MSSP

Market Segment Specialization Program

Passive Activity Losses

Reference Guide

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

Department of the Treasury
Internal Revenue Service

Training 3149-115 (2/96
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INTRODUCTION

The Market Segment Specialization Program (MSSP) guide on passive activity losses has been revised to reflect changes to section 469 of the Code and Treasury Regulations through June of 1995. The guide was developed to provide revenue agents and tax auditors with specific tools to examine issues relating to both income and losses. The guide provides specific guidance on potential audit issues, suggestions for issue identification, and lead sheets which can be used by the agent or auditor for assistance in examining a given issue. Additionally, it includes guidance on preparation of Form 8582, Passive Activity Loss Limitations, as well as highlighting common errors.

The following page entitled "What's New" summarizes new information provided in this revision to the Passive Activity Loss Guide. While most chapters have been enhanced, including discussion of the new relief provisions for so-called real estate professionals and the final activity regulations, some information on the temporary activity regulations has been deleted as the statute of limitations on most returns to which these regulations applied has expired. Should the examiner need information relating to the temporary activity regulations, he or she can refer to the training guide 3149-115 printed March 1994.

Audit lead sheets covering many of the common passive activity loss issues are contained in the exhibits along with other job aids. Examiners are reminded that the lead sheets are provided to assist the examiner and are not all encompassing. IRC section 469 and the related regulations may have to be researched. A summary of the exhibits can be located in the beginning of the guide just before Chapter 1. A summary of court cases and revenue rulings can be located in Exhibit 1-9.

The examples and the citations in this guide are based upon 1994 law. While some of the provisions of IRC section 469 are explained, the primary focus of this module is not an in-depth explanation of the law, but rather a guide to current audit issues. The reader should be aware that regulations have not yet been issued on dispositions and trusts.

Since not many audit issues have been noted relative to passive activity credits, this guide does not address the rules relating to them. However, should current tax law change to allow an investment tax credit, passive activity credits could become a significant issue.

This material can be used either in a classroom setting or as a self-study guide. Each lesson is designed to be self-contained. However, in most instances, Chapter 1, Overview, should be reviewed as the concepts are intrinsic to an understanding of subsequent lessons.

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WHAT'S NEW?

Significant portions of the Passive Activity Loss Guide have been revised and enhanced to reflect recent law changes, court cases, evolving issues, and additional audit techniques. The following are some of the new items which an examiner might want to review:

Chapter 1

Exhibit 1-7 Report Writing Aid
Exhibit 1-8 Helpful Hints for Form 8582
Exhibit 1-9 Summary of Court Cases and Rulings

Chapter 2

Real Estate Professionals (New section 469(c)(7))
Self-Rented Property (Now includes rentals to C-Corporations)
Exhibit 2-4 Lead Sheet-Real Estate Professionals
Exhibit 2-5 Lead Sheet-Recharacterization of Income

Chapter 3

Significant Participation Activities and Exhibits
Former Passive Activities (Passive to Nonpassive)
Discussion of Toups, Goshorn and Seits Court Cases
Addresses Material Participation and Income Issues
Retired Farmer Exception
Exhibit 3-7 Records

Chapter 4

Application of Recharacterization of Income to C-Corporations
Expanded Discussion of Dispositions
Exhibit 4-8 Lead Sheet-Income Issues on Disposition
Exhibit 4-9 Lead Sheet-Dispositions Triggering Passive Losses

Chapter 5

Limited Liability Companies
Consolidated Corporations
Change in Corporate Status
Exhibit 5-3 Lead Sheet-Self-Charged Interest
Exhibit 5-5 TEFRA Check sheet

Chapter 6

Discussion of IRC Section 469(j)(7) Interest
Rehabilitation Credit
Exhibit 6-2 Lead Sheet-Partnership Basis
Exhibit 6-5 Lead Sheet-Interest on Rental Property (IRC section 469(j)(7))

Chapter 7

SUMMARY OF EXHIBITS

Chapter 1 - Overview of Law and Form 8582

Chapter 2 - Rental Issues

Chapter 3 - Material Participation

Chapter 4 - Income Issues

Chapter 5 - Entity Issues

Chapter 6 - Interaction with Other Code Sections

Chapter 7 - Activity Rules

Chapter 1

AN OVERVIEW OF THE LAW AND FORM 8582

INTRODUCTION

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters, many of them abusive, which allowed taxpayers to deduct noneconomic losses against wages and investment income, thereby reducing or eliminating any tax.

The Tax Reform Act of 1986 (TRA '86) added IRC section 469 which limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities.

As a general rule, the passive activity loss rules are applied at the individual level. Although IRC section 469 was enacted to discourage abusive tax shelters, its impact extends far beyond shelters to virtually every business or rental activity whether reported on Schedules C, F, or E, as well as to flow through income and losses from partnerships, S-Corporations, and trusts. Generally, the law does not apply to regular C-Corporations although it does have limited application to closely held corporations.

Effective beginning in 1994, a relief provision, IRC section 469(c)(7), relating to rental real estate, was enacted for taxpayers who spend most of their time in real property trades or businesses. This new provision will allow certain taxpayers to deduct current losses from rental real estate activities in full without any passive loss limitation. The rules and potential audit issues are discussed in Chapter 2.

The following is a brief overview of the passive activity loss rules. If an issue arises in any area, see the cross referenced chapter for an in-depth discussion.

TWO TYPES OF PASSIVE ACTIVITIES

In general, after 1986, losses generated by passive activities can only be used to offset income generated by other passive activities. Stated differently, a taxpayer cannot deduct losses from business activities in which he or she does not materially participate nor rentals unless he or she reports passive income on the tax return against which to offset the losses.

Losses from passive activities cannot offset nonpassive income such as wages, salaries, portfolio, or investment income (except upon disposition of a taxpayer's entire interest in a passive activity, as explained in Chapter 4). Similarly, passive losses cannot offset nonpassive income from sole proprietorships, farms, partnerships, or S-Corporations in which the taxpayer materially participates. "Passive income" is income generated by a passive activity in the ordinary course of business, but it is never portfolio or investment income, typically reported on Schedules B or D. **There are two kinds of passive activities:**

1. **Rentals**, including both equipment and rental real estate, regardless of the level of participation, (but see IRC section 469(c)(7)) and

2. **Businesses in which the taxpayer does not materially participate** on a regular, continuous, and substantial basis. Thus income and losses on a tax return are divided into two categories:

   a. Passive: Rentals and businesses without material participation. A limited partner is generally passive due to more restrictive tests for material participation (Treas. Reg. section 1.469-5T). As a result, limited partners will generally have passive income or losses from the partnership. See Chapter 5.

   b. Nonpassive: Businesses in which the taxpayer materially participates. Also, salaries, guaranteed payments, 1099 commission income and portfolio or investment income are deemed to be nonpassive. Portfolio income includes interest income, dividends, royalties, gains and losses on stocks, pensions, lottery winnings, and any other property held for investment.

Income and losses from the following activities would generally be **passive**:

1. Equipment leasing

2. Rental real estate (except as provided in IRC section 469(c)(7))

3. Sole proprietorship or farm in which the taxpayer does not materially participate

4. Limited partnerships with some exceptions

5. Partnerships, S-Corporations, and limited liability companies in which the taxpayer does not materially participate.

Income and losses from the following activities would generally be **nonpassive**:

1. Salaries, wages, and 1099 commission income

2. Guaranteed payments

3. Interest and dividends

4. Stocks and bonds

5. Sale of undeveloped land or other investment property

6. Royalties derived in the ordinary course of business

7. Sole proprietorship or farm in which the taxpayer materially participates

8. Partnerships, S-Corporations, and limited liability companies in which the taxpayer materially participates.

9. Trusts in which the fiduciary materially participates.

ACTIVITY RULES

The term **activity** under IRC section 469 does not necessarily mean a single business or separate entity owned by the taxpayer. Generally, a taxpayer can treat several businesses as **one activity** if they form an appropriate economic unit. For example, to meet the 500 hour test for material participation, a taxpayer might want to group as *one activity* a Schedule C restaurant together with another restaurant activity which he or she owns via a 75-percent partnership interest. Because material participation is determined for <u>each activity</u>, the way the taxpayer's business and rental operations are combined or divided into "activities" is very important. Chapter 7 provides an in-depth discussion of the regulations relating to activities.

The temporary activity regulations, effective for tax years ending after August 9, 1989, and before May 11, 1992, were long and complex. The final activity regulations issued in 1994 (which can be applied back to the 1992 tax year) are much shorter and easier, applying a liberal "facts and circumstances" approach to the definition of an activity. Businesses forming an **appropriate economic unit** may be grouped into **one activity** based on the following five criteria:

1. Similarities/differences in types of activities

2. Extent of common control

3. Extent of common ownership

4. Geographic location of the activities

5. Interdependence between activities.

It is not necessary to have all five factors to be treated as a single activity. However, **a rental activity may not be grouped with a trade or business** unless it is insubstantial OR the taxpayer has the same ownership percentage in both the rental and business activities, AND the rental property is used in the trade or business. Activity issues are most often seen on the returns of high income taxpayers with multiple business enterprises.

<u>EXCEPTIONS TO THE LOSS DISALLOWANCE RULE</u>

In simple terms, IRC section 469 contains only one general rule: **passive activity losses can offset only passive activity income**. Stated differently, losses from passive activities cannot be deducted against wages, interest, dividends, and other portfolio income.

There are three exceptions to the loss disallowance rule:

1. Rental real estate losses up to $25,000 may be deducted in full by anyone whose modified adjusted gross income is less than $100,000 (ignoring any passive losses, IRA deduction, taxable social security and self-employment tax). To qualify for the $25,000 offset against wages and portfolio income, the taxpayer must actively participate (making management decisions), own at least 10 percent and not be a limited partner. The $25,000 exception is phased out at the rate of 50 cents for every dollar of modified adjusted gross income over $100,000. Thus, when the taxpayer's modified adjusted gross income exceeds $150,000, the $25,000 offset is not allowed. See IRC section 469(I). Beginning in 1994, qualifying real estate professionals may be able to deduct all current rental real estate losses. See Chapter 2.

2. Phase-in allowances for passive activities acquired prior to October 23, 1986, were allowed as follows: 1987 - 65 percent; 1988 - 40 percent; 1989 - 20 percent; and 1990 - 10 percent. While these phase-in allowances conceptually were simple, in practice they added enormous complexity to Form 8582 and confusion for examiners attempting to apply IRC section 469. The practical application of the passive activity rules, including the preparation of Form 8582, is significantly easier beginning with the 1991 tax year. See IRC section 469(m).

3. Disallowed passive activity losses can be carried forward indefinitely until there is passive income or an entire disposition which is fully taxable. The net gain on a sale of a passive activity is deemed to be passive income which can be offset by other passive activity losses.

PARTICIPATION RULES

There are two different and distinct types of participation: Material Participation and Active Participation. It is important to distinguish between them.

Material Participation

This concept generally applies to business activities. IRC section 469(h)(1) states that if the taxpayer works on a regular, continuous, and substantial basis (in other words, materially participates) in an activity, his or her losses are deemed to be nonpassive and are deductible in full without applying any of the limitations of IRC section 469. Temp. Treas. Reg. section 1.469-5T provides seven tests for material participation which are discussed in detail in Chapter 3, Material Participation.

Generally, if a taxpayer either works more than 500 hours a year or performs substantially all of the work in a business, he or she is deemed to be materially participating, and losses and/or income are nonpassive. Conversely, if he or she works 500 hours or less **or** does not perform most of the work or fails to meet one of the remaining tests, losses are not allowable unless he or she has passive income.

Under the new relief provisions effective for 1994 in IRC section 469(c)(7) for real estate professionals, the concept of material participation is also applied to rental real estate activities. See the third test contained in Exhibit 2-4.

Active Participation

For taxpayers (other than some real estate professionals as defined in IRC section 469(c)(7)), active participation must be met for rental real estate activities. This concept relates only to rental **real estate** and is a less stringent standard than material participation. Until regulations are promulgated defining active participation, no specific number of hours are required. If a taxpayer is actively involved with his or her rental real estate, making management decisions, he or she can deduct up to $25,000 in losses against wages and portfolio income. If the taxpayer is not involved in management decisions, losses are not allowable unless he or she has other passive income.

Chapter 2 on Rental Issues addresses the concept of active participation in depth.

It is important to note that neither the material participation standard nor the active participation standard apply to long-term equipment rentals. Generally, losses from long-term equipment leases are simply not deductible unless the taxpayer has other passive income. Again, Chapter 2 on Rental Issues will address this issue in significantly more detail.

Passive activity losses which cannot be used in the current year can be carried forward indefinitely until there is passive income or an entire disposition of the activity in a fully taxable transaction.

FORM 8582

Passive activity losses and income are most commonly found on Schedule E in the form of rentals and flow through losses from partnerships, S-Corporations, and trusts in which the taxpayer does not materially participate. The computational form used to limit these losses is Form 8582, Passive Activity Loss Limitations. The nonpassive loss column on the reverse side of Schedule E contains losses from entities in which the taxpayer has worked on a regular, continuous, and substantial basis. In other words, if the taxpayer materially participates in the activity, the losses and income are not entered on Form 8582.

Beginning in 1994, qualifying real estate professionals who materially participate in their rental real estate activities will not enter losses nor income on Form 8582 as they will be deemed nonpassive. It should be noted, however, that suspended losses from these real estate activities generally should be entered on Form 8582 line 1c. See chapter 2 and Exhibit 2-4 for additional information.

Completion of the Form and Worksheets

From 1987 through 1990, Form 8582 was significantly more complex as it reflected allowable phase-in percentages for activities acquired before October 23, 1986. Now that these transition rules no longer apply, completing Form 8582 is much easier. Exhibit 1-1 provides an example of Form 8582 as well as notes on the source of the numbers and the actual calculation of allowable losses.

Part I of Form 8582 is simply a breakdown of all the passive activities in which the taxpayer is involved. Rental real estate activities on line 1 (summarized on worksheet 1) are separated from all other passive activities on line 2. Rental real estate activities with active participation qualify for the special $25,000 allowance. All other activities, including rental real estate without active participation, and any equipment rentals are entered on line 2 (summarized on worksheet 2). Losses entered on line 2 are not deductible unless the taxpayer has passive income from other activities. It should be noted that beginning in 1994 rental real estate income and losses for qualifying real estate professionals under IRC section 469(c)(7) should not be entered on Form 8582.

It is important to recognize that income and losses from real estate rentals without active participation and from long-term equipment leasing activities belong on line 2 with all other passive activities. In addition, any income and losses from a Schedule K-1 for a limited partner should be entered on line 2 as limited partners cannot meet the active participation standard. Generally, limited partners are deemed to be passive. The entries on lines 1 and 2 must be from passive activities and are obtained from the following documents: Schedules K-1; Schedules C, E, and F with rentals or businesses with no material participation; and Form 4797 net gain from an entire disposition of a passive activity. Exhibit 1-2 (page 1-17) provides an example of a Schedule K-1 with notations on how an examiner can determine a limited partner and other pertinent items.

Part II is the calculation of the allowable portion of the $25,000 rental real estate offset based on entries on line 1. For assistance in computing the modified adjusted gross income on line 6, refer to the worksheet in Exhibit 1-3. If the taxpayer has no rental real estate activities entered on line 1 or if his or her adjusted gross income exceeds $150,000, there is no need to complete Part II.

Part III of Form 8582 simply calculates the total allowable passive activity losses for the entire return. In other words, line 11 (the last line on Form 8582) allows losses up to total passive income plus any allowable rental real estate loss up to $25,000. **Worksheets 5 and 6 allocate the allowable losses among the taxpayer's passive activities. If the taxpayer has multiple passive activities, refer to these worksheets to determine where the loss is reflected (Schedules E, C, F, etc.) and in what amounts.**

As stated earlier, the most common schedule is Schedule E. If the sum of Schedule E lines 24 and 28b is more than Form 8582 line 11, the taxpayer is probably deducting more than his or her allowable passive losses. Beginning in 1994, there is a major exception. A qualifying real estate professional may deduct all current losses from rental real estate if he or she materially participates in the rental real estate. Any prior year losses are still passive and subject to the limitations of section 469.

Refer to Exhibit 1-1 of Form 8582 (page 1-11) for additional guidance in preparation of the form and the worksheets. In addition, Exhibit 1-7 contains information which will assist with report writing. Exhibit 1-8, set up in the format of Form 8582, provides guidance on what should and should not be entered on the form for losses and income. This exhibit contains general rules and can be used as a quick reference in preparing Form 8582 or in identifying potential problems on a given return.

Audit Issues

On review of the Form 8582 and the Schedules K-1 provided by the taxpayer on examination, a number of issues can be raised. The lead sheet in Exhibit 1-4 is designed to be used as a guide to potential audit issues and can be included as a part of the examiner's work papers. Some of these issues will be expanded upon in subsequent chapters. The Information Document Request, Exhibit 1-5, provides the necessary documentation to review a passive activity loss issue. A 3-year comparison of passive and nonpassive activities will highlight inconsistent treatment from year to year.

ISSUE IDENTIFICATION

On perusal of a return either with or without Form 8582, potential passive activity loss issues generally can be easily identified. Exhibit 1-6 provides instructions for classifiers as well as examiners who are pre-auditing a return. These potential audit issues will be discussed in detail in the following chapters.

SUMMARY

1. The passive activity loss rules were enacted to discourage abusive tax shelters, but their influence extends to virtually all trades or businesses and rentals.

2. Generally, a passive activity is any rental activity **OR** any business in which the taxpayer does not materially participate. Nonpassive activities are businesses in which the taxpayer works on a regular, continuous, and substantial basis. In addition, passive income does not include salaries, portfolio, or investment income.

3. As a general rule, a passive loss cannot be deducted unless the taxpayer has passive income. However, rental real estate losses are allowed up to $25,000 if the taxpayer actively participates and his or her modified adjusted gross income (MAGI) is below $100,000. The $25,000 special allowance is phased out at the rate of 50 cents of every dollar of MAGI over $100,000. Prior to 1991, the phase-in rules allowed taxpayers to deduct a portion of their passive losses for activities acquired before October 23, 1986.

4. Beginning in 1994, a taxpayer who spends more than half of his or her personal services in real property trades or businesses **AND** works more than 750 hours a year **AND** materially participates in each rental real estate activity may deduct rental real estate losses in full.

5. Form 8582, Passive Activity Loss Limitation, is the form used to compute the allowable passive loss. Beginning in 1991, this form is significantly less complex and much easier to use.

6. Potential passive activity loss issues can be identified during classification of a given return whether or not a Form 8582 is attached.

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

► **See separate instructions.**
► **Attach to Form 1040 or Form 1041.**

OMB No. 1545-1008

1996

Attachment Sequence No. **88**

Name(s) shown on return | **Identifying number**

Part I **1996 Passive Activity Loss**

Caution: *See the instructions for Worksheets 1 and 2 on page 8 before completing Part I.*

Rental Real Estate Activities With Active Participation (For the definition of active participation see **Active Participation in a Rental Real Estate Activity** on page 4 of the instructions.)			
1a Activities with net income (from Worksheet 1, column (a))	**1a**		
b Activities with net loss (from Worksheet 1, column (b))	**1b**	( )	
c Prior year unallowed losses (from Worksheet 1, column (c))	**1c**	( )	
d Combine lines 1a, 1b, and 1c			**1d**
All Other Passive Activities			
2a Activities with net income (from Worksheet 2, column (a))	**2a**		
b Activities with net loss (from Worksheet 2, column (b))	**2b**	( )	
c Prior year unallowed losses (from Worksheet 2, column (c))	**2c**	( )	
d Combine lines 2a, 2b, and 2c			**2d**
3 Combine lines 1d and 2d. If the result is net income or zero, see the instructions for line 3 on page 9. If this line and line 1d are losses, go to line 4. Otherwise, enter -0- on line 9 and go to line 10.			**3**

Part II **Special Allowance for Rental Real Estate With Active Participation**

Note: *Enter all numbers in Part II as positive amounts. See page 9 of the instructions for examples.*

4 Enter the **smaller** of the loss on line 1d or the loss on line 3			**4**
5 Enter $150,000. If married filing separately, see page 9 of the instructions	**5**		
6 Enter modified adjusted gross income, but not less than zero (see page 9 of the instructions)	**6**		
Note: *If line 6 is equal to or greater than line 5, skip lines 7 and 8, enter -0- on line 9, and then go to line 10. Otherwise, go to line 7.*			
7 Subtract line 6 from line 5	**7**		
8 Multiply line 7 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see page 9 of the instructions			**8**
9 Enter the **smaller** of line 4 or line 8			**9**

Part III **Total Losses Allowed**

10 Add the income, if any, on lines 1a and 2a and enter the total	**10**
11 **Total losses allowed from all passive activities for 1996.** Add lines 9 and 10. See pages 10 and 11 of the instructions to find out how to report the losses on your tax return	**11**

Caution: *The worksheets are not required to be filed with your tax return and may be detached before filing Form 8582. Keep a copy of the worksheets for your records.*

Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c (See page 8 of the instructions.)

Name of activity	Current year		Prior year	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 1a, 1b, and 1c . . . . ▶					

Worksheet 2—For Form 8582, Lines 2a, 2b, and 2c (See page 8 of the instructions.)

Name of activity	Current year		Prior year	Overall gain or loss	
	(a) Net income (line 2a)	(b) Net loss (line 2b)	(c) Unallowed loss (line 2c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 2a, 2b, and 2c . . . . ▶					

Worksheet 3—Use this worksheet if an amount is shown on Form 8582, line 9 (See page 9 of the instructions.)

Name of activity	Form or schedule to be reported on	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
Total . . . . ▶			1.00		

Worksheet 4—Allocation of Unallowed Losses (See page 10 of the instructions.)

Name of activity	Form or schedule to be reported on	(a) Loss	(b) Ratio	(c) Unallowed loss
Total . . . . ▶			1.00	

Worksheet 5—Allowed Losses (See page 10 of the instructions.)

Name of activity	Form or schedule to be reported on	(a) Loss	(b) Unallowed loss	(c) Allowed loss
Total . . . . ▶				

Worksheet 6—Activities With Losses Reported on Two or More Different Forms or Schedules (See page 10 of the instructions.)

Name of Activity:	(a)	(b)	(c) Ratio	(d) Unallowed loss	(e) Allowed loss
Form or Schedule To Be Reported on:					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or Schedule To Be Reported on:					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or Schedule To Be Reported on:					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Total . . . . ▶			**1.00**		

Instructions for Recreating Form 8582 and Worksheets 1-6 As They Appear in Exhibit 1-1.

Form 8582 enter the following information:

At the top of the form: “EXAMINER NEEDS ALL K-1s AND WORKSHEETS 1-6"

Part I - Rental Real Estate Activities: “Not portfolio nor income from self-rented activities.”

Line 1a: “No limited partners no equipment rentals.”

Box 1a: “Worksheet 1"

Line 1b: “Tie to prior year F. 8582, worksheet 5.”

All Other Passive Activities: “= Businesses without material participation, limited partners, equipment rentals, etc. Never nonpassive income.”

Box 2b: “Worksheet 2"

Box 6: “AGI + PAL, etc.

Part II

Line 9: “Portion of $25,000 Allowed”

Part III

Line 10: “All passive income.”

Box 11: “Worksheet 5"

At the bottom of the form: “Line 11 is most commonly reported on Sch E lines 23 (rentals) and 27(g) (Partnerships and S-Corporations)”

Worksheet 1

Under Name of Activity: “RENTAL REAL ESTATE - ACTIVE”
“Verify income or loss ties to K-1.”
“Verify taxpayer owns more than 10% and is not a limited partner.”
“Verify Sch. E losses are for rental real estate.”

Worksheet 2

Under Name of Activity: “ALL OTHER PASSIVE ACTIVITIES”
“Verify income or loss ties to K-1.”

Worksheet 3

Under Name of Activity: “Real Estate”
“Allocates losses among real estate activities.”

First column: “Sch. E.”

Columns (a)-(c): “ Activity Loss “
Total rental real estate loss

Column (d): “To W/S 4 Column (a)

Worksheet 4

Under Name of Activity: “Combines rental real estate and other activities and allocates unallowed losses.”

Worksheet 5

First Column: “Sch. E”
“Sch. C”
“Sch. F”

Column (b): “Carryforward to next year”

Column (c): “Tie to Sch. E, etc.”

Worksheet 6

Top of page: “Allocation of losses among various schedules.”

Bottom of page: “Note: Losses are most often reflected on Schedule E. Consequently, worksheet 6 is frequently not needed.”

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SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

► See separate instructions.

For calendar year 1996 or tax year beginning , 1996, and ending , 19

OMB No. 1545-0099

1996

Partner's identifying number ►

Partner's name, address, and ZIP code

Partnership's identifying number ►

Partnership's name, address, and ZIP code

A This partner is a ☐ general partner ☐ limited partner ☐ limited liability company member

B What type of entity is this partner? ► ....

C Is this partner a ☐ domestic or a ☐ foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	**(ii)** End of year
Profit sharing	.... %	.... %
Loss sharing	.... %	.... %
Ownership of capital	.... %	.... %

E IRS Center where partnership filed return:

F Partner's share of liabilities (see instructions):

Nonrecourse . . . . $ ....

Qualified nonrecourse financing . $ ....

Other . . . . $ ....

G Tax shelter registration number . ► ....

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . ☐

I Check applicable boxes: **(1)** ☐ Final K-1 **(2)** ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	**(b)** Capital contributed during year	**(c)** Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	**(d)** Withdrawals and distributions	**(e)** Capital account at end of year (combine columns (a) through (d))
			( )	

		(a) Distributive share item		**(b) Amount**	**(c) 1040 filers enter the amount in column (b) on:**
Income (Loss)	1	Ordinary income (loss) from trade or business activities . . .	1		See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch. D, line 13, col. (f) or (g)
	f	Other portfolio income (loss) *(attach schedule)*	4f		Enter on applicable line of your return.
	5	Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6	Net gain (loss) under section 1231 (other than due to casualty or theft)	6		
	7	Other income (loss) *(attach schedule)*	7		Enter on applicable line of your return.
Deductions	8	Charitable contributions (see instructions) *(attach schedule)* . .	8		Sch. A, line 15 or 16
	9	Section 179 expense deduction	9		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	10	Deductions related to portfolio income *(attach schedule)* . . .	10		
	11	Other deductions *(attach schedule)*	11		
Investment Interest	12a	Interest expense on investment debts	12a		Form 4952, line 1
	b	**(1)** Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
		(2) Investment expenses included on line 10 above	b(2)		
Credits	13a	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
		(2) Other than on line 13a(1) for property placed in service before 1990	a(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
		(4) Other than on line 13a(3) for property placed in service after 1989	a(4)		
	b	Qualified rehabilitation expenditures related to rental real estate activities	13b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c	Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities.	13c		
	d	Credits related to other rental activities	13d		
	14	Other credits	14		

Instructions for Recreating Schedule K-1 As it Appears in Exhibit 1-2

Schedule K-1 enter the following information:

Under Partner's name, address, and ZIP code: "Limited partner if checked 'No'. No active participation. Generally no material participation."

Under Partnership's name, address, and ZIP code: "If out-of-state EI#, question taxpayer's level of participation if losses are not on Form 8582."

Line A: check limited partner box

Line D: "For rental real estate, if ownership % is less than 10%, not active. For businesses, if ownership % is small, questions material participation."

Column (a):

Line 4: "Never belongs on Form 8582 (Except self-charged interest)"

Column (b):

Line 1: "To 8582 line 2"
Line 2: "To 8582 line 1"
Line 3: "To 8582 line 2"
Line 9: "To 8582 line 2"
Line 12a: "To 8582 line 2"

MODIFIED ADJUSTED GROSS INCOME COMPUTATION

Rental Real Estate $25,000 Special Allowance

Adjusted Gross Income Per Return	________________
± Audit Adjustments Affecting AGI	+/-________________
- Taxable Social Security Line 21b on Form 1040	-________________
+ IRA/SEP Deductions Lines 24a, 24b, or 27 on Form 1040 No Keogh	+________________
+ Deduction for ½ Self Employment Tax Line 25 on Form 1040	+________________
+ Passive Activity Losses Excess passive losses after netting with passive income	+________________
+ Rental Real Estate Losses Allowed under Section 469(c)(7)	+________________
+ Nontaxable Income from US Savings Bonds Used for Higher Education Line 14 on Form 8815	+________________
Modified Adjusted Gross Income	=________________

ALTERNATIVE COMPUTATION: Modified adjusted gross income can be determined by computing adjusted gross income without any passive activity loss or passive income, rental real estate losses allowed by section 469(c)(7), IRA/SEP, taxable social security or one-half of self-employment tax. See IRC section 469(I)(3)(E).

LAW: For every dollar modified adjusted gross income (MAGI) exceeds $100,000, the $25,000 offset for rental real estate is reduced by 50 cents. If MAGI exceeds $150,000, the taxpayer is allowed none of the $25,000 offset. See IRC section 469(I)(3).

There are two exceptions to this phase-out rule: The deduction equivalent of the rehabilitation credit is phased out beginning at $200,000 of MAGI, and there is no phase out of the deduction equivalent of the low income housing credit. See IRC section 469(I)(3)(c).

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REVIEW OF FORM 8582 ON EXAMINATION

_____ Verify that the sum of Schedule E lines 23 and 28b and 33b does not exceed line 11 of Form 8582 . Form 8582 is a limitation form. Line 11 is the sum of all the losses that are deductible form passive activities on Schedules E, C, F, or anywhere else on the return. (Works for all taxpayers except real estate professionals beginning with the 1994 tax year.)

PART I

___ Verify that income on Form 8582 lines 1a and 2a has been reported on Schedule E lines 22, 28a (column h), or 33a (column d). If there was a disposition, passive income reflected on Form 8582 should also be reported as a gain on Schedule D. If Schedule C or F was designated a passive activity, income could also be reflected on these schedules.
LAW: Form 8582 is simply a computational form (similar to depreciation) to calculate the allowable passive loss. Income must still be reflected on the appropriate schedule of the tax return.

____ Review Schedules K-1 and verify that no losses from a limited partnership have been included on Form 8582, Line 1.
LAW: Limited partners cannot meet the active participation standard. Losses belong on Line 2. NOTE: Low income housing is an exception. This issue should be researched.

____ Review Schedules K-1 and verify that no losses from a taxpayer with less than 10 percent ownership have been placed on Line 1.
LAW: Taxpayer with less than 10 percent interest cannot meet the active participation standard.

____ Review Schedules K-1 and verify that no losses from a trust have been included on Line 1.
LAW: There is no active participation provisions for trusts, only for individuals (natural persons). Furthermore, passive losses from trusts are generally limited at the trust level. Exception: grantor trusts.)

____ Verify that rental of equipment or other personal property is not reflected on Line 1. Line 1 is only for real estate with active participation.
LAW: Long-term equipment rentals are generally passive and belong on Line 2.

____ Verify that no portfolio income (interest, dividends, stock sales, etc.) from the Schedules K-1, Schedule B, or any other place on the return, has been entered on Lines 1a or 2a.
LAW: Passive income is income derived from rentals or businesses in which the taxpayer does not materially participate. It is not portfolio income. Reference: Treas. Reg. section 1.469-2T(c)(3)(I). NOTE: Gain on disposition of a passive activity is generally passive income.

____ If line 1a reflects large amounts of rental income, peruse Schedule E for properties with few expenses, indicating that may possibly be rented to an entity in which the taxpayer materially participates. If so, income is recharacterized as nonpassive. See Exhibit 2-5.

____ Review Schedules K-1 and verify that losses from limited partners are on Form 8582, Line 2, rather than incorrectly as nonpassive losses on Schedule E, Part II, Line 27, column I.
LAW: Limited partners are presumed to be passive. Reference: Treas. Reg. section 1.469-5T(e).

____ Verify that income on line 2 is not from a nonpassive activity, that is, a business that the taxpayer participates in on a regular, continuous, and substantial basis. If the EIN is from the state in which the taxpayer lives, it could suggest possible material participation. If so, income belongs on Schedule E, line 28, column (k), but not on Form 8582.
LAW: Passive losses can only offset passive income.

PART II

____ Compare line 6 of Form 8582 with adjusted gross income on return. If they are the same, line 6 has not been properly computed. Line 6 should reflect adjusted gross income, increased by any loss from passive activities as well as several other minor modifications. **NOTE:** If there are no losses on line 1, even if modified adjusted gross income is incorrect, there is no need to recompute it.

IMPORTANT:

____ Review all Schedules K-1 for nonpassive losses entered on Schedule E, Line 27, column (I). If taxpayer is a limited partner, losses generally should be entered on Form 8582, line 2. If taxpayer has no passive income, losses generally will be fully disallowed. Material participation should be questioned on Schedules K-1 from out-of-state entities.

____ Verify material participation on losses from Schedules C and F with out-of-state EIN's. If it is determined that the taxpayer does not participate on a regular , continuous, and substantial basis (materially participate), losses should be entered on Form 8582, and will be disallowed in full unless the taxpayer has other passive income.
NOTE: Material participation tests can be located in Temp. Treas. Reg. section 1.469-5T(a).

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

Re: PASSIVE ACTIVITY LOSSES:

1. Form 8582 worksheets 1 through 6 for tax year___________________.
2. If there is a carryover of passive activity losses from prior years which is being used, Form 8582 worksheets 4, 5, and 6 from prior years to verify the amount of the carryover loss.
3. Schedules K-1 to verify both passive and nonpassive losses.
4. Log, calendar or narrative summary listing activities and hours for the ____________ year.

   (You may want to list Schedules E or C activities for which material participation is being questioned).

   (While reviewing losses from a passive activity standpoint, you may want to raise the issue of whether taxpayer has sufficient basis to deduct losses. Note: Basis and at-risk provisions override passive activity loss provisions.)

RE: BASIS

5. Basis calculations to support losses deducted for the following activities:____.
6. Copies of documents to support any loans claimed as part of basis.

Information Due By__________ At Next Appointment [ ] Mail In [ ]

FROM:	Name and Title of Requester	Date
	Office Location	

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FORM 1040

ISSUE IDENTIFICATION: PASSIVE ACTIVITY LOSSES

IF NO FORM 8582 IS ATTACHED TO RETURN:

Select returns where Schedule E losses in excess of $25,000 have been deducted and there is no Form 8582 and taxpayer is not a real estate professional.
LAW: IRC section 469 limits rental losses to $25,000 with active participation. Beginning in 1994, certain taxpayers who spend most of their time in real property businesses can deduct rental real estate losses in full.

Select returns where AGI exceeds $150,000 AND there are losses for rental real estate and taxpayer is not a real estate professional.
LAW: The $25,000 offset is phased out at a rate of 50 cents for every dollar of modified AGI over $100,000.

Select returns with large losses in the block for nonpassive losses on Schedule E, Part II, particularly if the first two digits of EIN are from out-of-state. Also select if return suggests: limited partnership, less than 10 percent ownership or tax shelter (same partnership on Form 8271).
LAW: Temp. Treas. Reg. section 1.469-5T(a) requires more than 500 hours a year, etc., to be materially participating.

Select Schedules C with equipment or vehicle rentals.
LAW: Equipment rentals are not eligible to receive $25,000 offset. Losses are allowable only if taxpayer has other passive income. Rentals of personal property should be reported on Form 8582, line 2 (never on line 1).

Watch for returns with Form 8582 AND Schedule A with large dollar investment interest deduction.
LAW: Interest expense from limited partnerships trade or business activities, rentals or any other passive activity is no longer deductible as investment interest.

IF FORM 8582 IS ATTACHED TO RETURN:

Select return if sum of Schedule E, lines 23 and 28(b) exceed line 11 of Form 8582.
Exceptions: Dispositions, PTPs and real estate professionals.

LAW: Passive losses are limited to passive income and $25,000 offset. Line 11 of Form 8582 is the sum total of all PAL's that can be deducted on return.

Select return if large amounts of income on Form 8582 are offsetting large passive losses, particularly if any of the following is suggested: income is from a nonpassive activity (same EIN as taxpayer's residence); income is not reflected elsewhere on the return; portfolio income; income from self-rented property; or installment sale income.
LAW: Passive losses can only offset passive income.

Check Form 8582, line 6 to verify that taxpayer is using modified AGI. If AGI on line 6 is same as AGI on Form 1040, Form 8582 is in error.
LAW: For every dollar over $100,000, the $25,000 offset is reduced by 50 cents. AGI is modified by passive losses, taxable social security and any IRA/SEP deduction.

If the tax return has attached Schedules K-1, check to see if the taxpayer is a limited partner.
LAW: Limited partners are presumed to be passive, and furthermore, cannot meet the active participation standard. Losses should be reported on line 2.

Additionally, on rentals, if K-1 is available, verify that taxpayer owns more than 10 percent, is not a limited partner, and is not a beneficiary in a trust. If not, losses should be on line 2 as taxpayer does not meet the active participation standard.

NOTE: Passive loss issues are most likely to occur on returns in TPI 534 and above.

REPORT WRITING: PASSIVE ACTIVITY LOSSES

NOTE: Worksheets 1 and 2 simply transfer over to lines 1 and 2 of Form 8582. If there are more than one or two passive activities, while not required, you may want to use the worksheets. If the taxpayer has numerous passive activities, an easy way to avoid entering all the data is to lump all of the unadjusted passive activities for rental real estate as one figure and enter them as "All Other Real Estate". Similarly, for line 2 with passive business activities, lump them together under the title, "All Other PALs".

IF PASSIVE <u>LOSSES</u> ARE ADJUSTED:

1. Remove full rental loss or K-1 loss from Form 8582.
   In some cases, the rental loss OR the passive Sch. C or F loss OR the passive K-1 loss will not have been entered on Form 8582 - so there will be nothing to remove.

2. Enter corrected loss per examination on line 1 (rental real estate if active) or line 2 (all other passive activities) of Form 8582 and recompute. Be sure to enter all passive activity losses including those identified on examination.

3. Adjustment is:
   Form 8582, line 11, per return _________
   LESS Form 8582, line 11, per audit _________
   Adjustment* _________
   *Adjustment = Corrected Sch. E (or C/F if passive) losses limited per IRC 469.

   NOTE: If examiner determines that loss on Sch. C or F or E Part II Column (I) has been erroneously designated as nonpassive (in other words, the taxpayer does not materially participate), the losses belong on Form 8582, line 2.

The RAR should reflect two adjustments:

1. Full disallowance of Sch. C or Sch. E loss determined to be passive.

2. Loss allowable per Form 8582 line 11 (detail on worksheet 5). This will be reflected as an overassessment amount on the report. In many cases, the allowable loss will be zero as passive business losses are simply nondeductible unless the taxpayer has passive income reported on the return. If the tax year is between 1987 and 1990, there are allowable phase-in percentages (65%-1987, 40%-1988, 20%-1989, and 10%-1990). An easy way to compute the allowable loss for activities acquired prior to 1987 without using Form 8582 when there is no passive income is simply to multiply the loss by the phase-in percent.

IF PASSIVE INCOME IS ADJUSTED:

In some cases passive income will be determined to be nonpassive.

1. Income deemed nonpassive should be removed from Form 8582 (but never from Sch. E or D).

2. The adjustment for the report will be the difference between Form 8582 per return and the corrected Form 8582 per audit. Generally, the adjustment will be the full amount of income removed from Form 8582.

IMPORTANT REMINDER: If examiner's adjustments of any kind for any reason, push modified AGI over $100,000 and taxpayer has rental property, there may be an automatic passive loss adjustment. For every dollar modified AGI exceeds $100,000, taxpayer loses 50 cents of his $25,000 offset. See line 6 of Form 8582.

INVESTMENT INTEREST: Generally, investment interest from a K-1 should be deducted on Form 4952, Investment Interest Deduction. This interest should not be entered on Form 8582, line 1 or 2, and thereby subjected to the passive loss limitations. However, interest expense directly related to a passive activity should be on Form 8582.

179 EXPENSE AND OTHER SEPARATELY STATED ITEMS: If activity is passive, 179 expense nor any other K-1 separately stated item should be deducted. Instead they should be entered on Form 8582 line 1 or 2 with the ordinary loss. EXCEPTIONS: Charitable contributions and expenses allocable to portfolio income.

PASSIVE ACTIVITY LOSS: The term means any passive loss remaining after total passive losses have been netted against total passive income.

PASSIVE INCOME is not interest, dividends, royalties, portfolio, nor investment income. Passive income only comes from passive activities, i.e. rental activities, limited partnerships and businesses with no material participation.

MODIFIED AGI: AGI computed without any passive activity loss nor income, IRA/SEP, taxable social security, ½ SE tax, nor any rental loss allowed under section 469(c)(7). No need to computed modified AGI if there is no rental real estate loss.

SALES OR OTHER DISPOSITIONS: All current and carryover operating losses are deductible in the year of an entire disposition in a fully taxable transaction to an unrelated party. Figures should be entered on F. 8582 only if there is a net gain after subtracting all current and carryover losses. If so, the net gain from F. 4797 should be entered on either line 1a or 2a as passive income. Current losses should be entered on line 1b or 2b, and carryover losses on line 1c or 2c.

If there is an overall net loss (after subtracting current and suspended losses), non of the gains nor losses should be entered on F. 8582. Instead, they should be entered on the normal schedules.

BASIS: If taxpayer has no basis, he cannot deduct any passive loss.

EXCEPTIONS TO PASSIVE LOSS LIMITATIONS: Low income housing AND oil & gas activities should generally be entered in the nonpassive loss column on the back of Sch. E (and not on Form 8582). For low income housing, however, if the taxpayer takes the credit, he agrees to subject himself to PAL limitations and losses should be entered on Form 8582. On oil & gas activities, if taxpayer is a limited partner or an investor in an 1120-S, he is subject to PAL limits and losses should be entered on Form 8582.

INSTALLMENT SALES: Current and suspended losses are deductible only in ratio to gain reported. If gain in current year exceeds current and suspended losses, no ratio is needed.

ALTERNATIVE MINIMUM TAX: If taxpayer has sufficient passive income to fully deduct his PALs, the adjustment item for AMT (Form 6251, line 5r) will generally be the full amount of the adjustment and preference items related to his passive activities. If taxpayers passive losses are not deductible because he has no passive income or does not qualify for the $25,000 offset, there will not be an adjustment item for AMT on F. 6251, line 5r. In other words, if line 11 of Form 8582 is zero, line 5r of Form 6251 will generally be zero. If the taxpayer's entire activity is disposed of in a fully taxable transaction to an unrelated party, current and c/o losses for AMT will be triggered, and it is likely that line 5r will reflect a <u>negative</u> number in the transition years which ended in 1990. For the post-transition years (1991 and subsequent), the disposition of passive activity frequently results in alternative minimum tax - as all the accumulated preference and adjustment items are also triggered (a positive number on line 11 of Form 6251).

LOW INCOME HOUSING: Low income housing LOSSES and low income housing CREDITS are each treated differently. For current years, LOSSES are generally subject to the passive loss limitations. Since most investors are limited partners and limited partners do not qualify for the active participation standard, losses should be entered on Form 8582, line 2b. Consequently, no $25,000 offset is available and losses are deductible only up to passive income reported on the return. However, a qualifying investor who owned a low income housing partnership interest on **<u>12/31/88</u>** and the property was placed in service between 12/31/85 and 8/17/86 may deduct all losses. Needless to say, this exception is very restrictive.

Code section 469(I)(6)(B) provides an exception for low income housing CREDITS. There is no participation requirement. Thus, even a limited partner may use the low income housing CREDIT. Furthermore, for tax years after 1989, there is no phaseout of the credit based on modified AGI. Therefore, a taxpayer with any amount of income may use the credit. However, we should remember that the credit is limited to the tax equivalent of $25,000.

Ref.: IRC section 469 and related regulation, Pub. 925.

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Exhibit 1-8

HELPFUL HINTS FOR FORM 8582

PART I

<u>Rental Real Estate with Active Participation</u>

Line 1a Enter net rental real estate income BUT ...

No interest, dividends, royalties or portfolio income (should be reflected on Sch. B, D or E).
No income from property rented to corporation or partnership in which taxpayer materially participates (unless there is a written binding contract prior to 2/18/88.)
No rental income from land or other nondepreciable property.
REMINDER: Income on line 1a or 2a should also be reported on Sch. E, line 22 or line 27(h) generally; or if there was a sale of rental property or other passive activity, income should be reflected on Form 4797 line 26.

Line 1b Enter net rental real estate losses BUT ...

No losses unless active participation in rental real estate.
No equipment leases or rentals of personal property.
No limited partners (K-1 box A checked "No").
No investor losses with less than 10% ownership.
No trust losses.
Generally no losses from net leases (unlikely to meet active participation standard per Committee Reports).

Line 1c Enter unused real estate carryover losses from prior years.

(From <u>prior</u> <u>year's</u> Form 8582 worksheet 5(b)

<u>All Other Passive Activities</u>

Line 2a Enter net income from ...

K-1 line 1 (ordinary income) of limited partnerships.
K-1 line 1 for Form 1065 or 1120-S where taxpayer does not materially participate.
Sch. C or F in which taxpayer does not materially participate.
Gain on sale or disposition of a passive activity (F. 4797 line 26).

BUT no income from ...

Interest, dividends, royalties or other portfolio income (should be reflected on Sch. B, D or E).
K-1s or other businesses in which taxpayer materially participates - possible indicator is in-state EIN (should be reflected on Sch. E line 27(k).

Line 2b Enter net losses from ...

Limited partners - K-1 line 1 or 3.
K-1 for 1065 or 1120-S where taxpayer does not materially participate (possible indicator is out-of-state EIN).
Equipment rentals or leases of personal property.
Any real estate losses not entered above.
Any loss from any other passive activity.

Line 2c Enter unused losses from prior years except those on line 1c.

(From prior year's worksheet 5(b)

PART II

Special Allowance for Rental Real Estate with Active Participation

(No need to complete lines 4 to 9 if there are no losses on lines 1b and 1c. Enter zero on line 9.)

Line 6 Enter modified AGI
(AGI computed without any passive activity loss, any rental loss allowable under section 469(c)(7), any IRA/SEP, any taxable social security nor half self-employment tax).

PART III

Line 11 Total losses allowed from all passive activities ...

Line 11 allows passive losses to be deducted up to passive income reported on the return PLUS up to $25,000 in rental real estate losses if taxpayer's modified AGI is below $100,000.
Generally, line 11 is the sum of losses to be entered on Sch. E line 23 (rental real estate losses) and line 27(g) (passive activity loss). If the taxpayer had a business in which he did not materially participate or a rental activity on Sch. C or F, losses on Form 8582 line 11 could also be reflected on these schedules.

SUMMARY OF RULINGS AND CASES

REVENUE RULINGS

1. Revenue Ruling 95-5, 1995-2, I.R.B.5 - Distributions in excess of basis are treated as gain from sale or exchange of that interest from an S-Corporation. Treats these distributions as passive income.

2. Revenue Ruling 92-92, 1992-45, I.R.B.21 - Character of COD income from a passive activity.

COURT CASES

1. *William H. Schaefer v. Commissioner*, 105 T.C., N16 (filed September 13, 1995) - Passive versus nonpassive income. Tax Court upheld the validity of section 1.469-2T(c)(F)(iv) and held that passive income does not include income from covenant not to compete.

2. *Shirley McVay Wiseman v. Commissioner*, T.C. Memo 1995-203 - Activity Rules under the Temporary Treasury Regulations 1.469-4T - Taxpayer was not allowed to aggregate three undertakings into one activity. Income from ground rents was recharacterized as nonpassive with a corresponding adjustment to allowable passive losses. Government sustained.

3. *Kevin and Marilynn K. Setts v. Commissioner*, T.C. Memo 1994-522 - Passive Income versus Investment Income - Gain from the sale of an apartment was considered investment income. Self-serving statements not accepted. Government sustained.

4. *William A. and Virginia O. Goshorn v. Commissioner*, T.C. Memo 1993-578 - Material Participation - Taxpayer did not materially participate in a chartering boat activity because the taxpayer's participation was investor hours and the management company at the marina performed more management services. Post-event ballpark guesstimates were not acceptable. Government sustained.

5. *Samuel G. and Elizabeth Shannon v. Commissioner*, T.C. Memo 1993-554 - COD income passive or nonpassive - Taxpayer's COD income was considered nonpassive because debt originated from assets held in a prior farm business. Government sustained.

6. *Floyd A. and Joanna R. Toups v. Commissioner*, T.C. Memo 1993-359 - Material participation - Taxpayer did not materially participated in a vacation cottage rented on the average of 7 days or less. The taxpayer's hours including travel were considered investors hours. Government sustained.

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Chapter 2

RENTAL ISSUES

INTRODUCTION

Beginning in 1994, newly enacted IRC section 469(c)(7) provides relief from the passive loss limitations for so-called real estate professionals. Taxpayers who spend more than half their personal services on real property businesses **and** work more than 750 hours a year **and** materially participate in their rental real estate activities can deduct current rental real estate losses in full without limitation.

The majority of taxpayers will not qualify under IRC section 469(c)(7) as it applies only to real estate professionals. There are a number of audit issues which can be raised relating to the passive activity rules for rentals, and many of them are relatively easy! Under IRC section 469(c)(2) any rental activity is passive (with the exception of qualifying real estate professionals discussed in the first paragraph). Thus, losses for rental activities generally are not allowable unless the taxpayer has income from another passive activity reported on the tax return. The one major exception to this rule is the $25,000 special allowance (sometimes referred to as the $25,000 offset) for rental real estate with active participation. While some examiners feel the active participation standard is so liberal it is not worthwhile raising issues, in fact, several simple issues can be raised which will result in quick adjustments.

One of the major reasons for the enactment of IRC section 469 was to limit the deductibility of rental losses. Prior to 1986, there were numerous abusive tax shelters which allowed taxpayers involved in tiered entities (a partnership or corporation investing in another partnership or corporation) to deduct inflated losses from equipment leasing, lithograph activities, real estate and many others, thereby offsetting a significant portion of their wages and otherwise taxable income. The enactment of the passive activity loss rules brought the abusive tax shelter industry to an abrupt halt. It should be noted that the provisions of IRC section 469 extend far beyond abusive tax shelters.

EXCEPTIONS TO RENTAL ACTIVITIES

Before we can begin to address rental issues, it is important to understand that the following six activities do not meet the definition of a "rental" as defined in Treas. Reg. section 1.469-1T(e)(3)(ii)(A). If the taxpayer meets any one of the following exceptions, he or she is not subject to the rental limitations, but instead must meet the material participation rules, that is, by regular, continuous, and substantial involvement in an activity. Refer to Chapter 3 for audit assistance on material participation.

1. The average period of customer use is 7 days or less. The average period is figured by dividing the total number of days for all rental periods by the number of rentals. Common examples are: a video store renting movie cassettes; automobile rentals, tuxedos, tools, and the short-term use of hotel and motel rooms.

2. The average period of customer use is 30 days or less and significant personal services are provided with the rentals. A hotel with maid service, for example, would not be treated as a rental activity as long as the average rental period does not exceed 30 days.

While the examiner should understand the remaining exceptions to rentals, they have not generated many audit issues (except for the sixth one).

3. Extraordinary personal services are provided in connection with customer use. For instance, a hospital whose primary function is providing medical services is excluded from the definition of a rental activity even though they are renting beds. The rationale would apply to boarding schools as the primary function is educational.

4. The rental is incidental to a nonrental activity.

5. The taxpayer customarily makes the rental property available during defined business hours for nonexclusive used by various customers. Examples: a golf course or a health spa.

6. The taxpayer provides the property for use in a nonrental activity of his own partnership, S-

Corporation, or joint venture. Whether income is passive or nonpassive depends on whether or not the taxpayer materially participates in the entity renting the property. Also see the recharacterization of income rules later in this chapter.

===

Audit Technique:

Watch for Schedules C and E with losses deducted in full which appear to have short-term rental activities. Particularly, if there appears to be on-site management, it would be difficult for the taxpayer to meet the material participation standard, that is, that he or she is working on a regular, continuous, and substantial basis. Additionally, if the Schedule C reflects an out-of-state employer identification number (EIN), the possibility of a passive activity loss issue under the material participation rules is enhanced.

===

EQUIPMENT RENTAL ISSUES

Unless the equipment rental falls in one of the exceptions above, IRC section 469(a)(2) defines it as a passive activity and losses are not deductible (unless the taxpayer has other passive income). Long-term equipment rentals (generally over 7 days) are passive, and losses should be entered on Form 8582, line 2. The net result is a complete disallowance unless the taxpayer has other passive activity income reported on the return. Common examples are: long-term computer leases, truck or heavy equipment rentals, medical equipment to partnerships, airplane leases, office machinery, automobiles, boats or any other equipment or personal property rented/leased more than 7 days to another entity.

On long-term equipment rentals, some taxpayers may argue either the material participation or active participation standard. Neither one applies. Losses without other passive income are simply not deductible (unless the taxpayer meets one of the six exceptions cited earlier).

Example 1

The tax return contains a Schedule C for a long-term "equipment lease." A $37,000 loss is deducted in full, no Form 8582 is attached to the return, and there is no passive income. On examination, it is discovered that the taxpayer is renting equipment to a partnership under an annual lease. The loss can be disallowed in full under IRC section 469(c)(2). If the examiner wanted, he or she could complete a Form 8582 to accompany his or her report. However, since there is no passive income, the bottom line for allowable passive activity losses will be zero.

(Exhibit 2-1 contains a lead sheet which can be used as a work paper in addressing equipment rental issues.)

Only rental **real estate** losses qualify for the $25,000 offset against wages and other investment income. Equipment or personal property rental losses of any kind do not qualify for the special $25,000 allowance. Examiners should watch for Schedule E losses from any activity which is not rental **real estate**. If the taxpayer has deducted the loss without completing Form 8582 or entered it on line 1 of Form 8582 (thereby giving himself or herself the benefit of the $25,000 offset in error), the tax return should be adjusted.

Example 2

John Gray's tax return contains a Schedule E for two activities: (1) a rental real estate property in which the taxpayer actively participates with a loss of $12,000 and (2) equipment rented to an S-Corporation with a loss of $10,000. Both losses were placed on line 1 of Form 8582 (rental real estate with active participation) and deducted in full. The taxpayer had no passive income. In this case, the examiner has an adjustment of $10,000, as the equipment loss does not qualify for the $25,000 offset and should have been placed on line 2 of Form 8582 (all other passive activities). Since there is no passive income, the only allowable loss is the $12,000 rental real estate loss, and the $10,000 is disallowed in full.

It has been noted that some taxpayers have placed equipment rental activities on Schedule C and deducted losses in full without entering the loss on Form 8582 or considering the passive activity loss limitations. Obviously, regardless of the schedule on which the equipment lease has been placed, the limitations of IRC section 469 remain the same. Long-term equipment losses are simply not deductible unless the taxpayer has other passive income such as income from a limited partner-ship or the sale of a rental property. Chapter 4 addresses income issues in depth.

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Audit Techniques:

* The following principal industry activity (PIA) codes on Schedule C indicate that a passive loss issue should be considered: 7773 for equipment rentals; 7922 for computer rentals; and 8813 for auto rentals.

* Particularly on partnership equipment rentals, the taxpayer may provide the examiner with leases, prospectuses, notes, loans and other paperwork. Regardless of the amount of documentation, intent for profit, or time the taxpayer applies to an equipment rental activity, the rules of IRC section 469 remain the same. Long-term equipment losses are passive and are deductible **only** if the taxpayer has other passive income to offset the loss against.

* If the activity falls into one of the exceptions to the rental definition, it does not mean losses are automatically deductible. The taxpayer must meet one of the material participation tests, the most common of which is the 500-hour test.

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REAL ESTATE ISSUES

IRC section 469(c) defines all rentals as passive activities. However, beginning with the 1994 tax year, new IRC section 469(c)(7) excepts real estate professionals who spend most of their time in real property businesses and materially participate in their rental real estate activities. See the segment on "Real Estate Professionals" at the end of this lesson and Exhibit 2-4.

For all other individual taxpayers owning rental real estate, IRC section 469(I) allows up to $25,000 in losses against wages and portfolio income if they actively participate (and meet certain income restrictions discussed later in the chapter). The active participation standard is less stringent than material participation (addressed in the following chapter). As long as the taxpayer participates in management decisions in a bona fide sense, he or she is deemed to be actively participating. No specific number of hours are involved, but the taxpayer must be exercising independent judgment and not simply ratifying the judgments of a manager or management company (S. Rep. No. 313, 99th Cong., 2d Sess. 738 (1986)).

Flow through rental real estate losses (generally reflected on Schedule K-1) from partnerships and S-Corporations can qualify for the $25,000 offset as long as the taxpayer actively participates -- in a bona fide sense. In other words, he or she is not simply ratifying a manager's decisions. Losses from flow through entities on line 1 of Form 8582 should be reviewed. Schedules K-1 should be scrutinized carefully as limited partners and those who own less than 10 percent of the activity do not meet the active participation standard.

If the taxpayer meets certain criteria, in many instances, he or she is allowed to deduct $25,000 in rental real estate losses **without** completing Form 8582. It should be noted that there is no active participation requirement for the low income housing or rehabilitation credits. These losses generally do not belong on Form 8582 and should be researched. Chapter 6, Interaction with Other Code Sections, contains additional information on low income housing.

Since active participation is a relatively liberal standard, some examiners have not raised the issue. However, **there are several limitations on the active participation standard, any ONE of which makes the $25,000 allowance unavailable:**

1. The taxpayer cannot be a limited partner (IRC section 469(I)(6)(C). Exception: a limited partner who is also a general partner.

2. The taxpayer must own 10 percent or more.

3. The losses cannot be from a trust. (This rule does not apply to grantor trusts as they are not generally viewed as an entities in the eyes of tax law.)

4. The losses generally cannot be from an entity under a net lease. A net lease is a rental agreement where the tenant pays most or all of the expenses. Net leases are common in instances where the taxpayer has a controlling interest in the S-Corporation or partnership.

===

Audit Techniques:

* Losses from any one of the above four categories belong on Form 8582 line 2. They should never be placed on line 1 as that would allow the $25,000 offset. The lead sheet on Exhibit 2-2 provides a workpaper that the examiner can use in raising the active participation standard.

* Some management firms are automatically issuing a letter to their clients which states that the client is "actively involved in management of the rental" and approves tenants, arranges for repairs, sets rental fees, etc. An accurate picture of the relationship of the client and the management firm may usually be obtained by inspecting a copy of the contract with the management firm. This document usually specifies the exact responsibilities of the management firm as well as the client's rights. REMINDER: The Committee Reports tell us that the taxpayer must be making management decisions in a bona fide sense, not just ratifying an on-site manager's decisions.

* A Schedule E without interest or taxes or many expenses is frequently indicative of a net lease. In other words, the building is being rented by an individual to a corporation or a partnership which pays most of the expenses. If the taxpayer falls into any of the above categories, he or she generally does not meet the active participation standard, and losses are, therefore, disallowed in full unless he or she has other passive income.

* Leases can be either written or oral. The term, "net lease," is not specifically defined under IRC section 469. However, the term means a rental agreement where the tenant pays most or all of the expenses. It could include the following: (a) property where the deductions allowed solely by reason of IRC section 162 are less than 15 percent of gross rents from that property or (b) property where the lessor is either guaranteed a specific return or is protected in whole or in part against loss of income.

  Since depreciation, interest expense, and property taxes are allowed because of IRC sections 167, 163, and 164, respectively (and not <u>solely</u> because of section 162), the deductions referred to in this definition are those deductions <u>other than</u> depreciation, interest or taxes. The active participation standard would be very hard to meet in the case of a rental property where the tenant is paying for more of the upkeep and repairs, simply because the lessor is not doing any of the work or making any decisions.

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Exhibit 2-2 provides a lead sheet which can be used as a workpaper in examining active participation issues.

$25,000 Offset Issues

Some taxpayers have deducted Schedule E rental real estate losses in excess of $25,000 without completing Form 8582 or limiting the losses. (It should be noted that although this is an automatic adjustment with no exceptions prior to the 1994 tax year, it was not being picked up by some service centers.) Similarly, some taxpayers with an AGI over $100,000 have deducted rental real estate losses without considering the passive loss limitations. In addition, certain taxpayers removed rental losses from Schedule E and placed them on Schedule C with creative titles such as "Real Estate Management" or "Management Services."

Example 3

Karen Shimer, an attorney, deducted $47,000 in rental real estate losses in full on Schedule C of her 1994 tax return. No Form 8582 was completed and she did not have any passive income.

Presuming that Karen is making management decisions, there would be an adjustment of $22,000 computed as follows:

Per return	$47,000
Per audit	25,000
Adjustment	$22,000

Beginning in 1994, the relief provision enacted for real estate professionals (for example, an individual who spends most of his or her time in construction and owns rental real estate) allows all current losses to be deducted if certain qualifications are met. Consequently, prior to raising a $25,000 offset issue, the examiner should scan the Forms W-2 and occupation of the taxpayer for indications that he or she might be in a real property profession of some kind.

Limited Partner Issues

It has been noted that losses from limited partnerships are being erroneously placed on line 1 of Form 8582, thereby incorrectly allowing taxpayers the $25,000 offset. Refer to Exhibit 1-2 at the end of Chapter 1 for an example of a Schedule K-1.

If the box on the Schedule K-1 by the general partner question is checked NO, the taxpayer is generally a limited partner. Consequently, he or she cannot meet the active participation standard, and losses should be entered on line 2 of Form 8582. Thus, the losses will only be deductible if he or she has other passive income.

Example 4

On inspection of Cathy Ranger's return it was noted that she had a loss of $6,500 on Form 8582 line 1. She also had passive income of $2,500 on Schedule E and on Form 8582. On review of her Schedules K-1, it was discovered that she was a limited partner in a real estate venture.

In this instance, there is an adjustment of $4,000 (the difference between the $6,500 loss per return and the $2,500 in passive income). Since Cathy is a limited partner, she does not qualify for the $25,000 offset as she cannot meet the active participation standard. Therefore her losses belong on Form 8582 line 2. The net result is that she can deduct losses only up to passive income reported on the tax return.

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Audit Techniques:

* While reviewing Schedules K-1, also verify that the taxpayer owns at least 10 percent. If not, he or she does not meet the active participation standard, even if he or she is a general partner.

* Particularly on flow through losses from partnership and S-Corporation real estate activities, probe to verify whether or not the taxpayer is making management decisions in a bona fide sense, especially if the activity is located at a significant distance from the taxpayer's residence.

* In addition to pursuing a passive activity loss (PAL) issue, the examiner may want to raise a basis issue. To deduct a loss, the taxpayer must have basis, and the burden of proof is on the taxpayer to provide basis calculations. When figuring allowable losses, the at-risk rules of IRC section 465 are applied before the PAL rules of IRC section 469. On an unagreed report, if both basis and PAL issues have been raised, basis should be the primary position. If the loss is from an S-Corporation, guaranteed loans do not increase basis.

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Vacation Rental Issues

Many vacation rentals, whether a cottage, condominium, or house, have an average period of customer use which is 7 days or less. As a result, the taxpayer **falls**

outside of the definition of a rental, and the $25,000 offset does not apply. **Instead, the far more stringent material participation standard must be met.**

It has been noted that the $25,000 offset is erroneously used when the average period of customer use is 7 days or less and there is a management firm which would make it difficult for the taxpayer to meet the material participation test. The lead sheet on Exhibit 2-3 can be used as a work paper in examining this issue. Also see *Toups v. Commissioner*, T.C. Memo. 1993-359.

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Audit Techniques:

* At the initial interview, secure a statement from the taxpayer on hours worked and activities performed during the year under examination. Scrutinize travel time to ensure that the primary purpose is for business rather than pleasure. Reminder: Hours spent reading reports and otherwise monitoring operations in a nonmanagerial capacity should not be counted as they are investor activities and do not constitute material participation unless the taxpayer is directly involved in day-to-day management or operations.

* When loss disallowances due to IRC section 469 are proposed, some taxpayers have asked that interest and taxes be moved to Schedule A as an itemized deduction. However, under IRC section 469, interest and taxes from a passive activity cannot be treated as an itemized deduction. They must be carried forward to subsequent years until there is passive income from a full disposition of the activity.

* Be sure to verify that the personal use limitations of IRC section 280A do not apply. Inquire whether family or relatives or the taxpayers themselves used it for more than 14 days or 10 percent of the property's rental time. The IRC section 280A limitations (losses are limited to income) apply even if the related parties paid fair rental value (unless it is their main home) OR other individuals are using it rent free. If the personal use limitations apply, IRC section 469 is not applicable. If IRC section 280A applies, an

allocable portion of interest and taxes are deductible as itemized deductions. See the segment in lesson 6 on Rental of Personal Residence.

* If the taxpayer is deducting interest citing IRC section 469(j)(7), verify that the taxpayer has spent more than 14 days or 10 percent of the days rented at the property as required under IRC section 280A. See the audit lead sheet contained in Exhibit 6-4. Most taxpayers check NO on line 2 of Schedule E, indicating they do not qualify under IRC section 280A. Therefore, the interest on the property would be deductible only if it is the taxpayer's principal residence.

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REMINDER: If the taxpayer's narrative summary does not make good common sense, be sure to ask for other documentation or third party verification. The Service does not need to accept at face value uncorroborated testimony if it is questionable, improbable, or unreasonable. *Quock Ting v. United States*, 140 U.S. 417, 420-21 (1891); *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968) *aff'g.* T.C. Memo. 1967-85; *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953), *aff'g.* 10 T.C.M. (CCH) 237 (1951); *Tokarski v. Commissioner*, 87 T.C., 74, 77 (1986).

AUTOMATIC ADJUSTMENTS

Any adjustment to AGI could result in a possible automatic PAL adjustment if the taxpayer is deducting rental real estate losses (and is not a real estate professional who qualifies for relief from the passive loss limitations). The $25,000 offset is phased out at the rate of 50 cents for every dollar that exceeds the taxpayer's modified adjusted gross income (MAGI). Consequently, adjustments of any kind to AGI also impact the $25,000 special allowance.

Modified AGI is simply AGI computed without any passive activity losses or income along with several other generally minor modifications (taxable social security, IRA/SEP deductions, self-employment tax, and rental real estate losses allowed under new IRC section 469(c)(7)). Exhibit 1-3 at the end of Chapter 1 provides a worksheet for the calculation of MAGI. When the taxpayer's modified adjusted gross income exceeds $150,000, none of his or her passive rental real estate losses are allowable (unless he or she has other passive income, of course).

Example 5

Tom Mitchell has the following items of income and losses:

Wages	$125,000
Interest income	5,000
Limited partnership loss	(30,000)
Rental real estate (active participation)	(22,000)

Tom's modified AGI is $130,000 ($125,000 + $5,000). Neither the limited partnership loss nor the rental real estate loss are considered in computing Tom's modified AGI as they are passive activity losses. As a result, the $25,000 offset is reduced as follows:

$25,000 offset	$25,000
Reduction ($30,000 X .5)	15,000
Allowable rental real estate loss	10,000

Since Tom has no passive income, he must carryforward the remaining $12,000 rental real estate loss as well as the $30,000 limited partnership loss.

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Audit Technique:

It is the **$25,000 offset** which is reduced. Consequently, if, for example, a taxpayer had a modified AGI of $110,000, his or her $25,000 offset would be reduced to $20,000. Thus, he or she would be able to deduct rental real estate losses up to $20,000.

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Several audit issues can result from the modified adjusted gross income. First, some taxpayers are simply deducting Schedule E rental real estate losses with adjusted gross incomes well in excess of $100,000. Form 8582 has not been used to limit the losses. This is simply a computational adjustment which an examiner should do whenever noted (unless the taxpayer is a qualifying real estate professional beginning in the 1994 tax year). These issues are most commonly seen on self-prepared returns.

Secondly, any adjustment to a taxpayer's Form 1040 which affects AGI will also affect modified AGI and could produce an automatic statutory passive activity loss adjustment similar to the medical expense adjust ment. For instance, using the example above with Tom Mitchell, should an under reporter transcript (IRP) reveal $6,000 in unreported dividend income, Tom's modified AGI would increase to $136,000 ($130,000 plus $6,000 in unreported dividends), and the examiner would have two adjustments:

Unreported dividends		6,000
Automatic PAL adjustment:		
$25,000 offset	25,000	
Reduction ($36,000 X .5)	18,000	
Allowable rental loss	7,000	
Deducted per return	10,000	
Automatic PAL adjustment		3,000
Total adjustments		9,000

In the above instance, the automatic PAL adjustment could have quickly been computed by multiplying the addition to adjusted gross income (dividends of $6,000) by 50 percent. However, this quick calculation will not yield the correct answer in all circumstances.

The following are some other common adjustments which could also produce an automatic statutory PAL adjustment if they push the taxpayer's AGI over $100,000 and a rental real estate loss has been deducted:

1. Unreported income of any kind
2. Adjustments to Schedule E
3. Any adjustment to a nonpassive Schedule C
4. Any adjustment to Schedule D
5. Constructive dividends from a corporation
6. Flow through adjustments from partnerships and S-Corporations.

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Audit Techniques:

* Many taxpayers with rental real estate losses less than $25,000 are not required to complete Form

8582. However, should audit adjustments push modified AGI over $100,000, an automatic passive loss adjustment could still result.

* Recharacterizing a Schedule C, E, or F loss from passive to nonpassive could also result in an automatic PAL adjustment to any rental real estate activity loss which the taxpayer is claiming if his or her modified AGI exceeds $100,000 after all adjustments.

* If an examiner makes an adjustment to a Schedule E loss which was already limited per return by the PAL rules, obviously no adjustment to modified AGI will result.

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REAL ESTATE PROFESSIONALS

Beginning with the 1994 year, a taxpayer who meets ALL of the following can deduct current rental real estate losses in full regardless of how high his AGI might be:

(Refer to the audit lead sheet contained in Exhibit 2-4 as you review this section.)

1. More than half of the taxpayer's personal services in all businesses must be in real property businesses. A real property business is real property development, construction, acquisition, conversion, rental, management, leasing, or brokerage.

2. The taxpayer must spend more than 750 hours a year in real property trades or businesses.

   NOTE: For time to be counted in either of the above two tests, the taxpayer must materially participate in the activity.

3. The taxpayer must materially participate in **each** rental real estate activity unless he or she has filed an election to group **all** rental real estate activities as one (for purposes of materially participating).

For the first two tests, each spouse's time is taken into account separately. Thus, one spouse alone must satisfy the personal services and 750 hour requirements.

For the third test, both spouses' time together can be counted, but only time applied to the rental real estate activity (and not to the real property business) is counted. It is important to note that even if the taxpayer meets all of the requirements and can deduct current rental real estate losses in full, prior year suspended losses remain passive. Some taxpayers incorrectly thought that meeting the requirements of IRC section 469(c)(7) triggered the deductibility of prior year suspended losses.

It should also be noted that these rules are not elective. Some taxpayers may meet the three tests with the result that their net rental income will be nonpassive and, consequently, the income cannot be used to offset other passive losses, such as limited partnership losses, for example.

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Audit Techniques:

* If Forms W-2 are from activities unrelated to a real property business, it is an indicator the taxpayer may not be able to meet the half personal services test.

* At the initial interview, inquire which spouse performs most of the work with the rental real estate and real property businesses.

* For the 750 hour test, verify that both spouses' time has not been combined. One spouse alone must meet both of the first two tests.

* Verify that the taxpayer is in a real property trade or business. An attorney or an accountant who specializes in real estate, for example, would not be a real property trade or business.

* For the third test, which requires material participation in the rental real estate activities, verify that the taxpayer materially participates in each separate rental real estate activity (unless an election has been filed to aggregate <u>all</u> rental activities as one). For this test, the husband's and wife's time may be combined. See the lead sheet in Exhibit 2-4 for the material participation tests as well as lesson 3 for an explanation of the rules.

* Also verify that the taxpayer has not added his or he time in real property businesses for the third test. The taxpayer **must materially participate** in each rental real estate activity **without adding time from his or her real property businesses**.

* If the taxpayer has filed an election to group his or her rental real estate as **one** activity, verify that he or she has grouped ALL rental real estate activities together. He or she cannot pick and choose only certain activities to group. Furthermore, verify that the taxpayer is not deducting suspended losses based on the sale of one of his or her properties (except to the extent of net gain from the disposition). The regulations indicate that any remaining suspended losses allocable to the disposed property are triggered only on disposition of substantially all of the activity.

* Verify that the taxpayer has not deducted suspended losses -- unless he or she has (1) passive income from his or her rental real estate, (2) passive income from other activities or (3) an entire disposition (or substantially all) of the property. The taxpayer can, however, trigger up to $25,000 in suspended losses each year if he or she continues to meet the active participation standard and his or her AGI is less than $100,000. Remember, however, that rental real estate losses allowable as a result of IRC section 469(c)(7) are an addback to modified AGI. Consequently, modified AGI is increased and the taxpayer may not qualify for the $25,000 offset.

* A number of taxpayers have asked if the relief provisions can be applied retroactively to years prior to 1994. The answer is clearly no.

* Finally, the examiner should always verify that losses being deducted under IRC section 469(c)(7) are true rentals, and not a hotel or some other activity which falls outside the definition of a rental activity as defined in Treas. Reg. section 1.469-1T(e)(3).

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INCOME FROM SELF-RENTED PROPERTY

Up to this point, the lesson has addressed passive *loss* issues. Now we will address a frequently seen *income* issue relating to rental activities.

One of the most common passive activity issues relates to recharacterization (or, stated simply, reclassifying) passive income from rental activities. Under Treas. Reg. section 1.469-2T(f)(6), if a taxpayer rents real property or equipment to a trade or business activity (whether in the form of a partnership, S-Corporation, trust, etc.) in which he or she materially participates, net rental income from the property is treated as nonpassive income. While it is still reportable on Schedule E, it should not be entered on Form 8582 (thereby allowing passive losses). NOTE: This rule does not apply if there was a written binding contract entered into before February 19, 1988. See the audit lead sheet contained in Exhibit 2-5.

Over the years, it has been common tax practice for shareholders in closely held corporations to personally own the building (and sometimes equipment and vehicles as well) and rent it to their corporation. The temporary regulations did not include activities conducted through C-Corporations; therefore, the recharacterization of income rule did not apply to regular C-Corporations until 1992.

With the sunset of the temporary activity regulations, this is no longer true. For taxpayers with taxable years ending after May 10, 1992, net rental income from rental to a C-Corporation in which the taxpayer materially participates is recharacterized as nonpassive. Consequently, beginning in 1993, a shareholder renting a building to a corporation in which he or she materially participates must report net income on Schedule E, BUT cannot use it to offset other passive activities. In other words, it should not be entered on Form 8582.

Since the regulations allow the taxpayer whose tax year includes May 11, 1992, an option of utilizing *either* the temporary or the final activity regulations, it will be difficult to pursue audit adjustments relative to the recharacterization of income issue pertaining to rentals to C-Corporations until the 1993 tax year. See the audit lead sheet on recharacterization of income contained in Exhibit 2-5.

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Audit Techniques:

* Schedule E rental activities with few expenses and significant net income could be indicative of a self-rented situation. If the income is reflected on Form 8582 line 1, be sure to ask the taxpayer who the property is rented to AND if he or she materially participates in the entity.

* Be sure to request any leases and verify when it was executed.

* On any closely held corporate examination, when reviewing the shareholder's return, look for evidence of self-rented property and check whether net rental income has been reflected on Form 8582 line 1.

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ISSUE IDENTIFICATION

Returns which reflect or suggest the following may have potential passive activity loss issues:

- Schedules C with losses whose activities are "equipment," "leasing," "computers," etc. Watch for PIA codes 7773, 7922, and 8813 which indicate a rental or leasing activity.

- Rental real estate losses in excess of $25,000 and no Form 8582 attached to the return. (Even a qualifying real estate professional for the 1994 year would generally be expected to have Form 8582 as Code section 469(c)(7) does not trigger suspended losses.)

- AGI exceeds $100,000, rental real estate losses are deducted and no Form 8582 is attached to the return.

- Rentals on Schedule E where there are few expenses (other than interest, taxes and depreciation), suggesting a possible net lease.

- Forms 8582 with large flow through losses in Part I for "Rental Real Estate with Active Participation."

- Forms 8582 where line 6 for modified AGI is the same as regular AGI per return.

SUMMARY

1. There are six exceptions to the definition of a rental, and if the activity falls into any one of the exceptions, the taxpayer must meet the material participation standard for that activity.

2. Long-term equipment rentals, whether on Schedule C or E, generally cannot be deducted unless the taxpayer has reported other passive income on the return.

3. A $25,000 offset has been allowed for taxpayers who actively participate in rental real estate activities. However, the active participation standard generally cannot be met by the following: limited partners, taxpayers who own less than 10 percent, rentals under a net lease, and losses from trusts.

4. Examiners should be particularly alert to limited partners who may erroneously deduct losses on line 1 of Form 8582, thereby allowing themselves the $25,000 offset.

5. Short-term vacation rentals are generally subject to the more stringent material participation rules. If there is a management firm or on-site manager, it could be difficult for the taxpayer to meet the material participation test.

6. Any audit adjustment which affects adjusted gross income (AGI) also affects modified AGI and can result in an automatic PAL adjustment.

7. Effective for 1994, taxpayers who spend most of their time in real property trades or businesses may deduct rental real estate losses without limit if they materially participate in each rental real estate activity.

8. Income from property rented to a partnership, S-Corporation or C-Corporation in which the taxpayer materially participates is recharacterized as nonpassive (unless there is a written binding lease executed prior to February 19, 1988.)

9. Passive activity loss adjustments for rentals can be relatively easily noted and classified. Classifiers may want to enclose the appropriate lead sheet in the case file.

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EQUIPMENT RENTALS

ISSUE: Schedule C/E for ___________________________________

Are losses limited as activity is passive?

(Generally, long-term equipment rentals are passive, and losses are not deductible unless taxpayer has passive income from another activity. Short-term rentals must meet material participation to deduct losses.)

AUDIT PROCEDURE:

_____ What is the average period of customer use? Days rented divided by number of customers for the year.

If the average period of customer use is more than 7 days, activity is probably a true equipment rental as defined by IRC section 469 and Treas. Reg. section 1.469-1T(e)(3)(I), and losses are allowable only up to passive income from other activities. (If customer use is less than 7 days, taxpayer is subject to the material participation rules. Under these rules, if taxpayer works more than 500 hours or does substantially all of the work, losses are allowable in full. See material participation workpaper for additional detail.)

LAW: Long-term rentals are passive, and losses are limited to passive income reported on the return. Exceptions to the definition of a rental activity per Treas. Reg. section 1.469-1T(e)(3)(ii), such as short-term rentals of 7 days or less, are subject to the material participation rules. Equipment rentals of any kind do not qualify for the $25,000 offset (that is, they should be reported on line 2 of Form 8582, never line 1). In summary, if the equipment rental activity does not fall into any of the exceptions of Treas. Reg. section 1.469-1T(e)(3)(ii), losses are disallowed in full unless there is passive income.

NOTE: The taxpayer may provide the examiner with lots of documentation (leases, notes, prospectus, etc.). Nevertheless, long-term equipment rentals under IRC section 469 are passive, and losses are not deductible unless the taxpayer has other passive income reported on the return.

Under the 1.469-4 final activity regulations issued October 1994, a taxpayer generally cannot group rental activities with a trade or business. However, if he or she owns the equipment rental activity in the same proportionate ownership as the business activity AND they form an appropriate economic unit, equipment rental losses could be deductible under IRC section 469. However, even if this exception to the passive loss provisions allows deductibility, if the equipment or personal property losses are from a rental to a C- or S-Corporation, examiner should consider whether losses should be disallowed as they are a corporate expense (unless there is a specific corporate resolution requiring the taxpayer to pay the expenses out of his or her salary). See Rev. Rul. 57-202; *Roach v. Commissioner*, 20 BTA 919 (1930); *J.S. King*, 40 T.C. Memo 1980-373; *G.P. Dietrick*, CA-6, 89-2 U.S.T.C. 9469 (6th Cir. 1989) ; *E.F. Grossman v. Commissioner*, 33 T.C.M. 1213, T.C. Memo 1974-269. REMINDER: It has been repeatedly held that the statute does not permit the deduction by one taxpayer of the expenses of a separate and distinct taxpayer. *Deputy v. Dupont*, 308 U.S. 488 (1940) enunciated the general principle that expenses of a corporation paid by a shareholder are not ordinary and necessary, but instead are expenses of the corporation. Similar rules also apply to partnerships.

If equipment falls into the short-term rental category and taxpayer meets the material participation test, be sure to verify the depreciable basis of assets via review of invoices and/or canceled checks before allowing the loss. If the activity appears to have elements of personal pleasure or other indications of a possible hobby loss, be sure to raise IRC section 183. If flow through losses from a partnership or other entity are for equipment which appears to be an abusive tax shelter, basis and at-risk under IRC section 465 should be considered as well.

If the equipment rental activity reflects net income, it is subject to self-employment tax. IRC section 1402(a)(2) excepts real estate, but not bare lease equipment rentals from SE tax. See *Carl Stevenson v. Commissioner*, T.C. Memo, 1989-357. Furthermore, if equipment is rented to an activity in which the taxpayer materially participates, it is recharacterized as nonpassive and does not belong on Form 8582. See Treas. Reg. section 1.469-1T(e)(3)(F)(vii).

CONCLUSION: Under IRC section 469, Schedules C/E equipment losses are/are not allowed.

Exhibit 2-2

RENTALS AND ACTIVE PARTICIPATION

NAME OF ACTIVITY: ____

ISSUE: Active Participation under IRC section 469

NOTE: Beginning in 1994, the rules below do not apply if the taxpayer is a real estate professional who spends more than half his or her personal services in real property businesses AND more than 750 hours a year AND materially participates in his or her rental real estate activities.

_____ Are rental real estate losses limited to $25,000 or up to passive income from another passive activity?

If not, limit losses to $25,000, and continue on to verify active participation.
If yes, continue on to verify active participation.

_____ Is taxpayer a limited partner (who is not also a general partner)? (Schedule K-1)
EXCEPTION: Low income housing.

_____ Does taxpayer own less than 10 percent? (Schedule K-1)

_____ Are flow-through losses from a trust ? (Schedule K-1)
Conference Report, H. R. Rep. 99-841, 99th Cong., 2d Sess., pg, II-141.
EXCEPTION: Grantor trusts.

_____ Are losses from an activity other than real estate?
(Equipment, computers, boats, vehicles, etc.)

_____ Are losses from a net lease? (Lessee/tenant pays most expenses.)

If any one of above five questions is answered YES, taxpayer does not qualify for $25,000 offset and loss should be moved to Line 2 of Form 8582 and recomputed. In effect, the loss will be disallowed (unless there is passive income from another activity reported on the tax return).

If all answers above are NO, verify taxpayer is actively participating (making management decisions regarding tenants, terms, major repairs, etc.) via taxpayer statement or oral testimony.

If modified AGI (AGI per return plus PAL and several other minor items) exceeds $100,000, verify that $25,000 offset has been reduced by 50 cents for every dollar over $100,000.

If average period of customer use is 7 days or less, activity does not meet the definition of a rental and the more stringent material participation test must be met. With a management firm, it could be difficult to qualify for material participation. Refer to lead sheet on vacation rentals.

CONCLUSION: Taxpayer is/is not actively participating.
Ref.: IRC section 469(I)(8); Treas. Reg. section 1.469-1T(e)(3), S. Rep. 313.

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VACATION RENTALS/CONDOS AND PASSIVE LOSS RULES

ISSUE: Schedule C/E for ____________________________________
should activity be treated as a rental qualifying for the $25,000 offset, OR should it be treated as a business in which the taxpayer is required to materially participate (work on a regular, continuous, and substantial basis)?

If taxpayer is deducting losses from a vacation rental or condo on Schedule E, Schedule C, or line 1 of Form 8582, thereby giving himself or herself the benefit of the $25,000 offset, ask:

_____ Are the deductions limited under IRC section 280A(c)(5)?
In other words, did taxpayer or related parties spend more than 14 days or 10 percent of days rented at FRV? If so, IRC section 469 does not apply. (IRC section 469(j)(10)). Pursue disallowance under IRC section 280A which generally limits losses to income from the activity.

If IRC section 280A does not apply, pursue passive loss issue:

_____ What is the average rental period?

LAW: The activity is not deemed a rental and does not qualify for the $25,000 offset if:

-- The average period of customer use is 7 days or less OR
-- The average period of customer use is 30 days or less and significant personal services are provided (such as maid service, cleaning services, etc.)

If none of the above apply, taxpayer may qualify for the $25,000 offset if he or she actively participates in the rental real estate activity. If any of the above exceptions apply, the activity falls out of rental category, and taxpayer must meet the more stringent material participation standard. See *Toups v. Commissioner*, T. C. Memo 1993-359.

QUESTIONS to ask if rental period requirement is not met, and taxpayer must meet the material participation requirement:

______ Is there a management service?

______ How many hours a month does taxpayer spend working on the activity?
The initial interview is the best time to secure an unbiased statement from the taxpayer of hours and types of participation performed. Once the taxpayer realizes that losses may be nondeductible or that certain participation does not count (see Chapter 3), hours spent may be overstated and types of participation may change. It is not well settled whether or not travel time should ever count. In cases in which satisfaction of the hourly tests of Temp. Treas. Reg. 1.469-5T(a) turns on travel time, the examiner should consult with the Office of Chief Counsel.

NOTE: If there is a management firm, it could be difficult for the taxpayer to meet the material participation standard. However, if taxpayer meets any one of the following, he or she is deemed to be materially participating and can deduct losses in full:

_____ Does taxpayer and/or spouse work more than 500 hours a year on activities related to the vacation rental? Reading reports and otherwise monitoring the condo in a nonmanagerial capacity does not constitute participation.

_____ Does taxpayer perform substantially all the work?
If there is a management firm, the answer to this question is no. If taxpayer is managing the property himself or herself, his or her losses would be deductible.

____ Does taxpayer put in at least 100 hours and no one else puts in more hours?
If there is a management firm, it would be difficult for taxpayer to meet this standard. See Treas. Reg. section 1.469-5T(f)(2)(ii). If taxpayer is not involved in "day-to-day management or operations," certain activities are disregarded when counting hours for material participation. The following activities would not constitute material participation: studying financial reports, preparing analysis for taxpayer's own use, and monitoring finances or operations in a nonmanagerial capacity. Periodic consultation is not sufficient to meet material participation standard. Telephone calls should be closely reviewed to ascertain whether or not taxpayer is simply monitoring operations, and telephone bills should be reviewed to verify hours claimed.

____ Does taxpayer have several passive trade or business activities with losses in which he or she participates 100-500 hours, and the total participation in these activities exceeds 500 hours?

____ Did taxpayer materially participate for any 5 out of 10 preceding years?

____ Do facts and circumstances indicate taxpayer is materially participating? This test does not apply unless taxpayer worked more than 100 hours a year. Furthermore, it does not apply if (1) any person received compensation for managing the activity or (2) if any person spent more hours than taxpayer managing the activity.

NOTE: If taxpayer's statements or narrative summary appears to be self-serving or questionable, be sure to request supporting documents, telephone records, or third party verification. We need not accept at face value uncorroborated testimony if it is questionable, improbable, or unreasonable. *Quock Ting v. United States*, 140 U.S. 417, 420-21 (1891); *Fleischer v. Commissioner*, 403 F.2d 403 (2d Cir. 1968), affg. T.C. Memo 1967-85; *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953); *Tokarski v. Commissioner,* 87 T.C. 74, 77 (1986).

CONCLUSION: Vacation rental or condo does/does not meet the definition of a rental per Treas. Reg. section 1.469-1T(e)(3)(ii) and taxpayer does/does not meet the material participation standard per Treas. Reg. section 1.469-5T. If activity is not rental and taxpayer is not materially participating, loss is disallowed unless taxpayer has other passive income reported on the return. See *Toups v. Commissioner*, T.C. Memo 1993-359.

ADJUSTMENT: If vacation rental/condo is not a "rental" activity and taxpayer does not materially participate, income/loss should be moved from Form 8582, line 1 to line 2. The adjustment is the difference between line 11 of Form 8582 per return and the corrected Form 8582. If the taxpayer did not complete Form 8582 and there is no other passive income on the return, the loss is simply disallowed in full.

If vacation rental/condo is not a "rental" activity and taxpayer materially participates in activity, remove income/loss from Form 8582. It would be reportable on Schedule E but not on Form 8582.

If vacation rental/condo is subject to limitation of IRC section 280(A)(c)(5), remove income/loss from Form 8582.

If taxpayer does not actively participate in vacation rental/condo, income/loss should be moved from Form 8582, line 1 to line 2.

RELIEF PROVISIONS FOR REAL ESTATE PROFESSIONALS

RENTAL REAL ESTATE AND NEW SECTION 469(c)(7)

Impacts: Rental real estate activities

Effective: Jan. 1, 1994 and subsequent years. Does not apply to 1993 and prior years.

LAW: Rental real estate losses are generally limited to $25,000 if taxpayer actively participates (making management decisions -- IRC section 469(I)).
However, under new IRC section 469(c)(7), if taxpayer spends most of his or her time in real property trades or businesses, meeting the ½ personal services and 750 hour tests, rental real estate losses are no long per se passive. If he or she materially participates in each rental real estate activity, current year losses are fully deductible. If not, losses are deductible only up to $25,000 if active.

Carryover losses from prior years are **not** triggered by new IRC section 469(c)(7). They should continue to be entered on Form 8582 line 1c until the taxpayer has income from the rental real estate, passive income from other activities or there is an entire disposition of the activity.
Carryforward losses as result of IRC section 469(c)(7) are treated as from a former passive activity.

______ Verify that taxpayer OR spouse meets BOTH of the following tests.

At the initial interview, inquire which spouse performs most of the work with the real property businesses and/or the rental real estate activities. At least one spouse alone must satisfy the following two tests.

FIRST TEST: Are half of personal services in ALL trades or businesses (T/B) for the year performed in real property T/B?
Forms W-2 attached to return and occupation will provide some indication as to whether taxpayer OR spouse may meet this test. If Forms W-2 for both husband and wife are from activities unrelated to real property businesses, it is a strong indication that neither can qualify for the ½ personal services test.

-- Real property T/B = real property development, construction, acquisition, conversion, rental operation, management, leasing or brokerage.

-- For time to be counted, taxpayer must materially participate in the real property T/B. Material participation is meeting any one of seven tests in 1.469-5T. The two most common are (1) does taxpayer spend 500 hours a year in the business or (2) does he or she perform substantially all of the work?
NOTE: For purposes of this test, each rental real estate activity is treated like a trade or business subject to material participation.

-- Time spent as an employee in real property activities in counted only if he or she is more than a 5-percent owner.

-- In counting time for this test as well as the 750 hour test, <u>each</u> spouse's personal services are taken into account <u>separately</u>. Thus one spouse must satisfy the requirement for half of his or her personal services in a real property T/B and the 750 hour test.

SECOND TEST: Does taxpayer spend more than 750 hours in real property T/B in which he or she materially participates?

_____ If answer is **NO** to either of above two tests, new 469(c)(7) does not apply to taxpayer's rental real estate activities, and losses are limited to $25,000 plus passive income if taxpayer actively participates.

_____ If answer is **YES** to both tests, apply material participation tests to EACH rental real estate activity to determine whether each activity is passive or nonpassive. In other words, each rental real estate activity will be treated like a trade or business subject to material participation to determine whether losses are or are not deductible. The following are the seven material participation tests in 1.469-5T:

_____ Does taxpayer and/or spouse spend more than 500 hours a year involved in the activity?
_____ Does taxpayer perform substantially all of the participation in the activity?
_____ Does taxpayer put in more than 100 hours and no one puts in more hours?
_____ Does taxpayer participate between 100-500 hours in each of several otherwise passive activities, and does the total participation exceed 500 hours?
_____ Did taxpayer materially participate in a personal service activity for any 3 prior taxable years?
_____ Do facts and circumstances indicate taxpayer is materially participating? This test does not apply unless taxpayer worked more than 100 hours a year. Furthermore, it does not apply if any person received compensation for managing the activity OR if any person spent more hours than the taxpayer managing the activity.

NOTES:

1. Taxpayer may not group rental real estate with any business activity to meet material participation for purpose of this test. Furthermore, he must materially participate in each separate rental real estate activity unless he makes the election discussed below to group all his rental real estate interests into a single activity.

2. Each rental real estate interest must be treated as a separate activity - unless the taxpayer has elected to treat ALL his rental real estate interests as ONE activity by filing a statement with an *original* return. If all rental real estate activities are treated as one, it will be easier to meet the 500 hour material participation test. However, if taxpayer makes this election and subsequently disposes of a property, suspended losses will be triggered only up to the net gain on disposition.

CONCLUSION:

1. Per 469(c)(7), the following rental real estate activities have been determined to be nonpassive and current (but not carryover) losses are fully deductible:
   ____ Enter current losses on Sch. E but not on Form 8582.

2. Taxpayer did not materially participate in the following real estate activities, but does actively participate (making management decisions): ___________________________
   Enter losses on Form 8582, line 1b. NOTE: The $25,000 offset is not reduced by losses allowable under section 469(c)(7).

3. Taxpayer does not actively participate in the following rental real estate activities:
   ______________________________ Enter losses on Form 8582, line 1c.

IMPORTANT NOTE: While this Check sheet primarily addresses losses, under section 469(c)(7), both income and losses could be recharacterized as nonpassive.

Exhibit 2-5

SELF-RENTED PROPERTY
INCOME RECHARACTERIZATION: SECTION 469

ISSUE: Should Schedule E net rental income for Property _____ be recharacterized as nonpassive (Treas. Reg. section 1.469-2(f)(6))? In other words, should income be removed from Form 8582, Passive Activity Loss Limitations, thereby reducing allowable passive activity losses?

NOTE: If Sch. E property reflects net income and appears to be under a net lease (interest, taxes and depreciation deducted with few other expenses) it is indicative of a possible self-rental situation.

AUDIT PROCEDURE:

_____ Did the taxpayer materially participate in the business which rented the building (or equipment) from the taxpayer individually?

For partnerships and S-Corporations, this can easily be determined by reviewing the income/losses on the reverse side of Schedule E. If they are in the nonpassive income/loss column, the taxpayer is indicating that he or she materially participated in the partnership or S-Corporation. For regular C-Corporations, check to see if taxpayer received a W-2 from the corporation which could indicate regular, continuous, and substantial participation in the corporation and ask the taxpayer how much time he or she spends on corporate activities.

Material participation is defined as regular, continuous, and substantial participation in a business activity. IRC section 469(h), Treas. Reg. section 1.469-5T.

The recharacterization of income rules did not apply to rentals to regular C-Corporations for years prior to 1992. However, with the sunset of the Treas. Reg. section 1.469-4T temporary activity rules (May 11, 1992), net income from rentals to C-Corporations can be reclassified as nonpassive (resulting in a corresponding disallowance of passive losses).

_____ Is there a written, binding contract (lease) executed prior to February 19, 1988?

If there is a lease, be sure to request it immediately to verify the date.

If the answer to the first question is YES and the answer to the second question is NO, income should be recharacterized as nonpassive.

In other words, income is still reportable on Schedule E, BUT cannot be entered as passive income on line 1 of Form 8582, passive activity loss limitation. For every dollar of income removed from Form 8582, allowable passive losses are reduced a dollar. REMINDER: Passive losses are deductible only up to passive income reported on the return PLUS $25,000 in rental real estate losses, if the taxpayer actively participates.

LAW: Under Treas. Reg. section 1.469-2T(f)(6), if a taxpayer rents property to a business in which he or she materially participates, net rental income (but not losses) is treated as nonpassive. Stated differently, rental income from essentially self-rented property cannot be used to trigger allowance of passive losses on Form 8582. This rule does not apply if there is a written binding contracted entered into before February 19, 1988.

CONCLUSION: Passive losses in the amount of _________ have/have not (circle one) been adjusted due to income recharacterized as nonpassive.

NOTE: The rules above are only one of the recharacterization of income provisions. There are also rules treating income from rental of nondepreciable property, rentals incidental to a development activity and several other scenarios as nonpassive. See Treas. Reg. section 1.469-2T(f).

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Chapter 3

MATERIAL PARTICIPATION

INTRODUCTION

To deduct losses in full from a trade or business, the taxpayer must materially participate on a regular, continuous, and substantial basis. Both losses and income from businesses in which the taxpayer materially participates are treated as nonpassive and are fully deductible (presuming the taxpayer has basis). The material participation rules apply to Schedules C and F as well as flow through losses and income from partnerships, S-Corporations and trusts. It is important to note that nonpassive income cannot be used to offset passive losses. Therefore, it is essential to determine if income and losses are classified properly on a given return.

The rules discussed in this lesson are applied at the 1040 level for individuals involved in partnerships and S-Corporations.

RULES OF TIME

The taxpayer is required to identify the amount of participation in a trade or business activity for each year. The type and quantity of time documented determines whether an activity should be treated as passive or nonpassive.

Material participation is a year-by-year determination. Consequently, it is conceivable that the taxpayer could be passive in one year and nonpassive (in other words, materially participating) in the subsequent year.

General Rule

Material participation requires the taxpayer to participate in the operations of an activity on a regular, continuous, and substantial basis. As a result, it could be difficult for taxpayers to meet the material participation standard in out-of-state partnerships, S-Corporations, trusts and joint ventures. In addition, the examiner should be alert to in-state entities where income is classified as passive. The taxpayer may materially participate, and the income should not be used to offset passive losses.

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Audit Techniques:

* On pre-audit of individual returns, watch for out-of-state employer identification numbers (EIN) on flow through losses deducted in full in the nonpassive loss column on Schedule E. Also watch for Schedules C and F with out-of-state EINs and wages or labor indicating an on-site manager. Some of the most productive PAL issues relate to losses which are never entered on Form 8582.

* For activities with passive income, be sure to probe for material participation. If the taxpayer materially participates, income is nonpassive and cannot be used to trigger passive losses. Prepare initial interview questions focusing on the taxpayer's time and participation in an activity. Exhibit 3-1 contains questions which could be used to address this issue.

* A 3-year comparative analysis of passive and nonpassive activities will sometimes highlight inconsistencies, both for passive income and passive loss issues.

* The same rationale above applies to pre-auditing Forms 1120-S and 1065. Watch for investors with out-of-state EINs as well as small percentages of ownership, both of which could indicate a lack of material participation. Be alert to in-state EI numbers with passive income reported. Inspect investor returns. Losses cannot be deducted unless the taxpayer is materially participating or unless he or she has passive income.

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Quantitative Time Tests

Treas. Reg. section 1.469-5T(a) provides seven different ways in which a taxpayer will be treated as materially participating in a trade or business for any given year. If the taxpayer meets any one of the seven tests, he or she is deemed to be materially participating in the activity. Consequently, he or she can deduct losses in full. On the other hand, if he or she does not materially participate, losses are not deductible unless he or she has passive income from another activity. Exhibit 3-5 provides a flowchart for the seven tests.

It is also important to remember that material participation applies to **income** as well. If the taxpayer works in a business on a regular, continuous, and substantial basis, net income cannot be used to offset passive losses and never belongs on Form 8582. Income issues will be addressed further in Chapter 4.

Although there are seven tests for material participation in Treas. Reg. section 1.469-5T, the first two are the most commonly seen. It is important to understand these quantitative tests before the documentation requirements are addressed. The lead sheet in Exhibit 3-2 can be used by the examiner as a work paper.

More Than 500 Hours

If the taxpayer participates more than 500 hours during the year, income or loss from the activity will be treated as nonpassive. This **numerical** test could be met by participating one day a week or one week a month in an activity. Participation of both spouses is counted, but not participation of the children.

Keep in mind the Code requires that the participation be **regular**, **continuous**, **and substantial**. When auditing the taxpayer and not the return, an examiner can determine whether the quantity of time documented is reasonable in light of other obligations. For example, it would be difficult for a surgeon who is on call to materially participate in an activity operating in an out-of-town location.

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Audit Techniques:

* Large W-2 wages from an employer could indicate that the taxpayer might have difficulty applying 500 hours to another activity, particularly if it is located a significant distance from his or her personal residence.

* The initial interview is the best time to attempt to secure a statement or list from the taxpayer of

hours and types of participation performed. Once the taxpayer realizes that his or her losses may be nondeductible or that certain participation (discussed later in the Chapter) does not count, hours spent may be overstated, and the types of activities may change.

* If the taxpayer who purports to spend significant hours on the phone, be sure to secure telephone bills, asking the taxpayer to highlight calls. Reminder: All or some of the time may constitute "investor activities" (such as monitoring an activity in a nonmanagerial capacity) which are not counted in the material participation test. Investor activities are addressed later in the chapter.

* On S-Corporation and partnership examinations, ask questions at the initial interview regarding the time and effort applied by each investor. On the tour of the business, be aware of which investors appear to be genuinely involved in its activities.

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Substantially All Participation

If the taxpayer's participation is substantially all the participation in that activity, the income or loss will be treated as nonpassive. An employee or a non-owner could cause the taxpayer to fail this test. There are no quantifying hours with this standard and the term "substantially" is not defined, but the following example will illustrate this standard.

Example 1

The taxpayer runs an appliance repair service out of his home and has no employees. The taxpayer has a W-2 wage job during the week, but works 2 days a month in the appliance business. Although the time spent in the appliance business does not exceed 500 hours, all the work performed in that activity is performed by the taxpayer since there are no employees.

100-500 Hours and More Than Anyone Else

If a taxpayer participates in an activity for more than 100 hours, but not more than 500 hours, and no other individual participates more than the taxpayer (including any employee of the activity), income or losses from the activity would be treated as nonpassive.

Example 2

Assume the same facts as Example 1. In addition, the taxpayer has an employee who makes deliveries one day a month. The time spent in the activity is more than 100 hours and does not exceed 500 hours. If the taxpayer spends more time than the employee, the activity would be treated as nonpassive.

Example 3

Assume the same facts as above except that the employee works every Saturday making basic repairs. The taxpayer's participation would remain more than 100 hours and not more than 500 hours. However, since the taxpayer's participation does not exceed that of the employee, the activity would be treated as passive unless one of the other tests for material participation is met.

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Audit Techniques:

* Particularly on Schedules C and F, be alert to employees who are managing the business, indicating that the taxpayer deducting losses may not be materially participating.

* When reviewing taxpayer's hours, watch for "investor" activities defined in Treas. Reg. 1.469-5T(f)(2): reviewing financial statements, preparing an analysis for the taxpayer's own use, and monitoring the activity in a nonmanagerial capacity. The hours for these types of activities do not count (unless the taxpayer is involved in day-to-day management or operations).

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Significant Participation Activity (SPA)

A **Significant Participation Activity** (SPA) is a business in which the taxpayer spends more than 100 hours, but not more than 500 hours. (A rental activity cannot be included in the Significant Participation Test.)

Refer to Exhibit 3-3 at the end of this lesson for a lead sheet which can be used as a work paper in addressing SPA issues.

If the sum of all the time spent in SPAs exceeds 500 hours, all the SPAs will be treated as nonpassive. In other words, the taxpayer can deduct losses in full.

Example 4

The taxpayer has the following activities:

Activity A	220 hours	$4,000 loss
Activity B	250 hours	$6,500 loss
Activity C	220 hours	$6,000 income
	-----	
	690 hours	

The taxpayer has treated all these activities as nonpassive on the return and deducted a net Schedule C loss of $4,500. In Activities A and C, the taxpayer has a part-time employee who does not participate more than the taxpayer. In Activity B, the taxpayer has a full time employee who runs the business during the day.

Based on these facts, Activity A and C would be considered nonpassive since the taxpayer materially participates under Treas. Reg. section 1.469-5T(a)(3). Accordingly, the taxpayer would have net nonpassive income of $2,000 and a passive loss of $6,500 that would need to be limited on Form 8582.

If the taxpayer has more than one SPA, but the aggregate hours participating in all SPAs is not more than 500, he or she is not a material participant in any of the SPAs.

Computation of Overall Gain or Loss on SPAs

The first step in determining the proper treatment of the gains or losses from significant participation activities is to compute the current gain or loss for each activity without considering any prior years' unallowed losses. For any activity with a current gain, prior years' losses will then reduce that gain.

The second step is to combine the results above to determine the overall net gain or loss from the significant participation activities.

Using our example 4 above, we can apply the above rules to determine overall net gain or loss from the activities. The three activities had the following income and expenses for the year.

	A	B	C
Current Gross Income	900	700	900
Current Deductions	(200)	(1000)	(300)
Current Gain (Loss)	700	(300)	600
Prior Years' Unallowed Loss	(300)		
Net Gain (Loss)	400	(300)	600

By using the third step of combining the results of all the SPAs, we get an overall gain of $700 (400 - 300 + 600). This overall gain of $700 is <u>recharacterized</u> as nonpassive. To do this, a <u>ratable</u> share of the gains from activities X and Z will be recharacterized as nonpassive.

Since the taxpayer did not meet the 500 hour test, if the overall results from the SPA was a loss, no recharacterization would be done and all of the activities would be treated as though they were passive.

The net effect of this different treatment of overall gains and losses is not popular with taxpayers because, in either case, the Government appears to win. In this situation where the taxpayer does not meet the 500 hour test, **overall gains are nonpassive and cannot be offset by passive losses. Overall losses are passive and cannot be used to offset nonpassive or income.**

Practical Note: Publication 925 contains worksheets which can be used in computing SPA income and losses.

The regulations do not currently explain the effect of prior years' unallowed losses on the recharacterization rules. The only guidance available can be found in Publication 925. An example where time spent in a SPA does not exceed 500 hours is contained in Treas. Reg. 1.469-2T(f)(2)(iii) Example (I).

See Exhibit 3-6 for a flow chart on Significant Participation Activities.

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<u>Audit Techniques</u>

* Be alert for taxpayers who have more than one business activity reporting passive income, especially if it appears that gains from these activities are being used to offset rental losses. If this is noted, verify the taxpayer's participation in these business activities. Possibly, grouping the hours may result in more than 500 hours with the result that the gains will be treated as nonpassive income.

* If taxpayers are using test 4 of the material participation tests to treat several SPAs as nonpassive, check to be sure that each individual SPA has participation of more than 100 hours (those which are less are automatically passive). Also verify that the taxpayer's allocation of hours is accurate and credible. Sometimes if the participation in just one activity is reduced, the hours claimed fall below 500 and the taxpayer will fail the SPA test.

* If a taxpayer argues that losses have been aggregated to meet the significant participation test, verify that the taxpayer is not including an activity in which he or she is performing substantially all of the work (thus otherwise materially participating). To meet the significant participation standard, the losses must be from a **passive** activity. Should a taxpayer have passive **income** from a SPA, it is recharacterized as nonpassive.

* Also verify that the taxpayer has not included a rental activity or investment or portfolio activity. A SPA is a passive <u>business</u> activity.

* Watch for returns where the taxpayer has many business (nonrental) entities or activities that may give the appearance of involving the taxpayer

only part-time. If these are reported as passive and have an overall gain which is being used to offset rental losses, consider whether the SPA rules might apply.

===

Any 5 of 10 Past Years

Treas. Reg. section 1.469-5T(a)(5) treats an activity as nonpassive if the taxpayer would have been treated as materially participating in any 5 of the past 10 years (whether or not consecutive). In other words the taxpayer can deduct his or her losses in full if he or she meets this test. However, the taxpayer has the burden of proof regarding material participation in past years including closed statute years. This is without regard to whether the rules under IRC section 469 have been in effect for the past 10 years. **REMINDER:** If a taxpayer materially participated any 5 of the prior 10 years, *income* is nonpassive and cannot be used on Form 8582 to trigger other passive losses. Income issues are more commonly noted with this test (and the next one as well) than with loss issues.

Any 3 Years in Personal Service Activity

If a taxpayer materially participated for any 3 years in a personal service activity (whether or not consecutive), the current year income or loss will be treated as nonpassive. See Treas. Reg. section 1.469-5T(a)(6).

A personal service activity is any activity involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other field in which capital is not a material income producing factor. See Treas. Reg. section 1.469-5T(d).

Example 7

A taxpayer has retained a 10 percent interest in a medical practice, but no longer participates in the operations. In prior years, this was the taxpayer's primary source of income. In the current year the taxpayer is reflecting net passive income of $12,000 from this activity. Is the $12,000 properly characterized as passive income?

Based on Treas. Reg. section 1.469-5T(a)(6), because the taxpayer materially participated in at least 3 prior years he or she is treated as materially participating in the current year. Therefore, the activity income would be treated as nonpassive.

===

Audit Technique:

* Because of these last two tests, taxpayers are less likely to meet the significant participation standard. If the taxpayer is treated as materially participating in an activity due to the level of participation in prior years, that activity cannot be aggregated and considered for the SPA.

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Facts and Circumstances

The facts and circumstances test may apply if none of the other tests are met. This test does not apply unless the taxpayer worked more than 100 hours a year. Furthermore, the taxpayer's time spent managing will not count if: (1) any person received compensation for managing the activity; and (2) if any person spent more hours than the taxpayer managing the activity.

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Audit Technique:

* Taxpayers will frequently argue the facts and circumstances test when they fail the others. However, due to the stringent limitations, few taxpayers can meet the facts and circumstances standard.

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LIMITED PARTNERS

Limited partners are generally passive because they are subject to a more restrictive standard for material participation. A taxpayer's interest in a limited partnership will be considered nonpassive if the taxpayer qualifies under the following material participation tests: more than 500 hours or the look-back tests (5 of 10 years or any past 3 years in personal service activity). See Treas. Reg. section 1.469-5T(e)(2). If a limited partner also has a general partnership interest in the same partnership all year, he or she may use any one of the seven tests to qualify for material participation. Additional guidance on limited partners is provided in Chapter 5, Entity Issues.

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Audit Techniques:

* The examiner should review Schedule K-1 on flowthrough losses before beginning to address the seven material participation tests. If the taxpayer is a limited partner, the examiner should review the partner's Schedule E. If losses have been entered as nonpassive, passive loss issue should be pursued.

* A 3-year comparative of passive and nonpassive losses using current, prior and subsequent years will sometimes highlight inconsistencies.

* It is critical that the examiner consider what is reasonable when applying these rules. The taxpayer's total time commitments should be considered. Consider the taxpayer's W-2 job, the commute, the travel and out-of-town requirements, in addition to personal commitments to children or other special circumstances.

* Review the K-1 contained in Exhibit 1-2 (from Chapter 1) for audit assistance with Schedules K-1. A small ownership percentage or an out-of-state address is an indicator that the taxpayer might not be materially participating.

* When examining a partnership or S-Corporation, the examiner should always question the level of participation of **each** investor.

  The Committee Reports state that "the presumption that a limited partnership interest is passive applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement."

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RETIRED OR DISABLED FARMER AND SURVIVING SPOUSE OF FARMER

If a farmer is retired or disabled, he or she is treated as materially participating if he or she materially participated 5 of the 8 years before the retirement or disability. A surviving spouse of a farmer is treated as materially participating in a farming activity if the real property used in the activity meets the estate tax rules for special valuation of farm property passed from a qualifying decedent, and he or she actively manages the farm.

TREATMENT OF FORMER PASSIVE ACTIVITIES

A former passive activity is any activity that is not a passive activity in the current year, but was a passive activity in any prior year. If the former passive activity has net income in the current year, any suspended losses from prior years can be used to offset the net income. Any remaining suspended losses are treated like any other passive loss. Passive losses can only be offset against passive income. Unused suspended losses may be carried over indefinitely. Change in status does not trigger a disposition.

===

Audit Technique

* Watch for deduction of suspended losses from rental real estate that no longer qualify for the $25,000 offset because it falls outside the definition of a rental activity (for example, short-term rentals such as a vacation condo). Suspended losses may appear on Form 8582 line 1 and on Schedule E as a deduction. The $25,000 offset applies only to suspended *rental* real estate losses if the taxpayer *actively* participates in the year that the loss arose and the year deducted.

===

PROOF OF PARTICIPATION

Treas. Reg. section 1.469-5T(f)(4) indicates that a taxpayer's participation in an activity may be established by **any reasonable means** such as appointment books, calendars or narrative summaries. A discussion of regulations, court cases and committee reports relating to record keeping can be found in Exhibit 3-7.

Questions regarding material participation should be asked during the initial interview and the taxpayer's time and type of participation in an activity should be ascertained. Exhibit 3-4 provides an IDR with items to be requested to help substantiate the level of participation. Much of the "participation" that some taxpayers provide on examination is specifically excluded as investor type activities.

Several court cases have addressed the validity of the taxpayer's narrative summaries. *Seits v. Commissioner*, T.C.M. 1994-52, pointed out that uncorroborated, self-serving statements need not be accepted at face value if questionable, improbable, or unreasonable. In *Goshorn v. Commissioner*, T.C.M. 1993-578, the court stated that "while the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow post-event ballpark guesstimates."

QUALIFYING PARTICIPATION

Once the taxpayer provides the type of participation and the approximate hours spent performing that participation, a determination can be made as to whether that participation (and time) qualifies.

There are several areas that the regulations cover concerning participation that is specifically excluded.

General Rule

Work performed by an individual or the spouse will be considered unless it falls under one of the exceptions listed under "Non-Qualifying Time." If the taxpayer is paid wages from an activity, the time spent earning those wages would be considered participation.

Work performed by either spouse will be considered even if the spouse does not own an interest in the activity or does not file a joint tax return. **This rule applies only to the spouse and not to the children of the taxpayer.**

Nonqualifying Time

Work performed in connection with an activity will not be treated as participation if it is not the type that is customarily done by an owner, and one of the principal purposes of performing the work is to avoid the disallowance under IRC section 469. Keep in mind that this is an area that is very subjective. It would not be unreasonable for a spouse to assist the taxpayer at the business site. The decision to raise this issue should be based on the type of business and the type of service performed.

Example 9

A taxpayer has two activities. The first activity is an accounting firm. The spouse is also a CPA and spends time assisting during busy periods. The second activity is a 2-percent limited partnership in a health club in which both taxpayers are members. The spouse spends 3 evenings each week "assisting" with the classes at the club. Both activities are treated as nonpassive on the return.

The material participation issue should be pursued on the health club activity. It appears that the spouse might be using the club rather than working. It is not likely that a limited 2-percent owner would teach classes. This issue might be pursued as an avoidance of the passive activity rules under Treas. Reg. section 1.469-5T(f)(2)(I).

Time spent in **investor-type** activities is not counted unless the individual is directly involved in the **day-to-day operations or management** of the activity. It is difficult for many taxpayers to meet this standard unless they are at the business site on a regular basis. It is also hard to justify day-to-day involvement if there is an on-site manager and the taxpayer has full-time obligations elsewhere.

Note: Remember that the Code requires that the taxpayer participate on a regular, continuous, and substantial basis.

Work performed in the capacity as an investor includes:

1. Studying and reviewing financial reports,

2. Preparing summaries or analyses for personal use,

3. Monitoring finances or operations in a non-managerial capacity.

Two court cases which address investor hours are: *Toups v. Commissioner*, T.C.M. 1993-359 and *Goshorn v. Commissioner*, T.C.M. 1993-378.

PARTICIPATION ISSUES

A material participation issue can arise on different schedules of the return. Any large nonpassive business loss on Schedule C, Schedule E, or Schedule F with an out-of-state employer identification number should be considered as an audit issue. If the taxpayer has a full-time business elsewhere, the time allocation to a material participation activity should be a consideration as well. Schedule E partnerships, S-Corporations, and trusts should be reviewed to determine if their losses are passive. Of course, if the K-1 indicates the taxpayer is a limited partner, generally losses are passive.

Passive business income on Form 8582 should also be applied against the standards of material participation. If the taxpayer materially participates in the business, income should not be reflected on Form 8582. Taxpayers sometimes incorrectly reflect gains from dispositions of business assets as passive income even though the assets are used in an activity in which the taxpayer materially participates. Chapter 4 contains additional information on income issues.

Special consideration should be given to the material participation rules itemized in Treas. Reg. section 1.469-5T(a) when conducting an initial interview. Be aware that the initial interview with the taxpayer may be the only time that the examiner will obtain a broad scope of all the taxpayer's duties.

ISSUE IDENTIFICATION

Returns which reflect or suggest the following should be classified for a potential passive activity loss issue:

1. Returns with large losses in the block for **nonpassive** losses on Schedule E Part II, particularly if the first two digits of the EIN are from out-of-state. (Also classify for basis.)

2. Schedule C or F with losses and an out-of-state EIN, particularly if wages, labor or management fees are a line item deduction.

3. If Schedules K-1 are attached to the return, always review them for a limited partnership interest and percentage of ownership.

4. Forms 8582 with large passive **income** reflected, particularly if anything suggests that it is from an in-state business.

SUMMARY

1. The material participation rules discussed in Treas. Reg. section 1.469-5T are applied to any trade or business activity. If any one of the seven tests are met, income or loss from that activity will be treated as nonpassive. These rules are applied on an activity by-activity basis and at the 1040 level. Different participation rules apply to rental activities (as discussed in Chapter 2).

2. The Code defines material participation as regular, continuous, and substantial participation by a taxpayer. There are seven tests under which a taxpayer would be treated as materially participating in an activity. The most common situations are when the taxpayer spends more than 500 hours or does substantially all the work involved in an activity.

3. Limited partners are passive unless they work more than 500 hours or meet one of the two tests relating to material participation in prior years.

4. The taxpayer is required to substantiate the participation in an activity by any reasonable means. The taxpayer should be able to provide a statement of approximate hours spent and the type of participation.

5. The taxpayer's participation in any capacity will count toward the material participation standard. Time spent by the spouse will also be considered.

6. Participation will not be considered if it is not customarily done by an owner and the primary purpose of such participation is to avoid the passive loss limitations. In addition, time spent as an investor will not be considered unless the taxpayer is involved in day-to-day management or operations.

7. Activities in which the taxpayer works more than 100 hours but not more than 500 hours and does not meet any of the material participation tests of Treas. Reg. section 1.469-5(a) are known as significant participation activities (SPAs).

8. A taxpayer must determine whether the result of all SPA operations combined is a net gain or a net loss.

   a. If there is an overall net loss from all SPAs, the losses and gains from these will be reported on Form 8582, and any allowable loss will be computed along with the taxpayer's other passive activities.

   b. If there is an overall gain from all SPAs, the net gain will be recharacterized as nonpassive.

   c. The amount to be recharacterized is spread ratably between all SPAs with net gains.

   d. The effect of this treatment is that overall losses from SPAs are treated as passive losses and are limited, while overall gains from SPAs are recharacterized as nonpassive and may not be offset by other passive losses.

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IRC SECTION 469: MATERIAL PARTICIPATION - INTERVIEW QUESTIONS

If Schedule E, line 27, column (I) Nonpassive Loss reflects large losses and partnership EIN is out-of-state, examiner should question whether or not taxpayer is materially participating. If not, losses should be reported on Form 8582, line 2 and are limited to passive income.

Partnership/Activity:______________________________________

_____ Is taxpayer a limited partner? Review Schedule K-1.
Limited partners (with the exception of qualified investors in low income housing) are presumed passive. IRC section 469(h)(c)

Tests 1, 5, and 6 of the material participation tests in Temp. Treas. Reg. section 1.469-5T(e)(2) are the exceptions. They are rarely seen on audit.

_____ Inquire whether taxpayer has grouped businesses into ONE activity for purposes of IRC section 469, and ask for list of businesses grouped and hours worked.

_____ Inquire whether taxpayer has grouped unrelated activities together under the significant participation test in Treas. Reg. section 1.469-5T. See SPA lead sheet.

_____ How many hours does taxpayer spend on the business?
NOTE: Early in the audit, be sure to inquire whether spouse works in the business. Both spouses time is counted. Temp. Treas. Reg. section 1.469-5(T)(a)(1) requires 500 hours a year or substantially all of the work, etc. Refer to material participation lead sheet and Temp. Treas. Reg. section 1.469-5(T)(a).

_____ What records does taxpayer have to substantiate hours worked?
NOTE: Temp. Treas. Reg. section 1.469-5(T)(f)(4) states participation may be substantiated by any reasonable means including appointment books, calendars, or narrative summaries. If taxpayer spends substantial hours on the phone, be sure to secure telephone bills with calls highlighted.

If taxpayer has no records, ask him or her to write down what he or she does, when, and how many tours he or she spends.
NOTE: Certain activities are disregarded when counting hours for material participation. See next page and Temp. Treas. Reg. section 1.469-5T(f)(2).

_____ Where is the principal location of the activity? Does taxpayer live within the physical area? How can taxpayer be materially participating if he or she does not live nearby?
NOTE: Committee Reports state the proximity of the taxpayer's residence to the business is significant.

_____ What activities does taxpayer perform? If taxpayer is involved in a partnership, request copy of partnership agreement with portion relative to taxpayer's involvement in partnership highlighted.

If taxpayer is claiming that his or her participation is in a management role, the following questions should be asked to verify that his or her participation is a valid, genuine, and significant involvement.

_____ Is taxpayer directly involved in day-to-day management? Temp. Treas. Reg. section 1.469-5T(f)(2)(ii) requires direct involvement in the "day-to-day management or operations." Unless the taxpayer is involved in day-to-day management or operations of the activity, the following items are not included in determining material participation: studying financial reports, preparing analysis for taxpayer's own use, and monitoring finances or operations in a non-managerial capacity. Periodic consultation is not sufficient to meet the material participation standard.

_____ Is the work taxpayer performs customarily done by an owner? If not, work is disregarded. Temp. Treas. Reg. section 1.469-5T(f)(2)(I)

_____ Is there an on-site manager/supervisor/foreman?

_____ Does taxpayer have signatory authority on checks?

_____ Does taxpayer have authority to borrow money? Hire/fire personnel?

_____ Is taxpayer merely approving decisions recommended by a paid manager/supervisor/ advisor? In other words, is taxpayer merely "rubber-stamping" expert decisions without any material input? Could the decisions have been made without taxpayer's involvement?

_____ Is work being performed by taxpayer required or necessary to the activity?

_____ Is taxpayer compensated for participation? If not, why?

_____ What is taxpayer's percentage of ownership (Schedule K-1)? Is it reasonable based on size of ownership that taxpayer is involved in management?

Taxpayer need not meet all these criteria to show valid, genuine, and significant involvement. However, if taxpayer's statements are self serving, be sure to ask for documentary evidence or third party statements verifying hours claimed.

LAW: Per IRC section 469, business activities in which the taxpayer does not materially participate (regular, continuous, substantial basis) are passive, and losses are deductible only up to other passive income reported on the tax return. (Material participation does not apply to the following: rental real estate with active participation except IRC section 469(c)(7), long-term equipment rentals, low-income housing, and working interests in oil and gas.

CONCLUSION: It has been determined that taxpayer is/is not materially participating.

PASSIVE ACTIVITY LOSSES AND MATERIAL PARTICIPATION

NAME OF SCHEDULE C, E, OR F ACTIVITY:________________________

ISSUE: Are losses limited under IRC section 469 as taxpayer is not materially participating? OR - Is taxpayer materially participating in the activity, and, therefore, income is nonpassive and cannot be used to offset passive losses?

____ Does taxpayer materially participate (regular, continuous, and substantial) in the activity? IRC section 469(h).

If answer is yes, neither income nor losses belong on Form 8582. Instead they belong on Schedule E in the nonpassive income and loss columns.

If answer is no, Form 8582 (starting with line 2) must be completed and taxpayer may deduct only losses for which there is passive income.

IMPORTANT: If taxpayer is a limited partner, he or she is presumed to be passive, and losses should be entered on Form 8582, line 2. IRC section 469(h)(2). See Temp. Treas. Reg. section 1.469-5T(e)(2) for exceptions.

To determine material participation, taxpayer must meet one of the following (first two are most common):

1.____ Does taxpayer and/or spouse work more than 500 hours a year in the business?

QUESTION TO TAXPAYER: How many hours a week do you spend in the business and what activities do you perform? NOTE: Reading reports and otherwise monitoring operations in a nonmanagerial capacity does not constitute participation. Also, Committee Reports state that proximity of business to taxpayer's residence is significant. Thus, if activity is in California but taxpayer lives in New Hampshire, how can he or she be materially participating 500 hours?

2.____ Does taxpayer perform substantially all of the participation in the activity? Even if the taxpayer does not meet the 500 hour test, but his or her participation is the only activity in the business (including employees), he or she would meet the material participation test. Example: sole proprietor with no employees.

3.____ Does taxpayer put in more than 100 hours and no one puts in more hours? Example: If owner puts in 175 hours a year and an employee works 190 hours a year, taxpayer would not meet material participation test.

4.____ Does taxpayer have several passive activities in which he or she participates between 100-500 hours each, and the total participation exceeds 500 hours?

The following activities should not be included in the above test: rental activities: activities involving portfolio or investment income, activities in which the taxpayer performs substantially all of the work and thus is materially participating. Furthermore, the time should not include investor-type activities such as reviewing financial statements and monitoring operations in a nonmanagerial capacity.

5.____ Did taxpayer materially participate in activity for 5 out of 10 preceding years (need not be consecutive)? Example: taxpayer who retired and his or her children now run business, but he or she stills owns part of partnership.

6.____ Did taxpayer materially participate in a personal service activity for any 3 prior taxable years (Need not be consecutive.)?
Personal service activity includes fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

7.____ Do facts and circumstances indicate taxpayer is materially participating? Test does not apply unless taxpayer worked more than 100 hours a year. Furthermore, it does not apply if (1) any person received compensation for managing the activity; or (2) if any person spent more hours than taxpayer managing the activity.

If answer to any of the above questions is YES, taxpayer meets material participation standard, losses nor income should not be on Form 8582, and taxpayer may deduct the full amount of loss in the current year.

It is not well settled whether travel time should ever count. In cases where satisfaction of the hourly tests turns on travel time, Chief Counsel's Office should be consulted.

REMINDER: Limited partners by Code are generally passive. The exceptions to the limited partner rule are tests 1, 5, and 6 above.

If answer is NO to all of the above or taxpayer is a limited partner and the answer is no to tests 1, 5, and 6, material participation standard is not met. Loss should be placed on line 2 of Form 8582 and the form completed. Taxpayer will be allowed only losses up to passive income (unless there is a full disposition of the activity).

If the taxpayer provides a narrative summary or oral testimony which is self-serving or questionable, be sure to ask for supporting documentation or third party verification. The Service need not accept at face value uncorroborated testimony if it is questionable, improbable, or unreasonable. See *Seits v. Commissioner*, T.C.M. 1994-52, *Quock Ting v. United States*, 140 U.S. 417, 420-421 (1891); *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968) *affg.* T.C.M. 1967-85; *Boyett v. Commissioner*, 104 F.2d 205, 108 (5th Cir. 1953), *affg.* Memo Opinion; T*okarski v. Commissioner*, 87 T.C. 74, 77(1986). In *Goshorn v. Commissioner*, T.C.M. 1993-578, the Court held, "While the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow the type of post-event ballpark guesstimates that petitioner used. As a matter of proof, therefore, he has failed to establish that he materially participated***."

CONCLUSION: In accordance with IRC section 469, it has been determined that the taxpayer is/is not materially participating.

AGGREGATION OF SIGNIFICANT PARTICIPATION ACTIVITIES (SPAs)

Names of SPAs:______________, ______________, ______________

AUDIT PROCEDURE:

_____ For each SPA, verify that taxpayer is working at least 100 hours, but not more than 500 hours a year.

_____ Verify that the SPA is not a rental activity. A SPA must be a trade or business. Temp. Treas. Reg. section 1.469-5T©

_____ For each SPA, request records on hours worked and verify that taxpayer has not included investor-type activities (reviewing financial reports; preparing analysis for his or her own use; and telephone calls or other activities which are monitoring operations in a non-managerial capacity) to meet the minimum 100 hours. Temp. Treas. Reg. section 1.469-5T(f)(2)(ii).

_____ For each SPA, verify that taxpayer is not materially participating because he or she performs substantially all of the work. Each SPA must be a passive activity.

Temp. Treas. Reg. section 1.469-5T(c)(ii). If the taxpayer is performing substantially all of the work, he or she is deemed to be materially participating and the losses from that particular activity would be allowable, but the time does not enter into the SPA calculation as it is not a passive activity.

_____ Verify that taxpayer did not materially participate in the SPA activity 5 of the prior 10 years. For example, if he or she performed substantially all of the work in prior years, he or she would be deemed to materially participate under test 5 in Temp. Treas. Reg. section 1.469-5T. Similarly, if the activity is a personal service activity, verify that the taxpayer did not materially participate in *any* 3 prior years.

_____ Verify that time is not for investment or portfolio activities which by Code are nonpassive.

_____ Review prior and subsequent year returns, and verify that income from SPAs has not been entered on Form 8582 in full. In other words, a portion of the income has been recharacterized as nonpassive. Pub. 925 provides worksheets. Consider doing a 3-year comparative analysis of SPAs.

LAW: If the total of all SPAs exceeds 500 hours, losses can be deducted in full. A SPA is a trade or business in which the taxpayer worked for more than 100 hours in the year, but did not materially participate. Temp. Treas. Reg. section 1.469-5T(c).

CONCLUSION: SPAs have/have not been properly aggregated in accordance with Temp. Treas. Reg. sections 1.469-5T(a)(4) and 1.469-5T(c).

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Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

The taxpayer is required to establish the type of services provided to each activity and the approximate number of hours spent performing such services during the year. Temp. Treas. Reg. Section 1.469-5T(f)(4) provides several suggestions for verifying the participation in an activity including appointment books, calendars or narrative summaries. It is essential to determine the number of hours spent performing various duties in the following activities:

Schedule C -
Schedule E -
W-2 Position -

Please keep in mind that the performance of services in these activities includes travel and meetings. If a complete calendar/appointment book was not maintained, the necessary information might be reconstructed using other records available. For example, phone bills would provide a good starting point for time spent in an activity which is out-of-state. In addition, credit card receipts for travel will be helpful when trying to reconstruct travel periods.

If taxpayer's statements or narrative summary is self-serving be sure to ask for third party evidence or documentary evidence supporting his or her testimony.

Information Due By__________ At Next Appointment [ ] Mail In [ ]

FROM:	Name and Title of Requester	Date
	Office Location	

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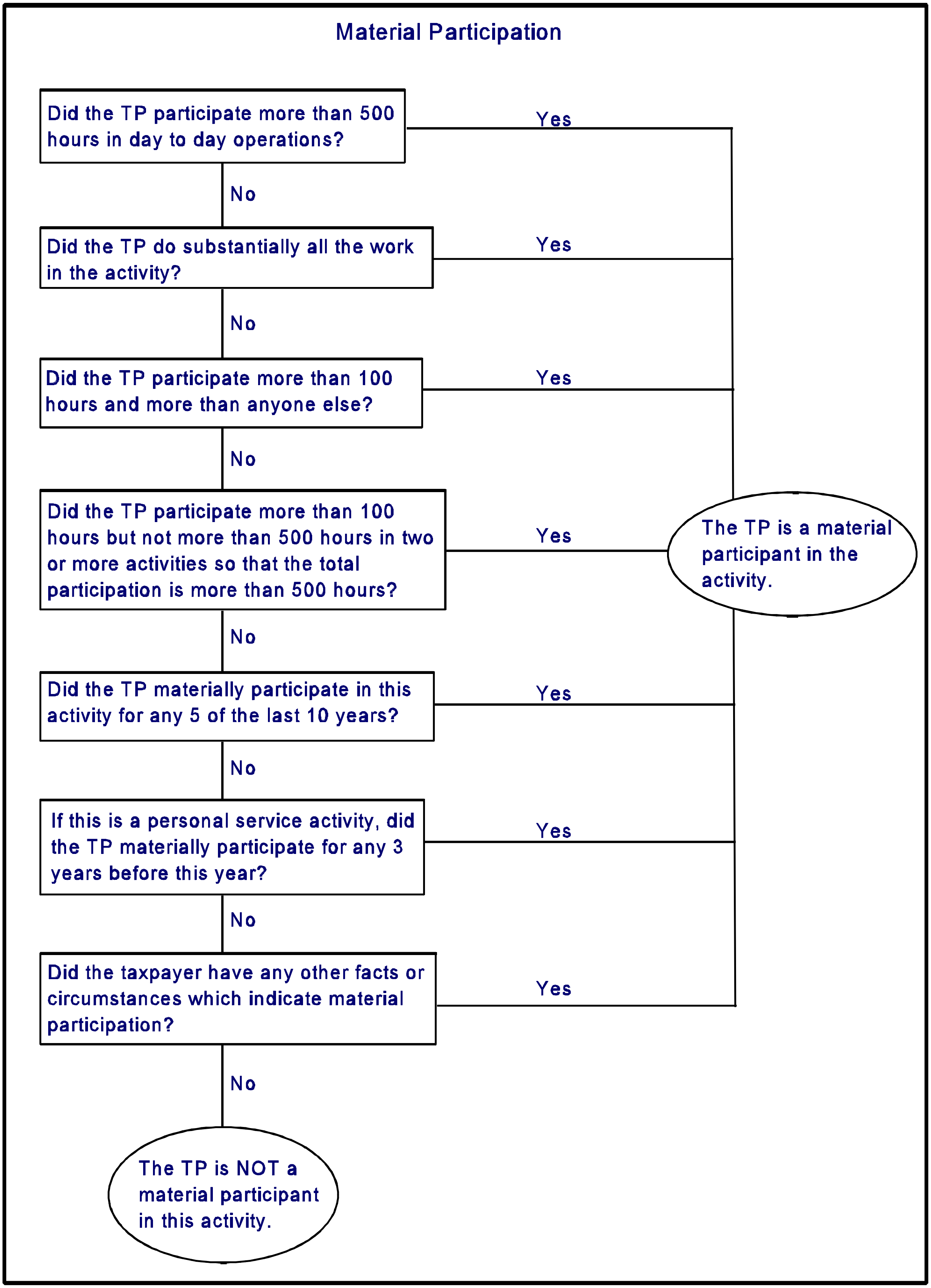
Material Participation
Did the TP participate more than 500 hours in day to day operations?
Yes
No
Did the TP do substantially all the work in the activity?
Yes
No
Did the TP participate more than 100 hours and more than anyone else?
Yes
No
Did the TP participate more than 100 hours but not more than 500 hours in two or more activities so that the total participation is more than 500 hours?
Yes
The TP is a material participant in the activity.
No
Did the TP materially participate in this activity for any 5 of the last 10 years?
Yes
No
If this is a personal service activity, did the TP materially participate for any 3 years before this year?
Yes
No
Did the taxpayer have any other facts or circumstances which indicate material participation?
Yes
No
The TP is NOT a material participant in this activity.

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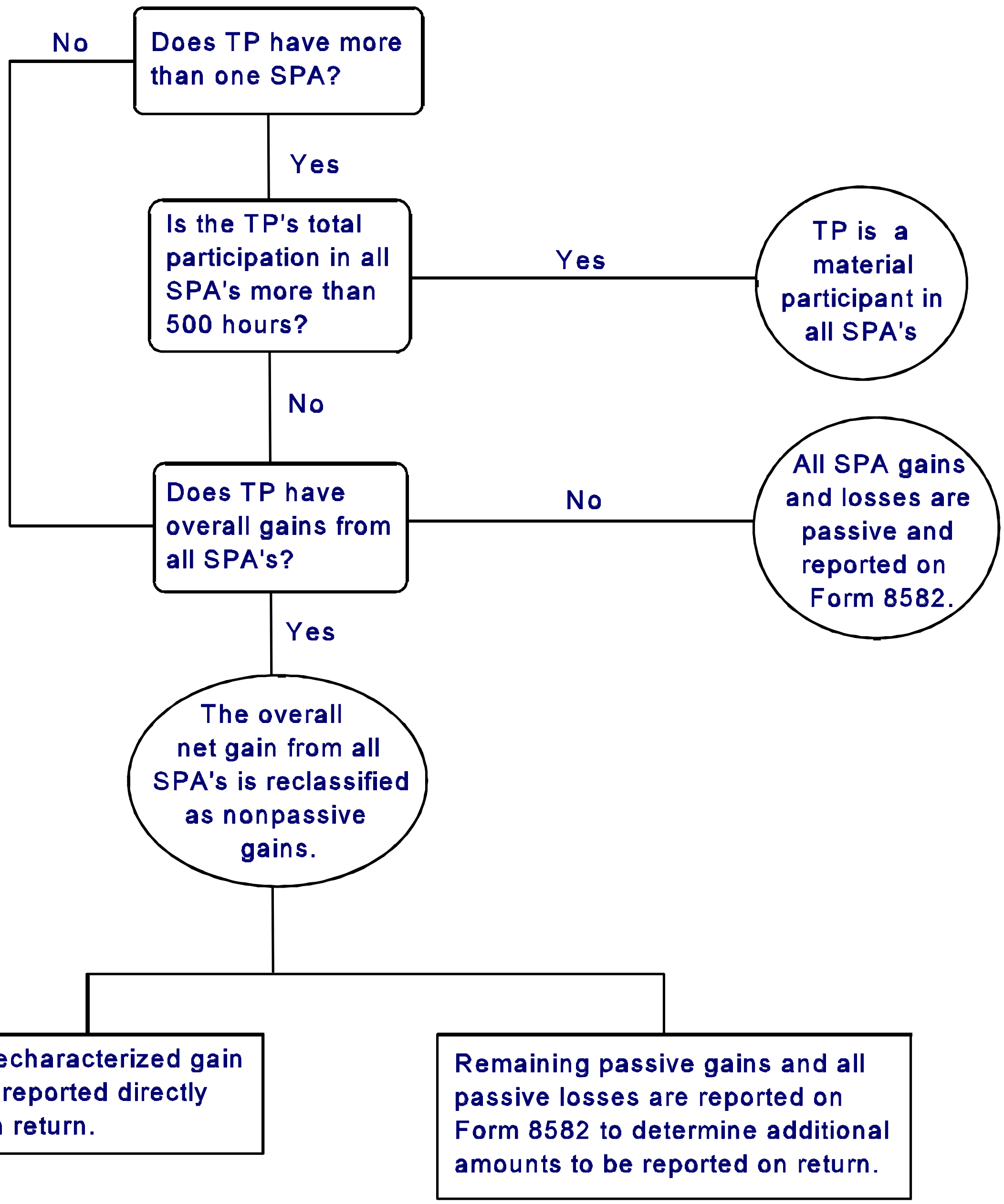
Treatment of Gains or Losses from Significant Participation Activities (SPA's)



Note: The gain to be recharacterized is spread ratably between all SPA's with individual net gains.

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RECORDS: PASSIVE ACTIVITIES CODE SECTION 469

Temp. Treas. Reg. section 1.469-5T(f)(4) indicates that a taxpayer's participation in an activity may be established by any **reasonable** means such as appointment books, calendars, or narrative summaries. (Most taxpayers provide narrative summaries.) Remember, the regulations require they be reasonable.

Post-event ballpark guesstimates -- In *Goshorn v. Commissioner*, T.C.M. 1993-578, the Court held, "While the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow the type of post-event ballpark guesstimate that petitioner used. As a matter of proof, therefore, he has failed to establish that he materially participated***."

Self-serving uncorroborated testimony -- The following are quotes from *Seits v. Commissioner*, T.C.M. 1994-52: "The only evidence petitioners offered in support of their position is petitioner's self-serving statements. We need not accept at face value such uncorroborated testimony if it is questionable, improbable or unreasonable." *Quock Ting v. United States*, 140 U.S. 417, 420-421 (1891); *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968) *affg*. T.C.M. 1967-85; *Boyett v. Commissioner*, 104 F.2d 205, 108 (5th Cir. 1953), *affg*. Memo Opinion; *Tokarski v. Commissioner*, 87 T.C. 74, 77(1986). "The failure of a party to introduce evidence...favorable to him gives rise to the presumption that if produced it would be unfavorable." *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 2285 (1946), *affd*. 162 F.2d 513 10th Cir. 1947).

Investor-type hours: Temporary Treasury Regulation section 1.469-5T(f)(2)(ii) states that work performed by an individual in the individual's capacity as an investor in an activity **shall not be treated as participation** unless the individual is directly involved in the <u>day-to-day</u> management or operations of the activity. Examples include: 1) studying and reviewing financial statements or reports on operations of the activity; 2) preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and 3) **monitoring the finances or operations of the activity in a non-managerial capacity**.

In *Toups v. Commissioner*, T.C. 1993-359, involving a short-term cottage rental, the taxpayer's activities, were found to be superficial and did not materially change the operations or management of the activity. Furthermore, the Court found that the activities appeared to be "investor-type" hours, not work of a type that is customarily done by an owner, and fell short of meeting the regular, continuous, and substantial requirement of IRC section 469(h)(1) for material participation.

In *Goshorn v. Commissioner*, T.C. 1993-578 (material participation relating to a charter boat), the taxpayer claimed he prepared budget analyses, negotiated insurance and financing; arranged for repairs and performed on-site inspections. The Court found, "*** even if petitioner expended the hours he claims *** a large part of these activities would not be considered participation under section 1.469-5T(f)(2)(ii)." They further stated, "We reject petitioner's claim that we should consider his travel time *** The most that can be said about this time is that it as spent on an investment-related activity."

Management time: Relative to management activities, the following are comments from the Committee Reports: "Even an intermittent role in management, while relevant, does not establish material participation." "The fact that one has responsibility for making significant management decisions with respect to an activity does not establish material participation." The Committee Reports repeatedly indicate that the taxpayer must be involved in operations. At one point, they state, "In order to satisfy the material participation standard, the individual's involvement must relate to operations." In another paragraph, they indicate, "Participation in management cannot be relied on unduly both because its genuineness and substantiality are difficult to verify, and because a general management role, absent more, may fall short of the level of involvement that the material participation standard in the provision is meant to require." Management services rendered by an individual are likely to be substantial and bona fide "when the individual rendering them is on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment."

Periodic consultation: The Committee Reports express the following: "Periodic consultation with respect to general management decisions does not satisfy material participation in the absence of regular, continuous and substantial involvement in operations." " A taxpayer is most likely to have materially participated in an activity where involvement in the activity is his principal business." "Another factor that may be highly relevant *** is how regularly the taxpayer is present at the place where the principal operations of the activity are conducted." The Committee Reports further indicate that the taxpayer has not materially participated if "decisions could have been made without his involvement."

Travel time: In *Goshorn v. Commissioner*, T.C.M. 1993-578, the Court refused to consider the taxpayer's travel time, stating, "The most that can be said about this time is that it was spent on an investment-related activity rather than the charter business." In *Toups v. Commissioner*, T.C.M. 1993-359, the Court held that, since the taxpayers were not involved in day-to-day operations of the cottage, driving time was an investor activity for which hours are not counted in the material participation test -- or possibly the driving time was a personal activity since a considerable portion of the hours claimed occurred during the 14 days they spent on vacation at the cottage. In those cases in which satisfaction of the hourly tests of Treas. Reg. section 1.469-5T turns on travel time, the examiner should consult with **Chief** Counsel's Office.

Chapter 4

PASSIVE INCOME ISSUES

INTRODUCTION

Because passive activity losses (PAL) generally can be offset only by **income from a passive activity**, one of the most common issues is whether income on Form 8582 is truly passive income. While many individuals think of interest, dividends, stock gains, and other portfolio income as "passive," for purposes of IRC section 469, these are generally not passive income and should not be entered on Form 8582. Taxpayers who are not entitled to the $25,000 offset cannot deduct any PALs **unless there is passive income**. Consequently, some taxpayers have attempted to "create" passive income. Significant passive income issues have been noted on 1991 and subsequent year returns.

This issue can be simply illustrated by a taxpayer who is a pilot with interest income of $10,000 and a rental loss of $12,000 with an adjusted gross income (AGI) of $160,000. With an AGI exceeding $150,000, the taxpayer is not entitled to the $25,000 offset. Thus, none of the taxpayer's rental loss would be deductible. However, if the interest income were incorrectly treated as "passive" and entered on Form 8582, the taxpayer would erroneously be allowed $10,000 in passive losses.

None of the following constitute passive income:

1. Portfolio income, lottery winnings or any other investment income

2. Salaries, wages, 1099 commissions and retirement income

3. Guaranteed payments from a partnership

4. Rental income from property rented to an activity in which the taxpayer materially participates.

Passive income can be generated only by a passive activity. A passive activity is either a rental or a

business in which the taxpayer does not materially participate.

Whether income is deemed passive or nonpassive, it always must be reported on the tax return. Passive income is most commonly entered on Schedule E as rental income or income from a partnership or S-Corporation in which the taxpayer does not materially participate. It could also be reflected on Schedule D or Form 4797 as net income from a disposition of a passive activity. In addition, although not often seen, it may be found on Schedules C or F where the taxpayer does not materially participate. Naturally, passive income is also reflected on lines 1a and 2a of Form 8582. The examiner should always verify that income reported on Form 8582 (which is merely a computational form) is also reported on Schedule E or another schedule whose total is entered income on Form 1040.

This chapter provides an explanation of the law and discusses some common passive income issues. It is the intent of this lesson to acquaint the examiner with passive income issues, not an in-depth analysis of the regulations. Exhibit 4-1 contains a lead sheet with common issues which can be used as a work paper.

GENERAL RULES

Passive activity income includes only income from rentals and trades or and businesses in which the taxpayer does not materially participate. A gain on a partial or entire disposition of a passive activity is treated as passive income in the year recognized. In addition, the gain on disposition from property used in a passive activity is treated as passive income in the year recognized. If the activity is nonpassive, gain will be treated as nonpassive income. (Temp. Treas. Reg. section 1.469-2T(c)(1) and (2)(I)(A).)

NONPASSIVE INCOME

There are several types of income that are often erroneously entered on Form 8582 but are specifically excluded from passive income. Refer to the items listed under Temp. Treas. Reg. section 1.469-2T(c)(7) and Treas. Reg. section 1.469-2(2)(7).

Material Participation Activities

One of the most common types of income misclassified on Form 8582 is income from activities in which the taxpayer materially participates. For example, if the taxpayer performs substantially all of the work, he or she is materially participating and income should be classified as nonpassive. Or, if the taxpayer performs no work in the current year, but materially participated in any 5 of the prior 10 years, he or she is deemed to be materially participating and income is nonpassive. When reviewing Form 8582 and worksheets, carefully review any item of large dollar item of income and verify that it is not from a business in which the taxpayer materially participates. Sometimes the taxpayer will have a Form W-2 from the same entity, indicating possible material involvement. Any activity with a local EIN or one that is related to the taxpayer's primary profession could be a nonpassive activity. If unfamiliar with the rules for material participation, review Temp. Treas. Reg. section 1.469-5T and Chapter 3 of this text.

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Audit Techniques:

* At the initial interview, ask who performs the work. Also, probe for taxpayer's involvement in prior years.

* A 3-year comparative analysis of passive and nonpassive income and losses will sometimes highlight inconsistencies from year to year.

* An audit determination that income on Form 8582 is nonpassive generally results in an adjustment of the same amount to passive losses as PALs are deductible only up to passive income.

* Verify that both passive and nonpassive income have been reported on Schedule E or another appropriate schedule.

===

Portfolio Income

Under section 469, portfolio income is generally NOT passive income. Possibly, because it seems like passive income to a taxpayer, it is erroneously entered on Form 8582. Portfolio income from Schedules K-1 is frequently erroneously entered on Form 8582, particularly on self-prepared returns.

Portfolio income includes interest, dividends, annuities, and royalties not derived in the ordinary course of business. Also, gain or loss from the disposition of property that produces these types of income or that is held for investment is not passive income. This income should not be included on Form 8582. (Temp. Treas. Reg. section 1.469-2T(c)(3))

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Audit Technique:

* Scan Schedules B and K-1 to verify that interest, dividends, stock gains, and other portfolio income have not been entered on Form 8582.

===

Personal Service Income

Passive activity income does not include compensation paid for the performance of personal services. This includes W-2 wages (earned income), 1099 commission income, property received for the performance of services, and retirement income. (Temp. Treas. Reg. section 1.469-2T(c)(4)(I))

Example 1

John owns 75 percent of the stock of Dooley Inc., an S-Corporation owning rental real estate. Dooley Inc. pays John a salary for managing the properties. Although John's share of Dooley Inc.'s pass through income is passive, the salary paid to John would be personal service income and would not constitute passive income.

Guaranteed payments from a partnership as defined in IRC sections 707 or 736 are generally considered compensation and would not be treated as passive income. Pursuing a compensation issue and reducing the net income from a flow-through entity could have a dramatic effect on the tax return.

Example 2

Tyler Taft is a 75 percent partner in a partnership. Tyler performs all the management services relating to the partnership's rental properties and receives a $30,000 guaranteed payment for his services. The net income of the partnership is $40,000. The partnership considered Tyler's share of net income as his compensation and did not deduct the $30,000 guaranteed payment in arriving at net income. By converting Tyler's net income from the partnership to the guaranteed payment, the $30,000 passive income would become nonpassive. Tyler would only report his share of the partnership net income (75 percent of $10,000) as passive income.

Example 3

Susan's return reflects the following:

Wages	80,000
Interest Income	13,200
Dividends	3,300
Gain from sale of C-Corp stock	2,500
Schedule C loss (works 3 days weekly)	-16,575
Loss from limited partnership	-12,000
Gain from sale of car used in Sch. C	3,500
Rental Loss	-25,000
Schedule F (no material participation)	5,000

These items are characterized as passive, nonpassive, and portfolio as follows:

NONPASSIVE	PORTFOLIO	PASSIVE
$80,000	$13,200	-$12,000
-16,575	3,300	-25,000
3,500	2,500	5,000

==

Audit Techniques:

* Always verify that income items reflected on Form 8582 are reported on the appropriate tax return schedule (typically Schedule E). It has been noted in a number of instances that taxpayers have entered income on Form 8582 but failed to reflect

it on the return itself. Passive income always must be recognized on the tax return.

* Ensure that income on Form 8582 is not personal service income nor portfolio income nor investment income.

* If there is a sale of a building or other asset, verify that it was used in a passive activity. Otherwise, it is simply investment income reportable on Schedule D, but should not be entered on Form 8582.

==

RECHARACTERIZATION ISSUES

The recharacterization rules contained in Treas. Reg. section 1.469-2(f) and Temp. Treas. Reg. section 1.469-2T(f) provide several circumstances where **income** that would have been passive is treated as **nonpassive.** In other words, these types of income cannot be used to offset passive losses and should not be reported on Form 8582. **These rules recharacterize only income, not losses**. If any of these activities result in a net loss, the loss will be treated as passive and subject to the limitations on Form 8582. These rules are not well understood by many taxpayers and may result in substantial adjustments. This section provides a brief overview of three of the rules. The regulations should be consulted for additional detail. There are also exhibits containing computational examples of how these issues impact a tax return.

Nondepreciable Rental Property

The first recharacterization rule addresses nondepreciable rental property. If less than 30 percent of the unadjusted basis of property rented is subject to depreciation, any **net income** from that activity is treated as not from a passive activity. **Consequently, income from leasing undeveloped land is nonpassive**. Remember that net income from an activity subject to recharacterization includes any gain on disposition. Exhibit 4-2 provides a worksheet to use in addressing nondepreciable rental issues. (Temp. Treas. Reg. section 1.469-2T(f)(3)). Also see *Wiseman v. Commissioner*, T.C.M. 1995-203.

Example 4

Robert purchases land for $300,000 and constructs a building for $100,000. The building was used in a rental activity for several years and then was sold for $600,000. Since the unadjusted basis of improvements ($100,000/$400,000) equals 25 percent of the unadjusted basis of all property, the net gain is treated as nonpassive. In addition, if Robert had net income from the rental activity, that income would also be recharacterized as nonpassive.

===

Audit Techniques:

* For farmers with passive income on Form 8582, be sure to inquire whether the income is from leased land.

* This issue should be considered anytime the taxpayer has a rentals involving a mobile home park, parking lots or any other ground rents.

===

Rental to Nonpassive Activity

One of the most common passive activity issues relates to rental income from essentially self-rented property. Congress believed it would be inequitable for a taxpayer to create passive rental income by renting property to an entity in which he or she owns an interest and that at the same time generates nonpassive losses. **When a taxpayer rents property to an activity in which he or she materially participates, rental income from the property is nonpassive.** (Treas. Reg. section 1.469-2(f)(6).) Accordingly, it is not included on Form 8582. This rule does not apply if there is a written binding contract executed prior to February 19, 1988. (Treas. Reg. section 1.469-11(c)(1)(ii).)See Exhibits 2-5 and 4-3.

Over the years, it has been common tax practice for shareholders in closely held corporations to personally own the building (and sometimes equipment and vehicles as well) and rent it to their corporation. The temporary regulations did not include activities conducted through C-Corporations; therefore, the recharacterization of income rule did not apply to regular C-Corporations.

With the sunset of the temporary activity regulations, this is no longer true. For taxpayers with taxable years ending after May 10, 1992, net rental income from a rental to a C-Corporation in which the taxpayer materially participates is recharacterized as nonpassive. Consequently, beginning in 1993, a shareholder renting a building to a corporation in which he or she materially participates must report net income on Schedule E, BUT cannot use it to offset other passive activities. In other words, it should not be entered on Form 8582.

Example 5

Karen is the 100-percent shareholder in a C-Corporation which is a restaurant in which she materially participates. Her Schedule E reflects the rental of a building with net income of $45,000 and placed in service in 1993. She also has losses of $20,000 from a limited partnership (in which she does not materially participate). During the examination it is determined that the building is rented to her C-Corporation. Since the taxpayer materially participates in restaurant activity, the net rental income of $45,000 is treated as nonpassive. Accordingly, the income should be excluded from Form 8582 (but is still reportable on Schedule E), and the $20,000 losses from the limited partnership would not be deductible in the current year.

Rental Incidental to Development Activity

Generally, net passive income from this type of activity will be treated as nonpassive income if ALL of the following apply:

1. Gain is recognized from sale/disposition of property during the tax year;

2. Rental of the property was initiated less than 12 months prior to the disposition;

3. Taxpayer materially or significantly participated for any tax year in an activity that involved the performance of services (such as construction and renovation) for the purpose of enhancing the value

of the property. See Treas. Reg. section 1.469-2(f)(5).

===

Audit Technique:

* Real estate developer returns are generally complex returns, sometimes involving multiple entities (partnerships and S-Corporations) with large net operating losses. These returns can have significant passive activity audit potential. Sometimes, multiple entities must be reviewed to trace the passive gains and nonpassive losses.

* On real estate developer returns, watch for inconsistent treatment from year to year. Some developers have reported certain types of income on Schedule D as investment income (which is taxed at 28 percent) in one year, but in another year where passive losses might be limited the same income has been entered on Form 8582 as passive income from a trade or business.

===

DISPOSITION ISSUES

While we do not have many regulations on dispositions, a number of audit issues can still be raised. In fact, disposition issues are some of the most commonly seen PAL issues. See the lead sheets in Exhibits 4-8 and 4-9.

General Rules

The Code discusses the rules relating to **losses** from dispositions, and the Regulations discuss the rules relating to **income** from dispositions. It is important to learn both rules and understand how they interrelate to other concepts in the passive activity rules. Income from the sale or other disposition of a passive activity is generally passive income. In addition, income from the sale of property used in a passive activity is passive income. (Temp. Treas. Reg. section 1.469-2T(c)(2)(I)(A)). If there is overall net income on a disposition (gain/loss on the sale exceeds current and prior year losses), income and losses should both be reflected on the same line of Worksheet 1 or 2. If there is an overall net loss, nothing should be entered on Form 8582 as discussed below. Exhibit 4-4 is provided as a worksheet to address disposition issues.

Losses

Current and carryforward passive losses are fully deductible on the disposition of a passive activity. However, IRC section 469(g) sets forth three criteria to be met before losses are deductible against nonpassive income. It requires that the taxpayer dispose of **an entire interest** in a **fully taxable transaction** to **an unrelated party**. All gain realized must be recognized. If these three criteria are met, the overall net loss is fully deductible (presuming, of course, that the taxpayer has basis). (IRC section 469(g)(1)).

The overall net loss is any loss on disposition and any current or suspended losses from the activity in excess of any gain on disposition or net income from the activity, or net income from all other passive activities. If there is overall net loss on the disposition (gain/loss on sale does not exceed current and prior year losses), the entire disposition is not reflected on Form 8582 and the entire loss is reflected on the appropriate schedules. If there are two dispositions, one with an overall net loss and one with an overall net gain, they should be netted.

===

Audit Technique:

* Watch for returns where the net gain from Form 4797 has been entered on Form 8582, but not the current and carryover losses. If there is an overall net gain after current and suspended losses, the net gain and all the losses should be on Form 8582. If there is an overall net loss, nothing should be on Form 8582. Via entering the income without losses, the taxpayer is erroneously triggering the deductibility of other passive losses.

* Even if losses are triggered by a disposition, the taxpayer still must have basis. Basis and at-risk limitations override section 469. If the taxpayer has inadequate basis or insufficient amounts

at-risk, losses are not deductible under any circumstance. Refer to Chapter 6, "Interaction with other Code Sections."

* Particularly on dispositions generating large amounts of income offsetting other passive losses, be sure to verify that the disposition is from a passive activity, in other words from a rental activity or a business activity in which the tax payer does not materially participate. Verify that the gain was not simply from the sale of land or a building which was only an investment activity. See *Seits v. Commissioner*, T.C.M. 1994-52.

Example 6

Annette sold her entire interest in a limited partnership in which she did not materially participate. Her net gain reflected on Form 4797 was $25,000. Current and suspended losses were $10,000 and $17,000, respectively. Since Annette has an overall net loss, neither the net gain nor any of the losses should be entered on Form 8582.

Nonqualifying Dispositions

A taxpayer is required to dispose of an entire activity in a fully taxable transaction to an unrelated party to fully deduct the current and prior year losses. Note that IRC section 469(g) requires a fully taxable event. **Numerous issues have been noted on dispositions which are not fully taxable**. The following are not fully taxable transactions:

Like-kind exchange.

Conversion to personal use.

Gift.

Transfer to a corporation, partnership or LLC.

Transfer to ex-spouse on divorce.

Installment sale.

Bankruptcy which has not been finalized.

==

Audit Technique:

* If there is no Form 4797 attached to the return, it is indicative that the taxpayer does not have a fully taxable transaction.

===

If the taxpayer disposes of an activity by **gift**, the accumulated current and prior year unallowed losses cannot be deducted in any year. Instead, the basis of the transferred interest must be increased by the unallowed losses.

A mere change in status, whether it be to a partnership, corporation, or limited liability company does not constitute a qualifying disposition which would trigger deductibility of suspended losses. Similarly, conversion of a business or rental activity from passive to nonpassive does not trigger losses. See chapter 3 for a discussion of treatment of former passive activities.

The transfer of passive activities incident to a divorce is not considered a fully taxable transaction and any suspended losses would not be freed-up under IRC section 469(g). IRC section 1041(b) states that any transfer of property incident to a divorce will be treated as a gift for purposes of Subtitle A (Income Taxes). Since IRC section 469 is part of Subtitle A, the transfer of passive activities incident to a divorce would be treated as gifts and the losses of the "donor" spouse are added to basis.

In a bankruptcy, nothing is triggered until the bankruptcy is complete, in other words, when gain or loss is recognized. Furthermore, beginning in 1993, suspended passive losses must first be applied against any relief of indebtedness (debt cancellation). In many instances, the debt forgiven under section 108 fully absorbs and current and suspended passive losses, and therefore nothing is deductible on the return.

On the death of a taxpayer, suspended passive losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased. (Basis is generally stepped up to fair market value.) If the increase in basis exceeds unused passive losses, no PALs are deductible on the decedent's return.

===

Audit Techniques:

*   On any disposition, be sure to verify that it is an entire disposition or "substantially all" of the property. On the sale of rental real estate after 1993, the examiner should inquire whether the taxpayer made an election to group his or her rentals as one activity under new IRC section 469(c)(7). If so, the sale of one property would not constitute an entire disposition.

*   Also be sure to verify that the disposition is to an unrelated party. Several issues have arisen where the property was transferred to a relative or corporation or partnership, the majority of which was owned by the individual taxpayer.

===

Information relating to the dispositions of partnership and S-Corporation interests has been included in Chapter 5, Entity Issues.

Installment Sales

If a taxpayer disposes of a passive activity on the installment basis (as defined in IRC section 453), IRC section 469(g)(3) provides that current and carryforward losses may only be deducted in the same ratio as the gain is reported. The allowable loss is calculated by the following fraction: gain recognized in the current year divided by unrecognized gain as of the beginning of the current year. See Exhibit 4-5.

Example 7

Elizabeth disposes of a rental property in an installment sale. Her total gain of $10,000 is to be reported over 5 years ($2,000 each year). Her current and suspended losses attributable to this rental were $30,000. The losses deductible under IRC section 469(g)(3) are as follows:

Year 1	($2,000/$10,000	X	$30,000) =	$6,000
Year 2	($2,000/$ 8,000	X	$24,000) =	$6,000
Year 3	($2,000/$ 6,000	X	$18,000) =	$6,000
Year 4	($2,000/$ 4,000	X	$12,000) =	$6,000
Year 5	($2,000/$ 2,000	X	$ 6,000) =	$6,000
				$30,000

If Elizabeth had deducted the entire $30,000 in the year of disposition, a $24,000 adjustment would have been made.

Example 8

Mary disposes of a rental property in an installment sale. Her total gain of $50,000 is to be reported over 5 years ($10,000 each year). Her current and suspended losses attributable to this rental were $30,000. The losses deductible under IRC section 469(g)(3) are as follows:

Year 1	$10,000
Year 2	$10,000
Year 3	$10,000
	$30,000

She can further deduct losses from other passive activities to the extent of income recognized in years 4 and 5.

When the gain recognized in the current year exceeds all the current and carryforward losses of the taxpayer, all of those losses would be deductible in the current year and the above computation is ignored.

==

Audit Techniques:

* Carefully review Form 8582 and verify that the entire unrecognized gain from an installment sale has not been entered as passive income.

* If Form 6252, Installment Sale, reflects that the taxpayer has disposed of an asset in the current year, verify that the entire current and suspended loss has not been deducted on Schedule E.

===

Substantially Appreciated Property

Net income from the disposition of substantially appreciated property will be treated as not from a passive activity unless the property was used in a passive activity for either 20 percent of the taxpayer's holding period or the entire 2-year period ending on the date of disposition. Property will be considered substantially appreciated if the fair market value of interest exceeds 120 percent of the adjusted basis. (Treas. Reg. section 1.469-2(c)(2)(iii)(A)(C).)

Example 9

Linda acquires a building on January 1, 1987, and uses the building in a business activity in which she materially participates until March 31, 1998. On April 1, 1998, she rents the building to Rose. On December 31, 1999, Linda sells the building for a gain of $150,000. At that time, the fair market value of the building was $450,000 and the adjusted basis was $300,000. Although the building was used in a passive activity at the time of disposition, the gain would not be treated as passive.

The property is considered substantially appreciated since the fair market value (the $450,000 selling price) is in excess of 120 percent of the $300,000 adjusted basis.

$300,000	
X 1.2	(120 percent)
$360,000	

The property was not used in a passive activity for 20 percent of the taxpayer's holding period:

Purchased 01/01/87
Sold 12/31/99
13 year holding period X 20 percent = 2.6 years (not rented 2.6 years)

The property was not used in a passive activity (in this case rented) for the 2 years prior to the sale:

Date of sale 12/31/99
Date rented 04/01/98
21 months

Since the property was not rented the entire 2 years prior to the sale and was not rented for 20 percent of the holding period, the gain on disposition is recharacterized as not from a passive activity and would not be included on Form 8582.

==

Audit Techniques:

* Consider raising this issue when the property involved is in an area of appreciated property values and the rental period was short.

* Many dispositions that are reported on Form 8582 as passive will meet these tests and should be excluded from the form and treated as nonpassive.

===

Exhibit 4-6 is a lead sheet for substantially appreciated property.

Multiple Activities in Past 12 Months

If an asset was used in more than one activity during the 12-month period before a disposition, the gain or loss realized on such disposition must be allocated between the activities on a basis that reasonably reflects the use of the property. (Temp. Treas. Reg. section 1.469-2T(c)(2)(ii).)

However, the taxpayer will be allowed to allocate the entire gain or loss to the activity in which the property was "predominantly used" if the fair market value of the interest does not exceed the lesser of

$10,000 or 10 percent of the fair market value of all property (including the disposition property) used in the activity immediately before the disposition.

Dealer Rules

For years the Service has addressed the issue of dealer versus investor. The passive activity rules have increased the interest in this issue. If a taxpayer is a nondealer (for example, he or she is not in the business of renting properties), gain or loss would be passive. If the taxpayer materially participates in an activity of dealing/selling real estate (in other words, he or she is in the business of dealing/selling real estate), the property would be inventory and the gain or loss would be nonpassive.

Sales of dealer property are characterized based on the participation level of the taxpayer. Property sold is deemed to be dealer property if: the taxpayer held similar property as inventory AND did not use the property in a nondealing activity (investment or rental activity) for more than 80 percent of the holding period OR the property was acquired for the principal purpose of selling as inventory. This issue is complicated when the taxpayer is holding multiple properties in different activities. Exhibit 4-7 is a lead sheet for dealer rules. See Treas. Reg. section 1.469-2(c)(2)(v)(A).

ISSUE IDENTIFICATION

If the return reflects or suggests any of the following items, the examiner should consider a possible passive income issue:

1. Large income items reflected on Form 8582.

2. Income on Form 8582 from same source as W-2 wages.

3. Portfolio or investment income on Form 8582.

4. Net income on rentals with:

   a. Little or no depreciation
   b. Land rental
   c. Self-rented to W-2 activity or Schedule C.

5. Overall net loss from disposition on Form 8582.

6. Like kind exchange or other non-recognition disposition.

7. Partial sale of interest with losses claimed.

8. Installment sale.

9. Multiple properties and sales with short holding periods.

SUMMARY

1. Passive activity income includes income from the activity and gain on disposition.

2. Nonpassive income should not be included on Form 8582. Nonpassive income is: net income from activities in which the taxpayer materially participates, portfolio income, wages, and guaranteed payments.

3. There are several recharacterization rules which prevent the taxpayer from generating what otherwise might be passive income. The recharacterization rules only recharacterize net income. Net losses remain passive and are subject to the limitations of IRC section 469. Income from nondepreciable rental property, typically land, is an example. Another example is income from a building or equipment rented to a trade or business activity in which the taxpayer materially participates. A third example is rental incidental to development activity. Net income is nonpassive if the taxpayer materially participated in the development of the property, gain is recognized from the sale in the current year and the property was not rented for 12 months prior to the disposition.

4. There are several rules for dispositions as well. If the disposition results in net income (the gain/loss on disposition exceeds the current and suspended losses), the net income will be treated as passive and should be reflected on Form 8582. If the disposition results in a net loss, the entire disposition should not be reflected on Form 8582, and the taxpayer would be able to deduct all current and suspended losses provided the taxpayer disposed of the entire activity in a fully taxable transaction. Nonrecognition dispositions, gifts,

and transfers as a result of a divorce are not entitled to this loss provision.

5. Sales on the installment basis require the taxpayer to deduct losses in the same ratio as the gross profit.

6. If property is substantially appreciated (fair market value exceeds 120 percent of adjusted basis), the net income will be treated as nonpassive unless the property was used in a passive activity for 20 percent of the holding period or the entire 2-year period ending on the date of disposition.

7. Sales of dealer property are characterized based on the participation level of the taxpayer. Generally, property is dealer property if the taxpayer held similar property as inventory and did not use the property in a rental or investment activity for more than 80 percent of the holding period.

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PASSIVE INCOME

AUDIT PROCEDURE:

If Form 8582 reflects significant income, perform the following:

____ Verify that income on Form 8582 is also reflected on Schedule E or elsewhere. Form 8582 is merely a computational form for allowable passive activity losses. Income on Form 8582 must also be reflected on the appropriate schedule to be properly reported on the tax return.

____ Verify that income is not interest, dividends, royalties, or stock sales. Portfolio income is not passive income and should not be entered on Form 8582.

____ Verify that income on Form 8582 is not from an activity in which the taxpayer materially participates. Review worksheet 2 of Form 8582 to see if income is coming from in-state activity -- an indicator that the taxpayer is possibly materially participating. If the taxpayer meets any of the following, he or she is materially participating and income is nonpassive:

___ Did taxpayer and spouse work more than 500 hours during the year in the business?
___ Did taxpayer perform substantially all the work?
___ Did taxpayer perform 100 hours and no one did more?
___ Are there several passive business activities which when grouped together exceed 500 hours worked?
___ Did taxpayer materially participate in any 5 of the prior 10 years?
___ Is the business a personal service activity and did taxpayer materially participate in any 3 prior years?

____ Verify that income is not from the rental of land or other nondepreciable property. Under Temp. Treas. Reg. section 1.469-2T(f)(3), if less the 30 percent of the *unadjusted* basis is depreciable, income is treated as nonpassive. Income the from sale of land which had been rented is also recharacterized as nonpassive.

____ Verify that income is not from a covenant not to compete.

____ If there is a Form 6252 for an installment sale of a passive activity, verify that:

-- Income entered on Form 6252, Line 24 ties to Form 8582, AND
-- Current and carryforward losses are deducted in same ratio as gain.

____ Verify that income is not from rental of building or equipment to a partnership or 1120-S in which the taxpayer materially participates (unless there is a binding contract entered into prior to February 19, 1988). Rental income from businesses in which the taxpayer materially participates is recharacterized as nonpassive and should not be reported on Form 8582. Gain on the sale of a self-rented building or equipment is also reclassified as nonpassive.

REMINDER: Bare equipment leases are subject to self-employment tax. IRC section 1402(a)(2) excepts real estate but not a bare equipment lease. Also see *Carl Stevenson v. Commissioner*, T.C. Memo 1989-357.

____ Does the return suggest that the taxpayer might be a real estate developer, and thus income from properties held as inventory would be treated as nonpassive? See Treas. Reg. section 1.469-2(c)(2)(v)(A)(2).

____ If the property is substantially appreciated, verify that the property was used in a passive activity for either 20 percent of the taxpayer's holding period OR the property was used in a passive activity for the entire 2-year period prior to disposition. See Treas. Reg. section 1.469-2(c)(2)(iii).

____ If the business generating passive income is similar to other nonpassive businesses controlled by the taxpayer and there are indications that the purpose for treating it as a separate activity is to circumvent the passive loss limitations, consider whether the businesses might be deemed an economic unit under Treas. Reg. section 1.469-4. If so, income would be nonpassive. See the example contained in Treas. Reg. section 1.469-4(f)(2).

CONCLUSION: In accordance with IRC section 469, passive income has/has not been correctly reflected on Form 8582. Passive losses in the amount of ______________ have been allowed/disallowed.

ADJUSTMENT: Income recharacterized as nonpassive should be removed from Form 8582. (Of course, it should still be reported on Schedule E or another appropriate schedule.) Form 8582 should then be recomputed without the income which was recharacterized. Passive losses will be disallowed up to the amount of passive income recharacterized as nonpassive.

NON-DEPRECIABLE PROPERTY

____ Is property being rented?

____ Does the activity result in net income?

	Unadjusted basis of rental Property (Land and buildings before depreciation)	____________
X	30%	

____	Is sum of depreciable assets less than this result?	===========

If the answers to the above questions are yes, the net income from the rental activity should be recharacterized as nonpassive income.

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SELF-RENTED PROPERTY

____ Does the taxpayer materially participate in the business which is renting property from the taxpayer?

____ Does the rental activity result in net income?

If each answer is YES the rental income should be treated as nonpassive and not be reflected on Form 8582 **unless** there is a written binding lease executed prior to February 19, 1988.

If any answer above is NO -

____ Is the asset being rented something other than real estate?

If yes, the activity should be on Form 8582, line 2.

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DISPOSITIONS

Net gain/loss on disposition	________________
Net income/loss from current year	________________
Prior year losses	________________
Overall net income/loss on disposition	=============
Property was sold to unrelated party?	_________
Did taxpayer dispose of entire interest?	_________
Was all gain realized recognized?	_________
Did disposition result in overall net income?	_________

If all answers are YES, the disposition should be on Form 8582 and all losses from the activity disposed of would be fully deductible.

If disposition results in an overall net loss, the disposition should not be reported on Form 8582 and all losses for this activity should be deducted on the appropriate schedule.

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INSTALLMENT SALE

1. Did Installment Sale result in overall net income in the current year?

   a) Installment Gain **Recognized this year** ________________

   b) Less: Current/Carryforward Loss ________________

   c) Net income/loss ________________

If answer to 1c is net income, all current and carryforward losses are deductible in current year. Gain recognized in future years will be treated as passive if passive in year of disposition.

2. If answer to 1c is net loss, perform the following computation:

$$\frac{\text{Installment gain recognized in current year}}{\text{Total gain to be recognized}} \times \begin{array}{l}\text{Current and}\\ \text{Suspended}\\ \text{passive loss}\end{array}$$

If this answer is greater than the gain recognized in the current year (line 1a), this is the total loss to be deducted in this year.

If this answer is less than the gain recognized in the current year (line 1a), the taxpayer is allowed to deduct additional losses up to the income recognized.

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Exhibit 4-6

SUBSTANTIALLY APPRECIATED PROPERTY

1. Is the property substantially appreciated?

    a. Fair market value (selling price) ______________

    b. 120% X adjusted basis ______________

    If a is larger than b, the property is substantially appreciated.

2. Was property used in passive activity for 20 percent of taxpayer's holding period?

    Date purchased ________________

    Date sold ________________

    Total holding period
    ==============

    a. Total holding period X 20 percent _____________

    b. Period used in passive activity _____________

    If period (b) does not exceed 20 percent of the holding period (a), property was not used in a passive activity for 20 percent of the holding period.

3. Was property used in a passive activity for the entire 2-year period prior to the disposition?

If the answer to question 1 was yes, perform the computations in questions 2 and 3. If the taxpayer does not meet either test (both answers are no), the net gain on the disposition will be treated as nonpassive and not included on Form 8582.

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DEALER RULES

Does Temp. Treas. Reg. section 1.469-2T(c)(2)(v)(A)(2) apply?

1. Does the taxpayer hold similar property as inventory in a "dealing" activity? ______

2. Was the disposed property used in a "nondealing" activity for more than 80 percent of the holding period? ______

3. Was the property used in nondealing activity more than 24 months and 20 percent of the recovery period as defined in IRC section 168? ______
   (For example, rented more than 2 years.)

4. Was property simultaneously offered for sale and used in nondealing activity for 25 percent or less of the period the property was used in nondealing activity? ______
   (For example, offered for sale while rented.)

If the answers to the above questions are all YES, the disposition will be treated as coming from the nondealing activity (possibly a rental activity) and the character of gain/loss will be based on the character of the nondealing activity.

If nondealing activity is rental activity, the gain on disposition would be passive and reflected on Form 8582.

If the answers to any of the above questions is no, the disposition will be treated as coming from the dealing activity (probably a nonpassive activity) and the character of gain/loss will be based on the character of the dealing activity.

(If taxpayer materially participates in dealing activity, the gain on disposition would be nonpassive and not reflected on Form 8582.)

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INCOME ISSUES ON DISPOSITION OF A PASSIVE ACTIVITY

ISSUE: On the sale (or other disposition) of a building, is income on Form 8582 properly reflected as passive income? In other words, should the income be removed from Form 8582, thereby triggering the disallowance of passive losses?

AUDIT PROCEDURE:

____ Verify that building was used in a passive activity. A passive activity is either a rental activity or a trade or business in which the taxpayer does not materially participate. In other words, verify that the building was not simply held for investment, and therefore income would be nonpassive. IRC section 469(c), Seits TCM 1994-52.

If income is nonpassive, it should be removed from Form 8582, thereby reducing allowable passive losses. **REMINDER:** Investment income is not passive income (IRC section 469(e)).

____ Inquire if income is from the sale of a building which was rented to a corporation or partnership in which the taxpayer materially participated. If so, ensure than gain has been treated as nonpassive. See Treas. Reg. section 1.469-2(f)(6).

____ Inquire if income is from the sale of previously rented land. If so, gain is treated as nonpassive. The same applies to any previously rented property where less than 30 percent of the unadjusted basis is (land and building before depreciation) is depreciable. Treas. Reg. section 1.469-2T(f)(3).

____ Verify that income on Form 8582 resulting from a disposition is also reflected on Form 4797 and Schedule D or elsewhere. Form 8582 is merely a computational form for allowable passive activity losses. Income on Form 8582 MUST also be reflected on the appropriate schedule.

Generally, income on Form 8582 from the sale of a building used in a rental activity is carried to Sch. D (capital gain portion) and Line 15 of the front Form 1040 (ordinary income).
IMPORTANT NOTE: If no Form 4797 is filed with the return, it is indicative that there was not a fully taxable disposition which would trigger suspended losses.

____ Verify that only the net gain (not the entire sales price) has been entered on Form 8582.

____ Verify that the net gain from Form 4797 has been entered on line 1a or 2a, that the current net loss is on line 1b or 2b and that the carryover losses are on line 1c or 2c. (The net result is that only the <u>excess</u> gain after current and carryforward losses have been absorbed can be used to offset other passive losses.) If there was a gain on disposition, but current and carryforward operating losses exceed the gain, nothing should be entered on Form 8582. In both of these instances, the full taxable gain should be entered on Schedule D and the current and carryforward losses on Schedule E.

IMPORTANT NOTE: Many taxpayers enter ONLY the Form 4797 gain on Form 8582 without considering the impact of current and suspended losses, thereby erroneously allowing other passive losses.

____ If there is a Form 6252 for an installment sale of a passive activity, verify that:

-- Income entered on Form 6252 Line 24 ties to Form 8582, AND
-- Current and carryforward losses are deducted in same ratio as gain.

NOTE: When gain recognized from an installment sale exceeds all the current and suspended losses, taxpayer need not compute any ratios and losses are fully deductible.

____ If the property is substantially appreciated, verify that the property was used in a passive activity for either 20 percent of taxpayer's holding period OR property was rented for the entire 2-year period prior to disposition. Property is substantially appreciated if FMV exceeds 120 percent of adjusted basis. See Treas. Reg. section 1.469-2T(c)(2)(iii).

____ Verify that income is not from the rental/sale of land or other non-depreciable property. Treas. Reg. section 1.469-2T(f)(3) recharacterizes such income as nonpassive.

____ If return suggests taxpayer might be a real estate developer, consider whether properties were held as inventory and gain should be treated as nonpassive? See Treas. Reg. section 1.469-2T(c)(2)(v)(A)(2).

____ Verify that income on Form 8582 is not from an activity in which the taxpayer materially participates. If the taxpayer meets any of the following, he or she materially participates and income is nonpassive:

___ Did taxpayer (and/or spouse) work more than 500 hours a year in business?
___ Did taxpayer perform substantially all the work?
___ Did taxpayer work 100 hours and no one worked more?
___ Did taxpayer work 100-500 hours in several passive activities, the sum total of which exceed 500 hours?
___ Did taxpayer materially participate in the activity any 5 of the prior 10 years?
___ If the business is a personal service activity, did he or she materially participate in any 3 prior years?

____ If taxpayer is involved in multiple related entities, consider whether they might form an "appropriate economic unit" (in other words, ONE activity) under the final activity rules in Treas. Reg. section 1.469-4, and consequently, taxpayer would be materially participating. Thus, income would be nonpassive.

CONCLUSION: In accordance with IRC section 469, passive income has/has not (circle one) been correctly reflected on Form 8582. Passive losses in the amount of ________________ have been allowed/disallowed (circle one).

ADJUSTMENT: Income reclassified as nonpassive should be removed from Form 8582. (Of course, it should still be reported on Schedule E or another appropriate schedule.) Form 8582 should then be recomputed without the income which was recharacterized. Passive losses will be disallowed up to the amount of passive income recharacterized as nonpassive.

DISPOSITIONS TRIGGERING PASSIVE LOSSES

ISSUE: Should unused current and suspended losses be triggered by disposition? In other words, is it an *entire* disposition to an *unrelated party* in a *fully taxable* transaction?

AUDIT PROCEDURE:

____ Verify that disposition is **fully taxable**. IRC section 469(g) The following are not fully taxable:

- -- Like-kind exchanges.
- -- Conversion to personal use.
- -- Gift.
- -- Transfer to a corporation or partnership.
- -- Transfer due to divorce (treated as gift-IRC sections 469(g) and 1041(b).
- -- Installment sale (PALs triggered in ratio to gain reported).
- -- Bankruptcy which has not been finalized (see below).

NOTE: If there is no Form 4797 attached to the return, it is indicative that the taxpayer does not have a *fully taxable* disposition.

____ If the taxpayer is in bankruptcy:

-- Verify that bankruptcy proceedings have been completed.

If not, losses are not triggered because it does not constitute an entire disposition in a fully taxable transaction (in other words, gain or loss has not been recognized) as required by IRC section 469(g).

-- If bankruptcy is complete, verify that current and suspended losses have first been applied against any relief of indebtedness (debt cancellation). In many instances, the debt canceled under section 108 fully absorbs any current or suspended losses, and therefore nothing is deductible on the return.

REMINDER: Before allowing losses, examiner should also consider basis and at-risk limitations.

____ Verify that disposition is not to a *related party*.
The following are related parties: Spouse, brothers, sisters, sons, daughters, grandchildren; an individual and a corporation owned more than 50 percent by the same person; a partnership and a partner who owns more than 50 percent. See IRC sections 267 and 707(b) for other related parties.

____ Verify that substantially all of the activity was sold or otherwise disposed of.
IRC section 469(g) and Treas. Reg. section 1.469-4.

____ If owner died, verify that suspended losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased. (Basis is generally stepped up to FMV.) If the increase in basis exceeds unused passive losses, no PALs are deductible on the decedent's return.

____ If the disposition was by gift, the loss is not deductible. Instead, the basis of the asset for the donee is increased by unused losses.
NOTE: Transfers of passive activities as a result of a divorce are treated as gifts. A divorce does not result in a fully taxable event as required by IRC section 469(g). Furthermore, IRC section 1041(b) indicates that property incident to a divorce is treated as a gift for purposes of Subtitle A. Section 469 is part of Subtitle A.

____ If taxpayer sold a piece of rental real estate and is a real estate professional who meets the relief provisions of IRC section 469(c)(7) (effective for 1994 and forward) inquire whether he or she made an election to treat all his or her rental real estate activities as a *single* activity. If he or she did make the election, he or she cannot trigger suspended losses as he has not disposed of his or her <u>entire</u> activity as required by IRC section 469(g). NOTE: To group rental real estate activities as one activity, Prop. Treas. Reg. section 1.469-4 requires a written election be filed with the tax return. Generally (though not always), this election will be filed with the 1994 or 1995 return.

LAW: Under IRC section 469(g), current and carryforward passive activity losses are fully deductible in the year of an entire disposition in a fully taxable transaction to an unrelated party.

CONCLUSION: Passive losses in the amount of $__________ have/have not been adjusted for the following reason: ____.

Chapter 5

ENTITY ISSUES

INTRODUCTION

For partnerships and S-Corporations, material and active participation are generally determined at the individual level. If the activity is a rental, investor losses are per se passive. While the passive activity loss (PAL) rule do not generally apply to regular C-Corporations, they do apply to personal service corporations and to closely held corporations in a limited way. This chapter identifies corporations subject to the passive loss rules and the treatment of partners and shareholders.

PARTNERSHIPS

Partnerships are pass-through entities organized for the purpose of carrying on a trade or business for profit. A partnership may be involved in numerous activities including active law or accounting businesses, trading personal property, rental activities, holding investments, or tax shelter syndications. The ownership of a partnership interest is acquired as a general partner or a limited partner.

The general partner is responsible for the management and operations of the activities. The passive loss limitations are applied to the activities of the partnership at the level of the partner. The partnership entity cannot materially participate. The partners must individually meet the material participation requirements.

A general partner’s losses can be either passive or nonpassive, depending on the individual’s level of participation in the entity’s businesses. Of course, all flowthrough losses from rental activities are passive, as the Code defines all rentals as passive. Exhibit 5-1 contains several audit issues relating to partnerships and passive activities.

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Audit Techniques:

* When examining a partnership, scrutinize Schedules K-1 for indicators that investors might be passive, such as an out-of-state address, small ownership percentage, or name/address which suggests a minor. Prepare interview questions relating to the time and activities of each partner.

* At the initial interview, ask if the taxpayer treated each activity separately for purposes of the passive loss rules OR if he chose to group business activities. It is important to recognized that some partners may have grouped related businesses from several entities into ONE activity for purposes of IRC section 469 in order to meet material participation and deduct losses on their individual Forms 1040.

* Question any investor in a real estate partnership who is claiming active participation to verify that he or she is a general partner owning at least 10 percent interest who make management decisions in a bona fide sense. For both TEFRA and non-TEFRA partnerships, passive loss issues, (similar to basis issues) are generally determined at the individual level. The facts necessary to determine material or active participation generally depend on the extent and nature of the taxpayer’s personal involvement in the partnership activity. See Temp. Treas. Reg. Section 1,469-5T; Senate report 1986-2 C.B. (Vol. 3) 730-37. Passive losses, similar to penalties, are an affected item for report writing on a TEFRA partnership. These same rules also apply to TEFRA S-Corporations.

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Limited Partnerships

IRC section 469(h)(2) provides that an interest in a limited partnership is presumed to be a passive activity. A limited partner is one who may not be held responsible for partnership debts and whose potential personal liability is confined to the amount of money or other property contributed to the partnership plus the partner’s share of undistributed profits.

There are three exceptions under which a limited partner could meet the material participation standard. While these exceptions are rarely seen on audit, an examiner should be aware of them:

1. An individual participates in an activity for more than 500 hours during the tax year,

2. An individual was a material participant in any 5 of the last 10 years, or

3. An individual materially participated in a personal service activity in any 3 preceding years.

If a taxpayer has both a limited and a general interest in a partnership at all times during the tax year, he or she may qualify under any of the seven material participation tests in Treas. Reg. Section 1.469-5T.

The Committee Reports state that "the presumption that a limited partner interest is passive applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement."

Limited Liability Companies (LLC)

Limited liability companies are an entirely new form of business organization that combines features of both partnerships and corporations. The most notable characteristics of LLCs are: contractual freedom, two or more members (some states have authorized single member LLCs), and limited liability for all investors. Most states have authorized LLCs as a form of doing business, and a significant number of partnerships, sole proprietorships, real estate ventures, and S-Corporations have converted to LLCs.

Most LLCs will be carefully structured to be treated as partnerships for federal income tax purposes (as opposed to corporations which would subject them to double taxation) and will file Form 1065. Since an LLC is an amalgamation of a partnership and a corporation, the examiner should review Treas. Reg. Section 301.7701-2 carefully to ensure partnership classification for federal income tax purposes is appropriate.

Practical Note: Since most states require "LLC" to be a part of the entity name, an examiner should be able to recognize on pre-audit that he or she is dealing with a limited liability company.

If an LLC is treated as a partnership, the rules discussed above will apply. The examiner will also want to review Exhibit 5-2, Partnership and Passive Activity Loss Issues, and Exhibit 6-1, Partner's Basis. Needless to say, as with any partnership, the examiner should consider whether investors materially participate.

Since each member of an LLC has a limited liability, investors are analogous to limited partners. Thus, for purposes of the passive loss rules, LLC members should be treated as limited partners even if the taxpayer is a member-manager. See Treas. Reg. section 1.469-5T(e). However, we need to remember that tests 1 (500 hour test), 5 (5 of 10 year test) and 6 (any 3 prior years - personal service activities) of the material participation tests except the taxpayer from the limited partner taint.

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Audit Techniques:

* As with any partnership, be sure to inquire what each member's responsibilities and activities were in the tax year and how much time was applied.

* It is critically important that the examiner solicit and read the LLC agreement, any management agreements, and any agreements relating to self-employment tax. Peruse the agreements for who manages the business and what responsibilities are vested in certain members. If the LLC agreements indicate that certain members are essentially limited partners for self-employment taxes and the partnership has losses, it is an indicator that the member should be treated as a limited partner. Conversely, even if the agreements indicate that members are limited partners, but the examiner's findings indicate they materially participate and the business is producing income, a self-employment tax issue should be raised.

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Publicly Traded Partnerships

A publicly traded partnership (PTP) is a partnership whose interests are traded on an established securities market or are readily tradable on a secondary market. Consequently, most PTPs would be available through a broker or a dealer in stocks, bonds, and other securities.

IRC section 469(k) provides that the passive activity loss limitations must be applies separately to items from **each** PTP. Thus a loss from one PTP generally can be offset only by income from the **same** PTP. As a result, income and losses from PTPs are not reported on Form 8582, but must be figured separately. Unused losses from PTPs are carried forward indefinitely to future years when the taxpayer has income from the PTP or disposes of his or her entire interest to an unrelated party in a fully taxable transaction.

CORPORATIONS

PAL rules generally do not apply to C-Corporations. However, certain corporations are also covered under IRC section 469 because Congress anticipated that without a provision covering these corporations, individuals would incorporate certain types of income. For example, individuals would transfer their portfolio income assets to a corporate entity in order to shelter their income with passive losses without limitation. To prevent the use of corporate entities to avoid the passive loss rules, IRC section 469 specifically covers personal service C-Corporations and closely held C-Corporations. The passive loss provisions apply specifically to these entities. Any corporation having passive activities will need to complete Form 8810 and worksheets (similar to Form 8582 for the Form 1040).

Material Participation for Corporations

For personal service corporations and closely held C-Corporations, the examiner must determine if the corporation is a material participant in its activities. For example, a C-Corporation could be engaged in the business of selling and installing telephone equipment. If that corporation is also a partner in a partnership which engages in farming activities and leases out commercial real estate to other businesses, the corporation would have three different activities (telephone equipment sales, farming, and commercial real estate leasing). To determine which, if any, of these are passive activities to the corporation, we must ascertain whether the corporation meets the material participation standards.

Material participation for corporations (personal service C-Corporations or closely held C-Corporations) is determined based on the level of participation of the shareholders. One or more individuals who hold more than 50 percent of the outstanding stock must materially participate in each activity in order for the corporation to meet the material participation standard. These standards can be found in Temp. Treas. Reg. section 1.469-5T(a) or Chapter 3, Material Participation. Closely held corporations may also materially participate by meeting the requirements of IRC section 465(c)(7)(C). See IRC section 469(h)(4). In the example above, shareholders owning more than 50 percent of the stock of the C-Corporation would need to be material participants in the telephone equipment and farming activities for the corporation to treat these activities a nonpassive. The commercial real estate rental is passive by definition, regardless of the participation of the shareholders. (Note: Only individuals are allowed the special $25,000 rental real estate allowance. It is not available to C-Corporations.)

In addition, it is important to note that the passive income recharacterization rules as discussed in Chapter 4 apply to corporations.

Example 1

Wooster Inc. is a medical corporation with three equal shareholders. Regardless of the number of activities in which the corporation is involved, to avoid having any of the corporation’s activities classified as passive two of the three shareholders must materially participate in **each** activity of the corporation.

Closely Held C-Corporations

The passive loss rules are applied on a limited basis to closely held C-Corporations. The closely held C-Corporation can offset net active income with passive activity losses; however, portfolio income cannot be offset by passive losses. Net active income is the taxable income of the closely held C-Corporation without including any income or loss from a passive activity or any portfolio income or loss. A closely held C-Corporation cannot have portfolio income offset by the passive activity loss. It should also be noted that the closely held personal service C-Corporations cannot offset net active income with passive activity losses.

A C-Corporation is closely held if at any time during the last half of the taxable year, more than 50 in value percent of its outstanding stock is owned directly or indirectly by not more than five individuals. See section 469 (j)(1), 465(a)(1)(B), and 547(a)(2).

Example 2

A closely held C-Corporation has the following items reflected on its return:

Income		Deductions	
Rents	$ 60,000	Rental	($100,000)
Business	100,000	Business	(80,000)
Portfolio	35,000	Portfolio	(15,000)
	$195,000		($195,000)
	========		==========

Assuming the corporation materially participates in the business activity, the corporation's net active income and correct taxable income is computed as follows:

Corporation's Net Active Income

Gross business income	$100,000
Gross business expenses	80,000
	20,000

Passive rental losses of $100,000 are allowable to the extent of passive rental income ($60,000) plus the net active income of the corporation ($20,000). The $20,000 of rental loss is suspended until the next year.

Corporation's Taxable Income

Gross Income	$195,000
Rental Expense	-80,000
Business Expense	-80,000
Portfolio Expense	-15,000
	$20,000

Relief Provisions for Closely Held C-Corporations

In the case of a closely held C-Corporation, material participation is satisfied if the requirements of IRC section 465(c)(7)(C) are met.

These requirements provide that for the entire 12-month period ending on the last day of the taxable year:

1. The corporation had at least one full time employee who spends substantially all of the time in the active management of the activity,

2. The corporation had at least three full time, nonowner employees who spend substantially all the time performing services directly related to the activity, and

3. The corporation's business expenses (excluding among others, interest, taxes, and depreciation) exceed 15 percent of the gross income from the activity for the taxable year.

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Audit Techniques:

* It is common practice with closely held C-Corporations for the shareholder to own the building personally. Always check Form 8582 on the shareholders Form 1040 to verify that income from self-rented property has not been entered on line 1 (unless there is a binding lease prior to February 19, 1988). See Chapter 4 for a discussion of the recharacterization of income rules.

* If the shareholder does not materially participate and there are unused passive losses, they cannot be carried back. Instead, they must be carried forward.

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Personal Service Corporations

The limitations of IRC section 469 generally apply to personal service corporations without regard to the exceptions noted above for closely held C-Corporations. Personal service corporations are clearly defined as those including only the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. See Temp. Treas. Reg. 1.469-1T(g)(3)(I) and 1.441-4T(d).

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Audit Technique:

* When examining a regular C-Corporation for a doctor, attorney, or engineer, remember that the passive loss rules apply. Thus the shareholders owning more than 50 percent of the corporation's activities must materially participate.

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S-Corporations

Considering the number of C-Corporations which changed to S-Corporations after 1986, examiners should be very familiar with the passive activity loss rules. Like partnerships, the law disallows **"investor"** losses to those who are not materially participating unless they report other passive income. Stated differently, PAL rules do not apply directly to an S-Corporation, but to each shareholder's share of any loss or credits attributable to any passive activity reported on the he Schedule K-1.

An S-Corporation reports the shareholder's distributive share from the trade or business activities, rental real estate, other passive activities, and portfolio income. The level of participation which would determine the character of income or loss is based on the shareholder's level of participation in the activities of the S-Corporation. Exhibit 5-3 contains several issues relating to S-Corporations and passive activity issues.

Consolidated Returns

The following is a brief description of the application of the passive loss rules to consolidated returns:

First, we must determine if the C-Corporation is a personal service corporation (PSC). A consolidated group is treated as a PSC for purposes of the passive loss limitations <u>only if</u> the <u>entire</u> group's primary activity is personal services. If it is a PSC, the PAL limitations generally apply in full. Material participation for PSCs is determined by test 1, but not test 2 below.

The determination of whether a consolidated group is closely held is made by looking at the ownership of the parent corporation only. If the consolidated group is a closely held C-Corporation, net active income, but not portfolio income, can be offset by PALs. For purposes of IRC section 469, generally the consolidated corporation is treated as a whole or as a single entity, in other words, as **ONE Corporation**. See Treas. Reg. section 1.469-1(h)(4)(ii).

The consolidated group will be treated as materially participating IF one of the two tests is met:

1. More than 50 percent of the stock of the group's common parent is held by individual(s) who materially participates in any member of the group, OR, for closely held C-Corporations only,

2. The business meets the three requirements of the at-risk rules of IRC section 465(c)(7)(C) as mentioned above (under "Relief Provisions for Closely Held C-Corporations") except that the rules apply to the group as a whole.

Change in Corporate Status

The passive loss limitations do not apply to broadly-held C-Corporations that are not personal service corporations. It is possible that a change in status may occur and a closely held C-Corporation or a personal service corporation may change its ownership and become a broadly-held C-Corporation or may change its activity so that it no longer qualifies as a personal service corporation.

IRC section 469(f)(2) states that the passive activity loss and credit carryover rules will continue to apply as if it were still a closely-held C-Corporation or a personal service corporation. The suspended losses for a former closely-held corporation will offset only net active income of that entity, no portfolio income, and for a personal service corporation will only offset passive income in future years. IRC section 469 will no longer apply to future activity losses.

Under IRC section 1371(b), if a C-Corporation elects to become an S-Corporation, suspended losses cannot be carried over to the S-Corporation years.

Note: The change in corporate status does not constitute a fully taxable disposition in which suspended losses are triggered.

LOSS DETERMINATIONS AND TEFRA ISSUES

If an examiner has only the individual Form 1040 open, and a determination can be made as to whether the taxpayer is passive or nonpassive without examining the partnership or S-Corporation books and records, opening the entity return is not required. As both material and active participation are determined at the individual level, many passive activity loss adjustments can be made without the necessity of opening the partnership, whether it be TEFRA or non-TEFRA. The following is a discussion of the rules relating to TEFRA partnerships. The same rules will apply to a TEFRA S-Corporation. Exhibit 5-6 contains a TEFRA check sheet which can be used in identifying TEFRA entities and administering required procedures.

For a TEFRA entity, the determination of whether a partner’s distributive share of loss is limited by IRC section 469 is an **“affected item”** rather than a partnership item. The characterization of loss as attributable to a passive activity for purposes of IRC section 469 requires at four basic determinations: (1) whether the partnership’s activities involve the conduct of a trade or business; (2) whether the partnership is engaged in a rental activity; (3) whether the partnership’s income is portfolio income; and (4) whether the taxpayer (partner) materially participated in the partnership’s activities.

Because partnerships are not required to take passive losses or credits into account for their taxable year, the passive loss limitation is not a partnership item. Moreover, the resolution of the issue of whether a partner is subject to the passive loss limitation is not a partnership item. Whether the passive loss limitations apply to a partner has no effect on any item on the partnership’s books and records.

However, many of the legal and factual determinations that underlie the determination of whether the partner is subject to IRC section 469 themselves are partnership items. For example, if a determination is made at the partnership level that the entity is engage in rental activity, which is generally a passive activity regardless of the degree of material participation, IRC section 469(c)(2) will preclude any claim by the investor in an affected items proceeding that the partnership activity was instead a service activity. Similarly, a determination that a partnership is engaged in a trade or business for purposes of IRC section 162 will be res judicata in any affected items proceeding regarding the application of IRC section 469. That means that the partners would be precluded from arguing that IRC section 469 does not apply because they were not engaged in the conduct of a trade or business. The subdeterminations of passive activity losses that involve partnership level determinations should be set forth in the notice of FPAA. The partnership level components for passive activity losses include.

1. Whether the partnership is engaged in a trade or business for purposes of IRC section 162;

2. Whether the partnership is engaged in a rental activity; and

3. Whether the partnership's income is portfolio income.

If the issue concerns the material participation of a taxpayer, the determination should be raised as an affected item in the affected items statutory notice and resolved at the partner level. The facts necessary to determine material or active participation are unique to each partner and depend upon the partner's individual participation rather than on determinations common to all partners. See Temp. Reg. section 1.469-5T; Senate Finance Committee Report NO. 313, 99th Cong., 2d Sess. (1986), reprinted in 1986-3 C.B. (Vol. 3) 713-46.

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Audit Techniques:

* Be sure to scrutinize the Schedules K-1 for possible indicators that the investors are passive such as: out-of-state addresses and/or small ownership percentage. Prepare initial interview questions focusing on the level of participation of each shareholder.

* Review the Schedule K-1 for percentage of ownership and raise questions relative to the taxpayer’s time and effort applied to the business.

* Review forms 1120-S and 1065 to determine what activities are included in the flow-through amount. Rentals, portfolio, and nonpassive activities should all be treated separately on the Schedule K-1 (and Form 1040).

* Review the partnership agreements, management or service contracts, corporate minutes and other documents which might provide clues as to the taxpayer’s level of involvement. Is he or she an officer involved in day-to-day operations or is he or she simply an investor?

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TAXABLE YEARS

A partnership, S-Corporation, estate, or trust may or may not have the same taxable year as its partners, shareholders, or beneficiaries. See Treas. Reg. 1.469-5(h)(3). The taxable year of the **partnership** or **S-Corporation** is the period during which the level of participation must be determined. However, this general rule may not always be workable given the flexibility that exists for determining activities under Treas. Reg. 1-469-4. For example, if a taxpayer groups several businesses together into one activity, and the businesses are conducted through several passthrough entities with different taxable years, it is not clearly evident which taxable year the taxpayer should use. Examiners confronting this situation should consult with the Office of the Associate Chief Counsel (Domestic).

TIERED STRUCTURES

Where a tiered structure is involved (for instance, where the taxpayer holds an interest in an S-Corporation or a partnership that itself holds an interest in a subsidiary partnership or S-Corporation) a look-through rule treats the taxpayer as holding an interest in the subsidiary entity. See Temp. Treas. Reg. section 1-469-2T(e)(3)(ii)(D)(3).

Example 3

Bob owns 100 percent of Bob’s Auto Works S-Corporation which owns 50 percent of XYZ partnership. The look-through rule states that a determination for purposes of IRC section 469 (that is, material participation) would be made as though Bob directly owned 50 percent of XYZ Partnership.

SELF-CHARGED INTEREST AND OTHER ITEMS

When a taxpayer lends money to his or her own partnership of S-Corporation that conducts a passive activity, that entity generally must pay the taxpayer a market value rate of interest. The interest the taxpayer receives normally would be considered portfolio income, while at the same time the taxpayer’s distributive share of the entity’s interest expense deduction would be passive. Therefore, without self-charged interest rules of Proposed Treas. Reg. section 1.469-7, an unfair situation would occur.

Example 4

Ann lends money to an S-Corporation in which she has a passive 100 percent interest. The result of this lending transaction would be to fully tax the interest income (since it is portfolio income) while limiting the passive interest expense to passive income. In reality, however, Ann has had no economic benefit at all. She has simply taken funds from one of her pockets and put them into another. This interest is called “self-charged interest”, because she (as a private lender) has charged herself (through her S-Corporation) interest.

Congress recognized the inequity of the above possibility and instructed Treasury to create regulations which would equitably resolve the matter. These regulations (Treas. Reg. section 1.469-7) were proposed in April 1991. See Exhibit 5-3 for a self-charged interest lead sheet. Exhibit 5-4 is a decision chart for self-charged interest.

Effect of Regulations

Under the regulations, where there are lending transactions between a taxpayer and his or her pass-through entity, a portion of the taxpayer's distributive share of the self-charged interest income is recharacterized from portfolio income to passive income (Proposed Treas. Reg. section 1.469-7(a)(1)(I) and (c)). It, therefore, becomes a passive income item for purposes of computing allowable passive losses on Form 8582. This is an easy concept when the taxpayer is a 100 percent shareholder of a passive S-Corporation. It becomes a bit more complicated when partners own less than 100 percent of the partnership or when several partners have loaned money to the partnership. It also becomes complex when the entity itself uses the funds in both passive and nonpassive activities.

It is <u>important</u> to note that this recharacterization applies only to interest income and interest expense from lending transactions. It cannot be used to recharacterize any other kind of self-charged item such as management fees, guaranteed payments for services from a partnership, salaries from a passive S-Corporation, etc.

Flow-through Entity's Election

The flow-through entity (not the taxpayer) can elect out of this treatment of self-charged interest (Proposed Treas. Reg. section 1.469-7(f)). In other words, if the partnership or S-Corporation makes this election, the partner or shareholder is denied the right to recharacterize the portfolio income as passive income. The election, once made, applies to all lending transactions between the entity and the owners and is effective for the owner's tax year within which the entity's election year ends, and all subsequent tax years that end before the election date is revoked. The election is made by attaching a statement to the entity's return (or amended return). It remains in effect until revoked and may only be revoked with the consent of the IRS.

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Audit Techniques:

* Watch for self-charged items other than interest which are inappropriately recharacterized such as:

a. Management fees from the entity to the taxpayer -- calling a similar amount of the passive loss “nonpassive”.

b. Guaranteed Payments for services paid by a partnership -- also calling a similar amount of the passive loss “nonpassive”.

c. Salaries from a passive S-Corporation -- same as above.

d. Rents from any pass-through entity. Under Treas. Reg. Section 1.469-2(f)(6), taxpayers must recharacterize net income from a rental to a flow-through entity in which the taxpayer is a material participant as nonpassive, while losses remain passive. This rule prevents the artificial manipulation of rent charged to create passive gains which were offset by other passive losses. Taxpayers cannot recharacterize the nonpassive gain as passive or passive losses as nonpassive!.

* Where interest income has been recharacterized as passive income on the taxpayer’s return, solicit the computations supporting the recharacterization. Verify that the loan proceeds were used in passive endeavors, and that no more than the correct amount is being recharacterized. As a general rule, for anyone other than a 100 percent owner of a fully passive S-Corporation, the correct amount to be recharacterized will be less than the total interest income received from the entity.

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<u>DISPOSITIONS OF PARTNERSHIP AND S-CORPORATION INTERESTS</u>

The disposition of partnership and S-Corporation interests adds complexity to computing passive income or loss. Many entities own a variety of assets and are engaged in several activities, but the determination of whether gain is passive will be determined at the **activity** level and not at the **entity** level. Temp. Treas. Reg. section 1.469-2T(e)(3)(ii) requires that a shareholder/partner’s gain or loss from a disposition of the interest be allocated among the various activities of the entity.

The allocation is made in proportion to the gain or loss that would have been allocated to the holder of each “activity” if the entity had sold its entire interest in that activity. The entity can select an **applicable valuation date** for this determination. Generally, the entity may select for this date either the beginning of its taxable year in which the disposition occurs or the date of disposition. See Temp. Treas. Reg. section 1.469-2T(e)(3)(ii)(D)(1) for more information regarding the determination of the applicable valuation date.

When gain is recognized from the disposition of a partnership interest, it should be allocated ratably among all activities of the entity that would have produced net gain if they were sold by the entity for fair market value of the applicable valuation date. Treas. Reg. section 1.469-2T(e)(3)(ii)(B). The allocation to each activity is equal to:

$$\text{Ratable portion allocable to an activity} = \text{Gain} \times \frac{\text{Net gain recognized form sale of interest in activity}}{\text{Total net gains from deemed sale of all activities producing a net gain}}$$

If a loss is recognized on a disposition, the allocation would be based on a similar computation only on those activities producing a net loss.

See Temp. Treas. Reg. section 1.469-2T(e)(3)(ii)(B) for additional examples.

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Audit Techniques:

* Watch for entities with large portfolio or nonpassive activities. If the entity is disposed of at a net gain, the gain might be characterized as nonpassive.

* Suspended losses are not triggered if the disposition of the entity involves a related party. See Chapter 4 for more details regarding disposition.

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<u>TRUSTS AND ESTATES</u>

Generally, the material participation of the fiduciary determines the character of the income and deductions of the trust or estate for purposes of computing the trust or estate's taxable income. See ***S. Rep. No. 313***, 99th Cong., 2d Sess. 735, reprinted at 1986-3 C.B. 735. A **fiduciary** is the person who is legally responsible for managing the assets of the trust. Any net loss from a trade or business activity in which the fiduciary does not materially participate or a net loss from a rental activity is subject to the limitations of IRC section 469. The fiduciary must complete Form 8582 to determine the passive activity loss allowed for purposes of computing the taxable income of the trust or estate. Temp. Treas. Reg. sections 1.469-8T(g) and 1.469-9T on trusts and estates have not yet been issued. However, they will contain other rules for applying passive activity rules to trusts, estates, and beneficiaries.

The active participation standard does not apply to trusts. Therefore, rental real estate losses in excess of passive income should be suspended at the trust level and carried forward to subsequent years.

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<u>Audit Technique:</u>

***** Watch for flow-through losses from a trust erroneously entered on Form 8582 line 1. They do not meet the active participation standard for rental real estate. Furthermore, passive losses are generally limited at the trust level.

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ISSUE IDENTIFICATION

1. Schedules K-1 reflecting any of the following:

    a. Low ownership percentage

    b. Out-of-state address

    c. Limited partner (general partner box checked "no")

2. Activity is rental or leasing of equipment and has a loss. If activity is equipment rental and has income, the investor is generally subject to self-employment tax.

3. Form 8582 appears to reflect items of income inappropriately recharacterized under the self-charged interest rules such as:

   a. Management fees (from the entity to the taxpayer -- calling a similar amount of the passive loss “nonpassive.”

   b. Guaranteed Payments for services from a partnership -- also calling a similar amount of the passive loss as “nonpassive/”

   c. Salaries from a passive S-Corporation - same as above.

   d. Rents from any pass-through entity. (Under Treas. Reg. section 1.469-2(f)(6), taxpayers must recharacterize net income from a rental to a flow-through entity in which the taxpayer is a material participant as nonpassive, while losses remain passive.)

SUMMARY

1. IRC section 469(h)(2) indicates that limited partners are generally passive. Test 1, 5, and 6 in Treas. Reg. section 1.469-5T are three exceptions to the limited partner taint.

2. The determination of whether a partner is a material or active participant is generally made at the individual level. If the activity of the entity is rental, all investors are passive.

3. Closely held C-Corporations and personal service corporations are subject to IRC section 469. The passive loss rules are applied in a modified form for closely held C-Corporations by allowing a passive activity loss to offset net active income, but not portfolio income.

4. Net active income is the he taxable income of the closely held C-Corporation without including any income from a passive activity nor any portfolio income or loss.

5. When a taxpayer receives interest income from a pass-through entity to which he or she has loaned money, the allocable share of interest income is recharacterized as passive income.

6. If the entity use the loan in a passive activity, a portion of the taxpayer's interest income (not exceeding the taxpayer's distributive share of <u>passive</u> interest expense passed through to him or her) is passive income.

7. The self-charged provisions of Treas. Reg. section 1.469-7 apply only to interest, and not to other items which may also be arguably "self-charged." Taxpayers may not recharacterize guaranteed payments from partnerships, salaries from S-Corporations, management fees paid for services by the entity, or rents from a pass-through entity.

8. On a TEFRA entity examination, the determination of whether an investor materially or actively participates is an affected item.

PARTNERSHIP AND PASSIVE ACTIVITY ISSUES

AUDIT PROCEDURE:

____ Scrutinize partner Schedules K-1 and consider raising a passive loss issue if the following is reflected: Limited partner, low ownership percentage, out-of-state address or name/address suggesting a minor. REMINDER: Limited partners are subject to more restrictive tests for material participation. Tests 1, 5, and 6 of the material participation tests in Treas. Reg. section 2.4569-5T are the exception.

____ At the initial interview, ask what each partner does. Determine the time and activities of each partner. Also request partnership agreement (and management agreements, or contracts, if any) with duties highlighted.

____ If the activity of the partnership is long-term leasing of equipment, secure RTVUEs or S/C 45 all partner returns. Losses are not deductible unless the individual taxpayer has other passive income. If the Schedule K-1 reflects net income, it is subject to self-employment tax.

____ If the activity is rental real estate and reflects net losses, secure investor returns, verify that they meet the active standard, and that they have limited losses to $25,000, if active. If not active, zero is allowed unless the taxpayer has other passive income. REMINDER: Limited partners and partners with less than 10 percent ownership cannot meet the active participation standard.

____ If the partnership rents its building or equipment from a partner individually, determine whether the partner materially participates in the business. If so, the net rental income is recharacterized as nonpassive. While it still is reportable on Schedule E of the Form 1040, it cannot be used to offset by other passive losses and should not be reflected on Form 8582. Exception: If there is a written binding lease prior to February 19, 1988, the partner may characterize net income as passive. It is suggested that leases be requested early in the examination. Temp. Treas. Reg. section 1.469-2T(f)(6).

____ When pursuing the partners' individual returns, verify that Schedule K-1 portfolio income (line 4) and royalties have not been improperly entered on Form 8582. This type of income is reportable on Schedules B, D, and E, but should not be reflected on Form 8582 as it is nonpassive income. If it is on Form 8582, the examiner will have a passive loss adjustment up to the amount of income removed from the Form 8582.

____ When making flow through adjustments to the individual partner returns, consider automatic adjustments due to modified AGI. If modified AGI (AGI per return plus an addback for any passive activity losses, taxable social security, any IRA/SEP) exceeds $100,000 AND the taxpayer has rental real estate, his or her $25,000 offset is reduced 50 cents for every $1 over $100,000.

____ If the partnership falls under TEFRA proceedings, prepare an "affected item" report for any passive loss issue.

NOTES:

ACTIVITY RULES: Under the activity rules in Treas. Reg. section 1.469-4, a taxpayer may group his or her activities into ONE activity to meet the material participation standard (generally the 500 hour rule) IF they form an appropriate economic unit. Factors considered are: similarities, common control, common ownership, geographical location, and reliance between or among activities. To be grouped, in a realistic sense, the business must form an integrated and interrelated economic unit.

RENTAL REAL ESTATE PARTNERSHIPS: For 1994 and subsequent years, a taxpayer who spends more than half his or her personal services in real property trades or businesses AND works more than 750 hours in real property trades or businesses AND materially participates in each rental real estate activity may deduct current losses in full. See IRC section 469(c)(7) and related regulations.

PTPs: If the partnership is a publicly traded partnership (PTP), IRC section 469(k) provides that the PAL limitations must be applied separately to items from each PTP. A loss from a PTP can only be offset by income from the same PTP. As a result, income and losses from PTPs are not reported on Form 8582, but must be figured separately.

S-CORPORATIONS AND PASSIVE ACTIVITY ISSUES

AUDIT PROCEDURE:

____ Review shareholder Schedules K-1 and consider raising a passive loss issue if the following is reflected: Low ownership percentage, out-of-state address, or name/address suggesting a minor.

____ At the initial interview, inquire what the duties of each shareholder are and how much time is applied. Also request corporate agreement, management contracts, and any service agreements with duties highlighted.

____ If the activity of the corporation is long-term leasing of equipment, secure RTVUEs or S/C 45 all shareholder returns. Losses are not deductible unless the individual taxpayer has other passive income. If the Schedule K-1 reflects net income, it is subject to self-employment tax. See IRC section 1402(a)(2). Also see Carl Stevenson 1989 TC 357.

____ If the activity is rental real estate and reflects net losses, secure investor returns, verify that they meet the active standard, and have limited losses to $25,000, if active. If not, zero is allowed unless the taxpayer has other passive income. IMPORTANT NOTE: Beginning in 1995, a taxpayer who spends more than half his or her personal services in real property businesses AND more than 750 hours a year AND materially participates in the rental real estate activity can deduct losses without limit. See IRC section 469(c)(7) and lead sheet contained in Exhibit 2-4.

____ If the activity is rental real estate and reflects net income, review 2 prior years. If the corporation has accumulated E&P from its C-Corporation years, as well as passive investment income that is more than 25 percent of its gross receipts for 3 consecutive years, its S-Corporation election is terminated. See IRC section 1362(d)(3).

____ If the S-Corporation rents its building from the shareholder, determine whether the shareholder materially participates in the business of the corporation. If so, income is treated as nonpassive. While it still is reportable on Schedule E of the Form 1040, it cannot be used to offset other passive losses and should not be reflected on Form 8582. EXCEPTION: If there is a binding contract prior to February 19, 1988, the shareholder may characterize income as passive. It is suggested that copies of leases be requested early on. Treas. Temp. Reg. section 1.469-2T(f)(6).

____ When pursuing shareholder individual returns, verify that Schedule K-1 portfolio income (line 4) and royalties have not been improperly entered on Form 8582. This type of income is reportable on Schedules B, D, and E, but should not be reflected on Form 8582 as it is nonpassive income. If it is on Form 8582, the examiner will have a passive loss adjustment up to the amount of income removed from the Form 8582.

____ If Accumulated Adjustments Account (AAA) account is negative OR if there are large corporate loans and few shareholder loans, verify basis. Whenever basis and a section 469 passive loss issues are raised together, basis should be the primary position.

____ When making flow through adjustments to the individual shareholder returns, consider automatic adjustments due to modified AGI. If modified AGI (AGI per return plus an addback for any passive activity losses, taxable social security, any IRA/SEP) exceeds $100,000 AND the taxpayer has rental real estate, his or her $25,000 offset is reduced 50 cents for every $1 over $100,000.

____ If the S-Corporation falls under TEFRA proceedings, prepare an "affected item" report for any passive loss issue.

Exhibit 5-3

SELF-CHARGED INTEREST

ISSUE: Has self-charged interest been appropriately characterized as passive income?

LAW: To offset interest income which taxpayer is required to report on Schedule B from loans to related entities, taxpayer is allowed to recharacterize certain interest as nonpassive on Form 8582. See Treas. Reg. section 1.469-7.

AUDIT PROCEDURE:

____ Verify that self-charged interest is from a partnership or S-Corporation. Prop. Treas. Reg. section 1.469-7(b)(1) defines a pass through entity only as a partnership or S-Corporation. Therefore, it does not apply, by implication, to trusts and estates.

____ Verify that interest income (from a related entity which is a passive activity) has been reported on Schedule B in the same dollar amount as self-charged passive income on Form 8582. REMINDER: Passive income on Form 8582 MUST be reported on the return. Form 8582 is merely a computational form which figures allowable passive losses. Entering income does not report it on the return. It must be entered on one of the return schedules to be appropriately reported. The recharacterization rules for self-charged income are the one exception where portfolio income is recharacterized from nonpassive to passive income. Typically, one would expect to find interest income reported on Schedule B.

____ Verify that a passive loss (from the same activity as self-charged interest) has also been entered on Form 8582. For self-charged interest to be on Form 8582, it must be from a *passive* activity.

____ Request loan instrument, and verify that self-charged interest is actually interest. Other self-charged items such as management fees or rents, etc. cannot be recharacterized.

____ Verify that self-charged interest has been properly allocated based on the portion that is self-paid.
Fraction to compute allocation: NUMERATOR-TP's share of entity's self-charged interest; DENOMINATOR-TP's Sch. B interest income. (Obviously, this audit procedure is not necessary if taxpayer is 100 percent shareholder of an S-Corporation.)

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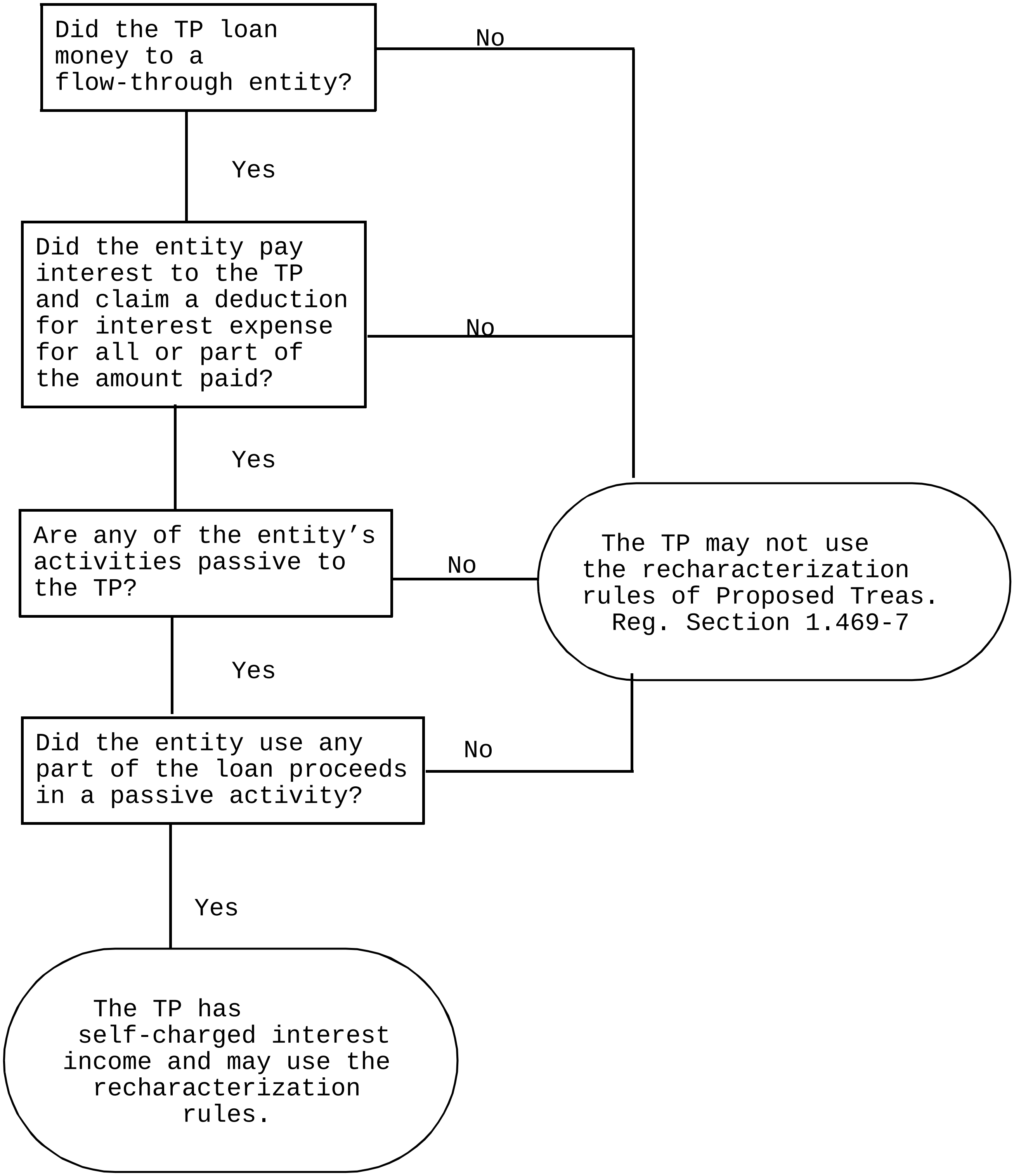
Exhibit 5-4

SELF-CHARGED INTEREST
(Proposed Teas. Reg. Section 1.469-7)



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TEFRA CHECK SHEET

Attach to Activity Record

TEFRA PARTNERSHIP: Partnership is TEFRA if tax year begins after September 3, 1982.

Small Partnership Exception: Partnership is non-TEFRA IF -

1. 10 or fewer partners, AND
2. All partners are natural persons or estates, AND
3. There are no non-resident aliens, AND
4. There are no unequal income/loss allocations, that is, each partner has same share of each item that he has of every other item. Perform "bright line" test. Guaranteed payments and other items cited in Reg. 301.6231(a)(1)-1(a)(3) are not special allocations.

Is return TEFRA? Yes_____ No_____. If yes, continue on.

TEFRA S-CORPORATION: S-Corp. is TEFRA if tax year begins after December 31, 1982.

Small Corporation Exception: S-Corporation is non-TEFRA IF -

Tax year ends after January 29, 1987, AND there are 5 or fewer shareholders, AND shareholders are not pass through entities.

Note: For any entity, husband and wife are treated as only one investor.

GENERAL INFORMATION

Date return assigned to examiner ________________________.

Does 1 year remain on statute? If no, District Director approval is required per IRM 4226 to start examination.

Date placed in status 12 _______________________.

Who is the TMP? ________________________________ Was TMP designation made in accordance with Treas. Reg. section 301.6231(a)7-1T and Rev. Proc. 88-16? Attach designation to back of first page of return.

SPECIFIC TEFRA PROCEDURES

Date NBAP (L-1787/1855) issued to TMP ________________.
If case is expanded to subsequent year, another NBAP must be issued. Retain dated copies of NBAPs in case file.

Was a no-change determination made within 45 calendar days after date of NBAP?
Yes_____ No_____

If yes, date TMP was notified of no-change _______________.
If no-change determination was made within 45 days, no further entries need be made.
If not, continue on with TEFRA procedures.

PCS CONTROLS

Prepare Form 8340 and attach copy of Form 1065/1120-S and all Schedules K-1.

Annotate each Schedule K-1 in red with MFT and district office of investor. Also note if investor is a non-notice investor (less than 1 percent).

Attach two calculator tapes:

1. Loss percentages totaling 100 percent.
2. Reconciliation of loss per return and investors' losses.

Attach current AMDISA for the key case return.

Secure Group Manager's approval and send Form 8340 package to PCS Coordinator.
Date:________________. Retain copy of Form 8340 in file.

Date of receipt of Form 886-Z(C)_______________.
1. Are names, TINs, and addresses correct? Yes___ No___
2. Does 886-Z (C) reconcile? Yes___ No___
If answer is NO, contact PCS Coordinator.

TEFRA CLOSING INFORMATION

Date summary report and L-1807/1856 issued to TMP_________________.

Date of closing conference_________________ (at least 30 days from summary report).

Date case submitted to Group Manager_______________. RAR should be in unagreed format, and penalties on a separate Form 886-A under the heading "Affected Item Report." Basis, at-risk, and passive activity loss issues raised as a part of the TEFRA entity examination are also affected items.

Is there more than 12 months on the statute?________ If "No", solicit statute extension from TMP. If TMP will not execute consent, send case to QMS for issuance of FPAA/FSAA.

STATUTE EXTENSION

Partnership: Form 872-P (specific date), 872-O (open-ended)
S-Corporation: Form 872-S (specific date), 872-R (open-ended)

Must be signed by TMP (never POA).

If examiner has investor returns for non-TEFRA issues, solicit Form 872 or 872A (TP signature) if Form 1040 statute expires within 8 months.

References: IRC sections 6221-6245, IRM 4226, 4227.

Court Cases: At-risk - *Roberts*, 94 T.C. 853 (1990); Basis - *Dial*, 95 T.C. 1 (1990); *University Heights*, 97 T.C. 278 (1991); *Nigh*, T.C.M. 1991-191; Same share rule - *Harrell*, 91 T.C. 21 (1988); *Z-Tron Computer*, 91 T.C. 22 (1988); Income under tax benefit doctrine *885 Investment Co*., 95 T.C. 156 (1990); Guaranteed payments - *Woody v. Commissioner*, 95 T.C. 193 (1990).

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Chapter 6

INTERACTION WITH OTHER CODE SECTIONS

INTRODUCTION

IRC section 469 on passive activity losses is only one Code section among several others that limit losses and deductions. Basis and at-risk should always be applied before passive losses. The examiner should be aware that after 1986, interest expense from a limited partnership or other passive activity is no longer deductible as investment interest. It is passive interest and must be limited using Form 8582. Similarly, any deduction from a passive activity, such as IRC section 179 expense from a limited partnership, for example, must be entered on Form 8582 along with the ordinary loss. Even if the taxpayer has sufficient passive income to trigger the losses under IRC section 469, IRC section 1211, and other Code section limitations must be considered.

Generally, an examiner should consider other obvious disallowance provisions, such as hobby losses under IRC section 183, before applying the passive activity loss rules. However, capital losses limited under IRC section 1211 are applied after the passive activity loss limitation.

There are two major exceptions to the passive activity loss (PAL) rules: (1) low income housing and (2) oil and gas activities. In both cases, with some limitations addressed later in this chapter the taxpayer is not subject to passive loss rules.

BASIS AND AT-RISK PROVISIONS

Three separate loss limitations apply to partners and shareholders and they are applied in the following order:

1. Basis rules.

   The taxpayer's loss cannot exceed his or her adjusted basis of:

   a. The partnership interest, or

b. The shareholder's stock and loans to the corporation. Loans in the corporate name but guaranteed by the shareholder are not basis until the taxpayer must actually pay.

2. At-risk rules.

   A taxpayer is at-risk if he or she is personally liable for repayment of a loan borrowed for use in the activity or if he or she pledged property (other than property used in the activity) as security for the loan.

3. Passive loss rules.

   If an examiner has raised a basis issue, an at-risk issue, and a passive loss issue, the basis issue should be the primary position, the at-risk issue should be the secondary position and the passive loss issue the third position. The lead sheets contained in Exhibits 6-1 and 6-2 provides audit techniques for these two issues.

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Audit Technique:

* Particularly on S-Corporation flow through losses, basis should be considered as an issue in conjunction with passive losses for out-of-state shareholders. Guaranteed loans are frequently improperly used to increase stock basis to deduct losses. The examiner can quickly ascertain whether there appears to be sufficient basis by reviewing the S-Corporation balance sheet. A beginning negative Accumulated Adjustments Account (AAA) may indicate that the shareholders do not have basis. Additionally, if the balance sheet reflects large loans by third parties to the corporation with few or no loans from the shareholder, it is an indicator that the taxpayer may have guaranteed the loan and may possibly be using it as basis.

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RENTAL OF PERSONAL RESIDENCE

If the taxpayer's personal residence as defined in IRC section 280A(c)(5) is rented, it is not a passive activity. Stated differently, losses from the rental of a taxpayer's personal residence should not be entered on Form 8582 if it was used personally for more than the **greater** of 14 days or 10 percent of the number of days during the year that the home was rented for fair market value. Instead IRC section 280A would apply, generally limiting losses to net income reported. See IRC section 469(j)(10).

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Audit Techniques:

* Watch for Schedule E rentals with the same or similar address as on the front of the return which would suggest rental of personal residence.

* While losses may not be subject to PAL rules, they are subject to the limitations of IRC section 280A, and are generally disallowable.

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Some taxpayers living overseas have rented out their personal residence and have not limited the mortgage interest on Schedule E but instead separated it out and deducted it in full, citing IRC section 469(j)(7) which states that the passive activity loss is "computed without regard to qualified residence interest." A qualified residence is defined in IRC section 163(h)(5)(A)(I) as either a principal residence or a second residence.

Since neither IRC sections 163(h)(3) nor 1034 defines principal residence, the examiner must look to the courts for a definition. See Exhibit 6-3 for guidance on developing this issue and possible questions to be asked relative to principal residence. IRC section 1034 indicates that a taxpayer cannot have more than one principal residence and that the property must have been "used by" the taxpayer. It is acceptable for a taxpayer to rent his or her principal residence on a temporary basis. However, if the taxpayer's absence is extended to several years, it is an indicator that the property is not a principal residence and, therefore, interest may not be qualified residence interest (unless the property is a second residence).

If the taxpayer indicates the property is his or her second residence, section 1.163-10T(p)(3)(iii) of the Treasury Regulations requires that the taxpayer use it personally for more than the greater of 14 days or 10 percent of the days rented (IRC section 280A(d)).

Practical Note: In virtually all cases, box 2 on Schedule E has been checked NO, indicating that the taxpayer fails these requirements. Therefore, the property does not qualify as a second residence. If on examination, it is determined that the personal use rules of IRC section 280A apply, then losses would generally also be limited to net income from the rental activity.

If the interest is determined to be qualified residence interest, it should be treated as an itemized deduction. Just because the interest is exempted from the passive loss limitations does not mean that it is not subject to other limitations in the Code. Some taxpayers who do not qualify to itemize have simply separated the interest on Schedule E from other expenses in Column A and entered it in Column B, thereby giving themselves double benefit for the standard deduction.

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Audit Techniques:

* In some cases where the taxpayer did not itemize, simply treating interest as an itemized deduction will result in a disallowance (since the standard deduction for married filing joint in 1994 is $6,200).

* Probe early in the examination as to whether the property is the taxpayer's principal or second residence.

* See the lead sheet at the end of the chapter for additional examination techniques.

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INVESTMENT INTEREST

Prior to 1986, a taxpayer could deduct interest from any kind of activity held for investment as investment interest. TRA '86 excluded interest from passive activities as defined in IRC section 469 (rentals and businesses in which the taxpayer does not materially participate) from investment interest, but allowed phase-in percentages for several years.

Beginning with 1991, a taxpayer who borrows money for investment can deduct interest on a loan only up to the amount of investment income. However, investment interest does **not** include any interest expense from a passive activity. Stated differently, interest expense from a limited partnership, rental real estate, and any other activity in which the taxpayer does not materially participate (that is, participates on a regular, continuous, and substantial basis) should not be included on Form 4952. Thus, line 12a of Form 1065 Schedule K-1, and line 11a of Form 1120-S Schedule K-1 should not include interest expense from any of these activities nor from nonpassive trades or businesses.

Interest expense from passive activities generally should be reported on Form 8582 and is not deductible until the taxpayer has income from passive activities. However, interest expense that is **properly allocable to portfolio income** from a pass through entity that also conducts a passive activity **is** investment interest expense and may be entered on Form 4952. In other words, investment interest from a pass through entity that also conducts a passive activity is deductible up to the amount of portfolio income from that and all other sources -- and both amounts would be entered on Form 4952. Exhibit 6-3 contains a lead sheet with audit procedures for investment interest.

Before TRA '86, examiners added all Schedule K-1 interest and other documents to verify that the total interest deduction was correct. Now they must also review Schedules K-1 and other documentation to verify that the taxpayer is not involved in a passive activity.

Investment **income** generally does not include passive income. See Treas. Reg. section 1.469-2(f)(10) for some minor exceptions. Consequently, your must again review the source of income to verify that it is not from a limited partnership, rental real estate, or other passive activity. **Reminder:** Interest, dividends, royalties, and other portfolio income do not constitute passive income as defined by IRC section 469(e)(1). Consequently, these types of income can be entered on Form 4952.

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Audit Techniques:

* Refer to Exhibit 1-2 in Chapter 1 for an example of a Schedule K-1 and how one determines if the taxpayer is a limited partner.

* Scrutinize investment **income** carefully. Verify that it is not passive income, and verify that it has been properly reflected on Schedules B, D, or E. Now that investment interest is deductible **only** up to investment income, in some cases, investment income has been inflated.

* Scrutinize investment interest to verify interest from a passive activity is not included.

* If the taxpayer has sufficient passive income to trigger investment interest from a passive activity, be sure to verify that he also has sufficient investment income before allowing the interest expense.

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NET OPERATING LOSSES

A regular net operating loss (NOL) can be carried back 3 years and forward 15 years. A loss from a passive activity which cannot be used due to the limitations of IRC section 469 must be carried forward indefinitely until there is passive income or a full disposition of the activity in a fully taxable transaction. In other words, if a taxpayer has a loss from a passive activity and no other passive income to offset it against, the loss cannot be carried back, but instead is suspended until a future year when the taxpayer has passive income or disposes of the activity.

Example 1

Gerald Monroe is a doctor who invested in an out-of-state partnership which generated a large loss. Since Dr. Monroe spends the majority of his time in his medical practice, he has little involvement with the partnership, and his losses are passive. As Dr. Monroe has no other passive income, he cannot deduct his distributive share of the loss from the partnership, but must suspend it and carry it forward.

A regular NOL carryforward can offset **any** income. However, a PAL carryforward can offset **only** passive income. In the event that both a regular NOL and a suspended loss from a passive activity are carried forward into the same year, the PAL carryforward is applied first against passive income before the regular NOL is applied.

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Audit Technique:

* If on examination it is determined that a "nonpassive" loss should have been classified as a passive loss, be sure to secure any carryback years if the loss was not fully absorbed in the current year.

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Passive losses allowed in excess of passive income due to the special $25,000 rental real estate allowance can become part of the taxpayer's NOL which is carried back 3 years or forward 15 years.

ALTERNATIVE MINIMUM TAX

Because tax law enables some taxpayers with substantial economic income to reduce their regular tax to a small amount via special deductions and credits, Congress enacted an additional tax, the alternative minimum tax (AMT). One of the adjustment items for AMT is passive activities (line 11 of Form 6251, Alternative Minimum Tax-Individuals, for the 1994 tax year).

This adjustment item is **not** the total allowable passive activity loss on the return (line 11 on Form 8582). The adjustment is the **difference** between line 11 of Form 8582 and line 11 of a second "AMT Form 8582" refigured by taking into account all AMT adjustment and preference items related to passive activities. Suspended losses from prior years based on the AMT rules also should be included on the second "AMT Form 8582." Any AMT adjustment or preference item that is entered on the second "AMT Form 8582" is not entered on any line of Form 6251 other than line 5r.

Example 2

Alan Rowan is a limited partner in Manchester Partnership. His Schedule K-1 reflects the following:

- A passive activity loss of ($8,000)
- An adjustment item for $500 of depreciation on property placed in service after 1986
- A preference item for $200 for depreciation on property placed in service before 1987

He had a second passive activity with $9,000 of passive activity income and no AMT items. Since he has more passive activity income than passive activity loss, he is allowed all of his $8,000 loss. Therefore, line 11 of his regular Form 8582 reflects allowable passive loss of $8,000.

The passive activity loss adjustment item for AMT is computed as follows:

Passive activity loss	($8,000)
Adjustment and preference items	700
Enter on W/S 2 of Form 8582	($7,300)

Since he is allowed PALs up to passive income, the second "AMT Form 8582" will reflect $7,300 on line 11.

Alan Rowan's AMT adjustment item for passive activity losses will be $700, computed as follows:

Form 8582 per return	($8,000)
AMT Form 8582	(7,300)
Line 11 of Form 6251	$700

The amount of passive activity losses that are not allowable for AMT purposes are carried forward. The PAL AMT carryforwards are frequently different from regular PAL carryforwards. Therefore, the taxpayer should be maintaining records for both.

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Audit Techniques:

* If the taxpayer has sufficient passive income to fully deduct passive losses, the adjustment item for AMT (line 11 of Form 6251) will generally be the full amount of the adjustment and preference items related to passive activities.

* If the taxpayer's passive losses are not deductible because he or she does not have passive income or does not qualify for the $25,000 special allowance for rental real estate, there will be no adjustment item for AMT passive loss on line 11 of Form 6251. In other words, if line 11 of Form 8582 is zero, line 11 of Form 6251 will generally be zero.

* If the taxpayer's entire activity is disposed of in a taxable transaction, the current and carryforward losses for AMT will be triggered, and it is likely that line 5r of Form 6251 will reflect a **negative** number in the transition years which ended in 1990. For post-transition years (1991 and subsequent), the disposition of passive activity frequently results in alternative minimum tax - as all the accumulated preference and adjustment items are also triggered (a positive number on line 11 of Form 6251).

* For 1991 and prior returns, the allowable phase-in percentage for passive losses was an adjustment item for AMT. While line 15 of Form 8582, Passive Loss Limitation, for 1991 and prior years reflects the allowable phase-in percentage, this number would not be accurate as the second "AMT Form 8582" is refigured adjusting passive income and losses for AMT adjustment and preference items. Consequently, the AMT adjustment item on Form 6251 would generally be a larger than line 15 of Form 8582.

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LOW INCOME HOUSING

The low-income housing and rehabilitation credits may be claimed by owners of qualifying residential rental properties that are rented to low-income tenants at restricted rental rates. A rental activity such as a low-income housing project is specifically defined to be a passive activity. See IRC section 469(c)(2).

For individuals, a special loss and/or credit allowance permits the taxpayer to claim up to $25,000 of losses (or the credit equivalent) from a rental real estate activity. However, the low-income housing and rehabilitation credits receive special treatment for purposes of this allowance.

First, for the rehabilitation credit, the adjusted gross income phaseout range is increased from $100,000-$150,000 to $200,000-$250,000. For the low-income housing credit, the gross income phaseout is eliminated. As such, the $25,000 allowance will apply regardless of the adjusted gross income of the taxpayer. However, this phaseout elimination only applies for property placed in service after 1989 where the taxpayer acquired the interest in such property after 1989. For projects that were placed in service before 1990 and for interests acquired before 1990, the low-income housing credit is treated the same as the rehabilitation credit.

Secondly, the active participation rule does not apply. Thus, investors in low-income housing or rehabilitation projects can claim tax credits without regard to their degree of participation. Note, however, that this special rule only applies to the credit itself and does not apply to any losses that are generated from the activity.

Low income housing LOSSES and low income housing CREDITS are each treated differently. For current years, LOSSES are generally subject to the passive loss limitations. Since most investors are limited partners and limited partners do not qualify for the active participation standard, losses should be entered on Form 8582, line 2b. Consequently, no $25,000 offset is available and losses are deductible only up to passive income reported on the return. However, a qualifying investor who owned a low income housing partnership interest on **12/31/88** and the property was placed in service between 12/31/85 and 8/17/86 may deduct all losses. Needless to say, this exception is very restrictive.

Code section 469(I)(6)(B) provides an exception for low income housing CREDITS. There is no participation requirement. Thus, even a limited partner may use the low income housing CREDIT. Furthermore, for tax years after 1989, there is no phaseout of the credit based on modified AGI. Therefore, a taxpayer with any amount of income may use the credit. However, we should remember that the credit is limited to the tax equivalent of $25,000.

The low-income housing provisions are complex, and the above is a brief description with general rules only. If you have a low-income housing issue, IRC sections 42 and 1250 should be researched.

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Audit Techniques:

* Verify qualifying dates for investors and partners. Note that the dates are quite restrictive and specific. If the taxpayer does not qualify, losses are limited to $25,000 offset.

* To verify that the property is qualified low-income housing, ask to see Form 8609, Low-Income Housing Credit Allocation Certification. Form 8609 is an annual statement which must be attached to the return each year.

* No low income housing credit is allowed for any person who has received transition rule relief.

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REHABILITATION CREDIT

While the active participation standard is not required for the rehabilitation credit and the phaseout range is raised to between 200,000 and $250,000, the credit is still limited to the tax equivalent of $25,000. It is important to note that this does not mean the taxpayer can deduct a credit of $25,000. Instead a taxpayer is allowed the tax equivalent of $25,000 for the rehabilitation credit. Thus, for example, a taxpayer in the 31 percent bracket could deduct a credit of up to $8,065. For additional audit techniques, see the MSSP Guide on Low Income Housing and the Rehabilitation Credit.

OIL AND GAS

Generally, a working interest in an oil or gas well is not a passive activity, and losses are, therefore, deductible in full (subject, of course, to the basis and at-risk provisions). A **working interest** must be held directly or through an entity that **does not limit the taxpayer's liability** (such as a general partner interest in a partnership). Consequently, neither an interest in a limited partnership, a limited liability company (LLC), nor an S-Corporation meets the definition of a working interest. Thus, losses deducted by limited partners and S-Corporation shareholders are subject to the limitations of IRC section 469. If the taxpayer is passive, losses are not deductible unless there is passive income from another activity.

If the working interest that produced losses begins producing income and the taxpayer obtains limited liability so that the activity is now passive, then the income is recharacterized as nonpassive.

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Audit Techniques:

* Do not casually allow a large nonpassive loss from an oil and gas entity. Always review the Schedule K-1 to verify that the taxpayer is not a limited partner or a shareholder in an S-Corporation.

* If the taxpayer reports passive income from a working interest with limited liability, review prior year's returns to see if losses were deducted in full because no limited liability existed. If so, income should be reclassified as nonpassive.

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CASUALTY LOSSES

Although most types of losses and deductions relating to a passive activity are generally limited under the rules of IRC section 469, there is an exception for casualty losses.

Treas. Reg. section 1.469-2(d)(2)(xi) states that a deduction for a loss from fire, storm, shipwreck, or from theft (as defined in IRC section 165(c)(3)) will not be treated as a passive deduction. Therefore, the deduction for these losses would be allowed in the year sustained (or the prior year pursuant to the election under IRC 165(I), if applicable). Naturally, losses can be deducted only up to the amount allowable under IRC section 165.

The exception to the passive loss limitations will not apply if losses occur regularly in the conduct of the business. For example, a loss resulting from a natural disaster will not be limited under IRC section 469. On the other hand, shoplifting losses at a retail store or accident losses sustained by an automobile rental activity would continue to be passive because they occur regularly in the conduct of those activities.

There are special rules for insurance reimbursements. If the casualty loss was not a passive loss under the regulation cited above, any insurance reimbursement received in a subsequent year (and includible in income in that year under Treas. Reg. section 1.165-1(d)(2)(iii)) will also not be considered passive activity income. If the casualty loss did not meet the exception to the passive loss rules, and, therefore, was considered a passive deduction, any gross income from insurance reimbursements would be passive income in the year the reimbursement is received. Treas. Reg. section 1.469-2(c)(7)(vi).

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Audit Technique:

* When a taxpayer has received an insurance reimbursement for a casualty which occurred in a prior year, the prior year's return should be inspected to determine how the original loss was treated. If it was treated as nonpassive, the income from the reimbursement is also nonpassive.

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SUMMARY

1. The basis and at-risk provisions always take precedence over the passive loss rules of IRC section 469. A taxpayer who has no basis, cannot deduct losses.

2. A rental of a property which is used by the taxpayer more than the greater of 14 days or 10 percent of the number of rental days during the year is not subject to PAL limitations. However, losses are limited by IRC section 280A, and generally are deductible only up to income reported from the rental.

3. Investment interest from a passive activity is not deductible as an itemized deduction, but instead should be entered on Form 8582. Passive income from a rental, limited partnership, or any activity in which the taxpayer does not materially

participate should not be entered as investment income on Form 4952.

4. Unused losses from passive activities must be carried forward until there is passive income or a complete disposition of the activity in a taxable transaction. If there is a regular NOL carryforward and a PAL carryforward, the PAL carryforward is applied first against passive income.

5. Alternative minimum tax has an adjustment item for passive losses. To accurately compute this item, a second "AMT Form 8582" should be completed reducing passive losses by AMT adjustment and preference items.

6. Losses from qualified low income housing projects are exempted from the passive activity loss rules during the transition period which ends with tax year 1992. The rules for qualified low income housing are very restrictive and should be carefully reviewed prior to allowing any loss.

7. A working interest in an oil and gas well is not a passive activity. However, since a limited partner and an investor in an S-Corporation do not meet the "working interest" definition, their losses are subject to the limitations of IRC section 469.

8. Casualty or theft losses from causes which do not occur regularly in the conduct of the passive activity will not be considered passive activity deductions. Any loss from this incident which would be allowable under IRC section 165 will be deductible in full on the taxpayer's return.

9. Insurance reimbursements received in years following a casualty or theft loss deduction, which are includible in income will take on the nature of the original loss claimed. If the original loss was passive, the insurance reimbursement will be passive income. If the original loss was nonpassive, the reimbursement will similarly be nonpassive.

SHAREHOLDER BASIS

AUDIT PROCEDURE:

____ Peruse S-Corporation balance sheet. If there is a negative Accumulated Adjustments Account, OR if there are large loans by third parties to the corporation with little or no shareholder loans, taxpayer may not have sufficient basis to deduct his or her losses.

____ Secure basis calculations from taxpayer. (Burden of proof is on taxpayer. It is not examiner's responsibility to calculate basis. If taxpayer provides no basis calculations, disallow losses.)

____ Review basis calculations for improper inclusion of corporate loans guaranteed by the shareholder. Personal guarantees for corporate loans are not basis until the shareholder is required to provide personal funds as a guarantor. Rev. Rul. 70-50, 1970-1 C.B. 178. *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (1989), 89-1 U.S.T.C. ¶ 9332, 63 AFTR2d 89P1437. *Raynor v. Commissioner*, 50 T.C. 762 (1968). *Borg v. Commissioner*, 50 T.C. 257 (1968). *Harrington v. Commissioner*, 65 F. Supp 53 (1985), 85-1 U.S.T.C. ¶ 9336. (If corporate balance sheet reflects minimal loans from shareholder but basis calculations do, guaranteed loans may be an issue.)

____ Review basis calculations for unpaid services. Services provided to the corporation are not basis unless taxpayer has previously included their value in income. *Borg v. Commissioner*, 50 T.C. 257 (1968). (Taxpayers rarely include unpaid services in income.)

____ Verify that loans from another S-Corporation or partnership are not being used as the taxpayer's basis. Even if the taxpayer controls the entity, loans generally do not constitute basis.

____ Ascertain that basis in assets contributed is cost less depreciation. (Sometimes, fair market value is erroneously used, particularly on appreciated real estate.) Round numbers for any asset should be questioned.

____ If the corporate balance sheet shows a repayment of a shareholder loan, verify that the loan was not used as basis in a prior year to deduct losses. If it was, the amount of the repayment constitutes ordinary income to the individual taxpayer up to the amount that was used previously as basis to deduct flow-through losses.

____ As a separate or alternative issue to basis, consider raising passive activity losses under IRC section 469 if the shareholder lives out-of-state, owns only a small percentage of the activity, or there are other factors which indicate the taxpayer is not materially participating in the corporation (that is, participating on a regular, continuous, and substantial basis). Refer to material participation lead sheet. If the taxpayer is not materially participating, losses are disallowed in full unless he or she has passive income reported on the return from another activity. If both basis and passive losses are raised, basis must be the primary position, and passive losses the alternative position.

LAW: IRC section 1366 indicates the amount of deductible shareholder losses shall not exceed the sum of the adjusted basis of stock and any indebtedness of the S-Corporation to the shareholder. Rev. Rul. 70-50 and numerous court cases clearly indicate that guaranteed loans and unpaid services are not deemed basis.

CONCLUSION: The taxpayer's pro rata share of ordinary losses have been allowed/disallowed based on above audit procedures.

PARTNER'S BASIS

AUDIT PROCEDURES:

____ Request taxpayer's calculations of basis in his or her partnership interest. If he or she provides nothing, disallow losses. Burden of proof is on taxpayer.
IRC section 704(d). The partnership is under no obligation to compute or keep track of a partner's basis. The partnership must, however, maintain the partner's capital account.

____ Review partnership agreement for:

-- Validity of loans

(Stop loss agreements, subordination agreements, letters of credit and anything else indicating taxpayer may not be personally liable for loans that is, not at risk under IRC section 465). For example, the taxpayer is not at risk if a separately obtained insurance policy will compensate him or her for any payments he or she must make because of his or her personal liability on a mortgage. The validity of loans can also arise when determining whether the partner has basis under IRC section 752 (treatment of liabilities).

(ALSO NOTE: Loans by a related partnership to an S-Corporation do not constitute basis to the shareholder. See Rev. Rul. 69-125 and 81-187; *Frankel v. Commissioner*, 61 T.C. 343 (1973); *Perry v. Commissioner*, 54 T.C. (1970). Rev. Rul. 69-125 holds that where shareholders of a corporation are equal partners in a partnership, debts owed by the corporation do not constitute basis to the shareholders as indebtedness must run directly to the shareholder. In other words, there must be an actual economic outlay leaving the taxpayer poorer in a material sense.)

-- Disguised sales:

1. Peruse partnership agreement for indications of contributed property and a related distribution of cash or other property within 2 years of contribution. Treas. Reg. section 1.707-3, *Otey v. Commissioner*, 634 F2d. 1046.

2. Look for refinancing of property shortly before its contribution to the partnership. The liabilities may be non-qualified liabilities under Treas. Reg. section 1.707-4 and 1.707-5, resulting in a taxable sale from the partner to the partnership.

NOTE: Disguised sales and validity of loans are common issues in the *initial year* of partnership formation. This is when a partner may attempt to pull cash tax free out of the partnership for a contributed piece of property.

-- Relief of liabilities: Relief of liability income is taxable under IRC section 61(a)(12).

IRC section 108(a) excludes relief of liability income if the taxpayer is bankrupt or insolvent. IRC section 108(d)(6) provides that we look to the partner (not to the partnership) to determine bankruptcy or insolvency.) Thus, the partnership can be bankrupt or insolvent and we still may have taxable relief of liability income under IRC sections 61(a)(12) and 108(a) to the partner. REMINDER: If the taxpayer excludes canceled debt from income, he or she generally must use the excluded income to reduce the following tax attributes: NOLs, general business credit carryovers, minimum tax credit, capital losses, basis, passive loss carryovers, foreign tax credit. Except for the credit carryovers, these tax attributes are reduced dollar for dollar of debt canceled. The credit carryovers are reduced 33.3 cents for each dollar of debt forgiven. RRA 93 added an exclusion from income for qualified real property business indebtedness if a timely election is filed and basis of depreciable assets is reduced. See IRC section 108(a)(1).

-- Contribution of appreciated property by one partner with receipt of partnership interest by another partner for services (taxable as income to the partner - otherwise no basis).

(In addition to basis considerations, the partnership agreement should be reviewed for: possible avoidance of corporate status under Treas. Reg. section 1.7701; capitalization of organizational expenses under IRC section 709; special allocations for contributed property - to be recognized, IRC section 704(b) requires them to be included in the partnership agreement; non-arm's length loans which could be potential distributions in excess of basis under IRC section 731; non-business loans which would be treated as short-term capital losses under IRC section 166; flip-flop or retroactive allocations which could constitute tax avoidance, etc.)

____ Secure 3 or 4 prior year returns, if possible, and review for indicators of basis problems. Review balance sheet for liabilities, cash contributed and distributions. These figures can be used to verify taxpayer's computations or to reconstruct basis.

____ Consider whether taxpayer is at-risk for loans? If nonrecourse loans for real property are from a related party or not from a bank, verify that proper accruals, loan instruments, etc. are in place. See IRC section 465.

____ Verify that assets contributed are at adjusted basis (cost less depreciation) NOT fair market value. IRC sections 722, 723. Also, while not often seen, a taxable event could arise if the relief of liability on contributed property exceeds the adjusted basis of the partner's interest in the partnership. See IRC sections 752(b) and 731.

____ For partners who contributed services for capital, verify income has been recognized up to FMV of services (value of partner's partnership interest - generally FMV). Be sure to review partnership agreement for details. Income is taxable when claim of right doctrine is satisfied (generally when capital account is granted). See IRC section 83 and Rev. Proc. 93-27. Case law on contributed services: *Diamond v. Commissioner*, 56 T.C. 530 (1971) and Robert Johnston, *etc ux v. Commissioner*, T.C.M. (1995). Taxpayers rarely recognize income for services contributed. If initial year is under examination, the adjustment recognizing income can be made to the partner's Form 1040. If not, value of contributed services should not be recognized as a part of the basis calculation.

____ For contributed property, consider whether gain should be recognized under IRC section 707(a) if sold within 2 years OR IRC sections 704© and 737 if sold within 5 years.

____ Was mortgage or other liability on property incurred within 2 years of transfer from partner to partnership? If so, liability may be non-qualifying under Treas. Reg. section 1.752-3 and income should be recognized as transaction is deemed a disguised sale. Also see Treas. Reg. section 1.707-5(a)(7). Treas. Reg. section 1.707-3(6)(2) provides 10 factors to be considered.

____ Consider whether guaranteed payments (IRC section 707(c)) might, in fact, be payments for property (IRC section 707(a)).

____ If the partnership is a transfer of an on-going business from another entity:

-- Verify that depreciation/credits have been recaptured.
-- Verify that assets are valued at adjusted basis (i.e. that basis is not stepped up).
-- Give consideration to tax effect of goodwill, inventory, etc.

LAW: IRC section 704(d) and Treas. Reg. section 1.704-1(D)(1) limit losses to the partner's basis in the partnership interest. Basis includes cash PLUS property contributed (IRC section 722) PLUS the partner's share of partnership liabilities (IRC section 752). Treas. Reg. section 1.469-2T(d)(6) provides the following sequence for limiting partnership losses: IRC section 704(d) limit first; IRC section 465 at-risk second; IRC section 469 passive loss limitations third.

CONCLUSION: Basis has/has not (circle one) been correctly computed. Adjustment has been made for the following reason:

____

NOTES:

1. Basis for a taxpayer involved in a TEFRA entity is generally a nonpartnership item as long as its elements are not required to be taken into account for the entity's taxable year under any provision of subtitle A of the Code. Accordingly, a regular report can be issued, and it is not necessary to open the entity or follow TEFRA procedures. If, however, verification of basis requires an examination of elements that are required to be taken into account for the entity's taxable year under any provision of subtitle A of the Code, the entity must be opened and TEFRA procedures must be followed. If the basis issue is large, unique or unusual, the examiner may want to consult with District Counsel as to whether it should be deemed a partnership or nonpartnership item.

2. Basis and at-risk limitations override passive loss limitations of IRC section 469. If it appears the taxpayer does not materially participate OR the activity is a rental activity, thus the partner is per se passive, raise basis as the primary issue and passive losses as the alternative issue.

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INVESTMENT INTEREST EXPENSE

AUDIT PROCEDURE:

____ Tie taxpayer's Schedules K-1, Forms 1099, etc., substantiating investment interest to line 1 of Form 4952.

____ Verify via review of Schedules K-1 that taxpayer has not included any interest expense from a passive activity (limited partnership, rental activity, or any other activity in which the taxpayer does not materially participate, that is, participate on a regular, continuous, and substantial basis). Interest from passive activities is reflected on Form 8582, but is no longer reflected on Form 4952.

____ Verify that taxpayer has not included tax exempt interest or any interest that should be capitalized such as construction interest subject to IRC section 263A.

____ Verify that income reflected on line 4 of Form 4952 has been properly reported on Schedules B, D, or E. Form 4952 is a computation form only, limiting the amount of investment interest deductible as an itemized deduction on Schedule A.

____ Verify via review of Schedules K-1, Forms 1099, etc., that income on line 4 of Form 4952 does not include any passive income.

____ Verify that the income on line 4 is interest, dividends, capital gain distributions from mutual funds, annuities, royalties, and net gains from the disposition of property held for investment. It does **not** include income derived from the ordinary course of a trade or business.

____ Verify that income has been properly reduced by investment expenses (expenses directly connected with the production of investment income).

____ Even if there is sufficient passive income on Form 8582 to trigger allowability of an investment interest expense from a passive activity, be sure to verify that there is sufficient investment income for the interest expense to be deductible. Stated differently, even though the expense may be allowable under the passive loss provisions, it still must meet the investment interest rules which require investment income in order to be deductible.

LAW: Beginning with 1991, investment interest is deductible only up to investment income. Interest from a passive activity is no longer deductible as investment expense.

CONCLUSION: In accordance with IRC sections 163 and/or 469, investment interest in the amount of $_________ has been allowed/disallowed. See work paper ____________.

ADJUSTMENT:

1. Remove any passive interest or income from Form 4952 and enter on Form 8582, Passive Activity Loss Limitation, and recalculate Form 8582. If there is no passive income, the taxpayer will get no tax benefit from his or her passive interest. It will simply be carried forward to subsequent years until the taxpayer has passive income. If passive income was erroneously entered on Form 4952, verify that it has been properly reported on Schedule E or elsewhere.

2. Make any other adjustments based upon your examination and recalculate Form 4952.

INTEREST ON RENTAL PROPERTY
IRC SECTION 469(j)(7)

ISSUE: Does taxpayer qualify for deductibility of interest under IRC section 469(j)(7)?
IRC section 469(j)(7) indicates that passive activity losses will be computed without regard to qualified residence interest as defined in IRC section 163. A "qualified residence" as defined by IRC section 163(h)(5)(A)(I) is either a principal residence or a second residence.

____ Verify that property is taxpayer's "principal residence". Treas. Reg. section 1.163-10T(p)(2) indicates that principal residence means principal residence as defined by IRC section 1034. Taxpayer <u>cannot have more than one principal residence</u> at any one time. IRC section 1034(a) provides for deferral of gain on sale of property <u>"used by"</u> the taxpayer as his or her principal residence. In *Stolk v. Commissioner*, 40 T.C. 345 (1963), *aff'd*, 326 F.2d 760 (2d Cir. 1964), *acq*., 1964-2 C.B. 7), the Court indicated the phrase used by the taxpayer as his principal residence means habitual use of the old residence as the principal residence. The antithesis is non-use of property as the principal residence. In *Stolk*, the taxpayer moved out of his principal residence 2 years prior to its sale, and the Court held that the property did not qualify as his principal residence. Similarly, in *Friedman v. Commissioner*, T.C.M. 1982-178, the Court held that a residence used by the taxpayer only during the summer months cannot qualify as a principal residence.

See reverse side for questions to ask taxpayer if he has been absent for an extended period of time and contends property should be deemed his principal residence.

If property is determined to be taxpayer's principal residence, skip the next step. If property is not taxpayer's principal residence, continue on.

____ Verify that property is taxpayer's "second residence."
If property is rented, Treas. Reg. section 1.163-10T(p)(3)(iii) states that it qualifies only as a residence if taxpayer used it personally it for more than the greater of 14 days or 10 percent of days rented (IRC section 280A(d)).

QUESTIONS TO TAXPAYER: How many days did you spend at the rental property in 19____? _________
How many days did you rent the property in 19__? _______

<u>IMPORTANT NOTE</u>: In virtually all cases, box 2 on Schedule E has been checked NO, indicating that the taxpayer fails the requirements of IRC section 280A(d). Therefore, the property does not qualify as a second residence.

____ Verify via review of bank statement and/or canceled check that interest was actually paid in tax year deducted.
If taxpayer fails qualified residence test OR cannot verify interest, disallow losses. If he passes, go to next step.

____ Verify that interest qualifying under IRC section 469(j)(7) has been properly reflected on Sch. A as an itemized deduction.
Some taxpayers have moved interest to another column on Schedule E, avoiding the itemized deduction limitations. LAW: Qualified residential interest is claimed as an itemized deduction from adjusted gross income. Section 161 provides that deductions permitted by subtitle A, ch. 1B, Part VI (itemized deductions), including interest deductions under 163, are taken in computing <u>taxable income</u> under 63. Therefore, it is improper for qualified residence interest to be claimed on Sch. E as a deduction from adjusted gross income.

CONCLUSION: In accordance with IRC section 469(j)(7) and (5)(A)(I), taxpayer has/has not (circle one) verified the deductibility of qualified residence interest from property rented on Schedule E.

QUESTIONS TO TAXPAYER RE PRINCIPAL RESIDENCE

Do you consider property to be your principal residence? _____
If answer is NO, there is no need to continue with remaining questions. Instead, continue on with next audit step, verifying whether the property qualifies as a "second residence."

How often did you visit the property? _________________

Did you physically reside in the property during the year?
_________ Dates:____________________

Where did you live? _________________________________
How many months/years? __________________

Did you file state returns where the rental property is located? _______________

Is your car registered in the state where the property is located? _______________

Is your driver's license from that state? ______________

Did you maintain membership in any civic or religious organizations in that state? ______
Which one(s)? ____

Are there any other factors which would indicate the property is your principal residence?
____

____

If answers to any of the above items appear questionable or unreasonable, be sure to ask for documentation or third party statements to corroborate taxpayer's oral testimony.
In any examination, we need not accept uncorroborated, self-serving testimony if it is questionable, improbable or unreasonable. See *Quock Ting v. United States*, 140 US 417, 420-421 (1891), *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968) *affg.* T.C.M. 1967-85; *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953), *affg.* 10 T.C.M. (CCH) 237 (1951), *Tokarski v. Commissioner* 87 T.C. 74, 77 (1986).

If taxpayer had an extended absence (2 or more years) from the property and responded in the negative to many of the above questions, it is indicative that the property is not his or her principal residence.

Chapter 7

ACTIVITY RULES

INTRODUCTION

The passive activity loss rules limit a taxpayer's losses from all passive activities to the amount of income from passive activities included on the taxpayer's return. Earlier chapters have presented audit techniques and general rules which will be encountered in examinations. This chapter discusses the rules used to define a taxpayer's activities.

The passive activity rules of IRC section 469 use the term **activity** throughout the Code and Regulations. It is important to understand that the term activity does not necessarily refer to each separate business or entity owned and operated by the taxpayer. Because material participation is determined for each activity, the way the taxpayer's business and rental operations are combined or divided into "activities" is very important.

In computing the passive loss limitation, the first, and most basic decision to be made is how the taxpayer's different trade or businesses are grouped or divided into different activities. This chapter discusses the final regulations effective for tax years ending after May 10, 1992. For information on the activity rules prior to that time, see Exhibits 7-1, 7-2, and 7-3. Exhibit 7-4 provides information on the proposed regulations which are similar to the final regulations discussed later in the chapter.

Temporary Treasury Regulations

The Temporary Treasury Regulations which were enormously complex apply to years ending after August 9, 1989, and before May 11, 1992. To begin with, operations are components of undertakings, undertakings are components of activities, and activities may be grouped together.

To determine how many activities a taxpayer has, the regulations consider a basic unit to be an "**undertaking**", which generally refers to each different type of business owned by the taxpayer. For example, if a taxpayer owns both a restaurant and a bar, these may be considered to be two separate undertakings, even if they are reported on the same Schedule C.

Generally, undertakings are treated as one activity if conducted at the same location and owned by the same person. In the example above, if the restaurant and bar were at the same location, they would be treated as one activity.

The regulations do not generally allow rental undertakings to be combined with trade or business undertakings. For example, if a taxpayer owned a building which was used partly in his or her accounting practice and partly as a commercial rental to other businesses, the taxpayer will have two separate activities.

For tax years ending after August 9, 1989, and before May 11, 1992, taxpayers generally will combine ("aggregate") activities in the same general line of business (such as agriculture, communications, transportation, etc.), forming one activity, regardless of location. They will also generally group two or more businesses which form a single, integrated unit into one activity. For example, an orange juice manufacturing plant and the orange groves which supply all the oranges to the plant would be combined into one activity. The regulations contain numerous examples and very specific rules for making elections, and should be researched if there is a question about the taxpayer's activities.

If the examiner needs more information concerning the "old" temporary regulations, contact the Passive Activity Loss Specialist.

Final Regulations

The final regulations are effective for tax years ending after May 10, 1992. Treas. Reg. section 1.469-4 is a facts and circumstances approach to defining an activity and is designed to be easy to apply. Although much shorter in length than the temporary regulations, the final regulations recognize that it is possible to have more than one grouping of activities. This may result in more discussion at the examination and the appellate level concerning the appropriateness of groupings.

Trade or Business Activity

The final regulations provide guidance on the definition of a trade or business. The definition generally excludes any rental activity or any activity treated as incidental to holding property for investment.

Appropriate Economic Unit

After determining what trade or business activities exist, a taxpayer is required to determine if any of these should be grouped together into one activity. The regulations state that one or more trade or business activities should be grouped into a single activity if the activities <u>constitute an appropriate economic unit for the measurement of gain or loss.</u>

The final regulations use a facts and circumstances approach in determining whether activities constitute an appropriate economic unit. A taxpayer may use "any reasonable method of applying the relevant facts and circumstances in grouping activities."

Five factors are given significant weight as relevant facts and circumstances. Not all five are necessary, however, for the taxpayer to group several activities into one; also other factors may be appropriate. The five factors given the greatest weight are:

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 the activities.

The regulations provide two examples illustrating possible groupings.

Example 1

A taxpayer owns a bakery and a movie theater in a shopping mall in Baltimore, and a bakery and a movie theater in Philadelphia. Depending on other facts and circumstances, four different results are possible:

1. One activity encompassing all four businesses;

2. Two activities: a bakery activity and a movie theater activity;

3. Two activities: a Baltimore activity and a Philadelphia activity; or

4. Four separate activities.

The second example groups an activity of a nonfood wholesaler and a trucking business which transports goods to grocery stores as a single activity. In this example, both businesses are under common control. The predominant portion of the trucking business is transporting goods for the nonfood wholesaler. The taxpayer is involved in one activity.

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Audit Techniques:

* Ask the taxpayer up front at the initial interview, how the activities are grouped on the tax return. Obtain the following information at the interview or include it in your initial document request:

  1. Verify the taxpayer's ownership and control over each trade or business.
  2. Determine the general line of business for each business.
  3. Determine its geographical location.
  4. Determine any interdependencies between the businesses.

  After obtaining this information:

  1. Group the businesses into appropriate activities.
  2. Determine participation in each.
  3. Compare your groupings to the taxpayer's grouping to confirm if the passive loss limitations are applied properly.

* Watch for large nonpassive losses from flow through entities on the Schedule E. The taxpayer may be grouping all activities as a single activity to

meet the material participation standards to bypass the passive loss limitations altogether. In some cases the single activity may not reflect an appropriate economic unit.

* Review the taxpayer's return for losses deducted as nonpassive and gains included as passive. The activity rules can be used to reclassify these into different groupings. Check for cases where the taxpayer is treating an activity with gains as passive when it is should be part of a nonpassive activity.

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Example 2

An orthopedic doctor in a successful practice also owns a profitable physical therapy business which gets most of its clients from referrals by the doctor. The doctor reports the physical therapy practice as passive and offsets its gain with large rental losses. The gain from the physical therapy business should be reclassified as nonpassive and not offset by the rental losses.

Rental Activities

The regulations prohibit the grouping of a rental activity with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and

1. Either is "insubstantial" in relation to the other (insubstantial is not defined in the regulations)

OR

2. Each owner of the business has the same proportionate ownership interest in the rental activity. Treas. Reg. section 1.469-4(d)(1)(I)

The final regulations also prohibit the grouping of real property and personal property rentals into one activity unless the personal property is provided in connection with real property or real property is provided in connection with personal property. This is significant for purposes of applying the $25,000 allowance to losses from rental real estate.

Example 3

A husband (H) and wife (W) file a joint return. H is the sole shareholder of an S-Corporation that conducts a grocery store business. W is the sole shareholder of an S-Corporation that owns and rents out a building to H's grocery store. The rental to H's grocery store business and the grocery store are not "insubstantial" in relation to each other.

Because the taxpayers file jointly for purposes of IRC section 469, both H and W are the sole owner of the grocery store. Therefore, each owner of the business activity has the same proportionate ownership interest in the rental activity.

Accordingly, the rental and the grocery store business activity may be grouped together into a single activity if the grouping is an appropriate economic unit.

A second example illustrates that the grouping of activities must constitute an economic unit. An attorney wholly owns a law practice. The taxpayer also rents residential real estate to third parties. These are both operated in the same town. The rental is "insubstantial" to the law practice activity and the taxpayer owns the same proportionate ownership interests. However, under the facts and circumstances, they do not constitute an appropriate economic unit and, therefore, may <u>not</u> be grouped as a single activity.

For 1994 and later years, the provisions of new IRC section 469(c)(7) carry their own rules concerning rental activities. Under the newly enacted IRC section 469(c)(7), rental real estate activities will be excepted from the automatically passive status if the taxpayer meets qualifying criteria. If the taxpayer meets these criteria, IRC section 469(c)(7)(A)(ii) indicates that each interest in rental real estate will be a separate activity unless the taxpayer elects to treat them <u>all</u> as one activity. Taxpayers may want to treat all their rental real estate activities as one under this rule in order to meet the material participation standards. A proper election must be filed with the original return.

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Audit Techniques:

* Ensure that the taxpayer is not erroneously mixing rental and nonrentals into one activity.

* Carefully scrutinize groupings to ensure that activities which, in a realistic sense, form an interrelated economic unit have not been separated in order to generate purported "passive income" to trigger rental or other unrelated passive losses. See Treas. Reg. section 1.469-4(f)(2).

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Limited Partners and Limited Entrepreneurs

In general, if a taxpayer is a limited partner (or limited entrepreneur) in one of the following activities described in IRC section 465(c)(1), he or she may not group that activity with any other activity:

1. Motion picture films or video tapes

2. Farming

3. Leasing personal property

4. Exploring oil and gas resources

5. Exploring geothermal deposits

However, the regulations allow groupings of limited partnership activities with an activity in which the taxpayer is not a limited partner if they are in the same type of business and if the grouping forms an appropriate economic unit.

A limited entrepreneur is a person who is not a limited partner and does not actively participate in management.

Example 4

The taxpayer is an individual who owns and operates a farm, is a member of a limited liability company that operates a cattle feeding business, and is a limited partner in a limited partnership that is engaged in oil and gas production. The taxpayer does not actively participate in the management of the cattle feeding business.

Because the taxpayer does not actively participate in the management of the limited liability company, he is a limited entrepreneur in that activity. Since the cattle feeding business is described in IRC section 465(c)(1)(B) relating to farming, it may not be grouped with any other activity that does not involve farming. The taxpayer's farm operation may be grouped with the cattle feeding activity if the grouping constitutes an appropriate economic unit.

Also, since the taxpayer is a limited partner in an activity described in IRC section 465(c)(1)(D) (relating to exploring for or exploiting, oil and gas resources) the taxpayer may not group this activity with any other activity that does not involve this same type of business. Therefore, this activity may not be grouped with the farm or cattle feeding operations.

Flow-Through Entities

Activities held as a partnership or S-Corporation must group its activities under the activity rules at the entity level.

Activities Conducted Through a Closely Held C-Corporation or Personal Service Corporation

An activity that a taxpayer conducts through a closely held C-Corporation or a personal service corporation may be grouped with another activity of the taxpayer only for purposes of determining whether the taxpayer materially participates in the other activity. Treas. Reg. section 1.469-4(d)(5)(ii).

Consistency Requirement

Once a taxpayer's activities have been grouped, the regulations impose a consistency requirement (Treas. Reg. section 1.469-4(e)). **The taxpayer may not change those groups in subsequent years unless the original grouping was inappropriate or there has been a material change in the facts and circumstances which makes the original grouping clearly inappropriate**. If a regrouping is required and appropriate, the taxpayer must make a full disclosure about the reasons for the change on his or her return.

Practical Note: In examining the taxpayer's passive activities for tax years after 1992, careful scrutiny should be done to ensure that the original grouping was appropriate, and that the original grouping has been consistently used each year. **Taxpayers are not allowed to regroup their activities each year simply to allow the deduction of the greatest amounts of losses!**

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Audit Techniques:

* Check subsequent years for consistency. Compare tax returns to see if the taxpayer's activities are fluctuating back and forth between passive and nonpassive categorization. This may be due to the annual test for material participation in each activity, but it could also be an indication of inconsistent treatment. Taxpayers are not allowed to regroup their activities each year simply to allow the deduction of the greatest amount of losses. If the taxpayer has not been consistent or has used inappropriate groupings, the activities must be regrouped. Material participation standards must be applied to the regroupings, and the proper amount of passive losses that are deductible must be computed.

* A 3-year comparative of passive and nonpassive income and losses on an entity by entity basis will highlight inconsistencies.

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Anti-Abuse Rule

The Commissioner (Examiner) may regroup a taxpayer's activities if:

1. The taxpayer's grouping fails to reflect one or more appropriate economic units, AND

2. One of the primary purposes of the taxpayer's grouping is to circumvent the underlying purposes of IRC section 469.

To illustrate, the regulations give us an excellent example at Treas. Reg. section 1.469-4(f)(2).

Practical Note: If the examiner wishes to regroup the taxpayer's activities under the anti-abuse rule, he or she should document the following facts as fully as possible:

1. What "appropriate economic unit" was not reflected in the original grouping;

2. The amount of tax avoided by the taxpayer's original grouping compared to the corrected grouping; and

3. Any other facts and circumstances which may show intent to circumvent section 469.

Effect on Dispositions

If a taxpayer disposes of substantially all of an activity, he or she may treat the part disposed of as a separate activity, but only if he or she can show with reasonable certainty:

1. The amount of suspended losses disallowed under the passive loss rules that is allocable to the substantial part of the activity, and

2. The amount of gross income and any other deductions and credits allocable to that part of the activity for the taxable year.

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Audit Technique:

* If the taxpayer is claiming suspended losses upon disposition of an activity, ensure that the disposition was a fully taxable transaction and that or substantially all of the activity was disposed of to an unrelated party.

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Example 5

The taxpayer's return shows the sale of a farm on Form 4797, and a deduction for suspended losses on Schedule F. The taxpayer's return also includes a 100 percent owned

S-Corporation engaged in farming which is passive. There is no election noted on the return. The taxpayer's farming undertakings, regardless of their form, constitute one activity, and the sale of only a part of the activity does not trigger the allowance of the suspended losses in the current year.

<u>Issue Identification</u>

1. The new activity rules recognize that there may be more than one way to group activities. However, the activities must be grouped into appropriate economic units and consistency must be maintained once the grouping is made. Since the new regulations generally apply to calendar year 1992 returns, the groupings reflected on the first return due after May 10, 1992, must be carefully examined to determine if it adequately reflects all appropriate economic units.

2. Watch for rental activities with losses reflected in the Nonpassive column on the Schedule E. It could be an indication that a rental and nonrental activity have inappropriately been grouped together.

<u>SUMMARY</u>

1. For tax years ending before May 11, 1992 (and, at the election of the taxpayer, for calendar year 1992 returns), a taxpayer's activities must be determined using the old, temporary regulations. These regulations are very detailed and provide specific rules of aggregation and integration in combining one or more trade or business undertakings into activities.

2. Under the old regulations, taxpayers must aggregate (combine) undertakings which are commonly controlled and in the same line of business, or which are conducted in reliance upon each other. They must also aggregate undertakings which are commonly controlled and operated in an integrated manner (as though they were a single economic unit).

3. For tax years ending after May 10, 1992, the regulations allow taxpayers to group their activities in any reasonable manner that forms an

"appropriate economic unit." Factors which are given the greatest weight:

a. Similarities and differences in types of business;
b. The extent of common control
c. The extent of common ownership
d. Geographical location
e. Interdependencies between the activities.

4. Once a grouping is made under the proposed regulations, it must be consistently used in all future years. It can be changed by the Commissioner if the grouping is inappropriate and the taxpayer has designed the grouping to circumvent the rules of IRC section 469.

Exhibit 7-1

PROPOSED/TEMPORARY TREASURY REGULATIONS

IDENTIFYING ACTIVITIES

Tax Years Ending Before August 10, 1989

[Temporary Regulation Section 1.469-4T(p)]

Taxpayers may use the temporary regulations as described in Treas. Reg. section 1.469-4T, or they may use **any reasonable method** to organize their business and rental operations into activities.

Methods are **not reasonable** if they either:

a. Group rental and nonrental operations together;
b. Group working interests in oil and gas wells with other operations.
c. Group a taxpayer's rental (which is also used by him or her as a residence) with any other passive activity.

Once this grouping is made by the taxpayer, he or she must use it consistently for both the 1987 and 1988 years.

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IDENTIFYING ACTIVITIES

Tax Years Ending Before May 11, 1992

[Temporary Regulation Section 1.469-4T]

Step 1: Identify all undertakings for a taxpayer.

- The general rule is that each undertaking at each different location is a separate activity. *[Treas. Reg. section 1.469-4T(b)(1)].*

- An "undertaking" is an income-producing operation or endeavor (whether rental or trade/business) in which a taxpayer owns an interest. It includes endeavors which involve the conduct or a trade or business, making property available for use by customers, and research or experimental expenditures which would be deductible under IRC section 174. It also includes endeavors which are conducted in anticipation of becoming a trade or business. *[Treas. Reg. section 1.469-4T(b)(2)(ii)(A)].*

A "location" is a fixed place of business. Operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of each other. *[Treas. Reg. section 1.469-4T(c)(4)]*

Step 2: Separate rental and nonrental operations at the same location into two undertakings.

- If an undertaking has both nonrental operations and rental operations, separate them into two undertakings unless either the rental or the nonrental operation is insignificant in relation to the other.

- An operation is "insignificant" if the gross income from that operation is less than 20 percent of the gross income from that location. *[Treas. Reg. section 1.469-4T(a)(3)(iv)]*

<u>Step 3: Identify undertakings with special rules:</u>

<u>A. Rental Real Estate Undertakings</u>

- A rental real estate undertaking is one in which at least 85 percent of the unadjusted basis of the property made available for use by customers is real property. *[Treas. Reg. section 1.469-4T(k)(1)(ii)]*

- For rental real estate undertakings, **each rental at a different location is generally a different activity.** *[Treas. Reg. section 1.469-4T(b)(1)].*

- Very liberal elections exist which allow taxpayers to combine or separate their rental real estate undertakings into one or more activities, as long as they maintain consistency in this treatment from year to year. *[Treas. Reg. section 1.469-4T(a)(4)(iv)].* Taxpayers are also allowed to separate different rental real estate undertakings at the same location into different activities if each unit may be separately conveyed under applicable state and local law. (For example, several condominium units in one physical structure may be divided into separate activities.) *[Treas. Reg. section 1.469-4T(k)(2)(iii)].*

<u>B. Professional Service Activities</u>

- A <u>professional service undertaking</u> is one in which more than 50 percent of its gross income is derived from the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. *[Treas. Reg. section 1.469-4T(h)(1)(ii)].*

- A taxpayer's interest in two or more professional service undertakings will be considered one activity if they are either controlled by the same interests or if they involve provision of significant similar or related services. *[Treas. Reg. section 1.469-h(2)(I) and (ii)].* **Professional service undertakings cannot be combined with any other undertaking under either the aggregation or integration rules.**

- Two professional service undertakings provide similar services if more than 20 percent of the gross income of each is from the same professional field. They are related if more than 20 percent of the gross income from one is derived from customers of the other.

C. Working Interests in Oil and Gas Wells

- If the taxpayer owns a working interest in an oil or gas well operation, that activity will be treated as a separate activity for the taxpayer. *[Treas. Reg. section 1.469-4T(e)(1)].* It is also generally not treated as a passive activity.

D. Publicly Traded Partnerships

- A publicly traded partnership (PTP) is one whose interests are traded on an established securities market or are readily tradable on a secondary market.

- Each publicly traded partnership interest of the taxpayer is treated as though the taxpayer had no other passive trade or business. Thus losses from a PTP can only be offset by gains from that same PTP. No other passive income can be offset by losses from a PTP. A PTP's losses can only be utilized by gains from that same PTP or by the disposition of the entire interest in that activity. *[Treas. Reg. section 1.469-4T(n)].*

Step 4: Determine which remaining trade or business undertakings are commonly owned and controlled.

- "Common control" exists in two or more undertakings if the same persons have the ability to direct the operations, even if the ability is not legally enforceable or they do not exercise their right to control. In general, if a group of 5 or fewer persons own more than 50 percent of two different undertakings, these undertakings will be (rebuttably) presumed to be under common control. *[Treas. Reg. section 1.469-4T(j)(1)]*

<u>Step 5: Aggregate similar trade or business undertakings.</u>

- Trade or business undertakings will be considered similar and will be aggregated if

1. their predominant operations are in the same line of business, or
2. they are vertically integrated. *[Treas. Reg. section 1.469-4T(f)(4)].*

- An undertaking has "**predominant operations**" if more than 50 percent of its gross income is attributable to operations in a single line of business. Note: if an undertaking does not have predominant operations, it cannot be combined with other undertakings!

- "**Lines of business**" are defined by Revenue Procedure 89-38 and are very broad. There are only 79 different lines of business listed for the entire economy.

- Two or more undertakings are "vertically integrated" if one supplies more than 50 percent of its products or services to the other, or one receives more than 50 percent of its property or services from the other.

<u>Step 6: Combine all trade or business activities (arrived at in step 5) which constitute an integrated business.</u> *[Treas. Reg. section 1.469-4T(g)(2)].*

- Whether the operations constitute a single integrated business is a matter of facts and circumstances. The regulations give us 12 different factors which are considered most significant in the matter:

a. Whether such operations are conducted at the same location;
b. The extent to which other persons conduct similar operations at one location;
c. Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;
d. The extent to which other persons treat similar operations as a unit in the primary accounting records;
e. Whether such operations are owned by the same person;
f. The extent to which such operations involve products or services that are commonly provided together;
g. The extent to which such operations serve the same customers;

h. The extent to which the same personnel, facilities, or equipment are used to conduct such operations;
I. The extent to which such operations are conducted in coordination with or reliance upon each other;
j. The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;
k. The extent to which such operations depend on each other for their economic success; and
l. Whether such operations are conducted under the same trade name.

Step 7: Consider the effect of any taxpayer elections.

- Once the aggregation and integration rules have been applied, the taxpayer is allowed to make an election to separate them. *[Treas. Reg. section 1.469-4T(o)].* They may elect to treat each undertaking as a separate activity primarily for the disposition rules. This election will not increase the taxpayer's participation requirement. If he or she would be considered a material participant in the larger activity, he or she will still be considered a material participant in each of the smaller portions. This election must have been made on the 1989 return.

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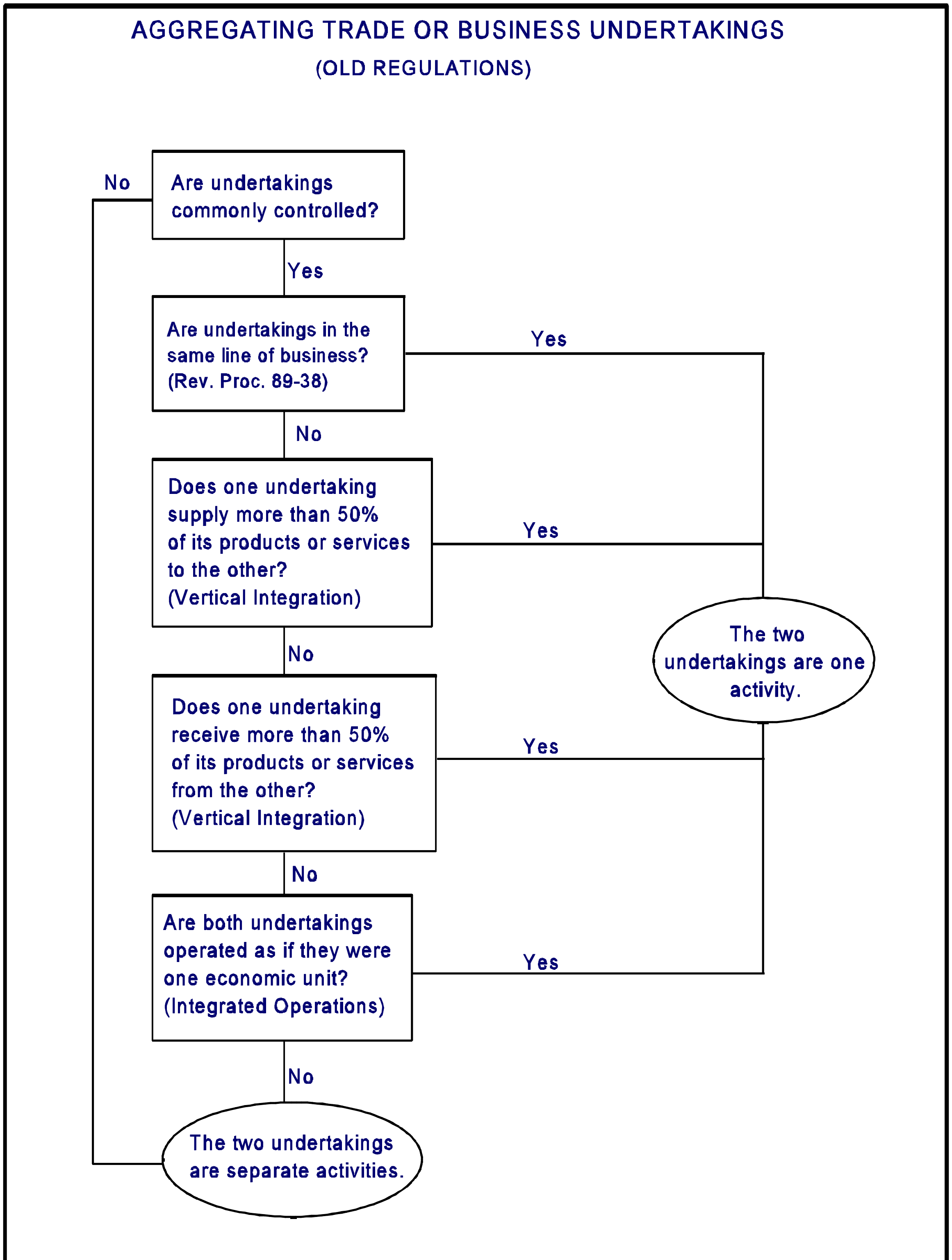
Exhibit 7-3



Note: Special rules exist for professional service undertakings, publicly traded partnerships and working interests in oil and gas.

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IDENTIFYING ACTIVITIES

Tax Years Ending After May 10, 1992

[Proposed Treas. Reg. section 1.469-4]

Step 1: Identify all rental operations.

- The proposed regulations prohibit grouping of rental activities with any trade or business operations unless either is insubstantial in relation to the other. *[Proposed Treas. Reg. section 1.469-4(d)]*

- The proposed regulations also prohibit grouping of real property rentals with personal property rentals. *[Proposed Treas. Reg. section 1.469-4(e)]*

Note: Although the regulations allow a person to group rental activities together to determine all appropriate economic units, since they are, per se, passive under the laws as in effect through December 31, 1993, there appears to be no real advantage or disadvantage to doing so.

- **For 1994 and later years**, the provisions of new IRC section 469(c)(7) carry their own rules concerning rental activities. Under the newly enacted IRC section 469(c)(7), rental real estate activities will be excepted from the automatically passive status if the taxpayer meets two qualifying criteria. If the taxpayer meets these criteria, IRC section 469(c)(7)(A)(ii) indicates that each interest in rental real estate will be a separate activity unless the taxpayer elects to treat them all as one activity. (Taxpayers may want to treat all their rental real estate activities as one under this rule in order to meet the material participation tests.)

Step 2: Identify all trades or businesses.

- A taxpayer's trade or business activities are all activities which:

1. Involve the conduct of a trade or business within the meaning of IRC section 162.
2. Are conducted in anticipation of commencement of a trade or business, or
3. Involve research or experimental expenditures that are deductible under IRC section 174. *[Proposed Treas. Reg. section 1.469-4(b)(1)]*

- A trade or business activity does not include any rental activity or any activity treated as incidental to holding property for investment.

- If a taxpayer has interests in flow-through interests, the flow-through entity must first determine its activities using these rules. The taxpayer then follows the designation of the entity for these activities. *[Proposed Treas. Reg. section 1.469-4(b)(1)]*

<u>Step 3: Group all activities from step 2 above into appropriate economic units.</u>

- The taxpayer will group all of his or her activities (including those flowing through from partnerships or S-Corporations) into **appropriate economic units**. *[Proposed Treas. Reg. section 1.469-4(c)(1)]*

- To determine what constitutes the appropriate economic units, the taxpayer will consider all the facts and circumstances. *[Proposed Treas. Reg. section 1.469-4(c)(2)]* The regulations give us 5 factors which are given significant weight as relevant facts and circumstances. These are:

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 the activities.

- The regulations allow for a multitude of outcomes, depending on the specific facts and circumstances of each taxpayer's case.

<u>Step 4: Apply special rules.</u>

<u>Limited Partners</u>

- In general, a taxpayer may not group a limited partnership activity with any other activity. However, the regulations allow for a grouping of two or more limited partnership activities if they are all limited and all similar. A taxpayer may also group a limited partnership activity with an unlimited activity if the businesses are similar and if the grouping is "appropriate under all the facts and circumstances." *[Proposed Treas. Reg. section 1.469-4(f)]*

<u>Consistency Requirement</u>

- Once a taxpayer has determined his or her original grouping, he or she may not change those groups in subsequent years unless *[Proposed Treas. Reg. section 1.469-4(g)]:*

1. There has been a material change in the facts and circumstances; or
2. The original grouping was inappropriate.

- If regrouping is required and appropriate, the taxpayer must make a full disclosure of the change and its reasons on the tax return for the year of change. Taxpayers are not allowed to regroup their activities each year simply to allow the deduction of the greatest amounts of losses.

<u>Anti-Abuse Rule</u>

- The Commissioner (Examiner) may regroup a taxpayer's activities if *[Proposed Treas. Reg. section 1.469.4(h)]:*

1. The taxpayer's grouping fails to reflect one or more appropriate economic units, **<u>AND</u>**
2. One of the primary purposes of the taxpayer's grouping is to circumvent the underlying purposes of IRC section 469.

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ACTIVITIES

Treas. Reg. section 1.469-4 (Final)

(Tax years after May 11, 1992)

ISSUE: Does taxpayer's grouping form an appropriate economic unit? In other words, in a realistic sense, does the grouping form an interrelated and integrated economic unit. (Taxpayer may choose to group activities into ONE activity in order to meet the 500 hour test for material participation in Treas. Reg. section 1.469-5T. Conversely, some taxpayers may attempt to separate inherently related activities in an attempt to created purported passive income.)

LAW: If a taxpayer's businesses form an appropriate economic unit, he or she may group activities in Sch. C, C- or S-Corporations, and partnerships or limited liability companies into ONE activity.

AUDIT PROCEDURE:

_____ At initial appointment or on first IDR, request statement of how activities are grouped.

_____ Verify that tax year falls after May 11, 1992. If not, taxpayer must use temporary regulations to group activities.

_____ Ensure that taxpayer has not grouped rentals of equipment or buildings with businesses unless -

Insubstantial OR

Owned in the same ownership percentage and they form an appropriate economic unit.

_____ Ensure that taxpayer has not grouped portfolio or investment activities.

_____ Verify that limited partner in IRC section 465(c)(1) business has not grouped that activity with any other activity unless they are in the same line of business. (IRC section 465© businesses include: 1) motion picture/video tape; 2) farming; 3) equipment leasing; 4) oil and gas; 5) geothermal deposits.)

_____ Verify the grouping forms an appropriate economic unit based on similarities, location, ownership, control, and interdependencies (purchase or sell goods between themselves, involve products or services that are generally provided together, have the same customers, have the same employees, or use a single set of books and records to account for the activities). Not all factors are necessary. Furthermore, there is no factor which is required to be present. Instead, the appropriateness of the grouping should be based on all the facts and circumstances.

_____ Ensure that the grouping has not been formed in order to circumvent the passive loss limitations. If so, under the anti-abuse provisions, the Commissioner (examiner) can regroup. Scrutinize carefully any entity which is producing purported passive income, but is related or in the same line of business as other nonpassive activities of the taxpayer. See example contained in Treas. Reg. section 1.469-4(f)(2).

_____ Review prior and subsequent years for passive and nonpassive losses and income on Sch. E to verify that taxpayer has used the same grouping consistently. (Do a comparative on an entity by entity basis. The taxpayer can alter the grouping only if there has been a material change.)

_____ If there has been a disposition of one entity, ensure that suspended losses have been deducted only to the extent of net gain from the disposition of that entity. Without passive income, suspended losses are not triggered - unless there is an entire disposition in a fully taxable transaction to an unrelated party.

_____ To verify material participation, request written documentation, explaining the activities performed and hours the taxpayer applied to each entity. Also, inquire how much time the taxpayer applies to his or her rental activities. On portfolio activities. On vacation, etc. Be sure to request appointment books, telephone records or other supporting documentations.

_____ Always inquire whether the spouse is involved in business activities, which ones, and how much time.

NOTE: If taxpayer is claiming losses from partnerships and S-Corporations, consider possible basis or at-risk issues.

CONCLUSION: In accordance with Treas. Reg. section 1.469-4, the taxpayer's businesses have / have not been properly grouped.

GLOSSARY

Active Participation: Involvement in a rental real estate activity making management decisions. Requires no specific number of hours.

Activity: The integral economic unit for measuring a taxpayer's level of participation in a trade or business. One location can have more than one business activity. Two or more related businesses can also be combined into one activity.

Aggregation: The combination of several business operations into a larger unit. Primarily used to combine passive trade or business undertakings into one or more activities in order to determine whether a taxpayer is a material participant.

Closely Held Corporation: A corporation with five or fewer shareholders who own more than 50 percent in value of the stock at any one time during the year.

Common Control: The situation where a group of five or fewer persons own more than 50 percent of an undertaking and therefore have the ability (whether or not it is exercised) to direct operations.

Entity: A partnership, S-Corporation, trust estate or joint venture of any kind.

Fiduciary: A person to whom property is entrusted to hold, control or manage for another. The fiduciary of a trust is the person who is legally responsible for managing the assets of the trust in a competent manner.

Integrated Operations: Two or more business operations which are conducted as though they were one single economic unit.

K-1: See Schedule K-1.

Limited Partner: An investor in a partnership whose personal liability is limited. Presumed to be passive according to the Code, but who nevertheless may be deemed to be nonpassive under certain circumstances. See Treas. Reg. section 1.469-5T .

Material Participation: Regular, substantial, and continuous involvement in a business on the part of either the taxpayer and/or spouse. Allows losses from trades or businesses to be deducted without limitation under the passive loss rules.

Modified Adjusted Gross Income (AGI): The taxpayer's AGI per return computed without considering any passive activity loss, allowable under IRC section 469(c)(7), IRA or SEP plans, taxable social security or the deduction for one-half of the self-employment tax. The $25,000 rental real estate allowance is reduced 50 cents for every $1 the taxpayer's modified AGI exceeds $100,000. If the taxpayer's modified AGI exceeds $150,000, the $25,000 allowance is reduced to zero.

Net Lease Property: Property where the tenant or lessee pays most of the expenses. Basically, a net lease as rental property is where the deductions allowed solely by reason of IRC section 162 are less than 15 percent of gross rents from that property OR property where the lessor is either guaranteed a specific return or is protected in whole or part against loss of income. Deductions allowed solely by reason of section 162 are deductions *other than* interest, taxes and depreciation.

Nonpassive Activity: A trade or business in which the taxpayer materially participates, that is, on a regular, continuous, and substantial basis. Losses can be deducted without limitation under IRC section 469. Income cannot be offset by passive losses, except those passive losses remaining after disposition of a passive activity. Income and losses from a nonpassive activity should not be reported on Form 8582.

Passive Activity: Rentals, regardless of participation, and trades or businesses in which the taxpayer does not materially participate. Losses are limited to passive income plus a special $25,000 allowance for rental real estate.

Passive Loss: Loss from a passive activity (rental or trade or business in which the taxpayer does not materially participate).

Passive Income: Income from a passive activity. In other words, income from rentals or businesses in which the taxpayer does not materially participate. Reported on the appropriate schedule (E, C, F, etc.) as well as on Form 8582. Portfolio income is not passive income.

Portfolio Income: Interest, dividends, royalties, and gains from the sale of stocks and bonds as well as other investment activities. Portfolio income is generally not considered passive income. Portfolio income cannot be offset by passive losses except those passive losses remaining after disposition of a passive activity.

Professional Service Activity: An activity involving services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Publicly Traded Partnership: A partnership whose interests are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Recharacterization Rules: Rules which reclassify passive income as nonpassive. This type of income should not be reported on Form 8582 and cannot be offset by passive activity losses except those passive losses remaining after disposition of a passive activity.

Schedule K-1: The form attached to Forms 1065, 1120-S and 1041 returns which provides the flow-through income and losses to an investor's individual return.

Self-Charged Interest: The portion of interest charged on a lending transaction between a flow-through entity and its partners or shareholders which represents a payment a person makes to himself or herself. Stated differently, it is the amount the lender/borrower reports as interest income expense which is equal to the lender's/borrower's distributive share of the flow through entity's interest deduction. The interest payments received are treated as portfolio income.

Self-Rented Property: Personal or real property a taxpayer rents to an entity in which the taxpayer materially participates. Stated in different terms, property rented by the taxpayer to a nonpassive activity of the taxpayer.

Significant Participation Activity: A business in which the taxpayer participates more than 100 hours without materially participating. If the aggregate hours of participation in a taxpayer's SPAs exceed 500, the taxpayers aggregate net income from SPAs is treated as nonpassive.

Substantial Part of an Activity: An identifiable piece or unit of a larger activity, such as a separate division or branch, or a separate product line of a business with several lines or divisions.

Suspended Losses: Passive losses which are carried forward indefinitely until the taxpayer has passive income or there is an entire disposition of the activity. Also called carryover or carryforward losses.

Tiered Entities: Partnerships or trusts or S-Corporations invested in other partnerships or trusts or S-Corporations.

Undertaking: Until 1993, a basic economic unit, one or more of which makes up an activity. Each different business or rental operation at each different location in which a taxpayer owns an interest is generally an undertaking.

Vertical Integration: A relationship between two business undertakings where one supplies more than 50 percent of its property or services to another, or where one receives more than 50 percent of its property or services from the other.