

Kenneth M. Wasserman, CPA
ken@kenwassermancpa.com

Kristof E. Ketzan, CPA
kketzan@kenwassermancpa.com

Leonard H. Andrews, CPA
len.andrews@kenwassermancpa.com

Limitations on Losses Applicable to Partners and S Corporation Shareholders

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I. Introduction

A. For losses to be deductible, there are three separate loss limitations applied in the following order as set forth in Reg §1.469-2T(d)(6):

1. Adjusted basis of partnership interest and shareholder's basis in stock and debt
 - a. Limitation established under §704(d) and §1366(d)
 - b. Limitation applied at level of interest in pass-through entity
2. Amount at risk - §465
 - a. Applies to individual partners and shareholders. §465(a)
 - b. Limitation applied at relevant activity level. §465(c)
3. Passive activity loss limitations - §469
 - a. Applies to individual partners and shareholders. §469(a)(2)
 - b. Limitation applied at relevant activity level. §469(c)

II. Basis in Partnership Interests and S Corporation Stock and Loans

A. Basis - Partners

1. Initial Basis in Partnership Interest

- a. Initial basis is money and adjusted basis of property contributed increased for any gain on contribution. §705(a)
- b. Contributions of money and property to partnerships (whether at formation or to existing partnership) exchanged for partnership interests are generally not taxable events. §721

2. Adjustments to Basis in Partnership Interest per Ordering Rules

- a. Basis is first increased by partner's contributions of capital, share of taxable and non-taxable income. §705(a); Reg §1.704-1(d)(2)
- b. Basis is then decreased for distributions. Id.
- c. Basis is then decreased by partner's share of nondeductible expenses and for losses. Id.
- d. Increase in share of partnership liabilities increases basis; decrease in share of partnership liabilities decreases basis. §752
- e. For purposes of ordering rules, an increase in liabilities is a deemed contribution of money to the partnership and a decrease a deemed distribution. §752; Reg §1.704-1(d)(2)

3. Treatment of Suspended Losses

- a. For utilization of suspended losses, there must be: (1) additional contributions or money or property; (2) receipt of partnership income; or (3) an increase in the partner's share of liabilities.
- b. To utilize suspended losses in year of partnership interest is disposed, additional contributions must be made prior to the end of the tax year of disposal. Sennett v. Comm'r, 80 T.C. 825

B. Basis - S Corporation Shareholders

1. Basis in stock

- a. At the time of corporate formation, the elements of §351 must be met to qualify for non-recognition; exchanges of stock for property fully taxable for existing S corps. §351; §1371
- b. Stock basis is first increased for stockholder's share of taxable and non-taxable income and additional paid-in capital, then decreased first for distributions, then for nondeductible expenses, and finally for the share of losses and nondeductible expenses. §1367(a); Reg. §1.1367-1(f)

2. Basis in loans to corporation

- a. S corporation shareholders do not get basis for share of entity's liabilities. Only loans made by shareholders to the corporation create debt basis. §1366(d)
- b. Guarantee of corporation debt by shareholders does not create debt basis.
- c. Debts should be properly executed and evidenced by relevant documentation to ensure that basis will be obtained. C.E. Jones v. Comm'r, 74 T.C. Memo. 473

d. Distributions are applied against stock basis only; they are taxable to the extent they exceed stock basis irrespective of any basis in loans. §1368

III. At-Risk Rules

A. General Rules

1. Originally applied only to certain enumerated industries; later amended to apply to all trade or business and production of income activities. §465(c)(2), (3)
2. Amount at risk consists of money and adjusted basis of property contributed to activity §465(b); and
3. Amounts borrowed with respect to activity to extent of personal liability or extent secured by property not used in the activity. Id.
4. Adjusted for contributions, profit from the activity, losses from the activity, and money and property withdrawn, including partnership and S corporation distributions. §465(b)(5)

B. Aggregation rules

1. For enumerated businesses (motion pictures, farms, oil & gas, etc.) each defined unit of property is considered a separate activity (each film or video tape, farm, oil & gas property, etc.) §465(c)(2)(A)
2. For other trades or businesses, all of the trade or business is considered a single activity if the taxpayer actively participates in management, or in the case of partnerships and S corporations, if 65% or more of losses allocable to individuals who actively participate in management of business. §465(c)(3)(B)

C. Treatment of Amounts Borrowed

1. No amount of borrowed money deemed to be at risk to extent protected against loss through non-recourse financing, guarantees, etc. §465(b)(4)
2. Amount not at risk if borrowed from someone with an interest in the activity (or related to that person.) §465(b)(3)(A)
3. Previous rule does not apply to lender whose only interest is as creditor or to shareholder loan to corporation. §465(b)(3)(B)
4. Interest in activity other than as creditor defined as net profits or capital interest. Prop. Reg. §1.465-8(b)(1)

5. Amount at risk typically unaffected by repayments of loans for which taxpayer is at risk, except in cases that loan is paid in manner not qualified to receive amount at risk (e.g. taking nonrecourse loan to pay off recourse loan.) Prop. Reg. §1.465-24(b)(1), (2)

D. Qualified Nonrecourse Financing

1. For activities involving holding real property, taxpayer is at risk for qualified nonrecourse financing secured by real property used in the activity. §465(b)(6)
2. Must be borrowed with respect to activity of holding real property, from a qualified person or government entity, for which no one is personally liable, and must not be convertible debt. Id.
3. A qualified person is actively involved in the business of lending money and is not a related party to the taxpayer, the person from whom the taxpayer acquired the property, or a person who receives a fee with respect to the investment in the property. Id.
4. For partnerships, the only persons personally liable must be partnerships, each partnership must hold only qualified property, and the lender can only proceed against property that is permitted as security for qualified nonrecourse financing. Prop. Reg. §1.465-27(b)(4)

E. Ordering Rules and Timing of Increases and Decreases

1. Deductions are allowed in the following order under the at-risk rules: all capital losses are allowed first, then §1231 losses, followed by all other deductions besides §57 tax preference items, and finally §57 tax preference items. Prop. Reg. §1.465-38
2. To compute amount at risk at the end of a tax year, all increases are taken into account followed by all decreases. Prop. Reg. §1.465-39

F. Recapture of Losses

1. When amount at risk goes below zero at the end of a tax year, the amount recaptured is the lesser of the negative amount at risk or the total amount of losses deducted from the activity since 1979 less any amounts previously recaptured. §465(e)

G. Transfers and Dispositions of Activities

1. Any gain is treated as income from the activity, and suspended losses can generally be recognized even if the taxpayer's participation ended prior to the transfer or disposition. The same rules apply to liquidations

of partnership interests and complete redemptions of S corporation shareholder interests. Prop. Reg. §1.465-66

H. Reporting At-Risk Limitations

1. Form 6198 must be filed with the taxpayer's return for any year that (1) the taxpayer carries on an activity as a trade or business or for production of income, (2) the activity has a loss for the year, and (3) the taxpayer has amounts invested in the activity that are not at risk.

IV. Passive Activity Loss Rules

A. General Rules

1. Passive activities include trade or business activities in which the taxpayers does not materially participate and rental activities. §469(c)
2. Passive activity loss is defined as aggregate loss from all passive activities in excess of aggregate income from passive activities. §469(d)(1)
3. Suspended losses carried forward until they are offset by passive income or become deductible on complete disposal of activity. §469(b), (g)

B. Defining Participation and Material Participation

1. Participation is any work done by a taxpayer in connection with an interest owned by the taxpayer. Reg. §1.469-5(f)
2. Work done by owner not deemed to be participation if not customarily done by an owner and done in order to avoid passive loss limitations. §1.469-5T(f)(2)
3. Work done in capacity as investor is not participation unless the taxpayer participates in the day-to-day operations of the activity. Id.
4. Participation by taxpayer's spouse is attributed to the taxpayer. §1.469-5T(f)(3)
5. Material participation is the standard by which activities are determined to be passive or non-passive. It is defined as participation that is regular, continuous, and substantial. §469(h)(1)
6. Regulations provide seven tests for material participation: (1) the 500 hour test; (2) the substantially all participation test; (3) the more than 100 hours and not less than participation by any other individual test; (4) the "significant participation activities" test; (5) the material participation for five of the last ten years

test; (6) the personal service activity with material participation for at least three preceding years test; and (7) the facts and circumstances test. §1.469-5T(a)

C. Treatment of Partners, LLC, and LLP Members

1. Limited partner typically subject to passive loss rules unless also owner of a general partner interest.

Reg. §1.469-5T(e)

2. Limited partners only allowed to demonstrate material participation under: (1) the 500 hour test, (5) the material participation for five of the last ten years test, and (6) the personal service activity with material participation for at least three preceding years test. Id.

3. LLC and LLP members were originally treated the same as limited partners. Now the determination is made in light of all facts and circumstances and all seven tests are available for use. Thompson v. U.S., 2009-2 USTC, 87 Fed. Cl. 728 (Fed. Cl. 2009)

D. Rental Activities

1. Rental activities treated as passive unless the taxpayer qualifies for a partial exemption for active participation (allowing deductions of up to \$25,000 annually) or qualifies as a real estate professional, which exempts the activity entirely. §469(i); §469(c)(7)

2. A rental activity is defined as an activity in which the gross income represents amounts paid principally for the use of tangible property. Reg. §1.469-1T(e)(3)

3. There are six exceptions that allow an activity to fall outside the definition of rent: (1) the average period of customer use is seven days or less; (2) the average period is less than thirty days and significant personal services are provided; (3) extraordinary personal services are provided by the owner for use by customers; (4) the rental activity is incidental to the non-rental activity; (5) the taxpayer customarily makes the property available during business hours for nonexclusive use by various customers; and (6) the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than rental activity and the taxpayer provides the property for use in the activity in the taxpayer's capacity as owner. Id.

E. Active Participation in Real Estate

1. Active participation is a lower standard than material participation. A taxpayer can actively participate by making management decisions in a significant and bona fide sense. Senate Committee Report to P.L. 99-514 (1986), S. Rep. No. 99-313.

2. A taxpayer and spouse do not qualify if their combined ownership is less than 10% of the activity or if either of them are limited partners. §469(i)(6)

3. Generally, the \$25,000 deduction is reduced by 50% of the amount that the taxpayer's AGI exceeds \$100,000 and is fully phased out when AGI reaches \$150,000. §469(i)

F. Real Estate Professionals

1. To qualify as a real estate professional and be exempt from passive loss rules, (1) more than one-half of the trades or businesses performed by the taxpayer are in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer must perform more than 750 hours per year relating to those activities. §469(c)(7)

2. Real property trades or businesses are defined as real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses. Id.

3. Each interest that a real estate professional has in real estate is treated as a separate activity unless the taxpayer elects to treat all rental real estate activities as a single activity. Id.

G. Grouping Passive Activities

1. One or more activities may be treated as a single activity if they constitute an appropriate economic unit. Reg. §1.469-4(c)

2. Regulations provides factors for determining an appropriate economic unit. It is not necessary for all factors to apply. They are: (1) similarities and differences in types of trades or businesses; (2) extent of common control; (3) extent of common ownership; (4) geographical location; and (5) interdependencies between or among the activities. Id.

3. Trade or business and rental activities may not be combined unless: (1) the rental activity is insubstantial in relation to the trade or business activity; (2) the trade or business activity is insubstantial in relation to the rental activity; or (3) each owner of the trade or business has same proportional ownership interest in the rental activity. Reg. §1.469-4(d)

4. Partners and S corporation shareholders may combine activities treated separately by the entity, or combine them with other activities that they own. But, they may never treat as separate those activities grouped together by entity. Reg. §1.469-4(d)(5)

H. Suspended Losses

1. Losses disallowed by passive loss rules are carried forward to the next tax year. §469(d)(1)
2. Suspended losses are allocated pro rata to all passive activities that had losses for the year. §469(j)(4);
Reg. §1.469-1T(f)(2)(i)
3. Suspended losses deductible in full in the tax year that an activity is fully disposed in a taxable transaction that is not made to a related party. §469(g)
4. Suspended loss applied first against passive income from the same activity, then passive income from other passive activities, then non-passive income. Uy v. Comm'r, TC Summary 2008-36
5. If the disposal is made to a related party, the original transferor may not deduct the loss until the related party has disposed of the property to a third, unrelated party. §469(g)(1)(B)
6. Disposal of less than an entire interest is usually considered income from the activity and does not allow the use of suspended losses. But, if substantially all the activity is disposed, the portion disposed may be treated as a separate activity if it can be established with reasonable certainty: (1) the amount of suspended losses allocable to that part of the activity; and (2) the amount of net income or loss allocable to that part of the activity for the current year. Reg. §1.469-4(g)
7. If in an interest in a partnership or S corporation which has suspended losses from passive activities is disposed, the taxpayer's gain or loss is allocated among the activities held by the entity based on a hypothetical disposition of each activity. Reg. §1.469-2T(e)(3)

I. Reporting Passive Activity Losses

1. Form 8582 (and if applicable, Form 8582-CR) must be attached to the tax return each year that a taxpayer has passive losses or suspended credits, unless the taxpayer has only net passive income or the taxpayer's only passive activities are rental activities that qualify under the active participation rule, those losses are less than \$25,000, and the taxpayer has no other suspended losses or credits. Only one Form 8582 should be filed no matter how many passive activities the taxpayer owns.
2. Statements must be submitted with a tax return for the first tax year that two activities are grouped as a single activity, including a declaration that the grouping constitutes an appropriate economic unit. Statements are also required for the addition of new activities to existing groupings and for regroupings of original groupings. Rev. Proc. 2010-13

3. For partnerships and S corporations, the instructions for Form 1065 and Form 1120-S require that schedules of activities be included as attachments to Schedules K-1. Partners and S corporation shareholders are generally not required to make any separate disclosures.