PacificCPE

COURSE
33103C

Partnerships and LLCs: Deductibility Limits on Losses

Loss limitations are among the most practical and frequently encountered issues in partnership taxation. This course focuses on the rules that restrict a partner's ability to deduct partnership losses, including how those limitations apply in the LLC context. Whether you're advising clients on structuring decisions or navigating a loss year, understanding these boundaries helps ensure accurate reporting and positions you to offer well-informed guidance on managing and preserving deductible losses.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the characteristics of passive activity income.

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Chapter 1: LIMITATIONS ON THE DEDUCTIBILITY OF PARTNERSHIP LOSSES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of passive activity income.

501 INTRODUCTION

The deductibility of partnership losses passed through to a partner is subject to three separate limitations. First, under Code Sec. 704(d), the loss may not exceed the partner’s tax basis in the partnership interest. Second, any losses that survive the Code Sec. 704(d) limitation are subject to the at-risk limitation of Code Sec. 465. Finally, losses may be disallowed under the passive loss limitations of Code Sec. 469 even if they do not exceed the partner’s tax basis or amount at risk in the partnership interest. Note that these limitations are applied sequentially—the Code Sec. 704(d) limitation is applied first, followed by the Code Sec. 465 limitation, and finally the Code Sec. 469 limitation. Amounts disallowed under each section are subject to different carryforward provisions.

Example 5-1

J is a one-third partner in JDR Partnership. Her tax basis in her partnership interest is $35,000, consisting of her $15,000 investment in partnership capital and her $20,000 share of partnership nonrecourse liabilities. None of these liabilities are qualified nonrecourse liabilities (i.e., they do not increase her amount at risk, as discussed at 505). J's interest in the partnership is a passive activity, and she has no passive income from any other source. For the current year, J's distributive share of the partnership's loss, reported on Schedule K-1, is $45,000.

Under Code Sec. 704(d), $10,000 of J's pass-through loss will be disallowed because it exceeds the tax basis of her partnership interest ($45,000 total loss − $35,000 tax basis). Of the $35,000 loss allowed under Code Sec. 704(d), an additional $20,000 will be disallowed under Code Sec. 465 because the non-qualified nonrecourse liabilities are included in her tax basis but not in her amount at risk. Finally, the remaining $15,000 of the pass-through loss will be disallowed under Code Sec. 469, since passive losses can generally only be deducted against passive income from other sources. Thus, none of the $45,000 loss allocated to J will be deductible this year. $10,000 will be disallowed (and carried forward) under Code Sec. 704(d), $20,000 will be disallowed (and carried forward) under the at-risk rules of Code Sec. 465, and the remaining $15,000 will be disallowed (and carried forward) under the Code Sec. 469 passive activity loss rules.

Note in the above example that although J's entire pass-through loss was denied under various statutory limitations of the Internal Revenue Code, her tax basis in her partnership interest is still reduced to zero, as is her amount at risk. Because losses were allowed under Code Secs. 704(d) and 465, those losses reduce her basis and at-risk amounts, respectively, even though the losses were subsequently disallowed under different statutes.

502 DISALLOWED LOSSES ARE CARRIED FORWARD

.01 Carryforwards under Code Sec. 704(d)

Any loss passed through to a partner in excess of his basis in the partnership interest is carried forward indefinitely until such time as the partner obtains additional basis sufficient to allow the deduction. Carryforward losses unused as of the date of sale or disposition of the partnership interest are lost—they do not carry over to the transferee (if any) of such interest, and they do not reduce the gain (if any) or increase the loss (if any) recognized in connection with sale of the partnership interest.

Example 5-2

E is a 25% partner in Lockwood Partners. His original tax basis in his partnership interest was $35,000, but pass-through losses of $40,000 reduced that basis to zero. The $5,000 excess of his distributive share of partnership losses over his tax basis in the partnership interest is carried forward under Code Sec. 704(d), and will be deductible when (and if) he obtains additional tax basis (e.g., as the result of an additional contribution to partnership capital).

This year, he sold his interest in the partnership for $10,000, recognizing a $10,000 capital gain (recall that his tax basis was zero). The gain does not increase his tax basis in the partnership interest—indeed, he no longer has an interest in the partnership. Thus, the $5,000 carryforward under Code Sec. 704(d) is lost.

Note that the loss carryforward is not deductible against E's capital gain from sale of the partnership interest because it did not reduce the tax basis of that interest. Put another way, had the loss been deductible, E's basis in the interest would presumably have been negative $5,000 ($35,000 tax basis less $40,000 pass-through loss). Sale of the interest for $10,000 would then have triggered a $15,000 capital gain, rather than $10,000 as above. Thus, E's gain from sale of the interest is already lower than it would have been had the loss been allowed. Accordingly, the loss carryforward cannot be utilized to offset the gain recognized on sale of the partnership interest.

.02 Carryforwards under Code Sec. 465

Losses disallowed under the at-risk rules of Code Sec. 465 are carried forward indefinitely just as are those denied under Code Sec. 704(d). Carryforwards under the two statutes have different effects on the partner, however. As noted above, to the extent deductible under Code Sec. 704(d), a partner's allocable share of the partnership's loss reduces her tax basis in the partnership interest whether or not it is ultimately deductible under Code Secs. 465 and 469. Thus, a partner's tax basis in her partnership interest is reduced by losses even if they are disallowed under the at-risk rules (Code Sec. 465). As a result, the partner's gain upon a subsequent sale of that interest is increased by losses that have previously been disallowed under the at-risk rules (because these losses reduced tax basis with no corresponding tax benefit). Thus, when a partner sells her interest in the partnership, losses carried forward under Code Sec. 465, unlike those carried forward under Code Sec. 704, are deductible in full, regardless of the amount of gain or loss recognized by the partner/member on the transaction.

Example 5-3

Q is a 10% limited partner in Quantum Limited Partnership. She has a zero tax basis in her partnership interest and her amount at risk is also zero. She has an $8,000 loss carryforward under Code Sec. 704(d) and a $3,500 loss carryforward under Code Sec. 465. She sold her interest in the partnership this year for $25,000, recognizing a $25,000 capital gain.

Note that the loss carryforward under Code Sec. 704(d) is disregarded in determining the tax consequences of the sale of Q's partnership interest. The carryforward cannot be deducted against her gain on the sale, and since she is no longer a partner in Quantum, she will never have additional basis in the interest. The Code Sec. 704(d) carryforward is essentially forfeited upon sale of her interest in the partnership.

In contrast, Q's loss carryforward under Code Sec. 465 consists of losses previously allowed under Code Sec. 704(d) before being disallowed by Code Sec. 465. Accordingly, these losses have reduced her tax basis in the partnership interest, even though they have not actually been deducted. Asaresult, Q's recognized gain of $25,000 exceeds the economic gain actually realized on the investment by the amount of the loss disallowed under Code Sec. 465. This imbalance is corrected by allowing Q to deduct her Code Sec. 465 loss carryforward in full on sale or disposition of her interest. She will therefore report a $25,000 capital gain and a $3,500 ordinary loss in the year of sale[1].

Example 5-4

T is a 10% partner in Slingshot Partners, a limited partnership. His tax basis in his partnership interest is $50,000, consisting of his $20,000 investment in partnership capital and his $30,000 share of the partnership's non-qualified nonrecourse debt. For the current year, T's distributive share of the partnership's taxable loss was $65,000. Under Code Sec. 704(d), only $50,000 of this loss will be deductible; the remaining $15,000 will be carried forward indefinitely. Because non-qualified nonrecourse debt is not included in T's at-risk amount, however, only $20,000 of the loss allowed under Code Sec. 704(d) will be deductible under Code Sec. 465. T's tax basis in his partnership interest will be zero at the end of the year, and he will have loss carryforwards of $15,000 under Code Sec. 704(d) and $30,000 under Code Sec. 465.

Example 5-5

Assume in the example above that the partnership has positive income in its second year of operations, and that T's share of this income is $28,000. This income gives T additional tax basis and increases his at-risk amount in the partnership interest. Since the additional basis exceeds the $15,000 loss carryforward under Code Sec. 704(d), that entire carryforward is deductible in year 2. After deducting the Code Sec. 704(d) loss carryforward, T's net income from the partnership in year 2 is $13,000. This income in turn increases T's amount at risk in the partnership interest, allowing him to use $13,000 of his Code Sec. 465 carryforward. Thus, for year 2, T will report no income from the partnership, and will have a remaining Code Sec. 465 loss carryforward of $17,000. His basis in the partnership interest will be $13,000 ($28,000 income minus $15,000 loss carryforward), and his amount at risk will be zero ($13,000 net income minus $13,000 at-risk carryforward utilized).

Example 5-6

Assume the same facts as in the previous two examples. Going into year 3, T has a $13,000 tax basis in his partnership interest, and a $17,000 loss carryforward under Code Sec. 465. Assume that in year 3, T sells his interest in the partnership for $18,000 cash, plus assumption of his $30,000 share of the partnership's non-qualified nonrecourse debt. Subtracting his $13,000 tax basis from the $48,000 net selling price yields a $35,000 taxable gain. This gain presumably will be capital innature. Saleofthe partnership interest triggers T's $17,000 loss carryforward under Code Sec. 465. This loss carryforward will be deductible in full, and will retain its character as an ordinary loss (assuming it was ordinary in nature in years 1 and 2 when originally passed through to T). Thus, in year 3, T will recognize a capital gain of $35,000 and an ordinary loss of $17,000.

If a partner disposes of an interest in a partnership in a non-taxable transaction (e.g., gift, contribution to another partnership, LLC or corporation), any carryforwards under Code Sec. 465 are added to the basis of the partnership interest in the hands of the transferee[2]. The carryforward loss has reduced the transferor-partner's basis in the partnership without a commensurate deduction. Thus, when the partner transfers the interest in a non-taxable transaction, the unused loss is added back to basis. In these non-taxable transactions, the transferee determines its tax basis in the interest by reference to the transferor-partner's basis in such interest.

Since the loss did not provide any tax benefit to the transferor-partner, it is effectively disregarded and added back to his or her basis in the interest. It is less clear what happens to a carryforward under Code Sec. 465 when the taxpayer dies. The rule cannot be the same as above, because the basis of the partnership interest in the deceased's estate is increased to FMV. Under Code Sec. 469(g)(2), a passive loss carryover may be deducted on the deceased taxpayer's final return to the extent that it exceeds the step-up in basis taken by the estate in the partnership interest. If the step-up exceeds the carryover, the carryover is lost. Logic would suggest that the circumstances are the same for carryovers under either Code Sec. 465 or 469, and that similar rules should therefore apply to carryovers under both statutes.

.03 Carryforwards under Code Sec. 469 (Passive Loss Carryforwards)

For individuals, losses from passive activities are only deductible to the extent of income from other passive activities. Any excess passive losses are not allowed in the current year. Losses disallowed under the passive loss limitations are carried forward indefinitely until such time as the partnership/LLC has sufficient passive income from other sources to absorb the carryforward. If the partner or LLC member completely disposes of his/her interest in the entity, any passive loss carryforward attributable to that investment (i.e., the specific investment in the partnership or LLC) is deductible in full in the year of disposition.

Example 5-7

C is a limited partner in Breakout LLP. Her partnership interest in Breakout is a passive activity for C and is subject to the passive loss limitations. She has no interest in any other passive activities. Assume that in Year 1, C's distributive share of the partnership's loss is $18,000. Further assume that her tax basis and at-risk amount are both $20,000. Since Breakout is a passive activity for C, she is not allowed a deduction for the pass-through loss. Note that although the loss is disallowed under the passive loss rules, it still reduces her basis and at-risk amounts to $2,000. In year 2, assume C sells her entire interest in the LLP, recognizing a $15,000 capital gain. Disposition of her entire interest in the activity will trigger the deduction of her passive loss carryforward. As in the above example, this loss retains the character of the original pass-through loss in year 1, even though her gain on sale of the partnership interest is capital in nature.

503 THE BASIS LIMITATIONS OF CODE SEC. 704(D)

.01 Losses Cannot Exceed Tax Basis

A general rule of taxation is that taxpayers may not claim a deduction for losses or expenses in excess of the amount they stand to lose in connection with the investment. Similarly, losses and/or depreciation deductions cannot be claimed in excess of the taxpayer's actual investment in depreciable property.

Example 5-8

R purchased an office building in the city several years ago for a total cost of $500,000. He claimed depreciation deductions totaling $225,000 prior to this year, when the building was destroyed by a tornado. When the building was destroyed, its fair market value had increased to approximately $650,000. Nonetheless, R's tax loss is limited to $275,000, the remaining unrecovered cost of his investment in the building. He paid $500,000 for the building, and his total deductions with respect to it cannot exceed that figure. Since he has already deducted $225,000 in depreciation expense, his tax basis—the amount he stands to lose with respect to the property—was only $275,000 at the date of the loss. He cannot deduct a loss in excess of his remaining basis even though the building was worth far more at the date of its destruction.

In the partnership context, this means that a partner cannot deduct partnership losses that exceed the tax basis of the partnership interest. For example, assume in the example above that R contributed the building to a partnership rather than selling it. For tax purposes, his investment in the partnership would be only $275,000, the remaining unrecovered cost of the building, even though the value of the building was much higher[3].

.02 Accounting for Debt

The fact that a taxpayer has directly paid only a portion of the total cost of an asset as of the date of loss does not affect the computation of his/her tax basis in that asset. Liabilities incurred to finance acquisition of the property are included in tax basis even though they represent amounts not yet paid by the taxpayer. The taxpayer's tax basis in an asset represents the amount that he/she stands to lose should the asset decline in value. The taxpayer's risk of loss encompasses not only amounts that he/she has directly paid in connection with acquisition and improvement of the asset, but also any amounts he/ she is obligated to pay in the future.