PacificCPE

COURSE
34053B

Residential Rental Properties: Passive Activity and At-Risk Rules

For tax professionals working with rental property clients, understanding passive activity and at-risk rules is essential to accurately determining deductible losses. This course covers the passive activity limits that apply to rental activities, the at-risk rules that can further restrict loss deductions, and how these two sets of rules interact. Clear and practical, it helps practitioners navigate one of the more nuanced areas of individual taxation with greater accuracy and confidence.

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

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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

- Recognize the two sets of rules that may limit the losses you can deduct on your tax return from any trade, business, rental, or other income-producing activity.

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TABLE OF CONTENTS

CHAPTER 01

Passive Activity And At-Risk Rules 4

1.01 I. Reminders 4

1.02 II. Introduction 5

1.03 III. Passive Activity Limits 5

1.04 IV. At-Risk Limits 41

Test Your Knowledge 53

Final Exam Copy 60

Index .....

Chapter 1: PASSIVE ACTIVITY AND AT-RISK RULES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the two sets of rules that may limit the losses you can deduct on your tax return from any trade, business, rental, or other income-producing activity.

I. REMINDERS

Excess business loss limitation. If you are a noncorporate taxpayer and have allowable business losses after taking into account first the at-risk limitations and then the passive loss limitations (Form 8582), your losses may be subject to the excess business loss limitation.

After taking into account all the other loss limitations, complete Form 461, Limitation on Business Losses, to figure the amount of your excess business loss.

Commercial revitalization deduction (CRD). The 120-month deduction period for rental real estate placed in service by December 31, 2009, has expired.

Changes in rules on grouping and definition of real property trade or business. Treasury Decision 9943 revised certain rules in the Regulations under section 469.

- **Applicable date.** The new rules apply to tax years beginning on or after March 22, 2021, but you may chose to adopt these rules earlier. See Regulations section 1.469-11(a)(1) and (4) for additional information on applicability dates and early adoption. If you are a calendar year taxpayer, the new provision applies to you in calendar year 2022.
- **Grouping rules.** Treasury Decision 9943 added Regulations section 1.469-4(d)(6), which prohibits grouping of trading activities described in Temporary Regulations section 1.469-1T(e)(6) subject to section 163(d)(5) (A)(ii) involving a non-passive trade or business in which the taxpayer does not materially participate with any other activity or activities including other trading activities.
- **Definition of real property trade or business.** Treasury Decision 9905 and 9943 expanded Regulations section 1.469-9(b)(2)(i) to define several terms used in determining whether a trade or business is a real property trade or business for purposes of section 469(c)(7)(C). Treasury Decision 9905 added

Regulations sections 1.469-9(b)(2)(ii)(H) and (I) defining real property operations and real property management. Treasury Decision 9943 added Regulations sections 1.469-9(b)(2)(ii)(A) and (B) defining real property development and real property redevelopment.

Regrouping Due to Net Investment Income Tax. You may be able to regroup your activities if you are subject to the Net Investment Income Tax. See Regrouping Due to Net Investment Income Tax under Grouping Your Activities, later, for more information.

At-risk amounts. The following rules apply to amounts borrowed after May 3, 2004.

- You must file Form 6198 if you are engaged in an activity included in (6) under Activities Covered by the At-Risk Rules and you have borrowed certain amounts described in Certain borrowed amounts excluded under At-Risk Amounts in this course.
- You may be considered at risk for certain amounts described in Certain borrowed amounts excluded under At-Risk Amounts secured by real property used in the activity of holding real property (other than mineral property) that, if nonrecourse, would be qualified nonrecourse financing.

II. INTRODUCTION

This chapter discusses two sets of rules that may limit the amount of your deductible loss from trade, business, rental, or other income-producing activity.

The first part of the chapter discusses the passive activity rules. The second part discusses the at-risk rules. However, when you figure your allowable losses from any activity, you must apply the at-risk rules before the passive activity rules.

III. PASSIVE ACTIVITY LIMITS

WHO MUST USE THESE RULES?

The passive activity rules apply to:

- Individuals,
- Estates,
- Trusts (other than grantor trusts),
- Personal service corporations, and
- Closely held corporations.

Even though the rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.

For information about personal service corporations and closely held corporations, including definitions and how the passive activity rules apply to these corporations, see Form 8810 and its instructions.

Caution!

Before applying the passive activity limits, you must first determine the amount of the deductions disallowed under the basis or at-risk rules. See Passive Activity Deductions, later.

PASSIVE ACTIVITY LOSS

Generally, the passive activity loss for the tax year is not allowed. However, there is a special allowance under which some or all of your passive activity loss may be allowed. See Special $25,000 allowance, later.

Definition of passive activity loss. Generally, your passive activity loss for the tax year is the excess of your passive activity deductions over your passive activity gross income. See Passive Activity Income and Deductions, later.

For a closely held corporation, the passive activity loss is the excess of passive activity deductions over the sum of passive activity gross income and net active income. For details on net active income, see the Instructions for Form 8810. For the definition of passive activity gross income, see Passive Activity Income, later. For the definition of passive activity deductions, see Passive Activity Deductions, later.

Identification of Disallowed Passive Activity Deductions

If all or a part of your passive activity loss is disallowed for the tax year, you may need to allocate the disallowed passive activity loss among different passive activities and among different deductions within a passive activity.

Allocation of disallowed passive activity loss among activities. If all or any part of your passive activity loss is disallowed for the tax year, a ratable portion of the loss (if any) from each of your passive activities is disallowed. The ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the tax year by the fraction obtained by dividing:

1. The loss from the activity for the tax year; by

2. The sum of the losses for the tax year from all activities having losses for the tax year.

Use Part VII of Form 8582 to figure the ratable portion of the loss from each activity that is disallowed.

Loss from an activity. The term "loss from an activity" means:

1. The amount by which the passive activity deductions (defined later) from the activity for the tax year exceed the passive activity gross income (defined later) from the activity for the tax year; reduced by
2. Any part of such amount that is allowed under the Special $25,000 allowance, later.

If your passive activity gross income from significant participation passive activities (defined later) for the tax year is more than your passive activity deductions from those activities for the tax year, those activities shall be treated, solely for purposes of figuring your loss from the activity, as a single activity that doesn't have a loss for such tax year. See Significant Participation Passive Activities, later.

Example

Terry holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the tax year are as follows.

	A	B	C	Total
Gross income	$7,000	$4,000	$12,000	$23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)
Net income (loss)	**($9,000)**	**($16,000)**	**$4,000**	**($21,000)**

Terry's $21,000 passive activity loss for the tax year is disallowed. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is as follows.

A: $21,000 × $9,000/$25,000	$7,560
B: $21,000 × $16,000/$25,000	13,440
Total	**$21,000**

Allocation within loss activities. If all or any part of your loss from an activity is disallowed under Allocation of disallowed passive activity loss among activities for the tax year, a ratable portion of each of your passive activity deductions (defined later), other than an excluded deduction (defined below) from such activity is disallowed. The ratable portion of a passive activity deduction is the amount of the disallowed portion of the loss from the activity for the tax year multiplied by the fraction obtained by dividing:

1. The amount of such deduction; by
2. The sum of all of your passive activity deductions (other than excluded deductions) from that activity from the tax year.

Excluded deductions. "Excluded deduction" means any passive activity deduction that is taken into account in computing your net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity. See Recharacterization of Passive Income, later.

Separately identified deductions. In identifying the deductions from an activity that are disallowed, you do not need to account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any tax year different from that which would result were such deduction not taken into account separately.

Use Form 8582, Part IX, for any activity if you have passive activity deductions for that activity that must be separately identified.

Deductions that must be accounted for separately include (but are not limited to) the following deductions.

- Deductions that arise in a rental real estate activity in tax years in which you actively participate in such activity. See Active participation, later.
- Deductions that arise in a rental real estate activity in tax years in which you do not actively participate in such activity. See Active participation, later.
- Losses from sales or exchanges of capital assets.
- Section 1231 losses. See Pub. 544, Sales and Other Dispositions of Assets, for more information.

Carryover of Disallowed Deductions

In the case of an activity with respect to which any deductions or credits are disallowed for a tax year (the loss activity), the disallowed deductions are allocated

among your activities for the next tax year in a manner that reasonably reflects the extent to which each activity continues the loss activity. The disallowed deductions or credits allocated to an activity under the preceding sentence are treated as deductions or credits from the activity for the next tax year.

PASSIVE ACTIVITY CREDIT

Generally, the passive activity credit for the tax year is disallowed.

The passive activity credit is the amount by which the sum of all your credits subject to the passive activity rules exceed your regular tax liability allocable to all passive activities for the tax year. Credits that are included in figuring the general business credit are subject to the passive activity rules.

See the Instructions for Form 8582-CR for more information.

PUBLICLY TRADED PARTNERSHIP

You must apply the rules in this part separately to your income or loss from a passive activity held through a publicly traded partnership (PTP). You also must apply the limit on passive activity credits separately to your credits from a passive activity held through a PTP.

You can offset losses from passive activities of a PTP only against income or gain from passive activities of the same PTP. Likewise, you can offset credits from passive activities of a PTP only against the tax on the net passive income from the same PTP. This separate treatment rule also applies to a regulated investment company holding an interest in a PTP for the items attributable to that interest.

For more information on how to apply the passive activity loss rules to PTPs, and on how to apply the limit on passive activity credits to PTPs, see Publicly Traded Partnerships (PTPs) in the instructions for Forms 8582 and 8582-CR, respectively.

PASSIVE ACTIVITIES

There are two kinds of passive activities.

- Trade or business activities in which you do not materially participate during the year.
- Rental activities, even if you do materially participate in them, unless you are a real estate professional.

Material participation in a trade or business is discussed later, under Activities That Are Not Passive Activities.

Treatment of former passive activities. A former passive activity is an activity that was a passive activity in any earlier tax year, but is not a passive activity in the current tax year. You can deduct a prior year's unallowed loss from the activity up to the amount of your current year net income from the activity. Treat any remaining prior year unallowed loss like you treat any other passive loss.

In addition, any prior year unallowed passive activity credits from a former passive activity offset the allocable part of your current year tax liability. The allocable part of your current year tax liability is that part of this year's tax liability that is allocable to the current year net income from the former passive activity. You figure this after you reduce your net income from the activity by any prior year unallowed loss from that activity (but not below zero).

Trade or Business Activities

A trade or business activity is an activity that:

- Involves the conduct of a trade or business (that is, deductions would be allowable under section 162 of the Internal Revenue Code if other limitations, such as the passive activity rules, did not apply),
- Is conducted in anticipation of starting a trade or business, or
- Involves the conduct of research or experimental activities, including software development, subject to either section 174 (foreign research) or section 174A (domestic research).

A trade or business activity does not include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

You generally report trade or business activities on Schedule C (Form 1040), Schedule F (Form 1040), or in Part II or III of Schedule E (Form 1040).

Rental Activities

A rental activity is a passive activity even if you materially participated in that activity, unless you materially participated as a real estate professional. See Real Estate Professional under Activities That Are Not Passive Activities, later.

An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property.