SECTION V: INVESTOR LOSSES

8627. What is a tax shelter?

In the traditional sense, a tax shelter is simply a method that a taxpayer uses to generate tax deductions and credits by participating in certain "investment activities" that often are not expected to generate any real profits. Historically, taxpayers specifically entered into these transactions with the anticipation of producing losses that could be used to offset a taxpayer's otherwise taxable gains.

The basic concept is presented in the example below, which illustrates the potential results of tax shelters that were available to investors before the enactment of legislation designed to curb the use of these shelters.

> *Example*: Simon has annual income of $450,000 and dividend income of $30,000. He invests $40,000 in a 10 percent interest in ABC partnership ("ABC"), which is in the business of breeding racehorses (Simon had no active role in ABC's business). ABC, through the use of $800,000 in nonrecourse financing and $200,000 in cash, purchased several horses as a part of this breeding program. After depreciation, interest and other deductions relating to the breeding program, ABC experiences a loss of $500,000. Simon's share of the loss is $50,000 (10 percent). Even though Simon only actually invested $40,000 in the partnership (and could have only lost $40,000 if the investment subsequently became completely worthless), he would have been entitled to deduct his entire $50,000 share in ABC's loss.

Although characteristics of a tax sheltered investment may vary depending on the form and type of vehicle employed, several common features are:

(1) *Leverage*. This refers to the maximization of investment return through the use of borrowed capital (see Q 8645 for a discussion of the current limitations imposed on the deductibility of investment interest expenses);

(2) *Depreciation and Depletion*. The tax shelter vehicle, such as an equipment leasing venture, may use the accelerated cost recovery system or accelerated depreciation with respect to the cost of the property. This is true even though all or part of the cost of the asset has been financed by other parties;

A depletion deduction may be available for an investment in natural resources such as oil, gas, timber and minerals. Although deductions for depreciation and depletion may create a loss from a tax standpoint, the investment's cash flow may still be positive. Thus, the investor may benefit from both a currently deductible loss and the receipt of cash flow for other investment or business endeavors;

(3) *Deferral*. If an investment is made in a venture which initially operates at a loss, the loss may be available to shield other income from current taxation. The tax liability is effectively deferred to later years when the investment is producing income.

Timing is important in this regard to avoid having deferred income taxed at a steeper rate in a later taxable year. Obviously, it is desirable that deductions are available in current high-income years while gain or investment income is realized in later low bracket years.

In recent years, the IRS has enacted legislation designed to prevent the use of tax shelters as vehicles that operate solely for the purpose of tax avoidance (see "abusive tax shelters," Q 8628), but one of the key elements of tax shelter partnerships prior to this legislative reform was the allocation of annual operating losses among the partners in such a manner that the investors seeking tax shelter were allocated losses that were disproportionately greater than their true relative economic interest in the partnership.

IRC Section 704(a) generally permits a partner's distributive share of income, gain, loss or deduction to be determined by the partnership agreement. IRC Section 704(b)(2), however, provides that a partnership agreement's allocation provisions that are different from the partners' "interests in the partnership" (taking into account all facts and circumstances) will be effective only in situations in which the allocations have "substantial economic effect."[1] The IRS has developed an extensive set of economic effect tests and a definition of "substantiality" in the final regulations interpreting Section 704.[2]

8628. What is an abusive tax shelter?

While Congress has recognized that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of "tax shelter" investments that yield tax benefits, losses from tax shelters often produce little or no benefit to society, or produce tax benefits that are exaggerated beyond those intended. These cases are called "abusive tax shelters," and are described by the IRS in Publication 550 as follows:

> "Abusive tax shelters are marketing schemes involving artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.
>
> Abusive tax shelters commonly involve package deals designed from the start to generate losses, deductions, or credits that will be far more than present or future investment. Or, they may promise investors from the start that future inflated appraisals will enable them, for example, to reap charitable contribution deductions based on those appraisals. They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or "write-off") is frequently said to be several times greater than one-to-one."[3]

1. IRC Sec. 704(b)(2).
2. IRC Secs. 465, 704(d), 704(e)(2), 706(d). See also Treas. Reg. §1.704-1(b).
3. IRS Publication 550, Investment Income and Expenses (2013).

The IRS has taken steps to combat abusive tax shelters and transactions. A comprehensive strategy is in place to:

- Identify and deter promoters of abusive tax transactions through audits, summons enforcement and targeted litigation;
- Keep the public advised by publishing guidance on transactions and shelters that are determined to be abusive;
- Promote disclosure by those who market and participate in abusive transactions; and
- Develop and implement alternative methods for resolving abusive transactions claimed by taxpayers.

Planning Point: An investment that is considered a tax shelter is subject to restrictions, including the requirement that it be disclosed and registered. The regulations require taxpayers to disclose certain reportable transactions involving abusive tax shelters in which they participate. These transactions include transactions that are the same as, or substantially similar to, a transaction specifically identified by the IRS or state tax agency as a tax avoidance transaction (a so-called "listed transaction").[1]

8629. What are the "at risk" rules with respect to investor losses?

The at risk rules are a group of provisions in the IRC and regulations that limit the current deductibility of "losses" generated by tax shelters (see Q 8627) and certain other activities to the amount that the taxpayer actually has "at risk" (i.e., in the economic sense) in the tax shelter. "Loss" for purposes of the at risk rules means the excess of allowable deductions for the tax year (including depreciation or amortization allowed or allowable and disregarding the at risk limits) over the taxpayer's income from the activity for the tax year.[2]

Historically, the primary targets of the at risk rules have been limited partners and the non-recourse financing of a limited partner's investment in the tax shelter (which was once common in tax shelters, see the example in Q 8627 for an illustration).

Despite this, the rules also apply to certain corporations and general partners in both limited and general partnerships and to non-leveraged risk-limiting devices (e.g., guaranteed repurchase agreements) designed to generate tax deductions in excess of the amount for which the investor actually bears a risk of loss in a shelter.[3]

Other at risk provisions of the IRC limit the availability of the investment tax credit with respect to property acquired for purposes of the tax shelters or other activities.[4]

1. IRC Secs. 6707A(c)(2) and 6664(d)(2)(A); Treas. Reg. 1.6011-4.
2. IRC Sec. 465(d); IRS Pub. 925, Passive Activity and At-Risk Rules (2013).
3. See Sen. Rep. 94-938, 1976-3 CB (vol. 3) 57 at 83.
4. IRC Secs. 49(a)(1), 49(a)(2).

8630. What types of investment activities apply to the "at risk" rules?

The "at risk" rules apply to each of the following activities when engaged in by an individual (including partners and S corporation shareholders, see Q 8631) as a trade or business or for the production of income:

(1) holding, producing, or distributing motion picture films or video tapes;

(2) farming (including raising, shearing, feeding, caring for, training, or management of animals);

(3) leasing of depreciable personal property (and certain other "IRC Section 1245" property);

(4) exploring for, or exploiting, oil and gas reserves;

(5) exploring, or exploiting, geothermal deposits;

(6) holding real property.[1]

8631. Who is subject to the at risk rules? Do the at risk rules apply to partnerships and S corporations?

Generally, the at risk rules apply to individuals, estates, trusts, and certain closely-held C corporations.[2] A C corporation is considered to be closely-held, and thus subject to the at risk rules, if more than 50 percent of its stock is owned, directly or indirectly, by five or fewer individuals.[3]

In the case of pass-through entities (such as partnerships and S corporations), the at risk rules will apply at the individual taxpayer level (e.g., to the partner or S corporation shareholder), rather than directly to the entity itself.

8632. How does a taxpayer subject to the at risk rules determine how much is "at risk" in an investment?

In the most general terms, an individual has amounts "at risk" to the extent the individual is not protected against the loss of the money or other property contributed to the activity. If the individual borrows the money contributed to the activity, the individual is "at risk" only to the extent the individual is not protected against the loss of the borrowed amount (i.e., to the extent of the individual's personal liability for repayment of such amount).[4] See Q 8633 for a discussion of when borrowed amounts will be considered "at risk."

1. IRC Secs. 465(c); 464(e).
2. IRC Sec. 465(a); IRS Pub. 925, supra.
3. IRC Sec. 465(a), 542(a)(2).
4. Prop. Treas. Reg. §1.465-6.

A partner's "amount at risk" is not affected by a loan made to the partnership by any other partner.[1] Payment by a purchaser to the seller for an interest in an activity is treated by the purchaser as a "contribution" to the activity.[2]

More specifically, an individual has an amount "at risk" in an activity equal to the sum of the following:

(1) The amount of money and the adjusted basis of any property that the taxpayer contributes to the activity; and

(2) Amounts that the taxpayer has borrowed with respect to the activity, to the extent the taxpayer (i) is personally liable for the repayment of the loan proceeds or (ii) has pledged property (other than property otherwise used in the activity) as security on the loan (to the extent of the fair market value of the taxpayer's interest in that property).[3] See Q 8633 and Q 8634 for a detailed discussion of the rules applicable when the taxpayer borrows the amounts contributed to the activity.

In the case of a partnership, amounts required to be contributed under the partnership agreement are not "at risk" until the partner actually makes the contribution. Similarly, a partner's amount at risk does not include the amount of a note that is payable to the partnership and on which the partner is personally liable until such time as the proceeds are actually applied to the activity.[4]

An individual is not considered "at risk" with respect to any amount that is protected against loss through guarantees, stop loss agreements, nonrecourse financing (other than qualified nonrecourse financing of real estate described in Q 8634), or other similar arrangements.[5] An investor is *not* at risk with respect to a note that may be satisfied by transferring to the creditor property that is derived from the activity if there is no obligation on the part of the investor-borrower to pay the difference should the value of the property transferred be less than the amount of the note.[6]

In any case, if a taxpayer engages in a pattern of conduct or utilizes a device that is not within normal business practice, or that has the effect of avoiding the "at risk" limitations, the taxpayer's amount at risk may be adjusted to more accurately reflect the amount that is actually at risk. For example, if considering all the facts and circumstances, it appears that an event that results in an increased amount at risk at the close of one year will be accompanied by an event that will decrease the amount at risk after the year ends, these amounts may be disregarded, unless the taxpayer can establish a valid business purpose for the events and establish that the resulting increases and decreases are not a device for avoiding the at risk limitations in the earlier

1. Prop. Treas. Reg. §1.465-7.
2. Prop. Treas. Reg. §1.465-22(d).
3. IRC Sec. 465(b).
4. Prop. Treas. Reg. §1.465-22(a).
5. IRC Sec. 465(b)(4). See Rev. Rul. 78-413, 1978-2 CB 167; Rev. Rul. 79-432, 1979-2 CB 289.
6. Rev. Rul. 85-113, 1985-2 CB 150.

year.[1] In effect, the increased amount of risk at the close of the year would be ignored under the proposed regulations except in limited circumstances.[2]

A partner's amount at risk is increased by the amount of the partner's share of undistributed partnership income and the partner's share of any tax-exempt proceeds.[3] It is reduced by distributions of taxable income and by losses deducted.[4] It is also reduced by nondeductible expenses relating to production of tax-exempt income of the activity.[5]

8633. What rules apply in determining a taxpayer's amount "at risk" when the taxpayer has borrowed the funds contributing to the activity?

In general, if an individual borrows the money contributed to an activity (or, in the case of a limited partnership, the money with which the interest is purchased), the individual is "at risk" only to the extent the individual is personally liable to repay such amounts, or to the extent property is pledged that is not otherwise used in the activity as security for the loan.[6]

If the individual borrowed funds to purchase the property contributed to the activity, the individual is "at risk" with respect to such property only to the extent that the individual would have been "at risk" had the borrowed funds themselves been contributed instead of the purchased property.[7]

If an individual is personally liable for amounts borrowed in the conduct of the activity, the individual is "at risk" to the extent of such amounts even if property used in the activity is also pledged as security for such amounts.[8] The fact that the partnership or other partners are in the chain of liability does not reduce the amount a partner is "at risk" if the partner bears ultimate responsibility.[9]

If the individual is initially personally liable for the borrowed amounts (i.e., as in recourse liabilities), but after the occurrence of some event or lapse of a period of time the liability will become nonrecourse, the individual is considered "at risk" during the period of recourse liability if both of the following are true:

(a) the borrowing arrangement was motivated primarily for business reasons and not tax avoidance; and

(b) the arrangement is consistent with the normal commercial practice of financing the activity for which the money was borrowed.[10]

1. Prop. Treas. Reg. §1.465-4.
2. Prop. Treas. Reg. §1.465-4(a).
3. Prop. Treas. Reg. §1.465-22(c)(1).
4. Prop. Treas. Regs. §§1.465-22(b), 1.465-22(c)(2).
5. Prop. Treas. Reg. §1.465-22(c)(2).
6. Treas. Reg. §1.465-20; Prop. Treas. Regs. §§1.465-6, 1.465-25.
7. See Prop. Treas. Reg. §1.465-23.
8. See Let. Rul. 7927007.
9. *Pritchett v. Comm.*, 87-2 USTC ¶9517 (9th Cir. 1987).
10. Prop. Treas. Reg. §1.465-5. See Rev. Rul. 82-123, 1982-1 CB 82; Rev. Rul. 81-283, 1981-2 CB 115.

If amounts are borrowed for use in the activity and the individual is not personally liable for repaying those amounts, but the individual pledges property that is not used in the activity as *security* for repayment, the individual is "at risk" only to the extent that the amount of the liability does not exceed the fair market value of the pledged property. If the fair market value of the security changes after the loan is made, the taxpayer must redetermine the amount at risk using the new fair market value.[1]

Property cannot be treated as security if such property itself is financed (directly or indirectly) by loans secured with property contributed to the activity.[2]

Even if an individual is personally liable or has pledged security for borrowed funds, borrowed amounts cannot (unless it is eventually provided in future regulations) be considered at risk (1) if they are borrowed from a person who has an interest (other than as a creditor) in the activity, or (2) if they are borrowed from a person who is related to another person (other than the taxpayer) having an interest in the activity.[3]

For this purpose, a "related" person includes the following: members of a family (i.e., an individual and brothers, sisters, spouse, ancestors, and lineal descendants); a partnership and any partner owning, directly or indirectly, 10 percent of the capital or profits interests in such partnership; two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital or profits interest; an individual and a corporation in which such individual owns, directly or indirectly, more than 10 percent in value of the outstanding stock; two corporations that are members of the same controlled group; a grantor and a fiduciary of the same trust; fiduciaries of trusts that have a common grantor; a fiduciary of a trust and the beneficiaries of that trust, or beneficiaries of another trust if both trusts have the same grantor; a fiduciary of a trust and a corporation if more than 10 percent in value of outstanding stock is owned, directly or indirectly, by the trust or by the grantor of the trust; a person and a tax-exempt organization controlled by such person or family of such person; a corporation and a partnership in which the same person owns a more-than-10 percent interest (by value of stock in the case of the corporation and by capital or profits interest in the case of the partnership); two or more S corporations if more than 10 percent of the stock (by value) of each is owned by the same person; an S corporation and a C corporation if more than 10 percent of the stock (by value) is owned by the same person; and an executor of an estate and a beneficiary of such estate (except in the case of a sale or exchange in satisfaction of a pecuniary bequest).[4]

Planning Point: Money borrowed to finance a contribution to an activity cannot increase the amount at risk by the contribution and by the amount borrowed to finance the contribution. The at-risk amount may be increased only once.[5]

See Q 8634 for the rules that apply when a taxpayer has obtained "qualified" nonrecourse financing with respect to an activity involving real property.

1. Prop. Treas. Reg. §1.465-25(a).
2. IRC Sec. 465(b)(2).
3. IRC Sec. 465(b)(3).
4. IRC Secs. 465(b)(3)(C), 267(b), 707(b)(1).
5. IRS Publication 925, Passive Activity and At-Risk Rules (2013).

8634. What rules apply for determining whether a taxpayer has amounts "at risk" when the taxpayer has received qualified nonrecourse financing with respect to the purchase of real property?

An investor in real estate (excluding mineral property) is considered at risk with respect to nonrecourse financing if:

(a) no person is personally liable for repayment (except to the extent provided in regulations);

(b) the financing is secured by real property used in the activity;

(c) the financing is borrowed with respect to the activity of holding real property;

(d) the financing is not convertible debt, and either (1) the financing is borrowed from a "qualified person" or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government, or (2) the financing is borrowed from a related person upon commercially reasonable terms that are substantially the same terms as loans involving unrelated persons.[1]

A "qualified person" is one who is actively and regularly engaged in the business of lending money and who is *not* (1) related in certain ways to the investor, (2) the one from whom the taxpayer acquired the property (or related to such a person), or (3) a person who receives a fee with respect to the lessor's investment in the real estate (or related to such a person).[2]

In the case of a partnership, a partner's share of qualified nonrecourse financing of the partnership is determined on the basis of the partner's share of such liabilities incurred in connection with the financing.[3]

8635. What are the passive loss rules?

The passive loss rules are a set of rules that are generally intended to prevent losses from passive activities from offsetting salaries, interest, dividends, and income from "active" businesses. They apply to individuals, estates, trusts, closely-held C corporations, and personal service corporations (see Q 8636).

Under the passive loss rules, aggregate losses from "passive" activities (see Q 8637) may generally be deducted in a tax year only to the extent they do not exceed aggregate income from passive activities in that year. Similarly, credits from passive activities may be taken against tax liability allocated only to passive activities.[4] (In the case of certain publicly traded partnerships, aggregation is not permitted. See Q 8641 for details.) The passive loss rules generally apply to losses incurred in tax years beginning after 1986.

1. IRC Sec. 465(b)(6).
2. IRC Secs. 465(b)(6)(D)(i), 49(a)(1)(D)(iv).
3. IRC Sec. 465(b)(6)(C).
4. IRC Sec. 469.

An *individual* can also deduct a limited amount of losses (and the deduction-equivalent of credits) arising from certain rental real estate activities against nonpassive income. A *closely-held C corporation* (other than a personal service corporation) can deduct its passive activity losses against its net active income (other than its investment, or "portfolio," income) and its passive credits can be applied against tax liability attributable to its net active income.[1]

Generally, a corporation is considered to be closely-held if it has five or fewer shareholders who own more than 50 percent of the value of its stock.[2] A personal service corporation is a corporation the principal activity of which is the performance of personal services and these services are substantially performed by employee-owners.[3]

A taxpayer may elect to treat investment interest (see Q 8645) as a passive activity deduction if the interest was carried over from a year prior to 1987 and is attributable to property used in a passive activity after 1986.[4] However, the interest deduction is not treated as being from a pre-enactment interest in a passive activity.[5]

8636. To which taxpayers do the passive rules apply?

IRC Section 469, governing the treatment of passive losses, applies to individual taxpayers, estates and trusts. Closely-held C corporations and personal service corporations are also subject to the passive loss rules in an attempt to prevent taxpayers from creating these entities solely to avoid the passive loss rules (see Q 8635).[6]

Planning Point: Even though the passive activity rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.[7]

The passive loss rules apply to S corporations and partnerships indirectly, because income and losses flow through the entity to apply at the individual taxpayer level (e.g., to the S corporation's shareholders or partnership's partners). See Q 8836 and Q 8810 for a detailed discussion of the pass-through rules applicable to S corporations and partnerships, respectively.

8637. What is a passive activity for purposes of the passive loss rules?

A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not "materially participate," (see Q 8638) or is a rental activity, without regard to whether or to what extent the taxpayer participates in such activity.[8]

The IRC provides that regulations may define the term "trade or business" to include activities undertaken in connection with a trade or business or activities that are engaged in for the production of income under IRC Section 212.

1. IRC Sec. 469(e)(2).
2. IRC Sec. 469(j)(1).
3. IRC Sec. 469(j)(2).
4. TAMRA '88, Sec. 1005(c)(11).
5. Notice 89-36, 1989-1 CB 677.
6. IRC Sec. 469(a)(2).
7. Temp. Treas. Reg. §1.469-1T(b); IRS Pub. 925.
8. Temp. Treas. Reg. §1.469-1T(e)(1).

The regulations provide that the IRS will treat real property held for the production of income under IRC Section 212 as a trade or business for purposes of the rental real estate with material participation exception (see Q 8640).

The term "passive activity" does not include a working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.[1] It also does not include the activity of trading personal property (e.g., stocks or bonds) on behalf of the owners of interests in the activity.[2]

Planning Point: However, if the taxpayer's interest in an oil and gas well would, but for the exception for wells drilled or operated pursuant to a working interest, be an interest in a passive activity for the year, and the well suffers a net loss for the year, then (1) the taxpayer's disqualified deductions (under IRC Section 469(e)(4)) from the well for the year will be treated as passive activity deductions; and (2) a ratable portion of the taxpayer's gross income from the well will be treated as passive activity gross income for the year.[3]

Whether an activity is passive or active with regard to a partner or an S corporation shareholder is determined at the level of the partner or shareholder, not at the level of the entity. This determination is made by considering the activities that took place during the entity's taxable year (not the partner's or shareholder's taxable year).[4]

However, if a publicly traded partnership is taxed as a corporation, the partnership is the taxpayer, and apparently the partnership is not subject to the passive loss rules.[5] In the case of a limited partnership interest in an electing large partnership, all passive loss limitation activities of the partnership are treated as a single passive activity.

8638. How is it determined whether a taxpayer materially participates in activity for purposes of determining whether an activity is active or passive?

In general, a taxpayer is considered to materially participate in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis.[6] The material participation requirement is generally met by a taxpayer who is able to satisfy any one of the following five tests:

(1) he does substantially all of the work required by the activity;

(2) he participates in the activity for more than 500 hours during the year;

(3) he participates in the activity for more than 100 hours during the year and meets certain other requirements;

(4) the activity is a significant participation activity for the taxable year, and the individual's total participation in all significant participation activities during such year exceeds 500 hours;

1. IRC Sec. 469(c)(3).
2. Temp. Treas. Reg. §1.469-1T(e)(6).
3. Temp. Treas. Reg. §1.469-1(T)(e)(4).
4. Temp. Treas. Regs. §1.469-2T(e)(1), 1.469-3T(b)(3).
5. IRC Sec. 469(a).
6. IRC Sec. 469(h)(1).

(5) he has materially participated in the activity in five out of the ten preceding years (determined without regard to this test); or

(6) he has materially participated in the activity, which involves the performance of personal services, in any three preceding years.

Planning Point: For purposes of (4) above, an activity is a significant participation activity if, and only if, the activity: (1) is a trade or business activity in which the individual significantly participates for the year; and (2) would be an activity in which the individual does not materially participate if material participation for the year were determined without regard to whether the individual's total participation in all significant participation activities during the year exceeded 500 hours.[1]

An individual who is a limited partner is treated as materially participating only if the individual also owns a general partnership interest, or can meet tests (2), (5) or (6), above.[2]

In determining whether an individual materially participates, the participation of the individual's spouse is considered.[3] Work done in the individual's capacity as an investor is not treated as participation unless the individual is involved in the day-to-day management or operations of the activity. The extent to which an individual participates may be shown by any reasonable means.[4]

A closely-held C corporation or a personal service corporation is considered to materially participate in an activity if either of the following are true:

(a) one or more stockholders who owns more than 50 percent (by value) of the outstanding stock of the corporation materially participates; *or*

(b) if the C corporation (other than a personal service corporation) has an active full-time manager throughout the year, at least three full-time non-owner employees whose services are directly related to the business of the corporation, and certain deductions of the business exceed 15 percent of the income for the year.[5]

Whether a trust materially participates in an activity is determined by reference to the persons who conduct the business activity on the trust's behalf, in addition to whether the trustee materially participates in the activity.[6]

8639. What happens if a taxpayer's passive losses for a tax year are disallowed?

Losses and credits that are disallowed under the passive loss rules may be carried over to offset passive income and the tax attributable to this income in later years.[7] If passive losses (or credits) from a publicly traded partnership are carried forward, such losses (or credits) may only be offset by passive income (or tax attributable to passive income) from the same partnership.[8]

1. Temp. Treas. Reg. §1.469-5T(c).
2. Treas. Reg. §1.469-5T.
3. IRC Sec. 469(h)(5).
4. Temp. Treas. Reg. §1.469-5T(f).
5. IRC Sec. 469(h)(4).
6. *Carter Trust v. Commissioner*, 2003-1 USTC 50,418 (N.D. Tex. 2003).
7. IRC Sec. 469(b).
8. IRC Sec. 469(k)(1).

Suspended losses and credits of an activity may also offset the income and tax of that activity when the activity ceases to be passive or there is a change in status of a closely-held corporation or personal service corporation. For a discussion of the treatment of losses allowed upon disposition of an interest in a passive activity, see Q 8644.

The rules relating to the treatment of suspended losses and credits when the activity is disposed of require that losses and credits carried over from year to year be traceable to a particular activity. Because of this, where there are losses or credits from two or more activities which, in the aggregate, exceed passive gains from other passive activities, the amount disallowed and carried over must be allocated among the different activities and between capital and ordinary loss. Disallowed passive losses are allocated among activities in proportion to the loss from each activity. The disallowed loss allocated to an activity is then allocated ratably among deductions attributable to the activity. Disallowed credits are allocated ratably among all credits attributable to passive activities.

In identifying the deductions or credits that are disallowed, the taxpayer is only required to separately account for those items that, if separately taken into account by the taxpayer, would result in an income tax liability different from that which would result if such deduction were not taken into account separately. Deductions arising from a rental real estate activity, or in connection with a capital or IRC Section 1231 asset, must be accounted for separately. Credits (other than the low-income housing or rehabilitation credits) arising from a rental real estate activity must also be accounted for separately.[1]

If an activity ceases to be passive (e.g., because the taxpayer begins to participate materially), its unused losses (or credits) from prior years continue to be passive, but may be used against the income (and tax liability) of that activity. If there is a change in the status of a closely-held C corporation or personal service corporation, its suspended losses from prior years will continue to be treated as if the status of the corporation had not changed.[2]

8640. What special passive activity rules apply to taxpayers who invest in rental real estate?

Except as provided below, a passive activity includes any rental activity, without regard to whether the taxpayer materially participates in the activity.[3] A rental activity is any activity where rental payments are made principally for the use of tangible property.[4]

There are a number of exceptions to this rule. An activity is not treated as a rental activity if:

(1) the average rental period is less than eight days;

(2) the average rental period is less than 31 days and the owner of the property provides significant personal services in order to make it available for use by customers;

1. Temp. Treas. Reg. §1.469-1T(f).
2. IRC Sec. 469(f).
3. IRC Sec. 469(c)(2).
4. IRC Sec. 469(j)(8).

(3) the rental of the property is incidental to the receipt of personal services or to a nonrental activity;

(4) the taxpayer makes the property available on a nonexclusive basis during regular business hours;

(5) the taxpayer rents property to a pass-through entity engaged in a nonrental activity, in his capacity as an owner of that entity; or

(6) the personal use of a residence that is also rented out exceeds the greater of 14 days or 10 percent of the rental days.[1]

Planning Point: For purpose of (2) above, in determining if a property owner's rental services are significant, all relevant facts and services—including the frequency of the services, type and amount of labor needed to perform them, and their value relative to the amount charged for the property's use—are taken into account.[2]

If an individual actively participates in a rental real estate activity subject to the passive activity rules, the individual may use up to $25,000 of losses and the deduction-equivalent of credits to offset nonpassive income. An individual need not actively participate in a rental real estate activity to obtain the $25,000 rental real estate exemption with respect to taking the low-income housing credit or rehabilitation tax credit.

If the investment is in real estate which is not rental property, the real estate activity will generally be considered a passive activity subject to the passive loss rule unless the taxpayer materially participates in the activity. The $25,000 rental real estate exemption is not available with respect to nonrental property.

8641. How are the passive activities of publicly-traded partnerships treated under the passive loss rules?

Special restrictions apply to publicly traded partnerships under the passive loss rules. A publicly traded partnership is a partnership that is traded on an established securities market or is readily tradable on a secondary market (or the substantial equivalent thereof).[3]

The rules are applied separately to items attributable to a publicly traded partnership, meaning that income, losses, and credits attributable to the partnership may not be aggregated with other income, losses, and credits of the taxpayer-partner for purposes of the passive loss rules.[4] Net passive loss from a publicly traded partnership will be treated as passive, while net passive income from a publicly traded partnership is to be treated as investment income.[5]

Generally, net passive loss from a publicly traded partnership is carried forward until the partner has additional passive income from the partnership or the partner disposes of the

1. Treas. Reg. §1.469-1T(e)(3), IRC Sec. 469(j)(10).
2. Temp Treas. Reg. §1.469-1(T)(e)(3)(iv).
3. IRC Sec. 469(k).
4. IRC Sec. 469(k)(1).
5. Notice 88-75, 1988-2 CB 386.

partnership interest. Also, the $25,000 rental real estate exemption (see Q 8640) is available with respect to a publicly traded partnership only in connection with the low-income housing credit and the rehabilitation investment credit.

Furthermore, a taxpayer will not be treated as having disposed of the taxpayer's entire interest in an *activity* of a publicly-traded partnership until the taxpayer has disposed of the entire interest in the partnership. It would seem that if a publicly traded partnership is taxed as a corporation, the partnership is not a taxpayer subject to the passive loss rules.[1]

8642. Do the passive loss rules apply to casualty losses?

An exception to the passive loss restrictions is applied to certain casualty losses (see Q 8649 to Q 8660) resulting from unusual events (including fire, storm, shipwreck, and earthquake). Losses from such casualties are generally not subject to the passive loss rules.[2]

Likewise, passive activity income does not include reimbursements for such losses if both of the following are true:

(1) the reimbursement is includable in gross income under Treasury Regulation Section 1.165-1(d)(2)(iii) as an amount the taxpayer had deducted in a prior taxable year; and

(2) the deduction for the loss was not a passive activity deduction.

In other words, both the losses and the reimbursement should be taken into account in the calculation of the partnership's gross income, not its passive activity gross income.[3]

The exception does not apply to losses that occur regularly in the conduct of the activity, such as theft losses from shoplifting in a retail store, or accident losses sustained in the operation of a rental car business.[4]

8643. How do the passive loss rules interact with the at-risk rules?

When determining whether a loss deduction will be allowed, the taxpayer must first apply the at-risk rules. If a deduction is disallowed in one year under the at-risk rules (see Q 8629 to Q 8634), it generally cannot be deducted as a loss under the passive activity rules.[5] Therefore, the loss will be suspended under the at-risk rules, and can be carried forward to the succeeding tax year if the taxpayer has sufficient amounts "at risk" in that later tax year.

1. See IRC Sec. 469(a).
2. Treas. Regs. §§1.469-2T(d)(2), 1.469-2(d)(2)(xi).
3. Treas. Regs. §§1.469-2T(c)(7), 1.469-2(c)(7)(vi).
4. TD 8290, 1990-1 CB 109.
5. Temp. Treas. Reg. §1.469-2T(d)(6)(i).

8644. What are the tax results when a taxpayer disposes of interests in a passive activity?

If a taxpayer disposes of his interests in a passive activity in a fully taxable transaction, losses from the activity will receive *ordinary loss treatment* (i.e., they may generally be used to offset other income of the taxpayer) to the extent that they exceed net income or gain from all passive activities (determined without regard to the losses just discussed) for the year. This treatment applies both to current year losses as well as losses carried over from previous years, with respect to the activity disposed of. The IRS has been given the authority to issue regulations that will take income or gain from previous years into account to prevent the misuse of this rule.[1]

For the purpose of determining gain or loss from a disposition of property, the taxpayer may elect to increase the basis of the property immediately before disposition by an amount equal to the part of any unused credit that reduced the basis of the property for the year the credit arose.[2] If the passive interest disposed of is sold under the installment method, previously disallowed passive losses are allowed as a deduction in the same proportion as gain recognized for the year bears to gross profit from the sale.[3]

If the disposition of the passive interest is to a related person in an otherwise fully taxable transaction, suspended losses remain with the taxpayer and may continue to offset other passive income of the taxpayer. The taxpayer is considered to have disposed of an interest in a transaction described in the preceding sentence when the related party later disposes of the passive interest in a taxable transaction to a party unrelated to the taxpayer.[4]

If the disposition is by death, the carried over losses may be deducted only to the extent the losses exceed the step-up in basis of the interest in the passive activity.[5] If the disposition is by gift, the losses are not deductible. Instead, the donor's basis just before the transfer is increased by the amount of the disallowed losses allocable to the interest.[6] However, where a donor makes a gift of less than his or her entire interest in property, a portion of the carried over losses is allocated to the gift and increases the donor's basis. A portion of the losses will continue to be treated as passive losses attributable to the interest that the donor has retained.[7]

If a trust or estate distributes an interest in a passive activity, the basis of such interest immediately before the distribution is increased by the amount of passive losses allocable to the interest, and such losses are never deductible.[8]

A taxpayer is not treated as having disposed of the entire interest in an *activity* of a publicly-traded partnership until the taxpayer disposes of the entire interest in the partnership.[9]

1. IRC Sec. 469(g)(1).
2. IRC Sec. 469(j)(9).
3. IRC Sec. 469(g)(3).
4. IRC Sec. 469(g)(1)(B).
5. IRC Sec. 469(g)(2).
6. IRC Sec. 469(j)(6).
7. Sen. Rep. 99-313, 1986-3 CB (vol. 3) 713, 726.
8. IRC Sec. 469(j)(12).
9. IRC Sec. 469(k)(3).

Planning Point: IRS Publication 925 (Passive Activity and At-Risk Rules) contains a number of examples of, and various scenarios relating to, passive activities and losses, and includes worksheets and filing instructions necessary for the completed reporting of passive activities.

8645. Can a taxpayer deduct interest expenses incurred in relation to property the taxpayer holds for investment?

Yes, within limits. Because of the substantial tax benefits that can result when a taxpayer's interest expenses are large compared to the amount of income realized from the investments at issue, Congress has taken steps to limit the amount of investment interest that a taxpayer can deduct in any tax year.

Therefore, a noncorporate taxpayer is permitted to deduct interest expenses incurred in funding the purchase of investment assets, but only to the extent that the taxpayer's interest expenses exceed net investment income (see below) for the year.[1] Any other investment interest expense is considered excess interest and is disallowed.

"Net investment income" for purposes of the interest expense deduction means the excess of investment income over investment expenses.[2] "Investment income" means the sum of the following four items:

(1) Gross income derived from property held for investment *other than* gain derived from the disposition of that property (e.g., income from interest, dividends, annuities and royalties not derived in the ordinary course of the taxpayer's trade or business);

(2) The excess, if any, of (i) "net gain" attributable to the disposition of property held for investment over (ii) the "net capital gain" determined by taking into account gains and losses from dispositions of property held for investment;

(3) The taxpayer's net capital gain determined by only taking into account gains and losses derived from the disposition of investment property *or* the taxpayer's net gain attributable to disposition of property held for investment, whichever is lower, but only to the extent the taxpayer *elects* to treat such income as investment income for purposes of Section 163; and

(4) Qualified dividend income, to the extent the taxpayer elects to treat such income as investment income for purposes of Section 163.[3]

In other words, net investment income, for purposes of the interest expense deduction, generally does not include net capital gain from the disposition of investment property *unless* the taxpayer makes the election to do so (see Q 8647 for the tax consequences of this election).

1. IRC Sec. 163(d).
2. IRC Sec. 163(d)(4)(A).
3. IRC Sec. 163(d)(4)(B).

The term "investment expenses" means deductions (other than the interest deduction) that are directly connected with the production of investment income.[1]

The Tax Court has held that net gain for purposes of IRC Section 163(d)(4)(B)(ii) means the excess (if any) of total gains over total losses, including capital loss carryovers, from the disposition of property held for investment. The Court further held that calculation of net gain required inclusion of the taxpayers' capital losses and capital loss carryovers for purposes of calculating the IRC Section 163(d)(1) limit on the investment interest expense deduction.[2]

The IRS has ruled privately that:

(1) The term "property" (under IRC Section 163(d)(5)(A)(i)) includes interest-free loans (which are deemed to yield gross income as a result of interest imputed under IRC Section 7872) to a tax-exempt foundation;

(2) Any imputed interest income that is deemed to be received by the taxpayer on the potential loan from the line of credit to the foundation is "investment income" (under IRC Section 163(d)(4)(B)(i)); and

(3) Any interest paid by the taxpayer on the line of credit used to make the potential loan to the foundation is "investment interest" (under IRC Section 163(d)(3)(A)).[3]

See Q 8646 for a discussion of the treatment of disallowed interest expenses and Q 8648 for a discussion of how the interest expense deduction is impacted by the passive loss rules.

8646. What is the result if a taxpayer has interest expenses that exceed net investment income for the tax year?

If a taxpayer has interest expenses that exceed his or her net investment income for the year, those expenses are considered excess interest and the deduction is disallowed. However, disallowed interest expenses from one year can be carried forward to the succeeding tax year.[4]

A taxpayer's investment interest expenses that are disallowed because of the investment income limitation in one year will be treated as investment interest paid or accrued in the succeeding tax year.[5] The IRS has issued guidance that provides it will not limit the carryover of a taxpayer's disallowed investment interest to a succeeding tax year to the taxpayer's taxable income for the tax year in which the interest is paid or accrued.[6] Prior to the issuance of this guidance, several federal courts had held that no taxable income limitation existed on the amount of disallowed investment interest that could be carried over.[7]

1. IRC Sec. 163(d)(4)(C).
2. *Gorkes v. Commissioner*, TC Summ. Op. 2003-160.
3. Let. Rul. 200503004.
4. IRC Sec. 163(d)(2).
5. IRC Sec. 163(d)(2).
6. Rev. Rul. 95-16, 1995-1 CB 9.
7. See, for example, *Sharp v. U.S.*, 94-1 USTC 50,001.

8647. What are the tax consequences when a taxpayer elects to treat all or a portion of capital gain or qualified dividend income as investment income when calculating the allowable investment interest deduction?

Net investment income, for purposes of the interest expense deduction, generally does not include net capital gain from the disposition of investment property or qualified dividend income *unless* the taxpayer elects to treat this income as investment income. See Q 8645.

If the taxpayer makes this election, any net capital gain or qualified dividend income treated as investment income are not eligible to be taxed at the capital gains rates and will be subject to the taxpayer's ordinary income tax rate for that tax year, rather than the special lower tax rates that otherwise apply to these types of income (see Q 8561 for a discussion of the currently applicable tax rates for capital gains and qualified dividend income).[1]

The advantage of making the election is that a taxpayer may increase the amount of investment income against which investment interest is deducted, thus receiving the full benefit of the deduction.[2]

> *Example*: Shawn incurred $15,000 in interest expenses related to investment property in 2014. His investment income included $6,000 of interest income, $2,000 received as qualified dividends and a $5,000 net capital gain on the sale of securities held for investment. If Shawn does not elect to treat his income from net capital gains and dividends as investment income, his investment income is $6,000 (i.e., only the interest income he realized for the year). He would, therefore, have $9,000 of disallowed interest expenses for the year. While he could carry those expenses forward to 2015 (see Q 8646), if he does make the election, his investment income would equal $13,000 and he would only carry $2,000 forward.

The election to treat net capital gain and qualified dividend income as investment income must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized, or the qualified dividend income is received, respectively.[3] The IRS has, however, privately ruled that a taxpayer was permitted to make a late election to treat capital gains as investment income based on the IRS' conclusion that the taxpayer had acted reasonably and in good faith, and that granting the extension would not prejudice the interests of the government.[4]

The elections are made on Form 4952, "Investment Interest Expense Deduction" and may not be revoked for that year, except with IRS permission.[5] The IRS has ruled privately that certain taxpayers who were properly classified as securities traders were permitted to revoke their election because such gains should have been treated as investment interest anyway (based on their status as professional securities traders). Therefore, allowing them to revoke their election did not prejudice the government or cause undue administrative burdens.[6]

1. Treas. Reg. §1.163(d)-1(a).
2. See IRC Sec. 163(d)(4).
3. Treas. Reg. §1.163(d)-1(b).
4. Let. Rul. 200033020. See also Let. Rul. 200303013.
5. Treas. Regs. §§1.163(d)-1(b), 1.163(d)-1(c).
6. Let. Rul. 200146018.

A taxpayer can elect to treat capital gain or dividend income as investment income in one year without any obligation to make the election in any other tax year.[1]

8648. Is the determination of a taxpayer's allowable investment interest deduction coordinated with the passive loss rules?

The investment interest limitation is coordinated with the passive loss rules (see Q 8635 to Q 8644), so that interest and income subject to the passive loss rules are not taken into consideration under the investment interest limitation.[2] Interest expense incurred to purchase an interest in a passive activity is allocated to that passive activity and is not investment interest.[3]

However, portfolio income of a passive activity and expense (including interest expense) allocable to it is considered investment income and expense, not passive income and expense.[4]

Investment interest expense and investment income and expenses do not include items from a trade or business in which the taxpayer materially participates. The IRS has determined that interest on a loan incurred to purchase stock in a C corporation was investment interest (where the purchaser was not a dealer or trader in stock or securities), even though the purchaser acquired the stock to protect his employment with the C corporation.[5]

In a decision citing Revenue Ruling 93-68, the Tax Court held that interest on indebtedness incurred to purchase a taxpayer's share of stock in a family-owned mortuary business was subject to the investment interest limitation, despite the fact that the taxpayer purchased the stock to conduct business full time and the fact that no dividends had been paid on the stock.[6]

Temporary regulations provide that, for purposes of the investment interest and passive loss rules, interest expense is generally allocated on the basis of the use of the proceeds of the underlying debt.

1. Treas. Reg. §1.163(d)-1(c).
2. IRC Secs. 163(d), 469.
3. Temp. Treas. Reg. §1.163-8T(a)(4)(B).
4. IRC Sec. 469(e)(1).
5. Rev. Rul. 93-68, 1993-2 CB 72.
6. *Russon v. Commissioner*, 107 TC 263 (1996).