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Handling Passive Activity Gains and Losses

-by Neil E. Harl*

Even though the legislation was enacted 28 years ago, in 1986, the rules governing the handling of passive activity gains and losses have remained a bit of a mystery for some tax practitioners when it comes to applying the rules to specific fact situations. Moreover, the shift in thinking on the part of the Internal Revenue Service as to how to view limited liability companies (LLCs) and, quite likely, other newly minted entities created in recent years, has contributed to the mystery. This article reviews the basic rules drawn from the 1986 legislation as likely to be applied currently.

Basic features of the 1986 legislation

The 1986 statute (especially as augmented by the 1988 temporary regulations) makes it clear that an activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity or a rental activity. But note that to be treated as materially participating in an activity, the taxpayer must be involved in the operations of the activity on a basis which is regular, continuous, and substantial. Some have confused that rule with the more widely known and recognized material participation rule which was originally enacted for social security purposes and is less demanding than the passive loss rule. Some, irreverently, refer to the passive loss material participation rule as “material participation on steroids.”

It is important to note that passive activity losses can only be deducted from income attributable to passive activities. Passive activity losses cannot be offset against non-passive activity income.

Yet a provision in the statute states that “in determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.” That would seem to indicate that if a husband and wife are both involved in a pass-through entity, one meets the material participation test but the other does not, they are both considered to be materially participating. A provision in the regulations states “in the case of any person who is a married individual... for the taxable year, any participation by such person’s spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year), shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.”

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Another significant provision, this one in the statute, states that the term “passive activity” includes any rental activity. However, the statute goes on to state that the provision stating that the term “passive activity” includes a rental activity is to be “applied without regard to whether or not the taxpayer materially participates in the activity.” That would seem to deny taxpayers the chance to meet the material participation test for rental properties by meeting one or more of the seven tests outlined in the regulations except for taxpayers meeting the requirements for those engaged in real property trades or businesses. Moreover, that seems to introduce an element of ambiguity in light of the straightforward subsection that states “in determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.”

Fact situations

Given these rules, assume a couple owns (equally) an LLC that is clearly engaged in a trade or business and there is no question about meeting the material participation test through the husband’s efforts. The wife has almost no involvement in that business. It would seem that, in the event of a loss in the LLC, the husband is unquestionably eligible to offset his portion of the loss against other trade or business income (non-passive income). What about the wife? By virtue of the statute and the regulations, the wife’s portion of loss should also be eligible to be offset against other trade or business income.

But what if the wife’s involvement is in a rental income activity? The regulations seem to say that she cannot resort to the seven ways to achieve material participation to elevate her status to trade or business except where she qualifies for a “real property trade or business” status. But does it negatively affect her right to be elevated to a position of materially participating as her husband’s spouse with respect to losses from his business? It would seem that the answer is no. Does it mean that, as the husband’s spouse, who automatically achieves material participation status because of his involvement in the business in which the wife is not deeply enough involved to qualify for material participation status herself, qualify her for achieving material participation status in the rental income activity? That focuses on the ambiguity mentioned above. However, the language of I.R.C. § 469(h)(5) on spousal imputation is unequivocal and addresses directly and without exceptions the fact that imputation is allowed between the spouses while the language in I.R.C. § 469(c) does not address imputation and further confuses the issue in stating, in the heading to I.R.C. § 469(c)(4), that MATERIAL PARTICIPATION NOT REQUIRED. [Emphasis in the original.]

The other option

In a more limited provision, a taxpayer may deduct annually up to $25,000 of passive activity losses (and the deduction equivalent of passive activity credits) attributable to rental real estate activities in which the taxpayer actively participates but does not materially participate. The $25,000 deduction allowance phases out ratably as the taxpayer’s adjusted gross income (determined without regard to passive activity losses) increases from $100,000 to $150,000. Moreover, the $25,000 allowance is not available to corporations. It should be noted that, under the regulations, a share rent lease is treated as a joint venture and not as a rental activity. That position has been criticized. The Department of the Treasury has indicated that the position outlined in the regulations is the correct interpretation.

ENDNOTES

4  I.R.C. § 469(c)(1).
5  I.R.C. § 469(b)(1).
6  I.R.C. §§ 1402(a), 1402(b).
7  I.R.C. § 469(d)(1).
8  I.R.C. § 469(b)(5).
10 Id.
11 I.R.C. § 469(c)(2).
12 I.R.C. § 469(c)(4).
13 I.R.C. § 469(c)(7).
14 I.R.C. Sec. 469(h)(5) (emphasis added).
15 I.R.C. § 469(h)(5).
18 I.R.C. § 469(i)(3).
19 I.R.C. § 469(i)(1).
22 Letter from Kenneth W. Gideon, Assistant Secretary (Tax Policy) to Senator Charles E. Grassley, October 24, 1990.

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