Deductions for Certain Investment Expenses and Losses

Learning Objectives

Upon completion of this chapter you will be able to:

LO.1 Discuss the basic rules governing the deduction of investment expenses.
LO.2 Describe the structure of a tax shelter.
LO.3 Explain the at-risk rules.
LO.4 Explain the passive loss rules.
LO.5 Understand the special treatment for interest expense related to a passive activity.
LO.6 Discuss the restrictions imposed on deductions related to vacation homes.

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Introduction

Since 1942 Congress has generally allowed taxpayers to deduct expenses and losses incurred in connection with investment activities. As explained in Chapter 7, Code § 212 currently authorizes the deduction of investment-oriented expenses. This provision specifically allows a deduction for expenses incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Deductible investment expenses typically include such items as fees paid to rent a safety deposit box to hold securities, cost of financial advice, and travel expenses incurred in managing property. Expenses incurred in operating rental property such as those for maintenance, depreciation, utilities, and insurance are also deductible under § 212. Similarly, deductions for interest expense incurred by taxpayers to finance their investments also are deductible under § 212, although certain restrictions apply (as discussed in Chapter 11). Most important, the law generally allows the deduction of losses flowing through to the taxpayer from investments in partnerships and S corporations. Specific investment expenses incurred by the taxpayer are normally classified as miscellaneous itemized deductions and are subject to the two percent limitation and the deduction cutback. However, expenses related to property held for the production of rents or royalties are deductible for A.G.I. In addition, losses flowing from a partnership or S corporation are generally deductible for A.G.I.

For many years, the general rules adequately governed the deduction of most investment expenses and losses. In time, these rules became insufficient to police growing abuse. As a result, Congress enacted special provisions to restrict investment-type deductions where it found the general rule to be lacking. This chapter examines four additional measures: the at-risk rules, the passive activity limitations, the restrictions on the deduction for interest expense related to passive activities, and the provisions related to the rental of vacation homes.

Introduction to Tax Shelters

Historically, the tax law has generally allowed taxpayers to use deductions from one activity to offset the income of another. Similarly, most credits could be used to offset tax attributable to income from any of the taxpayer’s activities.

Example 1

R earns $50,000 annually working as vice president of marketing at Plentiful Products, Inc. Over the years, he has accumulated a modest portfolio of stocks which generates dividends of about $10,000 a year. In addition, he is a 10% limited partner in a partnership that owns an apartment complex consisting of 200 units. During the year, the apartment complex had operating expenses that exceeded rental income, creating a $100,000 loss. Prior to 1987, R could use his share of the loss, $10,000, to offset his other income, both salary and dividends. Assuming R’s marginal tax rate was 30%, the loss produced tax savings of $3,000.

The above example illustrates the essentials of what is now a well-publicized phenomenon: under prior law, an individual could reduce his or her tax liability—even eliminate it—by investing in “tax shelters” that produced losses which could be offset against other income. The attraction of such losses for taxpayers wishing to avoid taxes was so great that the tax shelter business grew into a thriving industry.

A tax shelter is simply an investment which takes advantage of certain tax rules to enhance its rate of return. Like any investment, there is an outlay of cash (or credit) for something that hopefully will yield income year after year and produce gain on its disposition. The ultimate reward or potential loss is usually commensurate with the risk that the investor is willing to assume. It is the tax treatment of the various pieces of the investment that converts an ordinary investment to a potential tax shelter. For example, in the broadest sense, an investment in municipal bonds may be considered a type of tax shelter because the return paid on the investment—the interest—is tax exempt. In the real world, however, the term tax
Introduction to Tax Shelters

shelter is usually not associated with tax-exempt bonds—tax-favored probably would be a more appropriate label. The words “tax shelter” typically conjures up images of complex investments that—as in Example 1—throw off losses to “shelter” the investor’s other income.

Structure of a Tax Shelter

In the heyday of the industry, a tax shelter was organized as a limited partnership. From a tax perspective, the partnership form is the perfect structure for the shelter because it is not a separate taxable entity. Instead, a partnership acts as a conduit, enabling the tax benefits produced by the activity to flow through to the investing partners. Operating losses from the partnership’s business flow through to the partners who may be able to offset the losses against their other income. Long-term capital gains realized by the partnership flow through, retaining their favorable character to be reported by the partners on their own returns. Special credits generated by the partnership’s activity (e.g., the rehabilitation and low-income housing credits) might pass through to the partners to be used to reduce the tax on other taxable income. Observe the vital role that the flow-through characteristic of a partnership plays in a tax shelter. Such results could not be obtained with a C corporation. A C corporation, which is a separate taxable entity, pays taxes on its own income which may be taxed again when distributed to the shareholders as a dividend. More important, at least in a tax shelter sense, the losses of a C corporation can only be used by the corporation to offset its own income and, therefore, produce no benefits to the investing shareholders. For these reasons, tax shelters are not organized as C corporations. Indeed, it is not surprising that as tax shelters became more popular, the IRS tried to halt their growth by arguing that tax shelters posing as limited partnerships were not really partnerships but—because of their limited liability and their close resemblance to a corporation—were corporations. However, the government had little success with this theory and had to devise other techniques to eliminate the perceived abuse.

Promoters of tax shelters historically used limited partnerships—rather than general partnerships—as the vehicle of choice. The promoter, the one who put the deal together and got a fee for his efforts, normally acted as the general partner. To lure an investor, the promoter had to limit an individual’s exposure to risk. By structuring the investment as a “limited” partnership, individuals could invest and limit the possibility of financial loss to the amount of their investment. Any liability in excess of that borne by the limited partners was the responsibility of the general partner. This ceiling on an individual’s exposure was an extremely attractive feature in the promotion of tax shelters, paving the way for otherwise wary investors to make a financial commitment to the activity.

Elements of a Tax Shelter

Most tax shelters are constructed to offer three basic benefits: tax deferral, conversion of ordinary income into capital gain, and leverage. Each of these characteristics on its own can produce significant benefits. But when the three are combined into a single package, the result is almost too good to be true.

Deferral

Deferral is one of the most important tools in tax planning. Postponing the time at which taxes must be paid is the equivalent of an interest-free loan from the government. To illustrate, consider a taxpayer who can defer the payment of $10,000 of taxes for a five-year period. Assuming an after tax rate of return of ten percent, the present value of the tax payment is only $6,210 [$10,000 × (1/(1.10)^5)]. In this case, postponing payment of tax saves $3,790, a decrease of almost 38 percent!

A typical tax shelter achieves deferral through a mismatching of revenues and expenses. Mismatching occurs because of the timing of income and deductions. Normally a tax shelter produces deductible expenses prior to the period in which the investment produces income in sufficient amounts to offset the deductions. In the appropriately structured tax shelter, taxpayers may be able to use these excess deductions, in effect losses from the shelter, to offset income from other sources thus producing immediate benefits. Most tax shelters were built around this same modus operandi: deduct expenses now while the gain accrues and is not taxed until later. This approach, “deduct now, pay later,” is still the foundation of many current tax planning ideas.
Example 2

R, S, and T formed a partnership for the purpose of breeding cattle. Each contributed $15,000 for a one-third interest. The partnership uses the cash to purchase a herd of cattle consisting primarily of cows, heifers and a few bulls. The partnership’s only cash expenses during the year were the costs for breeding and maintaining the cattle totaling $45,000. No income was produced since none of the cattle were sold. Assuming the partnership uses the cash method of accounting and ignoring depreciation, the partnership has a loss of $45,000 which is allocated equally among R, S and T. As a result, R, S and T each have a $15,000 deduction for the losses attributable to their investment in the partnership, and this loss—prior to 1987—could be offset against income from other sources. Assuming each is in the 50% tax bracket (federal, state and local), each saves taxes of $7,500 ($15,000 × 50%).

[Note: while a 50% tax rate might seem high today, that has not always been the case. From 1965–1986, the top federal rate was 70%. Even in 2012, a taxpayer living in New York City could pay a combined rate of almost 50% (35% federal + 8.97% state + 3.876% city = 47.846%).]

Note in the above example that the tax savings occur because the cash method of accounting results in a mismatching of expenses and revenues. Had the partnership been required to use the accrual method or simply prohibited from deducting the expenses until the partnership sold the cattle, revenue and expenses would have been properly matched—at least in the financial accounting sense—and no tax savings would result (unless the cattle are later sold at a loss). It also should be emphasized that the taxes saved in this situation are not permanently avoided but only deferred until the future when the cattle are sold.

Example 3

Refer to the situation in Example 2 where expenses during the first year of operations were $45,000, producing a $45,000 deductible loss. Now assume that the cattle that were born and raised are sold for $45,000 on the first day of the next accounting period. If there were no other expenses, the partnership would have income of $45,000, each partner reporting $15,000. Note that the taxes paid in this period are the same as the taxes saved in the prior period. Thus, the taxpayer has not escaped $7,500 in taxes; nevertheless, the taxpayer has benefited since he deferred payment of the tax for one year. In addition, the taxpayer has benefited even though he had no gain or loss on the transaction as a whole ($45,000 income was equal to the $45,000 cost of breeding and raising). Of course, whether the taxpayers are happy with the result depends on the return that they could have otherwise received had the $45,000 been invested elsewhere.

The cattle example typifies the classic tax shelter but there were many more. Taxpayers could invest in partnerships created to explore for oil and gas, produce a movie or Broadway show, buy art masters from which lithographs and prints could be made, or lease equipment (e.g., railroad boxcars, barges, cable TV systems, houseboats, executive jets and any other item someone might be willing to rent). Perhaps the shelter of all shelters is real estate. Here the partnership buys an office or apartment building for which current depreciation deductions can be claimed even though the value of the building is holding or increasing. Despite their differences, all tax shelters had one common thread: claim deductions this year for expenses that add value that will not be taxed until next year.

While deferral is a huge advantage, the opportunities increase dramatically when the element of conversion can be added to the mix.

Conversion

The second element of the successful tax shelter involves conversion. Conversion is a two-step process. The first step concerns the treatment of deductions arising from the tax shelter activity. These expenses are deductible and reduce ordinary operating income that would otherwise be taxed at ordinary tax rates. The second step is where the conversion takes place.
When the tax shelter activity is sold, any gain on the sale is taxed as long-term capital gain, which is taxed at the far more favorable capital gain rates.

**Example 4**

Recall Example 3 where the cattle were purchased, bred and raised at a cost of $45,000. Assume now that the cattle are sold after they were held for more than two years—the holding period necessary for cattle if gain is to qualify for long-term capital gain treatment. Given this additional fact, the $45,000 gain would be treated as long-term capital gain and thus each partner would (using the tax rates in effect today) pay taxes at a capital gains rate of 20%, producing a tax of $3,000 (20% × $15,000) for each of the partners. Contrast the tax paid on the gain, $3,000, with the $7,500 of taxes saved from deducting the costs (50% × $15,000 share of the loss = $7,500). Most important, note that there was no real economic gain on the transaction: the cattle cost $45,000 to raise and then were sold for $45,000. However, because of the difference between the tax rates applying to ordinary income and capital gains, each partner is better off by $4,500 ([$7,500 − $3,000]). Note that in the previous example the $7,500 of taxes initially saved by each partner were entirely recouped by the government when the cattle were sold. In this situation, however, the government recoups only $3,000 of the original savings because the ordinary income was converted to capital gain. Thus, in this case, the taxpayer has not only benefited from deferral—deductions now, income later—but also earned $4,500 from the conversion of ordinary income into capital gain.

**Leverage**

The third element of most tax shelters is leverage. In physics, a strategically placed lever provides a mechanical benefit, enabling people to lift more than they would be able to with their own physical strength. The principle is the same in the world of finance. In investing, borrowing money enables an individual to obtain a larger return than otherwise could be obtained. For example, assume an individual purchases land for $100,000, $10,000 of her own money and $90,000 borrowed from a lender. If the investment is sold a year later for $120,000, there has been a 20 percent return on the total $100,000 investment. But for the individual investor, after paying back the lender $90,000 and $10,000 for the use of the money (i.e., interest), the $20,000 remaining means that she has doubled her money, a return of 100 percent! In tax terminology, the term **leverage** means that by borrowing money, a taxpayer can obtain a disproportionately large benefit from a small investment. The most common use, sometimes referred to as “tax leverage” concerns depreciation. For example, a tax shelter partnership might purchase a railroad boxcar for $25,000 down and finance the balance with a $75,000 note (i.e., the leverage). The law allows depreciation on the entire $100,000 not just the $25,000—creating much larger depreciation deductions than could have been obtained had depreciation been allowed only on the amount not borrowed.

**Example 5**

Assume the same facts as in the previous examples concerning the cattle breeding tax shelter except that the partnership acquired the original herd using an initial investment of $5,000 each—$15,000 total—and $30,000 of funds borrowed from the bank for which the partners are personally liable. Note the result when the taxpayer leverages a small investment with borrowed funds: each taxpayer receives a deductible loss providing a tax saving of $7,500 ($45,000 deduction ÷ 1/3 = $15,000 × 50%) which is more than his $5,000 original investment!

Note in the example above that by using leverage the taxpayers are able to generate $45,000 of deductions for an investment of only $15,000. In the language of tax shelters, this means that the taxpayers got a 3:1 write-off, $3 of deduction for each $1 invested. If the taxpayer is in the 50 percent tax bracket, a $3 deduction produces a benefit of $1.50 in tax savings at a cost of $1—clearly a miracle. When tax shelters were at the peak of their popularity, some investments boasted far greater benefits, 5:1, 10:1 and higher.
While the principle of leverage can work miracles, it can also spell disaster. If a taxpayer invests in a tax shelter where the write-off is 10:1, this means that the deal is highly leveraged—a large amount is being borrowed. If the investment goes sour, the lender still must be repaid. In such cases, the cost of the deductions could result in a severe financial loss. However, tax shelter promoters usually solved this problem by using a magical tool: nonrecourse financing.

A nonrecourse note is a loan for which the borrower bears no liability for the debt. If the borrower defaults on the loan, the lender can foreclose on the property (i.e., the collateral). However, if the funds derived from foreclosure and sale of the property are not sufficient to satisfy the loan obligation, the lender is out of luck—there is no recourse against the borrower. In a partnership, if the financing for the tax shelter activity was provided using nonrecourse debt (e.g., an office building or other real estate), the investing partners were only liable for the debt to the extent of their investment. As might be imagined, promoters took advantage of this phenomenon. In the most outrageous deals, the promoter would overstate the value of the investment and then act as the banker, providing the financing, all nonrecourse. The investors’ cash investment would cover any real costs of the promoter and the nonrecourse financing simply served to create deductions.

**Example 6**

P put together a limited partnership to create deductible losses for the investors. Ten doctors invested $10,000 each for a partnership interest. The partnership used the $100,000 to buy a building from P for $1,000,000. The partnership signed a nonrecourse note to P for $900,000, payable with interest only for 20 years and a balloon payment of $900,000 at the end of the term. Before consideration of depreciation, operation of the office building broke even. The partnership proceeded to depreciate the property (a noncash expenditure), producing net losses that could be passed through and deducted by the partners. At the end of 20 years, the partnership might default on the note. In this case, P would take back his property and each partner would have received essentially $100,000 of deductions at a cost of $10,000. If the partners were in the 50% tax bracket, the deductions would be worth $50,000 and the arrangement would have provided a terrific return on the partners’ investments. On the other side of the deal, P would pocket the $100,000 for his trouble. Note that the value of the building could have been whatever the partnership wanted to set, $1 million, $1.5 million, $2 million, or whatever, since the debt was nonrecourse and no one was ever going to pay!

In order to prevent what it considered the harmful and excessive use of tax shelters, Congress took action—albeit indirect—with enactment of the at-risk rules in 1976 and the passive loss rules in 1986. Perhaps fearing that it would alienate certain constituencies, Congress opted not to eliminate or limit the provisions on which shelters are built (e.g., special benefits for low-income housing and rehabilitation of old and historic buildings). Instead, the new legislation, placed limitations on the losses created by these special provisions.

### At–Risk Rules

As can be seen in Example 6, the linchpin that held many tax shelters together was nonrecourse financing. From the outset, the government believed that investors should not be entitled to deductions unless they actually incurred a cost—something that was not necessarily present when a tax shelter was structured with nonrecourse financing. Consequently, to eliminate the possibility of artificial deductions, as part of the Tax Reform Act of 1976, Congress enacted § 465 and the so-called at-risk rules. Section 465 generally limits the deductions of individuals and closely held businesses to the amount which they could actually lose from the investment—the amount at-risk. Consequently, to secure the deduction, investors generally must commit personal funds to the venture’s activities or be personally liable for debt incurred by the venture in carrying on its activities. The at-risk rules were subsequently amended in the Revenue Act of 1978 and the Tax Reform Act of 1986.
Initially, the at-risk rules were limited to four specific types of activities: (1) holding, producing, or distributing motion picture films or tapes; (2) farming; (3) leasing personal property; and (4) oil and gas exploration and development. As the list suggests, all of these were ripe for sheltering income. In 1978, legislation extended the rules to cover all other activities with one blatant omission: real estate. Real estate was added in 1986 but a huge exception was created in 1987. This exception essentially allowed real estate ventures to escape the at-risk limitations when they were financed using funds from a third-party commercial lender. Consequently, as the law currently reads, the at-risk rules apply to all trade or business or the production of income activities operated by individuals and closely held businesses. Real estate placed in service before 1987 (e.g., an office building or an apartment complex) is exempt as is a separate activity that involves the leasing of equipment by a closely held C corporation. It is important to realize that the at-risk rules cover any trade or business or investment activity. Unlike the passive loss rules discussed below, they are not limited to those investments that produce portfolio income or loss, or to those that produce passive income or loss.

**At-Risk Computation**

Under § 465(a), the at-risk provisions limit the deduction of losses incurred in an activity to the amount at-risk in the activity at the close of the tax year. Any loss in excess of the amount at-risk cannot be deducted in the current year but can be carried forward and used when there is an increase in the amount at-risk. The following formula can be used to compute the amount at-risk (see Form 6198):

\[
\text{Beginning at-risk balance} \quad + \quad \text{Contributions of cash and property (adjusted basis)} \quad + \quad \text{Increases in recourse debt (taxpayer is personally liable and the lender has no interest in the venture)} \\
\quad + \quad \text{Increases in debt for which the taxpayer has pledged property which is not used in the activity as security} \\
\quad + \quad \text{Increases in qualified nonrecourse debt related to realty} \\
\quad + \quad \text{Income (taxable and tax-exempt)} \quad - \quad \text{Cash or property withdrawals or distributions} \\
\quad - \quad \text{Nondeductible expenses related to tax-exempt income} \\
\quad - \quad \text{Decreases in qualified nonrecourse debt related to realty} \\
\quad - \quad \text{Decreases in recourse debt (T/P personally liable)} \\
\quad - \quad \text{Losses} \\
\quad = \quad \text{Amount at-risk}
\]

Observe that the calculation attempts to measure the amount of the taxpayer’s economic investment that could be lost from the activity. Accordingly, a taxpayer’s at-risk basis includes cash and other assets committed to the activity. Similarly, adjustments are made for income that is retained within the activity and not distributed since such amounts represent additional investments that might be lost. In addition, the at-risk amount includes amounts borrowed for use in the activity for which the taxpayer is personally liable for repayment—recourse debt—as well as amounts borrowed for which the taxpayer has pledged property as security (other than property used in the activity). Finally, as discussed further below, Congress appeased the real estate industry by including in the amount at-risk certain non-recourse debt related to the holding of real property. Note that while the taxpayer’s at-risk basis increases as these items increase, conversely, the at-risk amount is reduced as these items decrease (e.g., amounts are withdrawn, losses are incurred, recourse debt is reduced).

**Example 7**

In 2013, G started a business, designing web pages and providing connections to the Internet. He operated the business as a sole proprietorship. His first step was to purchase a server from a computer manufacturer for $100,000. He gave the company $10,000 cash and agreed to pay the manufacturer $90,000 over the next 10 years. In addition, he put up 20 shares of stock that he owned in his father’s business worth $20,000 as collateral. The company agreed to accept the stock and equipment as...
security for the loan. G also borrowed $150,000 from the local bank. The bank required S to sign a note for the loan for which he is personally liable for repayment. During 2013, he contributed another $50,000 of his own money to keep the business running. For 2013 the business turned a small profit of $30,000 and G left the money in the business for working capital. G’s at-risk basis includes, the $50,000 of his own money contributed to the business, the $10,000 used to purchase the equipment, the $20,000 of stock that he pledged to secure the equipment loan, the debt of $150,000 for which he is personally obligated, and the $30,000 of income that he left in the business for a total of $260,000. It does not include the $90,000 to be paid to the manufacturer since the note is nonrecourse and the property is used in the business. Note that the pledged property is included since the property is not used in the business as is the case with the equipment.

In the second year of operations, 2013, the business turned sour and produced a loss of $10,000. In addition, G withdrew $50,000 for personal use. He also made a $20,000 payment on the principal of the loan. Since G’s at-risk basis is $260,000 the loss is not limited and G may use the loss to offset his other income (assuming he satisfies the passive loss rules discussed later in this chapter). G must adjust his beginning at-risk basis of $260,000 by reducing it for the loss of $10,000, the distribution of $50,000 and the $20,000 payment of the debt, leaving an at-risk basis of $180,000.

While the at-risk rules went a long way to eliminate abusive tax shelters, one industry was able to escape—real estate. After much controversy, the real estate lobby convinced Congress to provide relief for real estate deals to the extent that they used arm’s length, third-party commercial financing (e.g., savings and loan provides loan and charges interest at a reasonable market rate). Consequently, a taxpayer’s at-risk amount includes so-called qualified nonrecourse financing. Section 465(b)(6) sets forth the specific requirements.

1. The financing is secured by the real property used in the activity.
2. No person is personally liable for the debt (nonrecourse debt).
3. The amounts are borrowed from a person who is regularly engaged in the lending business (e.g., a commercial lender such as a bank or savings and loan or a federal, state, or local governmental unit).
4. The lender is not related to the taxpayer. Note that financing made by a lending institution that has an equity interest in the venture is permissible if the loan is commercially reasonable and similar to those made to unrelated parties.
5. The lender is not the seller of the property or the promoter of the deal (i.e., receives a fee for the taxpayer’s investment) or related to the seller or promoter.

Example 8

J was one of 10 investors to contribute $100,000 to Silver Queen Partnership. Each investor received a 10% partnership interest. The partnership used the cash and $900,000 borrowed from First National Bank to purchase an office building for $1,000,000. The debt was secured by a mortgage on the building and was payable over 20 years with interest at 7%, the current market rate. None of the partners were personally liable on the obligation. This year J’s share of the partnership’s loss was $200,000. J’s at-risk amount is $190,000, including the $100,000 cash contribution and 10% of the $900,000 nonrecourse loan. The loan is considered qualified nonrecourse financing since it was borrowed from an unrelated commercial lender and not the seller. Although J’s share of the loss is $200,000, her deduction is limited to the amount she has at-risk, $190,000, and the balance is carried over. Her at-risk basis is reduced to zero and she may not deduct the $10,000 carryover until her amount at-risk increases.
Despite the at-risk rules, wily tax shelter promoters were able to structure investments that could avoid them. As might be expected, many of these deals involved real estate since real estate was effectively exempt if the financing was properly structured. To the chagrin of Congress, the tax shelters industry continued to grow. Perhaps one of the most revealing testimonials of the popularity of tax shelters can be found on the cover of the February 1986 issue of *Money* magazine. The cover pictured three highly successful individuals, and indicated that each had made more than a million dollars but paid no taxes. In light of this and other similar reports, it is not surprising that taxpayer confidence in the fairness of the tax system had badly eroded. Many taxpayers had come to believe that tax was paid only by the naive and the unsophisticated. This belief, in turn, was leading to noncompliance and providing incentives for expansion of the tax shelter market, often diverting investment capital from productive activities to those principally or exclusively servicing tax avoidance goals. Consequently, Congress took aim at tax shelters again in 1986 and enacted yet another hurdle to be cleared before losses could be deducted: the passive loss rules of § 469. These rules go beyond the at-risk provisions, placing far-reaching restrictions on when deductions, losses, and credits of a passive activity can be used to offset the income of another activity. Although these restrictions were designed principally for losses from a limited partnership interest, they also limit losses from rental activities, as well as losses from any trade or business in which the taxpayer does not materially participate.

**General Rule**

The thrust of § 469 is to divide a taxpayer’s income into three types: (1) wages, salaries, and other income from activities in which the taxpayer materially participates (e.g., income from an S corporation that the taxpayer owns and operates); (2) portfolio income (e.g., interest, dividends, capital gains and losses); and (3) passive income—the sort deemed to be produced by most tax shelters and rental activities. Expenses related to passive activities can be deducted only to the extent of income from all such passive activities. Any excess expenses of these passive activities—the passive activity loss—may not be deducted against portfolio income or wages, salaries, or any other income from activities in which the taxpayer materially participates. Losses that cannot be used are held in suspension and carried forward to be used to offset passive income of future years. Suspended losses from a passive activity can be used in full to offset portfolio or active income only when the taxpayer disposes of his or her entire interest in the activity. Upon disposition, any current and suspended losses (including any loss realized on the disposition) are used to offset income in the following order:

1. Any gain on the disposition of the interest
2. Any net income from all passive activities (after taking into account any suspended losses)
3. Any other income or gain (i.e., active and portfolio income)

Observe that this special ordering rule requires the taxpayer to use up the suspended losses against gain on the disposition and any passive income (net of any passive losses) before offsetting such losses against active or portfolio income. Without this rule, a taxpayer would use all of the suspended loss against active income, thus freeing up the passive gain on the disposition to absorb other passive losses.

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1 Suspended losses are carried forward to the following year, where they are treated as if they were incurred in such year. Temp. Reg. § 1.469-1T(d)(4)(B). Special limitations apply to farm losses of noncorporate taxpayers that receive subsidies (§ 461(j)).

2 § 469(g). To date, Regulations have not been issued on dispositions, leaving many unanswered questions. See Erickson, “Passive Activity Disposition,” *The Tax Adviser* (May 1989), p. 338. See TAM 9742002 where the taxpayer did not have to offset current and suspended losses from sold activities with passive income from only those activities that produced net incomes.
Example 9

T owned and operated her own construction company as a sole proprietorship. For the year, the company had net income of $120,000. T has a substantial portfolio that produced dividends of $15,000 and a short-term capital loss from the sale of stock of $7,000. In addition, her investment in LP1, a limited partnership, produced a passive loss. T’s share of the loss was $30,000. Her investments in LP2 and LP3, two other limited partnerships, generated passive activity income. T’s share of the income was $5,000. Under the capital gain and loss provisions, T may deduct $3,000 of the capital loss and carry over the remaining $4,000. The $30,000 passive loss is deductible only to the extent of passive income, which is $5,000. In effect, income and loss from the passive activities are netted, and the net loss attributable to LP1, $25,000, is carried over to the following year.

Example 10

Same facts as above. T held on to her investment in LP1 until this year, when she sold her entire interest, producing a gain of $40,000. Total suspended losses attributable to her investment in LP1 were $70,000. Net income from LP2 was $30,000 for the year while LP3 produced a net loss of $10,000. T may deduct the entire $70,000 loss: $40,000 against the gain, $20,000 against the net passive income from LP2 and LP3 ($30,000 − $10,000), and $10,000 against any other income.

As a practical matter, many taxpayers will have investments in several passive activities, some that produce income and some that produce losses. If the taxpayer has losses from more than one activity, the suspended loss for each activity must be determined in the event that the taxpayer subsequently disposes of one of the activities. The suspended loss of each activity is determined by allocating the total loss disallowed for the year, including any suspended losses, pro rata among the loss activities using the following formula:

\[
\text{Suspended loss for this activity} = \frac{\text{Total disallowed loss for year} \times \text{Loss for this activity}}{\text{Total losses from all activities with losses}}
\]

Note that this fraction simply represents the percentage of losses attributable to a particular activity. For example, if a loss from a particular activity represents 10 percent of all losses, 10 percent of the disallowed loss is allocated to such activity and carried over to the following year. Alternatively, it could be said that the particular activity absorbs 10 percent of any passive income. In effect, each loss activity absorbs this fraction of any passive income from other activities.

\[\text{Temp. Reg. § 1.469-1T(f)(2).}\]
Example 11
T owns an interest in three passive activities: A, B, and C. For 2013, activity B reports income of $2,000 while activities A and C report losses of $10,000, $6,000 from A and $4,000 from C. T is allowed to deduct the passive losses from A and C to the extent of the passive income from B. Thus he may deduct $2,000 of the losses. The remaining loss of $8,000 cannot be used to offset T’s income from other sources (e.g., wages, dividends, or interest income) but must be suspended and carried forward to the following year. The suspended loss of $8,000 must be allocated between the loss activities pro rata. Since 60% ($6,000/$10,000) of the net loss was attributable to A, the suspended loss for A is $4,800 (60% × $8,000). Similarly, the suspended loss for C is $3,200 (($4,000/$10,000) × $8,000). Alternatively, the loss activities could be viewed as absorbing the passive income. Using this approach, the suspended losses would be computed somewhat differently but with the same result.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Current Net Income (Loss)</th>
<th>Carryforward from Prior Years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ (5,200)</td>
<td>$ (4,800)</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>B</td>
<td>12,000</td>
<td>—</td>
<td>12,000</td>
</tr>
<tr>
<td>C</td>
<td>(1,800)</td>
<td>(3,200)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 5,000</td>
<td>$ (8,000)</td>
<td>$(3,000)</td>
</tr>
</tbody>
</table>

These losses are carried over and treated as if they were a deduction in the following year.

Example 12
Assume the same facts as in Example 11. The income and loss for 2014 of the three activities is shown below.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Current Net Income (Loss)</th>
<th>Carryforward from Prior Years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ (5,200)</td>
<td>$ (4,800)</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>B</td>
<td>12,000</td>
<td>—</td>
<td>12,000</td>
</tr>
<tr>
<td>C</td>
<td>(1,800)</td>
<td>(3,200)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 5,000</td>
<td>$ (8,000)</td>
<td>$(3,000)</td>
</tr>
</tbody>
</table>

The total passive loss disallowed in 2014 is $3,000. The $3,000 disallowed loss is allocated among the activities with total losses (taking into account both current operations and losses suspended from prior years) as follows:

<table>
<thead>
<tr>
<th>Activity</th>
<th>Total Disallowed Loss</th>
<th>Percentage of Total Loss</th>
<th>Allocable Portion of Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$3,000</td>
<td>× $10,000/($10,000 + $5,000) = 2,000</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>3,000</td>
<td>× 5,000/($10,000 + $5,000) = 1,000</td>
<td></td>
</tr>
</tbody>
</table>

In making the allocation, the disallowed loss is allocated based on an activity’s net loss including suspended losses (e.g., $10,000 for A) rather than the loss that actually occurred in the current year (e.g., $5,200 for A).
Example 13

J has three passive activities: R, S, and T. The suspended losses and current income and losses for each activity for 2013 are shown below. In addition, J sold activity S for a $10,000 gain in 2013. Because there has been a complete disposition of S, J is able to deduct all of the suspended losses for S as shown below.

<table>
<thead>
<tr>
<th></th>
<th>R</th>
<th>S</th>
<th>T</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suspended loss</td>
<td>(9,000)</td>
<td>(12,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Current income (loss)</td>
<td>(5,000)</td>
<td>(6,000)</td>
<td>(7,000)</td>
</tr>
<tr>
<td>Total</td>
<td>(14,000)</td>
<td>(18,000)</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Gain on disposition of S</td>
<td></td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Excess loss of S deducted against other income</td>
<td>8,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

J must first offset the suspended and current losses of $18,000 from activity S against the $10,000 gain on the sale of S. The next step is to offset the $8,000 balance of losses against any net passive income for the year. In this case, the activities have no income, and thus none of the loss is absorbed by passive income. At this point, the remaining loss of $8,000 is no longer considered passive and can be used to offset any active or portfolio income that J may have.

Example 14

K has three passive activities: X, Y, and Z. The suspended losses and current income and losses for each activity for 2013 are shown below. In addition, in 2013, K sold activity Y for a $21,000 gain. K is able to deduct all of the suspended losses of Y as shown below.

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suspended loss</td>
<td>(7,000)</td>
<td>(10,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Current income (loss)</td>
<td>(8,000)</td>
<td>(6,000)</td>
<td>8,000</td>
</tr>
<tr>
<td>Total</td>
<td>(15,000)</td>
<td>(16,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Gain on disposition of Y</td>
<td></td>
<td>21,000</td>
<td></td>
</tr>
<tr>
<td>Loss absorbed:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,000 × ($15,000/$25,000)</td>
<td>3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,000 × ($10,000/$25,000)</td>
<td></td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Suspended loss</td>
<td>(12,000)</td>
<td></td>
<td>(8,000)</td>
</tr>
</tbody>
</table>

K must first offset Y’s current and suspended losses of $16,000 against the $21,000 gain on the sale. Note that the balance of the gain ($5,000) is considered passive income that can be combined with the net losses (the sum of current income or loss and suspended losses) from the other passive activities for the year.4

Rules similar to those for passive losses apply to tax credits produced by passive activities (e.g., the low-income housing credit, rehabilitation credit, research credit, and jobs credit). Passive credits can be used only to offset any tax attributable to passive income. Any unused credit may be carried forward to the next taxable year to offset future taxes arising from

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4 § 469(g)(1)(A) and Temp. Reg. § 1.469-2T(c)(2)(i)(A)(2).
passive income. In contrast to passive losses, however, credits being carried over are not fully triggered when a passive activity is sold. In the year of disposition, like any other year, the credit can be used only if there is tax attributable to passive income (including gain on the sale of the activity). If the credit cannot be used, it can continue to be carried over to offset tax from other passive activities. However, the credit is subject to its own rules concerning carryover and expiration.

**Example 15**

T invested in a limited partnership that rehabilitated a historic structure. In 2013, T sold his interest, realizing a gain of $5,000. At that time, T had suspended losses of $20,000 and credits of $10,000. T is able to use $5,000 of the losses to offset the gain and the other $15,000 to offset other active or portfolio income. None of the credit can be used, however, because there is no income from the passive activity. Had T sold the property for a gain of $50,000, he would have had $30,000 of passive income. Assuming T is in the 28% tax bracket, he could have used $8,400 ($30,000 \times 28\%) of the credit. The remaining credit of $1,600 may be carried over to offset tax that may arise from passive income.

**Taxpayers Subject to Limitations**

The passive loss rules apply to individuals, estates, trusts, personal service corporations, and certain closely held C corporations. Partnerships and S corporations are not subject to the limitations per se. However, their activities flow through to the owners who are subject to limitation.

The passive loss rules generally do not apply to regular C corporations. Presumably, their immunity is based on the theory that individuals generally do not benefit from losses locked inside the corporate form. Congress, however, did not want taxpayers to be able to circumvent the passive loss rules merely by incorporating. Absent a special rule, a taxpayer could utilize corporate immunity to shelter income derived from personal services. Taxpayers would simply incorporate as a personal service corporation and acquire tax shelter investments at the corporate level. The losses produced by the tax shelters would offset not only the service income but also income from any investments made at the corporate level. Consequently, the passive loss rules apply to personal service corporations (PSC). A PSC is one where the principal activity is the performance of personal services and such services are primarily performed by employees who own stock in the corporation either directly or indirectly. Common examples of personal service corporations are professional corporations such as those of doctors, accountants, attorneys, engineers, actors, architects, and others where personal services are performed.

Without additional restrictions, any taxpayer—not just one who derives income from services—could incorporate his or her portfolio and offset the investment income with losses from tax shelters. To prohibit this possibility, the passive loss rules also apply in a limited fashion to all closely held C corporations (i.e., a regular C corporation where five or fewer individuals own more than 50 percent of the stock either directly or indirectly). Note that some personal service corporations that might escape the tests above may still be subject to the rules due to their status as closely held corporations. A closely held corporation may not use passive losses to offset its portfolio income. However, such corporations may offset losses from passive activities against the income of any active business carried on by the corporation.

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5 § 469(a)(2).
6 A PSC is defined in §469(j)(2) by reference to §269 to include any service. An employee-owner is one who owns any stock during the year either directly or constructively under §318 with certain modifications.
7 § 469(e)(2).
Example 16

R and his two brothers own Real Rustproofing Corporation. For 2013, the corporation suffered a loss from operations of $10,000. In addition, it received interest income from short-term investments of working capital of $20,000. The corporation also had a passive loss from a real estate venture of $30,000. In determining taxable income, the passive activity limitation rules apply since the corporation is closely held (i.e., five or fewer individuals own more than 50%). As a result, none of the loss can be deducted since the loss cannot offset portfolio income of the corporation and the corporation did not have any income from operations. Had the corporation had $50,000 of operating profit, the entire loss could be deducted since passive losses can be used by a closely held corporation to offset active income—but not portfolio income.

Passive Activities

Assuming the taxpayer is subject to the passive activity rules, the most important determination is whether the activity in which the taxpayer is engaged is passive. The characterization of an activity as passive generally depends on the level of the taxpayer’s involvement in the activity, the nature of the activity, or the form of ownership. Section 469(c) provides that the following activities are passive:

1. Any activity (other than a working interest in certain oil and gas property) that involves the conduct of a trade or business in which the taxpayer does not materially participate; and
2. Any rental activity regardless of the level of the taxpayer’s participation.

Given these definitions, several questions must be addressed to determine whether a particular endeavor of the taxpayer is a passive activity.

1. What is an activity?
2. Is the activity a rental or nonrental activity?
3. What is material participation?

Unfortunately, none of these questions are easily answered. An exceedingly complex set of Regulations exists that, in large measure, creates intricate definitions designed to prohibit wily taxpayers from deducting their passive losses. The basic rules are considered below.

Definition of an Activity

The definition of an activity serves as the foundation for the entire structure of the passive loss rules. Virtually all of the important determinations required in applying the passive loss rules are made at the activity level. Perhaps the most significant of these concerns the taxpayer’s level of participation. As discussed later in this chapter, if the taxpayer participates for more than 500 hours per year in a nonrental activity, he or she is deemed to materially participate in the activity, and the activity is therefore not passive. As the following example illustrates, this 500-hour test requires an unambiguous definition of an activity.

Example 17

Mr R. Rock owns and operates 10 restaurants in 10 different cities. In addition, in each of those 10 cities he owns and operates 10 movie theaters. R spends 80 hours working in each restaurant during the year for a total of 800 hours. R spends 70 hours working in each movie theater for a total of 700 hours. If each restaurant and each movie theater are treated as separate activities, it would appear that R would not be treated as a material participant in any one of the businesses because he devoted only a minimum amount of his time during the year, 80 or 70 hours, to each. On the other hand, if all the restaurants are aggregated and deemed a single activity, R’s total participation in all the restaurants, 800 hours would, in fact, be considered material. A similar conclusion could be reached for the movie theaters. In addition, if the restaurants are adjacent to the movie theaters (or in fact are concession stands in the theaters), it might be appropriate to treat the restaurant operation and the movie theater operation as a single activity.
The definition of an activity is not only important for the material participation test, but it is also significant should there be a disposition. As noted above, a complete disposition of an activity enables a taxpayer to deduct any suspended losses of the activity.

Example 18

Same facts as in Example 17 above. Also assume that there are suspended losses for each restaurant. If each restaurant is treated as a separate activity, a sale of one of the restaurants would enable R to deduct the suspended loss for that restaurant. In contrast, if the restaurant is not considered a separate activity, none of the loss would be recognized on the tax return for the year of sale.

Examples 17 and 18 demonstrate not only the importance of the definition of an activity but also the problems inherent in defining what constitutes an activity.  

The authors of § 469 obviously anticipated the difficulty in defining an activity and therefore provided no working definition in the Code. As a result, the formidable task of defining an activity fell in the laps of those who write the Regulations. Defining an activity would not be difficult if all taxpayers were engaged in a single line of business at one location. As a practical matter, this is not always the case. Some taxpayers, such as Mr. Rock in Example 17, are involved in several lines of business at multiple locations. Consequently, any definition of an activity had to consider such situations. In fixing the scope of an activity, the Treasury feared that a narrow definition would allow taxpayers to generate passive income at will that could be used to offset passive losses. For example, if Mr. Rock were able to treat each restaurant as a separate activity, he could easily manipulate his participation at each restaurant to obtain passive or active income as he deemed most beneficial. To combat this problem, the IRS initially designed a broad definition that generally required a taxpayer to aggregate various endeavors into a single activity. By establishing a broad definition that treats several undertakings as a single activity, the IRS made the material participation test easier to meet, resulting in active rather than passive income. Unfortunately, the initial definition was quite complicated, as evidenced by the Temporary Regulations, which contained 196 pages of intricate rules and examples devoted to the subject.8 In a refreshing change of direction, however, the IRS allowed these Temporary Regulations to expire, creating a far simpler approach all contained in only four pages9.

Appropriate Economic Unit

Under the final regulations, taxpayers are required to treat one or more trade or business activities or one or more rental activities as a single activity if the activities constitute an appropriate economic unit for measuring gain or loss.10 Whether two or more activities constitute an appropriate economic unit (AEU) is determined by taking into account all of the relevant facts and circumstances. Five factors are to be given the greatest weight in making the determination. These are as follows:

1. Similarities and differences in types of business;
2. The extent of common control;
3. The extent of common ownership;
4. Geographical location; and
5. Interdependencies between activities (e.g., they have the same customers or same employees, are accounted for with a single set of books, purchase or sell goods between themselves, or involve products or services that are normally provided together).

A taxpayer may use any reasonable method of applying the relevant facts and circumstances.

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8 Temp. Reg. § 1.469-4T(a)(2).
9 Reg. § 1.469-4(c)(1).
10 Reg. § 1.469-4(c)(1).
Example 19

C operates several businesses as a sole proprietor. These include a bakery and a movie theater at a shopping mall in Santa Fe and a bakery and a movie theater in Albuquerque. Reasonable groupings, depending on the facts and circumstances, may be as follows:

- A single activity
- A movie theater activity and a bakery activity
- A Santa Fe activity and an Albuquerque activity
- Four separate activities

Consistency Requirement

To ensure that taxpayers do not bounce from one grouping to another to fit their needs, a consistency requirement is imposed. Once the activities have been grouped in a particular manner, the grouping may not be changed unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping inappropriate.\textsuperscript{11} For instance, in Example 19 above, once one of the groupings is selected, the taxpayer is required to continue using the grouping unless a material change in the facts and circumstances makes it clearly inappropriate.

In addition, to prevent a taxpayer from misusing the facts-and-circumstances approach, the IRS has the power to regroup activities if the taxpayer’s grouping fails to reflect one or more appropriate economic units and one of the primary purposes of the taxpayer’s grouping is to circumvent the passive loss rules.\textsuperscript{12}

Activities Conducted through Conduit Entities

As a practical matter, many taxpayers will conduct activities through a partnership or an S corporation. In this case, the grouping is done at the partnership or S corporation level. Partners and S corporation shareholders then determine whether they should aggregate the entity activities with those they conduct directly or through other partnerships or S corporations.\textsuperscript{13}

Grouping of Rental and Nonrental Activities

Rental activities and nonrental activities normally may not be grouped together and treated as a single activity. This rule is consistent with the basic provision that all rental activities are passive regardless of the taxpayer’s participation. Therefore, it makes sense that rental and nonrental activities should not be aggregated. The practical significance of the rule is to prohibit taxpayers from sheltering active income with passive rental losses. Nevertheless, the Regulations do carve out an exception, allowing aggregation of rental and nonrental activities whenever either activity is insubstantial in relation to the other or the owners of the business activity have the same proportionate ownership interest as they have in the rental activity (e.g., 40% in one and 40% in the other).\textsuperscript{14}

\textsuperscript{11} Reg. § 1.469-4(g). In Notice 2008-64, 2008-31 IRB 268, the IRS proposed that taxpayers should be required to report any changes in groupings on the return.

\textsuperscript{12} Reg. § 1.469-4(h).

\textsuperscript{13} Reg. § 1.469-4(j).

\textsuperscript{14} Reg. § 1.469-4(d).
Example 20

PB&K, an accounting firm, operates its practice out of an office building that it owns. The firm occupies two floors of the building and leases the other three floors to third parties. This year, 90% of the firm’s income is from its accounting practice and 10% is from rental of the office space. Because the rental operation is insubstantial in relation to the nonrental operation, the rental and nonrental operations are aggregated into a single nonrental activity. Note that in this case any net loss on the rental activity is effectively combined with the income of the accounting operation.

Example 21

H and W, husband and wife, equally own Sliders, an S corporation that owns and operates 25 restaurants throughout the Midwest. Sliders is quite profitable. Several years ago, the company decided it should buy an airplane to enable it travel easily to its various locations. On the advice of their attorney, H formed Airmax, a single member LLC that purchased and leases out the plane. Sliders rents the plane on a long-term basis from Airmax. The S corporation pays the LLC a fair rent for use of the plane but because of depreciation and interest, the LLC annually reports a net rental loss from its operations. The LLC does not provide any services with respect to providing the plane so it is considered a rental activity and therefore is deemed to be passive. Absent any special rule, H would not be able to offset the losses of Airmax against the income from Sliders. However, under the Regulations, H may elect to group the LLC rental activity and the S corporation restaurant business as a single activity. This grouping election is permitted because the LLC and the S corporation have identical ownership. Alternatively, had there not been identical ownership, H may have been able to group the airplane leasing activity with the restaurant business assuming the rental activity is insubstantial to the restaurant activity.

It should also be noted that the rental of real property and the rental of personal property cannot be grouped unless the personal property is provided in connection with the real property.\(^{15}\)

Example 22

T owns a small apartment building with eight units that he rents completely furnished. In addition, the building contains a small room with coin-operated laundry facilities. As a general rule, the laundry rental and apartment rental cannot be aggregated because the rental of real property cannot be grouped with the rental of personal property. In this case, however, the rental income and laundry income can be grouped since the personal property is provided in connection with the real property.

Rental and nonrental operations normally must be separated because they are subject to different rules. For example, rental activities are always passive, whereas nonrental activities are passive only if the taxpayer does not materially participate in such activities. In addition, owners of rental real estate are normally entitled to deduct up to $25,000 of rental losses annually without limitation, whereas there is no comparable rule for nonrental activities. Although rentals and nonrental activities are usually separated, certain exceptions may allow aggregation. As discussed above, if either activity is insubstantial to the other, aggregation can occur or if the owners own the same proportionate interest in each activity, they may be grouped.

\(^{15}\)Reg. § 1.469-4(e).
Rental Versus Nonrental Activities
Under the general rule described above, all rental activities are deemed to be passive, regardless of whether the taxpayer materially participates. Congress adopted this view based on the belief that there is seldom any significant participation in rental activities. Therefore, it created a presumption that all rental activities would be passive. For this purpose, a rental activity is defined as any activity whereby a taxpayer receives payments that are principally for the use of property owned by the taxpayer (e.g., apartments or equipment).

Observe that this blanket rule effectively classifies many rental activities as passive even though an owner might render significant services in connection with the rental. For example, renting video tapes would be considered passive under the general rule even though the owner might perform substantial services. This approach would be unfair to those who participate yet suffer losses. Moreover, the rule creates a huge planning opportunity for those seeking passive income given that many rental businesses are profitable. Recognizing these problems, the authors of the Regulations identified six situations where what is normally a rental is to be treated as a nonrental activity.16

1. 1–7 Days Rental. The activity is not a rental if the average rental period is seven days or less. Under this exception, short-term rentals of such items as cars, hotel and motel rooms, or videocassettes are not considered rental activities.

2. 8–30 Days Rental. The activity is not a rental if the average rental period is 30 days or less and significant services are performed by the owner of the property. In determining whether significant services are provided, consideration is given to the type of service performed and the value of the services relative to the amount charged for the use of the property. In this regard, the Regulations indicate that telephone service and cable television are to be ignored as are those services commonly provided in connection with long-term rentals of commercial and residential property (e.g., janitorial services, repairs, trash collection, cleaning of common areas, and security services provided by landlords of shopping malls and centers). Unfortunately, the Regulations provide few other clues as to what constitutes significant services.

Example 23
T owns and rents a resort condominium in Florida. He provides telephone, cable, trash removal, cleaning of the common areas, and daily maid and linen service. The cost of the maid and linen services is less than 10% of the amount charged to tenants occupying the apartments. In determining whether significant services are provided, the telephone, cable, trash, and cleaning services are disregarded. Moreover, according to the Regulations, the maid and linen services would not be considered significant in this case. Because there are no significant services under the Regulations’ view, the activity would be considered a rental (assuming the average rental use exceeds seven days) and, therefore, a passive activity.

3. Extraordinary Services. The activity is not a rental if extraordinary personal services are provided by the owner of the property. Services are considered extraordinary if the use of the property is merely incidental to the services performed.

Example 24
Nathan Hale Military Academy, a private college preparatory school, provides housing for its students. The school’s rental of such facilities would be considered incidental to the educational services provided and thus be treated as a nonrental activity.

4. **Incidental Rentals.** The activity is not a rental activity if the rental of the property is merely incidental to the nonrental activity.

The Temporary Regulations identify two situations when this rule applies.\(^{17}\)

- **Investment Property.** An activity is not considered a rental if the rental property is held primarily for investment. Two tests must be met. First, the principal purpose for holding the property must be for the expectation of gain from appreciation due to market changes and not due to improvements to the property. Second, the gross rental income from the property is insignificant; that is, the rent must be less than two percent of the lesser of (1) the unadjusted basis of the property or (2) the fair market value of the property.

**Example 25**

S owns land that she is holding for future appreciation. She purchased the land for $500,000 and it is currently worth $800,000. To defray the costs of holding the land, she leases it to a rancher for grazing his cattle. The rent is $9,000 per year. Since the rent is less than $10,000 (2% of the lesser of the basis of the property $500,000 or its fair market value of $800,000), the two percent test is met. Because S is holding the property primarily as an investment and her rental income is insignificant (it is less than the two percent threshold), the rental is considered incidental and would not be automatically treated as a rental activity for purposes of the passive loss rules. On the other hand, if S bought the land intending to build a shopping center on it, the rental would not be considered incidental since the land is not considered held primarily for appreciation. In such case, the activity is deemed to be a rental.

- **Property Normally Used in a Trade or Business.** A rental is not considered a rental activity if the property is normally used by the taxpayer in a business and occasionally is rented to others when it is not needed in the business. The property qualifies as business property only if (1) the property is used in the business during the current year (or two of the last five) and (2) the two percent test is met (i.e., gross rental income from the property is less than two percent of the lesser of the unadjusted basis of the property or the fair market value of the property).

**Example 26**

P, a farmer, owns land that he uses for farming. This year a nearby country club, Roaring Fork Golf and Country Club, is hosting the U.S. Open. P rented a portion of his land to the club to be used for a parking lot for the month of June for $3,000. The allocable cost of the land is $200,000 and it is currently worth $500,000. The rental income is considered incidental and not passive since the property is normally used in P’s farming business and the $3,000 rent is less than $4,000 (2% of the lesser of the basis of the property $200,000 or its fair market value of $500,000). The result would be the same if P had rented the property to another farmer or for some other purpose.

5. **Nonexclusive Use.** The activity is not a rental activity if the taxpayer customarily makes the property available during defined business hours for the nonexclusive use of various customers. For example, this exception would apply to a golf course that sells annual memberships but which is also open to the public on a daily basis.

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6. **Property Made Available for Use in a Nonrental Activity.** The activity is not a rental activity if the taxpayer owns an interest in a partnership, S corporation, or joint venture to which the property is rented. For example, if T rents equipment to a partnership in which he is a partner, the rental is treated as a nonrental activity.

Similarly, rental of property to a C corporation in which the taxpayer materially participates is not considered a rental.

**Example 27**

Mr. F, an attorney, owns and operates F&H Corporation, a law firm. This year F and his wife leased a building that they owned jointly to F&H Inc. The corporation was the sole tenant. Mr. F would like to treat the rent as passive and use it to absorb the couple’s passive activity losses. Unfortunately, the regulations provide that rental to a C corporation in which the taxpayer materially participates is a nonrental activity. Therefore, the amounts received for leasing the building are not considered passive income.18

As noted above, any activity constituting a “rental” is a passive activity. Note, however, that those activities not classified as rentals (i.e., nonrental activities) may still be considered passive. Whether a nonrental activity is a passive activity depends on whether the taxpayer has materially participated in the activity.

**Material Participation**

Material participation serves a crucial role in the application of the passive loss rules. It is the criterion that distinguishes between “passive” and “active” nonrental activities. The Code provides that an individual meets the material participation test only if he or she is involved in the operation of the activity on a regular, continuous, and substantial basis. Without further guidance, applying this nebulous criterion would essentially be left to the subjective interpretation of the taxpayer. However, the Regulations establish objective standards that look to the actual number of hours spent in the activity.

Under the regulatory scheme, a taxpayer materially participates in an activity if he or she meets any of seven tests.19

1. **More Than 500 Hours.** An individual materially participates if he or she spends more than 500 hours in the activity during the taxable year. Apparently the authors of the Regulations believed that this threshold (e.g., about 10 hours per week) appropriately distinguished those who truly were involved in the business from mere investors. Note that the work of a spouse is counted if it is work typically done by owners. For example, if B owned an S corporation that suffered losses (e.g., a football team), he would materially participate if he devoted more than 500 hours to the activity. However, if he spent only 300 hours and hired his wife as a receptionist who spent 250 hours, the test is not met because her work is not normally done by owners.

2. **Substantially All of the Participation.** The individual and his or her spouse materially participate if they are the sole participants or their participation constitutes substantially all of the participation of all individuals (including nonowners and nonemployees) who participate in the activity. This test, as well as the next, takes into account the fact that not all businesses require 500 hours to operate during the year. For example, if S operates a snow removal service by himself and spends only 50 hours in the activity this year because of light snow, the test is met because he was the sole participant.

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18 See Remy Fransen, Jr., 99-2 USTC ¶50,882 (CA-5, 1999), aff’g 98-2 USTC ¶50,776 (D.C., E.D. La., 1998) where the Court upheld the validity of Reg. § 1.469-2(f)(6), recharacterizing the activity as active and not passive. See also Schwalbach, 111 T.C. No. 9 (1998).

19 Temp. Reg. § 1.469-5T(a).
3. **More Than 100 Hours and Not Less Than Anyone Else.** An individual materially participates if he or she participates for more than 100 hours and no other individual spends more time on the activity. For example, assume that S, above, occasionally hires E to help him remove snow. If S spent 160 hours and E 140, S qualifies because he spent more than 100 hours and not less than anyone else. Had S spent only 60 and E 40, S arguably would not qualify under either this or the previous test.

4. **Participation in Several Activities.** An individual materially participates if his or her total participation in all significant participation activities (SPAs) exceeds 500 hours. A “significant participation activity” is defined as a trade or business in which the taxpayer participates more than 100 hours, but fails the other six tests for material participation. Thus a taxpayer must spend more than 100 hours in each activity and greater than 500 in all. The rule derives from the view that an individual who spends more than 500 hours in several different activities should be treated the same as those who spend an equivalent amount of time on a single activity.

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**Example 28**

T spends 140 hours overseeing his car wash, 160 hours supervising his quick-lube operation, and 499 hours managing his gas station. Each activity qualifies as a SPA because T spends more than 100 hours in each. More importantly, T is treated as materially participating in each because the total hours in all SPAs exceed 500. However, if T spent two more hours in his gas station, then he would not be a material participant in either the car wash or quick-lube business. This occurs because the gas station would no longer be a SPA since the activity by itself satisfies the more-than-500-hours test. As a result, T’s total hours in all SPAs, 300 (160 + 140), would not exceed the 500-hour benchmark. Obviously, this is a strange result.

The Regulations provide what at first glance is a curious treatment of SPAs. As expected, losses from SPAs failing to meet the 500-hour test are passive and generally not deductible. However, income from SPAs failing to meet the 500-hour test is not passive. Note that the IRS obtains the best of both worlds when a taxpayer is unable to combine his or her SPAs to get over the 500-hour threshold: passive loss but not passive income. This “heads I win, tails you lose” approach was designed to prevent taxpayers from creating passive income that could be used to absorb passive losses by spending small amounts of time in unrelated activities that are profitable.\(^{20}\)

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5. **Prior Participation.** An individual materially participates if he or she has materially participated (by tests 1 through 4) in an activity for five of the past ten years. This test prevents the taxpayer from moving in and out of material participation status. For example, D and son are partners in an appliance business that D started 30 years ago. D has essentially retired, leaving the day-to-day operations to his son. Without a special rule, D could tailor his participation year by year to obtain passive or nonpassive income as fits his needs.

6. **Prior Participation in a Personal Service Activity.** An individual materially participates in a personal service activity if he or she has materially participated in the activity for at least three years. Like the previous test, this rule eliminates the flexibility those working for personal service businesses have in tailoring their participation to obtain passive or nonpassive income as they need. For example, if a general partner in a law firm retired and converted her interest to a limited partnership interest, she would still be treated as a material participant in that law firm.

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\(^{20}\) See Reg. § 1.469-2T(f)(2).
7. **Facts and Circumstances.** An individual materially participates if, based on the facts and circumstances, he or she participates in the activity on a regular, continuous, and substantial basis.

**Rental Real Estate Exception**

An extremely important exception to the passive activity rules is carved out in § 469(i) for rental real estate activities of the small investor. In many cases, the rental real estate held by a taxpayer is a residence that is used part-time, was formerly used, or may be used by the taxpayer in the future. Relief was provided for this type of rental real estate because it is often held to provide financial security to individuals with moderate incomes. In such a case, these individuals share little common ground with the tax shelter investors. The relief is provided solely to individuals and certain trusts and estates. Regular C corporations are ineligible.

Under the exception, a taxpayer who *actively* participates (in contrast to materially participates) may deduct up to $25,000 of losses attributable to rental real estate annually. The $25,000 allowance is reduced by 50 percent of the excess of the taxpayer’s A.G.I. over $100,000. This relationship may be expressed as follows:

\[
\text{Reduction in $25,000 allowance} = 50\% \times (\text{A.G.I} - 100,000)
\]

Based on this formula, high-income taxpayers (i.e., those with A.G.I. of $150,000 or more) cannot take advantage of this provision. A.G.I. for this purpose is computed without regard to contributions to individual retirement accounts, taxable social security, and any net passive losses that might be deductible. Any portion of the rental loss that is not deductible may be carried over and deducted subject to the same limitations in the following years.

**Example 29**

L moved to a new home this year. Instead of selling his old home, L decided to rent it out to supplement his income. For the year, rents were $3,000 while expenses including maintenance, depreciation, interest, utilities, and taxes were $10,000. L’s A.G.I. is $40,000. L may deduct the $7,000 loss for A.G.I. Had L’s A.G.I. been $140,000, he could have deducted only $5,000 and carried over $2,000 to the following year. This computation is illustrated below.

<table>
<thead>
<tr>
<th>Loss allowance ............................................................</th>
<th>$ 25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase-out: A.G.I. ........................................................</td>
<td>$ 140,000</td>
</tr>
<tr>
<td>Threshold .................................................................</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Excess A.G.I. .............................................................</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Rate $ \times 50% ......................................................</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Maximum loss allowed ....................................................</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

It should be emphasized that the taxpayer can use this exception only if the property is considered rental real estate. It cannot be used for losses from rental of personal property. More important, the real estate is not considered a “rental” activity where the rental period is either 1 to 7 days or between 8 and 30 days and significant services are performed. For example, consider the typical investor who owns a vacation condominium. If the average rental of the condominium is 1 to 7 days, the condominium is not considered rental property and the $25,000 exception does not apply. The result is the same if the average rental period is between 8 and 30 days and significant services are provided. Note that even though the

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21 For an excellent discussion of this topic and issue see Bomyea and Marucheck, “Rental of Residences,” The Tax Adviser (September 1990), p. 543.
The $25,000 exception is not available in either case, all is not necessarily lost. In both situations, the condominium is treated as a nonrental activity. In such case, the taxpayer will be able to deduct all losses if there is material participation.\textsuperscript{22}

\begin{tcolorbox}[colframe=black, colback=white]
\textbf{Example 30}

M lives in Orlando, where she practices law. M owns a condominium, which she rents out on a daily basis to tourists. M runs ads in the local newspaper, makes arrangements for the rental, and cleans the unit as needed. In this case, it appears that the activity is not a rental business because of the short-term rental. As a result, the $25,000 exception for rentals does not apply. However, M still may be able to deduct a loss. Since the property by definition is not a rental activity due to the short-term rental period, it is—by default—a nonrental activity. Accordingly, the loss would be deductible if she materially participates in the activity. For example, if M spent more than 100 hours in the activity and more than anyone else or met any of the other six material participation tests, the loss would be deductible.

As noted above, the Code draws a distinction between material and active participation. The primary difference concerns the taxpayer’s degree of involvement in operations. For example, a taxpayer is actively involved if he or she participates in management decisions such as approving new tenants, deciding on rental terms, approving capital or repair expenditures, or if he or she arranges for others to provide services such as repairs. In all cases, the taxpayer is not treated as actively participating in the activity if less than a 10 percent interest is owned. On the other hand, the taxpayer is not presumed to actively participate if the interest is 10 percent or more. The above standard still must be satisfied.

\subsection*{Real Estate Professional Exception}

Under the basic rules described above, taxpayers who are engaged in the rental real estate business (e.g., owners of warehouses, shopping centers, or office buildings) cannot deduct losses from such business activities since the law presumes that virtually all long-term rental real estate activities are passive. Note that this treatment occurs regardless of the amount of time and energy spent by the taxpayer in such activities. The level of the taxpayer’s participation is irrelevant. After much debate, however, Congress finally agreed in 1994 that the passive loss rules were aimed at passive investors in real estate and not those who were in the real estate business. For this reason, it took steps to enable these individuals to deduct losses arising from these activities. This special relief is granted only if the individual can pass certain tests that effectively establish that he or she is truly in the real estate business.

Generally, an individual can take advantage of the exception for real estate professionals if he or she spends more than half of their working hours in the real estate business and the number of hours spent exceeds 750. Technically an individual is eligible to deduct losses from rental real estate if both of the following conditions are met:\textsuperscript{23}

1. Services representing more than 50 percent of the total personal services performed by the individual in all trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates during the year. For this purpose, real property trades or businesses include real property development, redevelopment, construction, acquisition, conversion, rental, operation, management, leasing, and brokerage. In the case of a closely held C corporation, this test is met if more than 50 percent of the gross receipts of such corporation are derived from real property businesses in which the corporation materially participates.

2. The individual performs more than 750 hours of services in real property trades or businesses in which he or she materially participates.

\textsuperscript{22} See Steven D. Rapp, T.C. Memo 1999-249, 78 TCM 175 and Walter A. Barniskis, T.C. Memo 1999-258, 78 TCM 226
\textsuperscript{23} § 469(c)(7). For an interesting example, see Edward C. Hanna T.C. Summary Opinion 2006-57.
If a joint return is filed, the special relief is available if either spouse separately satisfies the requirements. Note that for this purpose, the couple cannot aggregate their hours.

Observe that satisfaction of these two tests merely opens the door for possible deduction of losses. In order to treat the losses as nonpassive, the taxpayer must still meet the material participation requirements (e.g., spend more than 500 hours in the activity). For this purpose, each activity is normally treated as a separate activity. However, the taxpayer may elect to aggregate such activities. In most cases, it would seem that those who are eligible and who elect to aggregate their real property businesses should be able to meet the material participation tests. It should also be emphasized that personal services as an employee in a real property business are not treated as performed in the real property business unless the individual owns at least 5 percent of the business.

**Example 31**

G graduated from the Vanderbilt law school in 1979 and has been practicing his trade ever since. Over the years, however, he has accumulated a number of properties. As a result, he is increasingly spending more time being a real estate magnate and less time being a lawyer. Currently, he owns, operates, and manages a small shopping center and several duplexes. Each of these rental activities produces a loss, primarily due to depreciation. According to G’s detailed diary of how he spends his time, he worked 40 hours a week for 50 weeks during the year for a total of 2,000 hours. Assuming G elects to aggregate his interests in each of the rental real estate activities and treat them as a single activity, the majority, 1,100 hours, was devoted to his real estate ventures. The other 900 hours related to his law practice. In this case, G meets both tests that enable him to treat the rental operations as nonrental activities: (1) more than 50% of his personal services were performed in real property businesses, and (2) his 1,100 hours of service in these businesses exceeded the 750-hour threshold. Although the rental taint is removed, this does not necessarily mean G is allowed to deduct the losses. He must still satisfy the material participation tests. Whether this final requirement is met depends on whether G elects to aggregate all of the activities. If so, his 1,100 hours of participation is greater than the 500 hours required and he would be entitled to deduct all of the losses.

**Recharacterized Passive Income**

As is evident throughout the passive loss Regulations, the IRS was concerned that taxpayers might create passive income which could be used to absorb otherwise nondeductible passive losses. Nowhere is this more evident than in the recharacterization rules. In certain situations, income that is characterized under the general rules as passive is recharacterized under a special rule and treated as active. An example of the type of recharacterization that can occur was discussed earlier in connection with SPAs. As noted in that discussion, income from SPAs that fail to meet the 500-hour test would normally be treated as passive, but under the special recharacterization rule it is treated as active. There are several other situations when this might occur. Consequently, before it can be concluded that income is passive, the recharacterization rules must be considered. These rules operate to convert the following types of income to nonpassive (i.e., active) or portfolio income rather than passive income.

1. **Significant Participation Activities:** Income from “significant participation activities” that fail to meet the 500-hour test is nonpassive.

2. **Rental of Nondepreciable Property:** Income from rental activities is active if less than 30 percent of the basis of the property rented is depreciable (e.g., rental of land). This

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24 The aggregation election is made by filing a statement with the taxpayer’s original income tax return for the taxable year pursuant to Reg. § 1.469-9(g). The statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to § 469(c).

rule makes not only rental income nonpassive but also gain on a sale of the activity or property used in it. However, losses are passive.

3. **Developer Sales of Rental Property:** Rental income, including gain on the sale of rental property, if (1) gain on the sale is included in income during the taxable year; (2) rental of the property commenced less than 24 months before the date of disposition; and (3) the taxpayer performed sufficient services that enhanced the value of the rental property.

4. **Self-Rented Property:** Income from rental of property to an activity in which the taxpayer materially participates, other than related C corporations.

5. **Licensing of Intangible Property:** Royalty income from a pass-through entity that the taxpayer acquired after the entity created the intangible property.

6. **Equity-Financed Lending Activity:** Income from the trade or business of lending money if certain conditions are satisfied.

### Example 32

Dr. S owns a dental practice that he operates through a corporation, Family Dentistry, Inc. He also has substantial passive losses derived from two rental properties, an apartment and shopping center. Hoping to generate some passive income to absorb such losses, he purchased a building and leased it to his corporation for $25,000 this year. The corporation uses the building to house the doctor’s dental practice. The self-rental rule treats the rental income received by Dr. S as portfolio income since S materially participates in the corporation to which the property is rented.26

In a similar move, S and his brother, B, formed an LLC to establish a trailer park. The LLC purchased the land for $300,000 and made depreciable improvements on the land of $100,000. Any rental income derived from the park is treated as portfolio income rather than passive income since the basis of the depreciable property (unadjusted for depreciation) is less than 30% of the basis of all the property used in the rental activity ($100,000/$400,000 = 25%). Any gain on the sale of the partnership interest would also be treated as portfolio income. Note that this recharacterization rule is usually triggered when the bulk of the rental property’s cost is in the land rather than the improvements.

### Example 33

In 2013, Dr. P borrowed $50,000 and invested it by acquiring an interest in a limited partnership that produces movies. Interest on the loan for the year is $5,000. P can deduct the interest only to the extent of any passive income that he may have.

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27 § 163(d)(3)(B).
Example 34
Assume the partnership above incurs interest expense related to loans obtained to
acquire equipment used in its operations. For the partnership, the interest is treated
as a normal deduction and is used in arriving at the partnership’s net income or loss
from operations. For 2013, the partnership suffered a net loss including deductions for
interest expense. Dr. P is allowed to deduct his share of the loss only to the extent he
has passive income from other activities.

Check Your Knowledge
Try the following true-false questions.

Review Question 1
This year T’s tax records revealed that he had income consisting of a salary of $90,000,
dividends of $10,000, and a capital gain from the sale of stock of $5,000. In addition, he
received a Schedule K-1 from a partnership in which he is a limited partner. According to
the K-1, his share of the partnership’s loss for the year was $50,000. T can deduct $15,000
of this loss (i.e., to the extent of his passive dividend and capital gain income).
False. While a taxpayer is entitled to deduct passive losses to the extent of passive income,
passive income does not include dividends, interest, capital gains, and the like, which are
considered portfolio income.

Review Question 2
A passive loss that cannot be deducted in the current year is generally suspended. The sus-
pended loss is deductible only in the year in which the property to which the loss relates is
sold, since the sale affirms the fact that the taxpayer has actually suffered an economic loss.
False. The above is true for the most part, but suspended passive losses are not frozen to
thaw only when the taxpayer sells his or her interest. Passive losses that cannot be deducted
in a particular year are carried over to the following year and treated as if they occurred in
that subsequent year. Accordingly, the suspended loss can be deducted to the extent that the
taxpayer has passive income in the following year. In addition, the taxpayer is allowed to
deduct the suspended losses whenever the property to which the loss relates is sold.

Review Question 3
A capital gain from the sale of stock in an S corporation in which the taxpayer does not
materially participate is considered portfolio income.
False. Capital gains are normally considered portfolio income, but when such gain arises
from the sale of the taxpayer’s interest in a passive activity, it is treated as passive income.

Review Question 4
The passive loss rules do not apply to regular C corporations since the losses do not flow
through and are not available to the individual shareholders.
False. The passive loss rules do apply to personal service corporations and closely held
corporations (i.e., corporations where five or fewer individuals own more than 50 percent of
the stock). Personal service corporations must play by the same rules applicable to individu-
als. Closely held corporations, however, are allowed to offset passive losses against income
from operations other than portfolio income.
**Review Question 5**

Moe, Larry, and Curly pooled all of their savings to start a new restaurant, Stooges. Stooges is operated as an S corporation, and its stock is owned equally by the threesome. In its first year, the restaurant produced a loss. Depending on the circumstances, Moe may be able to deduct his share of the loss this year while Larry and Curly may not be able to deduct their shares.

*True.* Whether a deduction is allowed for the loss depends on whether the taxpayer materially participates in the activity. Moe may be actively involved on a daily basis, and Larry and Curly may be passive investors. In such a case, only Moe would be able to deduct the loss currently.

**Review Question 6**

D operates a small bed-and-breakfast motel. Most of his customers rent rooms for one or two days. D’s operation is not considered a rental activity for purposes of the passive-loss rules.

*True.* An activity is not considered a rental for purposes of the passive-loss rules if the average period of customer use is seven days or less.

**Review Question 7**

T owns a duplex and rents it out. She normally signs six-month leases with her tenants. Any loss related to the rental is considered a passive loss and is not deductible regardless of T’s participation.

*True.* This activity is considered a rental since the average period of customer use exceeds 30 days and T does not provide any extraordinary services. Losses on long-term rental real estate are normally not deductible except to the extent of passive income unless the taxpayer can qualify under one of two exceptions. First, she is permitted to deduct up to $25,000 of losses from rental real estate if she actively participates and her adjusted gross income is less than $150,000. In addition, a special exception allows individuals who spend more than 50 percent of their time in real property businesses and more than 750 hours in such businesses to treat the activities as nonrental and deduct any losses if they materially participate in such activities.

**Review Question 8**

Several years ago, Q purchased an interest in a limited partnership. This year his share of the partnership’s loss was $10,000. Assuming Q’s adjusted gross income is $80,000, he may deduct the loss since it is less than $25,000.

*False.* The loss would be treated as a passive loss since Q does not materially participate in the partnership activity. The de minimis exception that enables a taxpayer to deduct up to $25,000 of passive losses annually applies only to losses from rental real estate activities in which the taxpayer actively participates.

**Review Question 9**

B opened her first Planet Jupiter Cafe five years ago in Aspen. Now she has five restaurants, each located in a different resort. Since each store is located in a separate city, she must treat each store as a separate activity.

*False.* A taxpayer is required to treat one or more activities as a single activity if the activities constitute an appropriate economic unit (AEU). The Regulations give the taxpayer a great deal of flexibility in determining what constitutes an AEU. Thus, the taxpayer could treat each as a separate activity, combine all and treat as a single activity, or use some other grouping that may be appropriate under the Regulations.

**Review Question 10**

B is a college professor who recently got involved in a mail-order smoke alarm business. This year he spent about 100 hours in the activity, taking orders and arranging to fill them. B materially participates in the business.

*True.* Under the general rule, a taxpayer is considered a material participant if he or she spends more than 500 hours in the activity during the year. Although B does not meet the general rule, he does meet an alternative test; that is, his participation constitutes substantially all of the participation in the activity. Therefore the activity is not a passive activity.
Review Question 11

G owns two businesses, a convenience grocery store and a dry cleaners. For the last several years, the grocery has not done as well as G had hoped and she has lost money. This year, G did not play as much golf as usual and spent about 400 hours trying to turn the business around. She spent about 300 hours at the cleaners. Each business has a number of full-time employees. G may offset any loss attributable to the grocery store against the profits from her dry cleaners.

True. The restaurant and the dry cleaners are considered significant participation activities since G spends more than 100 hours in each. If the total participation in all SPAs exceeds 500 hours, the taxpayer is deemed to materially participate in each of the activities. In this case, the total participation in all SPAs exceeds the 500-hour threshold, and G is therefore deemed to materially participate in each of the activities. Thus, she can use the loss in the grocery activity to offset the income from the cleaning business.

Review Question 12

Same as above, except G spends 100 hours at the cleaners, 300 hours at the grocery, and the remaining time at the beach. G may offset any loss attributable to the grocery against the profits from her dry cleaners.

False. In this case, G’s combined participation in the SPAs does not exceed 500 hours. This is the “heads we win, tails you lose” situation: the loss is passive, the income is nonpassive, and the two cannot be combined.

Review Question 13

J borrowed $100,000 to purchase an interest in the Lockwood Limited Partnership, which operates several apartment complexes. This year J paid $8,000 interest on the loan to acquire his interest. In addition, J’s share of the partnership’s losses was $10,000. J has no passive income. The loss is a passive loss and cannot be deducted, but the interest is treated as investment interest and is deductible to the extent of J’s investment income.

False. J simply treats the $8,000 of interest expense as another operating expense of the partnership, increasing the loss from $10,000 to $18,000. None of the loss, including the interest, is deductible.

Rental of Residence (Vacation Home Rentals)

Section 280A imposes restrictions on the deduction of expenses related to rental of a residence if the taxpayer is considered as using the residence primarily for personal purposes rather than for making a profit. These restrictions are aimed at the perceived abuse existing in the area of vacation home rental. Prior to the enactment of § 280A, many felt that personal enjoyment was the predominant motive for purchasing a vacation home. Any rental of the vacation home served merely to minimize the personal expense of ownership and not to produce income.

Basic Rules

In 1976, Congress prescribed an objective method for ascertaining the purpose of the rental activity as well as the amount of the deduction. According to this approach, the expenses incurred by the taxpayer in owning and operating the home (e.g., interest, taxes, maintenance, utilities, and depreciation) must first be allocated between personal use and rental use. The deductibility of the expenses allocated to each then depends on whether the home is considered the taxpayer’s residence or rental property. This latter determination is made based on the owner’s personal use and the amount of rental activity.\(^28\)

1. Nominal Rentals: If the residence is rented out fewer than 15 days, all rental income is excluded from gross income and no deduction is allowed for rental expenses. Otherwise allowable deductions, such as those for qualified residence interest, real estate taxes, and casualty losses may be deducted from A.G.I.

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\(^28\) §§ 280A(c)(5) and 280A(d) through (g).
2. **Used as a “Residence”**: If the taxpayer uses the vacation home for more than 14 days or 10 percent of the number of days the property is actually rented out, whichever is greater, the home is treated as his or her residence and deductions are restricted as explained below. A typical taxpayer caught by this rule is the owner of a vacation home who uses it for more than two weeks and rents it out to defray the cost.

   a. **Expenses Allocable to the Rental Use**: These expenses are deductible to the extent of gross income less otherwise allowable deductions. Any deductions in excess of gross income can be carried over and deducted to the extent of any future income. These expenses are deductible for A.G.I. since they are related to rental use. Note that the passive-loss rules do not apply since the property is used as a residence and not a rental.

   b. **Expenses Allocable to Personal Use**: Since these expenses are considered personal, they may be deducted only if they are specifically authorized by the Code. Allocable property taxes are deductible without limitation as an itemized deduction since such expenses are fully deductible regardless of the activity in which they are incurred. Interest expense may be deductible as an itemized deduction. Allocable interest is normally qualified residence interest since the home—in this case—is considered the taxpayer’s residence (e.g., because it is used more than 14 days). However, if the home is not the primary or secondary residence of the taxpayer (e.g., the taxpayer has several vacation homes), no deduction would be available. The other operating expenses are not deductible.

3. **Used as “Rental Property”**: If the taxpayer does not use the property extensively (i.e., more than the greater of 14 days or 10 percent of the number of days rented out), then the property is effectively treated as rental property.

   a. **Expenses Allocable to the Rental Use**: These expenses are deductible subject only to the restrictions on passive losses. If the property’s average rental period is either (1) 1–7 days or (2) 8–30 days and significant services are provided, the property is not rental property under the passive loss rules. Thus, the treatment of any loss depends on whether the taxpayer materially participates in this “nonrental activity.” If the taxpayer materially participates, any loss would not be passive and would therefore be fully deductible. If the property is considered a rental (e.g., perhaps under the facts-and-circumstances test or if the rental is 8–30 days and no significant services are provided) and the taxpayer is considered as having met the active participation standard, the taxpayer may qualify for the rental exception under the passive loss rules. This would allow the taxpayer to deduct up to $25,000 in losses annually. Any deductions would be for A.G.I.

   b. **Expenses Allocable to Personal Use**: As noted above, since these expenses are personal, they may be deducted only if they are specifically authorized by the Code. In this case, property taxes would continue to be fully deductible. On the other hand, none of the interest expense would be deductible as qualified residence interest since the vacation home is not considered a “residence” (because the taxpayer did not use it more than 14 days). However, the excess interest expense would be treated as investment interest and could be deducted to the extent of investment income. Other operating expenses would not be deductible.

   This treatment is summarized in Exhibit 12.1. For purposes of the owner use test, the number of days a unit is rented out does not include any day the unit is used for personal purposes. The unit is generally treated as used for personal purposes on any day where the owner or a member of his or her family uses it for any portion of the day for personal purposes or the unit is rented at less than a fair rental. A day on which the taxpayer spends at least two-thirds of the time at the unit (or if less than two-thirds then at least eight hours) on repairs is not counted as a personal day. This is true even though individuals who accompany the taxpayer do not perform repairs or maintenance.
**Example 35**

In 1985, Floyd Toups and his wife purchased a vacation home for $120,000. The unit was one of 155 individually owned “cottages” located at Callaway Gardens, a favorite vacation resort in Pine Mountain, Georgia, about 70 miles south of Atlanta. The units were marketed and managed by a development company that received 50% of the net rental income for its services. Each owner was entitled to rent-free use of the cottage for no more than 14 days during the year. On their 1988, 1989, and 1990 returns, the Toupses took the position that the cottage, which was generating losses, was a nonrental activity since the average period of customer use of the cottage was seven days or less, and accordingly the Toupses deducted the losses on their Schedule C on the grounds that they materially participated in the activity. However, the IRS disagreed and assessed deficiencies exceeding $3,000 for each year. In the Tax Court, the Toupses attempted to justify their position, explaining that they had spent 341 hours each year in activities related to the rental of the unit. They listed 13 activities, which they believed supported their claim. According to the couple they (1) provided funds for the purchase; (2) prepared an annual budget; (3) prepared a cash flow analysis; (4) provided a rental agency for renting their unit; (5) marketed the resort and rental of the cottage; (6) met with other owners; (7) established rental rates for the cottages with other owners; (8) inspected the cottage and common areas at least twice a year; (9) reviewed monthly reports received from the rental agent; (10) reviewed other correspondence from the rental agent; (11) reviewed advertising brochures about the resort received from the rental agent; (12) received and deposited net revenues received from the rental; and (13) issued checks for expenses of the cottage. The Tax Court agreed that the property was not “rental property” under the passive-loss rules and, therefore, did not qualify for the $25,000 allowance available for rental real estate. Unfortunately, the court did not agree with the taxpayers’ claim that they materially participated in the activity. The court found that the activities of the taxpayer did not constitute material participation because they were not involved in the day-to-day operation of their cottage or in its management. The activities of the taxpayers were considered to be activities of an investor, and therefore their losses were passive.31

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31 Floyd A. and Joanna Toups, 66 T.C.M. 370, T.C. Memo 1993-359.
As discussed above, the treatment of expenses incurred in operating a vacation home varies depending on whether the expenses are allocated to rental or personal use. Consequently, the critical first step in applying the vacation home rules is allocation of the expenses. Once expenses are properly allocated between rental and personal use, the appropriate limitations can be applied.

Vacation home expenses can be classified as either direct and indirect. Direct expenses are those that are not related to the general operation or maintenance of the unit but which are incurred to obtain tenants.\(^{32}\) For example, advertising, brokers’ fees, office supplies, and depreciation on office equipment used in the rental activity are considered directly related to the rental. These direct expenses reduce gross rental receipts to arrive at gross rental income. All other expenses are considered indirect expenses—including otherwise allowable deductions such as interest and taxes—and must be allocated between personal and rental use.

In allocating the expenses between personal and rental use, two different methods are used. Under the so-called Bolton approach, otherwise allowable deductions such as interest and taxes are assumed to accrue daily regardless of use.\(^{33}\) Consequently, the fraction for allocating these items to the rental use was:

\[
\text{Portion attributable to rental use} = \frac{\text{Number of rental days}}{365}
\]

In contrast, expenses such as utilities, maintenance, and depreciation are considered a function of use. As a result, the fraction used for allocating these items to the rental use was:

\[
\text{Portion attributable to rental use} = \frac{\text{Operating expenses} \times \frac{\text{Number of rental days}}{\text{Rental + Personal days}}}{\text{Rental + Personal days}}
\]

The method of allocating expenses and their treatment is summarized in Exhibit 12.2.

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\(^{32}\) Prop. Reg. § 1.280A-3(d)(2).

\(^{33}\) Dorance D. Bolton, 77 T.C. 104 (1982), aff’d at 82-2 USTC ¶9699, 51 AFTR2d 83-305 (CA-9, 1982).
deduct a larger amount of expenses allocable to the rental. At the same time, this method increases the amount of the itemized deduction for interest and taxes. The end result is that a larger deduction can be secured using the Bolton approach. Unfortunately, the IRS continues to oppose Bolton so taxpayers must proceed with caution.\textsuperscript{34} The example below follows Bolton.

**Example 36**

A owns a condominium in a ski resort. During the year, A uses the condominium as a secondary residence for 30 days and rents it out for 90 days. The condominium is not used the remainder of the year. During the year, A's rental agent, R, collected rents of $5,000. The agent's standard fee was 30% of rents; therefore the charge was $1,500 and R sent Form 1099 to A showing net rental income of $3,500. Total expenses for the entire year include maintenance and utilities of $1,000, interest of $6,200, taxes of $1,100, and $2,000 depreciation on the entire cost of the unit.

A's use for 30 days is more than 14 days, the greater of 14 or 9 days (10% of the 90 days rented). Therefore, the unit is treated as a residence. For this reason, expenses attributable to the rental are deductible to the extent of gross income as reduced by otherwise allowable deductions (the interest and taxes). Deductions are computed and deducted in the following order:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross rental receipts</td>
<td>$5,000</td>
</tr>
<tr>
<td>Deduct directly related expenses (brokerage fee).</td>
<td>−1,500</td>
</tr>
<tr>
<td>Gross rental income</td>
<td>$3,500</td>
</tr>
<tr>
<td>Deduct allocable portion of otherwise allowable deductions:</td>
<td></td>
</tr>
<tr>
<td>Interest and taxes ($7,300 \times (90 / 365))</td>
<td>−1,800</td>
</tr>
<tr>
<td>Gross income limitation</td>
<td>$1,700</td>
</tr>
<tr>
<td>Deduct allocable portion of deductions other than those otherwise allowable and depreciation:</td>
<td></td>
</tr>
<tr>
<td>Utilities and maintenance ($1,000 \times 90 / (30 + 90)]</td>
<td>−750</td>
</tr>
<tr>
<td>Gross income limitation</td>
<td>$950</td>
</tr>
<tr>
<td>Deduct allocable portion of depreciation:</td>
<td></td>
</tr>
<tr>
<td>Depreciation ($2,000 \times 90 / (30 + 90)] = $1,500 but limited to $950</td>
<td>−950</td>
</tr>
<tr>
<td>balance of gross income</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$0</td>
</tr>
</tbody>
</table>

All of the above deductions are \textit{for A.G.I.} The balance of interest and taxes not allocated to the rental use, $5,500 ($7,300 − $1,800), is deductible if the taxpayer itemizes deductions. Note that the interest in this case is qualified residence interest since the unit is treated as A's residence. The deduction for maintenance and utilities is not limited by gross income since all of these expenses attributable to the rental activity are deductible. The $250 ($1,000 − $750) remaining balance of maintenance and utilities would not be deductible in any case since it represents the expenses attributable to personal use. Of the remaining depreciation balance of $1,050 ($2,000 − $950), $550 ($1,500 − $950) attributable to the rental is not deductible due to the gross income limitation but may be carried over to subsequent years. The other $500 of depreciation is not deductible since it is the portion attributable to personal use. Also note that only the $950 of depreciation allowed is treated as a reduction in the basis of A's condominium.

\textsuperscript{34} § 280A(e). The IRS continues to take the position that all expenses should be allocated based on use. See \textit{Residential Rental Property}, IRS Publication 527 (2012), p. 17 on dividing expenses.
Example 37
Assume the same facts as in Example 36, except that A used the condominium for 10 days rather than 30. Also assume that the rental is on a three-month basis to locals and no services are provided. In such case, the condominium would be treated as rental property rather than as a residence since A stayed less than 14 days. In addition, the $25,000 rental exception of the passive loss rules would apply since there is a long-term rental and no significant services are provided. A’s deduction would be computed as follows:

Gross rental receipts ........................................................  $  5,000
   Deduct directly related expenses (brokerage fee). ..........................  −1,500

Gross rental income ........................................................  $  3,500
   Deduct allocable portion of otherwise allowable deductions
   ($7,300 × 90 ÷ 365) .................................................  −1,800
   Deduct allocable portion of utilities and maintenance
   [$1,000 × 90 ÷ (90 + 10)]. .............................................  −  900
   Deduct allocable portion of depreciation
   ($2,000 × 90 ÷ (90 + 10)]. .............................................  −1,800

Loss ....................................................................  $(1,000)

In this case, a loss is created that may offset any other income of the taxpayer under the $25,000 rental loss exception. In contrast to Example 36 above, however, the balance of the interest expense, $5,500 ($7,300 − $1,800), would not be deductible as qualified residence interest since the property does not qualify as a residence. Nevertheless, the taxpayer may be able to deduct the amount as investment interest to the extent of any net investment income that he or she may have from other investments. Lacking investment income, the taxpayer would be better off using the condominium more, in order that he could qualify it as a second residence and deduct the interest. The balance of the other expenses would not be deductible.

The vacation home rules, as discussed above, could operate to eliminate legitimate deductions for those taxpayers who convert their personal residence for rental during the year. In these cases, the owner usually uses the residence for more than 14 days and thus deductions are limited. However, § 280A(d) provides relief for taxpayers in these situations. The provision accomplishes this goal by not counting as personal use days any days of personal use during the year immediately before (or after) the rental period begins (or ends). This rule, often referred to as the qualified rental period exception, applies only if the rental period is at least a year (or if less than a year, the house is sold at the end of the rental period).

Example 38
B lived in her home from January through July. In August, she moved into a condominium and decided to convert her old home to rental property. B was able to find a tenant who leased the old home for a year. Under the normal rules of § 280A, B’s deductions related to the old home would be limited to gross income since her personal use exceeded 14 days. The relief measure of § 280A(d) removes this limitation because the seven months of personal use preceding the one-year rental period are not counted as personal use days. As a result, B would treat the lease as a rental activity and could deduct expenses subject to the passive loss rules, possibly qualifying for the $25,000 exception.
Check Your Knowledge

Review Question 1
During the Olympics held in Atlanta during 1996, many Georgians left town and rented their homes out for the two weeks the games were in town. It was rumored that some of the mansions were rented for more than $100,000 during this time. How would these temporary landlords treat the income?

Under § 280A, if the home is rented out for less than 15 days, all of the rental income is excluded and none of the expenses allocable to the rental period are deductible. Consequently, these temporary landlords received a real windfall because they were allowed to exclude all of the income.

Review Question 2
T owns a condominium in Vail. This year his rental agent was able to rent it out for 100 days (most guests stayed for six days). Unfortunately, he was able to use the condo for personal purposes for only one week in January because of a skiing accident in which he broke his shoulder. Interest expense and taxes allocable to the personal use were $500. The net loss attributable to the rental during the remainder of the year was $4,000. What amount can T deduct? Is the property considered rental property subject to the passive loss rules?

Since the personal use was nominal (i.e., not more than the greater of ten percent of the number of days rented or two weeks), the property is not considered a residence. Moreover, it is not considered rental property under the passive loss rules since the average rental period was less than eight days. Thus, it is considered a nonrental activity with the treatment dependent on whether T materially participates in the activity. Since he does not materially participate, the loss is a passive loss and is not deductible unless he has other passive income. The interest attributable to the period of personal use is not qualified residence interest since the unit did not qualify as a residence. Instead the interest is treated as investment interest and is deductible to the extent of investment income.

Review Question 3
W owns a condominium in St. John in the Caribbean. She rented it out for seven months (one month at a time) during the year but used it personally for the entire month of January. Can W treat the activity as a rental activity and take advantage of the $25,000 de minimis exception that would allow her to deduct a loss from the property?

No. If a taxpayer uses a home for more than two weeks or 10 percent of the number of days the unit is rented, she treats the home as a residence. In this case, the taxpayer used the home 31 days for personal purposes, thereby exceeding the threshold and converting the property to a residence. Any interest is deductible as qualified residence interest, assuming this is a first or second home. On the other hand, rental expenses can be deducted only to the extent of rental income. The excess expenses may be carried over and deducted in subsequent years to the extent the unit generates income. The passive loss rules do not apply, and the $25,000 allowance is not available.

Problem Materials

DISCUSSION QUESTIONS
12-1  Tax Shelters and the Solution. In 1982, T purchased for $10,000 an interest in Neptune III, a limited partnership created by Dandy Development Company to finance and build a 25-story office building in downtown Houston. T, who was in the 50 percent tax bracket, hoped that this investment would significantly cut her taxes.
   a. Explain the features of the investment that during that period made such investments attractive and might produce the benefits desired by T.
   b. Explain what steps Congress took in 1986 to eliminate the benefits of investments in such activities as Neptune III. Comment in some detail on the approach used by Congress to accomplish its objective.
   c. What steps might you have suggested had you been advising Congress on the restriction of tax shelter?
12-2 *Effect of Code § 469.* D owns and operates several ski rental shops in Vail, Aspen, Beaver Creek, and Steamboat Springs. Over the years, the shops have had their ups and downs, with profits in some years, losses in others. Recently, D has spent less and less time at the shop, letting his employees do most of the work.

a. What is the significance should the business be characterized as a passive activity?
b. Should D worry about his business being treated as a passive activity? When is an activity considered passive?
c. Does the fact that D’s business is a rental operation have any bearing on the nature of the activity?
d. What are the aggregation or grouping rules and why might they be important in D’s case?

12-3 *Taxpayers Subject to § 469.* Dr. R has been quite successful over the years. She left St. James hospital in 2000 and started her own sports medicine practice, The Sports Institute Inc., a regular C corporation. After building this operation into a thriving practice, she branched out. In 2009, she and a good friend opened their own restaurant, The Diner, a partnership. In 2012, her college roommate persuaded R to invest and buy stock in a new venture, Compatible PCS, a corporation that manufactured personal computers. Compatible PCS was owned by R and three other individuals and operated as a regular C corporation until this year, when it converted to S status. Dr. R’s other investments include a single family house that she rents out, a limited partnership interest in an oil and gas operation, and a limited partnership interest in a business that develops land into shopping centers. Explain how R is affected by the passive loss rules.

12-4 *Definition of an Activity and Planning.* D owns several businesses, including an indoor soccer facility, a gas station adjacent to the soccer facility (he bought it with the intention of someday expanding the soccer facility), and a fast-food restaurant across the street from the soccer facility. Within the soccer facility, he has rented space to a local soccer retail store. He also rents space in the facility to another company, which operates a small bar and restaurant. In any one year, each business may be profitable or may have losses. For simplicity, assume each business is operated as a sole proprietorship.

a. Assuming one of the businesses is profitable, would D prefer passive or active income?
b. Assuming one of the businesses has losses, would D prefer a passive or active loss?
c. Discuss the passive loss rules, how they might apply to D, and what planning might be considered. Identify as many questions as possible that might be asked in determining how the passive loss rules apply to D.

12-5 *Aggregating Activities.* Aggregation of activities may be required for purposes of the material participation tests.

a. Explain the general rules concerning aggregation and their purpose.
b. Explain when this rule is beneficial and when it is detrimental for the taxpayer.

12-6 *Rental Activities and Material Participation.* T owns a 10-unit apartment complex. He not only manages the apartments but also performs all of the routine maintenance and repairs as well as keeping the books. Most of the leases that he signs with tenants are for one year. This year the complex produced a loss of $30,000. How will T treat the loss, assuming his adjusted gross income from other sources is $90,000?

12-7 *Recharacterization.* Briefly explain the purpose of the recharacterization rules and why they must not be overlooked when dealing with passive activities.

12-8 *Credits from a Passive Activity.* P is considering rehabilitating a home in a historic neighborhood. She hopes to qualify for both the rehabilitation credit and the low income housing credit.

a. Assuming she qualifies, explain how she will compute the amount of credit that she may claim.
b. P’s accountant has explained the limitations that apply to losses and has indicated to P that any losses on the rental that are denied currently will ultimately be allowed once P sells the property. Can the same be said of credits?
**12-9 Grouping Activities.** Urged by their accountants to reduce their tax liability, a group of orthopedic surgeons invested in real estate that produced passive losses. Prior to 1986, these losses did in fact serve as tax shelters. After 1986, however, the passive loss rules significantly restricted the tax benefits of the investments. Consequently, the accountants prodded the doctors to form a partnership to acquire and operate X-ray equipment. The doctors do not participate in the X-ray partnership, and, therefore, any income produced by the partnership is passive income. Most of the income from operation of the partnership is derived from services provided to the doctors themselves. Will this scheme successfully produce passive income that can be used to absorb passive losses?

**12-10 Interest Expense.** This year Dr. Z purchased a 20 percent interest in a partnership that is building an office building in downtown Dallas. To finance the acquisition, he used his line of credit at the bank and borrowed $100,000. As a result, he paid $10,000 in interest during the year.

a. How will Dr. Z treat the interest expense?

b. After the building was completed, the partnership secured permanent financing. This year the partnership paid mortgage interest of $700,000, of which $14,000 represented Dr. Z's allocable share. How will Dr. Z treat the interest?

**PROBLEMS**

**12-11 Identifying Activities.** For each of the following situations, indicate the number of activities in which the taxpayer participates.

- S owns and operates an ice cream store in Southwoods Mall. He is also a camera buff and owns a camera shop in the same mall.
- T owns a small “strip” shopping center that houses 10 businesses, including T's own video store. This year T received $40,000 in income from renting out space in the shopping center and grossed $60,000 from her video store.
- O owns five greeting card stores spread all around Denver.
- P owns 10 gas stations throughout the state of Georgia. Each station not only sells gas but also sells groceries. Seven of the stations derive 60 percent of their income from gas sales and 40 percent from food sales. Two of the stations derive 55 percent of their income from food sales and 45 percent from gas sales. One station also provides auto repair services and derives one-third of its income from each operation.
- E owns a beer distributorship and ten liquor stores throughout Minneapolis. Sixty percent of the distributorship sales are to the liquor stores.

**12-12 Combining Activities.** T owns a 70 percent interest in each of three partnerships: a radio station (WAKO), a minor league baseball team (the Harrisville Hippos), and a video and film company (Dynamite Productions) that produces short subjects for television, including advertisements. In any particular year, one business may be profitable while another may be unprofitable. Each business is at a different location. Each business also prepares its own financial statements and has its own management, although T participates extensively in the management of all three partnerships. Any financing needed for the three partnerships is usually obtained from Second National, a local bank. The radio station broadcasts all of the Hippo games, and the production company often prepares material for local television spots on the Hippos. Occasionally, some employees in one partnership assist the other partnership in periods of peak activity or emergency. Explain how the passive loss rules apply to T in this case.

**12-13 Material Participation.** During the week, A is a mild-mannered reporter for the local paper. On the weekends, he is a partner with his brother-in-law, B, in a small van conversion operation in Elkhart. The two typically work seven or eight hours on most Saturdays during the year. This year, the partnership suffered a loss of $10,000.

a. How will A treat the loss?

b. What planning might you suggest?
12-14 Participation Defined. Three recent Purdue graduates—C, D, and E—formed their own lawn treatment company. Each of the three participates on a part-time basis because each is otherwise employed on a full-time basis. In this, their first year of operations, C spent 40 hours, D spent 70 hours, and E contributed 80 hours. E’s wife also kept the books for the partnership. Explain whether C, D, and E satisfy the material participation test.

12-15 Material Participation. F is an accountant with a large C.P.A. firm. She also has an interest in two partnerships: a night club and a family-owned drugstore. F maintains the accounting records for each partnership, spending 200 hours working for the night club and 400 hours for the drugstore.

a. How will F treat any losses that the partnerships might have?
b. How will F treat any income that the partnerships might have?

12-16 Material Participation. In 2001, H started his own replacement window business, Sting Construction, an S corporation. Up until 2010 H had been the sole shareholder. In 2010 he sold 90 percent of his stock to J and K, who continued the business. From time to time, H still provides advice to J and K. This year, H spent 300 hours working for the company. J and K each devoted 1,500 hours to the business. Unfortunately, the corporation suffered a loss this year because of a downturn in the economy. How will H treat the loss?

12-17 Rental or Nonrental Activities. Indicate whether the following are rental or nonrental activities.

a. P owns an airplane. She has an arrangement with a flying club at a small airport to lease the plane out on a short-term basis to its students. Most of the time the plane is rented for two to three hours.
b. Q owns a condominium in Aspen that he rents out during the year. The average stay is one week. Q has arranged to provide daily maid and linen service for the unit. In addition, his monthly condominium fee pays for maintenance of the common areas.
c. S and his wife, T, own White Silver Sands, a posh resort on the coast of Florida. As part of its package, the resort provides everything a vacationer could want (daily maid service, free use of the golf, tennis, and pool facilities, an on-site masseuse, etc.). The average stay is two weeks.
d. Z owns a duplex near the University of Texas that she normally rents out to students on a long-term basis. The average stay is nine months. Z provides typical landlord services such as repairs and maintenance.
e. B owns Quiet Quarters, a retirement home for the elderly. The home’s staff includes a physician and several nurses.
f. C owns and operates Body Beautiful, a fitness club. The club has over 1,000 members. who have use of the club daily from 6 a.m. to 11 p.m.
g. D owns a 200-acre parcel of land on the outskirts of Lubbock. The land is worth $700,000 (basis $200,000). During the year, D leased the land to a local car enthusiast who used it as a raceway. D collected rents of $5,000.

12-18 Passive Activities. G is the head chef for Half-Way Airlines, making a salary of $70,000 a year. In addition, his portfolio income is about $20,000 a year. Over the years, G has made numerous investments and has been a participant in many ventures. Indicate whether the passive activity rules would apply in each of the following situations:

a. A $10,000 loss from G’s interest in Flimsy Films, a limited partnership. G is a limited partner.
b. A $5,000 loss from G’s interest as a shareholder in D’s Bar and Grill, an S corporation. G and his wife operate the bar. Each spent 300 hours working there in the current year.
c. G and his friend, F, are equal partners in a partnership that produces and markets a Texas-style barbecue sauce. G leaves the management of the day-to-day operations to F. However, G spent 130 hours working in the business during the current year. For the year, the partnership had income of $15,000. Assume that this is G’s only investment.
d. Same as (c) except G has an ownership interest in three other distinctly different activities (e.g., construction and consulting). He spends 130 hours in each of the four activities.

e. G is a 10 percent partner in a restaurant consulting firm. The firm operates the business on the bottom floor of a three-story building it owns. The firm leases the other two floors to a law firm and a real estate company. The consulting side of the business reported a $100,000 profit from consulting, $5,000 in interest income, and had a loss from the rental operation.

f. G is the sole owner of Try, Inc., a regular C corporation that produces G’s special salad dressing. The corporation had an operating profit of $4,000. In addition, Try, Inc. had interest income of $5,000 and a $7,000 loss from its investment in a real estate limited partnership in which it was a limited partner.

12-19 Passive-Activity Limitations. M is a successful banker. Two years ago, M’s 27-year-old son, J, asked his dad to become his partner in opening a sporting goods store. M agreed and contributed $50,000 for a 50 percent interest in the partnership. J operates the store on his own, receiving little advice from his father. Information regarding M’s financial activities reveals the following for the past two years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Salary</th>
<th>Interest Income</th>
<th>Partnership Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$100,000</td>
<td>$20,000</td>
<td>$(40,000)</td>
</tr>
<tr>
<td>2014</td>
<td>100,000</td>
<td>20,000</td>
<td>12,000</td>
</tr>
</tbody>
</table>

All parties are cash basis, calendar year taxpayers. Answer the following questions.

a. How did M’s investment in the partnership affect his A.G.I. in 2013?

b. How did M’s investment in the partnership affect his A.G.I. in 2014?

c. Would your answer to (b) change if the partnership had a loss in 2014 and the income shown was from M’s interest as a limited partner in a real estate venture?

d. On January 1, 2015, M sold his interest in the partnership to his son for a $40,000 gain. What effect?

12-20 Passive-Activity Limitations: Rental Property. L, single, is the chief of surgery at a local hospital. During the year, L earned a salary of $120,000. L owns a four-unit apartment building that she rents out unfurnished. The current tenants have one-year leases, which expire at various times. This year, the property produced a loss of $30,000 due to accelerated depreciation. L is actively involved in the rental activity, making many of the decisions regarding leases, repairs, etc.

a. How much of the loss may L deduct?

b. Would the answer to (a) change if L materially participated?

12-21 Rental Real Estate. M and H are real estate moguls. Together they have created a number of partnerships that own more than 50 shopping malls as well as a few office buildings, apartments, and warehouses. Most of their lease agreements with their mall tenants are tied to the tenant’s gross receipts. Unfortunately, with the downturn in the economy, several of the mall projects have produced substantial losses. How will M and H treat their share of the losses?

12-22 Suspended Losses. When tax shelter activity was at its highest, G was one of its biggest proponents. Currently, she still owns an interest in several limited partnerships. She is now considering what she should do in light of the passive loss rules. To help her make this decision, she has put together her best guess as to the performance of her investments over the next two years. These are shown below.

<table>
<thead>
<tr>
<th>Activity</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$(7,000)</td>
<td>$(2,000)</td>
</tr>
<tr>
<td>Y</td>
<td>(3,000)</td>
<td>(9,000)</td>
</tr>
<tr>
<td>Z</td>
<td>6,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>
a. Determine the amount of suspended loss for each activity at the end of 2013 and 2014.

b. Assume the same facts as in (a) above, except assume that in 2014 G sells the Y activity for a $4,000 gain. Explain the effect of the disposition on any suspended losses G might have, including the amount of suspended losses to be carried forward to 2015.

12-23 **Characterizing Income.** Indicate whether the income in the following situations is passive or non-passive:

a. Ten years ago, T purchased a strip of land for $300,000. Shortly thereafter, he built an office building on the land for $100,000. He currently leases the entire building to a large corporation on a ten-year lease for $90,000 annually. This year he sold the building for $700,000.

b. Q owns a real estate development business that she operates as an S corporation. In 2012, she purchased a vacant lot for $100,000. Q proceeded to put in roads, sewers, and other amenities at a cost of $50,000. Shortly thereafter, she contracted for the construction of a warehouse at a cost of $1 million. Upon completion of the building in September 2012, Q began leasing the space. It was completely leased by June 2013. In December 2014, she sold the property for $2 million.

c. T owns 100 percent of the stock of Z Corporation, an S corporation that operates a construction company. This year T purchased and leased a crane to the corporation. T received total rents of $10,000.

d. X operates a travel agency and an office supply store to which she devotes 300 and 100 hours, respectively. The travel agency produced a profit of $10,000 while the office supply business sustained a loss of $40,000.

12-24 **Rental versus Nonrental Activities.** Identify rental activities that would not be considered “rental activities” for purposes of the passive loss rules.

12-25 **Vacation Home Rental.** S owns a condominium in Florida, which he and his family use occasionally. During the year, he used the condominium for 20 days and rented it for 40 days. The remainder of the year, the condominium was vacant. S compiled the following information related to the condominium for the entire year:

<table>
<thead>
<tr>
<th>Rental income</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Interest on mortgage</td>
<td>3,650</td>
</tr>
<tr>
<td>Maintenance</td>
<td>900</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6,000</td>
</tr>
</tbody>
</table>

a. Compute the tax effect of the rental activity on S.

b. Assuming S only used the condominium personally for ten days, compute the tax effect.

c. Assuming S only rented the condominium for 14 days, compute the tax effect.

12-26 **Vacation Home-Personal Use Days.** Indicate the number of personal use days in each of the following situations:

a. Saturday morning, March 3, S drove to Vail to replace a water heater in his vacation home. He arrived in Vail at 9 a.m. and skied until late afternoon, when he retired to his condominium at 6 p.m. After dinner, he worked on replacing the water heater until midnight, when he went to sleep. The following morning he awoke and went skiing until 5 p.m., when he returned home.

b. Same as (a) except S's wife and family accompanied him. S's family also skied but did not perform any repairs or maintenance related to the vacation home.

c. T owns a duplex, which he rents. On February 1 of this year, the one-year lease of the tenant living upstairs expired and she moved. Unable to rent the upstairs unit, T moved in on December I and remained through the end of the year.
12-27 Participation in Real Estate. When D reached age 60 several years ago, he decided to cut back on the number of hours he devoted to his dental practice. He figured that the income from a mini-warehouse, a trailer park, and a duplex that he owned would sufficiently supplement the income that he derived from his practice. Unfortunately, this year all of these rental activities produced losses. Assuming D has no passive income, indicate whether each of the following statements is true or false. If false, explain why.

a. D is not allowed to deduct the losses since rental real estate activities are considered passive regardless of the taxpayer’s participation.

b. D is allowed to deduct the losses if most of his working hours are spent managing the real estate properties.

c. Assuming D works 700 hours managing the properties and his wife spends 200 hours helping him, the couple will be able to deduct the losses on their joint return.

12-28 At-Risk Computation. Ajax Construction builds apartments and condominiums. It has developed a unique construction technique. It created forms in the shape of a U in which concreted is poured. The U forms are then inverted and set on top of each other to form the walls and floors of a building. A crane is needed to hoist a U out of the concrete forms and stack it on top of another U. The owners of Ajax Construction, A and B, formed the AB Partnership to purchase the crane and other heavy equipment that would be rented to Ajax and other parties. The partnership is formed on January 1, 2013 by equal partners A and B who each contribute $100,000. The AB Partnership reports on a calendar year and is engaged in activities subject to §465. The following transactions occurred during 2013 and 2014:

- 7/01/2013 AB Partnership borrows $120,000 from a bank using a recourse note.
- 10/01/2013 AB Partnership acquires equipment at a cost of $400,000 by giving a nonrecourse note to the vendor.
- 12/01/2013 AB Partnership reduces the recourse note balance to $30,000 and the nonrecourse note balance to $380,000.
- 12/31/2013 AB Partnership reports a taxable loss of $420,000 for 2013.
- 12/31/2013 Partners A and B each withdraw $40,000 from the partnership.
- 4/01/2014 Partners A and B each contribute $50,000 to the partnership.
- 12/31/2014 AB Partnership reports taxable income of $120,000

a. Compute partner A’s amount at risk on 12/31/2013.

b. Compute partner A’s amount at risk on 12/31/2014.

12-29 At-Risk: Real Estate. Kingsmill is a limited partnership. The partnership has three equal partners and it deals exclusively in rental real estate. S is the only general partner. On January 1, all three capital accounts were zero. No changes in the accounts occurred during the year. The partnership incurred losses of $75,000 during the year. As of the close of the year, the partnership had liabilities in the form of $20,000 of accounts payable and a $30,000 nonrecourse mortgage obtained from a commercial lender.

a. What losses can the partners claim as deductions on their returns for the year?

b. Would the result be the same if the partnership were engaged in equipment leasing rather than rental real estate?