Limitations on Losses and Credits

General Rules. Generally, losses from passive activities may not be deducted from nonpassive income (for example, wages, interest, or dividends) (Code Sec. 469). Similarly, tax credits from passive activities are generally limited to the tax allocable to those activities. In determining a taxpayer's allowable loss, the at-risk rules are applied before the passive activity loss rules.

Generally, to the extent that the total deductions from passive activities exceed the total income from these activities for the tax year, the excess (the passive activity loss) is not allowed as a deduction for that year. A disallowed loss is suspended and carried forward as a deduction from the passive activity in the next succeeding tax year (Reg. § 1.469-1(f)(4)). Any unused suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity in a fully taxable transaction (Code Sec. 469(g)).

Special rules apply to rental real estate activities in which a taxpayer actively participates. Losses and credits that are attributable to limited partnership interests are generally treated as arising from a passive activity (Code Sec. 469(h) (2)).

Activities Held Through Partnerships or S Corporations. Activities are first grouped by partnerships or S corporations at the entity level (Reg. § 1.469-4 (d) (5)). If appropriate, a partner or shareholder should further combine these activities with other activities outside the entity.

Rental Activities. Rental activities are grouped according to the "appropriate economic unit" standard (Reg. § 1.469-4(c)). A rental real estate activity may not be combined with an activity involving the rental of personal property (Reg. § 1.469-4(d)(2)).

Combining Trade or Business and Rental Activities. A rental
activity may not be grouped with a trade or business activity unless either the rental activity is insubstantial in relation to the trade or business activity or the trade or business activity is insubstantial in relation to the rental activity (Reg. § 1.469-4 (d) (1) (i)). Under the regulations, if each owner of the trade or business has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property to a trade or business activity may be grouped with the trade or business activity (Reg. § 1.469-4(d) (1) (i) (C)).

Partial Disposition of Activity. If the taxpayer disposes of substantially all of an activity, he may treat the interest disposed of as a separate activity, provided that he can establish the amount of gross income, deductions and credits allocable to that part of the activity for the tax year (Reg. § 1.469-4 (g)). This provision is designed to allow taxpayers to claim suspended passive losses even though they have not disposed of their entire interest in an activity.

Passive Activity Defined. A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate (Code Sec. 469(c)). Any rental activity is a passive activity whether or not the taxpayer materially participates. However, there are special rules for real estate rental activities and real estate professionals.

Trading personal property that is actively traded, such as stocks and bonds, for the account of owners of interests in the activity is not a passive activity. For example, the activity of a partnership that trades stock using money contributed by the partners is not a passive activity (Temp. Reg. § 1.469-1T(e) (6)).

Material Participation. Generally, to be considered as materially participating in an activity during a tax year, an individual must satisfy any one of the following tests:

(1) the individual participates more than 500 hours;

(2) the individual's participation constitutes substantially all of the participation in the activity;

(3) the individual participates for more than 100 hours and this participation is not less than the participation of any other individual;

(4) the activity is a "significant participation activity" and the individual's participation in all significant participation activities
exceeds 500 hours;

(5) the individual materially participated in the activity for any five years of the 10 years that preceded the year in question;

(6) the activity is a "personal service activity" and the individual materially participated in the activity for any three years preceding the tax year in question; or

(7) the individual satisfies a facts and circumstances test that requires the individual to show participation on a regular, continuous, and substantial basis for more than 100 hours during the tax year (an individual's participation in managing the activity does not count toward the 100-hour requirement if any other person received compensation for managing the activity or any other person spent more time managing the activity (Temp. Reg. § 1.469-5T(a))).

Limited Partners. Losses and credits attributable to limited partnership interests are treated as arising from a passive activity unless the limited partner participated for more than 500 hours, the limited partner materially participated in five of the 10 preceding tax years, or the activity is a personal service activity in which the limited partner materially participated for any three preceding tax years. A general partner who also holds a limited partnership interest is not treated as a limited partner (Code Sec. 469(h) (2); Temp. Reg. § 1.469-5T(e)).

Special rules are also provided for determining the material participation of limited partners (Temp. Reg. § 1.469-5T(e) (2)), certain retired or disabled farmers (Temp. Reg. § 1.469-5T(h) (2)), and personal service and closely held corporations (Temp. Reg. § 1.469-1T(g) (2) and (g) (3) (i)).

Significant Participation Activity. A significant participation activity is one in which the taxpayer participates more than 100 hours during the tax year but does not materially participate under any of the other six tests set forth above (Temp. Reg. § 1.469-5T(c)).

Personal Service Activity. A personal service activity involves the performance of personal service in (1) the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial services, the performing arts, or consulting or (2) any other trade or business in which capital is not a material income-producing factor (Temp. Reg. § 1.469-5T(d)).
**Definition of Participation.** Generally, any work done by an individual with respect to an activity that the individual owns an interest in is treated as participation (Reg. § 1.469-5(f) (1)). However, participation does not include work that is not customarily done by an owner if one of the principal purposes for performing the work is to avoid the passive activity limitations (Temp. Reg. § 1.469-5T(f) (2) (i)).

**Spouse’s Participation.** In applying the material participation tests, an individual's participation includes his spouse's participation even if the spouse does not own an interest in the activity and separate returns are filed (Temp. Reg. § 1.469-5T(f) (3)).

**Participation as an Investor.** Work done in an individual's capacity as an investor in an activity, such as studying and reviewing the activity's financial statements and operational reports, preparing summaries or analyses of the activity's finances or operations for personal use, and monitoring the finances or operations of the activity in a nonmanagerial capacity, is not counted as participation (Temp. Reg. § 1.469-5T(f) (2) (ii)).

**Proving Participation.** Participation may be established by any reasonable means. It is not necessary to maintain contemporaneous daily records of participation. An approximate number of hours of participation may be based on appointment books, calendars, or narrative summaries (Temp. Reg. § 1.469-5T(f) (4)).

**Rental Activities (Real Estate)**

**Special Rules for Rental Activities.** In general, a rental activity is treated as a passive activity (Code Sec. 469(c) (2)). An activity is a "rental activity" if (1) during the tax year, tangible property held in connection with the activity is used by customers or is held for use by customers, and (2) the gross income of the activity represents amounts paid mainly for the use of the tangible property (Temp. Reg. § 1.469-1T(e) (3) (i)). However, if any one of the following tests is met, the activity is not considered to be a rental activity for purposes of the passive loss rules:

(1) the average period of customer use of the property is seven days or less.

(2) the average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the
owner,

  (3) without regard to the period of customer use, extraordinary personal services are provided by or on behalf of the owner;
  
  (4) the rental of the property is incidental to a nonrental activity,
  
  (5) the property is customarily made available during defined business hours for the nonexclusive use of customers; or
  
  (6) the taxpayer provides property for use in an activity that is conducted by partnership, S corporation, or joint venture in which the taxpayer owns an interest and the activity is not a rental activity (Temp. Reg. § 1.469-IT(e) (3) (ii)).

**Active Participation in Rental Real Estate Activity.** There is a limited exception to the passive loss rules in the case of losses from rental real estate in which the taxpayer or the taxpayer's spouse actively participates (Code Sec. 469(i)). The exception is available only to individual taxpayers or their estates for tax years ending less than two years after the date of death. The estate qualifies during this period if the decedent actively participated before his death (Code Sec. 469 (i) (4) (A)).

The active participation standard is less stringent than the material participation standard. An individual may meet the active participation requirement if he participates in the making of management decisions (for example, approving new tenants, deciding on rental terms, approving expenditures) or arranges for others to provide services (for example, repairs) in a significant and bona fide sense. The requirement for active participation applies in the year in which the loss arose as well as the year in which the loss is allowed under the $25,000 allowance rule. However, real estate professionals may be able to treat rental property activities as nonpassive activities.

Under this exception, up to $25,000 of passive losses and the deduction equivalent of tax credits that are attributable to rental real estate may be used as an offset against income from nonpassive sources (for example, dividends and wages) each year. To be eligible for this exception, the individual must own at least a 10% interest of all interests in the activity throughout the year. The interest of an individual's spouse is taken into account in determining 10%
ownership (Code Sec. 469(i)(6)). This $25,000 maximum amount is reduced, but not below zero, by 50% of the amount by which adjusted gross income exceeds $100,000.

"Adjusted gross income" is computed for purposes of this exception by disregarding: taxable social security and railroad retirement benefits, the exclusion for qualified U.S. savings bonds used to pay higher education expenses, the exclusion for employer adoption assistance payments, passive activity income or loss included on Form 8582, any overall loss from a publicly traded partnership, rental real estate losses allowed to real estate professionals, deductions attributable to domestic production activities, deductions for contributions to IRAs and pension plans, and the deductions for one-half of self-employment tax, interest on student loans, and higher education expenses (Code Sec. 469(i)(3)(E)). The $25,000 is completely phased out when modified adjusted gross income reaches $150,000 (Code Sec. 469(i)(3)).

Separate Returns. For married taxpayers who file separate returns and live apart, up to $12,500 of passive losses may be used to offset income. This amount is reduced by 50% of the amount by which the taxpayer's modified adjusted gross income exceeds $50,000. The special allowance is completely phased out when modified adjusted gross income reaches $75,000. Married taxpayers who file separately and live together at any time during the tax year are not eligible for the special allowance (Code Sec. 469(i)(5)).

Real Estate Professionals. Certain real estate professionals may be able to treat rental real estate activities as nonpassive (Code Sec. 469(c)(7)). To qualify, (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during the tax year must involve real property trades or businesses in which the taxpayer (or the taxpayer's spouse) materially participates, and (2) the taxpayer must perform more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer (or the taxpayer's spouse) materially participates. These two requirements must be satisfied by one spouse if a joint return is filed. Assuming that the requirements for the exception are satisfied, the passive, activity loss rules are not applied.

Personal services performed as an employee are not taken into account for purposes of (1) and (2) unless the employee owns more
than a 5-percent interest in the employer.

A real property trade or business is a business with respect to which real property is developed or redeveloped, constructed or reconstructed, acquired, converted, rented or leased, operated or managed, or brokered (Code Sec. 469(c) (7) (C)).

The exception for real estate professionals is applied as if each interest of the taxpayer in rental real estate is a separate activity. However, a taxpayer may elect to treat all interests in rental real estate as a single activity for purposes of satisfying the material participation requirements.

A closely held corporation qualifies as a real estate professional if more than 50 percent of its annual gross receipts for the tax year are from real property trades or businesses in which it materially participates.

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