place the investor at additional risk.<sup>75</sup>

However, the rules for money loaned to an entity are less stringent than those for money used to buy into the entity. For debt purposes, the amount at risk can include loans the individual made to the company even if the funds were borrowed from another investor in the same entity.<sup>76</sup>

**Note.** For more information on the at-risk rules, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Schedule K-1.

## Schedule E At-Risk Issues<sup>77</sup>

The at-risk rules do not apply to losses from an activity of holding real property placed in service before 1987. They also do not apply to losses from any interest acquired before 1987 in a pass-through entity engaged in such activity. The activity of holding mineral property does not qualify for this exception.

## PASSIVE ACTIVITY LOSS RULES<sup>78</sup>

In general, under the passive loss rules, a loss or credit from a passive activity may only be used to the extent the taxpayer has income from a passive activity. If passive activity losses exceed a taxpayer's passive activity income, the losses are suspended until the taxpayer has sufficient income from the activity giving rise to the passive loss or from some other passive activity. Passive loss limitations are calculated on Form 8582, *Passive Activity Loss Limitations*.

The losses also cease to be suspended when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.<sup>79</sup>

**Example 9.** Gregory and Linda Mantle have owned and managed an apartment building for many years. Neither Gregory nor Linda qualify as a real estate professional (discussed later). The couple has suspended passive losses of \$110,000 from prior years. In 2019, the Mantles reported a \$10,000 loss on the real estate operation. On October 30, 2019, they sold the property in a fully taxable transaction for \$220,000. The suspended losses were released as fully deductible ordinary losses in 2019.

<sup>72</sup> IRS Pub. 925, *Passive Activity and At-Risk Rules*.

<sup>73</sup> Treas. Regs. §§1.465-8(a) and 1.465-20(a).

<sup>74</sup> IRC §465(b)(3).

<sup>75</sup> IRC §465(b)(4).

<sup>76</sup> IRS Pub. 925, *Passive Activity and At-Risk Rules*.

<sup>77</sup> Instructions for Schedule E.

<sup>78</sup> IRC §469.

<sup>79</sup> Instructions for Form 8582.

# 2020 Workbook

## For Example 9

**SCHEDULE E**  
(Form 1040 or 1040-SR)

**Supplemental Income and Loss**  
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

2019

Attachment  
Sequence No. **13**

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041.

▶ Go to [www.irs.gov/ScheduleE](http://www.irs.gov/ScheduleE) for instructions and the latest information.

Name(s) shown on return

Your social security number

**Gregory and Linda Mantle**

**111-44-9999**

**Part I** **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

- A** Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . .  Yes  No  
**B** If "Yes," did you or will you file required Forms 1099? . . . . .  Yes  No

<b>1a</b>	Physical address of each property (street, city, state, ZIP code)
<b>A</b>	<b>1951 Rook Lane, Urbana, IL 61801</b>
<b>B</b>	
<b>C</b>	

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>2</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>	<b>365</b>	<input type="checkbox"/>
<b>B</b>			<b>B</b>		<input type="checkbox"/>
<b>C</b>			<b>C</b>		<input type="checkbox"/>

**Type of Property:**

- 1 Single Family Residence      3 Vacation/Short-Term Rental      5 Land      7 Self-Rental  
 2 Multi-Family Residence      4 Commercial      6 Royalties      8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>	<b>14,250</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>	<b>150</b>		
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>	<b>1,000</b>		
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>	<b>2,500</b>		
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>	<b>2,500</b>		
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>	<b>5,600</b>		
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>	<b>3,000</b>		
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>	<b>1,000</b>		
<b>17</b> Utilities. . . . .	<b>17</b>	<b>4,000</b>		
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>4,500</b>		
<b>19</b> Other (list) ▶ . . . . .	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>24,250</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>(10,000)</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	<b>(120,000)</b>		
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>14,250</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>	<b>5,600</b>		
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>4,500</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>24,250</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. Do not include any losses . . . . .	<b>24</b>			
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>			<b>(120,000)</b>
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>(120,000)</b>

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040 or 1040-SR) 2019

# 2020 Workbook

## For Example 9

Form <b>8582</b> Department of the Treasury Internal Revenue Service (99)	<b>Passive Activity Loss Limitations</b> ▶ See separate instructions. ▶ Attach to Form 1040, Form 1040-SR, or Form 1041. ▶ Go to <a href="http://www.irs.gov/Form8582">www.irs.gov/Form8582</a> for instructions and the latest information.	OMB No. 1545-1008 <div style="text-align: center; font-size: 2em; font-weight: bold;">2019</div> Attachment Sequence No. 88
Name(s) shown on return <b>Gregory and Linda Mantle</b>		Identifying number <b>111-44-9999</b>
<b>Part I 2019 Passive Activity Loss</b> Caution: Complete Worksheets 1, 2, and 3 before completing Part I.		
<b>Rental Real Estate Activities With Active Participation</b> (For the definition of active participation, see <b>Special Allowance for Rental Real Estate Activities</b> in the instructions.)		
<b>1a</b> Activities with net income (enter the amount from Worksheet 1, column (a)) . . .	<b>1a</b>	
<b>b</b> Activities with net loss (enter the amount from Worksheet 1, column (b)) . . .	<b>1b</b> ( <b>10,000</b> )	
<b>c</b> Prior years' unallowed losses (enter the amount from Worksheet 1, column (c))	<b>1c</b> ( <b>110,000</b> )	
<b>d</b> Combine lines 1a, 1b, and 1c . . . . .	<b>1d</b>	<b>120,000</b>
<b>Commercial Revitalization Deductions From Rental Real Estate Activities</b>		
<b>2a</b> Commercial revitalization deductions from Worksheet 2, column (a) . . . . .	<b>2a</b> (            )	
<b>b</b> Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b) . . . . .	<b>2b</b> (            )	
<b>c</b> Add lines 2a and 2b . . . . .	<b>2c</b> (            )	
<b>All Other Passive Activities</b>		
<b>3a</b> Activities with net income (enter the amount from Worksheet 3, column (a)) . . .	<b>3a</b>	
<b>b</b> Activities with net loss (enter the amount from Worksheet 3, column (b)) . . .	<b>3b</b> (            )	
<b>c</b> Prior years' unallowed losses (enter the amount from Worksheet 3, column (c))	<b>3c</b> (            )	
<b>d</b> Combine lines 3a, 3b, and 3c . . . . .	<b>3d</b>	
<b>4</b> Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used . . . . .	<b>4</b>	<b>120,000</b>
If line 4 is a loss and: <ul style="list-style-type: none"> <li>• Line 1d is a loss, go to Part II.</li> <li>• Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.</li> <li>• Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.</li> </ul>		
<b>Caution:</b> If your filing status is married filing separately and you lived with your spouse at any time during the year, <b>do not</b> complete Part II or Part III. Instead, go to line 15.		
<b>Part II Special Allowance for Rental Real Estate Activities With Active Participation</b>		

6

### Material Participation

As a general rule, when the investor **does not materially participate** in the entity's business,<sup>80</sup> or if the entity is in the business of real estate rental,<sup>81</sup> the passive activity loss (PAL) rules apply. **Material participation** is generally defined as regular, continuous, and substantial involvement in the operations of the business activity by the individual.<sup>82</sup> However, the individual is considered to materially participate **if any of the following apply** during the year.<sup>83</sup>

1. The individual participates in the activity for more than 500 hours.
2. The individual's participation in the activity constitutes substantially all the participation in the activity by all individuals (including nonshareholders/nonpartners).
3. The individual participates in the activity for more than 100 hours, and no other individual participates in the activity more than the individual.

<sup>80</sup> IRC §469(c)(1)(B).

<sup>81</sup> IRC §469(c)(2).

<sup>82</sup> IRC §469(h)(1).

<sup>83</sup> Temp. Treas. Reg. §1.469-5T(d).

# 2020 Workbook

4. The activity is a significant participation activity (SPA) (defined as a trade or business activity in which the taxpayer's participation is greater than 100 hours and the taxpayer does not materially participate),<sup>84</sup> and the individual's aggregate participation in all significant participation activities exceeds 500 hours.

## Practitioner Planning Tip

In some situations, use of an SPA may be preferred to a grouping election. The grouping election is explained later.

5. The individual materially participated in the activity for any five of the preceding 10 tax years (not necessarily consecutive).
6. The activity is a personal service activity,<sup>85</sup> and the individual materially participated in any three preceding tax years (not necessarily consecutive).
7. Based on the facts and circumstances, the individual participates on a regular, continuous, and substantial basis.<sup>86</sup>

**Note.** Material participation is determined on an annual basis.

## Real Estate Exceptions<sup>87</sup>

Generally, the rental of real property is a rental activity under the PAL rules. However, exceptions apply. If the rental of property is not treated as a rental activity, a taxpayer must determine whether they are in the trade or business of property rental and, if so, whether they materially participated in the activity during the year.

Rental real estate losses are not limited by PAL rules if the taxpayer meets all the following conditions.

1. Rental real estate activities are the taxpayer's only passive activities.
2. The taxpayer does not have any prior year unallowed losses from any passive activities.
3. All the following apply if the taxpayer has an overall net loss from the rental real estate activities.
  - a. The taxpayer **actively participated** in all the rental real estate activities.
  - b. If the taxpayer is married filing separately (MFS), the spouses lived apart all year.
  - c. The overall net loss from the rental real estate activities is \$25,000 or less (\$12,500 or less if MFS).
  - d. The taxpayer does not have any current or prior year unallowed credits from passive activities.
  - e. The taxpayer's modified adjusted gross income (MAGI) is \$100,000 or less (\$50,000 or less if MFS).
  - f. The taxpayer does not hold any interest in a rental real estate activity as a limited partner or as a beneficiary of an estate or a trust.

<sup>84</sup> Defined in Temp. Treas. Reg. §1.469-5T(c).

<sup>85</sup> Defined in Temp. Treas. Reg. §1.469-5T(d).

<sup>86</sup> See also *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2001).

<sup>87</sup> Instructions for Schedule E.



**Active Participation.** Active participation does not require the taxpayer's regular, continuous, and substantial involvement in real estate activities. However, the taxpayer must participate in management decisions (e.g., approving new tenants, deciding on rental terms, approving capital or repair expenditures, etc.) or arranging for others to provide services (e.g., repairs) in a significant and bona fide manner.

A taxpayer is not considered to actively participate if, at any time during the tax year, their interest (including their spouse's interest) in the activity was less than 10% by value of all interests in the activity. In addition, a limited partner is not treated as actively participating in a partnership's rental real estate activities.

## Other Activities Exempted from PAL Rules

The following Schedule E activities have special PAL rules. All these activities are discussed earlier in the chapter.

- The rental of a dwelling unit that the taxpayer uses as a home is not subject to the PAL rules.
- A working interest in an oil or gas well held directly or through an entity that did not limit the taxpayer's liability is not a passive activity even if the taxpayer did not materially participate.
- Royalty income not derived in the ordinary course of a trade or business that is reported on Schedule E is generally not considered income from a passive activity.

## Real Estate Professional

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 activities are not considered passive.

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

1. The taxpayer owns at least one interest in rental real estate.<sup>88</sup>
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.<sup>89</sup>
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.<sup>90</sup>

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.<sup>91</sup>

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<sup>88</sup> Treas. Reg. §1.469-9(b)(6).

<sup>89</sup> IRC §469(c)(7)(B)(i).

<sup>90</sup> IRC §469(c)(7)(B)(ii).

<sup>91</sup> Treas. Reg. §1.469-9(b)(3).

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A real property trade or business includes the following types of activities associated with the real property.<sup>92</sup>

- 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 services are not treated as personal services performed in that activity unless the taxpayer is at least a 5% owner of the employer.<sup>93</sup> 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.<sup>94</sup>

It is important to note that the Tax Court has held<sup>95</sup> that the 750-hour requirement is not met by merely being on call. The Code<sup>96</sup> and underlying regulations<sup>97</sup> require that the taxpayer actually perform services that count toward the 750-hour requirement.

**Example 10.** Tristan works 700 hours renting personal watercraft and spends 800 hours in his trade or business of renting real estate. He maintains contemporaneous records to document the 800 hours he spends maintaining the property, marketing vacancies, and handling leasing issues. During 2019, Tristan reports a loss of \$23,000. Because he is a real estate professional, Tristan's loss is not limited as a passive activity. He files the following Schedule E.

Because Tristan is a real estate professional, his loss is also reported on page 2 of the Schedule E on line 43.

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<sup>92</sup> IRC §469(c)(7)(C).

<sup>93</sup> IRC §469(c)(7)(D)(ii).

<sup>94</sup> Treas. Reg. §1.469-9(c)(5).

<sup>95</sup> *James F. and Lynn M. Moss v. Comm'r*, 135 TC 18 (Sep. 20, 2010).

<sup>96</sup> IRC §469(c)(7)(B).

<sup>97</sup> Treas. Reg. §1.469-9(b)(4).

# 2020 Workbook

## For Example 10

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <span style="font-size: 2em; font-weight: bold;">2019</span> Attachment Sequence No. <b>13</b>
Department of the Treasury Internal Revenue Service (99)		
Name(s) shown on return <b>Tristan Tucker</b>		Your social security number <b>000-22-4444</b>

**Part I** **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . .  Yes  No

**B** If "Yes," did you or will you file required Forms 1099? . . . . .  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)

**A** **727 W Elm, Urbana, IL 61801**

**B**

**C**

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV	
<b>A</b>	<b>4</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>	<b>365</b>	<b>0</b>	<input type="checkbox"/>
<b>B</b>			<b>B</b>			<input type="checkbox"/>
<b>C</b>			<b>C</b>			<input type="checkbox"/>

- Type of Property:**
- 1 Single Family Residence
  - 2 Multi-Family Residence
  - 3 Vacation/Short-Term Rental
  - 4 Commercial
  - 5 Land
  - 6 Royalties
  - 7 Self-Rental
  - 8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>	<b>105,000</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>	<b>4,000</b>		
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>	<b>8,000</b>		
<b>8</b> Commissions. . . . .	<b>8</b>	<b>10,000</b>		
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>	<b>3,000</b>		
<b>11</b> Management fees . . . . .	<b>11</b>	<b>15,000</b>		
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>	<b>7,000</b>		
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>	<b>25,000</b>		
<b>17</b> Utilities. . . . .	<b>17</b>	<b>6,000</b>		
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>50,000</b>		
<b>19</b> Other (list) ▶	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>128,000</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>(23,000)</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	<b>(23,000)</b>		
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>105,000</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>50,000</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>128,000</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. Do not include any losses . . . . .	<b>24</b>			
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>			<b>(23,000)</b>
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>(23,000)</b>

# 2020 Workbook

## For Example 10

36					
37	Total estate and trust income or (loss). Combine lines 35 and 36 . . . . .				37
<b>Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) — Residual Holder</b>					
38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b
39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below				39
<b>Part V Summary</b>					
40	Net farm rental income or (loss) from Form 4835. Also, complete line 42 below . . . . .				40
41	Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18▶				41
42	Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AC; and Schedule K-1 (Form 1041), box 14, code F (see instructions) . . . . .				42
43	Reconciliation for real estate professionals. If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules . . . . .				43
				(23,000)	

Schedule E (Form 1040 or 1040-SR) 2019

## Land Rent<sup>98</sup>

A recharacterization rule applies to bare land leases. Under this recharacterization rule, net income from a rental activity is considered **not** from a passive activity if less than 30% of the unadjusted basis of the property is depreciable. The rule converts both net rental income and any gain on disposition from passive income to nonpassive income. However, the recharacterization rule only applies if there is net income from the rental activity. If there is a loss, the loss remains passive.

**Example 11.** Dr. Miller owns interests in multiple limited partnerships that have suspended passive losses. In an attempt to use those losses, Dr. Miller bought farmland for \$400,000. Of this amount, \$100,000 was allocated to fences, tile lines, grain bins, and other depreciable property. Dr. Miller cash leased the land to his cousin via a cash rent lease to generate passive income that he could use to offset his suspended passive losses. However, because only 25% of the unadjusted basis of the farming investment is attributable to depreciable property, the cash rent income is recharacterized (for passive loss rule purposes) as nonpassive income and cannot offset the suspended passive losses from the limited partnerships. If the cash rent produced a net loss after taxes, interest, and depreciation, it would be a passive loss. This is not the result that Dr. Miller was hoping to achieve.

## Self-Rental

Immediately after the Tax Reform Act of 1986 (TRA) was implemented, a number of new tax shelters arose. A common arrangement involved using self-rental arrangements to generate passive income to offset passive losses. The self-rental rule<sup>99</sup> was created to prevent taxpayers from shifting active income to passive income by renting property to a trade or business in which the taxpayer materially participates. Specifically, the self-rental rule recharacterizes as nonpassive a taxpayer's net rental activity income from an item of property if the property is rented for use in a trade or business activity in which the taxpayer materially participates.<sup>100</sup>

<sup>98</sup> Temp. Treas. Reg. §1.469-2T(f)(3) and see, e.g., *Wiseman v. Comm'r*, TC Memo 1995-203 (May 10, 1995).

<sup>99</sup> Treas. Reg. §1.469-2(f)(6).

<sup>100</sup> *Williams v. Comm'r*, TC Memo 2015-76 (Apr. 16, 2015).

**Note.** The self-rental rule has received renewed attention in the past several years because of the enactment of the NIIT and QBID. However, the final NIIT regulations<sup>101</sup> clarified that rental income recharacterized as nonpassive under the self-rental rule<sup>102</sup> is also treated as nonpassive for purposes of the NIIT. Accordingly, self-rental income is not subject to the NIIT.<sup>103</sup> Self-rental income qualifies for the QBID.

**Applicability of Self-Rental Rule.** To fall within the scope of the self-rental rule, the income must be received by the taxpayer for property that is:

- Rented for use in a trade or business activity<sup>104</sup> in which the taxpayer materially participates, and
- Is not property rented incidental to a development activity. (As described in Treas. Reg. §1.469-2(f)(5), this involves material or significant participation in an activity for the purposes of enhancing the value of the property if the property is rented during the year of its sale.)

Treas. Reg. §1.469-5(f) provides that any work done by an individual in connection with an activity in which they own an interest at the time the work is performed is treated as participation by the individual in the activity. A taxpayer materially participates in an activity if any of the seven tests previously mentioned are met.<sup>105</sup>

**Example 12.** Madge Juniper operates a construction business as a sole proprietor. Juniper, LLC (of which Madge is the sole owner) owns an office building. Juniper, LLC, rents the office building to Madge's construction business at a fair rental price.

This arrangement is subject to the self-rental rule. The building owned by the LLC is rented by the construction company for use in a trade or business in which Madge materially participates.

**Example 13.** Harry Ruffcorn is a 1% shareholder in Imagine That, Inc., an S corporation that runs an advertising business. Harry does not materially participate in the business. Harry is also a 50% owner of a building that Imagine That, Inc., rents for its offices.

This arrangement is not subject to the self-rental rules because Harry does not materially participate in the business of Imagine That, Inc.

**Self-Rental Income and Losses.** A taxpayer's rental income from an item of property rented for use in a trade or business activity in which the taxpayer materially participates is recharacterized as nonpassive. Conversely, the self-rental rule does not recharacterize as nonpassive a loss incurred through such a rental. A loss from a self-rental arrangement retains its character as passive.<sup>106</sup>

**Example 14.** June and Leland are married taxpayers who own commercial property. They lease their property to FallsCo, an S corporation in which they materially participate. During 2019, June and Leland earned \$100,000 in rental income from FallsCo. Under the self-rental rule, the \$100,000 in rental income received from FallsCo is recharacterized as nonpassive income.

June and Leland's Schedule E follows.

<sup>101</sup>. IRS Ann. 2014-18, 2014-17 IRB 983.

<sup>102</sup>. Treas. Reg. §1.469-2(f)(6).

<sup>103</sup>. Treas. Reg. §1.1411-5(b)(2)(i).

<sup>104</sup>. This term is used within the meaning of Treas. Reg. §1.469-2(e)(2).

<sup>105</sup>. Temp. Treas. Reg. §1.469-5T(a).

<sup>106</sup>. IRC §469(a)(1)(A).

# 2020 Workbook

## For Example 14

**SCHEDULE E**  
(Form 1040 or 1040-SR)

**Supplemental Income and Loss**  
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

2019

Attachment  
Sequence No. **13**

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041.

▶ Go to [www.irs.gov/ScheduleE](http://www.irs.gov/ScheduleE) for instructions and the latest information.

Name(s) shown on return

Your social security number

**June and Leland Mensching**

**999-88-7777**

**Part I** **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . .  Yes  No

**B** If "Yes," did you or will you file required Forms 1099? . . . . .  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)

**A** **134 Steel Lane, Lansing, IN 87890**

**B**

**C**

<b>1b</b>	Type of Property (from list below)	<b>2</b> For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>7</b>		<b>365</b>		<input type="checkbox"/>
<b>B</b>					<input type="checkbox"/>
<b>C</b>					<input type="checkbox"/>

**Type of Property:**

- |                           |                              |             |                    |
|---------------------------|------------------------------|-------------|--------------------|
| 1 Single Family Residence | 3 Vacation/Short-Term Rental | 5 Land      | 7 Self-Rental      |
| 2 Multi-Family Residence  | 4 Commercial                 | 6 Royalties | 8 Other (describe) |

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>	<b>150,000</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>	<b>7,000</b>		
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>	<b>5,000</b>		
<b>11</b> Management fees . . . . .	<b>11</b>	<b>10,000</b>		
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>			
<b>17</b> Utilities. . . . .	<b>17</b>	<b>15,000</b>		
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>13,000</b>		
<b>19</b> Other (list) ▶ . . . . .	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>50,000</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>100,000</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	( )	( )	( )
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>150,000</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>13,000</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>50,000</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. Do not include any losses . . . . .	<b>24</b>			<b>100,000</b>
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>	( )	( )	( )
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>100,000</b>

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040 or 1040-SR) 2019

# 2020 Workbook

**Example 15.** Use the same facts as **Example 14**, except June and Leland lost \$30,000 on the property they rented to FallsCo. The \$30,000 loss remains a passive loss.

June and Leland do not have passive income to offset the loss and had MAGI of \$160,000. They file the following Schedule E and Form 8582 to calculate their passive activity loss limit.

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. <b>13</b>		
Department of the Treasury Internal Revenue Service (99)				
Name(s) shown on return <b>June and Leland Mensching</b>		Your social security number <b>999-88-7777</b>		
<b>Part I Income or Loss From Rental Real Estate and Royalties</b> Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.				
<b>A</b> Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <b>B</b> If "Yes," did you or will you file required Forms 1099? . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No				
<b>1a</b>	Physical address of each property (street, city, state, ZIP code)			
<b>A</b>	<b>134 Steel Lane, Lansing, IN 87890</b>			
<b>B</b>				
<b>C</b>				
<b>1b</b>	Type of Property (from list below)	<b>2</b> For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days Personal Use Days QJV	
<b>A</b>	<b>7</b>	<b>A</b> <b>365</b>	<input type="checkbox"/>	
<b>B</b>		<b>B</b>	<input type="checkbox"/>	
<b>C</b>		<b>C</b>	<input type="checkbox"/>	
<b>Type of Property:</b> 1 Single Family Residence      3 Vacation/Short-Term Rental      5 Land      7 Self-Rental 2 Multi-Family Residence      4 Commercial      6 Royalties      8 Other (describe)				
<b>Income:</b>	<b>Properties:</b>	<b>A</b>	<b>B</b>	<b>C</b>
<b>3</b> Rents received . . . . .	<b>3</b>	<b>20,000</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>	<b>7,000</b>		
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>	<b>5,000</b>		
<b>11</b> Management fees . . . . .	<b>11</b>	<b>10,000</b>		
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>			
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>			
<b>17</b> Utilities. . . . .	<b>17</b>	<b>15,000</b>		
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>13,000</b>		
<b>19</b> Other (list) ▶ . . . . .	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>50,000</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>(30,000)</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	( )	( )	( )
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>20,000</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>			
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>13,000</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>50,000</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. Do not include any losses . . . . .	<b>24</b>			
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>	( )		
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>0</b>

# 2020 Workbook

## For Example 15

Form **8582**  
 Department of the Treasury  
 Internal Revenue Service (99)

### Passive Activity Loss Limitations

▶ See separate instructions.  
 ▶ Attach to Form 1040, Form 1040-SR, or Form 1041.  
 ▶ Go to [www.irs.gov/Form8582](http://www.irs.gov/Form8582) for instructions and the latest information.

OMB No. 1545-1008

**2019**  
 Attachment  
 Sequence No. **88**

Name(s) shown on return

**June and Leland Mensching**

Identifying number

**999-88-7777**

#### **Part I** 2019 Passive Activity Loss

**Caution:** Complete Worksheets 1, 2, and 3 before completing Part I.

**Rental Real Estate Activities With Active Participation** (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)

1a Activities with net income (enter the amount from Worksheet 1, column (a)) . . . . .	<b>1a</b>			
1b Activities with net loss (enter the amount from Worksheet 1, column (b)) . . . . .	<b>1b</b>	(	30,000	)
1c Prior years' unallowed losses (enter the amount from Worksheet 1, column (c)) . . . . .	<b>1c</b>	(		)
1d Combine lines 1a, 1b, and 1c . . . . .	<b>1d</b>			(30,000)

#### **Commercial Revitalization Deductions From Rental Real Estate Activities**

2a Commercial revitalization deductions from Worksheet 2, column (a) . . . . .	<b>2a</b>	(		)
2b Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b) . . . . .	<b>2b</b>	(		)
2c Add lines 2a and 2b . . . . .	<b>2c</b>	(		)

#### **All Other Passive Activities**

3a Activities with net income (enter the amount from Worksheet 3, column (a)) . . . . .	<b>3a</b>			
3b Activities with net loss (enter the amount from Worksheet 3, column (b)) . . . . .	<b>3b</b>	(		)
3c Prior years' unallowed losses (enter the amount from Worksheet 3, column (c)) . . . . .	<b>3c</b>	(		)
3d Combine lines 3a, 3b, and 3c . . . . .	<b>3d</b>			

4 Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used . . . . .	<b>4</b>			(30,000)
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If line 4 is a loss and:

- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

**Caution:** If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or Part III. Instead, go to line 15.

#### **Part II** Special Allowance for Rental Real Estate Activities With Active Participation

**Note:** Enter all numbers in Part II as positive amounts. See instructions for an example.

5 Enter the <b>smaller</b> of the loss on line 1d or the loss on line 4 . . . . .	<b>5</b>			(30,000)
6 Enter \$150,000. If married filing separately, see instructions . . . . .	<b>6</b>		150,000	
7 Enter modified adjusted gross income, but not less than zero. See instructions . . . . .	<b>7</b>		160,000	
<b>Note:</b> If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.				
8 Subtract line 7 from line 6 . . . . .	<b>8</b>			
9 Multiply line 8 by 50% (0.50). <b>Do not</b> enter more than \$25,000. If married filing separately, see instructions . . . . .	<b>9</b>			
10 Enter the <b>smaller</b> of line 5 or line 9 . . . . .	<b>10</b>			0

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

#### **Part III** Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

**Note:** Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.

11 Enter \$25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions . . . . .	<b>11</b>			
12 Enter the loss from line 4 . . . . .	<b>12</b>			
13 Reduce line 12 by the amount on line 10 . . . . .	<b>13</b>			
14 Enter the <b>smallest</b> of line 2c (treated as a positive amount), line 11, or line 13 . . . . .	<b>14</b>			

#### **Part IV** Total Losses Allowed

15 Add the income, if any, on lines 1a and 3a and enter the total . . . . .	<b>15</b>			0
16 <b>Total losses allowed from all passive activities for 2019.</b> Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return . . . . .	<b>16</b>			0

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 63704F

Form **8582** (2019)



The self-rental rule applies to an **item of property**, not an activity. This distinction remains even if the taxpayer has grouped activities as a single unit under the passive loss grouping rules (grouping rules are covered in the next section).<sup>107</sup> This means that the taxpayer cannot calculate net income or loss for all self-rental activities within their business.

**Self-Rental Rule and SE Tax.** Rentals from real estate and from personal property leased with real estate are excluded from the definition of SE income.<sup>108</sup> Consequently, income from self-rental properties does not trigger SE tax.

This exclusion does not apply to the rental of farmland when the owner materially participates in the farming operation.<sup>109</sup> Rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer materially participates in the production or the management of production on the land.

## Grouping Rules

To determine whether the taxpayer materially participated in their rental real estate activities, each interest in rental real estate is a separate activity unless the taxpayer elects to treat all their interests in rental real estate as one activity.<sup>110</sup>

Two or more activities may be grouped together and treated as one single activity.<sup>111</sup> 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.<sup>112</sup> This list is 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.**

The regulations expressly prohibit certain groupings.<sup>113</sup> 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.

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<sup>107</sup> Treas. Reg. §1.469-4(c)(1).

<sup>108</sup> IRC §1402(a)(1).

<sup>109</sup> Ibid.

<sup>110</sup> Instructions for Schedule E.

<sup>111</sup> Treas. Reg. §1.469-4(c)(1).

<sup>112</sup> Treas. Reg. §1.469-4(c)(2).

<sup>113</sup> Treas. Reg. §1.469-4.



## Practitioner Planning Tip

Taxpayers may want to consider grouping the self-rental activity producing a loss with their operating entity. They can do this if their activities together constitute an appropriate economic unit and the rental activity is insubstantial in relation to the business activity (or the business activity is insubstantial in relation to the rental activity).<sup>114</sup>

To define “insubstantial,” the Treasury Department originally created an “80/20 test” for purposes of grouping rental and nonrental activities.<sup>115</sup> Under that test, rental and nonrental activities may be grouped “if more than 80% of the income of the [activity]... is attributable to one class of operations (i.e., rental or nonrental).” While this temporary regulation is no longer in place and the final regulations do not adopt a bright-line or safe harbor gross revenue test, the courts still view the 80/20 test as an appropriate representation of what constitutes “insubstantial.”<sup>116</sup>

**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 identifies a facts-and-circumstances test to establish whether a particular grouping is appropriate. In general, under IRC §469, activities can only be grouped if they constitute an appropriate economic unit for measuring gain or loss (discussed earlier).

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.*<sup>117</sup> 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 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.

<sup>114</sup> Treas. Reg. 1.469-4(d)(1)(i).

<sup>115</sup> Temp. Treas. Reg. 1.469-4T.

<sup>116</sup> See, e.g., *Candelaria v. U.S.*, 518 F. Supp. 2d 852 (W.D. Tex. 2007).

<sup>117</sup> *Glick v. U.S.*, 96 F.Supp.2d 850 (2000).

Other benefits of grouping include the following.

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

**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 amount available to be offset by future passive losses.

**Regrouping.** 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.<sup>118</sup> 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.

Once activities are grouped together, the taxpayer may generally not regroup them in subsequent tax years.<sup>119</sup> 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.<sup>120</sup> 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.<sup>121</sup>

**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.<sup>122</sup> 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

<sup>118</sup> Treas. Reg. §1.469-11(b)(3)(iv).

<sup>119</sup> Treas. Reg. §1.469-4(e)(1).

<sup>120</sup> Treas. Reg. §1.469-4(e)(2).

<sup>121</sup> Treas. Reg. §1.469-4(f).

<sup>122</sup> Rev. Proc. 2010-13, 2010-4 IRB 329.

# 2020 Workbook

**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.<sup>123</sup>

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

**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 tax 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 §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 tax 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 tax 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 who 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.<sup>124</sup> 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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<sup>123</sup> Treas. Reg. §1.469-4(g).

<sup>124</sup> Rev. Proc. 2010-13, 2010-4 IRB 329.

**Fresh-Start Regrouping.** 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.<sup>125</sup> 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.

**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 and Treas. Reg. §1.469-9(g)(3).

**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.

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<sup>125</sup> Treas. Reg. §1.469-11(b)(3)(iv).

# 2020 Workbook

## ***Grouping and Regrouping Examples.***

**Example 16.** George is involved in two partnerships. In the George's Family Restaurant partnership, he is a general partner working 50 hours per year as a kitchen consultant for this restaurant activity. KitKatConsult is a catering business organized as a partnership. George is a partner in this activity as well. He works 50 hours per week as a consultant for the catering business.

In 2019, George's restaurant activity had a loss. His 2019 Schedule K-1 reports \$100,000 as his share of the loss. His 2019 Schedule K-1 for the catering consulting business reports a \$130,000 profit.

Tax filing season arrives and George takes his tax information to his tax preparer, Ginger. She reviews returns from prior years and his 2019 tax information, including both Schedules K-1. She discovers that George never made an election to group the partnership activities.

Ginger notes that because George does not materially participate in the restaurant activity, the \$100,000 loss is considered passive. She also notes that George 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 George 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 George. The benefits of making a grouping election are as follows.

1. George can offset the income from the catering consulting activity with the restaurant activity loss.
2. For 2019, George 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 George.

1. The grouping decision is irrevocable without the IRS's consent. However, if George 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.

George agrees to the election and Ginger files the required statement with his 2019 tax return. This statement follows.

# 2020 Workbook

## For Example 16

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

Taxpayer Name: **George Jones**                      Tax Yearend: **2019**

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.

<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
George's Family Restaurant	123 Island Dr., Oceanside, MD	39-5555555	Restaurant
KitKatConsult 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.

<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
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.

<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
N/A	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

# 2020 Workbook

George files the following Schedule E that shows the two activities grouped together.

Schedule E (Form 1040 or 1040-SR) 2019

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

**George Jones**

**999-99-9999**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** — **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . .  **Yes**  **No**

	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b> <b>George's Family Restaurant</b>	<b>P</b>	<input type="checkbox"/>	<b>39-5555555</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b> <b>KitKatConsult Partners</b>	<b>P</b>	<input type="checkbox"/>	<b>39-5456555</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>		<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>		<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Passive Income and Loss		Nonpassive Income and Loss		
(g) Passive loss allowed (attach <b>Form 8582</b> if required)	(h) Passive income from <b>Schedule K-1</b>	(i) Nonpassive loss allowed (see <b>Schedule K-1</b> )	(j) Section 179 expense deduction from <b>Form 4562</b>	(k) Nonpassive income from <b>Schedule K-1</b>
<b>A</b>		<b>100,000</b>		
<b>B</b>				<b>130,000</b>
<b>C</b>				
<b>D</b>				
<b>29a</b> Totals		<b>100,000</b>		<b>130,000</b>
<b>b</b> Totals		<b>100,000</b>		
<b>30</b> Add columns (h) and (k) of line 29a. . . . .			<b>30</b>	<b>130,000</b>
<b>31</b> Add columns (g), (i), and (j) of line 29b. . . . .			<b>31</b>	<b>( 100,000 )</b>
<b>32</b> <b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31 . . . . .			<b>32</b>	<b>30,000</b>

**Part III** **Income or Loss From Estates and Trusts**



# 2020 Workbook

**Example 17.** Use the same facts as **Example 16**. In addition to his 2019 partnership interests in the restaurant and consulting business, George also solely owned a catering business and a food truck business, which is part of the following election. He employs fulltime operations managers for each of these activities.

<b>Statement Filed in Accordance with Rev. Proc. 2010-13 and Election to Group Activities Under Treas. Reg. §1.469-4(c)</b>			
Taxpayer Name: <b>George Jones</b>		Tax Yearend: <b>2019</b>	
Taxpayer ID #: <b>999-99-9999</b>			
<b>New Groupings</b>			
The following activities were grouped as a single activity for the first time during the current tax year.			
<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
George's Family Restaurant	123 Island Dr., Oceanside, MD	39-5555555	Restaurant
KitKatConsult Partners	125 Island Dr., Oceanside, MD	39-5456555	Consulting
George's Catering	125 Island Dr., Oceanside, MD	39-6555555	Catering
George's Food Truck	125 Island Dr., Oceanside, MD	39-5555557	Food Truck
<b>Adding Activities to Existing Grouping</b>			
The following activities were added to an existing group during the current tax year.			
<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
N/A	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
<b>Regrouping Activities</b>			
The following activities were regrouped either due to an error or change in facts and circumstances during the current tax year.			
<b>Activity</b>	<b>Address</b>	<b>EIN</b>	<b>Type of Activity</b>
N/A	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

In 2020, George decides to invest in a kitchen supply business as a partner.

# 2020 Workbook

George's wealthy aunt died in 2020 and George inherited his aunt's vast holdings. From this inheritance, George purchased a rental property in 2020. He reports the rental real estate on Schedule E. In 2020, George'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: George's Family Restaurant	\$10,000		50 hours per year
KitKatConsult	(16,000)		2,600 hours per year
Catering	(8,000)		200 hours per year
Food truck	<u>(18,000)</u>		<u>50 hours per year</u>
Group 1 total	(\$32,000)	(32,000)	2,900 hours per year <sup>a</sup>
Kitchen supply company (passive activity)		(25,000)	80 hours per year
Real estate rental loss		(9,500)	

<sup>a</sup> George 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 George's 2020 adjusted gross income.

George's tax professional Ginger provides the following tax information to George.

Wages	\$230,000	
Interest income	11,000	\$11,000
Ordinary dividends from estate	29,000	29,000
Passive loss from rental (\$9,500)	0 <sup>a</sup>	
Kitchen supply business loss (\$25,000)	0 <sup>a</sup>	
Group 1 nonpassive loss	<u>(32,000)</u>	
MAGI	\$238,000	
Less: net investment income (NII) threshold <sup>b</sup>	<u>(200,000)</u>	
A: Excess of MAGI over NII threshold	\$ 38,000	
B: Total passive income		<u>\$40,000</u>
Lesser of A or B	\$ 38,000	
	<u>× 3.8%</u>	
NIIT	\$ 1,444	

<sup>a</sup> Passive loss limitation.

<sup>b</sup> See instructions for Form 8960, *Net Investment Income Tax*, and IRC §1411(b).

Ginger explains that because 2020 is the first year that George is subject to the NIIT, he is allowed to regroup his previous group 1 activities under the fresh-start provisions.

George elects to regroup his activities for 2020. He removes the restaurant activity from group 1 and adds the kitchen supply business to it. By doing this, he has created \$10,000 of passive income to offset the \$9,500 passive real estate rental loss. By adding the kitchen supply business to group 1, he can increase his group 1 activity loss by the \$25,000 kitchen supply loss.

# 2020 Workbook

After regrouping using the fresh-start election, George'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: KitKatConsult	(\$16,000)		
Catering	(8,000)		
Food truck	(18,000)		
Kitchen supply	(25,000)		
Group 1 total	(\$67,000)	(67,000)	
George's Family Restaurant (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, George saves \$1,311 (\$1,444 – \$133) in NIIT.

**Caution.** Unless there is a material change in George's facts and circumstances, he must continue with this grouping.

**Observation.** Although the grouping discussion has been focused on PAL and strategies associated with avoiding NIIT, there are different aggregation rules and strategies associated with qualified business income (QBI).

# 2020 Workbook

## QBID and Previously Disallowed Losses<sup>126</sup>

Various commenters on proposed §199A regulations observed that while previously disallowed losses from tax years beginning **after** December 31, 2017, must be taken into account in computing QBI,<sup>127</sup> there are no ordering rules for utilization of these losses. The IRS responded by including a first-in, first-out (FIFO) rule in the final regulations applicable to losses or deductions (including those under §§465, 469, 704(d), and 1366(d)) that were disallowed, suspended, limited, or carried over from prior years. However, these rules do **not** apply to losses or deductions from tax years ending **before** January 1, 2018.<sup>128</sup>

Another commenter on the proposed §199A regulations expressed concern regarding mismatches between §§469 and 199A activity aggregations and how passive loss carryovers should be applied in these circumstances. The IRS responded by issuing a proposed regulation modifying Treas. Reg. §1.199A-3(b)(1)(iv).<sup>129</sup> The relevant part of the proposed regulation follows, with the modifications bolded.<sup>130</sup>

*Previously disallowed losses or deductions (including losses disallowed under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year generally are taken into account for purposes of computing QBI **to the extent the disallowed loss or deduction is otherwise allowed by section 199A and this section.** These losses shall be used, for purposes of section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis **and shall be treated as losses from a separate trade or business.** **To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account.***

**Example 18.** Joe Strongheart owns a single family rental property. The rental activity qualifies as a trade or business. In 2017, his tenant did not pay rent during the year and Joe sustained a \$2,500 loss on the rental activity. The loss was suspended because Joe's modified AGI was \$150,000.

In 2018, the property was not in service due to substantial renovations made after Joe's last tenant vacated. The property again became available for rent in 2019 and Joe earned a profit of \$1,096. Joe's 2019 MAGI was \$150,000. The previously suspended loss was released to reduce his 2019 net rental profit for income tax purposes to \$0. Even though Joe has \$0 net income for tax purposes, he is eligible for a QBID because the passive loss that eliminated the taxable income for 2019 was incurred in a year beginning before January 1, 2018.

Relevant forms from Joe's 2019 tax return follow.

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<sup>126</sup> TD 9847, 2019-09 IRB 670, 680.

<sup>127</sup> Prop. Treas. Reg. §1.99A-3(b)(1)(iv).

<sup>128</sup> Treas. Reg. §1.199A-3(b)(1)(iv).

<sup>129</sup> REG-134652-18 (Jan. 18, 2019).

<sup>130</sup> Prop. Treas. Reg. §1.199A-3(b)(1)(v).

# 2020 Workbook

## For Example 18

<b>SCHEDULE E</b> (Form 1040 or 1040-SR)	<b>Supplemental Income and Loss</b> (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041. ▶ Go to <a href="http://www.irs.gov/ScheduleE">www.irs.gov/ScheduleE</a> for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. <b>13</b>
Department of the Treasury Internal Revenue Service (99)		
Name(s) shown on return <b>Joe Strongheart</b>		Your social security number <b>999-88-7777</b>

**Part I** **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

**A** Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) . . . . .  Yes  No  
**B** If "Yes," did you or will you file required Forms 1099? . . . . .  Yes  No

**1a** Physical address of each property (street, city, state, ZIP code)  
**A** **7821 First Street, Charleston, IL 61920**  
**B**  
**C**

1b	Type of Property (from list below)	2	Fair Rental Days	Personal Use Days	QJV
<b>A</b>	<b>1</b>	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the <b>QJV</b> box only if you meet the requirements to file as a qualified joint venture. See instructions.	<b>A</b>	<b>365</b>	<input type="checkbox"/>
<b>B</b>			<b>B</b>		<input type="checkbox"/>
<b>C</b>			<b>C</b>		<input type="checkbox"/>

**Type of Property:**  
 1 Single Family Residence      3 Vacation/Short-Term Rental      5 Land      7 Self-Rental  
 2 Multi-Family Residence      4 Commercial      6 Royalties      8 Other (describe)

Income:	Properties:	A	B	C
<b>3</b> Rents received . . . . .	<b>3</b>	<b>12,000</b>		
<b>4</b> Royalties received . . . . .	<b>4</b>			
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see instructions) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions. . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>	<b>654</b>		
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see instructions)	<b>12</b>	<b>1,250</b>		
<b>13</b> Other interest. . . . .	<b>13</b>			
<b>14</b> Repairs. . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>	<b>6,250</b>		
<b>17</b> Utilities. . . . .	<b>17</b>			
<b>18</b> Depreciation expense or depletion . . . . .	<b>18</b>	<b>2,750</b>		
<b>19</b> Other (list) ▶ . . . . .	<b>19</b>			
<b>20</b> Total expenses. Add lines 5 through 19 . . . . .	<b>20</b>	<b>10,904</b>		
<b>21</b> Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 . . . . .	<b>21</b>	<b>1,096</b>		
<b>22</b> Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions) . . . . .	<b>22</b>	<b>1,096</b>		
<b>23a</b> Total of all amounts reported on line 3 for all rental properties . . . . .	<b>23a</b>	<b>12,000</b>		
<b>b</b> Total of all amounts reported on line 4 for all royalty properties . . . . .	<b>23b</b>			
<b>c</b> Total of all amounts reported on line 12 for all properties . . . . .	<b>23c</b>	<b>1,250</b>		
<b>d</b> Total of all amounts reported on line 18 for all properties . . . . .	<b>23d</b>	<b>2,750</b>		
<b>e</b> Total of all amounts reported on line 20 for all properties . . . . .	<b>23e</b>	<b>10,904</b>		
<b>24</b> <b>Income.</b> Add positive amounts shown on line 21. Do not include any losses . . . . .	<b>24</b>		<b>1,096</b>	
<b>25</b> <b>Losses.</b> Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here . . . . .	<b>25</b>		<b>1,096</b>	
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040 or 1040-SR), line 5, or Form 1040-NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>0</b>

# 2020 Workbook

## For Example 18

Form **8582**  
 Department of the Treasury  
 Internal Revenue Service (99)

### Passive Activity Loss Limitations

▶ See separate instructions.  
 ▶ Attach to Form 1040, Form 1040-SR, or Form 1041.  
 ▶ Go to [www.irs.gov/Form8582](http://www.irs.gov/Form8582) for instructions and the latest information.

OMB No. 1545-1008

**2019**  
 Attachment  
 Sequence No. **88**

Name(s) shown on return  
**Joe Strongheart**

Identifying number  
**999-88-7777**

#### **Part I** 2019 Passive Activity Loss

**Caution:** Complete Worksheets 1, 2, and 3 before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see Special Allowance for Rental Real Estate Activities in the instructions.)			
<b>1a</b>	Activities with net income (enter the amount from Worksheet 1, column (a)) . . . . .	<b>1a</b>	<b>1,096</b>
<b>b</b>	Activities with net loss (enter the amount from Worksheet 1, column (b)) . . . . .	<b>1b</b>	( )
<b>c</b>	Prior years' unallowed losses (enter the amount from Worksheet 1, column (c)) . . . . .	<b>1c</b>	( <b>2,500</b> )
<b>d</b>	Combine lines 1a, 1b, and 1c . . . . .	<b>1d</b>	<b>(1,404)</b>
Commercial Revitalization Deductions From Rental Real Estate Activities			
<b>2a</b>	Commercial revitalization deductions from Worksheet 2, column (a) . . . . .	<b>2a</b>	( )
<b>b</b>	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b) . . . . .	<b>2b</b>	( )
<b>c</b>	Add lines 2a and 2b . . . . .	<b>2c</b>	( )
All Other Passive Activities			
<b>3a</b>	Activities with net income (enter the amount from Worksheet 3, column (a)) . . . . .	<b>3a</b>	( )
<b>b</b>	Activities with net loss (enter the amount from Worksheet 3, column (b)) . . . . .	<b>3b</b>	( )
<b>c</b>	Prior years' unallowed losses (enter the amount from Worksheet 3, column (c)) . . . . .	<b>3c</b>	( )
<b>d</b>	Combine lines 3a, 3b, and 3c . . . . .	<b>3d</b>	( )
<b>4</b>	Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used . . . . . If line 4 is a loss and: <ul style="list-style-type: none"> <li>• Line 1d is a loss, go to Part II.</li> <li>• Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.</li> <li>• Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.</li> </ul>	<b>4</b>	<b>(1,404)</b>

**Caution:** If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or Part III. Instead, go to line 15.

#### **Part II** Special Allowance for Rental Real Estate Activities With Active Participation

**Note:** Enter all numbers in Part II as positive amounts. See instructions for an example.

<b>5</b>	Enter the <b>smaller</b> of the loss on line 1d or the loss on line 4 . . . . .	<b>5</b>	<b>1,404</b>
<b>6</b>	Enter \$150,000. If married filing separately, see instructions . . . . .	<b>6</b>	<b>150,000</b>
<b>7</b>	Enter modified adjusted gross income, but not less than zero. See instructions . . . . .	<b>7</b>	<b>150,000</b>
<b>8</b>	Subtract line 7 from line 6 . . . . .	<b>8</b>	<b>0</b>
<b>9</b>	Multiply line 8 by 50% (0.50). <b>Do not</b> enter more than \$25,000. If married filing separately, see instructions . . . . .	<b>9</b>	<b>0</b>
<b>10</b>	Enter the <b>smaller</b> of line 5 or line 9 . . . . . If line 2c is a loss, go to Part III. Otherwise, go to line 15.	<b>10</b>	<b>0</b>

#### **Part III** Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

**Note:** Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.

<b>11</b>	Enter \$25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions . . . . .	<b>11</b>	( )
<b>12</b>	Enter the loss from line 4 . . . . .	<b>12</b>	( )
<b>13</b>	Reduce line 12 by the amount on line 10 . . . . .	<b>13</b>	( )
<b>14</b>	Enter the <b>smallest</b> of line 2c (treated as a positive amount), line 11, or line 13 . . . . .	<b>14</b>	( )

#### **Part IV** Total Losses Allowed

<b>15</b>	Add the income, if any, on lines 1a and 3a and enter the total . . . . .	<b>15</b>	<b>1,096</b>
<b>16</b>	<b>Total losses allowed from all passive activities for 2019.</b> Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return . . . . .	<b>16</b>	<b>1,096</b>

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 63704F

Form **8582** (2019)

# 2020 Workbook

## For Example 18

Form 8582 (2019)

Page **2**

**Caution:** The worksheets must be filed with your tax return. Keep a copy for your records.

**Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c** (see instructions)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
<b>Residential Rental</b>	<b>1,096</b>		<b>2,500</b>		<b>1,404</b>
<b>Total.</b> Enter on Form 8582, lines 1a, 1b, and 1c . . . . . ▶	<b>1,096</b>		<b>2,500</b>		

**Worksheet 2—For Form 8582, Lines 2a and 2b** (see instructions)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
<b>Total.</b> Enter on Form 8582, lines 2a and 2b . . . . . ▶			

**Worksheet 3—For Form 8582, Lines 3a, 3b, and 3c** (see instructions)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
<b>Total.</b> Enter on Form 8582, lines 3a, 3b, and 3c . . . . . ▶					

**Worksheet 4—Use This Worksheet if an Amount Is Shown on Form 8582, Line 10 or 14.** See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
<b>Total</b> . . . . . ▶			<b>1.00</b>		

**Worksheet 5—Allocation of Unallowed Losses** (see instructions)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
<b>Residential Rental</b>	<b>Sch E Ln 22</b>	<b>1,404</b>	<b>1.000000</b>	<b>1,404</b>
<b>Total</b> . . . . . ▶		<b>1,404</b>	<b>1.00</b>	<b>1,404</b>

Form **8582** (2019)

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# 2020 Workbook

## For Example 18

Form **8995**

Department of the Treasury  
Internal Revenue Service

## Qualified Business Income Deduction Simplified Computation

▶ Attach to your tax return.

▶ Go to [www.irs.gov/Form8995](http://www.irs.gov/Form8995) for instructions and the latest information.

OMB No. 1545-0123

2019

Attachment  
Sequence No. **55**

Name(s) shown on return <b>Joe Strongheart</b>		Your taxpayer identification number <b>999-88-7777</b>	
<b>1</b>	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
<b>i</b>	<b>Residential Rental</b>	<b>999-88-7777</b>	<b>1,096</b>
<b>ii</b>			
<b>iii</b>			
<b>iv</b>			
<b>v</b>			
<b>2</b>	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	<b>2</b>	<b>1,096</b>
<b>3</b>	Qualified business net (loss) carryforward from the prior year	<b>3</b>	<b>( 0 )</b>
<b>4</b>	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	<b>4</b>	<b>1,096</b>
<b>5</b>	Qualified business income component. Multiply line 4 by 20% (0.20)	<b>5</b>	<b>219</b>
<b>6</b>	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	<b>6</b>	
<b>7</b>	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	<b>7</b>	<b>( )</b>
<b>8</b>	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	<b>8</b>	
<b>9</b>	REIT and PTP component. Multiply line 8 by 20% (0.20)	<b>9</b>	
<b>10</b>	Qualified business income deduction before the income limitation. Add lines 5 and 9	<b>10</b>	<b>219</b>
<b>11</b>	Taxable income before qualified business income deduction	<b>11</b>	<b>137,800</b>
<b>12</b>	Net capital gain (see instructions)	<b>12</b>	
<b>13</b>	Subtract line 12 from line 11. If zero or less, enter -0-	<b>13</b>	<b>137,800</b>
<b>14</b>	Income limitation. Multiply line 13 by 20% (0.20)	<b>14</b>	<b>27,560</b>
<b>15</b>	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ▶	<b>15</b>	<b>219</b>
<b>16</b>	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	<b>16</b>	<b>( )</b>
<b>17</b>	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	<b>17</b>	<b>( )</b>

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

Cat. No. 37806C

Form **8995** (2019)



## EXCESS BUSINESS LOSSES

The Tax Cuts and Jobs Act (TCJA) introduced a new loss limitation for noncorporate taxpayers. Under the TCJA, such taxpayers could not deduct excess business losses (EBLs) during the TCJA period (i.e., tax years beginning after December 31, 2017, and before January 1, 2026). For tax years beginning in 2020, an EBL is defined as the excess (if any) of:<sup>131</sup>

1. A taxpayer's aggregate deductions from trades or businesses, over
2. The sum of:
  - a. The taxpayer's aggregate trade or business income and gains for the year, plus
  - b. \$259,000 (\$518,000 for married filing jointly (MFJ) taxpayers).<sup>132</sup>

EBL rules apply to losses from all noncorporate trades or businesses. The EBL limitation is calculated using Form 461, *Limitation on Business Losses*, after completing the Schedule E. **Any limitation to the loss resulting from the EBL rules is not reflected on the Schedule E.** Instead, it is added to the income on Form 1040 or Form 1040-SR, *U.S. Tax Return for Seniors*, and treated as an NOL that must be carried forward and deducted in a subsequent year. These rules also apply to losses from a partnership or S corporation.<sup>133</sup>



## CARES Act Changes

The CARES Act removes the EBL limitations for 2018, 2019, and 2020. However, the EBL rules are in effect for tax years beginning after December 31, 2020, and before January 1, 2026.

**Note.** For more information on EBLs, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Net Operating and Excess Business Losses. For more information on the CARES Act, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

## QUALIFIED JOINT VENTURE<sup>134</sup>

Generally, an unincorporated business owned by a married couple is classified as a partnership for federal income tax purposes. However, a married couple who are the only members of a jointly owned and operated rental real estate business can elect to be treated as a **qualified joint venture (QJV)**. A QJV is a joint venture that conducts a trade or business that meets all of the following requirements.<sup>135</sup>

1. The only members of the joint venture are a married couple who file a joint return.
2. Both spouses materially participate in the trade or business (defined earlier).
3. Both spouses elect not to be treated as a partnership.

**Caution.** The spouses must be conducting a trade or business. Merely owning property together is not sufficient to qualify for the election.<sup>136</sup>

<sup>131</sup>. TCJA §11012; IRC §461(l).

<sup>132</sup>. Rev. Proc. 2019-44, 2019-47 IRB 1093.

<sup>133</sup>. Instructions for Schedule E.

<sup>134</sup>. *Election for Married Couples Unincorporated Businesses*. Feb. 19, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses] Accessed on Apr. 6, 2020; Instructions for Schedule E.

<sup>135</sup>. IRC §761(f)(2).

# 2020 Workbook

The business **must be owned and operated by the spouses as co-owners**, not as a state law entity such as a limited partnership or limited liability company. The spouses must divide all items of income, gain, loss, deduction, and credit according to their respective interests in the venture. Additionally, each spouse must consider their spouse's respective share of such items as if they were attributable to a sole proprietorship conducted by their spouse.<sup>137</sup>

## ELECTION

A married couple makes the election for their rental real estate business by checking the “QJV” box on line 2 of the Schedule E for each property that is part of the QJV. Each spouse reports their interests as separate properties on line 1 of the Schedule E. For each separate property interest, the spouses enter their share of the applicable income, deduction, or loss on lines 3 through 22.<sup>138</sup>

The election can only be revoked with the IRS's consent. However, the election is only valid as long as the spouses continue to meet the requirements for a QJV. A new election is required for any future year after a year in which the spouses fail to meet the requirements of a QJV.

The election eliminates the requirement for the spouses to file a Form 1065, *U.S. Return of Partnership Income*, for any year the election is in effect. If the spouses filed a Form 1065 for the year prior to the election, the partnership terminates at the end of the immediately preceding tax year prior to the election taking effect.

## BENEFITS

Electing to treat the business as a QJV removes the requirement to file and keep records as a partnership. Additionally, both spouses in a QJV receive credit for social security and Medicare coverage purposes when a Schedule C is filed.



### Practitioner Planning Tip

Many small businesses are operated as sole proprietorships when in fact they are “mom and pop” operations in which both spouses work in the business. When reporting as a sole proprietorship, only one spouse is credited with social security and Medicare earnings from the business. With a QJV election, both spouses receive credit for their earnings. In addition to social security benefits, potential benefits include retirement account contributions, stepped-up basis for estate-planning purposes, and other tax benefits that merit consideration.

Another option is for one spouse to become an employee of the business.

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<sup>136</sup>. Instructions for Schedule E.

<sup>137</sup>. IRC §761(f)(1).

<sup>138</sup>. Instructions for Schedule E.

## SCHEDULE E VS. SCHEDULE C

It can be hard to distinguish which income gets reported on Schedule E compared to income that should be reported on Schedule C. As a general rule, a taxpayer uses Schedule C to report income or loss from a business or profession they operate as a sole proprietor. An activity qualifies as a business if the taxpayer's primary purpose for engaging in the activity is for income or profit and they are involved in the activity on a regular and continuous basis.<sup>139</sup>

### RENTAL

Rental of **real estate** is reported on Schedule E. If the taxpayer is in the business of renting personal property, any income and expenses from the rental of **personal property** is reported on Schedule C. If the taxpayer is not in the business of renting personal property, rental income and expenses are reported on Schedule 1, *Additional Income and Adjustments to Income*.<sup>140</sup>

### Substantial/Significant Services<sup>141</sup>

Generally, Schedule C is used when a taxpayer (including a QJV) provides substantial services in conjunction with the property. Services are substantial if the compensation for the services makes up a material part of the tenants' rental payments.<sup>142</sup> Substantial services are services that are primarily for the tenant's convenience, such as regular cleaning, changing linen, or maid service. Substantial services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc.

**Example 19.** Sharon lists her house on an online marketplace for vacation rentals. She rents it out to a couple for 20 days in July. Sharon provides the basic amenities such as water, electricity, air conditioning, and linens. No additional services are included in the rent other than the use of the property. The income and expenses from her rental are reported on Schedule E.

**Example 20.** Bradley lists his guest house on an online marketplace for vacation rentals. The guest house is on Bradley's property and is adjacent to his primary residence. He rents out the guest house to various occupants for a total of 27 days during the year. In addition to providing the necessary amenities, Bradley also prepares breakfast daily for the renters and has a maid service clean the guest house every other day. Because Bradley provides substantial services, he reports the income and expenses on Schedule C.

### Real Estate Dealers

A real estate dealer who is engaged in the business of selling real estate to customers with the purpose of making a profit from those sales reports the incidental rents from real estate held for sale to customers on Schedule C.<sup>143</sup> Generally, courts consider the following factors when determining whether a taxpayer is a dealer in real estate.<sup>144</sup>

- The nature and purpose of buying the property
- The length of time the taxpayer owned the property
- The continuity of sales activity over a period of time
- The number and frequency of sales
- The extent to which the taxpayer developed the property, solicited customers, and advertised
- The ratio of sales to other sources of income

<sup>139</sup> Instructions for Schedule C.

<sup>140</sup> *Topic No. 414 Rental Income and Expenses*. May 28, 2020. IRS. [www.irs.gov/taxtopics/tc414] Accessed on Jun. 10, 2020.

<sup>141</sup> IRS Pub. 527, *Residential Rental Property*.

<sup>142</sup> IRS Pub. 334, *Tax Guide for Small Business*.

<sup>143</sup> *Ibid*.

<sup>144</sup> *McCullen v. Comm'r*, TC Memo 1997-280 (Jun. 19, 1997).

# 2020 Workbook

Because income reported on a Schedule C is subject to SE tax, a taxpayer may try to avoid being labeled as a real estate dealer. The following tax issues apply to dealers.

- Depreciation is not an eligible expense on real estate property held as inventory in the ordinary course of business by a dealer.<sup>145</sup>
- A dealer applies ordinary gain rates to the sale of real estate property held as inventory in the ordinary course of business. An investor in real estate applies capital gains rates to the sale of real estate property.<sup>146</sup>
- A dealer cannot defer income tax under an installment sale under IRC §453(b)(2)(A).

**Example 21.** Taylor has two sources of income: flipping houses and renting out properties. Over the last six years, Taylor flipped seven houses; five made a profit and two were losses. In 2020, she purchased two properties in foreclosure and spent \$750,000 to remodel them. In November, Taylor completes the flip on the house she bought in January 2020. She sells the house for \$600,000 and earns a profit of \$70,000. Taylor flips the other house in September for a \$3,500 profit. The sales are subject to the ordinary tax rate, and Taylor cannot claim depreciation on the buildings. The houses are kept as inventory and Taylor is considered a real estate dealer. Her house-flipping activity is reported on Schedule C and is subject to SE tax.

Additionally, Taylor owns two properties that she rents out on annual leases and reports the income and expenses on Schedule E. During 2020, she remodels the kitchen and main bathroom in one of the rentals for a cost of \$100,000. After the remodel, Taylor sells the house for a \$25,000 profit. Her profit takes into account the accumulated depreciation she has claimed on the property since Taylor placed the building into service. Her profit is reported on Form 4797, *Sales of Business Property*, and is subject to depreciation recapture rules under IRC §1250.

## Practitioner Planning Tip

Because determination of whether a taxpayer is a real estate dealer is made at the property level,<sup>147</sup> a taxpayer with multiple properties should maintain separate records. A taxpayer benefits from classifying their real estate activity as Schedule E activity. It may be a good idea to place the rentals into separate legal entities apart from other real estate activities.

<sup>145</sup> See, e.g., *Wood v. Comm'r*, TC Memo 2004-200 (Aug. 31, 2004).

<sup>146</sup> See, e.g., *Murray v. Comm'r*, TC Memo 1965-148 (May 27, 1965); *Pool v. Comm'r*, TC Memo 2014-3 (Jan. 8, 2014).

<sup>147</sup> *Matthews v. Comm'r*, 315 F.2d 101 (6th Cir. 1963).

## ROYALTY INCOME

Self-employed writers, inventors, artists, etc., report their royalty income and expenses on Schedule C, rather than Schedule E.<sup>148</sup> Any ordinary and necessary expenses associated with royalty income are deductible under §162 on Schedule C. As mentioned previously, royalty income that is not considered a trade or business is reported on Schedule E.<sup>149</sup>

### Oil and Gas with Working Interest

Taxpayers with a **working interest** in oil and gas operations report their income and expenses on Schedule C.<sup>150</sup> A working interest (sometimes referred to as an operating interest) is an investment in an oil and gas drilling operation. The investor is directly liable for a percentage of the expenses related to exploring, drilling, and production in exchange for profits from successful wells.<sup>151</sup> This is in contrast to royalties from oil and gas activities, which are reported on Schedule E.

**Note.** Detailed information about oil and gas operations is beyond the scope of this chapter. More information can be found in Treas. Reg. §1.614-2(b) and IRM 4.41.1.3.1.2 (2005).

## INCOME OR LOSS FROM PARTNERSHIPS AND S CORPORATIONS

A partner or shareholder must report the income (even if not received) and loss items from their Schedule K-1 on Schedule E, part II, in accordance with the Schedule K-1 instructions.<sup>152</sup>

**Caution.** If a taxpayer treats items on their tax return differently from the way the partnership or S corporation reported them on its return, they may have to file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*.

Losses reported from a partnership or S corporation are subject to the same loss limitations discussed earlier. Any partnership loss that exceeds the partner's adjusted basis at the end of the partnership's tax year cannot be claimed. The loss is carried forward indefinitely and deducted in a future year, subject to basis limitations in that year. Similarly, a loss from an S corporation is limited to the taxpayer's basis in their stock (determined with regard to distributions received during the tax year) and any loans from the shareholder to the S corporation. Any loss is carried forward indefinitely and deducted in a future year subject to basis limitations in that year.<sup>153</sup>

<sup>148</sup>. Instructions for Schedule E.

<sup>149</sup>. Ibid.

<sup>150</sup>. Ibid.

<sup>151</sup>. *Working Interest*. Investopedia. [www.investopedia.com/terms/w/working-interests.asp] Accessed on Jun. 11, 2020.

<sup>152</sup>. Instructions for Schedule E.

<sup>153</sup>. Ibid.

# 2020 Workbook

A partner or shareholder who is subject to the at-risk basis limitations must check the box on part II, column (f) of Schedule E, and calculate the amount of any deductible loss on Form 6198, *At-Risk Limitations*. If the activity is nonpassive, any deductible loss from Form 6198 is reported in part II, column (i) of Schedule E.<sup>154</sup>

Schedule E (Form 1040 or 1040-SR) 2019

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations** — **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . .  **Yes**  **No**

<b>28</b>	(a) Name	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

<b>Passive Income and Loss</b>		<b>Nonpassive Income and Loss</b>		
(g) Passive loss allowed (attach <b>Form 8582</b> if required)	(h) Passive income from <b>Schedule K-1</b>	(i) Nonpassive loss allowed (see <b>Schedule K-1</b> )	(j) Section 179 expense deduction from <b>Form 4562</b>	(k) Nonpassive income from <b>Schedule K-1</b>
<b>A</b>				
<b>B</b>				
<b>C</b>				
<b>D</b>				
<b>29a Totals</b>				
<b>b Totals</b>				
<b>30</b> Add columns (h) and (k) of line 29a. . . . .			<b>30</b>	
<b>31</b> Add columns (g), (i), and (j) of line 29b. . . . .			<b>31</b>	( )
<b>32 Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31 . . . . .			<b>32</b>	

**Part III Income or Loss From Estates and Trusts**

A taxpayer with a PAL generally must first complete Form 8582 to determine the amount of the loss to report on Schedule E, part II, column (g). General partners or S corporation shareholders reporting a loss from a rental real estate activity and who meet all of the requirements listed earlier under "Real Estate Exceptions" do not need to complete Form 8582. Instead, their loss is entered directly in part II, column (g) of Schedule E. Any **passive income** is reported in part II, column (h) of Schedule E. Any **nonpassive income** or losses are reported in part II, columns (i) through (k) of Schedule E.<sup>155</sup>

<sup>154</sup>. Ibid.

<sup>155</sup>. Ibid.

# 2020 Workbook

## BASIS ATTACHMENT REQUIREMENT

Starting with the 2018 version of Schedule E, the IRS added the following language in part II above line 27.<sup>156</sup>

*If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you must check the box in column (e) on line 28 and attach the required basis computation.*

Schedule E (Form 1040 or 1040-SR) 2019 Attachment Sequence No. **13** Page **2**  
 Name(s) shown on return. Do not enter name and social security number if shown on other side. Your social security number

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** – **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . .  **Yes**  **No**

<b>28</b>	<b>(a)</b> Name	<b>(b)</b> Enter <b>P</b> for partnership; <b>S</b> for S corporation	<b>(c)</b> Check if foreign partnership	<b>(d)</b> Employer identification number	<b>(e)</b> Check if basis computation is required	<b>(f)</b> Check if any amount is not at risk
<b>A</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

**6**

While the language is new, the requirement to attach the basis computation is not. For example, the 2017 instructions for Schedule E state, "If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you." The expansion of the rules to **anyone who receives a distribution** encompasses more taxpayers with S corporation activity.

Shareholders can calculate their stock and debt basis on the following worksheets found in the shareholder's instructions for Schedule K-1 (Form 1120S).<sup>157</sup>

<sup>156</sup>. See Schedule E.

<sup>157</sup>. Instructions for Schedule K-1 (Form 1120S).

# 2020 Workbook

## Worksheet for Figuring a Shareholder's Stock and Debt Basis

### Part I—Shareholder Stock Basis

1. Stock basis at the beginning of the corporation's tax year . . . . .	1.	
2. Basis from any capital contributions made or additional stock acquired during the tax year . . . . .	2.	
3a. Ordinary business income (losses go on Part III) . . . . .	3a.	
b. Net rental real estate income (losses go on Part III) . . . . .	3b.	
c. Other net rental income (losses go on Part III) . . . . .	3c.	
d. Interest income . . . . .	3d.	
e. Ordinary dividends . . . . .	3e.	
f. Royalties . . . . .	3f.	
g. Net capital gains (losses go on Part III) . . . . .	3g.	
h. Net section 1231 gain (losses go on Part III) . . . . .	3h.	
i. Other income (losses go on Part III) . . . . .	3i.	
j. Excess depletion adjustment . . . . .	3j.	
k. Tax-exempt income . . . . .	3k.	
l. Recapture of business credits . . . . .	3l.	
m. Other items that increase stock basis . . . . .	3m.	
4. Add lines 3a through 3m . . . . .	4.	
5. Stock basis before distributions. Add lines 1, 2, and 4 . . . . .	5.	
6. Distributions (excluding dividend distributions) . . . . .	6.	
<p><b>Note.</b> If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.</p>		
7. Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15 . . . . .	7.	
8a. Nondeductible expenses . . . . .	8a.	
b. Depletion for oil and gas . . . . .	8b.	
9. Add lines 8a and 8b . . . . .	9.	
10. Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15 . . . . .	10.	
11. Allowable loss and deduction items. Enter the amount from Part III, line 13, column (c) . . . . .	11.	
12. Debt basis restoration (see net increase in instructions for Part II, line 8) . . . . .	12.	
13. Other items that decrease stock basis . . . . .	13.	
14. Add lines 11, 12, and 13 . . . . .	14.	
15. <b>Stock basis at the end of the corporation's tax year.</b> Subtract line 14 from line 10. If the result is zero or less, enter -0- . . . . .	15.	



# 2020 Workbook

## Part II—Shareholder Debt Basis

		<b>Debt 1</b> <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<b>Debt 2</b> <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<b>Debt 3</b> <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<b>Total</b>
<b>Amount of Debt:</b>					
1.	Loan balance at the beginning of the corporation's tax year . . . . .				
2.	Additional loans (see instructions) . . . . .				
3.	Loan balance before repayment. Combine lines 1 and 2 . . . . .				
4.	Principal portion of debt repayment (this line doesn't include interest) . . . . .	(      )	(      )	(      )	(      )
5.	Loan balance at the end of the corporation's tax year. Combine lines 3 and 4 . . . . .				
<b>Adjustments to Debt Basis:</b>					
6.	Debt basis at the beginning of the corporation's tax year . . . . .				
7.	Enter the amount, if any, from line 2 . . . . .				
8.	Debt basis restoration (see instructions) . . . . .				
9.	Debt basis before repayment. Combine lines 6, 7, and 8 . . . . .				
10.	Divide line 9 by line 3 . . . . .				
11.	Nontaxable debt repayment. Multiply line 10 by line 4 . . . . .				
12.	Debt basis before nondeductible expenses and losses. Subtract line 11 from line 9 . . . . .				
13.	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis . . . . .				
14.	Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter -0- . . . . .				
15.	Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (d) . . . . .				
16.	<b>Debt basis at the end of the corporation's tax year.</b> Subtract line 15 from line 14. If the result is zero or less, enter -0- . . . . .				
<b>Gain on Loan Repayment:</b>					
17.	Repayment. Enter the amount from line 4 . . . . .				
18.	Nontaxable repayments. Enter the amount from line 11 . . . . .				
19.	<b>Reportable gain.</b> Subtract line 18 from line 17 . . . . .				

# 2020 Workbook

The basis of a partner's interest in the partnership can be calculated using the worksheet found in the partner's instructions for Schedule K-1 (Form 1065).<sup>158</sup>

## Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership

Keep for Your Records



1. Your adjusted basis at the end of the prior year. Do not enter less than zero. Enter -0- if this is your first tax year	1. _____
Increases:	
2. Money and your adjusted basis in property contributed to the partnership less the associated liabilities (but not less than zero)	2. _____
3. Your increased share of or assumption of partnership liabilities. (Subtract your share of liabilities shown in item K of your 2018 Schedule K-1 from your share of liabilities shown in item K of your 2019 Schedule K-1 and add the amount of any partnership liabilities you assumed during the tax year (but not less than zero))	3. _____
4. Your share of the partnership's income or gain (including tax-exempt income) reduced by any amount included in interest income with respect to the credit to holders of clean renewable energy bonds	4. _____
5. Any gain recognized this year on contributions of property. Do not include gain from transfer of liabilities	5. _____
6. Your share of the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion	6. _____
Decreases:	
7. Withdrawals and distributions of money and the adjusted basis of property distributed to you from the partnership. Do not include the amount of property distributions included in the partner's income (taxable income)	7. _____
<b>Caution:</b> A distribution may be taxable if the amount exceeds your adjusted basis of your partnership interest immediately before the distribution.	
8. Your decreased share of partnership liabilities and any decrease in your individual liabilities because they were assumed by the partnership. (Subtract your share of liabilities shown in item K of your 2019 Schedule K-1 from your share of liabilities shown in item K of your 2018 Schedule K-1 and add the amount of your individual liabilities that the partnership assumed during the tax year (but not less than zero))	8. _____
9. Your share of the partnership's nondeductible expenses that are not capital expenditures	9. _____
10. Your share of the partnership's losses and deductions (including capital losses). However, include your share of the partnership's section 179 expense deduction for this year even if you cannot deduct all of it because of limitations	10. _____
11. The amount of your deduction for depletion of any partnership oil and gas property, not to exceed your allocable share of the adjusted basis of that property	11. _____
12. Your adjusted basis in the partnership at the end of this tax year. (Add lines 1 through 6 and subtract lines 7 through 11 from the total. If zero or less, enter -0-.)	12. _____
<b>Caution:</b> The deduction for your share of the partnership's losses and deductions is limited to your adjusted basis in your partnership interest. If you entered zero on line 12 and the amount figured for line 12 was less than zero, a portion of your share of the partnership losses and deductions may not be deductible. (See <i>Basis Limitations</i> , earlier, for more information.)	

**Note.** It is the responsibility of the taxpayer to maintain basis records.<sup>159</sup> However, it is complicated to calculate the change in basis annually, so many taxpayers expect their tax professional to perform the task. In the future, it may be the responsibility of the entity to maintain basis schedules for its shareholders, just as partnerships must currently maintain basis schedules for each partner.<sup>160</sup>

**Note.** Often, new clients do not have basis schedules. In the absence of historical records, tax preparers can make a reasonable estimate of basis from the S corporation returns.<sup>161</sup>

<sup>158</sup>. Instructions for Schedule K-1 (Form 1065).

<sup>159</sup>. Treas. Reg. §1.6001-1(a).

<sup>160</sup>. See Instructions for Schedule K-1 (Form 1065); IRS Notice 2019-66, 2019-52 IRB 1509.

<sup>161</sup>. *S Corporation Shareholder Basis*. IRS. [irstaxforumsonline.com/sites/default/files/players/scorp18/downloads/scorp18slides.pdf] Accessed on Jun. 11, 2020.

# 2020 Workbook

## PRIOR YEAR ADJUSTMENTS<sup>162</sup>

Taxpayers who report any loss not allowed in a prior year due to at-risk limitations, a prior year unallowed loss from a passive activity not reported on Form 8582, or unreimbursed partnership expenses must follow additional instructions. The IRS may send a notice of additional tax due if the amounts reported on Schedule K-1 do not match the amounts claimed on Schedule E. Therefore, the taxpayer may be required to disclose additional information in addition to checking “yes” in part II, line 27.

### Limited by Basis or At-Risk Rules

Any prior year unallowed losses due to basis or at-risk rules that are deductible in the current year must be entered in column (i) of line 28. The losses should not be combined with or netted against any current year amounts from the partnership or S corporation. “PYA” should be entered in column (a) to indicate the amount is a prior year adjustment.

**Example 22.** Francine and Frank Stix own 75% of Lollipops 4U, Inc. which is organized as an S corporation. The Stixes reported \$50,000 of ordinary income during 2019 and received a distribution of \$6,000. In 2018, they could not claim a \$10,000 ordinary loss due to insufficient basis. At the beginning of 2019, the Stixes had a basis of \$0.

The Stixes are required to file a basis attachment with their Schedule E.

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Schedule E (Form 1040 or 1040-SR) 2019 Attachment Sequence No. **13** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side. **Frank and Francine Stix** Your social security number **123-45-6789**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations** — Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section.  **Yes**  **No**

28	(a) Name	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b>	Lollipops 4U, Inc.	S	<input type="checkbox"/>	11-2222227	<input checked="" type="checkbox"/>	<input type="checkbox"/>
<b>B</b>	PYA: Basis Carryover	S	<input type="checkbox"/>	11-2222227	<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Passive Income and Loss		Nonpassive Income and Loss		
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
<b>A</b>		50,000		
<b>B</b>	10,000			
<b>C</b>				
<b>D</b>				
<b>29a Totals</b>		50,000		
<b>b Totals</b>	10,000			
<b>30</b>	Add columns (h) and (k) of line 29a.			30 50,000
<b>31</b>	Add columns (g), (i), and (j) of line 29b.			31 ( 10,000 )
<b>32</b>	<b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31			32 40,000

**Part III Income or Loss From Estates and Trusts**

<sup>162</sup> Instructions for Schedule E.

# 2020 Workbook

## For Example 22

<b>2019</b>	<b>Federal Statements</b>	<b>Page 1</b>																
Frank and Francine Stix		123-45-6789																
<p><b>Statement 1</b>  <b>Schedule E, Line 31</b>  <b>Basis Limitation</b>  <b>Activity Name: Lollipops 4U, Inc.</b></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Stock basis at beginning of year</td> <td style="text-align: right;">0.</td> </tr> <tr> <td>Additional amounts invested in current year</td> <td></td> </tr> <tr> <td>Current year distributions</td> <td style="text-align: right;">-6,000.</td> </tr> <tr> <td>Current year income from S Corporation</td> <td style="text-align: right;">50,000.</td> </tr> <tr> <td>Less income used to restore debt basis</td> <td></td> </tr> <tr> <td>Stock basis used for basis limitation</td> <td style="text-align: right;">44,000.</td> </tr> <tr> <td>Loss allowed by basis limitation</td> <td style="text-align: right;">10,000.</td> </tr> <tr> <td>Stock basis at end of year</td> <td style="text-align: right;">34,000.</td> </tr> </table>			Stock basis at beginning of year	0.	Additional amounts invested in current year		Current year distributions	-6,000.	Current year income from S Corporation	50,000.	Less income used to restore debt basis		Stock basis used for basis limitation	44,000.	Loss allowed by basis limitation	10,000.	Stock basis at end of year	34,000.
Stock basis at beginning of year	0.																	
Additional amounts invested in current year																		
Current year distributions	-6,000.																	
Current year income from S Corporation	50,000.																	
Less income used to restore debt basis																		
Stock basis used for basis limitation	44,000.																	
Loss allowed by basis limitation	10,000.																	
Stock basis at end of year	34,000.																	

**Example 23.** Use the same facts as **Example 22**, except Lollipops 4U is organized as a partnership and Francine Stix is a 75% partner. She received ordinary passive income from Lollipops 4U of \$50,000 during 2019.

In 2018, Francine had an ordinary loss of \$10,000. She did not have enough basis to claim the loss during the year. In 2019, when her basis was sufficient to claim the carryforward loss, the Stixes filed the following Schedule E.

Schedule E (Form 1040 or 1040-SR) 2019	Attachment Sequence No. <b>13</b>	Page <b>2</b>
Name(s) shown on return. Do not enter name and social security number if shown on other side.		Your social security number
<b>Frank and Francine Stix</b>		<b>123-45-6789</b>

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** – **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.  **Yes**  **No**

28 (a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b> Lollipops 4U	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b> PYA: Basis Carryover	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>		<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>		<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Passive Income and Loss		Nonpassive Income and Loss			
A	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
<b>A</b>		<b>50,000</b>			
<b>B</b>	<b>10,000</b>				
<b>C</b>					
<b>D</b>					
<b>29a</b> Totals		<b>50,000</b>			
<b>b</b> Totals	<b>10,000</b>				
<b>30</b>	Add columns (h) and (k) of line 29a.				<b>30</b> <b>50,000</b>
<b>31</b>	Add columns (g), (i), and (j) of line 29b.				<b>31</b> <b>( 10,000 )</b>
<b>32</b>	<b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31				<b>32</b> <b>40,000</b>

**Part III** **Income or Loss From Estates and Trusts**

# 2020 Workbook

## Limited by Passive Activity Not Reported on Form 8582

Passive losses that are not reported on Form 8582 are entered on a separate line in column (g) of line 28. These include losses that were not allowed in a prior year and are deductible in the current year because:

- The taxpayer does not have an overall loss from passive activities, or
- The taxpayer disposed of the entire interest in a passive activity in a fully taxable transaction.

The losses should not be combined with or netted against any current year amounts from the partnership or S corporation. "PYA" should be entered in column (a) of line 28 to indicate the amount is a prior year adjustment.

**Example 24.** Use the same facts as **Example 23**, except the ordinary loss carryforward from 2018 was because the Stixes did not have enough passive income in 2018 to offset the passive loss. The Stixes file the following Schedule E reporting their income from the partnership.

Schedule E (Form 1040 or 1040-SR) 2019 Attachment Sequence No. **13** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side. **Frank and Francine Stix** Your social security number **123-45-6789**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations** – Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.  **Yes**  **No**

<b>28</b>	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b>	Lollipops 4U	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b>	PYA: Passive Carryover	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

<b>Passive Income and Loss</b>		<b>Nonpassive Income and Loss</b>			
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
<b>A</b>		<b>50,000</b>			
<b>B</b>	<b>10,000</b>				
<b>C</b>					
<b>D</b>					
<b>29a</b>	<b>Totals</b>	<b>50,000</b>			
<b>b</b>	<b>Totals</b>	<b>10,000</b>			
<b>30</b>	Add columns (h) and (k) of line 29a.			<b>30</b>	<b>50,000</b>
<b>31</b>	Add columns (g), (i), and (j) of line 29b.			<b>31</b>	<b>( 10,000 )</b>
<b>32</b>	<b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31			<b>32</b>	<b>40,000</b>

**Part III Income or Loss From Estates and Trusts**

6

## Limited by Unreimbursed Partnership Expenses

Unreimbursed ordinary and necessary partnership expenses that a taxpayer pays on behalf of a partnership are deductible on Schedule E if the partner was required to pay the expenses according to the partnership agreement. Only trade or business expenses under §162 are deductible.

Unreimbursed partnership expenses (UPE) are **not reported separately** if the expenses are from a passive activity **and** the taxpayer is required to file Form 8582. Otherwise, the UPE from nonpassive activities are entered on a separate line in column (i) of line 28. These expenses are not combined or netted against any other amounts from the partnership.

A taxpayer with expenses from a passive activity who is not required to file Form 8582 enters the expenses on a separate line in column (g) of line 28. These expenses cannot be combined with or netted against any other amounts from the partnership. The expenses are labeled with "UPE" in column (a) of line 28.

# 2020 Workbook

**Example 25.** Use the same facts as **Example 23.** In 2019, Francine pays UPE of \$1,000. She reports the income and expenses from Lollipops 4U on the following Schedule E.

Schedule E (Form 1040 or 1040-SR) 2019

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number  
**123-45-6789**

**Frank and Francine Stix**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** — **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

**27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.  **Yes**  **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
<b>A</b>	<b>Lollipops 4U</b>	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>B</b>	<b>PYA: Basis Carryover</b>	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>C</b>	<b>UPE</b>	<b>P</b>	<input type="checkbox"/>	<b>11-2222227</b>	<input type="checkbox"/>	<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Passive Income and Loss			Nonpassive Income and Loss		
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
<b>A</b>	<b>50,000</b>				
<b>B</b>	<b>10,000</b>				
<b>C</b>	<b>1,000</b>				
<b>D</b>					
<b>29a Totals</b>	<b>50,000</b>				
<b>b Totals</b>	<b>11,000</b>				
<b>30</b>	Add columns (h) and (k) of line 29a.			<b>30</b>	<b>50,000</b>
<b>31</b>	Add columns (g), (i), and (j) of line 29b.			<b>31</b>	<b>( 11,000 )</b>
<b>32</b>	<b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31			<b>32</b>	<b>39,000</b>

**Part III** **Income or Loss From Estates and Trusts**