PASSIVE ACTIVITY LOSSES

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INTRODUCTION

Several Internal Revenue Code sections restrict expense and loss deductions. I.R.C. § 469 generally bars using losses from rental activities and passive business activities to reduce the taxable income generated by nonpassive business activities and portfolio investments.

This "Passive Activity Losses" chapter includes four learning objectives. The expectation is that after completing this session, participants will be able to perform the following job-related actions:

1. Describe three key tax law provisions that can defer loss deductions.
2. Explain the difference between active participation and material participation for the passive activity rules.
3. Apply the material participation tests to determine whether a trade or business activity is passive or nonpassive.
4. Determine if a loss becomes fully deductible when a taxpayer disposes of an interest in a passive activity.

LOSS LIMITATION FRAMEWORK

Several other federal tax law limitations that may prevent or postpone an expense or loss deduction must be considered before the passive activity rules are applied.

The Internal Revenue Code's approach to deductions is similar to baseball rules. In baseball, the batter's objective is to score runs. In tax compliance, the taxpayer's objective is to deduct all

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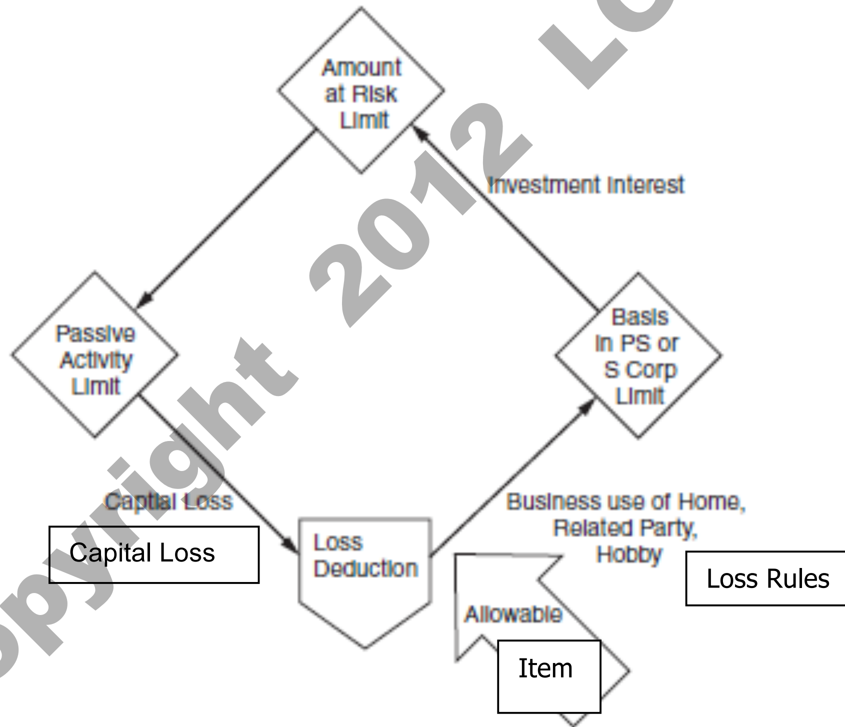
expenses and losses. Before a batter scores in baseball, he or she must touch all the bases. Before a taxpayer "scores" in tax, he or she must satisfy each deduction limitation.

Figure XX.1 illustrates some of the hurdles a deduction must clear. To begin the analogy, a taxpayer can "step up to the plate" only if he or she incurs an expense that is specifically allowable as a deduction—in general, those incurred in a trade, business, or investment activity. An expenditure that is made strictly for personal purposes or that is a gift does not even make it to this point.

Moreover, a loss or deduction cannot head for first base if it is stopped by the tax equivalent of a strike-out—the hobby loss, business use of home, or related-party loss disallowance rules. If the deduction cannot clear these restrictions, it will not be allowed, and no other limit is relevant.

Cross-Reference
Related-Party and Other "Strike-Out" Rules
See the xxxxxxxxxx National Income Tax Workbook for more information about the related party, hobby loss, and business use of home rules.

Figure XX.1 Ordering of Loss Limitations



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Running the Bases

"First base" represents the basis limitations that apply if the taxpayer's loss or deduction flows from a partnership, limited liability company (LLC), or S corporation.

If the activity is not owned through one of these entities, a potential deduction runs straight to second base. In most cases, an activity that moves toward second has a clear shot at scoring. If the deduction is for investment interest, however, the investment interest limit may catch the deduction between bases.

"Second base" represents the at-risk limitation. For owners of pass-through entities, the at-risk limit may be the same as the basis limitation. However, the at-risk limit occasionally causes a problem in the cases of seller-financing and activities that are not held in a pass-through entity.

"Third base" represents the passive activity loss (PAL) limit that applies to passive trade or business activities and to rental activities. Portfolio investments and the related deductions, such as investment interest or capital losses on the disposition of portfolio assets, are not subject to this restriction. Similarly, trade or business deductions and losses from an activity in which the taxpayer materially participates do not risk disallowance at this point.

When heading for "home plate," the capital loss limitation is the last cutoff. An individual's capital loss deduction from other income in any year is generally limited to recognized capital gains plus $3,000 ($1,500 if married filing separately), with any excess amount carried forward.

Tax Benefit after Running Bases

An allowable loss deduction does not necessarily confer a tax benefit. The U.S. tax system does not automatically confer a tax refund on a person with negative taxable income.

- If taxable income for the year is still positive after a deduction is allowed, there is a tax benefit from the reduced amount of tax due.
- If taxable income is negative, a tax benefit can be realized only through the net operating loss (NOL) rules. These rules allow a taxpayer to use an excess loss from one tax year as a deduction in a prior or future tax year.

Finally, the taxpayer must use the "instant replay feature" of the alternative minimum tax (AMT). This shadow taxing system generally applies the same limitations inherent in the regular income tax, but it requires different measures for each restriction.

FIRST BASE: BASIS RULES

Losses flowing from a partnership or S corporation are deductible only to the extent that the owner has tax basis in the entity. This section provides a quick overview of basis computation.

First base in the loss-deduction diagram is basis, where owners of pass-through entities may be tagged out. Losses incurred by a partnership or an S corporation are potentially deductible by the business's owners to the extent of the partner's or shareholder's basis. Basis cannot be reduced below zero. Losses in excess of basis are carried forward by the owner until basis is increased in the future. Although both entities use similar rules for passing through income, gains, deductions, and losses, the basis rules diverge.

S Corporation Shareholder Basis

A shareholder's basis in an S corporation includes stock basis and debt basis in loans from the shareholder to the corporation [I.R.C. § 1366(d)(1)]. Other corporate-level debt does not increase shareholder basis in the corporation.

Pass-through deductions and losses, as well as distributions to shareholders, decrease basis. Since 1997, distributions reduce basis before losses are considered. Any loss that is not deductible because of the basis limitation is carried forward to the next tax year—it does not expire, and it may be deducted when the shareholder gains sufficient basis to absorb it.

Basis is increased by flow-through income and gains and by the shareholder's contributions to the corporation.

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An S corporation loss or deduction must meet the general rules for deductibility before the basis limitations are considered. Thus, the item must not be barred by public policy (such as government fines and penalties), the accrual-method economic performance test, the related-party disallowance rules, or the personal expenditure or association with tax-exempt income limits.

The hobby loss and business use of home tests apply at the corporate level; if the corporation does not pass these tests, the loss or deduction cannot pass through to the shareholders.

Partner and LLC Member Basis

In concept, the outside basis rules for partners are similar to those for S corporation shareholders. However, some fundamental differences arise from the entirely different economic relationship between a partnership and its partners, compared to the relationship of a corporation and its shareholders.

Practitioner Note

Tax Classification of LLCs

Because there is no LLC entity in the Internal Revenue Code, an LLC must choose its federal tax treatment. Most domestic LLCs with more than one member are taxed as partnerships (their default classification). Most single-member LLCs are treated as disregarded entities (proprietorships, branches, or divisions that do not file separate federal income tax returns).

Either a multiple-member or a single-member LLC can elect to be treated as a corporation pursuant to Treas. Reg. § 301.7701-3 (commonly called the "check-the-box" regulation). If otherwise eligible, these LLCs can elect to be treated as S corporations for tax purposes.

However, most multiple-member LLCs are treated as partnerships, so this book generally includes LLCs and their members when it refers to partnerships and their partners.

A partner's basis begins with the partner's basis in the property the partner contributes to the partnership. However, partners also have basis (proportionately to their partnership interests) in the partnership's debts to outside lenders. An attractive feature of the partnership has been the partners' ability to leverage basis by including a share of the partnership's liabilities in their outside basis.

Except for the treatment of liabilities, the increases and decreases to basis for partners and LLC members are similar to the treatment of S corporation shareholders—basis is increased by pass-through income and gains; it is decreased by pass-through deductions, losses, and distributions.

The hobby loss and business use of home rules do not apply at the entity level for partnerships. However, losses that pass through to the partner are tested for these limits at the partner level.

Cross-Reference

Computation of Basis

See the xxxxxxxxxx National Income Tax Workbook for more detailed information about shareholder and partner basis computations.

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SECOND BASE: AMOUNT AT RISK

The I.R.C. § 465 at-risk rules can bar a current deduction even if the taxpayer has sufficient basis for it.

Getting to first base required clearing the hobby loss, business use of home, and related-party hurdles. When there is enough basis to allow a deduction, the potential loss or expense deduction can head for second base and the next obstacle—the amount at risk.

Practitioner Note
Investment Interest Expense Deduction

Taxpayers with investment interest expense face a special limitation en route to second base. I.R.C. § 163(d) limits the investment interest expense deduction to the amount of the taxpayer's net investment income. The excess carries forward to be treated as investment interest expense incurred in the next year. There is no limit on the number of years a disallowed expense can be carried forward.

Taxpayers Affected

The at-risk limits apply to individuals, estates and trusts, and closely held corporations (those in which five or fewer individuals own more than 50% of the corporation's outstanding stock at any time during the last half of the corporation's tax year). The limits do not apply directly to partnerships, LLCs, or S corporations, but each individual partner, member, or shareholder must determine the amount that he or she has at risk in the entity. A partner or shareholder applies the at-risk test to a flow-through loss from an entity-level activity only after applying the basis limit.

The at-risk rules cover any trade or business or investment activity. Deductions or losses are limited to the taxpayer's amount at risk in that activity. Any excess losses are suspended until there is an increase in the amount at risk. The suspended deductions or losses are a carryforward, but there is no carryback provision.

Investment interest expenses must clear the investment interest expense limit hurdle before they are measured against the amount at risk. For passive activities, however, the at-risk rules apply before the limits on passive losses. There is no apparent rationale for this difference in treatment.

At-Risk Amount Defined

A taxpayer's amount at risk includes money contributed to the activity and debts for which the taxpayer is personally liable. If the taxpayer who is not personally liable for a debt pledges property not used in the activity as security for the debt, the property's fair market value (FMV), reduced by any superior liens, is an amount at risk. Pledging property that is used in the activity does not increase the amount at risk, and any loan from a co-venturer in the activity does not give the borrower an amount at risk [I.R.C. § 465(b)].

Observation
At-Risk Amount Often Equals Basis

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

The IRS may look through an entity to its owners to determine whether the lender is a co-venturer. In *Riggs v. Commissioner*, T.C. Memo. 1992-323, a 50% shareholder in an S corporation borrowed money from another corporation that was wholly owned by the other 50% shareholder, using her stock in the S corporation as collateral for the loan. She was held not to be at risk with respect to the borrowed amounts. The IRS did not claim that the taxpayer lacked basis in her stock—only the at-risk limit was contested. The Tax Court reached a similar conclusion in *Van Wyk v. Commissioner*, 113 T.C. 440 (1999).

Example XX.1 At-Risk Amount Less Than Basis

Terri Towe acquired $100,000 of stock in TRS, an S corporation, by investing $10,000 of her own money and borrowing $90,000 from TRS. Her basis is $100,000, but her at-risk amount is only $10,000.[ENDOFEXAMPLE]

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Adjustments to At-Risk Amount

Many of the adjustments to an amount at risk are similar to the adjustments made to basis.

A taxpayer's amount at risk can be increased by

1. additional contributions of cash or property,
2. income produced by the venture and allocated to the taxpayer,
3. a loan refinancing that changes a nonrecourse loan to a recourse loan, and
4. the gain recognized when the taxpayer disposes of his or her interest in the activity [Prop. Treas. Reg. §§ 1.465-12(a) and 1.465-66(a)].

Note that the fourth item is a complete departure from the basis rules.

The amount at risk is decreased by

1. an investor's withdrawal of cash or property, and
2. a change in an investor's share of losses, such as refinancing of a recourse loan with a nonrecourse loan.

The taxpayer's amount at risk cannot be below zero. If a decrease will create a deficit, the taxpayer must recapture losses deducted in earlier years to bring the at-risk amount back up to zero [I.R.C. § 465(e)(1)].

Practitioner Note

Difference Between Loss Limitations

Little attention has been paid to the at-risk rules since enactment of the PAL rules. However, some taxpayers are surprised by the differences among the basis, at-risk, and PAL rules.

A U.S. district court case highlighted the distinction between the basis and at-risk limits. An S corporation shareholder recognized gain on the disposition of his stock. He had zero basis in the stock and losses in excess of his basis. He properly reported the gain, which increased his amount at risk. However, he and his CPA assumed that the gain was also an increase in basis. The IRS disagreed, disallowing about $200,000 of the claimed ordinary loss. The court agreed with the IRS, holding that there I.R.C. §§ 1366 and 1367 did not provide an increase in basis for gain on disposition of stock. Thus, there was no opportunity to deduct the excess losses that had been suspended [*Miller v. U.S.,* 39 F. Supp. 2d 678 (N.D. W.Va., 1999)]. Because the shareholder did not materially participate in the corporation's business activities, the gain did create income for I.R.C. § 469 purposes, but the deduction was still thrown out at first base.

The taxpayer and his CPA claimed to have relied on professional commercial tax preparation software that included the stock redemption gain in calculating basis. The court noted that a software program error does not entitle a taxpayer to a deduction.

Cross-Reference

Computation of At-Risk Amount

See the xxxxxxxxxx National Income Tax Workbook for more detailed information about computation of an amount at risk.

THIRD BASE: PASSIVE ACTIVITY LIMITS

The passive activity rules limit current loss deductions when taxpayers do not invest much personal time or effort in a trade or business venture. The rules also restrict most rental activity deductions, regardless of the taxpayer's time commitment.

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Third base is represented by the passive activity loss and credit limits. I.R.C. § 469 was a major provision of the Tax Reform Act of 1986 (Pub. L. No. 99-514) that spawned approximately 300 pages of complex regulations.

Rules Defer Loss Deductions

The passive activity rules can be extremely complex, but the key concept is quite simple. A taxpayer cannot claim a deduction for net losses incurred in a passive activity unless and until the taxpayer meets one of three criteria:

1. The taxpayer has income in the same year from other passive activities.
2. The taxpayer has income in a subsequent year from the same activity or other activities subject to the passive loss rules.
3. The taxpayer disposes of his, her, or its entire interest in the activity in a fully taxable disposition to an unrelated person or entity.

Taxpayers Affected

The passive activity loss rules apply to

- individuals
- estates
- trusts
- personal service corporations, and
- closely held C corporations.

Income Baskets

Figure XX.2 illustrates the three *baskets* (categories) of income and losses that a taxpayer might realize within the meaning of the passive activity loss (PAL) rules.

Figure XX.2 Categories of Income and Losses for I.R.C. § 469

	Active Basket	Portfolio Basket	Passive Basket
Examples of income in category	Wages, salaries, and business income from self-employment, partnership , and S corporation ownership, if the taxpayer materially participates in the business	Dividends, interest, some capital gains	Rents, income from limited partnerships, and business income from self-employment, partnership, and S corporation ownership if the taxpayer does not materially participate
Treatment of losses	Usually deductible to arrive at AGI (exception: employee business expense) after passing basis and at-risk limit tests; may create NOL carryover	Deductible within the applicable limits for capital losses, investment interest expense, and miscellaneous itemized deductions	Usually deductible to arrive at AGI, but limited to income from other passive activities or carried forward; in year of complete disposition, excess

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current and prior ordinary losses from the activity move to active basket

Objectives of Regulations

Losses connected with an active trade or business run right by the PAL rules, whereas income from passive activities can be offset with losses from other passive activities. Immediately after the Tax Reform Act of 1986 was enacted, taxpayers began to try to find *passive income generators* (nicknamed PIGs). Many creative ideas (such as publicly traded limited partnerships) emerged, along with responses from Congress and from the IRS.

Final and temporary regulations for I.R.C. § 469 are interspersed, forcing the reader to combine subsections from each in order to understand either. A thread of logic is found in the regulations, though—they consistently attempt to prevent taxpayers from characterizing their profitable activities as passive and their unprofitable activities as active.

If an activity is passive, a loss from that activity cannot be deducted against a taxpayer's income from any source other than a passive activity. Tax credits from a passive activity can be used only to offset the tax liability arising from passive activities. Net income from passive activities is taxable, although net losses may not be currently deductible.

Practitioner Note
Closely Held C Corporations

A significant liberalization of the PAL rules for closely held C corporations allows them to deduct passive losses and use passive-activity credits to the extent of net active income. Net active income includes income and deductions from all activities except portfolio investments.

Material Participation

Material participation generally requires an individual taxpayer to be involved in the operations of a trade or business activity on a *regular, continuous, and substantial basis*, regardless of whether he or she owns the interest directly as a proprietorship or indirectly through a general partnership or S corporation. The seven material participation tests provided in the regulations are covered later in this chapter.

There are still many gaps in the regulatory coverage of this issue, including the lack of a definition of material participation for activities held by trusts. (Congress says an estate or trust materially participates in an activity if the entity's fiduciary, in his capacity as fiduciary, materially participates [S. Rep. No. 99-313, at 735]).

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Activity Differs from Entity

The term *activity* is not the same as *entity*—the regulations make frequent reference to *activities* held by *entities*. Income or loss from an activity held by a partnership, LLC, or S corporation may be treated as passive income or loss for the owners. There is no such attribution of the character of a C corporation activity to its shareholders.

A taxpayer investing in a single partnership might be investing in several activities for I.R.C. § 469 purposes. If so, the partnership's complete, taxable disposition of just one activity could trigger the release of any suspended losses attributable to that activity. Conversely, if a taxpayer owns 30% of an apartment building directly and another 10% indirectly through a partnership, a sale of the partnership interest to an unrelated party does not release the suspended losses because the taxpayer still owns an interest in the activity.

Passive Activity Credits

I.R.C. § 469(d)(2) defines the term *passive activity credit* as the excess amount of allowable credits from all passive activities for a tax year over the regular tax allocable to all passive activities. This excess credit must be carried forward.

In any year that the taxpayer has a net loss from passive activities, passive activity credits will always be suspended and carried forward unless a special allowance applies. The special allowances for passive activity credits are not covered in depth in this chapter. Form 8582-CR, Passive Activity Credit Limitations, and its 16 pages of instructions provide general information and worksheets.

PAL Exceptions

Passive activities are defined in I.R.C. § 469 as

1. any rental activity, whether or not the taxpayer materially participates (the term *rental activity* is defined later in this chapter), and
2. an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.

Oil and Gas Investments

The term passive activity does not include a *working interest* in an oil or gas property that the taxpayer holds directly or as a general partner [I.R.C. § 469(c)(3)]. When an oil or gas investment qualifies as a working interest, its losses are not subject to the PAL limits. There are several complex rules to prevent churning these activities between passive and active status.

Practitioner Note
Working Interest Has Unlimited Liability

The form of ownership must not limit the taxpayer's liability for the venture's debts. The justification offered by Congress is that such ventures are so risky that they should not be subject to the passive activity limits.

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Casualty Losses

Because of a specific exception, the PAL limits do not apply to casualty or theft losses incurred in a passive activity [Treas. Reg. § 1.469-2(d)(2)(xi)].

Example XX.2 Passive Activity Casualty Loss

A flood caused extensive damage to a residential rental house owned by Noah Sark. He did not have flood insurance and received no disaster aid. Repairs cost $80,000; the property's adjusted basis was $100,000; and its FMV was $190,000 before the flood. Noah can claim an $80,000 I.R.C. § 165 loss, which is deductible without regard to the PAL limits. [ENDOFEXAMPLE]

Rental Activities

Some real estate professionals can characterize their rental activities as nonrental activities, as explained later in this chapter. Otherwise, rental activities are passive regardless of the taxpayer's level of participation, so it might appear that a taxpayer can create a PIG by calling gross receipts from any service activity "rent."

However, the regulations do not make it quite that easy to churn trade or business income into rent. They begin with a commonplace definition of *rent* as "payment for the use of property." They then carve out customer use and other special rules to exempt some activities from automatic classification as passive rental activities. In most cases, this exemption subjects the activity to the material participation tests. In a few cases, it apparently creates portfolio income.

Customer Use Tests

The regulations provide three tests for classification of an activity as rental that are based on the average length of customer use of the property. The average period of customer use is determined by dividing the total number of days in all rental periods by the number of rentals during the tax year.

Average Use Not More Than 7 Days

Income is not treated as rent if the average period of customer use does not exceed 7 days. The inherent presumption that the customer is paying primarily for services rather than for use of the property itself cannot be rebutted [Temp. Treas. Reg. § 1.469-IT(e)(3)(ii)(A)]. Thus, operation of a bed and breakfast facility is generally treated as a business rather than as a rental activity.

Average Use 8 to 30 Days

If the average period of customer use exceeds 7 days but is not more than 30 days, the income is classified as rent unless the owner provides *significant personal services*. The regulations describe significant personal services only by stating that "all of the relevant facts and circumstances shall be taken into account" [Temp. Treas. Reg. § 1.469-1T(e)(3)(iv)(A)] and excluding some services as not significant [Temp. Treas. Reg. § 1.469-1T(e)(3)(iv)(B)].

Relevant facts and circumstances include the frequency with which the services are provided, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for the use of the property.

The term *excluded services* means

- services necessary to permit lawful use of the property,
- services to repair or improve the property that extend the property's useful life for a period substantially longer than the average period that the property is used by customers, and,
- for improved real property, services that are similar to those commonly provided with long-term rentals of high-grade commercial or residential real property (such as cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

Average Use More Than 30 Days

If the average period of customer use exceeds 30 days, the activity is generally characterized as rental. An exception to this rule covers activities for which the owner provides of *extraordinary personal services,* so that the customer's use of the property is incidental to receiving the services [Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(C) and (v)]. There is little guidance to this exception, but the regulations mention hospitals and boarding schools as examples of situations where the services are extraordinary.

Temp. Treas. Reg. § 1.469-1T(e)(3)(viii), Example (9) illustrates the separation of a single business's activities into rental and nonrental with the application of the customer use rule.

> The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules

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to be contained in §1.469-4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

Other Anti-churning Rules

Several other rules make it difficult to churn income from other types of activities into rents:

1. Income or loss from an activity is not rent if the taxpayer makes the property available during defined business hours for nonexclusive use by various customers [Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(E)]. This applies to properties such as theaters and golf courses.
2. Income or loss from property rented to an employee for the convenience of the employer is not treated as rent [Treas. Reg. § 1.469-1(e)(3)(vi)(D)].
3. Incidental rental to others of property normally used in the taxpayer's nonrental trade or business activity is generally not treated as rent [Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(D) and (vi)(C)]. The property must have been predominately used in the business during the tax year or during 2 of the 5 preceding tax years.
4. Incidental rental of property held primarily for the realization of investment gain is not treated as rental income [Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(B)].

To qualify as *incidental rental* for exceptions 3 and 4, the gross rent received must be less than 2% of the smaller of the property's basis or its FMV.

Example XX.3 illustrates when rental income and loss might be treated as nonrental because of the investment motive exception.

Example XX.3 Land Held for Investment

Bill Mei owns 1,000 acres of unimproved land with a $350,000 FMV and a $210,000 unadjusted basis that he is holding in hopes of realizing gain from appreciation. To defray the cost of carrying the land, he leases the land for $4,000 a year to a rancher who uses it to graze cattle.

The $4,000 gross rental income is less than $4,200 (2% of $210,000, the lesser of the land's FMV or its basis). The lease qualifies as a nonrental activity because the rental is treated as incidental to Bill's activity of holding the property for investment.[ENDOFEXAMPLE]

Practitioner Note
Nonrental Still Subject to Participation Test

Classification of an activity as a nonrental activity using any of these tests does not mean that a loss from the activity is automatically deductible. The owner must then meet a material participation test (discussed later in this chapter) to move the income or loss from the passive basket to the active basket.

Property Provided by Partner or Shareholder

If the owner of an interest in a partnership, S corporation, or joint venture provides property to the business for use in a nonrental activity of the business, the owner's provision of the property is not considered rental. None of the income and expenses flowing through from the business is characterized as rental unless the business is engaged in a rental activity [Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(F) and (vii)].

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Crop Share Leases

The instructions to Form 4835, Farm Rental Income and Expenses, imply that a crop share lease is a rental activity under the PAL rules unless it is a business that is subject to self-employment tax. That implication arises from the instruction to "Use this form only if the activity is a rental activity for purposes of the passive loss limitations." This instruction apparently requires a taxpayer to either report the income and expenses from a crop share lease on Schedule F (Form1040), Profit or Loss from Farming—where it is treated as self-employment income—or treat the crop share lease as a rental activity automatically subject to the passive loss rules.

However, the temporary regulations indicate that a crop share lease can avoid being classified as a rental activity under the PAL rules. They state that an owner of land is not engaged in a rental activity if the taxpayer provides the property for use in a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Temp. Treas. Reg. § 1.469-1T(e)(3)(viii), Example (8), illustrates that rule:

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

The citation to paragraph (e)(3)(ii)(F) references the exception for property provided by the owner of an interest in the business through a partnership, S corporation, or joint venture.

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Different Material Participation Tests

The material participation tests for self-employment tax are not the same as the material participation tests for the passive activity rules. In most cases, if there is material participation for one purpose, there is material participation for the other, but it is possible to materially participate for one and not the other.

Application of Self-employment Tax

Rents received for the use of real property generally are exempt from self-employment (SE) tax [I.R.C. § 1402(a)(1)]. However, the SE tax is imposed on some rents received by real estate dealers and on some farm rental income. Farm rental income is subject to SE tax only if all three of the following criteria are met:

- There is an arrangement that requires the tenant to produce agricultural or horticultural commodities on the land.
- The arrangement requires the landlord to materially participate in production or

management of the production of the commodities.

- The landlord does personally materially participate in the production or management of the production of the commodities.

Material Participation for SE Tax

A farm landlord who satisfies any one of the following four tests materially participates for SE tax purposes.

- He or she performs any three of the following actions:
  - Pays, using cash or credit, at least half the direct costs of producing the crop or livestock.
  - Furnishes at least half the tools, equipment, and livestock used in the production activities.
  - Advises or consults with the tenant.
  - Inspects the production activities periodically.
- He or she regularly and frequently makes (or take an important part in making) management decisions that substantially contribute to or affect the success of the enterprise.
- He or she works a cumulative 100 hours or more during a period of 5 weeks or more in activities connected with agricultural production.
- He or she does things that, considered in their totality, show you are materially and significantly involved in the production of the farm commodities.

For example, a landlord who advises the tenant when to plant, spray, and pick a crop, and who inspects the crop every few days during the growing season to determine whether the tenant is properly taking care of it, materially participates even if the tenant furnishes all of the labor needed to grow and harvest the crop.

The material participation tests for passive activities are explained later in this chapter.

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$25,000 Special Allowance

If certain conditions are satisfied, low- and moderate-income taxpayers are allowed to deduct up to $25,000 of passive losses (or the credit equivalent) realized from either commercial or residential rental real estate activities. There are three qualifications for this special allowance:

- The taxpayer is a natural person or a qualifying estate.
- The individual *actively participates* in the rental real estate activity.
- The taxpayer's income does not exceed a specified limit.

There is no special allowance for most trusts, or for personal service corporations, or for closely held C corporations. Estates can qualify for tax years ending less than 2 years after the date of the decedent's death, if the decedent would have qualified for the special allowance in the year of death. Revocable trusts that elected to be treated as part of an estate for income tax purposes can qualify under the same conditions.

Active Participation

Active participation is a lower standard than material participation, which requires regular, continuous, and substantial involvement in operations. The test for active participation is met as long as the taxpayer participates in a *significant and bona fide sens*e by making management decisions or arranging for others to provide services such as repairs. The Senate Finance Committee explanation states that management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and making other similar decisions [S. Rep. No. 99-313 at 737-738].

Practitioner Note

At Least 10% Ownership Interest Is Required

An individual cannot meet the active participation test if his or her interest is less than 10% by value of all interests in the activity at any time during the year. The interests of a husband and a wife are combined for this purpose.

The next two examples are based on the Senate Finance Committee's general explanation of "active participation in a significant and bona fide sense."

Example XX.4 Rental of Former Home

A taxpayer owns and rents out an apartment that he formerly used as his primary residence. He hires a rental agent and uses a contractor to handle routine repairs. The taxpayer is likely to meet the active participation test, because his main purpose for the rental is probably not the generation of tax losses. [ENDOFEXAMPLE]

Example XX.5 Purchase from Promoter

A taxpayer purchases an undivided interest in a shopping mall from a promoter, based on a prospectus that describes the investment opportunity and stresses the tax benefits of the special $25,000 allowance for rental real estate. One of the taxpayer's main reasons for buying the property is to shelter income, so he relies on a professional management company to make all significant management decisions. To create an evidentiary record purporting to show active management, the management company sends letters to the owner detailing operating expenses, changes in tenants, and new lease terms. The management company also informs the owner as to market trends and requests approval of decisions to seek certain types of retailers as tenants. The owner ratifies such judgments without independently exercising judgment. The owner of the shopping mall has not met the active participation test.[ENDOFEXAMPLE]

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Income-Based Phaseout

Higher-income taxpayers are not eligible for the special allowance. If the taxpayer's modified adjusted gross income (MAGI) exceeds $100,000, the $25,000 maximum allowance is reduced by 50¢ for each $1 of excess income, so that it is fully phased out at $150,000 of MAGI. Two special rules apply to married taxpayers filing separate returns:

1. If they live together at any time during the year, they have no special allowance.
2. If they do not live together at any time during the year, each spouse has a $12,500 maximum deduction that is phased out at the 50¢ for each $1 rate for MAGI exceeding $50,000.

An estate's special allowance is reduced by the surviving spouse's special allowance.

Practitioner Note
Calculation of MAGI

MAGI starts with AGI before any net loss from passive activities and minus any taxable social security and tier 1 railroad retirement benefits. It adds back the deductions for individual retirement account (IRA) contributions, half of self-employment tax, student loan interest, and tuition and fees, and the exclusions of income from employer-provided adoption assistance and interest from U.S. savings bonds that is used to pay higher education expenses.

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Application of Allowance

The income and losses from all of the taxpayer's real estate rentals with active participation are netted. Income from such activities with net income is absorbed first by any rental real estate activities that produce losses. All income from rental real estate activities is allocated entirely to rental real estate loss activities if there is an overall net loss from rental real estate activities. Losses from other passive activities can be absorbed by income from rental real estate activities only if there is overall net income from the taxpayer's rental real estate activities.

Observation
Ordering Rule's Effect on Carryforward Losses

This allocation formula minimizes the allocation of carryforward losses to rental real estate activities, thereby reducing the probability of claiming the $25,000 rental real estate deduction in future years.

Example XX.6 Application of Special Allowance

Chuck Woods actively participates in his two rental real estate activities, A and B, and qualifies for the $25,000 special allowance. He also owns a limited partnership interest in activity C, which does not qualify for the rental real estate allowance. Figure XX.3 shows his income or loss from each activity for the tax year.

FIGURE XX.3 Loss Absorption

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

Activity A's $20,000 income is used first to absorb part of activity B's loss. The $25,000 special allowance is then applied to the remaining $35,000 loss from activity B. None of the activity C loss is deductible, and Chuck carries forward a $10,000 ($55,000 –$20,000 – $25,000) loss from activity B and the full $15,000 loss from activity C. [ENDOFEXAMPLE]

Commercial Revitalization Deduction (CRD)

Taxpayers that placed a new or substantially rehabilitated commercial (nonresidential) building in service in a renewal community before 2010 could elect to deduct up to half of their qualified expenditures in the year the building was placed in service [I.R.C. § 1400I]. If the building was a passive rental real estate activity, the $25,000 special allowance was available to the extent it was not used for active-participation rental real estate activities.

A taxpayer can claim a current-year CRD only if the taxpayer (or a pass-through entity in which the taxpayer was a partner or shareholder) had a CRD for a building placed in service before 2010 and elected to ratably claim a deduction for the CRD over a period of 120 months that includes all or part of the current tax year. The special allowance for the CRD is not limited by the taxpayer's adjusted gross income, and active participation in the activity is not required.

Passive Activity Credit

To the extent that the $25,000 special allowance is not used to permit the deduction of rental real estate losses, it may allow use of tax credits arising from rental real estate activities with active participation. The special allowance can also be applied to the low-income housing and rehabilitation credits, even if the taxpayer did not materially participate in the rental real estate activities giving rise to those credits.

Real Estate Professionals

As originally enacted, I.R.C. § 469 contained no provision for deducting other net rental losses, even if the taxpayer's full-time trade or business involved real estate. However, a change included in the Revenue Reconciliation Act of 1993 (Pub. L. No. 103-66) allows *real estate professionals* to treat their real estate rental activities as nonrental trades or businesses. Thus, a qualifying owner can treat these activities as nonpassive if a material participation test is met [I.R.C. § 469(c)(7)].

A real estate professional must spend at least 750 hours during the year in real estate business activities, which include management, operation, development, redevelopment, construction, conversion, rental, leasing, and brokering. In addition, more than half of all personal services that the individual performs in trades or businesses during the tax year must be devoted to real property trades or businesses in which the individual materially participates.

Litigation has involved both of those participation rules. In one case, the husband of a medical doctor claimed to be a real estate professional. The couple owned numerous real estate properties (including his wife's office building) that the husband managed, but he had no net income. He logged about 800 hours a year on the couple's rental activities.

Without addressing whether he otherwise qualified, the IRS challenged whether he spent 750 hours on real estate business activities. The taxpayer's log included more than 100 hours each year spent cleaning his wife's two medical office locations and shoveling snow at those locations.

The court granted summary judgment to the IRS, holding that janitorial work is not customarily performed by real estate professionals and the hours spent on it did not qualify as time spent on real estate property trades or businesses. Thus, the taxpayers failed to meet the 750-hour requirement, and the real estate losses were passive [*DeGuzman v. United States*, 147 F.Supp.2d 274 (D.C. N.J., 2001)].

Practitioner Note
Material Participation Required for Nonpassive Loss

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After the real estate professional tests are met, the taxpayer must still satisfy a material participation test (discussed in the next section of this chapter) for each rental real estate activity that sustains a loss for the loss to be nonpassive.

Nonrental Business Activities

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

Material Participation

Material participation requires *regular, continuous, and substantial involvement* in the activity's operations. The following comments are based on the Senate Finance Committee's General Explanation of the Tax Reform Act of 1986.

- Because limited liability status generally precludes a limited partner from participating in the partnership's business, a limited partnership interest is intrinsically passive, except as provided in regulations. [This restriction is codified in I.R.C. § 469(h)(2).]
- Material participation is determined separately for each tax year. In most cases, material participation (or a lack thereof) is not expected to change from year to year.
- An estate or trust is treated as materially participating (or actively participating in a rental real estate activity) if an executor or fiduciary meets the participation requirement in his capacity as executor or fiduciary.

Practitioner Note
Material Participation on Behalf of Trust

The trustee involvement requirement for a trust's participation was held to be too narrow in a U.S. District Court case involving the operation of a ranch. The court held that the trust's participation could be determined by reference to the participation of its agents and employees as well as its fiduciaries [*Mattie K. Carter Trust v. United States,* 256 F.Supp.2d 536 (N.D. Tex., 2003)]. Regulations have not been issued on material participation for a trust, but a place has been reserved for them.

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Regulation Provides Seven Tests

Temp. Treas. Reg. § 1.469-5T adopts seven tests to determine material participation, and a taxpayer who meets any one of the tests is deemed to materially participate in an activity. In general, any work the taxpayer performs in connection with an activity is treated as participation in the activity.

However, work that an *owner* performs is not treated as participation in the activity if both of the following statements apply:

- The work is not a type of work that is customarily done by the owner of that type of activity.
- One of the main reasons the owner does the work is to avoid the disallowance of any loss or credit from the activity under the passive activity rules.

(See *DeGuzman v. United States,* supra.)

Work performed as an *investor* in an activity is not participation unless the investor is directly involved in the activity's day-to-day management or operations. Work as an investor includes

- studying and reviewing financial statements or reports on operations of the activity,

- preparing or compiling summaries or analyses of the finances or operations of the activity for the investor's own use, and
- monitoring the finances or operations of the activity in a nonmanagerial capacity.

Married taxpayers generally may combine their services in determining whether they meet a material participation test, whether or not they file a joint return, although they cannot combine their services for the 750-hour real estate professional test.

The first four of the seven material participation tests are purely mechanical, requiring tracking the hours worked.

1. More Than 500 Hours

This standard requires the individual to participate in the activity for more than 500 hours during the tax year.

Example XX.7 More Than 500 Hours of Participation

Sharon and Sandra Smith are sisters who formed a computer software development company that is located in Austin, Texas. Sharon lives in Boston and Sandra lives in Austin. Both have other full-time occupations. Sharon is an engineer who designs and programs the software, and Sandra, who is a CPA, is the sales manager of the software company.

During the current tax year, the company's first year of operations, Sharon spent 550 hours developing products and Sandra spent 600 hours calling on potential customers and arranging advertising. Both Sharon and Sandra are material participants. [ENDOFEXAMPLE]

Practitioner Note

Substantiation of Hours Is Crucial

Substantiation of the hours worked in the activity is crucial. A full-time medical device salesman who owned a 35% interest in an S corporation that operated a fast-food restaurant did not maintain a contemporaneous log to establish his material participation using the 500-hour test. The Tax Court concluded that the hours claimed on the summary statement he submitted were questionable, and thus the losses were passive [*Newhart v. Commissioner*, T.C. Memo. 2001-289].

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2. Sole Participant

If an individual is the sole participant in an activity, or performs substantially all of the services provided by anyone in the activity for the tax year, that person's participation is material.

Example XX.8 Sole Participant in Activity

Ray Jackson, a teacher who lives in a rural area of Indiana, owns a truck with a snowplow and contracts with some of his neighbors to plow their driveways. He maintains and drives the truck, and he has no employees or contractors in this business. There was a mild winter during the current tax year, and he used the snowplow for only 10 hours. He is nevertheless a material participant in his snowplowing business.[ENDOFEXAMPLE]

3. More Than 100 Hours and Not Less Than Anyone Else

A third test of material participation requires that the taxpayer participate more than 100 hours in the activity, and that no other individual participate for more hours. Participation by employees as well as owners must be considered in applying this standard.

4. Significant Participation: Multiple Activities Combined

The 500-hour test can be met by combining disparate activities if the taxpayer participated for more than 100 hours in each of the combined activities but did not meet any of the other six

material participation tests for each included activity. These activities are known as *significant participation activities*, a term that materialized in the regulations. Generally, these activities can absorb passive losses only among themselves. Other aspects of significant participation activities that can lead to some strange results are discussed later in this chapter.

Example XX.9 Significant Participation Qualification

Jack Altrade is a full-time CPA who also owns a restaurant and a sporting-goods store. In the current tax year, he spent 400 hours working at the restaurant and 150 hours working at the store. Employees of those ventures spend more time than Jack does in each of those activities. However, he is still treated as a material participant in both the restaurant and the store, because each is a significant participation activity and his total participation in the two activities exceeds 500 hours. [ENDOFEXAMPLE]

The next two tests are also objective, but they relate to past, rather than current, involvement.

5. Material Participation in 5 of Last 10 Years

An individual who met one of the first four material participation tests in any 5 of the prior 10 years is considered a material participant in that activity for the current year.

Example XX.10 Retired Partner's Material Participation

Otto Sellers, a partner in an automobile dealership, completely retired at the end of 2010 after 40 years in the business. His daughter has been general manager since his retirement, and Otto does not interfere. However, he retains a 60% general partnership interest.

Otto is treated as a material participant in the dealership for 2012, because he materially participated for 5 of the prior 10 years. If he remains uninvolved in the business, by 2016 he will no longer be a material participant, because he will have materially participated in only 4 of the last 10 years.[ENDOFEXAMPLE]

6. Material Participation in Personal Service Activity

An individual who materially participates in a personal service activity for at least 3 years is treated as a material participant for the rest of his or her life. An activity is a personal service activity if it involves the performance of personal services in the fields of health (human or animal), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.

Example XX.11 Personal Service Activity

Jim Scott retired from his medical practice after 25 years, but he retains a partnership interest in the practice. He will always be treated as a material participant in the medical partnership. [ENDOFEXAMPLE]

The seventh and final test for material participation is somewhat nebulous. The examples in the regulations are of little help except to demonstrate a lack of material participation.

7. Facts and Circumstances

An individual who does not satisfy any of the six objective tests but who participates in an activity for more than 100 hours may be treated as a material participant if, based on all the facts and circumstances, he or she participates on a regular, continuous, and substantial basis. The regulations provide three rules regarding facts and circumstances:

1. A taxpayer who participates for 100 or fewer hours cannot be treated as materially participating under the facts-and-circumstances test.

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2. A taxpayer's management activities are not counted if
   a. anyone else is compensated for management services, or
   b. anyone else provides more hours of management services.
3. Satisfying a material participation test under another section of the code—such as the rules for self-employment tax (explained earlier in this chapter) or for estate tax special-use valuation—has no bearing on the material participation test for passive activities.

Practitioner Note
Interaction with Estate Tax Rules

If an individual meets the estate tax special valuation requirements in I.R.C. § 2032A(b)(4) or (5), he or she will also meet the material participation test for the passive loss rules [Temp. Treas. Reg. § 1.469-5T(h)(2)]. I.R.C. § 2032A(b)(4) treats a retired or disabled farmer as materially participating if he or she materially participated for 5 of the last 8 years preceding retirement or disability. I.R.C. § 2032A(b)(5) treats the surviving spouse of a farmer as materially participating if the farmer met the requirements at the time of his or her death and the surviving spouse actively participates in the farm business.

Limited Partners and LLC Members

An individual who owns an activity as a limited partner can use only three of the seven tests to claim material participation in the activity—the 500-hour test and two prior-year participation tests. A limited partnership interest is still treated as a passive activity even if the limited partner satisfies test two, three, four, or seven for the tax year.

An individual is not treated as a limited partner, however, if he or she was also a general partner in the partnership at all times during the partnership's tax year ending with or within the individual's tax year (or, if shorter, during the portion of the partnership's tax year in which the individual directly or indirectly owned the limited partner interest).

Although the owner's liability is limited, an LLC interest is not always treated as a limited partnership interest. The IRS acquiesced in result only to a summary judgment opinion in *Thompson v. United States*, 87 Fed. Cl. 728 (Fed. Cl. 2009), which concluded that LLC interests are not "limited partnership interests" for purposes of Treas. Reg. § 1.469-5T(e)(3)(i) [A.O.D. 2010-002, 2010-14 IRB]. Following *Garnett v. Commissioner,* 132 T.C. 19 (2009) and *Gregg v. United States,* 186 F. Supp. 2d 1123 (D. Ore. 2000), *Thompson* was the third court opinion holding that an interest in an LLC is not the same as a limited partnership interest under the regulation.

The taxpayer in *Thompson* directly owned 99% of an LLC that was in the airplane charter business and indirectly owned the remaining 1% interest in the LLC through a wholly owned S corporation. The IRS argued that the taxpayer did not meet the restricted material participation requirements that apply to limited partners, but both parties stipulated that if the LLC interest was not characterized as a limited partnership interest, the taxpayer could establish material participation using any of the seven tests.

The claims court held that the taxpayer's interest was not a limited partnership interest for purposes of the passive loss rules, and that even if it were treated as an interest in a limited partnership, the taxpayer should be treated as also holding a general partnership interest under Temp. Treas. Reg. § 1.469-5T(e)(3)(ii). Consequently, the court held that the LLC owner could establish material participation using any of the seven tests.

In the earlier *Garnett* case, the Tax Court also concluded that the taxpayer's interest in the LLC should be treated as a general partnership interest. Quoting from legislative history (the Senate committee report previously cited), the court focused on state laws that prevent limited partners from actively participating in the partnership's business. Because LLC members generally have no such constraints, the court said "it cannot be presumed that they do not

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materially participate." The court then stated that a factual inquiry is needed to determine whether an LLC member meets any of the seven tests for material participation.

Grouping Activities

A taxpayer engaged in more than one activity can treat two or more trade or business activities, or two or more rental activities, as a single activity **if** they form an appropriate economic unit for measuring gain or loss under the passive activity rules.

Grouping activities into a larger activity allows the taxpayer to measure material participation in the activity as a whole, rather than separately in each one. Grouping can also be important in determining whether a taxpayer meets the 10% ownership requirement for actively participating in a rental real estate activity.

Appropriate Economic Unit

All the relevant facts and circumstances must be considered in determining whether activities form an *appropriate economic unit*. The following factors have the greatest weight in determining whether activities form an appropriate economic unit. All of the factors do not have to apply to treat more than one activity as a single activity. The factors to be considered are

- similarities and differences in the types of trades or businesses,
- extent of common control,
- extent of common ownership,
- geographical location, and
- interdependencies between or among activities.

Interdependencies may include the extent to which the activities

- buy or sell goods between or among themselves,
- involve products or services that are generally provided together,
- have the same customers,
- have the same employees, or
- use a single set of books and records.

Consistency Requirements

After activities are grouped into appropriate economic units, a taxpayer generally may not regroup those activities in a later tax year. The IRS requires disclosure (discussed later in this section) when activities are first grouped and when a taxpayer adds or dispose of any activities in a group. However, if the original grouping is clearly inappropriate or there is a material change in the facts and circumstances that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and comply with any disclosure requirements of the IRS.

If a grouping is not an appropriate economic unit and one of the primary purposes of the grouping is to avoid the passive activity rules, the IRS may regroup the activities.

Rental Activities

In general, a rental activity may not be grouped with a trade or business activity. Rental and nonrental activities can be grouped together only if the activities form an appropriate economic unit and one of the following three statements is true:

1. The rental activity is insubstantial in relation to the trade or business activity.

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2. The trade or business activity is insubstantial in relation to the rental activity.
3. Each owner of the trade or business activity has the same ownership interest in the rental activity.

If item 3 is true, the part of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

In general, an activity involving the rental of real property and an activity involving the rental of personal property cannot be grouped as a single activity. However, they can be treated as a single activity if the personal property is provided in connection with the real property or the real property is provided in connection with the personal property.

Other Grouping Restrictions

In general, interests held as a limited partner or a limited entrepreneur in any of the following activities may not be grouped with any other activity in another type of business:

- Holding, producing, or distributing motion picture films or video tapes
- Farming
- Leasing any I.R.C. § 1245 property
- Exploring for, or exploiting, oil and gas resources
- Exploring for, or exploiting, geothermal deposits

Interests held as a limited partner or a limited entrepreneur in such activities may be grouped with other activities in the same type of business if the grouping forms an appropriate economic unit. A *limited entrepreneur* is a person who has an interest in an enterprise other than as a limited partner and does not actively participate in the management of the enterprise.

A personal service corporation, a closely held corporation, a partnership, or an S corporation must group its own activities. Once a partnership or S corporation groups its activities, a partner or shareholder in the entity may group those activity groupings with each other, with other activities conducted directly by the partner or shareholder, or with activities conducted through other entities. A partner or shareholder may not treat activities grouped together by an entity as separate activities.

A taxpayer may group an activity conducted through a personal service corporation or closely held corporation with other activities only to determine whether the taxpayer materially or significantly participated in those other activities.

A taxpayer may not group activities conducted through a publicly traded partnership (PTP) with any other activity, including an activity conducted through another PTP.

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Disclosure Requirements

Taxpayers are required to report to the IRS changes to groupings that occur during the tax year. If such changes are not reported, the IRS generally will treat each trade or business activity or rental activity as a separate activity. (The IRS may still regroup activities to prevent tax avoidance pursuant to Treas. Reg. § 1.469-4.)

A taxpayer who fails to file a required statement will be treated as having made a timely disclosure if both of the following conditions are met:

1. The entries on all affected income tax returns were consistent with the claimed grouping.
2. The taxpayer makes the required disclosure on the income tax return for the year in which the taxpayer first discovers the failure to disclose.

If the IRS discovers a failure to disclose, the taxpayer must have reasonable cause for not making the required disclosure. Otherwise, the IRS may ungroup or regroup the activities.

Written Statement Rules

The following disclosure requirements apply to tax years beginning after January 24, 2010 [Rev. Proc. 2010-13, 2010-4 I.R.B. 329]. An individual taxpayer's original income tax return for the first tax year in which two or more activities are originally grouped into a single activity must include a written statement that provides the names, addresses, and employer identification numbers (EIN), if applicable, for each of the activities being grouped as a single activity. The statement must also contain a declaration that the grouped activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

If a new activity is added to an existing group during a tax year, the taxpayer's original income tax return for that tax year must include a written statement that provides the name, address, and EIN, if applicable, for the activity that is being added and for the activities in the existing group. The statement must also contain a declaration that the activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

In addition, a written statement must be filed with the taxpayer's original income tax return for a tax year in which any activities are regrouped. The statement must provide the names, addresses, and EINs, if applicable, for the activities that are being regrouped. If two or more activities are being regrouped into a single activity, the statement must contain a declaration that the regrouped activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules. The statement must also contain an explanation of the material change in facts and circumstances that made the original grouping clearly inappropriate.

Groupings by Entities

Partnerships and S corporations must comply with the disclosure instructions for grouping activities that are provided in Form 1065, U.S. Return of Partnership Income, or Form 1120S, U.S. Income Tax Return for an S Corporation, whichever is applicable, instead of the disclosure rules for new groupings, addition to an existing grouping, or regroupings that are applicable to individuals.

A partner or shareholder is not required to separately disclose the groupings disclosed by the entity unless the partner or shareholder takes one of the following actions:

- Groups together any activities that the entity does not group together
- Groups an entity's activities with activities conducted directly by the partner or shareholder
- Groups an entity's activities with activities conducted through another entity

A partner or shareholder may not treat activities grouped together by the entity as separate activities.

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Recharacterization of Income

To counteract taxpayer efforts to generate passive income and active losses, the passive activity regulations recharacterize net income that arises from certain activities.

Significant Participation Activities

A trade or business activity in which a taxpayer participates for more than 100 but less than 500 hours in a taxable year is a significant participation activity (SPA) if it does not satisfy one of the other material participation tests by itself. Income and losses from all SPAs must be combined and treated as arising from one activity. Whether the net income or loss from the combined SPA is characterized as active or passive depends upon whether the combined SPA is profitable.

1. If the net result is a loss, the loss is passive and can be deducted only to the extent of the taxpayer's other passive income.
2. If the net result is income, the net income is recharacterized as active, so that it cannot be used to deduct losses from the taxpayer's other passive activities [Temp. Treas. Reg. § 1.469-2T(f)(2)].

Other Recharacterized Income

Five other types of income are subject to recharacterization as nonpassive income:

1. Net income from renting nondepreciable property, such as farmland or some parking lots; the income is considered nonpassive if less than 30% of the property's unadjusted basis is depreciable [Temp. Treas. Reg. § 1.469-2T(f)(3)]
2. Net interest income from a passive equity-financed lending activity; lending is equity-financed if the activity's average liabilities do not exceed 80% of its interest-bearing assets [Temp. Treas. Reg. § 1.469-2T(f)(4)]
3. Net income from renting property incident to its development; the criteria for this test include renting the property for less than 12 months before the date of its disposition, recognizing any gain from its disposition, and providing value-enhancing services to the property, such as construction, renovation, or lease-up services [Treas. Reg. § 1.469-2(f)(5)]
4. Net royalty income from an interest in a pass-through entity that was acquired after the entity created intangible property that it licenses [Temp. Treas. Reg. § 1.469-2T(f)(7)]
5. Net income from rental of property to a related entity for use in the taxpayer's nonpassive trade or business [Treas. Reg. § 1.469-2(f)(6)]

Item 5, often called the s*elf-rental rule,* recharacterizes net income as nonpassive if property is rented by a shareholder to an S corporation or a C corporation, by a partner to the partnership, or by an LLC member to the LLC, **if** the owner of the interest materially participates in the business. Thus, the net rental income may not be offset by passive activity losses. A loss incurred on this type of rental is still a passive loss.

Example XX.12 Self-Rental Rule

Dr. Chester Zee incorporated his medical practice and personally owns the office building that the practice rents. If he incurs a net loss from the rental, the loss is passive. However, if the rental income exceeds the related expenses, so that Dr. Zee realizes net income, the net income is treated as nonpassive so that it cannot offset losses from other passive activities. [ENDOFEXAMPLE]

This rule is designed to prevent a taxpayer from creating a tax shelter by charging excess rent that reduces active business income. The courts that have considered the issue of reclassifying self-rental income have upheld the regulation.

- A U.S. district court and the Fifth Circuit Court of Appeals held that a sole shareholder's lease of an office building to his C corporation (a law firm) did not generate passive activity income [*Fransen v. United States,* 191 F.3d 599 (5th Cir., 1999), *aff'g* 82 A.F.T.R. 2d (RIA) 98-6621 (E.D. La. 1998)].
- The First Circuit Court of Appeals upheld the Tax Court's decision that a sole shareholder's net rental income from leasing rehabilitated mills to his C corporation (a clothing manufacturer) was nonpassive [*Sidell v. Commissioner*, 225 F.3d 103 (1st Cir., 2000), *aff'g* T.C. Memo. 1999-301].
- The Tax Court was upheld by the Seventh Circuit Court of Appeals in ruling that an attorney's net income from leasing an office building to his law firm (a solely owned C

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corporation) could not offset a loss from renting another building to a health club that he wholly owned through a different C corporation [*Krukowski v. Commissioner*, 114 T.C. 366 (2000), *aff'd* 279 F.3d 547 (7th Cir., 2002)]. Because he had not elected to treat the rental activities as a single activity on his income tax return, the court did not consider his claim at trial that the activities should be grouped as a single activity.

Losses Remain Passive

Losses resulting from the rental of property to a controlled entity are still passive losses, and the self-rental rule prevents offsetting net income and net loss from multiple self-rentals. If a taxpayer owns two or more properties and rents them to different trade or business activities in which he or she owns an interest, the income and losses from each self-rented property must be considered separately, even though the properties might otherwise constitute a single activity. If one produces income and the other produces a loss, they may not offset, because the net income is reclassified as nonpassive and the net loss is passive.

In *Krukowski,* supra, the taxpayer did not prevail in a grouping argument because he had not grouped the self-rentals on his tax return. In *Carlos v. Commissioner*, 123 T.C. 275 (2004), the taxpayer rented two personally owned properties to separate wholly owned S corporations, realizing net income from one and a loss from the other. He did group the activities on his tax return, but the Tax Court held that the self-rental rule prevents netting profitable and unprofitable self-rental activities even when a grouping election is made.

Activities conducted at a single location may still be separate. An S corporation that sold petroleum products also leased retail fuel sites from its shareholders and subleased some parcels to a convenience store tenant. In a technical advice memorandum, the IRS concluded that the subleasing activity was separate from the activity of selling products to the ultimate customers. Thus, the rental loss was a passive loss [T.A.M. 2000-140-10 (December 20, 1999)]. The Tax Court reached a similar conclusion in *Shaw v. Commissioner,* T.C. Memo. 2002-35.

Example XX.13 Never the Twain Shall Meet

Clyde Bonney owns two parcels of land, each with a building, that he rents to Oneco Inc. and Twoco Inc., two S corporations in which he owns stock. The rental to Oneco produces a net loss, and the rental to Twoco produces net income.

Clyde must treat the net rental income from Twoco as nonpassive, but his net loss from the rental to Oneco is passive. It may be deducted only if another passive activity loss rule allows the deduction. [ENDOFEXAMPLE]

Self-Charged Interest

Interest income is generally characterized as portfolio income that an S corporation or partnership must report separately to its owners. Portfolio income cannot be offset by passive activity losses, but it can be offset by investment interest expense. This creates an imbalance when a taxpayer lends money to a flow-through entity and the entity uses the money in a passive activity that reports a loss for the year. The interest income the entity pays to the owner-lender is portfolio income, and yet its payment contributed to the entity's passive loss. Thus, while the owner-lender must report the interest income, he or she may not be able to deduct the passive activity loss.

In anticipation of this possibility, the IRS was authorized to write regulations rectifying the situation. Treas. Reg. § 1.469-7 allows a person who is on both sides of this arrangement to recharacterize the interest income as passive activity gross income. The loan giving rise to the interest must be traced to a passive activity; there is no recharacterization allowable to the extent that the borrowed funds were used for other purposes.

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The only self-charged expense item covered by the regulation is interest. A taxpayer who attempted to recharacterize a self-charged management failed to win his case at the appellate level. The taxpayer owned an interest in numerous entities that conducted passive rental activities. He also owned an interest in an S corporation that provided management services to the other entities. He materially participated only in the S corporation. When reporting his income from the S corporation, he deducted the management fees paid by the other entities.

The Tax Court found this treatment to be reasonable, but the IRS appealed, and the appellate court reversed the lower court's decision, finding "nothing in the plain language" of I.R.C. § 469 to permit the recharacterization [*Hillman v. Commissioner*, 114 T.C. 103 (2000), reversed in *Hillman v. IRS*, 250 F.3d 228 (4th Cir., 2001)].

Suspended Losses

Losses and credits that are not currently deductible because of the passive loss limitations are suspended and carried forward to be treated as deductions and credits from passive trade or business activities in the next year.

Allocations to Activities

If a taxpayer has more than one passive activity with a loss for any given year, the amount of loss that is suspended for each activity is determined on a pro rata basis. This can be a two-stage computation, requiring allocation both among the activities and within an activity if it includes more than one type of loss.

The portion of an activity's loss that is suspended and carried forward is determined by the ratio of net losses from that activity to the total net losses from all of the taxpayer's passive activities for the tax year. Tracking the suspended losses for any particular activity is necessary because the activity's losses are allowed in full upon a qualifying disposition, as discussed in the next section of this chapter. The allocations among activities and among losses within an activity are illustrated in Examples XX.14 and XX.15, which are based on Temp. Treas. Reg. § 1.469-1T(f)(2).

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Example XX.14 Allocation of Loss between Activities

An individual holds interests in three passive activities (A, B, and C). Activities A and B resulted in losses, while activity C had net income for the tax year. The gross income and deductions for each activity are shown in Figure XX.4.

Figure XX.4 Summary of Passive Activities

	A	B	C	Total
Gross income	$ 7,000	$ 4,000	$ 12,000	$ 23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)
Net income (loss)	$ (9,000)	$ (16,000)	$ 4,000	$ (21,000)

The $21,000 net passive-activity loss is disallowed, so ratable portions of the losses from activities A and B are disallowed. The A and B losses total $25,000, and the disallowed portion of each loss is determined as shown in Figure XX.5.

Figure XX.5 Allocation Between Activities

Passive Activity	Allocation Formula	Disallowed Loss

A	$21,000 × ($ 9,000 ÷ $25,000)	$ 7,560
B	$21,000 × ($16,000 ÷ $25,000)	13,440
Total		$21,000

Thus, the taxpayer can deduct $1,440 ($9,000 – $7,560) of the activity A loss and $2,560 ($16,000 – $13,440) of the activity B loss to offset the $4,000 passive income from activity C. The $21,000 suspended loss is allocated $7,560 to activity A and $13,440 to activity B. The suspended losses are netted with income or losses from the activities in the following year, and the passive loss limits are again applied. [ENDOFEXAMPLE]

Example XX.15 Allocation of Loss within Activity

The $9,000 total loss in Example XX.14 from activity A was composed of two parts, a $4,000 ordinary loss and a $5,000 I.R.C. § 1231 loss on sale of an asset. The $1,440 allowable loss and the $7,560 carryover loss must be allocated between the two loss components, to determine the current-year deduction and carryover amount for each part. Figure XX.6 shows these allocations.

Figure XX.6 Allocation Within Activity

Activity A Losses		
Ordinary deductions in excess of gross income	$	4,000
I.R.C. § 1231 loss on sale of one asset		5,000
Total	$	9,000
Amount disallowed		(7,560)
Amount allowed in loss year	$	1,440
Apportioned to ordinary deductions [$1,440 × (4,000 ÷ 9,000)]		640
Apportioned to § 1231 loss [$1,440 × (5,000 ÷ 9,000)]		800
Total	$	1,440
Carryover to succeeding year	$	7,560
Apportioned to ordinary deductions [$7,560 × (4,000 ÷ 9,000)]	$	3,360
Apportioned to § 1231 loss [$7,560 × (5,000 ÷ 9,000)]		4,200
Total	$	7,560

[ENDOFEXAMPLE]

Precedence of Other Rules

Activities that are subject to the hobby loss or business use of home rules are not subject to the passive activity loss rules [Treas. Reg. §§ 1.469-2(c)(7)(vii) and 1.469-2(d)(2)(xii)].

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Practitioner Note
Permanent versus Temporary Disallowance

As cumbersome and restrictive as the passive activity loss limits are, they are in fact more liberal than some other limitations, particularly the hobby loss rules. Future events can bring passive activity losses out of suspension and allow their deduction. There is no such relief provision for hobby loss limitations.

Disposition of Passive Activity

An activity's suspended losses are allowed in full when the taxpayer disposes of his or her entire interest in the activity. (Remember, they have already reduced the taxpayer's basis and amount at risk in the earlier year, passing first and second bases before they were stopped at third base by the passive loss limit.) Recognition of the suspended losses is still subject to other limits on deductions, such as the capital loss recognition limit [I.R.C. § 469(g)]. A partial disposition of an interest does not trigger all suspended losses.

Practitioner Note
Credits Still Carry Forward after Disposition

Suspended credits are not allowed in full when the taxpayer disposes of his or her entire interest in a passive activity—they continue to be carried forward and can be used to offset income tax due on other passive activities.

Alternatively, to the extent that the credit has not been allowed, the taxpayer can elect to increase the activity's basis for gain or loss on disposition by the amount of the original basis reduction due to the credit. The amount that is restored to basis then reduces the remaining credit that is carried forward.

Disposition of Entire Interest

Disposition of a taxpayer's entire interest in a passive activity often allows the taxpayer to recognize any loss associated with the activity. The disposition must be made in a completely taxable transaction, and it may not be made to a related party. When this occurs, all of the activity's losses—both its current-year losses and its suspended losses—are taken out of the passive activity category, reverting to the active category. This includes any loss realized on the disposition.

Disposition at a Loss

A loss recognized on disposition of a passive activity is not treated as a passive activity loss. It does not absorb any income from other passive activities, so that the income from the other passive activities is available to absorb losses from other passive activities.

Disposition at a Gain

A gain on the disposition is treated as gross income from a passive activity. After it absorbs any suspended losses from the same activity, it becomes available for allowing losses from other passive activities.

Example XX.16 Order of Loss Deductions

Mark Wells disposed of his interest in ThreeCo, a passive activity, in a completely taxable sale, recognizing a $50,000 gain. ThreeCo had a $35,000 total suspended loss from prior years. Mark's $50,000 gain on ThreeCo's disposition is reduced by the deduction of its $35,000 suspended loss. The remaining $15,000 ($50,000 – $35,000) of passive income then became available to absorb up to $15,000 of losses from other passive activities. [ENDOFEXAMPLE]

Practitioner Note
Capital Loss Deduction Limit

If the entire disposition of a passive activity results in a capital loss, the loss is subject to the usual capital loss deduction limits. If the disposition is not a complete disposition of the passive activity, the capital loss must qualify under the passive activity loss rules before it may be netted against capital gains.

Disposition by Gift

A gift of all or part of a taxpayer's interest in a passive activity does not trigger suspended losses because it is not a taxable disposition.

- If a taxpayer gives away his entire interest in passive activity property, he can never make a taxable disposition of it, so any suspended losses are added back to the basis of the property immediately before the gift. They do not transfer to the donee as suspended losses.

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- If the taxpayer gives away only a portion of her interest, an allocable portion of the suspended losses is added to the donee's basis. The remainder of the losses (the portion allocable to the interest retained by the donor) continues to be suspended in the donor's hands.
- The donee's treatment of subsequent deductions from the activity depends on whether the activity is treated as passive in the donee's hands.

Related-Party Transactions

Disposing of an entire interest in a passive activity to a related party does not trigger suspended losses even if the disposition is otherwise a fully taxable transaction. Because a related-party transaction is not treated as a disposition of the activity, the suspended losses remain with the taxpayer and can be offset by income from the taxpayer's other passive activities. Any losses that are still suspended at the time the related-party buyer resells the passive activity to an unrelated party can then be deducted by the original seller, as long as the original seller has disposed of all of his or her interest in the activity.

Example XX.17 Sale to Related Party

Martha James owned a lake cottage where her family vacationed each summer. After she retired, she began renting it in 2-week segments to produce additional income. She generally was able to rent it for 24 weeks each year, while reserving 2 weeks for her own family's use. When she died at age 95, her will transferred ownership of the cottage to her three children, Sam, Stu, and Sue.

For 5 years, the children continued to rent the cabin to their mother's long-time tenants. Although the rentals still produced a positive cash flow, the increase in depreciation due to the basis step-up at Martha's death created losses for federal income tax purposes. Sam and Sue were able to use the $25,000 special allowance for rental real estate and benefited from the tax deduction. Stu's MAGI exceeded the limit, and because he had no passive income, his losses were suspended.

Stu wanted to sell the property, but Sam and Sue wanted to keep it, so they agreed to purchase Stu's one-third share. A stagnant real estate market meant Stu had no gain on the sale, so his suspended losses from prior years will remain suspended until he has some passive income or until Sam and Sue sell the cottage to an unrelated party. [ENDOFEXAMPLE]

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Transfer of Interest Due to Death

A transfer of a taxpayer's interest in an activity due to his or her death causes suspended losses to be allowed as a deduction on his or her final return to the extent they exceed the amount of any basis increase under I.R.C. § 1014. Suspended losses are eliminated to the extent of the basis increase.

Installment Sale of Entire Interest

An installment sale of the taxpayer's entire interest in an activity in a fully taxable transaction triggers the allowance of suspended losses, but they are not fully recognized that year. The losses are allowed each year that payments are received in the ratio that the gain recognized in each year bears to the total gain on the sale.

Activity No Longer Treated as Passive

Circumstances may arise that terminate the application of the passive loss rules to a specific activity. For example, an individual may begin materially participating in a trade or business activity that previously generated net passive losses. When this occurs, the previously suspended losses remain suspended and continue to be treated as passive activity losses. But unlike passive

activity losses generally, these suspended losses can offset income from the same activity that is realized after it ceases to be a passive activity for the taxpayer. The taxpayer must be able to show that the income and loss are from the same activity.

Practitioner Note
Like-Kind Exchanges

Losses generally are not triggered by I.R.C. § 1031 like-kind exchanges of the taxpayer's entire interest in an activity, because the exchange is not a fully taxable disposition. To the extent that boot is recognized as income, losses are triggered [Senate Committee Report 99-313, 1986-3 C.B. 726-27]. Legislative history indicates that the remaining suspended losses attach to the replacement property and can be offset by income from the replacement property.

Sale of Partial Interest

Gain recognized on the transfer of a partial interest in a passive activity is treated as being from a passive activity. It may be offset by losses and credits from passive activities, but transfers of partial interests do not trigger all suspended losses from the activity.

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

Example XX.18 Sale of Partial Interest

Jerry Jeffers owned a one-third interest in a partnership engaged in a rental activity. He did not actively participate, so he did not qualify for the $25,000 rental real estate allowance. Before selling 40% of his one-third interest in the partnership, Jerry had a $40,000 suspended passive loss from the activity. He realized a $10,000 capital loss on the sale.

The sale is not an event that allows him to recognize his suspended losses, because it is not a complete disposition of his interest. His total income from other passive activities in the year of sale is $20,000, and he has no income or loss from his retained interest in the partnership.

The $20,000 passive activity income is two-fifths of Jerry's $50,000 ($40,000 + $10,000), total loss so it permits Jerry to recognize two-fifths of his suspended ordinary losses and capital loss. His treatment of the losses is shown in Figure XX.7.

Figure XX.7 Loss Allocation for Sale of Partial Interest

Character of Loss	Losses from Partnership	Fraction Recognized	Allowable Ordinary and Capital Losses	Loss Carryforward
Suspended ordinary loss	$40,000	2/5	$16,000	$24,000
Capital loss	10,000	2/5	4,000	6,000
Total	$50,000		$20,000	$30,000

The $16,000 ordinary loss is fully deductible, but if Jerry has no capital gains in 2008, he can deduct only $3,000 of the $4,000 otherwise allowable capital loss. The remaining $1,000 is carried forward as a capital loss carryover that is no longer subject to the I.R.C. § 469 limits.

Jerry also carries forward as suspended passive losses the remaining $24,000 ordinary loss and the $6,000 capital loss until he either has passive income or disposes of his entire interest in the partnership. The $6,000 capital loss is subject to the capital loss deduction limit when it is no longer suspended under I.R.C. § 469. [ENDOFEXAMPLE]

Practitioner Note
Grouping's Effect on Loss Recognition

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If two activities are grouped into one larger activity and the taxpayer disposes of one of the two, the taxpayer has disposed of only part of his or her entire interest in the activity. But if the two activities were not grouped and the taxpayer disposes of one of them, he or she has a complete disposition for full loss recognition.

HOME RUN: TAX BENEFIT FROM LOSS

This section briefly summarizes the NOL computation for an individual taxpayer.

A deduction can run the bases (the basis, at-risk, and passive-activity loss) and still not provide a tax benefit until the taxpayer finds some income to reduce by the allowable deduction. Congress has never enacted a truly negative income tax that automatically entitles a person with negative taxable income to a refund. Instead, a taxpayer may be able to use negative income from one year as a deduction in another year. This requires calculating an NOL and then determining the income years in which it may be claimed as a deduction.

Calculation of NOL

Negative taxable income does not necessarily mean there is an NOL. The computation of an individual NOL is complicated because the rules allow only business losses to be carried to another year. The NOL rules also prevent duplication of losses that are carried to another year under other tax law provisions, such as the capital loss rules.

An NOL is the excess of deductions over income, modified to obtain the taxpayer's true business loss. In general, the taxpayer must separate nonbusiness from business items, and modify the negative taxable income to eliminate investment expenses, itemized deductions, and exemption deductions.

Practitioner Note

Personal and Dependent Exemption Deductions

Personal and dependent exemption deductions are not allowed in computing an NOL [I.R.C. § 172(d)(3)]. Therefore, they are not allocated to either business or non-business deductions.

Net Business Income

Business income includes salaries, wages, rents, commissions, and farm income. Business deductions include employee business expenses, moving expenses, state and local income taxes on net business income, losses on I.R.C. § 1244 stock, and the taxpayer's share of a partnership, LLC, or S corporation business loss. All casualty losses are treated as business deductions and thus are included in the NOL.

Net Nonbusiness Income

Nonbusiness income includes interest, dividends, pensions, annuities, and some royalties. Nonbusiness deductions include the standard deduction, IRA contributions, Keogh plan contributions, alimony, medical expenses, taxes, interest, and charitable contributions.

Because nonbusiness losses cannot be carried to other years under the NOL rules, the NOL computation allows nonbusiness deductions to be considered only to the extent of nonbusiness income [I.R.C. § 172(d)(4)]. This rule is implemented on the Form 1045, Application for Tentative Refund, Schedule A—NOL, by starting with the tax return taxable loss and adding back nonbusiness deductions that exceed nonbusiness income.

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If nonbusiness capital gains exceed nonbusiness capital losses, the excess nonbusiness capital gains increase the taxpayer's nonbusiness ordinary income for the purpose of allowing nonbusiness deductions.

Capital Losses

Because capital losses are carried forward under separate rules, they are deductible in computing an NOL only to the extent of capital gains [I.R.C. § 172(d)(2)(A)]. Schedule A—NOL (Form 1045) implements this rule by adding back capital losses in excess of capital gains.

Capital Gains

Nonbusiness capital gains are subject to two netting rules, because they can be used in the NOL computation to offset nonbusiness deductions or any type of capital losses. Schedule A—NOL (Form 1045) first nets nonbusiness capital gains and losses. If nonbusiness capital gains exceed nonbusiness capital losses, the excess is used to allow other nonbusiness deductions. If there are still excess nonbusiness capital gains after nonbusiness deductions are allowed, the remainder is used to allow business capital losses.

If gain was recognized on the sale of any I.R.C. § 1202 small business stock, the excluded portion of that gain is added back.

Domestic Production Activities Deduction

In an ironic twist, the I.R.C. § 199 domestic production activities deduction (DPAD) is not treated as a business deduction for calculating an NOL [I.R.C. § 172(d)(7)]. However, because the DPAD is based in part on taxable income from business activities, and a business loss is required for there to be an NOL, this is not likely to be a frequently encountered situation. It does affect the carryover of losses from an earlier year to a later year, and in essence means that the carryforward loss is reduced by the carryback year DPAD.

Other NOL Deductions

No NOL deduction (carried from another year to the current year) may be deducted in computing the current-year NOL.

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Carryover Periods

For tax years beginning before 1998, the general carryover period for NOLs was back 3 years and forward 15 years. For tax years beginning after 1997, the general period is back 2 years and forward 20 years. However, Congress occasionally enacts special provisions for certain situations. Different carryback periods apply to NOLs arising from the items shown in Figure XX.8.

Figure XX.8

Type of Loss	Carryback Period	Citation
Real estate investment trusts (REITs)	None	I.R.C. § 172(b)(1)(B)
Specified liability losses [product liability losses, plus (for accrual basis taxpayers) losses resulting from expenses	10 years	I.R.C. § 172(b)(1)(C) I.R.C. § 172(f)

required by federal or state law for dismantling oil rigs, decommissioning nuclear power plants, reclaiming land, remediating environmental contamination, and paying worker's compensation]		
Casualty and theft losses of individual taxpayers	3 years	I.R.C. § 172(b)(1)(F)(ii)(I)
Small business (gross receipts less than $5 million) losses in presidentially declared disaster areas	3 years	I.R.C. § 172(b)(1)(F)(ii)(II)
Farming losses	5 years	I.R.C. § 172(b)(1)(G)

A taxpayer may elect to forgo the carryback period and carry a loss forward only [I.R.C. § 172(b)(3)].

Planning Pointer
Carryback or Carryforward?

Usually, a carryback is preferable to a carryforward because it results in a certain and quick tax refund. In making the choice, a taxpayer should try to determine the years with the highest tax rate and use as much of the NOL deduction as possible in those years.

If the carryback years were taxed at very low rates, and the year following the NOL is likely to produce high income and a high tax rate, the taxpayer may want to opt for the carryforward only.

Because an NOL is absorbed to the extent of modified taxable income, but its tax benefit is limited to taxable income, taxpayers should avoid carrying an NOL to a year in which modified taxable income is much greater than taxable income.

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Practitioner Note
Substantiation of NOL

Taxpayers must maintain accurate records showing how an NOL arose and how it was used in the carryback and carryforward years for the entire period that any return showing an NOL deduction can be examined. An IRS agent examining a return that includes an NOL deduction will request verification. The Tax Court has noted that deductions are a matter of legislative grace and the taxpayer bears the burden of proof for an NOL's existence, amount, and year [*United States v. Olympic Radio & Television, Inc.*, 349 U.S. 232 (1955); *Keith v. Commissioner,* 115 T.C. 605 (2000)].

Filing for Carryback Refund

There are two options for filing a claim for a refund based on an NOL carryback.

1. The taxpayer may file a Form 1040X, Amended U.S. Individual Income Tax Return, for each carryback year. The deadline for filing these returns is 3 years after the due date (including extensions) for Form 1040 for the loss year.
2. An easier option that may result in a quicker refund is filing a Form 1045 covering all of the carryback years. The deadline is shorter: Form 1045 must be filed be the end of the first year after the loss year ends.

In either case, Form 1040 must be filed for the loss year to establish the NOL before the IRS can process a carryback claim.