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Passive Loss Limitations I.R.C. § 469

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Passive Loss Limitations I.R.C. § 469

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INTRODUCTION

The Tax Reform Act of 1986 ("TRA") came into existence with battle cries of "fairness", "lower taxes" and "simplification" resounding in Congress. This Act stands to be anything but simple and whether the elusive concept of "fairness" will truly be achieved remains to be seen. The tax base has been broadened, an estimated six million working poor will be removed from the tax roll, and the highest individual tax rate has been lowered to 28%.¹ The TRA was so extensive that henceforth, the Internal Revenue Code of 1954 will be known as the Internal Revenue Code of 1986 (the "Code").

One of the focal points of TRA is Code section 469 concerning passive loss limitations.² Section 469 may further the goal of fairness³ and even be one of the enabling factors in lowering the tax rates,⁴ but it is

1. I.R.C. § 1 (1986). Note, however, that the top rate is actually 33% because there is a five percent surcharge for individuals with higher incomes. *Id.*

2. I.R.C. § 469 (1986).

3. According to the Senate report "[e]xtensive shelter activity contributes to public concerns that the tax system is unfair, and to the belief that tax is paid only by the naive and the unsophisticated. . . . To the extent that these [average] citizens feel that they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened." S. Rep. No. 313, 99th Cong., 2d Sess. 714 (1986).

4. According to the Senate report, "[s]o long as tax shelters are permitted to erode

also one of the most complicated provisions in the entire Act. The Senate report states: "[t]his provision is estimated to increase fiscal year budget receipts by \$823 million in 1987, \$2,945 million in 1988, \$3,822 million in 1989, \$5,027 million in 1990, and \$6,028 million in 1991."⁵

With section 469, Congress dealt a decisive blow against tax shelters. Proponents of the passive loss limitations hope the effect of this section will be to promote economic, as opposed to tax oriented, business planning. The Senate report notes, "[t]he availability of tax benefits to shelter positive sources of income also has harmed the economy generally by providing a non-economic return on capital for certain investments."⁶ In reality, however, passive loss limitations will affect not just tax shelters, but several other businesses as well in a variety of complex and interrelated ways.

Analysis of the passive loss limitations section is, in part, speculative since Congress has authorized the Treasury Department to formulate regulations implementing the provisions.⁷ The regulations are not likely to be promulgated, or at least not finalized, for some time. Nonetheless, the effects of section 469 must be dealt with currently.

Section 469 is not, on its face, a complicated provision. Under the section, all activities and resulting income are divided into three categories: (1) active, (2) portfolio, and (3) passive. All losses and credits from passive activities can be offset only against passive income. To the extent passive losses exceed passive income, the deductions and credits are deferred until passive income exceeds current passive losses and suspended losses or until the activity is disposed of in a taxable transaction. Simple, right?

II. TAXPAYERS SUBJECT TO SECTION 469

Section 469 applies to individuals, estates, trusts, personal service corporations, and closely held corporations. The passive loss limitations also flow through to partners and shareholders in S corporations.⁸ While the passive loss limitations do not apply to most regular

the federal tax base, a low-rate system can provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bears a fair relationship to the ability to pay." S. Rep. No. 313, 99th Cong., 2d Sess. 714 (1986).

5. S. Rep. No. 313, 99th Cong., 2d Sess. 746 (1986).

6. S. Rep. No. 313, 99th Cong., 2d Sess. 716 (1986).

7. Congress has given the Treasury Department the authority to implement regulations on material and active participation as well as several other crucial provisions. I.R.C. § 469(k) (1986).

8. The limitations flow through to the partners and individual S corporation shareholders due to the conduit theory which governs much of partnership and S corporation law. For example, the test for material participation is applied to each

C corporations,⁹ such corporations will be subject to tough new alternative minimum tax rules which will similarly limit their tax shelter activities.¹⁰

For purposes of section 469, the definition of a closely held corporation utilizes the stock ownership rules applicable to personal holding companies contained in section 465(a)(1)(B).¹¹ A closely held corporation is basically one in which five or fewer shareholders own 50% or more of the stock at any time during the last half of the tax year.¹² Closely held C corporations were included among the taxpayers subject to section 469 to prevent individuals from incorporating their investments to avoid the passive loss limitations.¹³

"Personal service corporation" is defined similarly to the definition in section 269A(b)(2) concerning personal service corporations formed or availed of to avoid or evade income tax.¹⁴ With the appropriate modifications (as required by section 469) the definition would read:

The term personal service corporation means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners. The term employee-owners means any employee who owns, on any day during the taxable year, any of the outstanding stock of the personal service corporation. For purposes of the preceding sentence, section 318 shall apply, except that "any" shall be substituted for "50 percent" in section 318(a)(2)(c). A corporation shall not be treated as a personal service corporation unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners (within the meaning of section 269A(b)(2) as modified).¹⁵

Stock attribution rules apply in determining the ownership percentages.¹⁶

Neither "personal services" nor "substantially performed" are defined. While in certain circumstances it is clear that personal services are being performed, for example, where the corporation is made up of dentists practicing their trade, other cases may not be so obvious. If "personal services" is construed expansively, a corporation could be

individual partner or shareholder, as opposed to being applied to the organization in its entirety. See S. Rep. No. 313, 99th Cong., 2d Sess. 720 (1986).

9. This conclusion can be inferred from the exclusion of corporations (with the exception of closely held C corporations and personal service corporations) from the list of persons subject to § 469. I.R.C. § 469(a)(2) (1986).
10. The new alternative minimum tax rules for corporations require the alternative minimum tax base (regular taxable income plus tax preferences minus certain deductions minus an exemption amount) to be multiplied by 20%. If the resulting amount exceeds the approximated regular tax, the alternative minimum tax must be used instead. See I.R.C. §§ 53-59 (1986).
11. I.R.C. § 469(j)(1) (1986).
12. I.R.C. § 465(a)(1)(B) (1986).
13. S. Rep. No. 313, 99th Cong., 2d Sess. 722 (1986).
14. I.R.C. § 469(j)(2) (1986).
15. This definition is derived by substituting terms delineated in I.R.C. § 469(j)(2) for other terms listed in section I.R.C. § 269A(b).
16. I.R.C. § 269A(b).

considered as providing personal services if it provided anything other than products. Thus, transportation corporations such as airlines, buses, and railroads could be considered personal service corporations. While it is not likely that personal services would be interpreted so broadly, there will be a gray area in which judgment calls must be made and in those cases there will be a risk of error. Similar uncertainties will arise in determining when a service has been "substantially performed" by an employee-owner.

III. DEFINITION OF PASSIVE ACTIVITIES

Section 469 classifies all activities and resulting income into one of three categories: (1) active, (2) passive, or (3) portfolio.¹⁷ The active category includes, in general, compensation for personal services (*i.e.*, wages) and income from an active trade or business. The portfolio category includes income and deductions attributable to interest, dividends, annuities or royalties not derived from the ordinary course of a trade or business. If the activities in question clearly fall outside of the active and portfolio categories, the activities are subject to scrutiny under section 469.

However, the battle lines are not always clearly drawn. In some instances, what appears to be portfolio income at first glance may be classified as passive income after closer examination. This may occur, for instance, when categorizing the interest income derived from the installment sale of a piece of land used directly in a trade or business. Normally interest income is considered portfolio income, however, if the business is deemed passive, the interest from the sale would seem better placed in the passive category as opposed to the portfolio category. Congress has given the Treasury Department broad regulatory discretion in categorizing various types of income to prevent taxpayers from manipulating the categories so as to continue to receive tax benefits when they are no longer warranted.¹⁸

A. Passive Activities

A passive activity is defined as "any activity—(A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."¹⁹ The first question is what constitutes an "activity". For instance, suppose the taxpayer operates a cemetery/mortuary. If this is considered one activity, then material participation need only be considered in connection with the operation in its entirety. However, if the cemetery and the mortuary are considered separate activities, material participation must then be estab-

17. I.R.C. § 469(e) (1986).

18. I.R.C. § 469(k) (1986).

19. I.R.C. § 469(c)(1) (1986).

lished in both activities. If the taxpayer can show material participation only in the mortuary business, the taxpayer will be considered as deriving "active" income or loss from it, but passive income or loss from the cemetery business.

Whether the trade or business is to be categorized as one activity or as two separate activities should be based on "realistic economic sense."²⁰ Factors to be examined include whether the "undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss."²¹ In addition, it may be helpful to look at the regulations under section 183 (hobby losses) which deal with a similar question.²² In the case of the cemetery/mortuary, if the mortuary was located at the cemetery and everyone must first use the mortuary before going to the cemetery, there would be a good basis to argue there is only one activity.

B. Material Participation

"Material participation" is the determinative factor in categorizing an activity as active or passive. This factor was chosen since it is believed that taxpayers who materially participate in an activity are doing so for economic as opposed to purely tax reasons. Additionally, if the taxpayer materially participates, then the taxpayer should be allowed to use any tax benefits resulting from such activity.²³ If the taxpayer can prove that she is materially participating in the conduct of an activity, the income or loss from such activity is thrown into the active income category and is not subject to the passive loss limitations. However, if the taxpayer cannot show material participation, the resulting income is placed in the passive income category and is subject to the constraints of section 469.²⁴

The key words in defining material participation are "regular, continuous, and substantial."²⁵ The Code provides that the Secretary shall promulgate such regulations as are necessary concerning material participation,²⁶ and one would assume such regulations would elaborate on the regular, continuous and substantial requirements.

Obviously, the lack of a clear definition of material participation will cause tax planning problems for attorneys and their clients. Pending the promulgation of regulations, existing regulations, cases

20. S. Rep. No. 313, 99th Cong., 2d Sess. 739 (1986).

21. S. Rep. No. 313, 99th Cong., 2d Sess. 722 (1986).

22. The regulations under § 183 may be of help because the purposes of § 183 and § 469 are somewhat analogous.

23. S. Rep. No. 313, 99th Cong., 2d Sess. 716 (1986).

24. I.R.C. § 469(c)(1) (1986).

25. I.R.C. § 469(h)(1) (1986).

26. I.R.C. § 469(k)(1) (1986).

and rulings interpreting the definition of material participation in sections 1402(a) (self-employment taxes)²⁷ and 2032A (farm valuations for estate tax purposes)²⁸ may provide some guidance. Existing interpretations should, however, be viewed with caution, there may and probably will be instances where a taxpayer may be materially participating for purposes of sections 1402(a) or 2032A but will not qualify as materially participating under section 469. The different purposes behind these code provisions may produce different results. For instance, it is possible that although a farmer is deemed to have materially participated for purposes of section 2032A, by answering a management questionnaire and occasionally going out to the fields to watch the corn grow, such participation may be deemed insufficient to qualify under section 469.

The legislative history provides some factors that would indicate material participation.²⁹ For instance, when the activity in question is the principle business of the taxpayer, it is more likely that the taxpayer is materially participating in that business. Similarly, if the activity in question is not the taxpayer's principle business, it is less likely that the taxpayer is materially participating in that business.³⁰ Proximity to the business is also considered in determining material participation in many cases.³¹ For instance, it would be easier to show material participation in the operation of a shoe store if the taxpayer was living close to the store and was often physically in the store as opposed to living across the country from the store.

Material participation may be shown through physical services as well as managerial services. However, in the case of managerial services, the services must be based on the taxpayer's personal knowledge. That is, the taxpayer must base her management decisions upon her personal knowledge and not rely on the advice and expertise of a third party. The legislative history includes an example of managerial services that would most likely not constitute material participation. The example indicates that a taxpayer would not be materially participating in a cattle feeding operation when she merely checks the boxes on a "management questionnaire."³²

Finally, the code indicates that unless otherwise provided in the regulations, a taxpayer with a limited partnership interest is not materially participating in such activity.³³ The rationale behind this subsection is to insure that limited partnerships—which compose many of

27. See I.R.C. § 1402(a) (1986).

28. See I.R.C. § 2032A (1986).

29. See generally S. Rep. No. 313, 99th Cong., 2d Sess. 732-35 (1986).

30. *Id.*

31. *Id.*

32. *Id.*

33. I.R.C. § 469(h)(2) (1986).

today's lucrative tax shelters—are subject to the passive loss limitations of section 469. This furthers the Congressional war against tax shelters since the heavy up-front losses available in the typical limited partnership tax shelter will no longer shelter the limited partner's general income (wages, portfolio income, etc.). Instead, the losses generated by the limited partnership will be deemed passive and subject to all of the restrictions of section 469 and as a result be useful only in offsetting passive income.

In summary, helpful indicators in determining material participation include:

1. Whether the taxpayer is involved in the activity on a regular, substantial and continuous basis.
2. Whether the taxpayer is regularly present at the place of the activity.
3. Whether the taxpayer is involved in the day-to-day operations and management of the activity.
4. Whether the activity is the principle trade or business of the taxpayer.
5. Whether the taxpayer has the knowledge and expertise necessary to truly participate in the activity.

The determination of whether activities conducted by an entity meet the material participation test is made at the individual level. In the case of partnerships and S corporations each respective partner and shareholder must show material participation with respect to the entity's activities.³⁴ In the case of trusts, the Code looks to the trustee or fiduciary to see if the material participation requirements are met.³⁵ With estates, the Code looks at the executor or administrator in evaluating material participation.³⁶ Shareholders who together own more than 50% of the stock of a personal service corporation are examined in determining material participation.³⁷ Finally, in the case of closely held, non-personal, service corporations, the material participation test is met if the corporation either qualifies under the material participation test applied to personal service corporations or if it is a "qualifying business" for purposes of the at risk rules of section 465(c)(7)(C).³⁸ A business is a "qualifying business" if:

- (i) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 1 full-time employee substantially all the services of whom were in the active management of such business,
- (ii) during the entire 12-month period ending on the last day of the taxable

34. This is due to the conduit approach to partnerships and S corporations. *See supra* note 8.

35. S. Rep. No. 313, 99th Cong., 2d Sess. (1986).

36. *Id.*

37. I.R.C. § 469(h)(4)(A) (1986).

38. I.R.C. § 469(h)(4) (1986).

year, such corporation had at least 3 full-time, nonowner employees substantially all of the services of whom were services directly related to the business,

(iii) the amount of the deductions attributable to such business which are allowable to the taxpayer solely by reason of sections 162 and 404 for the taxable year exceeds 15 percent of the gross income for such business for such year
...³⁹

In certain instances material participation is irrelevant. In the case of working interests in oil and gas, as long as the taxpayer has not limited her liability, she will be immune from the passive loss limitations of section 469.⁴⁰ Material participation is also deemed irrelevant in the case of rental activities. Rental activities are deemed passive.⁴¹ As shall be seen, however, there is a \$25,000 "exemption" from the passive loss limitations where the taxpayer actively participates in rental real estate activities.⁴²

IV. TAX ATTRIBUTES SUBJECT TO LIMITATIONS

Once an activity is determined to be passive, the next step is to identify all losses, credits and income associated with the activity. In determining the "passive activity loss" for the taxable year, the total of all losses from all passive activities of a taxpayer are subtracted from the income resulting from all such passive activities.⁴³ If losses exceed income, the net result is the passive activity loss for the year.⁴⁴ In the case of the "passive activity credit," there is a passive activity credit if the amount of the credits resulting from the passive activity exceed "the regular tax liability of the taxpayer for the taxable year allocable to all passive activities."⁴⁵

The determination of whether a loss will be suspended under section 469 is made only after applying the at-risk rules, interest deduction limitations and various other limitations, imposed in determining taxable income. To determine the regular tax liability allocable to the passive activities, the first step is to determine the tax liability which would result from a tax on all income (passive, active and portfolio) without regard to the credits. The second step is to determine the tax liability which would result solely from the active and portfolio income (once again without regard to the credits). After these calculations are made, the tax liability figure based on all of the income is subtracted to reach the tax liability attributable to the passive income. If the passive activity credits exceed this amount, they are subject to

39. I.R.C. § 465(c)(7)(C) (1986).

40. I.R.C. § 469(c)(3) (1986).

41. I.R.C. § 469(e)(2) (1986).

42. I.R.C. § 469(i) (1986).

43. I.R.C. § 469(d)(1) (1986).

44. *Id.*

45. I.R.C. § 469(d)(2) (1986).

the passive loss limitations of section 469.⁴⁶

For example, suppose that Taxpayer A has \$56,000 of regular tax liability based on the total of active, portfolio and passive income. However, the tax liability would be only \$46,000 if just active and portfolio income was used in the computation. In that case \$10,000 of the tax liability is attributable to passive income. Finally, assume that taxpayer A has a total of \$13,000 in credits resulting from passive activities. As illustrated below, \$3,000 of those credits will be subject to the passive loss limitations of section 469.

\$ 56,000 regular tax (portfolio, active and passive)
 -46,000 regular tax (portfolio and active)
 \$ 10,000 regular tax (passive)

\$ 13,000 total passive activity credits
 -10,000 regular tax (passive)
 \$ 3,000 credits subject to passive limitations

The amount by which passive losses exceed passive income and passive credits exceed passive tax liability are not lost forever. Section 469 provides that these losses and credits can be carried forward (but not backward) until they can be used.⁴⁷ The deferral of losses and credits serves to delay loss recognition and, as a result, diminish the value of many current tax shelters. Many tax shelters depended on quick, up-front losses to attract investors. The value of these losses was in the time value of money savings—it is better to pay taxes next year than this year. Section 469 puts a crimp in the loss recognition which attracted investors. In addition, passive credits are subject to at risk limitations.

As mentioned previously, the expansiveness of the passive income category will depend on how broadly the Treasury Department drafts the regulations for section 469. To fulfill the Congressional goal of eradicating tax shelters, the Treasury Department must walk the fine line between overly broad regulations that scoop more taxpayers into the passive net than intended and overly narrow regulations that allow for creative reclassification and the continuation of old tax shelters, albeit on a limited scale. If the regulations are overly broad many taxpayers will be hurt by having income classified as passive even though the taxpayers were not involved in traditional tax shelters.

An example of an overly broad regulatory scheme can be illustrated as follows. Assume a Washington shoe store owner, after twenty years in business, decides to move to Florida. If the owner elects to continue to operate the Washington shoe store from his Florida condominium, he may have trouble meeting the "substantial, regular and continuous" requirements for material participation. If the

46. *Id.*

47. I.R.C. § 469(b) (1986).

activity is classified as passive and the business suffers a turn for the worse, any passive losses would be subject to the limitations in section 469 even though the owner did not intend to operate and was not in fact operating a tax shelter.

The more troublesome task for the Treasury Department will be drafting regulations that prevent taxpayers from reclassifying part of their "active" income as "passive" income and, as a result, continue to shelter income by offsetting it with passive losses. Since the effectiveness of section 469 depends upon limiting passive losses to the amount of passive income, an increase in passive income will proportionately increase the amount of passive losses that can be expended instead of suspended.

Creative tax planning in the future will include finding passive income that can be used to offset passive losses. In many instances, taxpayers may be "locked into" passive losses due to their investment in traditional tax shelters before the Tax Reform Act of 1986 was passed. These "locked-in" losses will lose most of their value if the taxpayers cannot find a source of passive income. Creative tax planning might include putting a traditionally active trade or business into limited partnership form. The resulting income would then be classified as passive. In connection with this scheme, the taxpayer might attempt to have her wages (active income under section 469) paid in "partnership distributions," thereby reclassifying income as passive. If the passive income results from reclassifying active or portfolio income, the purposes of section 469 are defeated since the sheltering of active income will continue.

However, if passive income generated to offset the "locked-in" passive losses is the result of economic as opposed to purely tax-oriented transactions, then the purposes of section 469 are furthered. The Treasury Department must formulate regulations that will further this goal. Possible regulations might include modification of the general rule that income received by a limited partner from a limited partnership is always passive income. The Treasury Department may wish to reclassify this income when the purposes of section 469 would otherwise be defeated. One such instance where reclassification would be desirable is when a limited partner attempts to make her wages passive in the manner described above. To allow the wages, in effect, to be reclassified as passive allows tax shelters to continue and flourish.

The impact of the passive loss limitations of section 469 cannot be viewed in isolation. When combined with the at risk rules, alternative minimum tax provisions and basic credit limitations, the result of section 469 on the unwary taxpayer can be shocking. For example:

Assume a married taxpayer filing a joint return has \$300,000 of taxable income without regard to passive losses derived from a low-income housing

real estate limited partnership in which he invested in 1985. Assume that the taxpayer is required to contribute \$150,000 additional capital to the partnership in each of years 1987, 1988 and 1989. Assume that the partnership projects losses to the taxpayer of \$300,000 in each of such years. Under current law the taxpayer would have a zero regular tax liability and would not be subject to the alternative minimum tax because the total amount of tax preferences (e.g., "excess" depreciation) did not exceed the \$40,000 exemption amount.

Under the Committee Proposal the disallowed losses and the regular tax resulting from disallowance would be calculated as

<u>Year</u>	<u>Disallowed Losses</u>	<u>Tax on Disallowed Losses</u>
1987	\$105,000 (35% \$300,000)	\$28,350
1988	\$180,000 (60% \$300,000)	\$48,600
1989	\$240,000 (60% [sic, 80%] \$300,000)	\$64,800

In addition, under the Committee Proposal, the portion of the passive losses which are not disallowed would be treated as a tax preference item under the alternative minimum tax ("AMT") rules.

The AMT in each year would be 20% of the allowed losses less a \$40,000 exemption amount and would be computed as follows:

<u>Year</u>	<u>Allowed Losses less \$40,00 Exemption Amount</u>	<u>AMT [(Allowed losses-exemptions) × 20%]</u>
1987	\$155,000	\$31,000
1988	\$ 80,000	\$16,000
1989	\$ 60,000	\$12,000

In 1987 the AMT of \$31,000 would be greater than the regular tax of \$28,350. In 1988 and 1989 this would not be the case. Thus, although the taxpayer made his investment decision prior to the Senate Finance Committee action on the Committee Proposal he will nevertheless have the Committee Proposal applied retroactively. Under current law, the taxpayer would have owed no tax; under the Committee Proposal the same taxpayer who made investment decisions based on existing law would owe taxes of \$144,400 (\$31,000 + \$48,600 + 64,800).⁴⁸

Note that this example assumes a flat rate of 27%.

V. RENTAL ACTIVITIES

As mentioned previously, rental activities are automatically deemed passive.⁴⁹ The extent of taxpayer involvement in the rental activities is irrelevant for material participation purposes. The definition of rental activities is not limited to the rental of real estate. Other rental activities include long term leasing of office equipment and automobiles.⁵⁰ Certain rental activities that include substantial provision of services fall outside of "rental activities".⁵¹ This is the case

48. P. FASS, R. HAFT, L. LOFFMAN AND S. PRESANT, REAL ESTATE SYNDICATION TAX HANDBOOK ch. 19-10 (1986).

49. I.R.C. § 469(c)(2) (1986).

50. S. Rep. No. 313, 99th Cong., 2d Sess. 720 (1986).

51. *Id.*

with hotels and nursing homes where the rental portion is secondary to the services rendered. This is also the case with short term car rentals where the emphasis is on services provided.

However, when the taxpayer is renting real estate on a long term basis and the taxpayer "actively" participates in such real estate rental activities, she can use up to \$25,000 in passive activity losses, or in the case of passive activity credits, deduction equivalents to offset other income.⁵² Like material participation, "active participation" is not clearly defined. As a starting point "active" connotes something less than "material" participation.⁵³ In other words, the taxpayer need not be regularly, substantially and continuously involved in the rental activities. It is possible for the taxpayer to have a regular full time job and still actively participate in rental activities. For instance, it is possible for a lawyer to actively participate in renting his apartment complex even though he does not devote a substantial amount of time to the activity. The lawyer might be actively participating even if he hires an apartment manager to run the complex on a day-to-day basis as long as the lawyer oversees the activity.

Once again, Congress has given the Treasury Department broad authority in drafting regulations to further define "active participation."⁵⁴ Congress has, however, promulgated definitive rules in two instances. First, the code states that if a person owns less than ten percent in value of the rental activity at any time during the taxable period, the person will be deemed not to have actively participated.⁵⁵ The ten percent in value includes any ownership interests of the spouse.⁵⁶ In addition, a limited partner in a limited partnership will not be considered as actively participating in the rental activities.⁵⁷ An exception to the limitation on limited partners is made with respect to low income housing credits. Even a limited partner is allowed to take the deduction equivalent of \$25,000 in low income housing credits.⁵⁸ Also, note that the \$25,000 "exemption" from section 469 is not available to corporations.⁵⁹ The \$25,000 exemption is phased out between \$100,000 and \$150,000 adjusted gross income on regular rental real estate activities and between \$200,000 and \$250,000 for low-income housing and rehabilitation credits.⁶⁰

52. I.R.C. § 469(i) (1986).

53. S. Rep. No. 313, 99th Cong., 2d Sess. 737-38 (1986).

54. I.R.C. § 469(k) (1986).

55. I.R.C. § 469(i)(6)(A) (1986).

56. *Id.*

57. I.R.C. § 469(i)(6)(C) (1986).

58. I.R.C. § 469(i)(6)(B) (1986).

59. I.R.C. § 469(i)(1) (1986).

60. I.R.C. § 469(i)(3) (1986).

VI. RECOGNITION OF SUSPENDED LOSSES

Section 469 provides that all suspended losses, (but not credits), are entitled to full recognition at such time as there is a taxable disposition of the passive activity.⁶¹ The threshold requirement for recognition is a disposition which is taxable. Sales to third parties, and even abandonments, will trigger recognition of suspended losses.⁶² However, a non-recognition transaction such as a section 1031 like-kind exchange will not trigger the suspended losses except to the extent that gain is recognized in the transaction.⁶³ In the case of a like-kind exchange, the suspended losses can not be recognized until the newly traded property is disposed of in a taxable transaction.

As mentioned, only losses, as opposed to credits, may be taken in full upon taxable disposition of the passive activity. The distinction is based on the economic versus tax oriented battle that motivated Congress to enact section 469. As explained in the Senate report, "[s]ince the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by a reason of a disposition."⁶⁴

For purposes of disposition, it is necessary to determine the scope of the activity involved because the entire activity must be disposed of before the suspended losses may be recognized.⁶⁵ Disposition of the entire activity means that the taxpayer must dispose of all interests in the activity held indirectly (through partnerships, S corporations, etc.) as well as directly. Also, if the activity which gives rise to the passive income is a sole proprietorship, all assets which compose the enterprise must be disposed of for purposes of an entire disposition. For instance, in the previous cemetery/mortuary example, if the cemetery/mortuary business is classified as one passive activity and only the cemetery is sold, the suspended losses attributable to the cemetery are not entitled to recognition until the mortuary is also sold. However, if the cemetery/mortuary was considered two separate passive activities, the sale of the cemetery would cause immediate recognition of the suspended losses. As a planning pointer, to aid in the cemetery and mortuary being classified as two separate activities, separate books should be kept on each business. The passive losses generated from each activity and the extent losses were used and/or suspended must be traceable so that upon disposition the amount of suspended losses still available and attributable to the disposed of activity can be determined.

61. I.R.C. § 469(g)(1) (1986).

62. *Id.*

63. I.R.C. § 469(g)(1) (1986).

64. S. Rep. No. 313, 99th Cong., 2d Sess. 725 (1986).

65. *Id.*

When an interest is disposed of via an installment sale, suspended losses from that activity are allowed based on a ratio of gain recognized each year to total gain on the sale.⁶⁶ The purpose for this provision is to prevent a taxpayer from using an installment sale to trigger total recognition of suspended losses, and yet defer gain recognition over a long period of time. Once again, it is a Congressional attempt to mesh economic and tax realities.

The order in which suspended losses may be utilized upon total disposition of a passive activity is clearly delineated in section 469(g)(1)(A). This section provides that all suspended passive losses shall no longer be considered passive and shall be deductible in the following order: (1) income or gain resulting from the passive activity (both during the year and realized as a result of the disposition), (2) net income or gain from all passive activities for the taxable year in question, and (3) all other income or gain.⁶⁷ It is possible that much of the suspended losses will be consumed by gain realized on the disposition of the activity. However, where all suspended losses are not used on gain resulting from the disposed of activity, the losses must next be used against net income from passive activities.

The rationale for this provision may be Congress' desire to limit these now "unsuspended" losses to passive activities as much as possible. If the tax year results in no net income or gain from passive activities other than the one disposed, the "unsuspended" losses can now be used against all other income or gain including wages and portfolio income. If all of these now "unsuspended" losses cannot be used in the disposition year, the losses are merged with other non-passive losses and become subject to the constraints imposed on nonpassive losses. Query: does this mean that the taxpayer can take these now "unsuspended" losses and carry them back to past years? This author believes so.

Another unanswered question concerns the reverse of the above situation. Can a taxpayer utilize passive losses and credits from other activities to offset any gain realized on the sale of a passive activity? For instance, assume the cemetery/mortuary is considered two separate passive activities. Taxpayer sells the cemetery and must recognize \$40,000 in gain (assuming all "unsuspended" losses have already been taken into account). Query: can the taxpayer utilize the current passive losses and/or the suspended passive losses from the mortuary to offset the \$40,000 gain? That is, should the gain recognized from the sale of the passive activity be placed in the passive category or perhaps the portfolio category? The legislative history does not provide a definitive answer on this point. However, based on the order in which

66. I.R.C. § 469(g)(3) (1986).

67. I.R.C. § 469(g)(1)(A) (1986).

"unsuspended" losses must be utilized, one could argue that the taxpayer should be entitled to use losses and credits from other passive activities to offset any gain recognized upon the disposition of a passive activity. Since "unsuspended" (and now non-passive) losses must first be offset against gain from the activity disposed of and then from other passive activities before applying such losses to all other income and gain, it follows that the gain recognized on the disposition of the activity should first be reduced by losses connected with the activity, then by losses associated with other passive activities and finally by other losses. The legislative history indicates that

[g]ain recognized on a transfer of a partial interest in the passive activity, and gain (boot) on a tax-free transfer of an entire or partial interest, are treated as from a passive activity. Gain on such transfers may be offset by losses and credits from passive activities, but such transfers are not treated as dispositions triggering all suspended income from the activity.⁶⁸

Suspended losses also become "unsuspended," but not without limitations, when a taxpayer who previously did not materially participate presently meets the requirements for material participation.⁶⁹ In this case, the suspended passive losses from the activity in question are allowed against income derived from the activity by the now materially participating individual.⁷⁰ This allows the taxpayer, even though there was no taxable disposition, to offset income from this particular activity by suspended passive losses that accrued prior to the taxpayer materially participating.

Likewise, when a closely held corporation or a personal service corporation changes form (by going public for example) and as a result is no longer subject to section 469, previously suspended losses are allowed to offset active income of the corporation.⁷¹ The previously suspended losses cannot offset portfolio income.

VII. PHASE IN PROVISIONS

The passive loss rules of section 469 generally become effective January 1, 1987.⁷² Pre-1987 interests (those activities acquired before January 1, 1987 which under the new classification scheme are deemed passive activities) will gradually become subject to section 469. In 1987 35% of all passive losses and credits resulting from pre-1987 interests will become subject to section 469.⁷³ In 1988 60% of all passive losses and credits will become subject to section 469.⁷⁴ In 1989

68. S. Rep. No. 313, 99th Cong., 2d Sess. (1986).

69. I.R.C. § 469(f) (1986).

70. *Id.*

71. *Id.*

72. I.R.C. § 469(l) (1986).

73. I.R.C. § 469(l)(2) (1986).

74. *Id.*

80% of all passive losses and credits will become subject to section 469.⁷⁵ In 1990 90% of all passive losses and credits will become subject to section 469.⁷⁶ In 1991 and taxable years thereafter 100% of all pre-1987 interests' generating passive credits and losses will be subject to section 469.⁷⁷

VIII. CONCLUSION

Section 469 was designed, in part, to curtail the use of tax shelters and as a result achieve a more fair and equitable tax system. One of the areas most affected by section 469 will be the limited partnership. The limited partnership, prior to TRA 1986, was one of the most common organizational forms for the traditional tax shelter. For purposes of sheltering taxable income, the limited partnership was designed to incur substantial up-front losses. These losses would then flow through to the various limited partners who invested in the scheme. These partners could then utilize the losses to shelter their wages as well as other income. Under the TRA of 1986, and with the implementation of section 469, the losses and/or credits derived from the limited partnership described above will be characterized as passive and as such will be available to offset only passive income. The limited partner will no longer be able to shelter her wages and portfolio income. If this in fact occurs, we will all be benefited.

Creative tax planners will attempt to recharacterize passive losses as active to avoid the limitations of section 469. However, the regulations to be promulgated will most likely curtail this practice. In the alternative, tax planners will in effect adhere to the adage—"If you can't beat them, join them"—and attempt to recharacterize active or portfolio income as passive income. Reclassifying active and/or portfolio income as passive would allow the traditional tax shelters to continue, albeit 1987 style. Persons with passive losses from traditional shelters could continue to shelter their now "passive" income with their old passive losses.

One possible plan would be for owners of successful active trades or businesses to sell limited partnership interests in their businesses. This will provide the owners with an influx of capital and at the same time provide the limited partners with a source of passive income to offset their passive losses. The Treasury Department has the authority to promulgate regulations to deal with this abuse. However, it will be much harder for the Treasury to draft regulations keeping income from being classified as passive than it will be to prohibit losses from being classified as active.

75. *Id.*

76. *Id.*

77. *Id.*

Probably the most disturbing aspect of section 469 is its suddenness. For instance, tax planners in 1984 could not foresee that such a section would be enacted and as a result could not prepare their clients. Many taxpayers in 1987 will find themselves locked into traditional tax shelters that prior to the TRA of 1986 were extremely beneficial, but after the TRA of 1986 are extremely undesirable. Although there is a phase-in period, section 469 will still have very negative tax consequences for people who did not and could not foresee its enactment.

As mentioned previously, the difficult task for the Treasury Department will be to walk the fine line between defining passive activities too broadly or too narrowly. To the extent the Treasury Department can achieve this task, section 469 will be beneficial. It will be interesting to see how the Treasury Department meets this challenge.

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