

## Passive Activity Rules

### Chapter 14

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### Passive Activity Rules Apply To

- ▶ Individuals
- ▶ Estates and trusts
- ▶ Certain personal service corporations
- ▶ Closely held regular corporations
  - Not publicly held corporations

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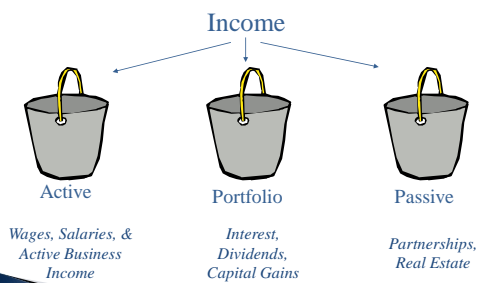
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### Taxable Income



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## Passive Activity

- ▶ **Passive Activities Include**
  - Activities in which the taxpayer does not materially participate
  - Limited partnership interests
  - Any rental activity (even if the taxpayer does materially participate)
- ▶ **Exclusions**
  - Working interest of oil and gas ventures, as long as the taxpayer is not a limited partner

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## Material Participation

- ▶ Requires involvement in the operations of the activity on a regular, continuous, and substantial basis
- ▶ Mere management approval does not qualify

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## Material Participation Example

Reilly and Kasey are brothers, and each owns a 10% interest in JarvCo, LLC, a closely held family business. Reilly is the general manager of JarvCo's local office. Kasey decided to become a physician, and does not participate in the operation of the family business.

The distributive share of the partnership income that Reilly receives is treated as active income since Reilly materially participates in the conduct of JarvCo's business. Kasey's distributive share of the partnership income will be treated as passive income/loss since Kasey is not materially participating in the conduct of the business activities.

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## Tests for Material Participation

1. More than 500 hours
2. More than 100 hours, but no less than anyone else
3. All substantial participation is the taxpayer's
4. More than 100 at several activities and more than 500 in total
5. Materially participate in 5 of the last 10 years
6. Materially participate in personal service activity for at least 3 years
7. Facts and circumstances indicate regular, continuous, and substantial activity

*Limited Partners must meet test 1, 5, or 6.*

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## Grouping of Passive Activities

- ▶ Referred to as an *Appropriate Economic Unit*
- ▶ 5 Factors:
  - Similarity/Difference in types of business
  - Extent of Common Control
  - Extent of Common Ownership
  - Geographic Location
  - Interdependencies between various activities

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## Grouping of Passive Activities

- ▶ Once chosen, cannot be changed unless
  - The original grouping was clearly inappropriate
  - Material change in facts and circumstances
- ▶ IRS can reallocate groupings if it determines the groupings are inappropriate

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## Grouping of Passive Activities Example

Mike participates in 3 activities (A, B, and C). He dedicates 120 hours to Activity A, 150 hours to Activity B, and 270 hours to Activity C.

He can group the three together to be a material participant in all ( $120 + 150 + 270 = 540$ ).

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## Inappropriate Groupings

### ▶ Rental and Nonrental Activities

- *Exception:* when one activity is insubstantial in relation to the other

### ▶ Rental of Real and Personal Property

- *Exception:* when personal property is provided in connection with real property

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## Limitations on Passive Activity Losses (PALs)

### ▶ The basis limitation

- Maximum loss deductible is limited to basis

### ▶ The at-risk limitation

- May not deduct in current year more than the amount at risk for investment
- Basis is reduced by nonrecourse debt
- Determines how much is subject to PAL rules
- Disallowed losses carry forward

### ▶ The passive activity loss rules

- Determine the income tax deduction

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## Passive Activity Loss Rules

- ▶ Losses falling into the passive bucket can only be offset by gains in the same bucket
  - Excess losses can be carried forward indefinitely
- ▶ Losses can be accelerated by
  - Disposing of the activity generating the losses. The loss will offset (in the specified order)
    - Gain on disposition of the interest
    - Net income from passive activities
    - Active and portfolio income

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## Suspended PALs and Financial Planning

- ▶ Death
  - Deductible on final income tax return to extent they exceed step-up to FMV
- ▶ Gifts of assets with suspended PALs
  - Donee's basis is increased by the suspended loss

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## Suspended Loss When Taxpayer Dies Example

Roger died last week. Throughout his life, he relied on the advice of his friend Larry and purchased a series of passive investments that persistently generated losses and had little prospect of increasing in value.

Roger's total basis in the passive investments was \$150,000. As of the date of his death, Roger had \$150,000 in suspended passive losses, and the fair market value of his passive investments was \$20,000.

Since Section 1014 will result in a new basis of \$20,000 (a step down) in the hands of the estate beneficiary who receives the investments, Roger is permitted to deduct the entire \$150,000 suspended loss on his final income tax return.

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## PALs and Financial Planning

- ▶ Installment Notes
  - PALs must be deferred over the term of the note
  - Use same percentage as gain recognized
- ▶ Non-Taxable Exchange
  - Suspended losses are carried over to the replacement property

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## Rental Activities

- ▶ Rental of tangible (real or personal) property is automatically passive activity unless it meets one of 6 exceptions
- ▶ If an exception applies, the rental activity is subject to the material participation test

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## Rental Activity Exceptions

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| 1. | Customer use $\leq$ 7 days   |
| 2. | Customer use $\leq$ 30 days and personal services provided   |
| 3. | Extraordinary personal services are provided   |
| 4. | Rental activities incidental to non-rental activity  |
| 5. | Rental activity available during business hours for nonexclusive use of customers                              |
| 6. | Rental property used in activity conducted by partnership, etc. where taxpayer is owner and active participant |

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## Real Estate Professionals Exception

### ▸ Requirements

- More than  $\frac{1}{2}$  of personal services performed in all trades or business during the taxable year are in real property trades or businesses in which the taxpayer materially participates
- At least 750 hours of service

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## Real Estate Professionals Exception

### ▸ Closely held C corporations

- Are eligible if more than 50 percent of the gross receipts of the corporation is derived from real property trades or businesses in which the corporation materially participates
- May utilize excess PALs against active, but not portfolio, income

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## Individual Investor Exception

### ▸ Up to \$25,000 deduction against non-passive income

- Have AGI that is equal to or less than \$100,000 - \$150,000 (phaseout)

### ▸ Requirements

- Active Participation
  - Requires bona fide participation in management decisions
- 10% ownership interest

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### Rental Real Estate Individual Investor Exception Example

- ▶ Ralph and Kaco, a married couple, have AGI of \$138,000 and have a loss of \$30,000 from rental real estate property. Since they are beyond the \$100,000 in AGI they can only deduct 50 cents for every dollar of loss that they are below the \$150,000 phaseout.
- ▶  $\$150,000 - \$138,000 = \$12,000/2 = \$6,000$  deduction
- ▶ Therefore, they can deduct \$6,000 against ordinary income. The remainder of the loss is suspended under the passive activity rules.

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### Passive Credits

- ▶ Used to offset any tax attributed to taxable income
- ▶ Include
  - Low-income housing credit
  - Rehabilitation credit
  - Research credit
- ▶ Credits are nonrefundable

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