
Internal Revenue Service

Passive Activity Loss

Audit Technique Guide (ATG)

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This ATG is referenced in an
endnote at the Bradford Tax Institute.
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The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *U.S. Government Printing Office Style Manual*.



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Passive Activity Loss Audit Technique Guide

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INTRODUCTION

The Audit Technique Guide (ATG) on Passive Activity Losses (PAL) has been significantly revised to reflect an issue-based format. Additionally, it has been updated to encompass current emerging issues, changes to Form 8582, Passive Activity Loss Limitation, and recent case law. The guide was developed to provide Revenue Agents and Tax Compliance Officers with technical information and tools to examine issues relating to both income and losses from passive activities.

This text provides specific guidance on potential audit issues along with summaries of the applicable Internal Revenue Code (IRC) and Federal Tax Regulations (Regulations) and highlights of common errors. We have attempted to write this ATG in plain layman's language, addressing issues which may be encountered on an audit. The text is not all encompassing and does not cover every exception. The IRC § 469, the related Regulations, and case law may have to be researched.

Included in the ATG are many job aids, designed to be used by examiners: a summary of court cases, checksheets for common issues, and decision trees. Examiners are reminded that the checksheets have been provided to assist the examiner, but are not all encompassing. The IRC § 469 and the related Regulations may have to be researched. In some instances, line numbers on various forms have been referenced. The examiner is reminded that line numbers may change from year to year. The job aids can be located at the end of each chapter. A summary of court cases and rulings can be located in the first exhibit in Chapter 1.

While certain provisions of the IRC § 469 are explained, the primary focus of this text is not an in-depth explanation of the law or Form 8582, but rather a guide to current and emerging audit issues. Regulations for activities (grouping rules for related entities), real estate professionals and self-charged interest have been finalized. However, the majority of the IRC § 469 regulations remain in temporary format. Temporary Regulations carry the same weight of authority as final regulations. Regulations have not yet been issued on dispositions and on trusts.

This material can be used in a classroom setting or as a self-study guide. Each lesson is designed to be self-contained. However, in most instances, Chapter 1, Overview, should be reviewed, as the concepts are intrinsic to an understanding of later lessons. Additional information on passive activities can be found at the PAL Intranet site or you can call the Passive Loss Technical Advisor.

A Quick Look Inside!

What's in here that would make me interested enough to go on.....?

- **Help with Form 8582** – Chapter 1
- **Cases** – very first exhibit in Chapter 1

Lots of issues you might see

- Equipment and vehicle leases – Chapter 2
- Real estate professionals – Chapter 2
- Rental real estate – Chapter 2
- Vacation condos, hotels, Bed & Breakfast (B&B) – Chapter 2

- Income issues on Form 8582 – Chapter 3
- Property leased to a business where the taxpayer works – Chapter 3
- Land leases – Chapter 3

- Material participation – Chapter 4
- What time does and does not count in the hourly tests – Chapter 4

- When losses are *not* triggered on disposition - Chapter 5
- When gain on disposition should *not* be on FORM 8582 – Chapter 5

- Issues with trusts (there's lots of them) – Chapter 6
- C corporation issues – Chapter 6
- Rules for Limited Liability Companies (LLCs) – Chapter 6
- Self-charged items – Chapter 6

- When interest expense is and is not deductible – Chapter 7
- Investment interest is limited to investment income – Chapter 7

- When the taxpayer's grouping might be wrong – Chapter 8
- When *you* might want to group related business – Chapter 8

- Issues with credits – Chapter 9

Checksheets, decision trees and other job aids at end of each chapter.

Chapter 1: Overview

Introduction

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct non-economic losses against wages and investment income. The Tax Reform Act of 1986, added IRC § 469, which limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities.

The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity whether reported on Schedule C, Profit or Loss From Business (Sole Proprietorship); Schedule F, Profit Loss From Farming; or Schedule E, Supplemental Income and Loss, as well as to flow through income and losses from partnerships, S Corporations, and trusts.

The passive loss limitations also apply in full to personal service corporations. The IRC § 469 also applies to closely held C Corporations, but has a limited applications.

The following is a brief overview. If an issue arises in any specific area, see the referenced chapters for in-depth discussions.

Types of Passive Activities

In general, losses generated by passive activities can only be used to offset income generated by passive activities.

There are two kinds of passive activities (IRC § 469(c)):

1. Rentals, including equipment leasing and rental real estate; and,
2. Businesses in which the taxpayer does not material participate (includes activities on Schedules C or F and from partnerships, S Corporations and LLCs^[1])

What is Passive?

Income and losses from the following activities are generally passive^[2]:

1. Rental real estate (except rentals in which a real estate professional materially participates – IRC § 469(c)(7))
2. Equipment leasing

3. Sole proprietorship or farm in which the taxpayer does not materially participate (i.e. does not regularly work)
4. Limited partnership interest, with some exceptions^[3]
5. Partnership, S c, and limited liability company business in which the taxpayer does not materially participate

Income and losses from the following are generally non-passive:

1. Salaries, wages, and Form 1099-Misc commissions
2. Guaranteed payments
3. Portfolio income (interest, dividends, royalties, gains on stocks and bonds)
4. Sale of undeveloped land or other investment property
5. Royalties
6. Sole proprietorship or farm in which the taxpayer regularly works (i.e. materially participates)
7. Partnership, S Corporation or LLC business in which the taxpayer materially participates.

Activity Rules

- The term “activity” under IRC § 469 does not necessarily mean a single business or separate entity owned by the taxpayer. Depending on the grouping decision made at the time the activity was acquired or in 1994 when the regulations were finalized, a taxpayer can treat several businesses as one single activity if they form an appropriate economic unit. Or, there could be two or more distinct activities within a single entity. **For example, there could be a rental activity and a business activity within the same partnership.**
- Because material participation^[4] is determined for each activity, the way the taxpayer’s business and rental operations are combined or divided into “activities” is very important.
- Businesses forming an appropriate economic unit may be grouped into one single activity based on the following criteria^[5]:
 1. Similarities/differences in types of activities
 2. Extent of common control
 3. Extent of common ownership
 4. Geographic location of the activities
 5. Interdependence between activities

For more information on activities, refer to Chapter 8.

Exceptions:

The general rule in IRC § 469 provides that passive losses can offset only passive income. There are, however, exceptions:

- On an entire disposition to an unrelated party in a fully taxable transaction, both current and suspended losses may be deducted against wages, portfolio income and other non-passive income^[6]. See Chapter 5.
- Rental real estate losses up to \$25,000 may be deducted by an individual whose modified adjusted gross income (MAGI) is less than \$100,000^[7]. To qualify for this offset, the taxpayer must actively participate, own at least 10 percent and not be a limited partner. The \$25,000 exception is phased out at the rate of 50 cents for every dollar of MAGI over \$100,000. Therefore, when MAGI exceeds \$150,000, the \$25,000 offset is not allowed. See Chapter 2.

Beginning in 1994, a real estate professional may be able to deduct all current rental real estate losses regardless of how high his MAGI might be^[8]. To deduct losses without limit, the taxpayer must spend more than half of his time in real property businesses and work more than 750 hours a year and materially participate in each separate rental real estate activity. Again, see Chapter 2.

Disallowed passive losses can be carried forward indefinitely^[9] until there is passive income or an entire disposition in a fully taxable transaction. Net gain on the sale of a passive activity is generally passive income, which can be offset by unrelated passive losses. See Chapter 5.

Participation Rules

There are two distinct types of participation:

- Material participation; and,
- Active participation.

Material participation generally applies to business activities. The IRC § 469(h)(1) provides that if the taxpayer works on a regular, continuous, and substantial basis in operations, his losses are non-passive, i.e. deductible in full. There are seven tests^[10] discussed in Chapter 5.

Active participation^[11] relates only to rental real estate activities and is a less stringent standard than material participation. If the taxpayer makes management decisions, he generally can deduct up to \$25,000 in losses against non-passive income, subject to the \$150,000 MAGI limitation. See exhibit at end of Chapter 2.

Neither the material participation standard nor the active participation standard generally applies to long-term equipment rentals. Equipment leasing losses are generally passive regardless of the level of participation^[12]. Thus, equipment leasing losses are generally not deductible unless the taxpayer has passive income from other sources.

FORM 8582

Passive losses and income are most commonly found on Schedule E. The computational form used to limit these losses is Form 8582, Passive Activity Loss Limitations, with line 16 being the sum of passive losses allowed for the current year (line 11 for tax years before 2002).^[13] See exhibit at the end of this chapter for more help. The following breaks down Form 8582 for 2002 and later years:

Part I of Form 8582 simply breaks down all passive activities in which the taxpayer is involved into three categories:

1. Rental real estate activities in which the taxpayer actively participates belong on line 1. These rentals qualify for the special \$25,000 allowance, subject to the MAGI limitations, which is computed on line 7.
2. The commercial revitalization deduction from rental real estate activities belongs on line 2. The taxpayer will get the revitalization deduction regardless of the level of his income and whether or not he actively participates - up to the \$25,000 offset not up used by other rental losses.
3. All other passive activities, including rental real estate without active participation and equipment rentals, go on line 3. Losses entered on line 3 are not deductible unless the taxpayer has passive income.

Part II is the calculation for allowable losses from rental real estate with active participation on line 1. See MAGI computation in Chapter 2.

Part III calculates the total allowable passive activity losses for the entire return. Line 16 (bottom line) allows losses up to total passive income, plus any allowable rental real estate losses and the commercial revitalization deduction up to \$25,000.

Beginning in tax year 2002, Form 8582 contains line changes due to the commercial revitalization deduction enacted in 2000. If the taxpayer enters his passive business losses on Form 8582 line 2b as he did in past years, he will incorrectly be permitted the \$25,000 offset. In 2002, if he properly enters his losses on line 3b, no loss will be allowed in the absence of passive income.

Some of the important line changes are as follows:

FORM 8582

- Losses from a passive business
2001 Line # 2b in **2002** is Line # 3b
- Portion of \$25,000 offset used
2001 Line # 9 in **2002** is sum of Line # 10 & Line # 14
- Total passive losses allowed currently
2001 Line # 11 in **2002** is Line # 16

- Worksheet - where losses are on return
2001 Line # WS 5 in **2002** is Line # WS 6

Resources

- Passive Activity Intranet Web site: <http://abusiveshelter.web.irs.gov/pal/> (not available to the public). Web site includes interviews, IDRs, questions and answers, and self-study Powerpoints for many issues.
- IRS Publication 925, Passive Activity and At-Risk Rules
- IRS Publication 527, Residential Rental Property (includes vacation homes)
- Instructions for Form 8582
- MSSP Partnership Guide
- Trust Audit Technique Guide
- PAL Technical Advisor

Summary

1. There are only two types of passive activities:
 - Rentals, regardless of the level of participation, and
 - Businesses^[14] in which the taxpayer does not materially participate.
2. Passive activities are deductible only to the extent of passive income. The following are exceptions to this rule:
 - Up to \$25,000 in rental real estate losses are permitted if MAGI is less than \$100,000.
 - A real estate professional may deduct rental real estate losses, if he materially participates.
 - Current and suspended passive losses are allowed on a qualifying disposition.
3. Material participation applies to businesses and to rentals of a real estate professional. Active participation applies to taxpayers who are not real estate professionals.
4. The Form 8582 computes allowable passive losses for the current year. The worksheets merely allocate the \$25,000 offset and passive income amongst passive activities on a prorata basis.

^[1] The LLC will file as either Partnerships, C Corporations, or are disregarded, in which case, the activity is reported on an individual's Form 1040 Schedule C. See IRC § 301.7701-3(a). For the sake of simplicity in this text, where we use "partnership", included are multi-member LLCs taxed as partnerships. When we use "sole proprietorship", we also mean single-owner LLCs.

^[2] See IRC § 469(c)(2). There are exceptions discussed later in the text in Reg. § 1.469-1T(e)(3).

^[3] See Chapter 4 and Reg. >§ 1.469-5T(e).

^[4] IRC § 469(h)(1)

^[5] Reg. § 1.469-4(c)

^[6] IRC § 469(g)

^[7] If married filing separately and living apart from spouse at all times during the tax year, up to \$12,500 in rental real estate losses may be deducted if MAGI is less than \$50,000. See IRC § 469(i).

^[8] IRC § 469(c)(7) and Reg. 1.469-9

^[9] IRC § 69(b)

^[10] Reg. § 1.469-5T(a)

^[11] IRC §469(i)(6)

^[12] IRC § 469(c)(2)&(4)

^[13] Generally, FORM 8582 should be attached to the return. See the instructions for FORM 8582 for exceptions. Publication 925, Passive Activity and At-Risk Rules also provides good information.

^[14] “Business” means a non-rental business activity throughout the text.

Exhibit 1.1: IRC § 469 – CITATIONS Case Law and Rulings

Activity (Grouping) Rules – Reg. § 1.469-4

- Gates, T.C. Memo Summary Opinion 1998-181 à Rentals could not be grouped with a business under Reg. 1.469-4(b)(1). A summary opinion cannot be cited as precedent for any other case (§ 7463(b)).
- Glick, 96 F Supp2d 850 200-1 à Grouping rental real estate with a management arm in another entity was permitted.
- Gregg, USTC AFTR 2d 2001-503 (Oregon) à No pro-ration for short year; LLC member not a limited partner; grouping of similar businesses. Note: not a precedent setting case.
- Kahle, T.C. Memo 1997-90 à Taxpayer could not group rental and nonrental operations into a single undertaking. Note: issue was based on temporary regulations, now expired.
- Schumacher, T.C. Summary Opinion 2003-96 A Schedule C airplane leasing activity was insubstantial under Reg. 1.469-4(d)(1)(A) in relation to an S Corporation business.
- Vezev, No. F96-0055-CV, 1988 U.S. District Court of Alaska à Rental could not be grouped with a closely held C Corporation.
 - PLR 199924012
 - TAM 200014010
 - FSA 199907011

Condo / Hotel / Vacation Rentals – Reg. § 1.469-1T(e)(3)(ii)(A)&(B)

- Barniskis, T.C. Memo 1999-256 à Jointly held condo was passive activity; losses nondeductible. Excepted from rental definition. Taxpayer failed to show material participation.
- Chapin, T.C. Memo 1996-56 à The taxpayer failed requirement for regular and continuous participation to materially participate in condo.
- Madler, T.C. Memo 1998-112 à No material or active participation in condo.
- Mordkin, T.C. Memo 1996-187 à Board chairman did not materially participate in hotel condo.
- Pohoski, T.C. Memo 1998-17 CA-9 à No material participation in one Hawaii condo, but material participation in another.
- Rapp, T.C. Memo 1999-249 à No material participation in condo for condo president.
- Scheiner, T.C. Memo 1996-554 à No material participation in hotel condo.
- Serenbetz, T.C. Memo 1996-510 à No material participation in condo.
- Toups, T.C. Memo 1993-359 à Cottage rented on average less than 7 days; no material participation.
 - TAM 9505002
 - TAM 9543003

Credits

- Sidell, T.C. Memo 1999-301 à Self-rental rules apply to C Corporations; cannot offset rehabilitation credit.
- Housing Pioneers, Inc., à Did not qualify as a low income housing nonprofit organization.

Equipment Leases

- Blewett T.C. Summary 2001-174 Equipment leased to a C Corporation was excepted from the passive loss rules as gross receipts were less than 2 percent of basis or Fair Market Value (FMV), i.e. activity was incidental to the business.
- Frank, T.C. Memo 1996-177 à Losses from airplane lease were passive and not deductible.
- Goshorn, T.C. Memo 1993-578 à Charter boat – no material participation.
- Hairston, T.C. Memo 2000-386 à Losses from lease of construction equipment to taxpayer's corporation were nondeductible.
- Kelly, T.C. Memo 2000-32 à Airplane leased to flight school was a rental. Fact that it was subleased hourly was not relevant.
- Kenville, 97-2 USTC ¶ 50,936 à Airplane chartered in two ways (a) charter activity #1 met exception to a rental as extraordinary personal services were provided; (b) charter activity #2 did not meet exception to a rental for “nonexclusive use exception to a rental”.
- Schetzer, T.C. Memo 1999-252 à No \$25,000 offset for an auto rental; definition of a rental activity.
- Vezev, No. F96-0055-CV, 1988 U.S. District Court of Alaska à Rental could not be grouped with a closely held C Corporation.
- Welch, T.C. Memo 1998-310 à Taxpayer leased his tools on average for less than 30 days and provided significant services. Thus, standard was material participation.
 - TAM 9722007
 - TAM 9343010
 - TAM 199949036

Income

- Carlstedt, T.C. Memo 1997-331 à Income determined to be non-passive as Taxpayer materially participated in business.
- Cox, T.C. Memo 1993-326 à In community property State, husband could take half deduction for rent expense from wife, and half was reportable as rental income.
- Edelberg, T.C. Memo 1995-386 à Fees from previously owned medical billing company not passive income.
- Mayer, T.C. Memo 1994-209 à Gain from sale of securities business was not passive.

- Sandy Lake Road LP, T.C. Memo 1997-295 à Rollback taxes and attorney's fees related to the determination of such taxes are incurred "in connection with" property from which portfolio income is derived, and are therefore expenses allocable to portfolio income.
- Seits, T.C. Memo 1994-522 à Sale of coop apartment - not passive income.
- Schaefer, 105 TC No. 16 à Income from a covenant not to compete is not passive.
- Shannon, T.C. Memo 1993-554 à Discharge of indebtedness not passive income as debt originated in farm where taxpayer materially participated.
- Wiseman, T.C. Memo 1995-203 à Activity issue, recharacterization income-land non-passive.
 - PLR 200010004
 - PLR 199924020
 - FSA 200002015
 - FSA 1999-1202

Investment Interest Expense

- Malone, T.C. Memo 1996-408 à Interest on a loan to by C Corporation stock was investment interest expense.
 - PLR 200010004

Marinas & Charter Boats

- Dougherty, T.C. Memo 1994-597 à No material participation in marina.
- Goshorn, T.C. Memo 1993-578 à Charter boat – no material participation.
- Oberle, T.C. Memo 1998-156 à No material participation in a charter boat activity.
- Speer, T.C. Memo 1996-323 à No material participation in two S Corporations.

Material Participation Also see Condo above.

- Dougherty, T.C. Memo 1994-597 à No material participation in marina.
- Goshorn, T.C. Memo 1993-578 à Charter boat – no material participation.
- Gregg, USTC AFTR 2d 2001-503 (Oregon) à No proration for short year; LLC member not a limited partner: grouping similar businesses.
- Hasan, T.C. Memo 1997-439 à No credible argument that losses from a limited partnership were anything but passive.
- Machado, 97-2 USTC ¶ 50,593 CA-9; T.C. Memo 1995-526 à Taxpayer did not materially participate in horse racing partnership.
- Oberle, T.C. Memo 1998-156 à No material participation in a charter boat activity.
- Speer, T.C. Memo 1996-323 à No material participation in two S Corporations.

- FSA 200102018

Mini Storage Units

- Harris, T.C. Memo 1998-332 à Mini-storage units are rentals; thus losses are limited under IRC § 469.

Real Estate Professional

- Bailey T.C. Memo 2001-296 Attorney not a real estate professional. Taxpayer did not rise to 750 hour test.
- DeGuzman 2001-2 USTC para 50,560, US District Court, NJ Taxpayer did not rise to 750 hour test. Time must be in a business or rental in which you own an interest.
- Fowler TC Memo 2002-223 Heating and air condition business owner did not rise to 750 hour test.
- Galagar T.C. Summary Opinion 2004-39: Taxpayer did not meet the 750-hour test in order to be a real estate professional.
- Jahina T.C. Summary Opinion 2002 \$150,000 Taxpayer failed half personal services test in order to be a real estate professional.
- Kosonen, T.C. Memo 2000-107 à Taxpayer did not file a proper election to group his rentals as a real estate professional.
- Mowafi, T.C. Memo 2001-111 à The taxpayer, a full-time manager of research for a large corporation, did not meet either half-personal services test or 750 hour test.
- Paleveda, T.C. Memo 1997-416 à Relief provisions for real estate professionals cannot be applied to years prior to 1994.
- Pungot, T.C. Memo 2000-60 à Taxpayer was not a real estate professional as he did not own more than 5 percent of a construction firm.
- Shaw TC Memo 2002-35, the Government argued that Taxpayer did not established he was a real estate professional. Documentation provided not reasonable.

Rental v. Business

- Gates, T.C. Memo Summary Opinion 1998-181 à Taxpayer argued his rental business constitutes a business in which he materially participates. A summary opinion may not be treated as precedent for any other case.
- Kenville, 97-2 USTC ¶ 50,936 à Airplane chartered in two ways (a) charter activity #1 met exception to a rental as extraordinary personal services were provided; (b) charter activity #2 did not meet exception to a rental for “ non-exclusive use exception to a rental”.
 - PLR 9251003
 - TAM 9247003

Self-Charged Items

- Hillman, 114 TC No. 6 19893-97 Feb. 29, 2000, David H. Hillman, et ux. v. IRS; 87 AFTR2d Par. 2001-803; No. 00-1915 (17 Apr 2001) à On appeal, Government sustained. S Corporation shareholder cannot treat management fees as a self-charged item, i.e. passive income.
 - TAM 96240070

Self-Employment Tax

- Norwood, T.C. Memo 2000-84 à The fact that the taxpayer's interest in a partnership was passive did not exempt him from self-employment tax, because he was a general partner in a partnership.
 - TAM 9750001

Self-Rented Property

(Recharacterization of income for property leased to a business where the taxpayer works)

- Connor, T.C. Memo 1999-185 à Self-rented income not passive, Reg. 1.469-2(f)(6) applies to rentals to C corporations.
- Fransen, 98-2 USTC ¶ 50,776 à Self-rental recharacterization applies to rentals to C Corporations.
- Krukowski, 114 TC No. 25 à Options to renew are not pre-88 binding contracts; self-rental recharacterization applies to rentals to C Corporations beginning 5/11/92.
- Kucera, T.C. Memo Summary 2001-18 à Post-88 lease is a *new* contract. Taxpayer materially participated. Rentals should be grouped with business.
- Schwalback, 111 TC No. 9 à Self-rental recharacterization applies to C-Corporations.
- Sidell, T.C. Memo 1999-301 à Self-rental rules apply to C Corporations; cannot offset rehabilitation credit.

Tax Equity and Fiscal Responsibility Act (TEFRA)

- Estate of Robert Quick, 110 TC 172 à Passive losses are an affected item, governed by the partnership TEFRA statute.

Validity of Section 469 Regulations

- Adler, U.S. Court of Federal Claims 93-720T; 32 FedCl 736 Validity of temporary regulations.
- Mordkin, T.C. Memo 1996-187 à Court upheld the validity of the temporary regulations.

- Schaefer, 105 TC No. 16 à Upheld validity of Reg. § 1.469-2T(c)(7)(iv) of the temporary regulations.
- Schetzer, T.C. Memo 1999-252 à no \$25,000 offset for an auto rental; definition of a rental activity.
- Schwalback, 111 TC No. 9 à Court held that the plain language of the regulation clearly indicated that it applied to entities in which the taxpayer materially participated.
- Sidell, T.C. Memo 1999-301 à Court held that the self-rental rule in Reg. § 1.469-2(f)(6) is valid.

Miscellaneous PAL Items

- Business v. Portfolio Royalty Income - PLR 9225027
- Cancellation of Debt (COD) Income from passive source is passive - Revenue Ruling 92-92, 1992-45 I.R.B. 21
- Distributions in excess of Basis - Revenue Ruling 95-5, 1995-2 I.R.B. 5
- Distributions in excess of Basis - TAM 9501001
- No Carryback of PALs / Primary Purpose of IRC § 469 - Adler, 32 FedCl 736
- Carryforward of PAL from C Corporation to new S Corporation - St. Charles Investment Co., 110 TC 46
- Personal Services Corporation - Char-Lil Corp., T.C. Memo 1998-457
Rental losses were disallowed as corporation was a personal service corporation. Interest income is not passive income.

Legislative History

- Senate Report 99-313, 1986-3 C.B. (Vol. 3) 1 (passive activity losses addressed in pages 718-746).
- House Report 99-841, 1986-3 C.B. (Vol. 4) 1 (passive activity losses on pages 137-150).
- The CCH has reported portions of the Committee Reports on P.L. 99-514 (Tax Reform Act of 1986) at paragraph 21,960.20 (2002)

Exhibit 1.2: FORM 8582 – Line by Line Comments (Tax year 2003 and subsequent years)

Rental Real Estate With Active Participation

1a Net rental real estate income, but no interest, dividends, gains on stocks & bonds. Gain on disposition of rental property generally is also passive income. While interest income generally is not passive income, self-charged interest income may be passive income (Reg. § 1.469-7).

1b Net rental real estate losses.

Exception: No limited partners or Schedule K-1s, Partner's Shares of Income, Credits, Deductions, etc., with less than 10 percent ownership.

1c Prior year rental real estate losses from last year's Form 8582 W/S 6.

1d Sum of lines 1a, 1b and 1c.

Commercial Revitalization Deduction

2a Commercial revitalization deductions (generally from Schedule K-1s)

2b Prior year unallowed commercial revitalization deductions

2c Sum of 2a and 2b

All Other Passive Activities

3a Net income/gain from all other passive activities, but no interest, dividends, gains on stocks and bonds.

3b Includes equipment leases, Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, businesses in which Taxpayer does not materially participate, and many vacation condos.

3c Prior year losses from all other passive activities form last year's Form 8582 W/S 5.

3d Sum of line 3a, 3b and 3c.

Special Allowance (Commonly called the \$25,000 offset)

7 MAGI: If no loss on line 1d OR MAGI is over \$150,000 enter \$150,000 here.

Total Losses Allowed

15 Sum of income on line 1a and 3a.

16 Sum of all passive losses allowed in the current year.

Passive losses are allowed only to the extent of passive income (line 15) and \$25,000 special allowance (lines 10 and 14). Line 16 is most commonly reported in two places: Rental losses on the front of Schedule E and Form 1065 & Form 1120S losses on the back of Schedule E in the passive loss column.

Passive losses from trusts are also reflected on the back of Schedule E.

Allowable passive losses from a sole proprietorship are entered on Schedule C.

Allowable losses from a farm are entered on Schedule F.

Losses which are disallowed for the current year are not reflected on the face of Form 8582. They are found on Worksheet 6.

Exhibit 1.3: PASSIVE ACTIVITIES COMMON ISSUES: Schedule A, C, E, F

Schedule A - Itemized Deductions – Investment Interest Line 13

- Interest expense to buy rental real estate, an equipment leasing activity, or an investment in a partnership or S Corporation is not investment interest! If the borrowed funds were used to buy rental real estate or equipment leasing or a Form 1065/1120S in which the taxpayer does not materially participate, that interest expense is passive activity interest and belongs on Form 8582. In the absence of passive income, it is generally not deductible. Reg. § 1.469-2T(d)(3), § 1.163-8T(a)(4)(B) and Notice 89-35
- Investment interest expense is deductible only to the extent of investment income (Form 4952, Investment Interest Expense Deduction line 4f). Investment income is generally only interest, dividends, royalties, annuities, and short-term capital gains. An investment in a partnership or S Corporation business or a rental activity is not investment income.

Schedule C- Profit or Loss From Business (Sole Proprietorship)

- **Equipment, vehicle and airplane leases** are often passive activities. Thus losses are generally not deductible without passive income. See IRC § 469(c)(2)&(4).
- **Hotel, motel, vacation cottage or condo.** If on-site employees do the day-to-day work, it may be difficult for the taxpayer to materially participate. See Reg. § 1.469-5T(a).
- **Charter boat** located a long way from the taxpayer's home may be passive, i.e. the taxpayer does not materially participate.

Schedule E- Supplemental Income and Loss

- **Net rental income** from a business where the taxpayer works is generally not passive income. If that income is on Form 8582 line 1a, there is an adjustment. When a dollar in passive income is removed from Form 8582, a dollar in passive losses is generally disallowed. Passive losses are allowed only up to passive income. See Reg. § 1.469-2(f)(6).
- Net rental income is from **leased land** is not passive income. If that income is on Form 8582 line 1a, there is an adjustment. See Reg. § 1.469-2T(f)(3).
- Unless the taxpayer is a real estate professional (Schedule E line 43), **rental losses are generally limited to \$25,000** and completely phased out when MAGI is more than \$150,000. Even if the taxpayer is a real estate professional, rental losses are still passive and belong on Form 8582 unless the taxpayer **materially participates in the rental**.

Indicators taxpayer does not materially participate: rental is out-of-state, commissions, and/or management fees.

- The taxpayer does not materially participate in an **out-of-state partnership or S-Corporation** business on the back of Schedule E. See IRC § 469(h) and Reg. § 1.469-5T(a).

Schedule F- Profit Loss From Farming

- The taxpayer does not materially participate in the **farm**. Indicators: it is out-of-state or there is on-site management. See IRC § 469(h), Reg. § 1.469-5T(a).

Chapter 2, Rental Losses

In A Nutshell

Rentals generally are passive activities and are subject to the passive loss disallowance rules. See IRC § 469(c)(2). A loss from a passive activity is not currently deductible unless one of the following applies:

- Passive income exists (losses are allowed to the extent of passive income);
- The taxpayer actively participates in a rental real estate activity and qualifies for the \$25,000 special allowance;
- There is a qualifying disposition under IRC § 469(g); or,
- The taxpayer meets the requirements of IRC § 469(c)(7) for real estate professionals.

Audit issues, exclusions, and exceptions are discussed later in this chapter. For Rental Income issues, see Chapter 3.

Issues

- The \$25,000 rental real estate allowance under IRC § 469(i)(8) allows individuals to offset losses from rental real estate without necessarily having passive income.
- Six exceptions exist to the definition of “rental” (Reg. § 1.469-1T(e)(3)(ii)). Certain activities normally thought of as “rentals” are specifically treated as non-rental businesses under this section.
- A real estate professional is permitted treat a rental activity like any other business, i.e. the taxpayer must materially participate to treat it as non-passive.
- Equipment rentals normally are passive whether or not the taxpayer materially participates and do not come under the rules for active participation or material participation. Because equipment leases do not involve rental real estate, they are not able to use even the special \$25,000 offset under IRC § 469(i).^[1]
- Short-term vacation rentals are often treated as businesses, subject to the material participation standard.

The \$25,000 Allowance In a Nutshell

A taxpayer may deduct up to \$25,000 in rental real estate losses as long as the taxpayer actively participates and MAGI is less than \$100,000.

Exception: the amount allowed for married taxpayers filing separately is either \$12,500 (if they did not live together) or zero (if they did live together during the year). See active participation checklist at end of chapter.

Sub-Issues

- The activity must consist of rental real estate (not an equipment lease).
- The taxpayer must have “actively participated” in the rental.
- The MAGI must be less than \$100,000 in order to obtain the full \$25,000 benefit.

Issue Identification

- The Form 8582, Part II, will show the amount of the special allowance that was calculated by the taxpayer.
- Look for rental or non-rental losses deducted without completing Form 8582 including those generated by partnership and S- Corporations.

Active Participation Sub-Issue

As long as a taxpayer participates in management decisions in a bona fide sense, he actively participated in the real estate rental activity. There is no specific hour requirement. However, the taxpayer must be exercising independent judgment and not simply ratifying decisions made by a manager.

Several categories of taxpayers do not meet the standard of active participation and therefore do not qualify for the \$25,000 special allowance:

- A limited partner in an activity (IRC § 469(i)(6)(c)).
- A taxpayer who has less than 10 percent ownership (IRC § 469(l)(6)(A)).
- A trust or corporation. The \$25,000 is available only to natural persons.

Exception: Grantor trust owned by a natural person because it is not deemed a separate entity.

- A taxpayer whose rental activity consists of a net lease. Under a net lease, the tenant pays most of the expenses.

Examination Techniques:

- Review Schedule K-1s to determine whether the taxpayer is a limited partner or a general partner.
- Review ownership interests in each activity to determine whether the taxpayer meets the 10 percent ownership requirement.

Modified Adjusted Gross Income Sub-Issue

The full \$25,000 allowance is available for taxpayers whose MAGI is less than \$100,000. For every \$2 a taxpayer’s MAGI exceeds \$100,000, the allowance is reduced by \$1.

Example: If MAGI = \$110,000, the \$25,000 allowance is reduced by \$5,000 to a \$20,000 maximum allowance. Once MAGI exceeds \$150,000, the special allowance is no longer available.

Exception: commercial revitalization deduction.

Examination Techniques:

- Look for taxpayers who are not real estate professionals (no entry on Schedule E line 43), but deducted rental real estate losses in excess of \$25,000.
- Watch for returns with an AGI over \$150,000 and rental losses were deducted. If the taxpayer is not a real estate professional, the \$25,000 offset is usually not available. In the absence of passive income or a disposition, losses are not deductible.
- Ask for the taxpayer's calculation of MAGI. Make sure that all addbacks are included, including losses deducted as non-passive by a real estate professional. See Reg. § 1.469-9(j).

\$25,000 Allowance Supporting Law

- **IRC § 469(i):** \$25,000 offset defined.
- **Madler T.C. Memo 1998-112:** Court ruled that taxpayers did not materially participate in their condo operation and stated that their level of participation did not even rise to the active participation standard.

Exceptions to Rental Definition

There are six exceptions to the definition of rental. Under Reg. § 1.469-1T(e)(3)(ii), six types of activities normally defined as rentals, are treated as non-rental activities, i.e. as businesses, in most cases. As a result, the active participation standard and the \$25,000 allowance do not apply. If the activity falls outside the rental definition, it is passive or non-passive based on whether the taxpayer materially participates. Following are the six exceptions:

1. The average period of customer use is 7 days or less. **For example:** condo rentals, short-term use of hotel/motel rooms, and businesses that rent videos/tuxedos/cars/tools, etc.
2. The average period of customer use is 30 days or less and significant personal services are provided with the rental. **Examples: hotels and motels.**
3. Extraordinary personal services are provided with the rental. Examples: hospitals, nursing homes and boarding schools.
4. The rental is incidental to a non-rental activity.

5. The taxpayer customarily makes the rental property available during defined business hours for nonexclusive use by various customers.
Example: golf courses, health clubs and spas.
6. The taxpayer provides the property for use in a non-rental activity of his own partnership, S Corporation, or joint venture. The key word here is “provides,” not “rents.” **For example: a partner contributes property in exchange for an ownership interest. This non-leasing transaction with the partnership is not a rental.** Reg. § 1.469-1T(e)(3)(vii) states: **“Thus, if a partner contributes the use of property to a partnership, none of the partner’s distributive share of partnership income is income from a rental activity...”**

Examination Techniques:

- Determine the number of days of an average rental period in the activity. Condo rentals falling under Exception #1 or #2 in Reg. § 1.469-1T(e)(3)(ii) may be erroneously entered on Form 8582, Lines 1b or 1c (for activities qualifying for \$25,000 allowance). Since the activity is not defined as a rental, it is not eligible for the special rental real estate allowance and should be on Form 8582, line 3b.
- Losses from activities meeting the exception to the rental definition are not automatically non-passive! They are generally business activities. The taxpayer must now meet the material participation standard to avoid designation as a passive activity.

Real Estate Professional In A Nutshell

Beginning in 1994, a real estate professional may treat rental real estate activities as non-passive if the taxpayer materially participates in the rental activities.^[2] The material participation requirement applies separately to each rental activity (unless the taxpayer made a timely election to group all his rentals as a single activity). These rules apply to individual taxpayers and closely held C Corporations. See checksheet and interview questions at end of chapter.

Issues

- To qualify as a real estate professional, the taxpayer must spend:
 1. more than 50 percent of his/her time in real estate activities; AND,
 2. more than 750 hours in real estate activities.
- A real estate professional must materially participate in *each* rental activity for the loss to be deductible.^[3]

Exception: A real estate professional may file a written election to group all rental real estate activities as one activity. As a practical matter, most elections were filed in 1995. However, the taxpayer may file the election in any year, and it will bind future years from that point.^[4]

Issue Identification

- Check to see if all Schedule E rental real estate losses have been deducted as non-passive, possibly not considering the fact that the taxpayer must materially participate in each rental activity.
- Look at the taxpayer's occupation next to the signature block and Schedule E line 43. To be a real estate professional, the taxpayer must spend the majority of time^[5] in real property businesses and/or rental real estate.
- Review the Schedule E activities, Schedule K-1s for Form 1065 and Form 1120S returns, and W-2s for other indications regarding the nature of the taxpayer's activities.

Real Estate Professional

To be a real estate professional, an individual must spend the majority of his or her time in real property businesses:

- Development or redevelopment
- Construction or reconstruction
- Acquisition or conversion
- Rental
- Management or operation
- Leasing
- Brokerage

The taxpayer must meet *each* of the following two time requirements:

- More than 50 percent of his/her time working in real property businesses; AND,
- More than 750 hours of service during the year.^[6]

One spouse alone must meet both tests. In addition, services performed as an employee do not count unless the employee is at least a 5 percent owner.

Finally, before rental losses are deductible without being limited by the passive losses rules, the taxpayer must materially participate in each rental.^[7]

Examination Techniques:

- Determine whether the taxpayer materially participates in one or more of the specific real estate trades or businesses listed above.
- Determine who is the real estate professional, husband or wife.
- Request and closely examine the taxpayer's documentation regarding time. The taxpayer is required under Reg. § 1.469-5T(f)(4) to provide

proof of services performed **and** the hours attributable to those services. See Chapter 4 for more on methods of proof.

- Scrutinize other activities the taxpayer is engaged in to determine whether time claimed makes sense.
- Qualification as a real estate professional is a determination, not an election. A taxpayer may attempt to manipulate the passive activity rules by inappropriately claiming to be a real estate professional, or conversely, by not claiming to be one (for instance, if certain activities are generating net income).

Material Participation for Real Estate Pros

A real estate professional may deduct rental real estate losses only to the extent he or she materially participates in each rental activity. Unless the taxpayer elected to group his rentals as a single activity, each rental is treated as a separate activity. Under the material participation rules, the time of both spouses is counted.¹⁸¹ The material participation test⁹¹ then applies separately to each individual rental real estate activity. If the taxpayer materially participates in an activity, net income or loss from that activity is non-passive. If the taxpayer does not materially participate, despite being a real estate professional, the rental is passive and losses (or income) go on Form 8582.

A taxpayer, who does most of the work in a rental, meets Test 2 for material participation in Reg. § 1.469-5T(a)(2). However, if there is on-site management, it may be difficult for the taxpayer to materially participate because:

1. Rental activities, by nature, normally do not require significant day-to-day involvement, i.e. they are not time intensive.
2. For many taxpayers using any kind of outside management, the only material participation test available is the 500 hour test. In many situations, the other tests will not apply.
3. In many circumstances, an individual rental activity will not require 500 hours of participation, nor will the taxpayer have sufficient time available to spend 500 hours on each individual rental real estate activity.

Examination Techniques:

- During the initial interview, question the taxpayer regarding time spent in all activities (personal, business, civic, family, hobbies, etc).
- Request and closely examine the taxpayer's documentation of time utilized for material participation in each activity. See the log-Chapter 5.
- Look for time spent by others in the activity. Indicators: commissions, management fees, expenses for cleaning, maintenance, repairs, etc.

Election to Group Rental Real Estate

A real estate professional may make an election to group all rental real estate activities as one single activity. In order to make a valid election, Treasury Regulation § 1.469-9(g) requires a taxpayer to file a written statement and attach it to an original return. This election cannot be made on an amended return or during an audit!

Examination Techniques:

- Question the taxpayer in the initial interview whether an election was made, grouping rental real estate interests as a single activity.
- Request a copy of the return with the election. Request the original Form 1040, U.S. Individual Income Tax Return, from the IRS Center if doubts exist as to the documents furnished.
- Review prior and subsequent year's returns for consistency.
- Closely scrutinize any passive income on Form 8582 line 1a. If the taxpayer is a real estate professional and did most of the work on the rental, gain on disposition does not belong on Form 8582.

Real Estate Pro: Law

- **IRC § 469(c)(7)**: Real estate professional defined (special rules for taxpayers in real property trades or businesses).
- **IRC § 469(c)(7)(A)(ii) and Reg. 1.469-9(e)(3)**: Each interest in a rental real estate activity is a separate activity for purposes of meeting the material participation tests.
- **Reg. § 1.469-9(g)**: Election available to group all rental real estate as one activity. Must be a written statement filed on an original return.
- **IRC § 469(c)(7)(D)(i)**: Application of real estate professional rules to closely held C Corporations.

Equipment Rentals In a Nutshell

As a general rule, equipment rentals are defined as passive activities under IRC § 469(c)(2). Income and losses should be entered on Form 8582, line 3 (All Other Passive Activities). Rental activities are passive whether or not the taxpayer materially participates^[10]. Material participation is generally irrelevant if the activity is a rental activity. Unless a taxpayer meets one of the six exceptions^[11] to the rental definition, neither the active participation standard nor the material participation standard apply. As a result, the \$25,000 allowance for rental real estate activities cannot be used for equipment rentals. See equipment rental checklist at end of chapter.

Issues

Equipment rentals generally are passive. See IRC § 469(c)(2)&(4).

- Since the activity does not involve rental real estate, the active participation standard and the \$25,000 allowance do not apply.
- Activities meeting one of the six exceptions are treated as businesses. A taxpayer must then materially participate in order to treat the gain/loss as non-passive.

Issue Identification

Equipment leasing activities are typically reflected on Schedules C & E as well as

Form 1065 & Form 1120S. Business Code/NAICS Code 532400 is used for commercial and industrial machinery and equipment rental and leasing.

Examination Techniques:

- Request a copy of the lease.
- If no written lease, determine if a true rental arrangement exists.
- Ask the taxpayer to explain what services, if any, the taxpayer provides with the equipment.
- Request a copy of the management agreement or charter contract.
- Determine the average period of customer use. If the rental activity falls under one of the six exceptions, request a detailed list of hours and services performed by the taxpayer.
- Request a statement from the taxpayer as to whether any activities have been grouped.

Equipment Leasing Supporting Law

- **IRC § 469(c)(2) & (4):** Rental activities are passive regardless of whether the taxpayer materially participates.
- **Reg. § 1.469-1T(e)(3)(ii)(A)-(F):** Six exceptions to the definition of rental. If an exception applies, the rental activity is treated as a business and the material participation rules apply.
- **Reg. § 1.469-1(e)(3)(iii):** Each period during which a customer has a continuous or recurring right to use the property is a separate period. **For example**, if the property is used only a few hours at a time, but the lessee has a recurring right to use the property all year, the period of customer use is a year.
- **Reg. § 1.469-4(d)(1)(i):** General Rule: Rentals may not be grouped with businesses.

Exceptions:

1. a rental can be grouped with a business if insubstantial; or,
2. owned in the exact same percentage and rented back to that business activity.

Vacation Rentals In a Nutshell

Many condos, vacation cottages, time-shares, hotels, motels, and bed and breakfasts have an average rental period of seven days or less. As a result, these activities are not defined as rentals^[12], but instead are treated as businesses. Net losses from these activities are passive unless the taxpayer materially participates. Because many of these activities have a management company and may not be near to the taxpayer's residence, materially participating^[13] may be difficult. See checksheet at end of chapter.

Sub-Issues

- Activities with an average rental period of 7 days or less are defined as businesses, not rentals. Therefore, the active participation standard and the \$25,000 rental real estate allowance do not apply to these types of activities. Losses, if passive, go on Form 8582 line 3b, not 1b.
- The personal use rules IRC § 280A take precedence over IRC § 469. If the taxpayer or family members spent more than 14 days at the property, losses generally are not allowed under the rules in IRC § 280A. The losses do not enter into the passive activity computation and should not be entered on Form 8582.^[14]

Issue Identification

- Review Schedule E to determine the location of the activity.
- Inquire about personal use, including family members **or** those renting at less than fair rental value.
- Determine whether a management company has been hired for the day-to-day operations. Indicators: commissions or management fees deducted.
- Review Schedule C for short-term rentals.
- Check the back of Schedule E for non-passive losses from hotels from flow through entities. Does it make sense that the taxpayer materially participated in the partnership or S Corporation business?
- Losses from businesses should be entered lines 3b, not 1b.

Material Participation Sub-Issue

Taxpayers sometimes attempt to qualify as a material participant in a vacation rental under one of the following tests.

- 100 hours and more than anyone else^[15]: The taxpayer must not only prove he worked more than 100 hours, *but more than anyone else*. He must be ready to provide evidence of the participation of others. Additionally, there is no provision in IRC § 469 to divide employee time by each unit.
- Substantially all^[16]: It will be very difficult for the taxpayer to meet this test for any condo-type activity that either has a management firm or is located away from the taxpayer's residence with someone who manages the activity.
- Facts and circumstances^[17]: This test cannot be used if anyone besides the taxpayer is paid to manage the activity. An on-site management agency disqualifies the taxpayer from using this test.

For information on the material participation tests, see Chapter 4.

Examination Techniques:

- Tie down the taxpayer's day-to-day involvement and specific hours regarding the activity.
- Request, as soon as possible, a log or other documentation itemizing the nature of the participation and the hours for each type of work claimed during the year. See log at end of Chapter 4.
- Request a copy of any management or commission agreement. Frequently, there is little left for the taxpayer to do.
- Refer to Chapter 4 if significant time claimed for reading reports, paying bills or other investor-type hours, which are generally disregarded in the material participation tests. Also see Chapter 4 for comments on travel.

IRC § 280A Sub-Issue

If a taxpayer or family members use a vacation property for more than 14 days or 10 percent of the property's rental time, the personal use limitations of IRC § 280A apply and IRC § 469 is no longer applicable. The IRC § 280A severely limits losses. See

IRC § 469(j)(10) and Chapter 8 for more information on this issue.

Examination Techniques:

- Review Schedule E, Part I for information regarding personal use.
- Request information verbally during the initial interview on time worked on the condo.
- Also ask for any agreements with the management company.

IRC § 469(j)(7) Interest

Interest Expense on Rental of Personal Residence – See Chapter 7

Summary

- Up to \$25,000 in rental real estate losses are allowed for taxpayers with MAGI of \$100,000 or less^[18].
- The MAGI is adjusted gross income computed without any passive losses and several other minor modifiers. When MAGI exceeds \$150,000, rental losses are generally not permitted unless the taxpayer is a real estate professional.
- A taxpayer who spends the majority of his time on real property businesses and rentals may deduct his rental real estate losses, if he materially participates in the rental.^[19]
- Equipment rentals are generally passive activities. Losses are nondeductible in the absence of passive income.
- Many vacation rentals fall outside the rental definition^[20] and are treated as businesses. If there is on-site management, it may be difficult for the taxpayer to meet the material participation standard.

^[1] IRC § 469(c)(2)&(4)

^[2] IRC § 469(c)(7)

^[3] Reg. § 1.469-9(e)(1)

^[4] Reg. § 1.469-9(g)

^[5] The majority of time he or she spends performing personal services in trade or businesses must be in real property trades or businesses. IRC § 469(c)(7)(B).

^[6] IRC Section § 469(c)(7)(B)

^[7] If the taxpayer elected to group his rentals as a single activity under the provisions of Reg. § 1.469-9(g), then he must prove material participation in the grouped rental activity .

^[8] IRC § 469(h)(5), Reg. § 1.469-5T(f)(3) and Reg. § 1.469-1T(j)

^[9] Reg. § 1.469-5T(a)

^[10] IRC § 469(c)(2)&(4)

^[11] Reg. § 1.469-1T(e)(3)(ii)

^[12] Reg. § 1.469-1T(e)(3)(ii)(A)

^[13] Reg. § 1.469-5T(a)

^[14] IRC § 469(j)(10)

^[15] Reg. § 1.469-5T(a)(3)

^[16] Reg. § 1.469- 5T(a)(2)

^[17] Reg. § 1.469-5T(a)(7) & (b)(2)

^[18] IRC § 469(i)

^[19] IRC § 469(c)(7) and Reg. 1.469-9(e)(1)

^[20] Reg. §1.469-1T(e)(3)(ii)(A)

Exhibit 2.1: Rental Decision Tree

Is the Activity a True Rental?

Note: Losses are nondeductible unless offset by passive income. Refer to IRC 469(a) and 469(d).

Decision Tree

Is the rental owned in the same % as the business entity or it insubstantial in relation to the business, and are the two activities interrelated?

- If yes, loss may be okay. Refer to Reg. Section 1.469-4(d)
- If no, does the activity fall within one of the rental exceptions in Reg. Section 1.469-1 T(e)(3)(ii)

Exceptions

- Is the average use less than 7 days?
- Is the average use less than 30 days with significant personal services?
- Are extraordinary personal services provided such that rental is incidental to services?
- Is the rental is *incidental* to a non-rental activity?
- Is the property customarily available to customers during defined business hours for nonexclusive use by customers?
- Is the property provided to TP's 1120 or 1065?
- If no, activity is a rental. Losses are reported on Form 8582 line 3b and are nondeductible without passive income.

Does the TP materially participate in the activity?

- If no, losses are reported on Form 8582 line 1b or 3b and are not deductible without passive income
- If yes, losses are fully deductible.

Exhibit 2.2: Modified Adjusted Gross Income Computation

Modified adjusted gross income (MAGI) for FORM 8582 line 7 is determined by computing:

AGI without:

- Any passive loss or passive income, or
- Any rental losses (whether or not allowed by IRC § 469(c)(7)), or
- IRA, taxable social security or
- One-half of self-employment tax (IRC § 469(i)(3)(E)) or
- Exclusion under 137 for adoption expenses or
- Student loan interest.
- Exclusion for income from US savings bonds (to pay higher education tuition and fees)
- Qualified tuition expenses (tax years 2002 and later)
- Tuition and fees deduction
- Any overall loss from a PTP (publicly traded partnership)

OR you can do the following alternative computation.

If there are capital gains/losses from passive activities, use method above.

Adjusted Gross Income Per Return

| | |
|--|-----|
| | |
| + Audit Adjustments Affecting AGI | +/- |
| | |
| Except passive activities (rentals and passive businesses) | |
| - Taxable Social Security IRC § 86 | - |
| | |
| + IRA Deductions IRC § 219 | + |
| | |
| + Deduction for 1/2 Self Employment Tax | + |
| | |
| + Passive Losses IRC § 469(i)(E)(iv) | + |
| | |

Passive loss=Net rental loss **and**

Passive Business Loss (Excess passive losses after netting with passive income)

+ Rental Real Estate Losses per 469(c)(7) IR§469(i)(E)(iv) +

+ Nontaxable Income from US Savings +

Bonds Used for Higher Education

+ Exclusion under IRC§137 for adoption expenses (W-2) +

+ Student loan interest deduction +

Modified Adjusted Gross Income Form 8582 =

MODIFIED ADJUSTED GROSS INCOME COMPUTATION NOTES

REMINDERS:

1. The MAGI includes non-passive losses and non-passive income on the back of Schedule E.
2. Net income from self-rented property or net income from leased land, which are non-passive, increase MAGI.
3. Rental losses allowed for real estate professionals do not reduce MAGI.

You can tell if the taxpayer is a real estate professional via the last line on the back of Schedule E.

DISPOSITIONS:

If there is an overall loss after considering current and suspended losses against gain on disposition, the loss is non-passive. See IRC § 469(g). Thus, it enters into the modified AGI computation, and will reduce income, just as another non-passive loss would. Stated differently, both the income and the losses enter into the MAGI computation.

If there is an overall gain after considering current and suspended losses against gain on disposition, neither the gain nor the losses should be considered in

computing MAGI. The reason is because the net gain constitutes passive income under Reg. §1.469-2T(c)(2).

Exceptions to MAGI rule:

- The deduction equivalent of the rehabilitation credit is phased out beginning at \$200,000 of MAGI. Even a limited partner may take the rehabilitation credit. There is no participation requirement for the low income housing credits (LIHC), rehabilitation credits, or for the commercial revitalization deduction. See IRC § 469(i)(6)(B).
- There is no phaseout range for the LIHC, i.e. *any* taxpayer can take the LIHC, including a limited partner. See IRC § 469(i)(3)(c)(D). Furthermore, for both the rehabilitation credit and LIH, even a limited partner may use the \$25,000 offset. Both of these credits impact FORM 8582-CR, not Form 8582.
- A real estate professional, who materially participates in each rental (including LIH and rehabilitation activities) may deduct all current losses without limitation. However, even if the taxpayer is a real estate professional, many LIH and rehabilitation interests are owned via a limited partner interest; thus losses from these activities generally will still be subject to the same passive loss rules. For rental losses which are allowed by virtue of the real estate professional rules, those losses increase MAGI. Thus, raising the amount and very possibly limiting the amount of \$25,000 offset available. See IRC § 469(i)(3)(E)(iv).
- There are special rules for taxpayers who file married filing separately. See IRC § 469(i)(5).
- There is no phaseout for the commercial revitalization deduction. See IRC § 469(i)(3)(c).

Exhibit 2.3: Rental Real Estate Losses: Active Participation

Passive loss limitations for rental real estate generally apply to:

- Leased residential property
- Leased vacation homes if average rental period is more than 7 days.
- Leased condos if average rental period is greater than 7 days.
- Leased commercial buildings
- Leased land
- Mini-warehouses
- Self-storage units

ISSUE: Does the taxpayer actively participate and does he qualify for the \$25,000 special allowance under IRC § 469(i)?

_____ **Have rental real estate losses been limited to \$25,000** (or up to passive income from another passive activity)? If not, limit losses to \$25,000, and continue on to verify active participation. If yes, continue on to verify active participation.

_____ **Is MAGI more than \$150,000?** MAGI is simply AGI computed without rental losses and any other passive losses and some minor modifiers. If AGI is more than \$150,000, MAGI is almost always more than \$150,000. If AGI plus the rental losses is more than \$150,000, MAGI is more than \$150,000.

_____ **Is the taxpayer a limited partner** (and not also a general partner)? See IRC § 469(i)(6)(B). Note: Since many investors in low income housing are limited partners, losses will not qualify for the active participation standard and should be on line 3b. Therefore, no \$25,000 offset is available. While LIHC are excepted from the active participation requirement, no such exception exists for LIH losses.

_____ **Does the taxpayer own less than 10 percent?** See Schedule K-1.

_____ **Are losses from an activity other than real estate?** Equipment, computers, boats, vehicles, etc. Leases of personal property are generally passive regardless of the level of participation See IRC § 469(c)(2)&(4).

If answers to any of the last 3 questions are answered YES, Taxpayer does not qualify for \$25,000 offset. Loss should be moved to Line 3 of FORM 8582 and recomputed. In effect, the loss will be disallowed (unless there is passive income from another activity reported on F1040). If all answers above are NO, verify the taxpayer is actively participating (making management decisions relative to tenants, terms, repairs) via a statement or oral testimony. To be actively participating, the taxpayer must be making management decisions in a bona fide sense, not merely ratifying an on-site manager's decisions.

CONCLUSION: The taxpayer is/is not actively participating. Ref. IRC § 469(i), Reg. § 1.469-1T(e)(3).

Exhibit 2.4: Real Estate Professionals

LAW: Under IRC § 469(c)(7) & Reg. 1.469-9, if the taxpayer spends the majority of his time in real property businesses, meeting the 1/2 personal services and 750-hour tests, rental real estate losses are no longer per se passive. If the taxpayer materially participates in each rental real estate activity, losses are fully deductible. If not, even though the taxpayer is a real estate professional, losses are passive and deductible only up to \$25,000 (if MAGI is less than \$100,000). The IRC § 469(c)(7) does not trigger carryover losses from prior years.

_____ **Verify that one spouse alone meets BOTH of the following tests.**

FIRST TEST: Are more than half of personal services in all businesses (T/B) for the year performed in real property T/B and rental real estate?

--Real property T/B = real property development, construction, acquisition, conversion, rental operation, management, leasing or brokerage. Time spent as an employee in real property activities counts only if the taxpayer is more than a 5 percent owner.

SECOND TEST: Does taxpayer spend more than 750 hours in real property businesses and rentals in which he materially participates?

_____ **If answer is NO to either of above two tests, IRC § 469(c)(7) does not apply**, and losses are generally limited to \$25,000.

_____ **If answer is YES to both tests, apply material participation tests to each rental real estate activity** to determine whether each activity is passive or non-passive. While not seen often, the taxpayer may have made a one-time election to group all rentals as a single activity. Thus material participation is determined based on the grouped rentals. See IRC § 469(c)(7)(A) and Reg. § 1.469-9(g).

CONCLUSION:

1. Per IRC § 469(c)(7), the following rental real estate activities have been determined to be non-passive and current (but not carryover) losses are fully deductible: _____. Current losses are entered on Schedule E, but not on FORM 8582.
2. Taxpayer is a real estate professional, but did not materially participate in the following real estate activities: _____. He does, however, actively participate, making management decisions. Losses are entered on FORM 8582 line 1a.
3. Taxpayer does not actively participate in the following rental real estate activities: _____. Limited partners and Taxpayers who own

less than 10 percent cannot rise to the active participation standard.
Losses are entered on FORM 8582, line 3b (2b for years before 2002).

Exhibit 2.5: Real Estate Professional: Interview Half Personal Services Test

_____ Describe the work you perform as a real estate professional. Check occupations by signatures and W-2s.

_____ Who is the real estate professional, you or your spouse?

_____ Does the spouse claiming to be the real estate professional work full-time or part-time? If the taxpayer has a full-time job working 2080 hours a year in a non-real property business, he must work 2081 on his real property businesses to meet half-personal services test!

_____ What percentage of each real property business(es) do you own? Unless taxpayer owns 5 percent or more, time is not counted. See IRC § 469(c)(7)(D)(ii). If, for example, the taxpayer works full-time for a construction company, but does not own any of the company, he is not a real estate professional.

750 HOUR TEST

Time does not count for purposes of the 750 hour test and the half personal services test – unless the taxpayer materially participates in the activity. One spouse ALONE must meet the 750 hour test.

_____ Who performs the services, husband or wife? Hours by husband? Hours by wife?

_____ Approximately how many hours did you spend working on your rentals in the year under exam? Ask the taxpayer for supporting documentation (appointment books, diaries, calendars, logs, etc.) You may want to give taxpayer a log to be completed for each rental – and for each year under exam. Material participation is a year by year determination. Rentals are generally not time intensive.

_____ If non-working spouse claims to be the real estate professional, ask what other commitments he/she may have. Is the spouse a student? Is the spouse providing full-time care to young children?

MATERIAL PARTICIPATION IN THE RENTALS

_____ Who monitors the rentals? Who collects the rent? Who does the repairs?

_____ Do you have a real estate agent or manager or employee responsible for any of the rentals? Ask for each rental property. Check Schedule E properties for large commissions or management fees. Also check for large labor expense -

possibly a hired contractor spent more time than taxpayer. If there is paid management, it is a strong indicator taxpayer did not materially participate.

_____ Is anyone besides you involving with managing or overseeing any the properties? Does a relative or friend manage/monitor the property for free?

_____ Does a tenant receives free/reduced rent for managing the rentals – or for caring for the properties?

Exhibit 2.6: Equipment Rentals IRC § 469(c)(2) and Reg. § 1.469-1T(e)(3)

ISSUE: Schedule C/E for _____

Are losses limited because activity is passive? Generally, long-term equipment rentals are passive, and losses (from Schedule C, E, F1065s or S Corporations) are not deductible unless taxpayer has passive income from another activity. An equipment lease of greater than seven days is generally passive. Whether or not the taxpayer materially participates is irrelevant. The IRC § 469(c)(2)&(4). Passive equipment rentals go on FORM 8582 and cannot be deducted in the absence of passive income. With short-term rentals, the activity is treated like a business and taxpayer must materially participate to deduct losses. See Reg. § 1.469-1T(e)(3)(ii) for exceptions to the rental definition.

_____ **Determine the average period of customer use.** Days rented divided by number of customers for the year. Customer use = Each period during which a customer has a continuous or recurring right to use the property (whether or not he actually uses it). Does the taxpayer have preferential rights to use the property? If so, the period of customer use is generally the entire year. If the average period of customer use is more than 7 days, activity is generally a rental activity (IRC § 469(c)(2)&(4) and Reg. § 1.469-1T(e)(3)(i)), and losses are allowable only up to passive income from other activities. If customer use is less than 7 days, the activity is still passive unless the taxpayer materially participates (IRC § 469(h) and Reg. § 1.469-5T(a)).

_____ **Secure lease and any other agreements.** What is lease period? Does taxpayer have a recurring right to use the equipment? Does lease stipulate payments are for use of the equipment? OR are payments primarily for taxpayer's services in driving and/or maintaining the equipment? A rental is defined as the lease of tangible property where amounts paid are principally for use of the property (Reg. § 1.469-1T(e)(3)(b)) - as opposed to a service intensive activity where rental of property is incidental to services received. Service intensive activities are generally treated as businesses.

_____ **Secure insurance contracts.** Is equipment insured personally? Is it insured for use by customers?

_____ **Is the equipment leased to an S corporation in which the taxpayer is the 100 percent shareholder?** If so, the taxpayer may be able to deduct his losses under IRC § 469. While rentals generally may not be grouped as a single activity under Reg. § 1.469-4(d), there is an exception, which permits a rental activity and the business leasing the property to group IF they are owned in identical percent and they form an integrated, interrelated economic unit. A rental activity, however, can never be grouped with a C Corporation.

CONCLUSION: Under IRC § 469, equipment losses are/are not allowed.

Exhibit 2.7: Vacation Rentals/Condos/B&Bs/ Hotels Reg. § 1.469-1T(e)(3)(ii) and Reg. § 1.469-5T(a)

ISSUE: Should the activity be treated as a rental real estate activity qualifying for the \$25,000 offset, OR should it be treated like a business in which taxpayer must materially participate (Reg. § 1.469-5T(a)). Condos rented on average seven days or less are treated as businesses.

If taxpayer deducted losses from a vacation rental or condo on Schedule E, Schedule C or line I of Form 8582, giving himself the benefit of the \$25,000 offset, ask . . .

_____ **Did the taxpayer or related parties spend more than 14 personal days at the property** OR 10 percent of the days rented at fair rental value? In other words, are deductions limited under IRC § 280A(c)(5)? If so, the passive loss rules do not apply. See IRC § 469(j)(10). Losses are limited to income from the activity under IRC § 280A. In other words, expenses may not be deducted beyond gross rents under IRC § 280A. Qualified residence interest and taxes that exceed gross income may be deducted on Schedule A as itemized deductions.

If IRC § 280A does not apply, pursue passive loss issue:

_____ **What is the average rental period?**

The activity is not deemed a rental and does not qualify for the \$25,000 offset if:

- The average period of customer use is 7 days or less; OR,
- The average period of customer use is 30 days or less and significant personal services are provided (such as maid service, cleaning services, etc.)

If neither of the above apply, the taxpayer qualifies for the \$25,000 offset, if active. If either of the above exceptions apply, the activity is not a rental activity. It is treated as a business, and the far more stringent material participation standard applies.

QUESTIONS to ask if rental period requirement is not met, and the taxpayer must materially participate:

_____ **Is there a management service or anyone who manages the property other than the taxpayer?**

_____ **How many hours a month does the taxpayer spend working on activity?** Ask taxpayer to provide documentation of hours worked for the years under examination. The initial interview is the best time to secure a statement

from the taxpayer of hours and types of participation performed. If statements are self-serving or questionable, be sure to request telephone records, documents or third party verification to corroborate taxpayer's statements. The IRS does not need to accept self-serving testimony or narrative summaries, which do not make sense.

_____ **Does taxpayer and/or spouse work more than 500 hours** a year on activities related to the vacation rental? Reading reports and otherwise monitoring the condo in a non-managerial capacity does not constitute material participation.

_____ **Does the taxpayer perform substantially all the work?**

If there is a management firm, the answer is no.

_____ **Does the taxpayer work at least 100 hours and no one works more?**

If there is a management firm, it would be difficult for taxpayer to meet this standard. See Reg. § 1.469.5T(f)(2)(ii). It is the taxpayer's burden to prove how many hours he worked and how many hours employees worked. If taxpayer is not involved in day-to-day management or operations, certain activities are disregarded when counting hours for material participation. The following activities would not constitute material participation: studying financial reports, preparing analysis for taxpayer's own use, and monitoring finances or operations in a non-managerial capacity. Periodic consultation is not sufficient to meet material participation standard.

_____ **Does taxpayer have several passive businesses with losses in which he participates 100-500 hours, and the total participation in these activities exceeds 500 hours?**

_____ **Did taxpayer materially participate for any 5 out of the last 10 years?**

_____ **Do facts and circumstances indicate taxpayer materially participates?** This test in Reg. § 1.469-5T(a)(7) does not apply unless the taxpayer worked more than 100 hours a year. Furthermore, it does not apply if (1) any person received compensation for managing the activity or (2) if any person spent more hours than taxpayer managing the activity.

NOTE: If the taxpayer's statements or narrative summary appears to be self-serving or questionable, be sure to request supporting documents, telephone records or third party verification. We need not accept at face value uncorroborated testimony if it is questionable, improbable or unreasonable.

_____ **Request any management contract with condo association's responsibilities highlighted.** Frequently, there is little left for the taxpayer to do.

CONCLUSION: Activity does/does not meet the definition of a rental per

Reg. § 1.469-1T(e)(3)(ii) and taxpayer does/does not meet the material participation standard per Reg. § 1.469-5T(a). If activity is not a rental and taxpayer is not materially participating, loss is disallowed unless taxpayer has other passive income on the return.

Chapter 3: Passive Income

In a Nutshell

Because passive losses generally can offset only income from passive activities, some taxpayers have attempted to “create” passive income in order to trigger passive losses. In other words, non-passive income may have been improperly classified as passive and entered on Form 8582 in order to trigger deductibility of otherwise nondeductible passive losses. Therefore, a common issue is whether income on Form 8582 lines 1a or 3a is truly passive. For every dollar of passive income removed from Form 8582, there is frequently an adjustment to allowable passive losses of a dollar. Passive losses are generally deductible **only to the extent of passive income**.

Regardless of whether income is deemed to be passive or non-passive, it must always be reported somewhere on the return, most typically on Schedule E. The Form 8582 is computational only, figuring the amount of passive loss deductible for the current year. It not the form used to report income.

See passive income checksheet at end of chapter.

Passive Income

Passive income can only be generated by a passive activity. Just because the taxpayer did not work for the income does not mean it is passive. There are only two sources for passive income:

1. a rental activity; or,
2. a business in which the taxpayer does not materially participate.

Gain on a partial or entire disposition of a passive activity generally is passive income. See **Chapter 5** for a detailed discussion of passive income issues on disposition.

While the following may **seem** passive, generally none are passive income:

- Portfolio income, including interest, dividends, royalties, annuities and gains on stocks and bonds; ^[1]
- Lottery winnings; ^[2]
- Salaries, wages, Form 1099-Misc. commissions and retirement income; ^[3]
- Guaranteed payments for services; and, ^[4]
- Income from any activity in which the taxpayer materially participates. ^[5]

Even if generated by a passive activity, portfolio income is non-passive.

Issue Identification:

- Passive income is most commonly reflected on Schedule E as a net rental income or as income from a partnership or S Corporation in which the taxpayer does not materially participate.
- Passive income may also be reflected on Form 4797, Sale of Business Property or Schedule D, Capital Gain and Losses due to the disposition of a passive activity or asset used in a passive activity.
- Passive income may also be found on Schedule C and F if these are activities in which the taxpayer does not materially participate.

Examination Techniques:

- Review Form 8582 lines 1a and 3a. Verify income is reported somewhere on the return (Schedule E, D, C, F, etc.). The Form 8582 is computational only, figuring the allowable passive loss. It does not report income. If there is income on Form 8582, which is not reflected elsewhere on the return, you have unreported income!
- Scan Schedules B, Fiscal Year Supplemental Schedule of Income and Retirement Income Credit, Schedule D, and Schedule K-1 to verify that passive income does not include interest, dividends, royalties or stock and bond sales.
- Verify the income is not from a partnership that is a trader in stocks, bonds and other securities. Traders fall completely outside the passive activity rules (Reg. § 1.469-1T(e)(6)). Schedule K-1 line 1 income from a trader in stocks and bonds is non-passive, even if the taxpayer is a limited partner!
- For activities claimed as passive on Form 8582, verify that income is not from a business in which the taxpayer materially participates. You may want to use one of the search engines on the internet to see what is said about the level of activity of the taxpayer.
- Verify that income is not from a business which is related to another activity in which the taxpayer materially participates. If so, possibly, the two businesses should be grouped as a single activity under Reg. § 1.469-4(f). See Chapter 9.
- Verify that passive income is not from the rental of a building or equipment to a business where the taxpayer works. Reg. § 1.469-2(f)(6) recharacterizes so-called “self-rental” income as non-passive.
- Verify that passive income is not from the rental or sale of land or other nondepreciable property. See Reg. § 1.469-2T(f)(3).
- Verify that compensation for the performance of personal services is not classified as passive income. This includes W-2 wages, Form 1099-Misc commissions, retirement income and guaranteed payments.

Documents to Request:

- The Form 8582 worksheets break down the income items on Form 8582. Worksheet 1, 2 and 3 reveal which entities are generating income. Worksheet 5 (6 beginning in 2002) indicates which schedule an allowed passive loss is reflected on.
- Schedule K-1s and other documents supporting amounts reflected on Form 8582.

Supporting Law:

- **IRC § 469(c)** Passive income can only be generated by a rental activity or a business in which the taxpayer does not materially participate.
- **Reg. § 1.469-2T(c)** Income is passive if and only if the income is from a passive activity.
- **Reg. § 1.469-2T(c)(2)** Gain on the sale of a passive activity is passive income, if it was a passive activity in the year of disposition.
- **IRC § 469(e)(1)A) and Reg. 1.469-2T(c)(3)** Portfolio income is non-passive.
- **IRC § 469(e)(1)(A)(ii) and Reg. 1.469-2T(c)(3)(C)&(D)** Gain on the sale of stocks and bonds is non-passive.
- **Reg. § 1.469-2T(f)(3)** Net income from lease or sale of land is non-passive.
- **Reg. § 1.469-2(f)(6)** Income from rental real estate, equipment or other property leased to a business where the taxpayer works is non-passive.
- **Carlstedt TC Memo 1997-331** The taxpayers failed to sustain their burden of proving they did not materially participate in an S Corporation.
- **Seits TC Memo 1994-522** Gain from the sale of an apartment was investment income, not passive income.
- Refer to **Chapter 1 Case Summaries** for more cases related to income.

Self-Rental Income

Certain types of income are treated (“recharacterized”) as non-passive. If a taxpayer rents a property to a business in which he materially participates, net rental income is non-passive and should not be on Form 8582 line 1a as passive income. See Reg. § 1.469-2(f)(6) and self-rented property checksheet at the end of the chapter. Net rental losses, however, generally remain passive.

Even though income is treated as non-passive, it may offset suspended prior year passive losses from the same activity.^[6]

- Peruse Schedule E for any property with net income and few expenses, indicating that the property might be under a net lease. Income from property leased to an entity where the taxpayer works is often structured as a net lease.

- Check Form 8582 line 1a to see if what appears to be self-rental income from Schedule E is improperly reflected there.

Self-rented property is a frequent adjustment, as it is common practice for many professionals to own the property personally and lease it to a corporation or partnership where they conduct business.

Exception: Pre-88 Lease

Self-rental income is passive if there is a written currently binding lease signed before 2/19/88.^[7] However, as a practical matter, pre-1988 leases that bind years under examination are rarely seen, as the lease period would have to be 15 years or more. Renewable options generally do not constitute a written binding lease, as the option is not legally binding until exercised.^[8]

Examination Techniques:

Ask to see the lease for the year under examination. If the lease was signed after 1988, income is non-passive

Leased Land

Income from leased land (ground rents) is non-passive and should not be on Form 8582 line 1a. Reg. § 1.469-2T(f)(3) recharacterizes income from leased property where less than 30 percent of the unadjusted basis is depreciable as non-passive.

Examples: fields leased to a farmer, mobile home parks, land leased for billboards, lots leased to sell Christmas tree, land leased for cell towers and campgrounds.

The character of an activity is not changed. Even though income is recharacterized as non-passive, the activity remains a passive activity and, in fact, if it produced losses, they would generally be passive. See Reg. § 1.469-2T(f)(1).

Land held for Investment

Property (land, for example) held for investment is non-passive under IRC § 469(e)(1)(A)(ii)(II).

Issue identification:

- If the land is entered on Schedule D and gains are limited to 20 percent versus being taxed at ordinary rates potentially as high as 39.6 percent, it is an indicator that the land was held for investment. See IRC § 1(h).

Examination Techniques:

- Peruse Schedule E. If there is little or no depreciation, it is an indicator that the activity may be leased land.
- If the taxpayer claims to be in the business of land sales, i.e. the activity is on Schedule C or in partnership, sporadic sales is an indicator that land is being held for investment versus being treated as a business. **Reminder:** if the taxpayer performs most of the work in a business, income is non-passive. See Reg. § 1.469-5T(a)(2).

Supporting Law

- **IRC § 469(c):** Passive income can only be generated by a rental activity or a business in which the taxpayer does not materially participate.
- **Reg. § 1.469-2T(c):** Income is passive if and only if the income is from a passive activity.
- **Reg. § 1.469-2T(c)(2):** Gain on the sale of a passive asset or activity is passive income if it was a passive activity in the year of disposition.
- **IRC § 469(e)(1) and Reg. § 1.469-2T(c)(3):** Portfolio income is non-passive.
- **IRC § 469(e)(1)(A)(ii) and Reg. § 1.469-2T(c)(3)(C)&(D):** Gain on the sale of stocks and bonds is non-passive.
- **Reg. § 1.469-1T(e)(6):** Traders in stocks, bonds and other securities are not passive activities.
- **Reg. § 1.469-2T(f)(3):** Net income from lease or sale of land is non-passive.
- **Reg. § 1.469-2(f)(6):** Income from property leased to a business where the taxpayer works is non-passive.
- **Carlstedt T.C. Memo 1997-331:** The taxpayers failed to sustain their burden of proving they did not materially participate in an S-Corporation.
- **Seits T.C. Memo 1994-522:** Gain from the sale of an apartment was investment income, not passive income.

Summary

- Passive income has only two sources: net rental income and income from a business in which the taxpayer does not materially participate.
- Interest, dividends, royalties, annuities and gains on stocks and bonds are not passive income.
- Net rental income from property leased to a business where the taxpayer materially participates is non-passive and should not be reflected on Form 8582.
- Income from land, whether leased land or property held for investment, is non-passive. Stated differently, net income (but not net loss) from the leasing of nondepreciable property (such as land) is treated as non-passive.

^[1] IRC § 469(e)(1)

^[2] PLR 8943055

^[3] IRC § 469(e)(3)

^[4] Reg. § 1.469-2(e)(2)(ii)

^[5] IRC § 469(c)(1)

^[6] IRC § 469(f)(1)

^[7] Reg. § 1.469-11(c)(2)

^[8] Thomas P. Krukowski, 114 T.C. No. 25 US Tax Court

Exhibit 3.1: Passive Income

Large amounts of passive income on Form 8582 line 1a and 3a should be scrutinized carefully. Passive income can be generated only by a rental **or** a business in which the taxpayer does not materially participate. Both are more apt to produce net losses than net income. If Form 8582 reflects significant income on line 1a or 3a, perform the following:

_____ **Verify that income on Form 8582 is also reflected on Schedule E lines 22 & 28(a) Col (h), Form 4797 or elsewhere.** Form 8582 is merely a computational form which figures the amount of allowable passive losses (Form 8582 line 11). Income on Form 8582 **MUST** also be reflected on the appropriate schedule to be properly reported. If income on Form 8582 is not reflected elsewhere on the return, the examiner has an adjustment for unreported income!

_____ **Verify that income is not interest, dividends, royalties, or gains on the sale of stock.** Portfolio income is not passive income and should not be entered on Form 8582.

Exception: self-charged interest income. See Reg. § 1.469-7.

_____ **Verify that income is not flowing from a partnership or LLC which a trader or stocks, bonds or other securities.** An activity involving trading of stocks and bonds is not a passive activity. Thus, income would be non-passive and should not be reflected on Form 8582. See Reg. § 1.469-1T(e)(6).

_____ **Verify that income is not from rental of building to a partnership, corporation, or business where the taxpayer materially participates** (unless there is written currently binding lease signed before 02/19/88). Rental income from businesses in which the taxpayer materially participates (i.e. works on a regular basis) is non-passive and does not belong on Form 8582 line 1a. See Reg. § 1.469-2(f)(6).

_____ **Verify that income is not from leased of land or other non-depreciable property.**

Example: leased field, parking lot, ground rents for trailers or mobile homes, leased land for cell towers. See Reg. § 1.469-2T(f)(3).

_____ **Verify that income on Form 8582 line 1a or 3a is not from the sale of land.** Investment income is not passive income. See IRC § 469(e)(1)(A)(ii)(II). Passive income must be generated by a passive activity.

_____ **Verify that income is not from an activity in which taxpayer materially participates.** See Reg. 1.469-5T(a). Review the worksheets of Form 8582 to see if income is coming from an in-state activity - an indicator that the taxpayer is

possibly materially participating. Even if the taxpayer does nothing, in the current year, if losses/income were non-passive in any 5 of the prior 10 years, income is non-passive in the current year. Reg. § 1.469-5T(a)(5). Also if the activity is a personal service activity (doctors, attorneys, accountants, financial planners, actors, consultants, engineers, etc.), income is non-passive if the taxpayer materially participated any prior 3 years. See Reg. § 1.469-5T(a)(6).

_____ Verify that income is not from an investment such as lots, the sale of a building never rented or used in a business, or the sale of timber.

Investment income is not passive income. See IRC § 469(e)(1)(a)(ii)(II). Passive income only comes from a passive activity, i.e. passive income must be generated either by a rental activity OR a business in which the taxpayer does not materially participate. If income on Form 8582 is from Schedule D, examiner should consider the possibility that it could be simply investment income. Some real estate developers have splintered their projects into many separate entities and entered net gains on Schedule D, limiting their tax rate to 20 percent. If income is treated as investment income (as opposed to business income), it cannot be passive income. The examiner should consider whether the motivation in creating multiple entities was to circumvent **IRC § 469**. If so, the examiner may want to invoke the anti-abuse rule in Reg. § 1.469-4(f) and regroup the entities as one single activity. Also consider whether the taxpayer should be treated as a dealer. Consequently, property would be inventory and taxed at ordinary rates versus capital gain.

_____ Verify that income is not compensation for personal services such as wages, guaranteed payments from a partnership or Form 1099-Misc commission income. See IRC § 469(e)(3), Reg. § 1.469-2T(c)(4).

_____ Verify income is not from a covenant not to compete. Reg. § 1.469-2(c)(7)(iv).

_____ If there is a Form 6252, Installment Sale Income, for an installment sale of a passive activity, verify that:

- Income entered on Form 6252 Line 24 ties to Form 8582; AND,
- Current and suspended losses are deducted in same ratio as gain is reported.

Note, however, that passive losses will be triggered up to the amount of gain reported in the current year. See IRC § 469(g)(3).

_____ Verify that neither husband nor wife materially participate in a business producing passive income. The husband's participation is attributed to the wife and vice versa. Even if one spouse does nothing, if the other spouse materially participates, income is non-passive. Participation of one spouse is

treated as participation of the other spouse. IRC § 469(h)(5), Reg. 1.469-5T(f)(3), Reg. 1.469-1T(j)

_____ **If there was a gain on disposition of a passive activity, verify that the Form 4797 gain and current and carryforward losses have been entered on Form 8582.** If there was a gain on sale, but current and suspended operating losses exceed the gain, nothing should be entered on Form 8582. In both instances, the full gain should be entered on Form 4797. Reminder: passive income is not investment income under IRC § 163(d). The same type of income should never be entered on both Form 4952 and Form 8582.

_____ **If income is generated by an oil & gas entity, ask the taxpayer if there were losses in prior years.** If so, request prior year returns. If losses were claimed as *non-passive* under the working interest exception in any prior year, income in subsequent years is non-passive and should not be in Form 8582. See IRC § 469(c)(3)(B).

CONCLUSION: Passive income has/has not been correctly reflected on Form 8582. Passive losses in the amount of _____ have been allowed/disallowed.

ADJUSTMENT: Remove non-passive income from Form 8582 L1a, or 3a, and recompute. Adjustment to allowable passive losses is difference between Form 8582 L16 per return and Form 8582 L16 as corrected (without income determined to be non-passive).

Report: Disallowed Passive Losses.

Exhibit 3.2: Self-Rented Property - Income Recharaterization

ISSUE: Should net rental income for Property ____ be recharacterized as non-passive? When the taxpayer rents property to his own business, income generally is non-passive. In other words, should income be removed from Form 8582 line 1a, thereby reducing allowable passive losses?

NOTE: Net losses are generally passive under IRC § 469(c), even in a self-rental situation. Reg. § 1.469-2(f)(6) recharacterizes only net income.

____ **Did the taxpayer or spouse work in a partnership, LLC, S-Corporation or C Corporation, which leases its building or equipment from him?** For partnerships and S Corporations where the taxpayer works, material participation can easily be determined by reviewing the income/losses on the back of Schedule E. Income/losses in the non-passive column means the taxpayer claims to have materially participated in the partnership or S Corporation. For regular C Corporations, check for a W-2 from the corporation which is an indicator of material participation and ask the taxpayer how much time he and his spouse spends on corporate activities. If the taxpayer is a corporate officer, check Form 1120, U.S. Corporation Income Tax Return, Schedule E (which appears on back of Form 1120), Compensation of Officers, for percentage of time.

____ **Is there a written lease signed before 2/19/88 which binds the year under examination?** As a practical matter, there are very few leases executed before 1988, which would bind current years. See Reg. 1.469-11(c)(ii). If there is a lease, be sure to request it immediately to verify the date it was signed and that it binds the current year.

If the answer to first question is **YES** and answer to second question is **NO**, income is non-passive and should not be on Form 8582 line 1a.

LAW: Under **Reg. § 1.469-2(f)(6)**, if a taxpayer rents property to a business in which he materially participates, net rental income is non-passive. Stated differently, rental income from self-rented property cannot be used to trigger allowance of passive losses on Form 8582. This rule does not apply if there is a written binding contract entered into before 2/19/1988.

CONCLUSION: Income in the amount of ____ has been determined to be non-passive and removed from Form 8582. Thus passive losses in the amount of ____ have been adjusted due to income recharacterized as non-passive.

ADJUSTMENT: Income is still reportable on Schedule E, but cannot be entered as passive income on Form 8582 line 1a. Remove self-rented income from Form 8582 and recompute. For every dollar of income removed from Form 8582, allowable passive losses generally are reduced a dollar. Passive losses are

deductible only up to passive income reported on the return PLUS \$25,000 in rental real estate losses. The difference between FORM 8582 line 16 per return and as corrected is your adjustment. The MAGI on Form 8582 will be increased by the amount of self-rented income determined to be non-passive. Thus, the taxpayer also may lose part of his \$25,000 offset under IRC § 469(i).

Exhibit 3.3: Passive Income Decision Tree

Does income belong on Form 8582, i.e. is it truly passive income?

Decision Tree

If the answer is yes to any of the following, income on Form 8582 lines 1a or 3a is not passive income:

- Interest (except self-charged interest), dividends, royalties or gains on stocks and bonds
- Income from something other than a rental or business activity
- Income from a business where the taxpayer works, i.e. materially participates
- Income from a business in which the taxpayer materially participated any 5 of the prior 10 years

If the answer is no, income generally is passive income.

Chapter 4, Material Participation

In a Nutshell

A taxpayer materially participates in an activity if he or she works on a regular, continuous and substantial basis in operations (IRC § 469(h)(1)). If a taxpayer does not materially participate, losses are passive, which means they generally are not deductible in the absence of passive income. Material participation is time sensitive. A taxpayer materially participates in an activity only if he or she meets any one of the seven material participation tests in Reg. § 1.469-5T(a).

A taxpayer is required to identify the amount of his or her participation in a trade or business activity for each year. The type and quantity of time documented determines whether an activity should be treated by the taxpayer as passive or non-passive. A taxpayer can have a significant financial interest in a business, and yet not materially participate.

Material participation is a year by year determination. Consequently, it is conceivable that a taxpayer could be passive in one year and non-passive (in other words, materially participating) in the subsequent year.

It is essential for an examiner to determine if reported losses are classified properly on a given return. Losses from businesses, whether conducted as a Schedule C, Schedule Form, partnership or S Corporation, are passive if the taxpayer does not materially participate. See checksheet, decision tree and log at end of chapter.

The rules discussed in this lesson are applied at the Form 1040 level for individuals involved in partnerships and S Corporations.

Material participation does not apply to the following activities:

- Rentals are generally passive, whether or not the taxpayer materially participates. However, rental real estate interests of real estate professionals are subject to the material participation tests. See Reg. § 1.469-9(e)(1).
- Working interests in oil and gas activities are excepted from the passive loss limitations. If liability is not limited, the taxpayer has a “working interest”.
- Income from a partnership or S Corporation that trades in stocks, bonds or securities for the accounts of the partners or shareholders is non-passive. Income or losses, even from a limited partnership interest, may be deducted as non-passive. See Reg. § 1.469-1T(e)(6).

Activity Defined

Regulation § 1.469-4 provides the definition of an activity.

A trade or business activity is an activity that:

- Involves the conduct of a trade or business (within the meaning of IRC § 162);
- Is conducted in anticipation of starting a trade or business; or,
- Involves research & development expenditures that would be deductible under IRC § 174.

There are only two business activities that are excepted from the passive loss rules:

1. working interests oil and gas activities;^[1] and,
2. traders in stocks & bonds^[2].

Grouping of Activities

Related businesses that form an appropriate economic unit are treated as a single “activity”. Related businesses conducted via a Schedule C, partnership, C or S Corporation, or limited liability company may be grouped into one activity. An “activity” is not constrained by entity lines. See Reg. § 1.469-4(c) and 1.469-4(d)(4).

It is also possible that several different activities may exist within a single entity: two unrelated businesses, or a business and a rental activity.

By grouping related businesses as a single activity, the taxpayer can more easily meet the 500-hour test for material participation discussed below. Before considering the material participation tests, the examiner should identify related businesses and determine if the taxpayer has grouped any to form a specific “activity”. Ask- or Issue an IDR - asking if the taxpayer has grouped any activities under Reg. § 1.469-4; to explain why the grouping is appropriate; and when the grouping decision was made. See Chapter 8.

A trade or businesses is a passive activity if the taxpayer does not materially participate. The taxpayer materially participates *if and only if* he or she meets **one** of the following seven tests provided in Reg. § 1.469-5T(a). See checksheet and log at end of chapter.

1. The taxpayer works 500 hours or more during the year in the activity.
2. The taxpayer does substantially all the work in the activity.
3. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer.

4. The activity is a significant participation activity (SPA), and the sum of SPAs in which the taxpayer works 100-500 hours exceeds 500 hours for the year.
5. The taxpayer materially participated in the activity in *any* 5 of the prior 10 years.
6. The activity is a personal service activity and the taxpayer materially participated in that activity in *any* 3 prior years.
7. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the activity.^[3]

Note: The first four tests look to a set number of hours of participation in the tax year. The next two tests look to material participation in prior tax years. The final test looks to the facts and circumstances, but is highly restrictive.

Material participation applies to **income** as well as to losses. One of the purposes of the last four material participation tests is to prevent the taxpayer from “failing” material participation when the activity generates income instead of losses.

For tiered entities, the look-through rule in Reg. § 1.469-2T(e)(3)(ii)(D)(3) treats the taxpayer as holding an interest in a subsidiary entity. In other words, the examiner will look to the lowest tier for participation by the individual taxpayer. Thus, for example, if the individual taxpayer fails to materially participate in a partnership which flows losses to an S Corporation in which he is a shareholder, losses are generally passive to him.

500 Hours

If the taxpayer participates more than 500 hours during the year in a business, income or loss from the activity will be non-passive. Participation of both spouses is counted, but not participation of the children or employees.

Participation in operations must be **regular, continuous, and substantial**. The examiner should determine whether the quantity of time documented is reasonable in light of other obligations.

Examination Techniques:

- Review W-2s and other non-passive activities. Does it seem likely that the taxpayer could spend 500 hours on the activity in light of other employment obligations?

- Ask questions on taxpayer activity time early in the examination. Establish time the taxpayer spends on all activities during the initial interview if possible. See exhibit with log at the end of the chapter.
- Determine the location of each activity. If located far from the taxpayer's residence, how likely is the taxpayer to have spent substantial time on the activity?

Substantially All

Stated simply, if the taxpayer does most of the work, income or loss will be non-passive. The involvement in the activity of an employee or non-owner could cause the taxpayer to fail this test.

Note: There is no specific number of hours associated with this test. In addition, the term "substantially" is not defined in the regulations.

100 Hours

If a taxpayer participates in an activity for more than 100 hours and no other individual participates more than the taxpayer (including any employee or non-owner), income or losses from the activity are non-passive.

Examination Techniques:

- Be alert to employees who are managing the activity, indicating the taxpayer deducting the losses may not be materially participating (particularly on Form 1040 Schedules C & F).
- When reviewing taxpayer hours, watch for "investor" activities (Reg. § 1.469-5T(f)(2)(ii)). The taxpayer must be involved in the activity's day-to-day management or operations. Hours spent toward reviewing financial statements, preparing analysis for personal use, and monitoring the activity in a non-managerial capacity do not count.

Significant Participation Activities (SPA)

The term ***significant participation activity*** is unique to Reg. § 1.469-5T. If the sum of the taxpayer's time in all SPAs is more than 500 hours for the year, then income or losses from the businesses are non-passive. For each SPA, the regulations require:

- The taxpayer to participate more than 100 hours during the year.
- The activity must be a business, i.e. it cannot be a rental or investment activity.
- The business must be a *passive* activity. Thus, if the taxpayer works more than 500 hours in the business, it is not a SPA as 500 hours is one of the qualifying tests for material participation. Similarly, if the taxpayer does

most of the work in the business, it cannot be a SPA as Reg. § 1.469-5T(a)(2) holds that performing substantially all the work qualifies for material participation.

Any 5 of the Last 10 Years

An activity is non-passive if the taxpayer would have been treated as materially participating in *any* 5 of the previous 10 years (whether or not consecutive). This test usually applies when a taxpayer “retires from material participation” but maintains an ownership interest in the activity.

Even if the taxpayer performs no services for a business currently, the examiner should inquire about involvement in prior years and review the returns to see if income or losses were treated as non-passive.

Any 3 Years in a Personal Service Activity

If a taxpayer materially participated for any three prior taxable years in a personal service activity the current year income or loss will be treated as non-passive. It does not matter whether those three prior taxable years were consecutive.

Personal service activity means services performed in:

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

Facts and Circumstances

The facts and circumstances test may apply if none of the other tests are met. This test does not apply unless the taxpayer worked more than 100 hours a year. Furthermore, the taxpayer’s time spent managing will not count if:

- Any person received compensation for managing the activity; and,
- Any person spent more hours than the taxpayer managing the activity.

Examination Techniques:

- Taxpayers may argue the facts and circumstances test when they fail the others. However, due to the stringent limitations, few taxpayers can meet the facts and circumstances standard. If there is paid on-site management, the facts and circumstances test cannot be used.

Indicators

Indicators that the taxpayer did not materially participate:

- The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wage or commissions.
- The taxpayer's residence is hundreds of miles from the activity.
- The taxpayer has a W-2 wage job requiring 40+ hours a week for which he or she receives significant compensation.
- The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.
- There is paid on-site management/foreman/supervisor and/or employees who provide *day-to-day* oversight and care of the operations.
- The taxpayer is elderly or has health issues.
- The majority of the hours claimed are for work that does not materially impact operations.
- Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

What are My Issues?

- Does the taxpayer work on a regular basis in the operations of the partnership, S Corporation, Schedule C, or farm? *If not, losses generally are not deductible.*
- Has the entity been grouped by the taxpayer with another related entity as a single activity? If grouped with a business where the taxpayer works regularly, losses will be deductible.
- Is the entity a significant participation activity (SPA)? If so, are there other SPAs (passive businesses) with which it can be grouped, and does the sum of all SPA hours exceed 500 hours for the tax year? *If activity is a SPA and there are other SPAs with time over 500 hours, losses are deductible.*
- Is the time claimed plausible in terms of the taxpayer's other commitments or from a common sense standpoint? Should portions of time be discounted as they are investor-type hours or work not customarily done by an owner?

Limited Partners The IRC § 469(h)(2) presumes that limited partner interests are per se passive, and losses are therefore not deductible unless the taxpayer has passive income reported on the return.

There are three exceptions to the limited partner passive taint^[4]:

- The taxpayer works 500 hours or more in the trade or business activity.
- The taxpayer materially participated in the activity in *any* 5 of the prior 10 years.

- The activity is a personal service activity and the taxpayer materially participated in that activity in *any* 3 prior years.

If a taxpayer holds both a general and a limited partnership interest all year, he may use any one of the seven tests to qualify for material participation.^[5]

Examination Techniques:

- Scrutinize losses claimed in the non-passive column of Schedule E. Is the employer identification number out of state?
- Review Schedule K-1s. Is the taxpayer a limited partner? Does he have a small ownership interest?
- A 3-year comparative analysis of passive and non-passive losses using current, prior and subsequent year data may reveal inconsistencies.
- It is critical that you consider what is reasonable. The taxpayer's total time commitments should be considered. Consider the taxpayer's W-2 job, the commute, the travel and out-of-town requirements, in addition to personal commitments to children or other special circumstances.
- When examining a partnership or S Corporation, question the level of participation of each investor. You may want to focus on those who are limited partners or who have a small ownership interest or who live out of town, as they are most likely to be passive.

Reminder: If the activity of the entity is equipment leasing or rental real estate, losses are generally passive to the investor.

Treatment of Former Passive Activities

A former passive activity is an activity that is non-passive in the current year, but was a passive activity in prior years. If the former passive activity generates net income, suspended passive losses from prior years can offset that net income. Remaining suspended losses are treated like any other passive loss. Passive losses can only be offset against passive income. Unused suspended losses may be carried forward indefinitely. Change in status does not constitute a qualifying disposition.

Methods of Proof

To meet the recordkeeping requirements of Reg. § 1.469-5T(f)(4), the taxpayer must establish his participation by **reasonable** means. Reasonable records may include:

- An identification of the services provided; AND,
- The approximate number of hours spent, based on appointment books, calendars, or narrative summaries.

Contemporaneous daily records are not required if the taxpayer's participation can be reasonably established. If records provided are not reasonable, i.e. there is a credibility issue, you may request contemporaneous records. The courts have repeatedly taken a dim view of self-serving guesstimates of time. See Scheiner, Tax Court Memo 1996-554, 72 T.C.M. (CCH) 1532 and Carlstedt Tax Court Memo 1997-33, 74 T.C.M. (CCH) 170.

Examination Techniques:

- Questions regarding material participation should be asked as early in the examination process as possible, preferably during the initial interview. The log in the exhibit at the end of the chapter is a good document to give to the taxpayer to establish his services and hours.
- Time claimed should be scrutinized for investor-type time and work not customarily performed by an owner, which are specifically excluded in the hourly tests for material participation. See Reg. 1.469-5T(f)(2)(ii).
- If hours provided are suspicious, appear inflated, or there is a credibility issue, be sure to state so in your report with examples.

Qualifying Participation

Once the taxpayer provides the type of participation and the approximate hours spent performing that participation, a determination can be made as to whether that participation qualifies.

General Rule

Work performed by an individual or the spouse will be considered unless it falls in one of the exceptions listed under "Non-qualifying Time."

Work performed by either spouse will be considered even if the spouse does not own an interest in the activity.^[6]

Non-Qualifying Time

While the taxpayer may have spent time working on various aspects of the activity, certain hours do not count in the tests for material participation:

Investor-type activities do not count unless the taxpayer is *directly* involved in day-to-day management or operations. The Reg. § 1.469-5T(f)(2)(ii)(B) provides that the following types of activities do not count unless the taxpayer is directly involved on a day-to-day basis in management or operations:

- Studying or reviewing financial statements or reports.
- Preparing or compiling summaries or analyses for the individual's own use.

- Monitoring finances or operations in a non-managerial capacity.

The above list is not all inclusive. Other activities could be investor-type activities such as organizing records, preparing taxes, and paying bills^[7].

Work not ordinary done by an owner is not counted if it is claimed in an effort to avoid the passive loss limitations. This would be work performed by an owner that would normally be assigned to an employee. Generally the taxpayer/owner has no reason to include these services in the hourly computations other than in an attempt to avoid disallowance of losses under IRC § 469^[8].

Travel Time generally should not be considered in computing the hourly tests for material participation, particularly if other factors indicate the taxpayer is not participating in the activity on a regular, continuous and substantial basis.^[9] Legislative history provides that "services must be integral to operations". It is somewhat difficult to construe that travel constitutes "services" or "participation" as contemplated by Congress or the Regulations. More importantly, travel is not *integral* to operations in most cases.

Supporting Law

- **IRC § 469(h)**: The taxpayer materially participates if he is involved in the operations of an activity on a regular continuous and substantial basis.
- **IRC § 469(h)(5), Reg. 1.469-5T(f)(3), Reg. 1.469-1T(j)**: Participation of *both* spouses counts. Income or losses for both spouses are non-passive, even if only one spouse rises to any of the seven tests for material participation.
- **IRC § 469(h)(4)**: Material participation rules for closely held C-Corporations and for personal service corporations.
- **Reg. § 1.469-5T(a)**: The taxpayer materially participates if and only if he or she meets one of 7 tests in each separate tax year.
- **Reg. § 1.469-5T(a)(7) & 1.469-5T(b)**: Facts and circumstances test is not applicable unless the taxpayer works more than 100 hours and more than anyone else does. This test is also not applicable if anyone, other than the taxpayer, is paid compensation for managing the activity.
- **Reg. § 1.469-5T(e)**: A taxpayer is excepted from the limited partner taint if he works 500 hours during the year **or** materially participated 5 of the prior 10 years **or** materially participated in a personal service activity for any three prior years.
- **Reg. § 1.469-5(f)(1)**: The taxpayer must own an interest in the activity *at the time the work is done* (See **Example 6** in the regulations).
- **Reg. § 1.469-5(f)(2)(i)**: Work not customarily done by an owner is not counted.
- **Reg. § 1.469-5T(f)(2)(ii)**: Investor-type activities are not counted unless the taxpayer is directly involved in day-to-day management or operations of the activity.

- **Reg. § 1.469-5T(f)(4):** Reasonable means for proving hours requires:
 1. an identification of services provides; *and*,
 2. hours spent performing those services during the year *based on* appointment books, calendars, narrative summaries.
- **Reg. § 1.469-4** Related business may be grouped as a single activity, making it easier to meet the 500-hour test. Rentals, however, may not be grouped with businesses unless they are insubstantial or owned in the same percentage as the business^[10]

Summary

- Related businesses may be grouped as a single activity, making it easier to meet the 500 hour test for material participation.
- A taxpayer materially participates if and only if he meets one of seven tests for material participation.
- While limited partners are presumptively passive^[11], there are three exceptions to the limited partner taint^[12], the most common being that the taxpayer works more than 500 hours during the year in the business.
- Net income from a former passive activity, even though non-passive, may offset prior year losses from the same activity.
- If the taxpayer has not provided both services performed and hours attributable to those services, he does not meet the record-keeping requirements of IRC § 469.
- Certain hours, even if performed, are not counted in the hourly tests for material participation, most notably time spent performing activities typical of an investor.

^[1] IRC § 469(c)

^[2] Reg. § 1.469-1T(e)(6)

^[3] Reg. § 1.469-5T(b)

^[4] Reg. § 1.469-5T(e)(2)

^[5] Reg. § 1.469-5T(e)(3)(ii)

^[6] IRC § 469(h)(5) and Reg. § 1.469-5T(f)(3)

^[7] W.A. Barniskis, 78 TC Memo 226, December 53,486(M), TC Memo 1999-258

^[8] Reg. § 1.469-5T(f)(2)(i)

^[9] We have no express statutory guidance on travel. While not precedent setting and just a summary opinion, the following case provides guidance on travel time: Thomas E. Truskowsky, T.C. Summary Opinion 2003-130

^[10] Reg. § 1.469-4(d)(1)

^[11] IRC § 469(h)(2)

^[12] Reg. § 1.469-5T(e)(2), Reg. § 1.469-5T(e)(3)(ii)

Exhibit 4.1: Material Participation

ISSUE: Are *losses* limited, as taxpayer is not materially participating?

OR

Is taxpayer materially participating in the activity; therefore, *income* is non-passive and cannot be used on FORM 8582 to offset passive losses?

ACTIVITY: If the return reflects several related businesses, particularly for income issues, the examiner should consider whether they should be grouped as a single activity under Reg. § 1.469-4. The grouping rules are also a position the taxpayer may raise in loss situations. The time for the taxpayer to group is when the first return with the entity was filed.

To determine material participation in an activity, the taxpayer must meet ONE of the following:

1. **___ Does taxpayer and/or spouse work more than 500 hours a year in the business?**
2. **___ Does taxpayer do most of the work?** Even if taxpayer does not meet 500 hour test, but his participation is the only activity in the business, he materially participates. **Example:** sole proprietor with no employees.
3. **___ Does taxpayer work more than 100 hours and no one** (including non-owners or employees) **works more hours?** **Example:** If owner puts in 175 hours a year and an employee works 190 hours a year, taxpayer would not meet material participation test.
4. **___ Does taxpayer have several passive activities in which he participates between 100-500 hours each, and the total time is more than 500 hours?** The following activities should not be included in the above test: rental activities: activities involving portfolio or investment income, and activities in which the taxpayer does most of the work.
5. **___ Did taxpayer materially participate in activity for any 5 out of 10 preceding years** (need not be consecutive)? **Example:** taxpayer who retired and his children now run business, but he stills owns part of partnership.
6. **___ Did taxpayer materially participate in a personal service activity for any 3 prior years** (need not be consecutive)? Personal service activity includes fields of health, law, engineering, architecture, accounting, actuarial science, performing arts and consulting.

7. ____ **Do the facts and circumstances indicate taxpayer is materially participating?** Test does not apply unless taxpayer worked more than 100 hours a year. Furthermore, it does not apply if:

1. any person, other than the taxpayer, received compensation for managing the activity; or,
2. if any person spent more hours than taxpayer managing the activity.

REMINDER: Limited partners under IRC § 469(h)(2) are generally passive. The exceptions to the limited partner rule are tests 1, 5 and 6 above. If taxpayer holds both a general and limited partner interest, he will have all seven tests available.

If the answer to **any** of the above questions is **YES** the taxpayer meets the material participation standard. Losses or income should not be reflected on Form 8582, and the taxpayer may generally deduct in full the amount of the loss in the current year. If the taxpayer materially participated, losses or income are reflected on the return as non-passive.

If the answer is **NO** to all seven tests, the material participation standard is not met, and losses are passive. Taxpayer will be allowed losses only to the extent of passive income.

CONCLUSION: Under IRC § 469, it has been determined that the taxpayer is /is not materially participating.

Reminder: If the taxpayer does not materially participate, credits arising from the business are generally passive. In the absence of passive income, a passive activity credit is nondeductible in the current year.

Examples: investment credit, rehabilitation credit, work opportunity, disabled access, credit for employer social security and medicare taxes on employee tips, etc. See Instructions for Form 8582-CR for a list.

ADJUSTMENT: Generally, the adjustment is the full amount of the loss disallowed, unless the taxpayer has remaining passive income which has not been used to trigger other passive losses. Passive income is net income from a rental or from a business in which the taxpayer does not materially participate. Losses belong on Form 8582 line 3b (2b for years prior to 2002). As a practical matter, there is often no need to compute Form 8582 if there is no remaining passive income.

Exhibit 4.2: Material Participation Decision Tree Reg. 1.469-5T(a)

Is the taxpayer a material participant in a business activity?

Decision Tree

If answer to any one is yes, losses are excepted from the passive loss limitations and generally fully deductible.

- Did the taxpayer work more than 500 hours in the activity during the year?
- Did TP perform substantially all the work in the activity?
- Did TP work more than 100 hours and more than anyone else (including non-owners)?
- Did the taxpayer work more than 100 hours, but less than 500, in two or more businesses and the sum of all the hours in these businesses is more than 500?
- Did the taxpayer materially participate in the activity for any five of the last ten years?
- If the activity is a personal service activity, did the taxpayer materially participate for any three prior years?
- Under all the facts and circumstances, did the taxpayer work on a regular, continuous and substantial basis in the activity? This test is not available if anyone was paid compensation in connection with management of the activity.

If answer to all the above tests is **no**, the taxpayer does not materially participate. The loss is passive and not deductible in the absence of passive income.

Exhibit 4.3: Material Participation Activity (SPA) Reg. 1.469-5T(a)(4)

Is the activity a SPA? Losses are nonpassive if the sum of hours in all SPAs is more than 500 hours for the year.

Decision Tree

Activity cannot be a SPA if it is:

- A rental or leasing activity
- An investment activity or a trader in stocks and bonds
- Any business in which the taxpayer materially participated. TP materially participated if he did more than 500 hours work; did most of the work; materially participated any 5 of the last 10 years: or met one of the other tests in Reg. 1.469-5T(a).
- An activity in which the taxpayer worked less than 100 hours during the year.
- A limited partnership interest

Go to the next step. Do not include any of the above activities in the following step.

Activity is a SPA, and losses are nonpassive if:

- The taxpayer worked 100-500 hours during the year in the activity.
- Hours in all SPAs are more than 500 in total.

Chapter 5, Dispositions

In A Nutshell

Passive losses are generally deductible only to the extent of passive income. However, current and suspended losses are fully deductible if there is a “qualifying disposition.” Under IRC § 469(g), a “qualifying disposition” requires three criteria:

1. Disposition of an **entire interest** (or substantially all^[1])
2. In a **fully taxable** event (where all gain/loss is realized and recognized).
3. To an **unrelated** party.

If these three tests are met, losses are fully deductible against non-passive income (unless the taxpayer has basis limitations). Thus, in the year of disposition, losses allocable to the passive activity may offset portfolio and other investment income or may become part of a net operating loss.

We have no regulations governing dispositions. Thus, we must look to IRC § 469(g) and legislative history^[2] for guidance.

Entire Interest

The taxpayer must dispose of his entire interest in the activity, or substantially all of it, in order to trigger the recognition of loss. If less than an entire interest is disposed, then the issue of ultimate economic gain or loss is unresolved.

A mere change in the form of ownership is not a qualifying disposition. An entity is not necessarily an activity. The conversion by the taxpayer of a business or rental activity from a sole proprietorship to an LLC or S Corporation in which the taxpayer still owns an interest is not a qualifying disposition, which triggers current and suspended losses.

If a partnership conducts two separate activities within the entity, a fully taxable disposition of all assets used or created in one activity constitutes a disposition of the partner’s or shareholder’s entire interest in the activity. The taxpayer must have adequate records of suspended losses and credits that are allocable to that activity.

Partial Interest

Disposing of *substantially all* of an activity (rather than an *entire* interest) may be treated as an “entire” disposition. Reg. § 1.469-4(g) provides that the taxpayer must be able to show with reasonable certainty income, deductions and credits allocable to that part of the activity.

Reminder: The taxpayer must still meet the fully taxable requirement and the sale must be to an unrelated party before losses are allowed as non-passive.

Real Estate Professional:

If the taxpayer made an election to group his rentals as a single activity under Reg. § 1.469-9(g), the sale of one property would not constitute an entire disposition. See Chapter 2 regarding Real Estate Professionals. However, losses will be triggered to the extent of net gain reported.

Fully Taxable Transaction

In a fully taxable disposition, all gain or loss is realized and recognized in the current year.

An exchange of the taxpayer's interest where all gain or loss is not recognized does not trigger suspended losses, (such as transactions governed by IRC § 351, 721 or 1031). To the extent the taxpayer has recognized gain on the transaction, that income generally is passive and may be entered on Form 8582, triggering passive losses.

Transactions that are **not fully taxable events** include:

- Likekind exchanges – IRC §1031
- Conversion to personal use
- Gift (donor's suspended losses added to basis, no loss deduction allowed to the donor in any year - IRC § 469(j)(6))
- Transfer of the activity to a corporation, partnership or LLC
- Bankruptcy that has **not** been finalized. Simply filing for bankruptcy is not a qualifying disposition.

Reminders:

- When debts are discharged in bankruptcy, to the extent cancelled debt is not taxed under IRC § 61(a)(12), IRC § 108(c) holds that the amount of the debt forgiven absorbs certain tax attributes including passive losses. Passive losses which have been absorbed by cancelled debt are not deductible.
- For individuals who file for bankruptcy under Chapter 7, the unused passive activity losses and credits are transferred to the bankruptcy estate. See Reg. § 1.1398-1(c).

Death

Current and suspended passive losses are permitted only to the extent they exceed any step-up in basis in the hands of the beneficiary. Basis is stepped up

to fair market value.^[3] If the increase in basis exceeds unused passive losses, no losses are deductible on the decedent's return.

As a practical matter, the basis step-up to fair market value is generally significant and absorbs remaining losses. Thus none may be deducted. They are lost forever.

Installment Sale

If the taxpayer sells a passive activity on the installment basis, current and suspended losses may only be deducted in the same ratio as the gain reported. If there is excess gain, that gain is passive income under Reg. § 1.469-2T(c)(2) and will permit deductibility of additional losses to the extent of the gain.

Unrelated Party

If a passive activity is sold to a related party, losses are not triggered (except to the extent passive income is generated). They remain with the taxpayer and are shown on Form 8582 until the activity is ultimately acquired by an unrelated third party. See IRC § 469(g)(1)(B). Aside from IRC § 469(g), IRC § 267 generally does not permit a loss on the sale of property to a related parties. The following are related parties^[4]:

- Members of a family;
- An individual and a corporation in which he owns directly or indirectly more than 50 percent in value of the outstanding stock;
- Two corporations which are members of the same controlled group;
- A grantor and trustee of any trust;
- A trustee and a beneficiary of the trust;
- A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest in the partnership;
- An S Corporation and another S Corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or,
- An S Corporation and C Corporation if the same person owns more than 50 percent in value of the outstanding stock in each corporation.

Issue Identification:

On disposition, losses are entered on the same schedules normally used:

- Schedule E for current and suspended losses.
- The Form 4797 and Schedule D for disposition of assets and the sale of a partnership interest. If there is no Form 4797 attached to the return, there

may not be a fully taxable disposition, (i.e. the sale of assets may not yet have been completed).

The instructions to Form 8582 advise taxpayers to note “entire disposition of a passive activity” on any schedule reflecting gain or loss. However, many taxpayers fail to make this note:

- If there is a Form 6252, Installment Sale Income, for an installment sale, determine whether losses were deducted in excess of the prescribed ratio.
- If the return indicates the taxpayer is deceased, look for large non-passive losses deducted. Sometimes losses have not been reduced by the basis step-up.

Examination Techniques:

- Ask who the activity was sold to and if the buyer is related to the taxpayer.
- Determine if the taxpayer retained an interest in the activity.
- Determine if the taxpayer is still responsible for any liabilities of the activity.
- Determine if **all** gain (or loss) is reflected on the return.
- Determine if a final return has been filed for the S Corporation or partnership.
- If an installment sale of a passive activity is indicated on Form 6252, ensure that only the recognized gain is reflected on Form 8582 and that the entire current and suspended losses have not been deducted on the Schedule E.
- Verify prior year losses via review of last year’s Form 8582 worksheet 5. If suspicious, request prior years’ Schedule K-1s to verify total amount of carryforward losses.

FORM 8582: Dispositions with Net Losses

If there is an **overall net loss** on disposition of a passive activity (after considering all current and suspended losses), none of the gains or losses should be entered on Form 8582. Gains and losses from the sale should be reported on Schedule D and/or Form 4797. Current and carryover losses should be reported on Schedule E in the non-passive column with a note to the left “Entire Disposition of Passive Activity”.

The purpose of Form 8582 is to compute the allowable passive losses. If the disposition of the passive activity is a qualifying disposition as previously discussed, the losses attributable to that activity are allowed in full, and, as such, would not be required to be reflected on Form 8582.

Dispositions with Overall net Gain

Income from the sale or other disposition of passive activity is generally passive income *if the activity was a passive activity in the year of sale* (Reg. § 1.469-2T(c)(2)(i)). Similarly, income from the sale or property used in a passive activity is passive income. If there is overall net income on a disposition (gain on the sale exceeds the current and prior years losses), income and losses should both be reflected on the same line of Worksheet 1, 2 or 3 of Form 8582. As discussed above, if there is an overall net loss on the disposition, nothing should be entered on Form 8582. If there are two dispositions, one with an overall net loss and another with an overall net gain, they should be netted.

The following gains generally are **not** passive and should **not** be used to offset passive losses:

- Sale of land (whether leased^[5] or held for investment^[6])
- Sale of self-rented property^[7]
- Sale of a building not used in a passive activity in the year of sale^[8]

Additionally, gain on the sale of a rental is non-passive if the taxpayer is a **real estate professional**^[9] and performed most of the work.

The fact that an activity is passive does not determine the character of the gain (or loss) in terms of whether it is capital or ordinary in nature. Gain on disposition, usually capital in nature, will be reflected on Form 4797 and Schedule D. Current gains/losses as well as suspended losses represent ordinary income. They are generally entered on Schedule E and do not reduce capital gains reflected on Schedule D.

Issue Identification: Watch for returns where the net gain on Form 4797 has been entered on Form 8582, but **not** the current and carryover losses. If there is an overall net loss, nothing should be reflected on Form 8582. By entering the income without the losses, the taxpayer has erroneously triggered deductibility of other passive losses.

Examination Techniques:

- On dispositions generating large amounts of income offsetting other passive losses, verify the disposition is from a passive activity (from a rental activity or a business activity in which the taxpayer does not materially participate).
- Verify the gain was not from the sale of land **or** a building used in an investment activity. Investment income is no passive income.
- Verify the **net** gain and not the sales price was entered on Form 8582. If the sales price is used, passive income is inflated and unrelated passive losses are triggered in error.

FORM 8582: Dispositions with Net Gain

As indicated above, gain on the sale or other disposition generally is passive income. Gain on Form 4797 and Schedule D should first offset losses from the same activity. If any gain remains, it offsets losses from other unrelated passive activities.

On dispositions with an overall net gain, the net gain, current losses, and suspended losses are *all* reflected on Form 8582. Entering the gain, but not the losses, on the Form 8582 results in unrelated passive losses being allowed in error. Any gain must first offset losses from the same activity.

The purpose of Form 8582 is purely computational. The examiner should verify that all income shown on Form 8582 line 1a or 3a is reflected elsewhere on the return, most commonly on Schedule E or Schedule D. The Form 8582 does not report income. If income shown on Form 8582 is not reflected on the return, it is unreported income!

Summary

- For current and suspended losses to be deductible, the taxpayer must sell or otherwise dispose of his entire interest in a passive activity.
- The disposition must be a fully taxable transaction. Transfers to other entities and likekind exchanges are non-qualifying dispositions. Losses remain on Form 8582.
- When a taxpayer dies, only losses in excess of the step-up in basis are allowed. Stated differently, the decedent's losses are allowed only to the extent they exceed the amount by which the beneficiary's basis in the passive activity has been increased.^[10]
- On an installment sale, losses are triggered in ratio to gain reported.
- When gain and current and suspended losses are netted, if there is an overall loss, nothing should be entered on Form 8582.
- If there is an overall gain on disposition, all gains and losses should be entered on Form 8582. Any excess gain, generally is passive income which may trigger deductibility of unrelated passive losses.

Supporting Law

- **IRC § 469(g):** Passive losses are allowed on an entire disposition to an unrelated party in a fully taxable transaction.
- **IRC § 469(g)(1)(B):** If an entire interest in a passive activity is sold to a related party, passive loss remains with the taxpayer on FORM 8582 until the related party sells to an unrelated party.
- **IRC § 469(g)(2):** On death of a taxpayer, passive losses are deductible on to the extent they exceed the difference between adjusted basis and the stepped-up basis FMV in the hands of the beneficiary. In other words,

the step-up in basis usually absorbs the decedent's passive losses, and therefore, no deduction is allowed to the taxpayer, estate, or beneficiary.

- **IRC § 469(g)(3):** On an installment sale, losses are recognized in the same ratio as gain reported.
- **IRC § 469(j)(6):** When a passive loss is gifted to a person or charity, losses are added to the donee's basis. They are not deductible by the taxpayer/donor.
- **IRC § 469(j)(12):** When an estate or trust distributes a passive activity, losses are not deductible by the estate or trust. They are added to the beneficiary's basis.
- **IRC § 1398(f)(1), Reg. § 1.1398-1(d)(1):** A transfer of an interest in a passive activity between an individual and a bankruptcy estate is not a qualifying disposition, which triggers deductibility of losses.
- **Reg. § 1.469-2T(c)(2)(i)(A)(2):** Gain on disposition generally is passive income if the activity was a passive activity in the year of disposition.
- **Reg. § 1.469-2T(c)(2)(i)(A)(3):** Gain on disposition is *not* passive income if the activity is not a passive activity *in the taxable year of disposition*.
- **Reg. § 1.469-2T(f)(3):** If less than 30 percent of the unadjusted basis of leased property is depreciable, gain is non-passive.
- **Reg. § 1.469-2(f)(6):** Gain on the sale (or rental income) of property leased to a business in which the taxpayer materially participates (i.e. where he regularly works) is non-passive.
- **Reg. § 1.469-4(g):** If substantially all of an activity is sold, that portion may be treated as a separate activity.
- **Reg. § 1.469-6** on dispositions has not yet been written. Thus, we have no regulations on dispositions other than those mentioned above.

^[1] Reg. § 1.469-4(g)

^[2] Committee Reports on P.L. 99-514 (Tax Reform Act of 1986)

^[3] IRC § 469(g)(2)

^[4] IRC § 267(b) and § 707(b)

^[5] Reg. § 1.469-2T(f)(3)

^[6] IRC § 469(e)(1)(A)(ii)(II)

^[7] Reg. § 1.469-2(f)(6)

^[8] Reg. § 1.469-2T(c)(2)(i)(A)(3)

^[9] IRC § 469(c)(7)

^[10] IRC § 469(g)(2)

Exhibit 5.1: Dispositions IRC 469(g)

Computation

Net gain/loss on disposition of property _____

Net income/loss from current year (+/-) _____

Prior year suspended losses (+/-) _____

Overall net income/loss on disposition _____

Decision Tree

Overall Gain: If there is an overall net gain, all income, including gain on sale of property generally goes on Form 8582, as do the current and suspended losses. All income and losses are also reported on the appropriate schedules, typically Schedule E and Form 4797. Losses are fully deductible.

Overall Loss: If there is an overall net loss, none of the losses go on Form 8582, but are reported on the appropriate schedules, ***if answer to all the following is yes:***

- Is there an entire disposition of the activity?
- Is all gain or loss realized and recognized?
- Is sale or other disposition to an unrelated party?

If the answer to any of the above is no, income and losses from the activity are reflected on Form 8582. Losses are deductible only to the extent of passive income.

Exhibit 5.2: Dispositions Triggering Losses

ISSUE: Are current and suspended passive losses fully deductible due to a disposition? In other words, is the transaction an *entire* disposition to an *unrelated party* in a *fully taxable* transaction? If not, losses remain on Form 8582 and are deductible only to the extent of passive income.

_____ **Verify that all gains and losses have been realized and recognized.**
The following are not **fully taxable**:

- Like-kind exchanges.
- Conversion to personal use.
- Transfer to a corporation or partnership.
- Transfer due to divorce (treated as gift-IRC § 469(j)(6) & § 1041(b)).
- Installment sale (PALs triggered in ratio to gain reported).
- Bankruptcy (see below).

NOTE: The absence of Form 4797 attached to the return may indicate that there is not a *fully taxable* disposition.

_____ **Verify the loss has been deducted in the correct year.** The Senate Report indicates that the taxpayer's accumulated tax losses should be permitted to be deducted when, and only when the actual economic gain or loss on the activity can finally be determined.

_____ **Does the taxpayer still own the activity, just in a different entity form?** An entity is not an activity. An activity is a business or a rental activity. The entity form may change, i.e. from a partnership to an LLC, but the taxpayer has not disposed of his "activity", i.e. rental or business activity.

_____ **Did the taxpayer sell his partnership/S Corporation interest – and then repurchase it within a short time?** Substance versus form governs in tax law. The Senate Finance Committee Report on P.O. 99-514 (1986) states, "For example, sham transactions, transfers not properly treated as sales due to the existence of a put, call or similar right relating to repurchase do not give rise to allowance of suspended losses."

_____ **If the taxpayer is in bankruptcy:**

- A transfer of a passive activity to a bankruptcy estate does not constitute an entire disposition in a fully taxable transaction (in other words, gain or loss has not been recognized). See IRC § 469(g), IRC § 1398(f)(1), Reg. § 1.1398-1(d)(1).
- If bankruptcy is complete, verify that tax attributes have been reduced by cancelled debt, specifically that current and suspended losses have first been applied against any mortgage or other debt forgiven. In many

instances, the debt cancelled under § 108 fully absorbs any current or suspended losses, and therefore nothing is deductible on the return.

- Inquire whether the bankruptcy estate may have already used suspended passive losses. Some taxpayers carry the losses into subsequent years, despite having been used by the bankruptcy estate.
- Before allowing losses, consider basis and at-risk limitations. Furthermore, if the property is transferred out of the bankruptcy estate back to the taxpayer, he still has an ownership interest and losses are not triggered by IRC § 469(g). Such a transfer is not a qualifying disposition.

_____ **Verify that disposition is not to a *related party*.** See IRC § 469(g)(1)(B), § 267, § 707(b). If passive activity was sold or otherwise transferred to a related party, losses stay with the taxpayer. There is not a triggering disposition. The following are related parties: Spouse, brothers, sisters, sons, daughters, grandchildren; an individual and a corporation owned more than 50 percent by the same person; a partnership and a partner who owns more than 50 percent. The IRC § 267(a) disallows losses for sales or exchanges to related parties under IRC 267(b).

Be sure to look at the ownership percent on the Schedule K-1. Under IRC § 707(b)(1)(A), if a person, directly or indirectly, owns more than 50 percent of the capital interest **or** the profits interest of a partnership, he is a related party.

_____ **Verify that substantially all of the activity was sold or otherwise disposed of.** See IRC § 469(g) & Reg. § 1.469-4(g).

_____ **Verify that activity has been truly terminated** (in other words, that it is not continuing on as an LLC or other entity or another Schedule C under a different name, but the taxpayer still retains an ownership interest). The Senate Report (S. Rep. 99-313, 99th Cong., 2d Sess.) states, "The taxpayer must dispose of his entire interest in an activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of ultimate economic gain or loss on his investment in the activity remains unresolved. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and ... all assets used or created in the activity." (Emphasis added.) Note that the Senate report indicates all entities and all assets (used in the activity and inventory created by the activity).

_____ **Check Form 8582 to see if Form 4797 gain on disposition may have been improperly entered on line 1a or 3a.** Gain on disposition belongs on Form 8582 *only if there is an overall gain after considering current and suspended losses*. If there is an overall gain, both the gain **and** the losses should be on Form 8582. Gain should never be reflected on Form 8582 without the associated losses. If there is an overall loss after current and suspended

losses are subtracted from net gain, nothing (neither gain nor losses) should be on Form 8582.

_____ **If owner died, verify that suspended losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased.** Basis is generally stepped up to FMV. If the increase in basis exceeds unused passive losses, no PALs are deductible. Neither the deceased taxpayer nor the beneficiary will ever be able to deduct the losses.

_____ **If disposition was by gift or charitable contribution, loss is not deductible.** Instead, the basis of the asset for the donee is increased by unused losses. See IRC § 469(j)(6).

_____ **If loss is from a "rental", verify that it was not a temporary rental of the taxpayer's residence.** If the rental period was less than a year or two, IRS may view it as a temporary rental lacking in the necessary profit motive under IRC § 183, i.e. a nondeductible loss. Deductions for rental of a personal residence may also be limited under IRC § 280A.

_____ **Verify via Form 4797 and the depreciation schedules that prior year depreciation has been properly recaptured and treated as ordinary income.**

_____ **Consider whether the taxpayer is subject to AMT.** Depreciation and other AMT preference and adjustment items relating to a passive activity are suspended until the year of a qualifying disposition (or there is passive income to trigger losses). Consequently, in the year of sale or other disposition, AMT may result. All prior and current year suspended preference and adjustment items should be reflected on the line on Form 6251, Alternative Minimum Tax-Individuals for passive activities.

LAW: Under IRC § 469(g), current and carryforward passive activity losses are fully deductible in the year of an entire disposition in a fully taxable transaction to an unrelated party. A qualifying disposition may create an Net Operating Loss (NOL) which can be carried back. See IRC § 172. **NOTE:** Whether or not there is a qualifying disposition, passive losses will always be triggered up to passive income reflected on the return.

CONCLUSION: Passive losses in the amount of \$ _____ have/have not been adjusted for the following reason: _____.

Exhibit 5.3: Income Issues On Disposition Of A Passive Activity

ISSUE: On the sale (or other disposition) of a passive activity, is gain or other income on Form 8582 truly *passive* income? Should gain on sale be removed from Form 8582, thereby limiting deductibility of passive losses?

_____ **Verify that income on Form 8582 line 1a, and 3a resulting from a disposition is also reflected on Form 4797 and Schedule D or elsewhere.**

Form 8582 is merely a computational form for allowable passive activity losses. Income on Form 8582 **must** also be reflected on the appropriate schedule.

Generally, income on Form 8582 from the sale of a building used in a rental activity is carried from Form 4797 to Schedule D (capital gain portion) and Line 15 of the front Form 1040 (ordinary income).

NOTES: (1) If no Form 4797 is filed with the return, it is indicative that there was not a fully taxable disposition which would trigger suspended losses. (2) Gain on sale, however, generally is passive income. See Reg. § 1.469-2T(c)(2).

_____ **Ensure that only net gain has been entered on Form 8582 line 1a or 3a, not the entire sales price.**

_____ **Verify that net gain from Form 4797 has been entered on Form 8582 line 1a or 3a and the current net loss on line 1b, 2b or 3b and carryover losses on line 1c or 2c.** The result is that only excess gain after current and carryforward losses have been absorbed can be used to offset other passive losses. If there was a gain on disposition, but current and carryforward losses exceed the gain, nothing should be entered on Form 8582. In both instances, the full taxable gain should be on Schedule D and current and suspended losses on Schedule E. See Form 8582 Instructions, page 8.

NOTE: Some taxpayers enter *only* the Form 4797 gain on Form 8582 without considering the impact of current and suspended losses, thereby erroneously allowing other passive losses. If net gain is more than current and suspended losses, both the net gain **and** all losses must be reflected on Form 8582.

_____ **Verify that activity was a *passive* activity (rental or business without material participation) in the year of disposition in which gain is recognized.**

Reg. § 1.469-2T(c)(2)(i)(A)(3) If activity is not passive for taxable year of disposition, gain is non-passive. Example: building rented in prior years, but not rented in the year of sale. Check Schedule E (or Form 8825, Rental Real Estate Income and Expense of a Partnership or an S Corporation, if from a partnership or S Corporation) for rental income and advertising. If none, indicates not rented.

_____ **Verify that income is not from the sale of land.** Passive income is only generated by rentals or passive businesses. Whether held for investment or leased, gain on the sale of land is not passive and should not be on Form 8582. See IRC § 469(e)(1)(A)(ii)(II), Reg. § 1.469-2T(c), Reg. § 1.469-2T(f)(3).

_____ **If there is a Form 6252 for an installment sale, verify that:**

- Income entered on Form 6252 line 24 ties to Form 8582 line 1a, AND
- Current and carryforward losses are deducted in same ratio as gain.

NOTE: When gain recognized from an installment sale exceeds all the current and suspended losses, taxpayer need not compute any ratios. Losses are fully deductible.

_____ **If the property is substantially appreciated, verify that the property was used in a passive activity for either 20 percent of taxpayer's holding period OR property used in a passive activity for the entire two-year period prior to disposition.** Property is substantially appreciated if FMV exceeds 120 percent of adjusted basis. See Reg. § 1.469-2(c)(2)(iii). If 20 percent and 2-year rule requirements are not met, income is non-passive.

_____ **If gain is from the sale of a building, verify that building was used in a passive activity in the year of sale.** Passive activity is either a rental activity (check Schedule E for rental income and advertising) or a business in which the taxpayer does not materially participate. If there are no gross receipts/rents and no advertising, it is an indicator that there may be no rental or business activity in the year of disposition. Also verify that building was not simply held for investment, and thus income is non-passive. See IRC § 469(c), Reg. § 1.469-2T(c), Seits T.C. Memo 1994-52 If income is non-passive, it should be removed from Form 8582, thereby reducing allowable passive losses. Investment income is not passive income (IRC § 469(e)(1)(A)).

_____ **If a business interest is sold, verify the taxpayer did not materially participate in any 5 of the prior 10 years.** If losses/income are **non-passive** in any 5 of 10 years, current year gain will be non-passive even if the taxpayer did not work in the activity in the current year. See Reg. § 1.469-5T(a)(5).

_____ **For 1994 and later years, consider whether the taxpayer might be a real estate professional.** If he did most of the work or otherwise materially participated in the rental sold OR if he elected to group rental properties, gain on disposition is non-passive. A real estate professional is an individual who spent more than half his time on real property businesses and rentals **AND** more than 750 hours during the year. See IRC § 469(c)(7), Reg. § 1.469-9.

_____ **Consider whether property was held for investment** and thus falls outside the rental definition (i.e. that the rental activity is incidental to an

investment motive). Did the taxpayer seriously intend to generate rental income or was his motive ultimate gain via capital appreciation? Reg. § 1.469-1T(e)(3)(vi) provides that property will not be treated as a rental if the principal purpose was gain from appreciation AND gross rental income is less than 2 percent of unadjusted basis or FMV **OR** property was leased to a business in which the taxpayer has an ownership interest AND gross rental income is less than 2 percent of unadjusted basis or FMV.

_____ **Verify that income on FORM 8582 line 3a (2a for 2001 and prior years) is not from an activity in which the taxpayer materially participates.** See Reg. § 1.469-5T(a). If the taxpayer and/or the spouse meets any of the following, he materially participates and income is non-passive and should not be on Form 8582, triggering passive losses:

- Did taxpayer work more than 500 hours a year in business?
- Did taxpayer do most of the work?
- Did taxpayer work 100 hours and no one worked more?
- Did taxpayer work 100-500 hours in several passive activities, the sum of which exceed 500 hours?
- Did taxpayer materially participate in the activity any 5 of the prior 10 years?
- If the business is a personal service activity, did he materially participate in any 3 prior years?

_____ **If the taxpayer is involved in multiple related business entities, consider whether they form an "economic unit" (in other words, one *single activity*)** under the activity rules in Reg. § 1.469-4(c). Consequently, the taxpayer materially participates, and income is non-passive. See anti-abuse provision in Reg. § 1.469-4(f).

_____ **Consider whether taxpayer is subject to AMT.** Depreciation and other AMT preference and adjustment items relating to a passive activity are suspended until the year of a qualifying disposition (or there is passive income to trigger losses). Consequently, in the year of sale, there may be AMT.

LAW: Gain from disposition (including recapture) of assets used in a rental activity or business in which taxpayer did not materially participate is generally passive income (Reg. § 1.469-2T(c)(2)(A)(2)). However, there are several exceptions, including gain on the sale of land. Gain on disposition may be used to trigger other PALs only if it exceeds current and suspended losses from the entity/property sold.

ADJUSTMENT: Income reclassified as non-passive should be removed from Form 8582. Of course, it should still be reported on Schedule D or another appropriate schedule. Form 8582 should then be recomputed without the

income which was recharacterized. Passive losses generally will be disallowed up to the amount of passive income treated as non-passive.

Chapter 6, Entity Issues

Overview

This chapter consists of four separate and distinct topics as they relate to passive activities: C Corporations, Trusts, LLCs, and the self-charged rules.

The passive loss rules do not apply to partnerships and S Corporations. They apply to *investors* in these entities. Thus, material participation for a partner or shareholder is determined at the individual level. The IRC § 469 does, however, apply to C Corporations and to trusts. There are also special rules for LLCs. Finally, unlike most interest income, self-charged interest from loans to passive activities may be used as passive income on Form 8582.

C Corporations In a Nutshell

The passive loss limitations apply to all Personal Service Corporations (PSCs). For other closely held C Corporations, they apply only to a limited extent. The passive loss rules do not apply to large C Corporations that are not closely held and are not PSCs. See the checklist for C Corporations at end of chapter.

Material Participation for Corporations

It must be determined if a PSC or closely held corporation materially participates in its activities (including partnership and S Corporations) for losses to be deductible. Generally, the level of participation of the shareholders determines material participation. Of course, rentals are passive regardless of the level of participation^[1], and there is no \$25,000 offset as a corporation is not a natural person^[2].

One or more of the individuals who hold more than 50 percent of the outstanding stock must materially participate in each activity for the corporation to meet the material participation standard. See Chapter 4 for the seven material participation tests. If not, losses are passive and belong on Form 8810, Corporate Passive Activity Loss and Credit Limitations. They are not deductible in the absence of passive income.

Closely held corporations, but not PSCs, may also materially participate by meeting the requirements of IRC § 465(c)(7)(C). In certain limited circumstances, a full-time employee of the corporation can meet the material participation test.

Personal Service Corp

A PSC is a corporation whose principal activity is the performance of personal services by employee-owners.

Examples: doctors, attorneys, engineers, actors, consultants, accountants, actuaries, and financial planners.

- Passive loss limitations apply in full to all PSCs, including closely held PSCs.
- A loss is passive if the loss stems from rental real estate or equipment leasing activities **or** from any partnership or S- Corporation business in which shareholders holding more than 50 percent of the outstanding stock do not materially participate.
- Passive losses can offset only net income from another passive activity.
- Passive losses cannot offset PSC ordinary income, or portfolio income, or any other non-passive income.

Rental real estate losses

- Not deductible against PSC ordinary income or income from interest, dividends, stocks or other non-passive income.
- No \$25,000 offset is available, as a corporation is not a natural person.
- Passive losses are deductible only to the extent of passive income.

There is no carryback of rental losses or passive business losses in which the corporation does not materially participate. They can only be carried forward^[3].

Audit Considerations PSCs

Equipment leasing ^[4]

- Even if shareholder materially participates, losses generally are passive. Whether the leasing activity is conducted by the C- Corporation or through a partnership or S Corporation flowing into the entity, losses are passive.^[5]
- Losses from equipment leasing activities generally belong on Form 8810 and can offset only passive income.

Partnership and S Corporation *business* losses flowing into the PSC

- Not deductible against non-passive business income and portfolio income unless the PSC materially participates in the partnership or S Corporation.
- Material participation means that shareholders owning more than 50 percent of the stock work on a regular, continuous and substantial basis in the operations of the partnership or S Corporation.

- The IRC § 469(h)(4) exception, referencing IRC 465(c)(7)(C) and involving employees, for closely held C Corporations does not apply to PSCs! A shareholder, not an employee, must always prove he materially participates.
- If the PSC (i.e. a shareholder) does not materially participate, partnership or S Corporation losses are passive.
- Losses belong on Form 8810. They are not deductible unless there is passive income. Similarly, if the PSC does not materially participate, net income is passive.
- It is possible that the partnership or S Corporation is a related entity to the C Corporation and has been grouped as a single activity under Reg. § 1.469-4(c); thus losses will be deductible. Under the anti-abuse rule in Reg. § 1.469-4(f), an examiner may also want to consider whether an *income* producing entity should be grouped with another related entity. In other words, the examiner should consider whether the taxpayer's grouping truly is an appropriate economic unit and that the principal purpose is not to circumvent § 469. See Chapter 8.

Questions to ask:

- Are there any losses or credits from rental or leasing activities offsetting corporate and portfolio income (i.e. non-passive income)?
- Are there any partnership or S Corporation losses or credits which are from rental real estate or leasing activities?
- Which shareholders work in the partnerships or S Corporations? Are there any businesses conducted in partnerships and S- Corporations in which shareholders owning more than 50 percent of the stock do not materially participate?

Closely Held C Corporations

General Rule: For closely held C Corporations that are not PSCs, passive losses and credits can offset C-Corporate net income BUT not portfolio income. Stated differently, a passive losses can offset corporate earnings of a closely held C Corporation business, but not portfolio income^[6].

Closely held simply means that 5 or fewer shareholders control more than 50 percent of the outstanding stock during the last half of the year^[7]. Even many publicly traded corporations are closely held, despite having hundreds of shareholders.

If the shareholder(s) do not material participation, passive losses can offset net active corporate income, **but not portfolio income**. Furthermore, a passive loss cannot be carried back, but instead must be carried forward.

Audit Considerations on Closely held C Corporations

Identify rental real estate losses, equipment leasing losses, and partnership or S Corporation losses.

- Verify that that passive losses have not been used to offset interest, dividends, royalties, gains on stocks and bonds and other portfolio income.
- Verify that passive losses have not created or increased a NOL. If so, pick up the NOL years and adjust them. Unlike an NOL, a passive activity loss cannot be carried back. It may only be carried forward^[8].

Issues on the shareholder's individual return:

- Assets owned personally by a shareholder and leased to the corporation: If the building or equipment is personally owned by the shareholder and leased to the corporation, net rental income may be non-passive (Reg. § 1.469-2(f)(6)).
- Equipment held in a partnership/LLC and leased to the corporation: If equipment is held in a separate partnership or S Corporation and leased to the corporation, losses generally are not deductible by the investors in the absence of passive income.

Consolidated Corporations

A consolidated corporation is treated as **one** corporation. Thus, if the shareholder materially participates in any entity, he is deemed to materially participate in all. See IRC § 469(j)(11) and Reg. § 1.469-1(h).

Supporting Law

Closely Held C Corporations

- **IRC § 469(a)(2)(B)**: The passive loss limitations apply to closely held C-Corporations.
- **IRC § 469(j)(1)** Closely held C Corporation is defined via reference to § 465(a)(1)(B), i.e. 5 or fewer shareholders that control more than 50 percent of the outstanding stock.
- **IRC § 469(e)(2) and Reg. 1.469-1T(g)(4)**: For closely held C-Corporations that are not personal service corporations, a passive loss can offset net active corporate income, but not portfolio income.
- **IRC 469(c)(7)(D)(i)**: Rental real estate losses of a corporation are excepted from the passive loss limitations **if** more than 50 percent of the corporation's gross receipts are from real property businesses and the corporation materially participates in the rental activity (Reg. § 1.469-9(e)(1)).

- **IRC § 469 (h)(4)(A) and Reg. § 1.469-1T(g)(3):** A personal service corporation and a closely held C Corporation materially participate in an activity (partnership or S Corporation business) only if one or more shareholders owning more than 50 percent of the stock materially participate in the activity.
- **IRC § 469(h)(4)(B):** For closely held C Corporations that are not personal service corporations, they can also materially participate if they meet the requirements of IRC § 465(c)(7)(C)(i), (ii), and (iii).
- **IRC §465(c)(7)(C)** requires that
 - For the entire 12 months;
 - A full-time employee spends all his time managing the activity AND the corporation has 3 or more non-owner employees performing services directly related to the activity; AND,
 - The C Corporation's expenses¹⁹¹ exceed 15 percent of gross income (excluding interest, taxes and depreciation).

If the corporation meets the above criteria, it will be deemed to materially participate.

Personal Service Corporations

- **IRC § 469(a)(2)(C):** The passive loss limitations apply to PSCs.
- **IRC § 469(j)(2):** A PSC is defined via reference to IRC §269(A)(b)(2)

Examples: doctors, veterinarians, accountants, engineers, attorneys, actuaries, actors, consultants, financial planners, etc.

- **IRC §469(i)(1)** The \$25,000 offset is available only to natural persons.

Trusts In a Nutshell

There is no provision in either Subchapter J or IRC § 469 for passive losses to flow out of a simple or complex trust¹¹⁰¹. Passive losses generally remain suspended at the trust level until there is passive income. Thus, rental losses or losses from a business in which the trustee does not materially participate may not be deducted in the absence of passive income. See checksheet at the end of the chapter.

Losses from partnerships and S Corporations in which the trustee does not materially participate are not deductible against portfolio income of the trust. Passive losses go on Form 8582 line 3b (2b prior to 2002) and must be carried forward until there is passive income or a disposition to an unrelated party in a fully taxable transaction.

Estates are similar to complex trusts. The same tax rules that apply to trusts also generally apply to estates. In this Chapter, we have used the term “trustee”. If you are examining an estate, substitute executor or administrator for trustee.

Trusts Rental Issues

Since rentals are defined as passive activities in IRC § 469(c)(2), losses from rental real estate or equipment leasing activities are passive^[11] and are generally not deductible in absence of passive income.

While an individual receives a special allowance of up to \$25,000 in rental real estate losses, no such allowance is available to trusts since they are not natural persons^[12]. An estate may, however, use the \$25,000 offset for two years^[13] if there was active participation by the decedent and to the extent that the surviving spouse does not use it.

Also, while relief is provided for taxpayers with rentals who spend the majority of their time in real property businesses (real estate professionals) under IRC § 469(c)(7), this provision does not address trusts.

Issue Identification:

- Passive business losses or rental losses on Form 1041, U.S. Income Tax Return for Estates & Trusts, lines 5 and 6 may not have been entered on Form 8582.
- Unless there is sufficient passive income to absorb all passive losses, the absence of Form 8582 on a trust return with losses on lines 5 and 6 is an indicator the passive loss limitations may have been ignored.
- Losses on Form 1041 lines 8 and 15a labeled as net operating losses may actually be generated by a rental activity or business in which the taxpayer does not materially participate. In other words, they may be passive losses, which, unlike an NOL, cannot offset portfolio income and cannot be carried back.

Examination Techniques:

- Read the trust instrument or will for details on who manages the businesses, partnerships or S Corporations.
- Verify that rental real estate losses have **not** been entered on Form 8582 line 1b, thereby permitting the \$25,000 offset in error. Other than estates, rental losses should be entered on line 3b (2b prior to 2002) of Form 8582.
- Review Schedule K-1s to determine if any rental losses were improperly passed through to the beneficiary returns.

Documents to Request:

- Trust instrument or will including any amendments and codicils.
- Detailed description of any rental activities.
- List of activities, nature of the business, and amounts that comprise any NOL.

Supporting Law:

- **IRC § 469(a)(2)(A) & Reg. § 1.469-1T(b)(2):** Passive loss rules apply to trusts and estates. Since neither IRC § 469 (passive activities) nor § 641-692 (trusts and estates) contain any provision for a pass through of passive activity losses, disallowed passive losses generally remain suspended at the estate or trust level and do not flow out to beneficiaries^[14].
- **IRC § 469(i):** A trust is not a natural person; it is an artificial entity. Thus, rental losses are generally disallowed in the absence of passive income, and the \$25,000 rental real estate offset is not applicable.
- **IRC § 469(i)(4)(A):** An estate may use the \$25,000 offset for two years after the decedent's death. However, **IRC § 469(i)(4)(B)** requires that the portion used by the surviving spouse reduce the \$25,000 offset.

Trusts Material Participation

If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S Corporations or LLCs.

The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates^[15].

As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).

Grantor Trusts: Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

Qualified Subchapter S Trust^[16] (QSST): The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;^[17] and,
2. Working interests in oil and gas activities^[18]. Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.
- Partnership or S corporation with losses.
- Entity with an EIN and address a long distance from the trust or trustee.
- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.
- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.
- Copies of Schedule K-1s from related entities.
- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S Corporations.
- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S Corporation.
- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law

- The **Senate Report^[19]** clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.
- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, “Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S Corporation’s activity is a passive activity with respect to the beneficiary.”

Trusts Dispositions, Distributions and Gifts

Under IRC § 469(g), when a passive activity is sold or otherwise disposed of in a fully taxable transaction to an unrelated party, current and suspended losses are triggered^[20]. Changes in the form of the entity and likekind exchanges are not qualifying dispositions under IRC § 469(g), as they are not fully taxable. Thus, losses remain suspended on Form 8582 at the trust level.

As a practical matter, passive activities are often sold to a beneficiary or trustee, i.e. related party. Thus, losses remain suspended by the trust^[21]. Furthermore, even without the provisions of IRC § 469 regarding sales to related parties, IRC § 267 prohibits the deductibility of losses on dispositions to related parties. Losses will be triggered only to the extent of any net taxable income from the sale.

When a trust **distributes** a passive activity (rental or passive partnership interest, etc.) to a beneficiary, current and suspended passive losses are added to the basis immediately before the distribution^[22]. The distribution is not, under any circumstances, a triggering event which would allow deductibility of losses by either the trust or the beneficiary.

A rental property, partnership interest or other passive activity which is **given** to a charitable organization is not an event which triggers deductible losses for the trust on line 5 or Schedule E. Instead, current and suspended losses are added to the donee's basis^[23]. Losses are not deductible by either the trust or the beneficiaries.

Issue Identification: Watch for:

- Final returns with losses on disposition but no Form 4797
- Form 4797 with a zero in the selling price column.

Examination Techniques:

- Ask who purchased the property. Was it a beneficiary or a business (corporation, partnership, LLC) of the beneficiary? Even though there may

have been a sale at fair market value, current and suspended losses from the passive activity remain suspended at the trust level until the activity is ultimately sold to an unrelated party.

- Review losses triggered on a disposition to verify that it was indeed a sale and not merely a distribution to a beneficiary. If there is a loss on disposition yet no F4797, it is an indicator that there was merely a distribution to a beneficiary. Final returns should be scrutinized carefully for this issue.
- Inquire whether the passive property or activity was sold, distributed or gifted to a beneficiary, trustee or other related party

Documents to Request:

- Secure appraisals to determine if the property was sold at fair market value.
- Copy of the settlement statement or other documents verifying the amount of the sales price and the parties involved in the sale.
- Basis computations.

Supporting Law

- **IRC § 469(g)(1)(B):** If the disposition involves a related party, passive losses stay with the trust. They are not triggered until the activity is acquired by an unrelated party.
- **IRC § 267(b)(6):** A trustee (fiduciary) and a beneficiary are related parties.
- **IRC § 469(j)(6):** If a passive activity (rental or passive business) is gifted, losses are added to the recipient's (donee's) basis. They are not deductible by the trust or estate.
- **IRC § 469(j)(12):** If a passive activity is distributed to a beneficiary by a trust or estate, losses are added to the basis of the asset immediately before the transfer. No loss is deductible by the trust or estate.

LLCs In a Nutshell

The LLCs combine features of both partnerships and corporations. The most notable characteristics of LLCs are contractual freedom and limited liability for all investors. An LLC with more than one owner is treated as partnership and files Form 1065 unless the LLC elects to be treated as a corporation. Single member LLCs are generally disregarded, and gain or loss is reported on the single member's return (Form 1040 for an individual).

Since each member of an LLC has limited liability, investors are analogous to limited partners under IRC § 469. For purposes of passive loss rules, LLC members are treated as limited partners, even if the taxpayer is a member-manager.

See LLC checklist at the end of the chapter.

Material Participation for LLCs

When looking at an LLC, the very first step is to determine whether you are dealing with a rental/leasing activity **or** a business activity. If the LLC is a rental activity, all member losses are generally passive^[24], even if a member materially participates. The IRC § 469(c)(2)&(4) hold that rentals are passive regardless of the level of participation.

If the activity is a trade or business, a member must prove material participation^[25]. The IRC § 469(h) requires regular, continuous and substantial basis in operations. Reg. § 1.469-5T(e)(3)(i)(B) holds that a partnership interest will be treated as a limited partnership interest *if the liability of the holder is limited under the law of the State*. Under most state laws, an LLC member has limited liability. Therefore, LLC members are treated as limited partners^[26]. The Reg. 1.469-5T(e)(2) holds that only three tests are available to limited partners (LLC members):

- The taxpayer must prove he worked more than 500 hours during the year.
- The taxpayer must prove he materially participated any 5 of the last 10 years.
- If a personal service activity (doctor, accountant, engineer, architect, consulting, etc), the taxpayer must prove he materially participated any 3 prior years.

Refer to Chapter 5 for more detail on Material Participation.

Self-Charged Interest In a Nutshell

The self-charged interest income rule in Reg. § 1.469-7^[27] is the sole exception where portfolio income is recharacterized from non-passive to passive income. Interest income *may* be treated as passive income if it results from a loan between a taxpayer and a passthrough entity in which he has a direct or indirect ownership interest. See checklist at the end of the chapter. Interest income may be treated as passive income only if:

- The activity involved is a *passive* activity. (The taxpayer does not materially participate in the activity, **or** it is a rental activity)
- It is from a pass-through entity, i.e. partnership or S Corporation.
- It is from a lending transaction.

The Reg. § 1.469-7(c)(3) provides that a taxpayer must use an “applicable percentage”. Generally, this means the taxpayer’s ownership interest in the partnership or S Corporation is multiplied by the amount of interest income received. Thus, if the taxpayer received \$1,000 in interest, but had only a 10

percent ownership interest in a partnership, only \$100 of the interest income can be used as passive income on Form 8582.

Issue Identification:

- Look for self-charged interest income on Form 8582, which might have been entered on Form 4952 as investment income, erroneously triggering deductions for investment interest expense. Passive income is not investment income and should not be on Form 4952^[28].
- Verify that self-charged interest income has been reported on Schedule B in the same dollar amount as on Form 8582 line 1a or 3a. Form 8582 does not report income. It merely calculates the allowable passive loss for the year. Taxpayers sometimes reflect self-charged interest on Schedule E. If the income is not on Schedule B or E, it is possible that some other self-charged item has been recharacterized as non-passive. There is no provision in law for recharacterization of any item as passive income other than interest. If rents, guaranteed payments or any other self-charged item (other than interest income) is on Form 8582, it should be removed and an adjustment made.
- Verify that a passive loss (from the same activity as self-charged interest) has also been entered on Form 8582. For self-charged interest to be on Form 8582, it must be from a *passive* activity (a rental/leasing activity or business in which taxpayer does not materially participate).

Summary

- The PSCs are fully subject to passive loss limitations, even if closely held.
- For closely held C Corporations, other than PSCs, corporate income, other than portfolio income, generally may offset passive losses.
- The passive loss limitations apply to trusts. For trusts, there is no \$25,000 offset for rental real estate. For business activities held by the trust, the trustee must materially participate for losses to be non-passive and offset portfolio income.
- Members of LLCs are treated as limited partners for purposes of the passive loss rules. If the LLC member works more than 500 hours in the business, he is non-passive.
- The self-charged interest rule treats interest income from a loan to a related entity as passive income. No other self-charged item may be recharacterized as passive income and entered on Form 8582.

^[1]IRC § 469(c)(2)&(4)

^[2]IRC § 469(i)

^[3] IRC § 469(b)

^[4] IRC § 469(c)(2)&(4) and Reg. § 1.469-1T(e)(3)

^[5] See Chapter 2 and Reg. 1.469-1T(e)(3) for what is and is not a rental activity.

^[6] See IRC § 469(e) and Reg. § 1.469-2T(c)(3)

^[7] IRC § 469(j)(1)

^[8] IRC 469(b)

^[9] IRC § 162 and § 404 business expenses

^[10] On distribution of a passive activity, however, the basis of the activity is increased by suspended losses. The increased basis will give the beneficiary the benefit of the loss when he eventually disposes of the activity. See IRC § 469(j)(12)(A)

^[11] See Chapter 2 and Reg. § 1.469-1T(e)(3) for a discussion of what is and is not a rental activity.

^[12] IRC § 469(i)

^[13] For estate tax years ending less than two years after the death of the decedent.

^[14] See Reg. § 1.1398-1 for bankruptcy estates for individuals.

^[15] Note that Reg. § 1.469-5T(g) is “Reserved”.

^[16] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.

^[17] Reg. § 1.469-1T(e)(6)

^[18] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v)

^[19] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3)1, at 735.

^[20] See Chapter 5 for much more information on dispositions.

^[21] IRC § 469(g)(1)(B)

^[22] IRC § 469(j)(12)

^[23] IRC § 469(j)(6)

^[24] See Chapter 2 and Reg. § 1.469-1T(e)(3) for a discussion of what is and is not a rental activity.

^[25] See Chapter 4 for additional information on material participation.

^[26] Single member LLCs are disregarded entities. Since they are not recognized by federal tax law, the taxpayer will have all seven tests in Reg. § 1.469-5T available to him. He will not be subject to the limited partner taint.

^[27] Final Regulation § 1.469-7 was issued on 08/21/2002.

^[28] IRC § 163(d)(4)(D)

Exhibit 6.1: C Corporations: Passive Activity Issues

Personal Service Corps

The passive loss limitations in IRC § 469 apply in full to all PSCs, whether or not closely held. A passive loss cannot offset corporate income or portfolio income - nor can it create an NOL. A passive loss goes on Form 8810 and is deductible only to the extent of passive income.

_____ Are there any losses or credits from rental or leasing activities offsetting corporate and portfolio income?

_____ **Are there any partnership or S corporation losses or credits which are rental real estate or leasing activities?** Typical passive activity credits: low income housing credit and rehabilitation credit.

_____ **Are there any businesses conducted in partnerships and S Corporations in which a 50 percent + shareholder does not materially participate?** (See log at end of Chapter 4.)

Closely Held C Corporations

A closely held C Corporation that is not a PSC can offset a passive loss against net against net active corporate income, *but not against portfolio income*. A passive loss cannot create an NOL. Closely held means 5 or fewer shareholders hold more than 50 percent of the stock at year-end.

_____ **Are losses or credits from rentals OR partnership or S Corporation businesses in which the corporation (50 percent + shareholder) does not materially participate in offsetting interest, dividends, gains on stocks and bonds, royalties or other portfolio income in error?**

_____ **Have losses from rentals and partnership or S Corporations businesses been carried back in error as NOLs?** Passive losses can only be carried forward. They cannot be carried back.

Related issues which fall out on the shareholder's Form 1040:

Applies to both PSCs and closely held C Corporations.

_____ **Is the building owned by the shareholder and leased back to the corporation? Or is the building held in a partnership and leased back to the corporation?** If so, net rental income generally should not be on Form 8582 line 1a, triggering otherwise nondeductible passive losses. See Reg. § 1.469-2(f)(6).

_____ **Is any equipment or vehicle held in partnership or by the shareholder personally and leased back to the corporation?** If so, losses are may be passive, i.e. they belong on Form 8582 line 3b (2b prior to 2002) on the shareholder's Form 1040. Losses from leasing activities are nondeductible in the absence of passive income. See IRC § 469(c)(2)(4).

Exhibit 6.2: Trusts: Passive Loss Issues

LAW: Generally passive losses are limited at the trust level. Unused passive losses due to the limitations in IRC § 469 are suspended by the trust. Passive losses can offset only passive income at the trust level. Unused passive losses must be carried to next year per IRC § 469(b). The \$25,000 rental real estate offset cannot be used by a trust because trusts are not natural persons as defined by IRC § 469(i)(1).

Note: Rental real estate losses should be reflected on line 3b, not line 1b. Thus, lines 1a, 1b and 1c should be blank. As a practical matter, it is of no consequence whether income is on line 1a or 3a as long as it is truly generated by a passive activity.

_____ **Does trust have passive activities?** Scrutinize Form 1041 line 3,5,6,8, and 15 for losses which might be passive and may have been erroneously deducted. Rentals, whether real estate or equipment leasing, are generally passive. Furthermore, businesses in which trustee or executor does not materially participate are passive. All of a trust's passive losses go on Form 8582 and are deductible only up to passive income.

_____ **Verify rental real estate losses have been entered on Form 8582 line 3b (not line 1b which erroneously gives the benefit of the \$25,000 offset).** If losses are on line 1b, disallow losses on Form 1041 and secure beneficiaries returns and disallow losses which may have been deducted (unless there is passive income on the trust's FORM 8582 OR the activity was sold to a unrelated party). Rentals must be separated from interest, dividends, gains on stocks/bonds and other portfolio income. Trusts are not an individual and do not qualify under IRC § 469(i) for the \$25,000 offset. Thus, rental losses are not deductible in the absence of passive income. Unused passive losses are suspended (not passed through to beneficiaries). If there are passive activities, the absence of FORM 8582 is an indicator that the passive loss limitations may not have been considered.

NOTE: For estates, if the taxpayer actively participated before he died, IRC § 469(i)(4)(A) provides the estate may use the \$25,000 offset for 2 years after his death. However, IRC § 469(i)(4)(B) provides that the \$25,000 offset is reduced by the portion of the \$25,000 offset used by surviving spouse.

_____ **Verify that Schedule E royalties are not improperly reducing rental losses.** Royalties are not passive income. See IRC § 469(e) and Reg. § 1.469-2T(c)(3)(E).

_____ **Verify that interest, dividends, capital gains from stocks and bonds, annuities, and royalties have not been entered on FORM 8582 line 1a no or 3a.** While these types of income seem "passive", they are not passive under IRC

§ 469. Passive income is net rental income OR net income from businesses in which taxpayer does not materially participate. The Form 8582 is a computational form to limit passive losses to passive income. For every dollar of income removed from Form 8582, allowable passive losses are generally reduced by a dollar. Passive income, of course, is always reportable on the return, typically on Schedule E.

_____ **Verify that income from land, whether leased or held for investment, has not been included on Form 8582 line 1a or 3a.** Land income, including gain on sale, is non-passive. It may not be used as passive income. See IRC § 469(e)(1)(A)(ii)(II) property held for investment and Reg. § 1.469-2T(f)(3) leased land.

_____ **Review the non-passive column on the back of Schedule E.** Non-passive means the trustee materially participated in the partnership or S-Corporation. The trustee or fiduciary must work on a regular basis in the business before losses are deductible in the non-passive column. See IRC § 469(h). Passive business losses should be on Form 8582 line 3b and are not deductible without passive income. Portfolio income is not passive and should not be on Form 8582. IRC § 469(e)(1)(A)

_____ **Verify Schedule F farm losses have been entered on Form 8582 line 3b unless trustee materially participates.** For farm losses to be fully deductible without considering the passive loss limitations, the trustee must materially participate in the farm. Material participation does not simply mean making management decisions. It means working on a regular, continuous and substantial basis in operations. See IRC § 469(h).

_____ **Verify that NOLs (Form 1041 line 8 or 15) are not, in fact, passive losses (rentals or passive business losses)** - which should be on Form 8582 line 3c (not on the face of F1041 which will offset portfolio and other non-passive income). Remember, a passive loss cannot offset portfolio income. An NOL will however, offset portfolio income or any other kind of income on the Form 1041.

_____ **If a rental property or passive partnership interest was gifted to a charitable organization or individual, verify current and suspended losses were not deducted.** The IRC § 469(j)(6) requires passive losses to be added to donee's basis.

_____ **If passive losses have been triggered due to a disposition, ask if the disposition was, in fact a distribution to beneficiary?** If so, suspended losses from the trust are added to basis of asset. They are not a current deduction. If return reflects a disposition or large losses deducted, but no Form 4797, it is an indicator property was distributed to beneficiary. Final returns should be carefully scrutinized for this issue. Review trust Schedule K-1s and beneficiary's Form 1040 Schedule E to verify losses have not been improperly

deducted. IRC § 469(j)(12) A distribution does not trigger losses under IRC § 469(j)(12). Furthermore, a beneficiary often is a related party. See IRC § 469(g)(1)(B).

_____ **If a rental property or passive partnership interest is sold, ask if sale was to a beneficiary, trustee, or other related party.** If so, losses may not be deducted. They remain suspended at the trust level until there is passive income or the property or interest is acquired by an unrelated party. The IRC § 469(g)(1)(B) Losses will, however, be triggered to the extent of net gain reported on the sale. Reg. § 1.469-2T(c). Passive income will always trigger passive losses. See IRC § 469(d).

_____ **If you are reviewing a return for the year of an individual's death, verify via review of the final Form 1040 that suspended passive losses are allowed only to the extent they exceed the step-up in basis (FMV) in the hands of the beneficiary.** Frequently, the step-up in basis to fair market value absorbs all passive losses. Thus, none are deductible. See IRC § 469(g)(2).

Example in Pub. 925, Passive Activity and At-Risk Rules: If the basis of a passive activity in the hands of a transferee is increased by \$6,000, and taxpayer had unused passive losses a date of death of \$8,000, the decedent's deduction is limited to \$2,000 (8,000 less 6,000).

GRANTOR TRUSTS: As a grantor trust is not an entity in the eyes of tax law, for purposes of the passive loss limitations, we ignore the trust and look directly to the grantor (individual taxpayer) to determine whether the active or material participation standard has been met. An examiner will generally know he is dealing with a grantor trust as no Schedule K-1 will be filed (generally taxpayer has only a letter or a statement) and losses are generally reflected on Schedule C or the front of Schedule E. Often no F1041 is filed for a grantor trust. However, if a Form 1041 is filed, the box in the upper left hand side of the F1041 will be checked "Grantor Type Trust".

Exhibit 6.3: LLCs: Passive Activity Issues

_____ **If a rental has been transferred into an LLC, verify that losses on disposition have not been deducted on Form 1040 Schedule E or D.** In particular, look for losses erroneously entered in the non-passive column of Schedule E – or losses in excess of \$25,000 on the face of Schedule E due to a “disposition”. The transfer is NOT a qualifying disposition under IRC § 469(g) as it is not fully taxable nor is it to an unrelated party. A mere change in form is not a qualifying disposition. Losses stay with the individual and remain on Form 8582.

_____ **For businesses conducted via an LLC, scrutinize LLC member Schedule K-1s and consider raising a passive loss issue if:** Low ownership percentage, out-of-state address or name/address suggesting a minor.

REMINDER: The Reg. 1.469-5T(e)(3)(i)(B) holds that a partnership interest is a limited partnership interest *if the liability of the holder of the interest for obligations of the partnership is limited under the law of the State in which the partnership is organized.* If state law generally limits the liability of LLC members. The LLC members will be treated as limited partners under Reg. § 1.469-5T(e)(4)(v)(3). Limited partners are subject to more restrictive tests for material participation. Tests 1 (500hour), 5 (material participant 5 of prior 10 years) and 6 (material participant in personal service activity any 3 prior years) in Reg. § 1.469-5T(a) are the exceptions to the limited partner taint. If a limited partner fails these three tests and has no passive income on his Form 1040, business losses are generally not deductible. They go on Form 8582 line 3b.

_____ **At the initial interview, ask what each LLC member does.** Determine the time and activities of each LLC member. Also request LLC agreement (and management agreements, or contracts, if any) with duties highlighted. See log in Chapter 4.

_____ **If the LLC is involved in long-term leasing of equipment, review all LLC member returns.** Losses are generally not deductible unless the individual taxpayer has other passive income. See IRC § 469(c) and Chapter 2.

_____ **If the LLC rents its building or equipment from an LLC member individually, determine whether the LLC member works on a regular basis in the business.** If the member materially participates, the income is recharacterized as non-passive. While it still is reportable on Schedule E of Form 1040, it cannot be used to offset other passive losses and should not be reflected on Form 8582 line 1a.

Exception: If there is a written, currently binding lease signed before 2/19/88, the LLC member may characterize net income as passive. See Reg. § 1-469-2T(f)(6) and § 1.469-11(c)(ii). This exception is rarely seen as the lease period would have to be more than fifteen years to bind the current year.

_____ **When perusing the LLC members' individual returns, verify Schedule K-1 portfolio income (line 4) have not been entered on Form 8582 line 1a or 3a.** This type of income is reportable on Schedule B, D and E, but should not be on Form 8582 as it is non-passive income under IRC § 469(e). If portfolio income is on F 8582, it should be removed. **Result:** there is generally a passive loss adjustment up to the amount of income removed from Form 8582.

_____ **Verify that guaranteed payments or other types of personal service income has not been entered on members' Form 8582 line 1a or 3a as passive income.** Passive income can only be generated by a rental activity OR a business in which the member does not materially participate. See IRC § 469(e)(3) and Reg. §1.469-2T(c)(4).

_____ **When making flow through adjustments to the individual LLC member returns, consider automatic adjustments due to MAGI.** If MAGI (AGI per return plus an add back for any passive activity losses and several other minor modifiers) exceeds \$100,000 AND the taxpayer has rental real estate, his \$25,000 offset is reduced 50 cents for every \$1.00 over \$100,000. See MAGI exhibit at the end of Chapter 1 and IRC § 469(i)(3)(Form) .

_____ **If the LLC falls under TEFRA, prepare an affected item report for passive issues.**

NOTES:

ACTIVITY RULES: Under the activity grouping rules in Reg. § 1.469-4, a taxpayer may group his activities, including LLC businesses, into ONE single activity IF they form an appropriate economic unit. Often it is easier for the taxpayer to meet the 500-hour test material participation if businesses are grouped. Factors considered are: similarities, common control, common ownership, geographical location, and reliance between or among activities. To be grouped, the business must form an integrated and interrelated economic unit. See Chapter 8.

RENTAL REAL ESTATE LLCs filed as PARTNERSHIPS: For 1994 and subsequent years, a taxpayer who spends more than half his personal services in real property trades or businesses AND works more than 750 hours in real property trades or businesses AND materially participates in each rental real estate activity may deduct losses in full. See IRC § 469(c)(7), Reg. § 1.469-9, and Chapter 2.

BASIS AND AT-RISK: Basis and at-risk rules override IRC § 469. If taxpayer has no basis or is not at-risk under IRC § 465, LLC losses are not allowable - even if the loss would have been allowed under IRC § 469. See Reg. § 1.469-2(a)(2)(ii) and Reg. § 1.469-2(d)(2)(x).

Exhibit 6-4: Self-Charged Interest

ISSUE: Are self-charged items on Form 8582 line 1a or 3a non-passive? If so, the income should be removed from Form 8582, thereby limiting allowable passive losses. Stated differently, have self-charged items for passive activities been appropriately characterized as passive income?

Since passive losses are deductible only to the extent of passive income, removing income from FORM 8582 generally results in the amount of currently deductible passive losses being reduced.

LAW: To offset interest income which taxpayer is required to report (generally on Schedule B) from loans to related entities, the taxpayer may treat self-charged interest income as passive income (reflecting it on Form 8582, thereby triggering the same amount of interest expense). See Reg. § 1.469-7. The recharacterization rule for self-charged items applies *only to interest income*. There is no provision in law for any other self-charged income item to be entered on Form 8582 as passive income.

_____ **Verify that self-charged interest income on Form 8582 line 1a or 3a** (which has been recharacterized as passive income per Reg. § 1.469-7) **has not also been entered on Form 4952** as investment income, erroneously triggering deductions for investment interest expense. The same income should never be on both Form 8582 and Form 4952. The IRC § 163(d)(4)(D) specifically states that investment income does not include any income taken into account in computing passive losses under IRC § 469. Since investment interest expense is deductible only up to investment income, removing self-charged interest income from Form 4952 will result in automatic adjustments to investment interest expense. While the interest income should not be reflected on Form 4952, it is, of course, reportable on Schedule B.

_____ **Request the loan instrument and verify that self-charged interest income is actually interest on a loan.** Also check balance sheet for loans from shareholder/partner. Other self-charged items such as management fees, guaranteed payments, rents, royalties, etc. should not be on Form 8582 as passive income. There is no provision in IRC or Regulations for any other type of income to be treated as passive other than interest income as provided for in Reg. § 1.469-7. To read proposed Reg. §1.469-7 as providing self-charged treatment to nonlending transactions expands the Regulations to transactions it was not intended to cover.

_____ **Verify that loans are not between two entities which are not tiered.**

Example: Two S Corporations owned 100 percent by one shareholder). One S Corporation loans the other money. One entity does not own part of the other entity; therefore, no direct interest. See Reg. § 1.469-7(b)(1).

_____ **Verify that self-charged interest is from a partnership or S-Corporation.** Reg. §1.469-7(b)(1) defines a pass through entity as a partnership or S- Corporation.

_____ **Verify that interest income has been reported on Schedule B in the same dollar amount as self-charged passive income on Form 8582** line 1a or 3a. Passive income must be reported on the return. Form 8582 is merely a computational schedule which figures allowable passive losses. Entering income does not report it on return. It must be entered on one of return schedules to be appropriately reported. The self-charged income rules are the one exception where portfolio income is recharacterized from non-passive to passive income. Typically, interest income is reported on Schedule B – although taxpayers sometimes reflect it on Schedule E in the passive income column.

_____ **Verify that income in the same amount as the self-charged interest has NOT been removed from Schedule B.** Reg. § 1.469-7 merely permits interest income (which otherwise is non-passive) to be entered on FORM 8582 as passive income in order to trigger a like amount of loss (representing the related interest *expense*). The allowed loss would generally be reflected on Schedule E line 27 in the passive loss column. If in doubt as to where the loss is reflected, refer to worksheet 6 of Form 8582 which designates the schedules allowed passive losses are entered on. Reminder: Form 8582 is only a computational schedule. It does not in any manner report income. If income is removed from Schedule B and reflected only on Form 8582, it results in unreported income!

_____ **Verify that interest expense on a loan which is *capitalized* has not been recharacterized.** Reg. § 1.469-7(c)(1)(i) & (d)(1)(ii) provide that the loan must give rise to an interest deduction *for the same year*.

_____ **Verify that a passive loss** (from the same activity as self-charged interest) **has also been entered on FORM 8582.** For self-charged interest to be on Form 8582, it must be from a **passive** activity (a rental/leasing activity OR business in which taxpayer does not materially participate). The Reg. § 1.469-7(a)(1)(ii) and § 1.469-7(c)(iii) and § 1.469-7(d)(iii)

_____ **Verify that the interest income is not from a non-passive activity.** If the partnership or S Corporation generating the interest is entered as non-passive, the interest income cannot be on Form 8582. Similarly, if the taxpayer materially participated any 5 of the prior 10 years, income in the current year is non-passive.

_____ **Verify that self-charged interest has been properly allocated based on the portion that is self-paid.** Fraction to compute allocation: Taxpayer's ownership percentage (i.e. his share of entity's self-charged interest expense) multiplied by taxpayer's Schedule B interest income. Obviously, this procedure is

not necessary if taxpayer is 100 percent shareholder of an S Corporation. **For example**, if the taxpayer receives \$100 in interest income and has a 10 percent ownership interest, only \$10 may be treated as passive income on Form 8582 line 1a or 3a. **There are very clear examples of how the applicable percent works with multiple investor in Reg. § 1.469-7 Example (1) and Example (2).**

Adjustment: Remove income from Form 8582 Line 1a or 3a and recompute. Adjustment to allowable passive losses is difference between Form 8582 Line 16 per return and Form 8582 Line 16 as corrected. Also, modified AGI on Form 8582 line 7 will be increased by the amount of income determined to be non-passive. Thus, the taxpayer may lose part of his \$25,000 offset under IRC § 469(i), i.e. you may have a second computational adjustment.

Chapter 7: Interaction With Other IRC Sections

INTRODUCTION

The IRC § 469 on PAL is only one IRC section among several others that limit losses and deductions. Basis and the at-risk rules in IRC § 465 should always be applied before the passive loss rules^[1]. Interest expense generated as a result of an “investment” in a limited partnership or other passive activity is not investment interest. It is passive activity interest expense^[2] and must be limited using Form 8582. Similarly, any deduction from a passive activity (**IRC § 179** expense, for example) must be entered on Form 8582 along with the ordinary loss. **Even if the taxpayer has sufficient passive income to trigger losses under IRC § 469, other IRC section limitations must be considered.**

Generally, an examiner should consider other obvious disallowance provisions, such as hobby losses under IRC § 183, before applying the passive loss rules. However, capital losses limited under IRC § 1211 are applied *after* the passive activity loss limitation.

There are two major exceptions to the passive loss rules:

1. Working interests in oil and gas activities;^[3] and,
2. Traders in stocks and bonds^[4].

This Chapter addresses several other IRC sections, that reference or rely upon IRC § 469.

Investment Interest In a Nutshell

Investment Interest Expense

Investment interest expense is deductible *only to the extent of investment income*^[5]. If there is no investment income, no investment interest expense is deductible currently. See checklist at end of chapter.

Investment interest expense is interest paid on loans to buy portfolio assets such as CDs or stocks and bonds. Interest expense on an “investment” in a partnership or S Corporation generally is **not** investment interest expense. Interest traceable to an investment in a partnership or S Corporation is either:

1. Interest attributable to a business in which the taxpayer materially participates and thus fully deductible; OR;
2. Interest attributable to a passive activity, which goes on Form 8582 line 1b or 3b and is generally limited to passive income.

Investment Income

Property held for investment is defined in IRC § 163(d)(5) via reference to IRC § 469(e)(1). Investment interest expense is deductible *only to the extent of investment income*. Investment income is:

- Interest income, but not self-charged interest used as passive income.
- Dividends, royalties, annuities, but not pension income.
- Rental income from leased land^[6].
- Net short-term capital gains or other ordinary income from disposition of investment property.
- Net long-term gain on the stocks and bonds **only if** there is an election on line 4e of Form 4952 for that income to be taxed at ordinary rates. The same amount must also be entered on Schedule D line 21 if the long-term gain is used as investment income on Form 4952.
- Net income from a business, which is not a passive activity, and in which the taxpayer does not materially participate. This is a highly restrictive provision. Only two activities fit this criteria:
 - Working interests in oil and gas; and
 - Traders in stocks and bonds.

If income on Form 4952 is in the non-passive column on the back of Schedule E, it is a strong indicator that the taxpayer may be incorrectly using ordinary business income as investment income. Business income generally is not investment income.

Investment Interest Expense

Investment interest expense is:

- Interest on loans to buy CDs, stocks, bonds or other assets producing portfolio income (interest, dividends, annuities, royalties).
- Interest to buy C Corporation stock (produces dividends)^[7], but not to buy S Corporation stock.
- Interest on land held for investment^[8] (no intent to develop).
- Interest expense paid on an investment in an entity which is a trader in stocks and bonds, if the investor does not materially participate^[9]

Note: Interest attributable to an S Corporation or partnership businesses in which the taxpayer materially participates is generally deductible without limitation. It is reflected on the back of Schedule E in the non-passive column. See Notice 89-35. If the taxpayer does not materially participate in a partnership or S-Corporation, interest expense is passive activity interest^[10], goes on Form 8582 line 3b, and is not deductible without passive income.

Issue Identification:

- Form 4952 line 4 income is generally composed of interest, dividends and short-term capital gains, which can be easily identified via Form 1040 lines 8 and 9 and Schedule D line 7. Investment *income* on Form 4952 line 4 is *not* income from any business, *nor* ordinary income from partnerships or S Corporations *nor* any kind of rental income. An adjustment to investment income generally produces a disallowance of investment interest expense, since investment interest expense is deductible only *to the extent of investment income*.
- Investment interest *expense* on Form 4952 line 1 is *not* interest expense traceable to a business in which the taxpayer does not materially participate *or* any rental activity. These are passive activities and passive activity interest goes on Form 8582. It does not matter if the passive activity is conducted through a partnership or S Corporation. Interest expense belongs on Form 8582 not Form 4952.

Investment Interest Examination Techniques

Examination Techniques:

Investment Income: For investment income, request a schedule detailing:

- The Form 1099-Misc, Schedule K-1s, or other supporting documents for interest, dividends, royalties and any other income claimed as investment income on Form 4952.
- The source of investment income on Form 4952 line 4a.

Reminder: Income from a rental activity **or** business, whether a partnership, S Corporation or other entity, is not investment income. Business income, whether passive or non-passive, is not investment income.

Exceptions: (1) working interests in oil and gas and (2) traders in stocks and bonds.

- Determine if investment income on line 4 of F4952 is reflected elsewhere on the return. Investment income is generally on Schedule B as interest and dividends and on Schedule D line 7 as short-term capital gains.

Reminder: investment income *must* be reported on the return. The Form 4952 does not report income. Investment income is not income from a business nor is it income from the sale of a business asset.

- If a capital gain election has been made on Form 4952 line 4e, **verify the same amount is also on Schedule. D line 22**. In other words, verify that the income has been taxed at ordinary rates. If there is no entry on

Schedule D line 22, the taxpayer has erroneously used the lower capital gain rate.

Investment Interest Expense

- Request Form 1099-Misc and Schedule K-1s supporting investment interest expense claimed on Schedule A line 13.
- Inquire what the purpose of the loan was. Ascertain that the interest expense was for loans used to buy CDs, stocks, bonds, annuities, or an investment in land. An investment in a rental activity or passive business (including those conducted via a partnership or S Corporation) is passive activity interest and belongs on Form 8582 line 1b or 3b, not on Form 4952.
- Frequently, Schedule K-1s from partnerships will reflect large amounts of interest expense designated as investment interest expense (Schedule K-1 line 14a for 2003 and prior years). By designating the interests expense as investment interest expense, that means the partnership borrowed monies to buy CDs, stocks, bonds, etc. If there is a large number on line 14a, the examiner may want to consider an examination of the partnership return in order to question what the loan proceeds were used for. An investment in another partnership or S Corporation generally is not property held for investment under IRC § 163(d).

Investment Interest Supporting Law

- **IRC § 163(d)(1):** Interest on loans to buy CDs, stocks, bonds, land (i.e. investment interest expense) is deductible only to the extent of investment income. Interest income is defined via reference to IRC § 469(e)(1).
- **IRC § 469(e)(1):** Portfolio income includes: Interest, dividends, annuities or royalties *not* derived in the ordinary course of a business. Gains on stocks, bonds, land, etc. *not derived in the ordinary course of a business*.
- **Reg. § 1.469-2(f)(10):** Permits income that is recharacterized as non-passive under *Reg. § 1.469-2T(f)(3)* [leased land], *(4)* [equity financed lending activities], and *(7)* [acquisition of entity engaged in licensing intangible property] to be treated as portfolio income, i.e. investment income. The regulation does not include self-rented income. Thus, income which is recharacterized under *Reg. § 1.469-2(f)(6)* is neither passive income nor investment income.
- **Reg. § 1.163-8T(a)(3):** Interest expense is allocated in the same manner as the debt to which the interest relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures.
- **IRC § 163(d)(3)(B):** Interest traceable to a rental or business, partnership, or S-Corporation in which the taxpayer does not work on a regular basis (passive activity) is not investment interest (does not go on Form 4952 line 1; instead it is reflected on Form 8582 1b or 3b).

- **IRC § 163(d)(4)(iii):** Investment income is also net long-term capital gain if the taxpayer elects (F4952 line 4e) to be taxed at ordinary rates as opposed to the lower capital gains rate. If no election, long-term capital gains are not investment income.
- **Reg. § 1.163(d)-1(b):** Election to treat long-term capital gains as investment income, and thus taxed at ordinary rates, must be made by due date of return (including extensions).
- **IRC 1§ 63(d)(4)(D)** Income from a rental or business (including those conducted via a partnership or S Corporation) in which the taxpayer does not work on a regular basis is **not** investment income.
- **Notice 89-35** Allocation of interest in connection with partnerships and S Corporations.

RENTAL OF PERSONAL RESIDENCE IN A NUTSHELL

Interest expense on the rental of a personal residence or second home^[11] is excepted from the passive loss rules under IRC § 469(j)(7). Other expenses attributable to the rental activity are still subject to all the passive loss rules. See checksheet on IRC § 469(j)(7) interest at end of chapter.

Furthermore, the personal use provisions of IRC § 280A override the passive loss limitations^[12]. If the taxpayer or relatives^[13] use the property at less than fair rental value for more than the greater of 14 days or 10 percent of the number of days rented at fair market value, then IRC § 280A applies and generally limits losses to net income. To the extent that the property was used personally, a pro rata share of interest and the full amount of taxes are permitted on Schedule A as itemized deductions.

Issue Identification:

- Watch for Schedule E rentals with the same or similar address as on the front of the return.
- Unusually low gross receipts during peak rental periods may indicate rental at less than fair market value or possible personal use.
- Property that has little or no advertising and was unrented for many weeks during the year may indicate high personal use.

Examination Techniques:

Inquire early in the examination as to whether the property was used personally by the taxpayers or relatives. Ask if anyone used the property at less than the standard rental rate, i.e. at less than fair rental value.

Documents to Request:

- Copies of any leases or rental agreements

- Detail regarding personal use by taxpayers, relatives or any other person at less than fair market value^[14] in order to calculate personal days versus days rented at fair market value.

Supporting Law:

- **IRC § 280A:** Disallows certain expenses in connection with business use of home, rental of vacation homes, etc.
- **IRC § 469(j)(10):** If a passive activity involves the use of a dwelling unit to which IRC § 280A(c)(5) applies for any taxable year, then any income, deduction, gain, or loss allocable to such use shall not be taken into account for purposes of this section for such taxable year.

Interest Issues

Under IRC § 469(j)(7), interest expense on the rental of a personal residence or second home is excepted from the passive loss rules. However, as with any personal residence interest^[15], it must be entered on Schedule A and is subject to the itemized deduction limitations^[16]. This provision does not permit the entire loss to be deducted without limitation; it only provides that interest is excepted from the passive loss limitations.

Issue Identification:

- Has qualified residence interest expense been placed on Schedule A where it is subject to various limitations? It is simply not deductible in another column on Schedule E.
- Is the rental truly the taxpayer's personal residence? A property in which the taxpayer has not lived in for years may no longer qualify as a residence.
- Watch for taxpayers who currently live overseas and rent their personal residence.
- Is the rental merely a *temporary* rental with no profit motive under IRC § 183? Therefore, no loss of any kind may be deducted.

Examination Techniques:

- Probe early in the examination as to whether the property is the taxpayer's principal or secondary residence.
- Verify via bank statements and/or cancelled checks that the interest was actually paid in the tax year deducted.
- Verify that qualifying interest has been properly reflected on Schedule A as an itemized deduction.

Documents to Request:

- Detailed explanations from the taxpayers regarding the use of their property as their principal residence.
- How often did the taxpayers visit the property?
- Did the taxpayers physically reside in the property during the year? Provide exact dates.
- Do the taxpayers file state tax returns where the property is located, have a car registered in that state, have a valid driver's license from that state?
- If the responses appear questionable or unreasonable, ask for documentation or third party statements to corroborate the taxpayer's oral testimony.

Supporting Law:

- **IRC § 469(j)(7) and Reg. 1.163-8T(m)(3):** Provides that passive activity losses will be computed without regard to qualified residence interest.
- **IRC § 163(h)(4)(A)(i):** Defines qualified residence interest as either a principal residence or a second residence.
- **Stolk 40 T.C. 345, affirmed 326 F.2d 760 (2nd Circumstance 1964)** The taxpayer moved out of his principal residence two years prior to its sale, and the Court held that the property did not qualify as his principal residence.
- **Friedman TC Memo 1982-178** The Court held that a residence used by the taxpayer only during the summer months cannot qualify as a principal residence.

Net Operating Losses

Unlike passive losses, a NOL can be carried back 2 years and forward 20 years for 2003^[17] and can offset portfolio income as well as wages and other non-passive income. An important audit step is to verify that a purported NOL is not, in fact, a passive loss. The chart below addresses the carryback and carryforward rules for various years.

| NOL Year Ending | Carryback Years | Carryforward Years |
|-----------------|-----------------|--------------------|
| 2003 | 2 | 20 |
| 2001 – 2002 | 5 | 20 |
| 8/6/97-2000 | 2 | 20 |
| Prior 8/6/1997 | 3 | 15 |

A loss from a passive activity which cannot be used due to the passive loss limitations must be carried forward indefinitely^[18] until there is passive income or an entire disposition of the activity in a fully taxable transaction^[19]. In other words, if a taxpayer has a loss from a passive activity and no other passive income to offset it against, the loss cannot be carried back, but instead is

suspended until a future year when the taxpayer has passive income or disposes of the activity.

On a qualifying disposition of a passive activity under IRC § 469(g), triggered prior year losses can create an NOL. If, however, the sale is to a related party^[20] or there is not a fully taxable transaction, losses remain passive and cannot create an NOL.

A regular NOL carryforward can offset **any** income. However, a PAL carryforward can offset **only** passive income. In the event that both a regular NOL and a suspended loss from a passive activity are carried forward into the same year, the PAL carryforward is applied first against passive income before the regular NOL is applied.

Passive losses allowed in excess of passive income due to the special \$25,000 rental real estate allowance can become part of the taxpayer's NOL, which is carried back 3 years or forward 15 years.

Working Interests in Oil And Gas Property

OIL AND GAS

The passive loss limitations do not apply to an oil and gas activity in which the taxpayer has a working interest^[21] if the entity does not limit his liability^[22]. As a practical matter, this means if the taxpayer is a general partner or owns his interest in an oil and gas activity via a joint venture^[23], his liability will not be limited. The passive loss limitations do not apply. Losses or income will be non-passive.

On the other hand, if the taxpayer is a limited partner, LLC member, or S Corporation shareholder, his liability is limited, and he is fully subject to the passive loss rules. He must prove that he materially participates, i.e. works on a regular, continuous and substantial basis in oil and gas operations before losses will be deductible. See Chapter 4 on material participation, IRC § 469(h), and Reg. § 1.469-5T(a).

Trading Personal Property for an Owner's Account

TRADERS IN STOCKS AND BONDS

If a partnership or S Corporation is actively trading^[24] property such as stocks or bonds for the account of the taxpayer/owner, the losses (or income) are non-passive under Reg. § 1.469-1T(e)(6). Neither income nor losses belong on Form 8582. Even if the taxpayer is a limited partner, he may deduct losses from a partnership which trades in stocks and bonds on his account. Losses from an

entity which trades in stocks and bonds belong in the non-passive column of Schedule E.

Income from a trading partnership should not be on Form 8582 line 3a. Trading activities are not passive activities. Thus the income, even if the taxpayer performs no work, cannot be passive income. Clues the entity may be a trading activity: name containing "investment", "equity", "securities", "financial", "hedging", "XXX fund", etc. Furthermore, most trading partnerships use 523900 as the business code in block C on Form 1065.

CASUALTY LOSSES

Casualties Losses

Even though an activity is passive, casualty losses are permitted if the casualty requirements in IRC § 165 are met. Reg. § 1.469-2(d)(2)(xi) states that a casualty as defined in IRC § 165(c)(3) will not be treated as a passive deduction^[25].

Losses not compensated by insurance^[26] can be deducted only up to the amount allowable under IRC 165. While tax law permits a loss to the extent of FMV before and after the casualty, losses are limited to the taxpayer's *adjusted basis*.

In some cases, there may actually be a taxable gain: insurance proceeds less adjusted basis = gain.

A casualty loss (business or nonbusiness) is limited to the *lesser* of:

- Difference between FMV before and after casualty; **OR**,
- Adjusted basis (cost less depreciation)^[27]

A personal casualty is also subject to a \$100 floor AND 10 percent AGI limitation^[28].

Low Income Housing Losses

LOW INCOME HOUSING

For current years, low income housing *losses* are subject to the passive loss limitations just like any other rental real estate activity. The exceptions for credits provided for in IRC § 469(i)(3)(C) and § 469(i)(6)(B) do not apply to LIH losses. For information on the LIH credit, see chapter 10.

The taxpayer must actively participate to qualify for the \$25,000 offset. Furthermore, the \$25,000 special allowance is phased out at the rate of 50 cents for every dollar over MAGI of \$100,000. If AGI exceeds \$150,000, no LIH losses may be deducted (unless he has passive income). As many investors are limited

partners, and limited partners do not qualify for the active participation standard^[29], losses for limited partners should be entered on FORM 8582 line 3b (not line 1b). Thus, no \$25,000 offset is available, and losses are deductible only up to passive income reported on the return.

Audit Tip: Some taxpayers automatically place *any* rental activity on Form 8582 line 1. For LIH losses to be entered on line 1, a taxpayer must actively participate. The IRC § 469(i) provides that limited partners do not actively participate. Examiners should carefully scrutinize Form 8582 line 1b (or worksheet 1) to verify that LIH losses have not been improperly entered there. Entering LIH losses from limited partners on line 1b (instead of 3b where they belong) erroneously permits deductibility of up to \$25,000 in losses against wages and portfolio income. Examiners should also verify that an LIH loss has not been deducted in the non-passive column of Schedule E.

Summary

- An investment in a partnership or S Corporation generally does not generate investment interest. If the activity is a rental or is a business in which the taxpayer does not materially participate, interest belongs on Form 8582. It is passive activity interest.
- Interest expense attributable to a rental of the taxpayer's residence is not subject to the passive loss limitations. It belongs on Schedule A and is subject to the itemized deduction limitations.
- On disposition, prior year passive losses can create an NOL.
- Losses attributable to working interests in oil and gas activities generally are fully deductible. They are excepted from the passive loss rules.
- Income or losses from a trading partnership that trades on the partner's account are not passive activities and should not be on Form 8582.
- Casualty losses are not subject to the passive loss limitations.
- Low income housing losses are fully subject to the passive loss limitations (unless the taxpayer is a real estate professional who materially participated in the LIH activity). However, even a limited partner may take the LIH credit to the extent of the tax equivalent of \$25,000.

^[1] Reg. § 1.469-2(a)(2)(ii) and Reg. § 1.469-2(d)(2)(x)

^[2] Reg. § 1.469-2T(d)(3), 1.163-8T(a)(4)(B) and Notice 89-35

^[3] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v)

^[4] Reg. § 1.469-1T(e)(6)

^[5] IRC § 163(d)

^[16] Reg. § 1.469-2(f)(10) and Reg. § 1.469-2T(f)(3)

^[17] IRC § 469(e)(1)

^[18] IRC § 469(e)(1)(A)(ii)(II)

^[19] IRC § 163(d)(5)(A)(ii)

^[10] Reg. § 1.469-2T(d)(3), § 1.163-8T(a)(4)(B) and Notice 89-35

^[11] Qualified residence interest under IRC § 163(h)(3)

^[12] IRC § 469(j)(10) and § 280A(c)(5)

^[13] IRC § 280A(d)(2)(A) and § 267(c)(4)

^[14] IRC § 280A(d)(2)(C)

^[15] Reg. § 1.163-8T(m)(3), IRC § 163(h)(4)(A), IRC § 280(d)(1)

^[16] Total home acquisition debt cannot exceed \$1,000,000 (500,000 if MFS) - IRC § 163(h)(3)(B)(ii). Total home equity debt cannot exceed \$100,000 (\$50,000 if MFS). Interest which goes over these limits is nondeductible personal interest. Home equity debt is limited to the *smaller* of (1) the \$100,000 threshold or (2) the amount that the residence's FMV exceeds the home acquisition debt. The \$1,000,000 and \$100,000 dollar thresholds apply to the *combined* mortgages on the primary and second residence. There is a 3 percent phaseout for most itemized deductions. Home mortgage interest expense is limited if AGI is more than \$126,600 (for 1999), 132,950 (2001), 137,3000 (2002), 139,500 (2003).

^[17] IRC § 172 ; also see IRS Pub. 536

^[18] IRC § 469(b)

^[19] IRC § 469(g)

^[20] IRC § 469(g)(1)(B)

^[21] Reg. § 1.469-1(e)(4)(iv) defines "working interest" as a working or operating mineral int in any tract or parcel of land with the meaning of § 1.612-4(a).

^[22] IRC § 469(c)(3) and Reg. § 1.469-1T(e)(4)(v) (v)

^[23] Oil and gas joint ventures are generally reflected on Schedule C

^[24] Reg. § 1.469-1T(e)(6)(ii) and § 1092(d)

^[25] Same information in Notice 90-21, 1990-1 C.B. 332.

^[26] IRC § 165(a)

^[27] Reg. § 1.165-7

^[28] IRC § 165(h)

^[29] IRC § 469(i)(6)(C)

Exhibit 7.1: Investment Income And Investment Interest Expense

LAW: Under IRC § 163(d) interest on debt on property held for investment is limited to net investment income. Investment income is only income defined in IRC § 469(e)(1), i.e. generally portfolio income. Additionally, it is reduced by investment expenses. It is not business income (other than working interests in oil and gas and traders in stocks and bonds) nor rental income. Furthermore, after 1992 investment income generally does not include long-term capital gains from the sale of investment property unless the taxpayer elects to forego the lower capital gains rate. Also see Reg. § 1.163-8T on interest tracing and Notices 89-35, 88-37 and 88-20 relating to passive activity interest.

INVESTMENT INCOME:

Investment income includes interest, dividends, royalties, annuities, short-term capital gains, and long-term capital gains (if election on line 4e).

_____ **Verify via review of Schedule K-1s, Form 1099-Misc., etc. that Form 4952 line 4 (investment income) does not include business income or rental income.** Whether the business or rental is on Schedule C/E, Form 4797 or a flow through from a partnership, S Corporation or trust, income generally is not investment income. If investment income on Form 4952 is also on the back of Schedule E in the non-passive column, it is strong indicator that the taxpayer erroneously used ordinary business income as investment income. Investment income is portfolio income as defined in IRC § 469(e)(1) (interest, dividends, royalties, annuities, short-term capital gains, and long-term capital gains if election on Form 4952 line 4e to tax at ordinary rates.

Reminder: Investment interest is deductible only up to investment income.

LAND: Income from leased land is also treated as investment income (Reg. § 1.469-2(f)(10) and § 1.469-2T(f)(3)) This income goes on Form 4952, but should not be on Form 8582 line 1a as it is non-passive under Reg. §1.469-2T(f)(3).

PTPs: Net income from PTPs (also known as master limited partnerships) is investment income. See Notice 88-75.

_____ **Verify income on line 4a does not include capital gains from the disposition of business property (Schedule D flowing from Form 4797) nor income from a business, whether in the form of a sole proprietorship, partnership or S Corporation nor distributions from mutual funds.** Verify that investment income is only interest, dividends, annuities, royalties, and short-term capital gains, etc. Beginning with the 1993 tax year, if capital gains are included in investment income on line 4, that income must be taxed at ordinary income rates. Taxpayer loses the benefit of the lower capital gain rate for capital gains on Schedule D. The amount on Form 4952 line 4e should also be on

Schedule D line 22 reducing the amount available for the lower capital gain rate. Furthermore, capital gains on Form 4952 line 4e should be gains from stocks, bonds or other securities. Capital gains from the sale of any business asset or interest in a rental property are not investment income. If gain flows from Form 4797, it should not be on Form 4952.

_____ **Verify that line 4 of Form 4952 does not include capital gains from rentals nor any other passive activity.** Since gain on disposition of rentals is passive income, it cannot be used as investment income. See Reg. § 1.163(d) & 1.469-2T(c).

_____ **Verify that line 4b does not contain any income that was reflected on Form 4797.** The Form 4797 is for the sale of business assets. The Form 4952 reflects income from investments.

_____ **Verify that investment income has been reduced by losses from working interests in oil and gas activities** (Schedule C or E). IRC § 163(d)(1) provides that investment interest shall not exceed *net* investment income. The IRC 163(d)(5)(A)(ii) provides that property held for investment includes a business which is not a passive activity and taxpayer does not materially participate. A working interest in oil and gas fits this criteria IRC § 469(c)(3).

_____ **Verify that investment income has been reduced by losses from partnership and S Corporations that trade in stocks and bonds and other securities on the owner's account.** Check for Schedule E non-passive losses from Form 1065s with names such as XXX Equities, XXX Mutual Funds, XXX Investors – all of which are generally traders in stocks and bonds. While those losses are excepted from the passive loss limitations under Reg. § 1.469-1T(e)(6) the losses are nothing more than investment expenses that reduce investment income. The IRC § 163(d)(5)(A)(ii) provide that property held for investment includes a business that is not passive and in which the taxpayer does not materially participate. Traders in stocks and bonds fall into the investment interest rules because IRC § 163(d)(5)(A)(ii) defines property held for investment as any interest in a business which is not a passive activity and in which the taxpayer does not materially participate. Trading is a business. It is not a passive activity under Reg. § 1.469-1T(e)(6). Most limited partners do not materially participate. In other words, traders fit squarely within the definition in IRC § 163(d)(5)(A)(ii). The IRC § 163(d) repeatedly uses the term net investment income. Investment income and losses must always be netted to determine the amount of net investment income. Furthermore, IRC § 163(d)(4) (A) explains that the term net investment income means the excess of investment income over investment expenses.

_____ **Verify that income reflected on line 4 of Form 4952 has been reported on Schedule B, D or E.** The Form 4952 is a computational form only, limiting

the amount of investment interest deductible as an itemized deduction on Schedule A. It does not report income.

_____ **Verify via review of Schedule K-1s, Form 1099-Misc., etc. that income Form 4952 line 4 does not include any passive income**, i.e. income that would properly belong on Form 8582. Passive income is income from a rental activity or from a business in which the taxpayer does not materially participate.

_____ **Verify that *only* income recharacterized under Reg. § 1.469-2T(f)(3) (land), (4) or (7) has been used as investment income.** See Reg. § 1.469-2T(f)(10). Income from self-rented property, for example, which is recharacterized under Reg. § 1.469-2T(f)(6) is not investment income.

_____ **Verify that income has been reduced by investment expenses** (costs directly connected with production of investment income). Also verify that investment expenses have not been deducted on Schedule C.

_____ **Verify that investment income on Form 4952 has not also been entered on Form 8582 lines 1a or 3a as passive income.** Investment income is never passive income, and passive income is not investment income. The same type of income should never be entered on both Form 4952 and Form 8582. IRC § 163(d)(4)(D)

_____ **Verify that self-charged interest income from loans to related parties on Form 8582 lines 1a or 3a** (which has been recharacterized as passive income under the provisions of Reg. 1.469-7) **has NOT** also been **entered on Form 4952** as investment income, erroneously triggering deductions for investment interest expense. The IRC § 163(d)(4)(D) specifically states that investment income does not include any income taken into account in computing passive losses. Since investment interest expense is deductible only up to investment income, removing self-charged interest income from F4952 will result in automatic adjustments to investment interest expense.

_____ **Verify that capital losses including loss carryovers have been used to *reduce* capital gains.**

_____ **Via review of Schedule D line 22, verify that ordinary rates** (versus lower capital gain rates) **were used for any amount of Form 4952 line 4e.** In other words, the amount elected as investment income is subtracted on Schedule D from the amount which receives the preferential capital gains rate (20/10 percent). Instead it is taxed as ordinary income, i.e. potentially as high as 39.6 percent.

INVESTMENT INTEREST EXPENSE

_____ **Tie Schedule K-1s and Form 1099-Misc. substantiating interest Form 4952, line 1.**

_____ **Verify via loan documents, etc., that interest expense is for monies borrowed to buy investments that produce interest, dividends, royalties or annuities.** It is not interest expense to purchase a business or rental property. See § 163(d) and § 469(e)(1). Investment interest expense is NOT interest to purchase an "investment" in a partnership or S Corporation. If entity is a rental, interest goes on Form 8582 line 1b or 3b. If the taxpayer does not materially participate (work on a regular basis-IRC § 469(h), Reg. § 1.469-5T(a)) in the entity, interest expense goes on Form 8582 line 3b. If the taxpayer materially participates in business, interest is deductible on back of Schedule E.

_____ **Verify via review of Schedule K-1s that the taxpayer has not included any interest expense from a rental property or other passive activity** (partnership, S Corporation or business without material participation - regular, continuous and substantial). Interest from passive activities is reflected on Form 8582, but is not reflected on Form 4952. Even interest on a loan to purchase stock in a passive activity carries a passive taint under the tracing rules and should be entered on Form 8582 lines 1b or 2b (not on F4952). Notices 89-35, 88-37, 88-20. Under the interest tracing rules in Reg. § 1.163-8T, interest allocable to a passive activity remains passive even in years after disposition of the activity. It is not investment interest because it is allocated to a passive activity expenditure. See Reg. § 1.469-2T(d)(3) and § 1.163-8T(a)(4)(B) & (b)(4).

_____ **Verify that the taxpayer has not included tax exempt interest (IRC § 265(a)(2) Ex. municipal bond interest) nor any interest that should be capitalized,** such as construction interest subject to

IRC § 263A.

ADJUSTMENT: Remove incorrect expense or income from Form 4952 and recalculate. Remove passive interest or income from Form 4952 and enter on Form 8582, PAL Limitation, and recalculate Form 8582. If there is no passive income, the taxpayer will receive no current tax benefit from his passive interest. It will be carried forward to subsequent years until he has passive income. If passive income was erroneously entered on Form 4952, verify that it has been properly reported on Schedule E or elsewhere. Make any other adjustments based upon your examination and recalculate Form 4952.

Exhibit 7.2: IRC § 469(j)(7) - Interest On Rental Residence

ISSUE: Is interest expense on Schedule E deductible under IRC § 469(j)(7)? The IRC § 469(j)(7) and Reg. § 1.163-8T(m)(3) provide that passive activity losses will be computed without regard to qualified residence interest as defined in IRC § 163. A "qualified residence" as defined by IRC § 163(h)(5)(A)(i) is either a principal residence or a second residence.

NOTE: Qualified residence interest belongs on Schedule A and is therefore subject to the itemized deduction limitations.

_____ **Verify that property is taxpayer's "principal residence".** Reg. § 1.163-10T(p)(2) indicates that principal residence means principal residence as defined by IRC §1034. The taxpayer cannot have more than one principal residence at any one time. In *Stolk V. Comm.*, 40 TC 345 , the taxpayer moved out of his principal residence two years prior to its sale, and the Court held that the property did not qualify as his principal residence. Similarly, in *Friedman v. Comm.*, T.C. Memo 1982-178, the Court held that a residence used by the taxpayer only during the summer months cannot qualify as a principal residence.

If property is taxpayer's principal residence, skip the next step.

If it is not the taxpayer's principal residence, continue on.

_____ **Verify that property is taxpayer's "second residence".** If property is rented, Reg. § 1.163-10T(p)(3)(ii) states that it qualifies as a residence only if taxpayer used it personally for the greater of 14 days or 10 percent of days rented (IRC § 280A(d)).

QUESTION: How many days did you spend at the rental property during the year?

NOTE: In virtually all cases, box 2 on Schedule E has been checked NO, indicating that the taxpayer fails the requirements of IRC § 280A(d). Therefore, the property does not qualify as a second residence. If box 2 is YES and taxpayer spends more than 14 days, losses are limited IRC § 280A, i.e. expenses deductible up to rental income.

_____ **Verify via review of bank statement and/or cancelled check that interest was actually paid in year deducted.** If taxpayer fails qualified residence test OR cannot verify interest, disallow losses. If he passes, go to next step.

_____ **Verify that interest expense qualifying under IRC § 469(j)(7), i.e. qualified residence interest, has been properly reflected on Schedule A as**

an itemized deduction. Some taxpayers have moved interest to another column on Schedule E, avoiding the itemized deduction limitations.

LAW: Qualified residential interest is claimed as an itemized deduction from adjusted gross income. The IRC §161 provides that deductions permitted by subtitle A, Ch. 1, Subchapter B, Part VI (itemized deductions), including interest deductions under 163, are taken in computing taxable income under 63. Therefore, it is improper for qualified residence interest to be claimed on Schedule E as a deduction from AGI.

CONCLUSION: Under IRC § 469(j)(7) and § 163(h)(5)(A)(i), taxpayer has/has not (circle one) verified the deductibility of qualified residence interest from property rented on Schedule E. **OR**

A personal residence is subject to the itemized deduction limitations on Schedule A, including the 3 percent phaseout for high income taxpayers. The IRC § 469 does not override other IRC sections. It is merely one of several IRC sections, which limit losses on a tax return. While § 469(j)(7) excepts qualified residence interest from the passive loss limitations, nowhere does the IRC, Regulations, or legislative history state or imply that home mortgage interest is not subject to the itemized deduction limitations. To the contrary, Reg. §1.469-1T(d) specifically provides that the application of IRC § 469 does not affect the treatment of items under any provision of the IRC other than IRC § 469. In other words, the mere fact that IRC § 469 permits deductibility does not mean that other IRC sections may not limit the interest expense. Qualified residential interest is claimed as an itemized deduction from adjusted gross income. The IRC §161 provides that deductions permitted by subtitle A, Ch. 1, Subchapter B, Part VI (itemized deductions), including interest deductions under 163, are taken in computing taxable income under 63. Therefore, it is improper for qualified residence interest to be claimed on Schedule E as a deduction from AGI. There is nothing in the language of the IRC, Regulations or committee reports to suggest that personal residence interest from a rented residence should be excepted from itemized deductions.

Chapter 8: Activities (Grouping Rules)

In a Nutshell

If related businesses form an appropriate economic unit, entities may be grouped as a **single** activity, making it easier to meet the 500-hour test. The taxpayer needs to show he materially participates in the grouped activity as a whole. A sole proprietorship (Schedule C or F), C or S Corporation, partnership or LLC may be grouped into one single activity *if the businesses form an appropriate economic unit*. See Reg. § 1.469-4.

An “activity” is not constrained by entity lines. If the taxpayer spends 500 hours among the grouped businesses, even though in different entities, he materially participates in all. The entire 500+ hours could be spent all in one business entity or could be spread among several related entities. See checksheet at end of chapter.

It is important to note that Reg. § 1.469-4(a) only provides for grouping of businesses (or rentals). Businesses generally may not be grouped with rentals. Land or buildings held for investment may not be grouped. And, of course, no personal activity or portfolio activity belongs in the grouping.

It is possible that several different activities may exist within a single entity. **Example:** two unrelated businesses or a business and a rental activity within a single partnership.

The temporary regulations expired in 1992. The Reg. § 1.469-4T cannot be relied upon for current years. All rules and definitions for what constitutes an activity are in Reg. § 1.469-4, which is in final format.

Five Factors

The Reg. § 1.469-4 provides a facts and circumstances approach to determine whether two or more activities form an appropriate economic unit for the measurement of gain or loss. Five factors^[1] are given significant weight:

1. Similarities and differences in the types of businesses.
2. Extent of common control.
3. Extent of common ownership.
4. Geographical location.
5. Interdependencies between or among the activities.

Not all factors are necessary. The determination as to whether related entities form a single activity is made based on all the facts and circumstances. In a realistic sense, are the entities interrelated, integrated businesses?

Audit Techniques

- On examination, taxpayers may argue that, while they do not materially participate in an entity, it forms an economic unit with another business. Early in the examination, it is important to determine what the taxpayer's activities are. In the initial Information Document Request (IDR), ask the taxpayer to explain any grouping under Reg. § 1.469-4, why the grouping is appropriate, what the nature of each entity or activity is, and when the grouping decision was made. If each activity is a separate activity, request an affirmative statement in writing to that effect.
- Look for any rentals in a grouping. As discussed later in the chapter, a rental generally may not be grouped with a business (Reg. § 1.469-4(d)(1)).
- Secure as many prior year returns as possible and peruse them for inconsistencies between passive and non-passive. Particularly, in income years, some taxpayers classify the activity as passive. At a minimum a three-year comparison of passive and non-passive income and losses is suggested. The consistency requirement is discussed later. The fluctuation between passive and non-passive could be due to the annual test for material participation. However, it could also be a significant indicator that each entity was treated as a separate activity or of inconsistent treatment.

Rentals

The Reg. § 1.469-4(d)(1) prohibits grouping a rental activity with a trade or business unless:

- Either is insubstantial in relation to the other; **OR**,
- The owner has the same proportionate interest in the rental as in the business^[2].

Grouping real property and personal property rentals is also prohibited unless the personal property is provided in connection with the real property.

Audit Techniques:

- Ensure that the taxpayer is not erroneously mixing a rental with a business activity, i.e. using a rental loss to offset business income on Schedule C or F.
- Look for rental losses which might have been erroneously entered on Schedule E in the non-passive column. Even if owned via a partnership or S Corporation interest, rentals generally retain their passive taint.

Limited Partners

A limited partnership interest (or limited entrepreneur) generally may be grouped with other activities which form an appropriate economic unit. However, a limited partnership interest in any of the following types of businesses may not be grouped with another business unless it is the same type of business and the two form an appropriate economic unit^[3]:

- Motion picture films or videotapes
- Farming
- Leasing IRC § 1245 property (personal property)
- Exploring for or exploiting oil and gas
- Exploring for or exploiting geothermal deposits

C Corporations

A personal service corporation or closely held C Corporation may be part of the grouping that forms an appropriate economic unit^[4].

Partnerships and S Corporations

If an entity contains more than one business or rental activity, it must group or separate activities. Once the entity groups its activities, the investor may group those activities with each other, with activities he conducts himself or with activities conducted through other entities – as long as the grouped businesses form an economic unit, i.e. they are integrated interrelated activities. See Reg. § 1.469-4(d)(5).

Consistency Requirement

The Reg. § 1.469-4(e) imposes a consistency requirement. Once the taxpayer has selected his grouping, he must use that same grouping in future years unless the original group is clearing inappropriate or there is a material change in facts and circumstances.

A decision *not* to group, i.e. to treat each activity separately, *is a grouping decision*. This decision generally should have been made starting in 1994 when Reg. § 1.469-4 was finalized or, if subsequent to that date, at the time the activity was first reflected on a return. A taxpayer cannot pick and choose each year what his grouping is. The taxpayer must maintain the grouping he originally chose under the consistency rules in Reg. § 1.469-4(e).

Audit Technique:

In the IDR, ask:

- Has each activity on the return been treated as a separate activity under Reg. § 1.469-4 [appropriate economic unit rules]? If so, please provide a statement to that effect.
- If the Schedule C business or partnership interest or S Corporation interest has been grouped with another business OR rental activity under Reg. § 1.469-4, please provide a written explanation of the grouping and why it is appropriate. If activities or entities were grouped under Reg. § 1.469-4, in what **year** were they grouped?
- If there are tax workpapers or other documentation supporting your grouping, please provide them. If you have no documentation from prior years on your grouping decision, please state so.

Anti-Abuse Provision

The anti-abuse provision in Reg. § 1.469-4(f) permits the Commissioner (examiner) to regroup businesses if:

The taxpayer's grouping is not an appropriate economic unit; **and**,

One of the primary purposes of the taxpayer's grouping is to circumvent the underlying purposes of IRC § 469.

To illustrate, the regulations provide an excellent example in Reg. 1.469-4(f)(2). In this example, a limited partnership (formed by five doctors, each of whom were limited partners) produced net income. Because it formed an economic unit with the doctors' practices and the purpose was to circumvent IRC § 469, the Government could group the two businesses as a single activity, with the result that income from the partnership was deemed non-passive.

Practical Note: If the examiner wishes to regroup the taxpayer's activities under the anti-abuse rule, document the following facts as fully as possible:

- The factors indicating the two businesses form an economic unit: related businesses, same customers, etc.
- All facts indicating an attempt to circumvent IRC § 469. Probably the most common factor is that, in the absence of the purported passive income, passive losses would be nondeductible.

Supporting Law

- **IRC § 469(c):** The term passive *activity* means any business in which the taxpayer does not materially participate. It also generally includes any rental or leasing activity, regardless of the taxpayer's participation.
- **IRC § 469(c)(2) & (4):** In general, all rentals are passive whether or not the taxpayer materially participates.

- **IRC § 469(h):** A taxpayer must work on a regular, continuous and substantial basis in the operations of an activity in order to meet the material participation standard. *If the taxpayer can group two or more businesses as a single activity, it will be easier to meet the 500-hour test for material participation.*
- **Reg. § 1.469-4T:** Contains the temporary grouping rules for related businesses and rentals. These regulations expired on 5/11/92. If the taxpayer cites any provision in Reg. § 1.469-4T, he is citing old law which has no applicability for years after 1992.
- **Reg. § 1.469-4:** Contains the final regulations for grouping businesses and/or rentals. Reg. § 1.469-4 governs current years and was effective for 1994 and subsequent years. Sole proprietorships, farms, partnerships, S Corporations, personal service corporations and closely held C Corporations may be grouped as a single activity if they form an appropriate economic unit, i.e. they form integrated interrelated business activities. Grouping makes it easier for the taxpayer to meet 500 hour test for material participation. An activity is not an entity. It is an integrated interrelated economic unit, which could be comprised of more than one entity. A single entity also may contain more than one activity, i.e. several different and distinct activities.
- **Reg. § 1.469-4(c):** Entities may be grouped as a single activity if the form an appropriate economic unit. Factors: similarities; common control; common ownership; geographic location; interdependencies.
- **Reg. § 1.469-4(d)(1):** Rental real estate or equipment leasing activities may not be grouped with a business unless insubstantial or owned in the same proportionate ownership interest.
- **Reg. § 1.469-4(d)(3):** Limited partners involved in motion pictures, videotapes, farming, exploring or exploiting oil and gas, and exploring or exploiting geothermal deposits may group with another activity ***only if it is in the same line of business.***
- **Reg. 1.469-4(d)(5)(ii):** A C Corporation may be grouped with another activity only for purposes of determining whether the taxpayer materially or significantly participates in the other activity.
- **Reg. § 1.469-4(e)(2):** The taxpayer may change his grouping *only if the original grouping was clearly inappropriate* or there has been a material change in the facts and circumstances that makes the original grouping inappropriate. If the taxpayer wants to change his grouping, he must prove that the grouping in prior years was clearly inappropriate.
- **Reg. § 1.469-4(f)** The Commissioner may regroup the taxpayer's activities if they do not form an appropriate economic unit and a principal purpose is avoidance of the passive loss limitations.

Summary

- The five factors indicating that activities form an economic unit are: similarities, common control, common ownership, location, and interdependencies.
 - A rental may not be grouped with a business unless it is owned in the same percentage as the business or it is insubstantial in relation to the business.
 - Limited partners in IRC § 465(c)(1) activities may not group with other activities, unless in the same line of business.
 - The PSCs and closely held C Corporations may be grouped with other businesses, but only to determine material participation.
 - An examiner may regroup business acts, including treating income producing activities as separate activities, to prevent abuse of the grouping rules.
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^[1] Reg. § 1.469-4(c)(2)

^[2] A rental is permitted to be grouped under the same ownership rule only if it is leased to the business activity in the grouping. See Reg. § 1.469-4(d)(1).

^[3] Reg. § 1.469-4(d)(3) and IRC § 465(c)(1)

^[4] Reg. § 1.469-4(d)(5). Note that Reg. § 1.469-4(d)(5)(ii) permits a C Corporation to be grouped only for the purposes of determining whether the taxpayer materially or significantly participates.

Exhibit 8.1: Activities (Grouping Entities)

ISSUE: Does the grouping form an appropriate economic unit? In other words, in a realistic sense, does the grouping form an interrelated, integrated economic unit? Taxpayers may group related business entities into one single activity in order to meet the 500 hour test for material participation in Reg. § 1.469-5T(a)(1). Conversely, some taxpayers may attempt to separate inherently related activities in an attempt to create purported passive income which would trigger otherwise unallowable passive losses. In abusive situations, particularly with passive income, the Government may regroup activities to prevent the taxpayer from circumventing IRC § 469.

LAW: Under Reg. § 1.469-4, if businesses form an economic unit, the taxpayer may group Schedule C/F, C or S Corporation and partnerships/ LLCs into a **single** activity. Rentals may not be grouped with a business unless owned in identical percentages as the business **or** insubstantial in relation to the business.

_____ **At the initial appointment or first IDR, ask if entities were grouped. Request statement as to how activities are grouped, which entities or undertakings are grouped, and why they form an appropriate economic unit.**

_____ **If the taxpayer states that he has grouped activities, ask when the grouping decision was made and request tax workpapers or other documents addressing the entities grouped.** While not absolutely critical to the issue, the failure to provide any written documentation generated at the time of return filing (either in current or prior years) is an indicator that taxpayer did not group his activities. In other words, each activity is separate. The decision to group or not group is **not** made at the time of an audit. It is a decision which generally should have been made in 1994 or in the year the interest in the activity was acquired, whichever is later. The Reg. § 1.469-4(e) contains a consistency requirement from year to year and provides that taxpayer may not regroup (unless original grouping was inappropriate or there is a material change). The Reg. § 1.469-4(g) does not permit losses to be deducted under the "substantially all" provision unless the taxpayer can establish amount of deductions and credits allocable to that part of the activity. Obviously, in both instances, it is critical to know what constitutes the "activity".

_____ **Separate businesses from:**

1. Any rental or leasing activity
2. Portfolio activities (stocks, bonds, securities, etc.)
3. Land held for investment (IRC § 469(e)(1)(A)(ii)(II))

_____ **Verify the grouping forms an appropriate *economic* unit based on:**

__ Similarities __ Location __ Ownership __ Common control and

__ Interdependencies (purchase or sell goods between themselves, involve products or services that are generally provided together, the same customers, the same employees, or use a single set of books and records to account for the activities).

Not all factors are necessary, and there is no factor which is required to be present. Instead, the appropriateness of the grouping should be based on all the facts and circumstances. It is important that examiner address the 5 factors and anything else that points to the appropriateness or inappropriateness of the grouping

_____ **Ensure the taxpayer has not grouped rentals with businesses unless:**

- Insubstantial; OR,
- Owned in the **same** percentage and the rental is leased to the business.

_____ **Verify that limited partners in IRC § 465(c)(1) activities** (equipment leasing, farming, etc.) **have not been grouped unless in the same line of business.**

_____ **Ensure that the grouping was not to circumvent the passive loss limitations.** Have similar businesses been treated as *separate* activities in order to create passive income? If so, under the anti-abuse provisions, the Commissioner can regroup. Scrutinize carefully any entity which produces purported passive income, but is related or in the same line of business as other *non-passive* activities. See example in Reg. § 1.469-4(f)(2).

_____ **Review prior and subsequent year returns for passive and non-passive losses and income to verify that the same grouping has been used consistently.** Do a comparative analysis of three years (or more) on an entity by entity basis. Reg. § 1.469-4(e) provides that once the taxpayer has grouped activities he cannot regroup in subsequent years unless the original grouping was clearly inappropriate or a material change makes the original grouping inappropriate.

_____ **To verify material participation, request written documentation, explaining the activities performed and hours the taxpayer applied to each entity.** Also, inquire how much time the taxpayer applies to his rental activities, on portfolio activities, on hobbies, on vacation, etc. See Log at end of Chapter 4.

_____ **Always inquire whether the spouse is involved in business activities, which ones, and how much time.** Both spouses' time counts. Furthermore,

one spouse's participation is attributed to the other spouse. Even if the spouse does nothing, if the other spouse materially participates, income or losses are non-passive. See IRC § 469(h)(5) and Reg. § 1.469-5T(f)(3)

_____ If the taxpayer argues on audit that he is grouping entities, some which were listed as passive and some which were listed as non-passive, check the Form 8582 worksheets to see if each entity was listed separately.

If so, it is an indicator that taxpayer did not group. Page 8 of the Instructions for Form 8582 advise the taxpayer to enter income and losses **for each activity** for columns (a), (b) and (c). The instructions clearly state that each activity should be entered (not each entity). Proper allocations are important to determine the correct gain on disposition and because there is a consistency requirement for groupings.

CONCLUSION: In accordance with Reg. § 1.469-4, the taxpayer's businesses have/have not been properly grouped.

NOTE: If the taxpayer is a real estate professional as defined in IRC § 469(c)(7), to group rentals, he **MUST** file a **timely written** election with his return. See Reg. § 1.469-9(g) and Reg. § 1.469-11(a)(3).

Chapter 9: Credits

In A Nutshell

Credits generated by a rental activity or by a business in which the taxpayer does not materially participate are generally subject to the passive loss limitations. Passive losses are first applied against passive income; passive activity credits are limited to the tax equivalency of remaining passive income (tax attributable to remaining passive income). As a practical matter, often there is no remaining passive income to offset passive activity credits. Credits generated by rental real estate activities, most notably the LIHC, are eligible for the \$25,000 special allowance^[1]. See LIH checksheet at end of the chapter. The disposition rules under IRC § 469(g) do not apply to credits.

Issues

- Most credits generated by passive activities are classified as passive credits and thus deductibility of the credit is limited to passive income.
- Credits are applied against passive income on a tax equivalency basis.
- Credits in excess of passive income cannot be deducted upon disposition.

Issue Identification

- Identify the origin of all credits taken on the back of the Form 1040, looking for passive activity credits which may have been deducted without considering the passive activity credit limitations in IRC § 469.
- Review Form 8582 and 8582CR for passive loss and credit calculations.
- Examine the taxpayer's Schedule K-1s and information on the return for credit detail.
- Remember that the passive loss and credit rules apply to individuals, trusts, estates, and PSC; and to a lesser extent, to closely held C Corporations.

Types of Credits

Most credits that originate with a passive activity are subject to the passive loss limitations. Passive activities include:

1. Rentals; and,
2. Businesses where the taxpayer does not materially participate.

Credits from rental activities typically include the LIHC and the rehabilitation credit. Credits from business activities can include any of the following: investment credit, work opportunity credit, credit for alcohol used as a fuel, credit for increasing research activities, enhanced oil recovery credit, disabled access credit, renewable electricity production credit, empowerment zone employment

credit, Indian employment credit, credit for employer social security and Medicare taxes paid on employee tips, orphan drug credit, credit for contributions to community development corporations, non-conventional source fuel credit, or qualified electric vehicle credit.

Exception: The foreign tax credit is not subject the limitations in IRC § 469^[2].

Examination Techniques:

Review and determine the origin of any credit taken. Determine whether any credit is a passive credit.

Check Form 8582CR to see if passive activity credits have been limited.

Application of Credit

Credits are subject to an ordering rule. First, passive losses are offset against passive income. Then, to the extent any passive income remains, passive credits are allowed against the *tax equivalent* of remaining passive income. For example, a taxpayer in the 28 percent tax bracket with \$9,000 in passive credits also has \$8,000 in passive income and \$6,000 in passive losses. The allowable credit is computed as follows:

| | |
|-------------------------------|-------------------------|
| Passive Income | 8,000 |
| Less: Passive Losses | (6,000) [applied first] |
| Remaining Passive Income | 2,000 |
| Passive Income Tax Equivalent | 560 [2,000 x 28%] |
| Passive Credit Allowed | 560 |
| Disallowed credit | 8,440 [9,000 less 560] |

If the credits are from rental real estate, credits will also be allowed up to any remaining \$25,000 offset after passive losses. Above is a simplified example. The Form 8582CR provides detailed instructions and a worksheet for calculating the tax equivalency of passive income available for passive credits.

Examination Techniques:

- If passive losses exceed passive income, passive credits are not allowable – except for the low income housing and rehabilitation credit, which are permitted to the extent of the remaining \$25,000 offset.
- Make sure that Line 6 of Form 8582-CR includes only the tax equivalent of net passive income (after subtracting losses), not total passive income. Income on line 6 should be carefully scrutinized. Often little, if any passive income remains after passive losses.

- Verify that the same passive income was not used twice once on Form 8582 and again on Form 8582-CR. Income is entered on Form 8582 lines 1a, 2a and 3a. The tax attributable to passive income (i.e. tax equivalent of passive income) is entered on Form 8582-CR on line 6.

Special Rental Real Estate Allowance

The \$25,000 special allowance for rental real estate activities applies when passive losses and credits exceed passive income (See Chapter 2). Thus, low income housing and rehabilitation losses or credits *may* use the special \$25,000 offset if certain requirements are met. The \$25,000 is available only to individuals and is subject to phase-out limitations based on modified adjusted gross income.

For low income housing credits or rehabilitation credits, the active participation requirement *does not apply*.^[3] Result: these credits automatically qualify for the \$25,000 allowance.

The \$25,000 allowance is subject to phase-out provisions based on MAGI. For LIH rental activity losses, the phase-out range is the regular \$100,000-150,000. For rehabilitation credits, however, the phase-out range is \$200,000-250,000. For LIH credits, the phase-out range does not apply. For the phase-out, the \$25,000 allowance is reduced \$1 for every \$2 that the MAGI exceeds the \$100,000 (or \$200,000 for the rehabilitation credit). See Chapter 2 for more detail. The chart below summarizes these rules:

| Issues | LIH Credits | LIH Rental RE Losses | Rehab Credits | Other Credits |
|--------------------------------------|----------------|---|-----------------------|----------------|
| \$25,000 offset available? | Yes | Yes | Yes | Yes |
| Active participation required | No | Limited Partner cannot be active Yes | No | Does not apply |
| Phaseout range | Does not apply | \$100,000 - \$150,000 | \$200,000 - \$250,000 | Does not apply |

The \$25,000 special allowance is absorbed in the following order:

1. Losses from rental activities with active participation;
2. Rehabilitation credit (tax equivalent); and,
3. Low income housing credit (tax equivalent)

Rental losses of real estate professionals are excepted from the passive loss limitations *if* the taxpayer materially participates in the rental. Since many

investors in LIH are limited partners, it is important to recognize that it is unlikely that the taxpayer who is a limited partner will rise to material participation.

Examination Techniques:

- Review LIH losses closely since the taxpayer may erroneously believe that losses are treated the same as credits. A limited partner or the taxpayer with less than a 10 percent interest cannot be active⁴¹. Thus, losses go on Form 8582 line 3b and receive no \$25,000 offset. Check Schedule K-1s.
- The aggregate amount of total losses and credits (tax equivalent) are limited to \$25,000. The taxpayer is entitled to only one \$25,000 offset for all rental losses *and* credits in each tax year.
- Check the non-passive column on the back of Schedule E to verify that LIH losses have not been entered there erroneously, thereby avoiding the passive loss rules.

Dispositions

While IRC § 469(g) permits losses to be deducted upon disposition, passive credits may not be deducted under this provision even if the disposition is fully taxable and was made to an unrelated party! Instead, the taxpayer may elect to increase the basis of the disposed property by any unused credits (IRC § 469(j)(9)). The election is made by completing Form 8582-CR, Part VI. Absent the election, unused credits must be carried forward to future years in which passive income is available.

Examination Techniques:

- For any disposition activity, make sure the credits were not deducted. IRC § 469(g) triggers losses, but not credits.
- Look at Form 8582-CR, Part VI, to see whether an election has been made to use credits to increase basis.
- Remember that passive activity income must exist in order for the taxpayer to deduct the tax equivalent of passive credits, even in the year of disposition.

Supporting Law

- **IRC § 469(a)(1)(B):** Passive activity limitations apply to credits generated by rentals and businesses in which the investor does not materially participate.
- **IRC § 469(d):** Passive activity credits are deductible only to the extent of the tax allocable to (tax equivalency) passive income.

- **IRC § 469(i)(6)(B):** Low income housing credits and rehabilitation credits do not require active participation to qualify for the \$25,000 special allowance. Even a limited partner can use the tax equivalent of \$25,000.
- **IRC § 469(j)(9):** Passive credits are not deductible on disposition. An election may be made to increase the basis of the disposed property.

Summary

- Most credits generated by passive activities are subject to the passive loss limitations with the exception of the foreign tax credit.
- A passive activity credit is generally deductible only to the extent of the tax equivalent of passive income which remains after all passive losses are absorbed. Excess unused passive income after passive losses are absorbed is converted to the amount of tax that the passive income would generate. The tax equivalent of remaining passive income permits deductibility of passive activity credits.
- The tax equivalent of any \$25,000 offset which remains after being absorbed by rental real estate losses permits deductibility of the LIH and rehabilitation credits.
- A passive activity credit is not deductible on disposition of a passive activity. The taxpayer may make an election to add the unused credit to basis.

^[1] IRC §469(i)(3)

^[2] IRC § 469(d)(2)(A)(ii) excludes IRC § 27(a) from the passive loss limitations.

^[3] IRC § 469(i)(6)(B)

^[4] IRC § 469(i)(6)(A)&(C)

Exhibit 9.1: Low Income Housing And Passive Loss Limitations

LAW: Low income housing partnerships are rental activities and are therefore subject to the limitations of IRC § 469, the passive loss rules. The LIH LOSSES and low income housing CREDITS are each treated differently. See IRC § 469(i)(6)(B). For current years, LOSSES are generally subject to the passive loss limitations - just like any other rental real estate activity. Limited partners do not qualify for the \$25,000 offset; thus losses are deductible only up to passive income reported on the return. The IRC § 469(i)(6)(B) provides an exception for low income housing CREDITS. There is no participation requirement. Thus, even a limited partner may use the low income housing CREDIT. Furthermore, for current tax years, there is no phaseout of the credit based on MAGI. Therefore, a taxpayer with any amount of income may use the credit. However, the credit is limited to the *tax equivalent* of \$25,000. Furthermore, LIHC are only allowed IF any \$25,000 offset remains after rental losses and the rehabilitation credit. Beginning in 1994, there is an exception for a qualifying real estate professional. Under IRC § 469(c)(7), if he materially participates in the LIH project, current losses and credits are fully deductible.

NOTE: The LIH *credit* is reflected on Form 8586, Low-Income Housing Credit, which is carried to Form 8582-CR, which is carried to Form 3800, General Business Credit, which is ultimately carried to Form 1040. The LIH *losses* from limited partners should be entered on Form 8582 line 3b, and, if allowable due to passive income, would be carried to the back of Schedule E, the passive loss column.

For taxpayers claiming to be real estate professionals, complete the following two steps.

If the taxpayer is not a real estate professional, SKIP first two steps.

_____ **Verify that the taxpayer qualifies as a real estate professional** (spends more than half his personal services in real property businesses and more than 750 hours a year – IRC § 469(c)(7)(B)). A real estate professional is a taxpayer who spends the majority of time on REAL PROPERTY businesses. See IRC § 469(c)(7) & Reg. § 1.469-9.

_____ **If the taxpayer is a real estate professional, verify that he materially participated** (Reg. § 1.469-9(e)(1) & Reg. § 1.469-5T(a)) in the activity generating the low income housing losses and credits. Since many investors are limited partners (see Schedule K-1), they will not meet the material participation standard - unless a timely written election was filed with the return to group ALL rentals as one activity. If the taxpayer does not materially participate, losses are entered on Form 8582 line 3b and credits should be on Form 8582-CR.

If taxpayer is a qualifying real estate professional AND materially participates in the LIH partnership, STOP! LIH losses and credits are fully deductible. The low income housing credit will not be limited by the passive loss limitations. However, as a practical matter, many investors are limited partners and do not materially participate.

LIH CREDIT ISSUES:

_____ **Verify LIH credits on Forms 8586 and 3800 are on Form 8582CR.** The LIH credits are most often on FORM 8582-CR line 3.

_____ **Review Form 8582-CR and verify that the low income housing credit has been limited to the tax equivalent of \$25,000.**

_____ **Verify that income on Form 8582-CR line 6 is *not* the tax equivalent of the same amount of income on Form 8582,** i.e. a duplication! The same amount of income cannot be used both on Form 8582 for losses and Form 8582-CR for credits. Legitimate passive income from any source will trigger deductibility of low income housing losses and credits. However, passive *losses* first absorb passive income, followed by certain passive credits, the rehab credit and, lastly, the LIHC.

_____ **Verify LIHC have not been deducted on disposition.** Passive credits may be claimed only in future years when there is passive income (after absorbing passive losses) OR the taxpayer may elect to increase his basis in the property by any unused credits.

_____ **Verify that the taxpayer has computed the *tax equivalent* of passive income on Form 8582-CR line 6.** In other words, verify that the taxpayer has not entered the exact dollar amount of passive income from his documentation, but instead has computed the *tax equivalent* at his tax bracket. Form 8582-CR instructions provide good information.

_____ **Verify that the taxpayer has not improperly deducted credits on disposition of the LIH activity.** The taxpayer may elect to increase the basis on the LIH property by completing Form 8582-CR Part VI OR he must continue to carry forward the credit until he has passive income or the \$25,000 offset.

LIH LOSS ISSUES:

_____ **Verify that losses have been properly reflected on Form 8582 line 3b.** Because many investors are limited partners and limited partners do not qualify for the active participation standard under IRC 469(i), losses should be entered on FORM 8582 line 3b (not line 1b which would erroneously give taxpayer benefit of the \$25,000 offset). Thus, LIH losses will not be deductible -

unless the taxpayer has passive income on FORM 8582 line 1a or 3a OR an entire disposition.

_____ Verify that losses have not been erroneously deducted in the non-passive column on the back of Schedule E.

Exception: A qualifying real estate professional may be able to deduct LIH losses IF he materially participated in the LIH activity (Reg. § 1.469-9(e)(1)) . Many investors are limited partners, and thus will not meet the material participation standard. The IRC § 469(c)(7) and § 469(h).

Exhibit 9.2: Passive Loss Credit Decision Tree

Decision Tree

Is the credit a foreign tax credit?

If **yes**, the credit is not subject to the passive activity limitations.

Is the credit any of the following:

- Investment credit
- Rehabilitation credit
- Low income housing credit
- Credit for increasing research
- Credit for alcohol used as fuel
- Work opportunity credit
- Renewable electricity production credit
- Disabled access credit
- Enhanced oil recovery credit
- Credit for employer social security and Medicare tax paid on employee tips
- Indian employment credit
- Empowerment zone employment credit
- Nonconventional source fuel credit
- Credit for contributions to community development corporations
- Orphan drug credit
- Qualified electric vehicle credit

If **yes**, is it attributable to a rental real estate activity. If so, the credit is deductible to the extent of the tax equivalent of any remaining \$25,000 special allowance. Exception: credits attributable to rental real estate of a real estate professional, if the taxpayer materially participated in the rental activity.

If **yes**, is the credit attributable to a trade or business in which the taxpayer did not materially participate. If so, the credit is not deductible, unless the taxpayer has passive income. If there is excess passive income after passive activity losses, the credit is deductible to the extent of the tax equivalency of remaining passive income.