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Living with Passive Losses—A Practical Approach

Richard M. Lipton

Checklist to Apply Section 469

Richard M. Lipton — Sonnenschein Nath & Rosenthal

STEP ONE — TAXPAYERS SUBJECT

Is the taxpayer an individual, an estate, a trust, a personal service corporation or a closely-held C corporation? If yes, go to Step 2; if no, Section 469 does not apply and end of analysis.

STEP TWO — ACTIVITIES

- A. **Undertakings.** Identify how the taxpayer owns the businesses (including rental businesses) in which the taxpayer has an interest. This involves the determination of each partnership, S corporation or proprietorship through which the taxpayer conducts a trade or business or owns rental property. Each separate location at which a separate person conducts business is a separate "undertaking."
- B. **20% Rental Income.** Determine whether an undertaking has 20% or more of its gross income from the rental of property. If it does, determine whether the rental constitutes a rental activity under Step 4. If it does not, it is a trade or business undertaking; go to Step 2C.
- C. **Common Control.** Determine whether any trade or business undertakings are commonly controlled. For this purpose, common control usually exists if more than 50 percent of the owners are the same. If two or more undertakings are commonly controlled, go to Steps 2D and 2E; if the undertakings are not commonly controlled, go to Step 2F.
- D. **Aggregation.** All trade or business undertakings that are commonly controlled will be treated as a single trade or business activity to the extent they are in the same (broadly defined) line of business. An undertaking is in the line of business in which it derives more than 50% of its gross income. If commonly controlled undertakings are in different lines of business, go to Step 2E.
- E. **Integration.** All trade or business undertakings (or activities determined under the aggregation rule) that are commonly controlled will be treated as a single trade or business activity if the operations are conducted in an integrated manner. If the operations are not conducted in an integrated manner, go to Step 2F.
- F. **Other Businesses.** Each trade or business undertaking that does not share common control with another trade or business undertaking or that is not subject to the integration or aggregation rule will be treated as a separate trade or business activity.
- G. **General Rules.** If an undertaking (i) receives more than 50% of its gross income from professional services, (ii) has oil and gas working interests, or (iii) involves a publicly traded partnership, there are special rules for determining activities.

STEP THREE — MATERIAL PARTICIPATION

- A. **Start with Activities.** The taxpayer's trade or business activities were determined in Step 2.
- B. **Hours.** Calculate the number of hours that the taxpayer works in any capacity in each trade or business activity (whether as an employee, independent contractor or otherwise). Go to Step 3C.

- C. 500-Hour Rule.** If the taxpayer participates for more than 500 hours in an activity in the year, the taxpayer materially participates in the activity. If so, the activity is not a passive activity and section 469 does not apply. If not, go to Step 3D.
- D. Other Material Participation Rules.** Determine whether the taxpayer (i) does substantially everything in the activity, or (ii) worked more than 500 hours in the activity in five of the last ten years. If so, the activity is not a passive activity and Section 469 does not apply. If not, go to Step 3E.
- E. Significant Participation.** Did the taxpayer work more than 100 hours in the activity during the taxable year? If so, net income from the activity is not passive, whereas any losses may be passive or active depending upon other facts and circumstances. If not, the activity is a passive activity; go to Step 5.

STEP FOUR — RENTAL ACTIVITIES

- A. 20% Rental Income.** As set forth in Step 2B, determine whether an undertaking derives more than 20 percent of its gross income from the rental of property.
- B. Average Period of Customer Use.** Determine the average period of customer use of the rented property. A "short hand" method is to determine the average period of customer use for the class of property that generates the most gross income.
- C. 7-Day Test.** If the average period of customer use is more than seven days, the rental of property generally must be treated as a separate rental activity (exceptions apply if significant or extraordinary personal services are provided). If the average period of customer use is less than seven days, the activity is not a rental activity; go back to Step 2C.
- D. 80% Rule.** If the rental of property is a rental activity, determine whether the rental of property results in 80% or more of the gross income from the undertaking. If it does, treat the entire undertaking as a separate rental activity and go to Step 4E. If gross income from the rental of property is more than 20% but less than 80% of total gross income, treat the rentals as a separate rental activity (go to Step 4E) and go back to Step 2C for the nonrental business.
- E. Treatment of Rental Activities.** Every rental activity is a passive activity. Except as provided in Step 8E, relating to elections, each rental undertaking is a separate activity of the taxpayer. Go to Step 5.

STEP FIVE — NONPASSIVE ITEMS

- A. Portfolio Income.** All interest, dividends, royalties, annuities, etc., will generally be portfolio income and must be subtracted from the gross receipts of each activity.
- B. Personal Service Income.** Any personal service income received by the taxpayer should also be treated as nonpassive.
- C. Self-Charged Items.** If a passive activity has borrowed money from, or made loans to, the taxpayer, apply the "self-charged" rules by treating an amount of deductions as nonpassive to the extent of the taxpayer's share of interest expense.

STEP SIX — RECHARACTERIZATION

- A. 37 Rules.** There are 37 recharacterization rules in the regulations, only some of which are labelled as such. The eight most important recharacterization rules are:
1. Significant participation (more than 100 hours).
 2. Self-enhanced rental property sold within 12 months of placement in service.

3. Self-rented property.
 4. Rentals of nondepreciable property.
 5. Substantially appreciated property sold within 24 months of commencement of use in a passive activity.
 6. Incidental sales of property by dealers.
 7. Qualified working interests in oil and gas.
 8. Active participation rental real estate.
- B. Implementation.** If a recharacterization rule applies, determine income or loss under Step 7 and then recharacterize. Otherwise, go to Step 7 to determine that amount of the passive income or loss from each activity.

STEP SEVEN — COMPUTATION

- A. Calculate PADs.** Determine the total amount of deductions from each passive activity (PADs). The PADs for each activity include not only items of deduction and loss from the current year, but also carryover deductions from the prior year (see Step 7E).
- B. Calculate PAGI.** Determine the total amount of gross income (PAGI) from each passive activity (after elimination of items under Step 5).
- C. Net Loss.** The taxpayer's passive activity loss for the taxable year is the amount by which PADs from all activities exceed PAGI from all activities. If total PADs from Step 7A for all activities exceeds the total PAGI from Step 7B for all activities, there is a net passive activity loss; go to Step 7D. If PAGI exceeds PADs, there is not a passive activity loss and Section 469 is inapplicable.
- D. Determine Net Loss for Each Activity.** For each activity, subtract the amount in Step 7A from that in Step 7B. If the result is negative, there is a passive activity loss (PAL) in that activity. If the result is positive, there is passive activity income in that activity. The amount of the net loss allocable to each activity that incurred a loss is determined by multiplying the total net loss from all activities by the fraction the numerator of which is the loss from the activity and the denominator of which is the total loss from all activities that incurred losses.
- E. Carry Loss to Subsequent Years.** The loss for each activity determined under Step 7D is carried over to the next year as an item of passive activity deduction.
- F. Partial Allowance of PALs.** A portion of the net passive loss from pre-enactment interests is treated as active. This determination is made by multiplying the net loss for each activity for each year, determined under Steps 7A through 7D but without the carryover from prior years under Step 7E, by the applicable phase-in percentage. The phase-in percentages are:
 1. 65% for 1987.
 2. 40% for 1988.
 3. 20% for 1989.
 4. 10% for 1990.
 5. 0% thereafter.

There is no phase-in of the passive loss rules for alternative minimum tax purposes.

STEP EIGHT — DISPOSITIONS

- A. **Sales.** Upon the sale of the taxpayer's entire interest in an activity, after offsetting any gain on the sale and other items of passive income for the year, the loss attributable to the activity under Step 7E becomes an active loss.
- B. **Gifts.** If an interest in an activity is transferred by gift, the loss attributable to the activity under Step 7E is added to basis.
- C. **Inheritance.** If an interest in an activity is transferred by inheritance, the loss attributable to the activity under Step 7E is disallowed to the extent of the basis step-up at death.
- D. **Former Passive Activities.** The change in the character or nature of an activity is not a disposition. However, the loss attributable to an activity under Step 7E can offset future income from the activity even if the taxpayer materially participates in the activity in a subsequent year.
- E. **Elections.** Every taxpayer and every passthrough entity (partnership or S corporation) that is engaged in a trade or business activity should make the election under Reg. § 1.469-4T(o) to treat each trade or business undertaking as a separate activity for disposition purposes. Although rental undertakings (each of which constitutes a separate activity) can also be combined or separated into activities under Reg. § 1.469-4T(k), this election often is not necessary.