IRS

Partnership - Audit Technique Guide - Chapter 5 - Loss Limitations (Revised 12/2007)

LMSB-04-1107-076
Revised 12/2007

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Each chapter in this Audit Techniques Guide (ATG) can be printed individually. Please follow the links at the beginning or end of this chapter to return to either the previous chapter or the Table of Contents or to proceed to the next chapter.

Chapter 4 | Table of Contents | Chapter 6

Chapter 5 - Table of Contents

Introduction
Issue: Basis Limitations
Issue: At-Risk Limitations
Issue: Automatic Adjustments Due to Passive Loss Limitations
Issue: Equipment Leases
Issue: Rental Real Estate Losses
Issue: Real Estate Professionals
Issue: Material Participation
Issue: Self-Rented Property
Issue: Loss Limitations on Certain Sales

Note: The names used in the examples are hypothetical. The names for some entities were chosen at random from a list of names of American colleges and universities as shown in Webster's Dictionary.

INTRODUCTION

A partner's ability to deduct partnership losses are subject to three sets of limitations, which are applied in the following order:

1. Under IRC section 704(d), the loss must not exceed the amount of the partner's basis in the partnership interest;
2. The loss is subject to the at-risk rules of IRC section 465;
3. The loss is subject to the passive activity rules of IRC section 469.

Losses that do not meet the requirements for any of the three limitations are suspended at that level. Each of the three limitations provides for a carryover of any disallowed loss. Therefore, the three limitations address matters of timing rather than true disallowance.

In addition to the above loss limitations, IRC section 707(b) limits loss recognition on certain sales of property between "persons" and controlled partnerships or between two commonly controlled partnerships.

ons (Revi...

back to the top

ISSUE: BASIS LIMITATIONS

A partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest. This is calculated at the end of the partnership taxable year in which the loss occurs. The partner's outside basis is not allowed to fall below zero. The IRC section 704(d) limitation of losses must be met before at-risk and passive limitations apply. Thus, for example, if the partner has insufficient basis, losses are suspended and should not be reflected on either Form 6198 for the at-risk limitation or on Form 8582 for the passive loss limitations. See IRC section 705(a)(2) and IRC section 733.

A partnership may have several types of income, gain, loss, or deductions. If there are losses in all categories, and the IRC section 704(d) limitation applies, then each category of loss is limited in the proportion it bears to total losses, including disallowed losses from prior years. See Treas. Reg. section 1.704-1(d)(4) example (3).

Revenue Ruling 66-94 states that before applying the IRC section 704(d) limitation, the adjusted basis of a partner's interest is first reduced by withdrawals. This treatment favors the potential for treating distributions as tax-free and also permits the partners a measure of control in timing the use of a distributive share of partnership loss. A partner could, for example, trigger the use of a suspended loss in a high income year by making a capital contribution to the partnership. Alternatively, basis could also be increased by having the partnership borrow money. See Treas. Reg. section 1.704-1(d)(4) example 2.

If a partner with suspended IRC section 704(d) losses sells his/her entire partnership interest at a gain, the losses may not be utilized. This is true even if the gain exceeds the losses that have been carried over. In effect, losses suspended due to the IRC section 704(d) limitation remain at the partnership level.

Examination Techniques

- If there is little difference between book and tax (check M-1), a quick method to verify that the taxpayer has sufficient outside basis is to add the ending capital account on the K-1 **and** the nonrecourse and recourse amounts from the K-1. If there is a negative capital account at year-end and the capital account is still negative after netting out recourse and nonrecourse liabilities, the taxpayer does not have basis for his losses. This method will not work if the capital account reflects assets at fair market value.
- If there are large K-1 losses or if there are significant distributions, issue an IDR and ask the taxpayer to provide his outside basis computations.
- Determine whether the partner has sufficient basis to deduct K-1 line 1 trade or business losses or line 2 rental

real estate losses If not, losses are suspended indefinitely until his basis is increased.

back to the top

Issue Identification

Scrutinize the K-1s for significant losses on K-1 line 1 (trade or business), line 2 (rental real estate), or line 3 (other rentals).

Scrutinize the K-1s for distributions (line 19 for 2004 and later years).

Request the partner's related returns to review losses actually taken on the returns. If losses are in the nonpassive column on the back of Schedule E, that means they have been deducted in full. If losses are in the passive column on the back of Schedule E and on Form 8582, that means they have been subjected to the passive loss limitations.

Review K-1s for negative ending capital accounts. For 2004 and later years, the capital account analysis is in box N of the K-1. Reminder: A negative capital account may be of greater concern if the partnership is filing a final year return.

Documents to Request

- Prior and subsequent year partnership returns;
- Copies of partners' returns;
- Outside basis computation for partners with large losses;
- Suspended loss computation;
- Partnership agreement;
- Loan documents, guarantees.

Interview Questions

1. Were there cash or property distributions to any of the partners during the year?
2. How many years has the partnership operated with losses?

Supporting Law

IRC, Subchapter K:
Section 704
Section 705
Section 733
Supporting regulation and specific regulations cited above.

Kingbay v. Commissioner 46 T.C. 147 – Partner's basis in the current year was determined to be zero because of the distributive share of the partnership losses. The Court held that deductions of partnership losses by limited partners are allowed only to the extent of the adjusted bases of their interests in the partnership at the end of the partnership year in which a loss occurred.

Revenue Ruling 66-94, 1966-1 C.B. 166 – Distributions are taken into consideration before losses in computing a partner's adjusted basis in the partnership interest under IRC section 704(a).

Sennett v. Commissioner 80 TC 825, aff'd per curiam, 752 F2d 428 (9^{th} Cir. 1985) – A partner's suspended deductions under IRC section 704(d) expire upon the sale of his partnership interest.

Resources

RIA U.S. Tax Reporter – Income Taxes
CCH Standard Federal Tax Reporter
Practitioners Publishing Co.

back to the top

ISSUE: AT-RISK LIMITATIONS

In 1976, Congress added IRC section 465 to combat the use of tax shelters that were based on the use of nonrecourse financing. The intention was to prevent taxpayers from using nonrecourse debt to create non-economic losses.

The at-risk rules originally applied to only the following five activities:

1. Farming;
2. Exploring for or exploiting oil and gas resources;
3. Holding, producing, or distributing motion picture films or videos;
4. Equipment leasing;
5. Exploring for or exploiting geothermal deposits.

These five areas were considered to be the ones most prone to the marketing of tax shelters. Prior to the enactment of IRC section 465, tax shelter promoters had employed unrealistic purchase prices of property financed with nonrecourse debt to generate tax deductions. The use of nonrecourse debt protected the taxpayer from suffering any true economic loss. The at-risk rules were eventually expanded to include *all* activities.

In the context of partnerships, the at-risk rules apply at the individual partner level. Not all partners, however, are subject to the rules. The at-risk rules apply only to individuals and closely held corporations. A closely held corporation is one in which five or fewer shareholders own more than 50% of the corporation's stock during the last half of the tax year.

If the partnership is subject to the TEFRA unified audit procedures, the examiner should be aware that certain components of at-risk are partnership items. Determinations concerning partnership assets, investments, transactions, and the nature of liabilities that are necessary to determine the amounts at risk in an activity are made at the partnership level. Whether an individual partner is at risk pursuant to IRC section 465 is an "affected item" and determined at the partner level.

Losses in excess of a partner's amount at-risk are suspended and carried forward until such time the at-risk amount is increased. These suspended losses can be carried forward indefinitely. Unlike the basis rules under IRC section 704(d), suspended losses may be used to offset any gain on the sale of a partnership interest. See Prop. Treas. Reg. section 1.465-66.

Amount at Risk

Amounts at risk are generally made on an activity-by-activity basis. The proposed regulations provide rules for aggregating or separating activities**.** A partner is at risk for:

- Cash contributed to the partnership,
- Adjusted basis of property contributed to the partnership, and
- Amounts borrowed by the partnership if the partner is personally liable for repayment or has pledged property (other than property used in the activity) as security for the loan.

The amount at risk is generally increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

Guarantees

IRC section 465(b)(4) states that a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. The reference to "other similar arrangements" has been key in addressing creative tax shelters. The reference to "guarantees", however, should be put in a broader context of subsequent court decisions, **although it should be noted that the Service's position continues to be that set forth in Proposed Regulation section 1.465-6(d)**.

Proposed Regulation section 1.465-6(d) provides that guarantees do not increase at risk basis until the taxpayer actually pays the guaranteed debt and has no right to reimbursement. Specifically, the regulation states:

> If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk. If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.

In a 1983 decision (*Brand v. Commissioner* 81 T.C. 821), the Tax Court held that the partners were not at risk for the amount of the partnerships' loans they guaranteed and could therefore not deduct losses in excess of their capital contributions. The court stated that "Since a guarantor is entitled to reimbursement from the primary obligor, it is clear that Congress did not intend that a guarantor of a loan is personally liable for repayment of the loan within the meaning of section 465(b)(2)(A).

However, since the *Brand* case, several other cases have permitted an increase in at risk basis for guarantees by partners or LLC members under certain conditions. This line of thought focuses on whether the guarantor bears the ultimate economic responsibility for either the entire debt or a portion of the debt if the entity defaults in a worst case scenario. The worst case scenario assumes that no "arrangement" exists whereby the taxpayer is protected against economic loss.

In *Melvin v. Commissioner*, 88 T.C. No. 5, the court stated:

> The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case. Furthermore, the fact that the partnership or other partners remain in the 'chain of liability' should not detract from the at-risk amount of the parties who do have the ultimate liability. The critical inquiry should be who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls.

Some commentators take the position that the worst case scenario set forth in the *Melvin* case is essentially equivalent to the hypothetical transaction described in Treas. Reg. section 1.752-2 in which all of the partnership's assets, including cash, are deemed to be worthless and each partner's obligations are measured by the effect of the hypothetical transaction on the partners' capital accounts. However, a Tax Court decision (*Hubert Enterprises v. Commissioner*, 125 T.C. No. 6 (Sept. 21, 2005) takes the position that, unlike under a IRC section 752 analysis, a partner is not at risk under section 465 by virtue of a deficit restoration obligation (DRO)1 before all conditions are met that establish a partner's obligation to the entity. The issue in the case was whether a DRO that would only be triggered upon a member's liquidation of its LLC interest would increase that member's amount at-risk in years in which no liquidation took place. Recently, the Court of Appeals for the Sixth Circuit vacated the Tax Court's decision and remanded the issue for further development.

The proposed regulations for the at risk rules were issued in 1979 and have never been finalized.2 In considering at risk issues, the examiner should always evaluate the substance of the transaction, bearing in mind that the at risk rules were designed to prevent a taxpayer from deducting losses in excess of their actual economic stake in an activity. In applying section 465, substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid IRC section 465.3

Qualified Nonrecourse Financing

Prior to 1986, holding real property (except for mineral property) was excluded from the at risk rules. Again, Congress was concerned about the possibility of taxpayers generating inflated deductions through the use of seller financing, nonrecourse debt, and unrealistically high purchase prices. Because this type of manipulation does not lend itself to situations in which a commercial loan is secured by the property, the concept of "qualified nonrecourse financing" was introduced.

Generally, qualified nonrecourse financing is any financing that meets the following requirements:

1. The funds are borrowed with respect to holding real property.
2. The funds are borrowed from a "qualified person", or from or guaranteed by, any federal, state, or local governmental entity.
3. Generally, no person is personally liable for repayment of the funds.
4. The loan does not constitute convertible debt.

In defining "qualified nonrecourse financing", a "qualified person" is any person who is actively and regularly engaged in the business of lending money and who is not:

1. The seller of the property, or a person related to the seller;
2. A person who receives a fee with respect to the taxpayer's investment in the property (or a person related to that person);
3. A person related to the taxpayer unless the financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons.

These rules are designed to ensure that the financing is on arms' length terms. Thus, no portion of seller or promoter financing is qualified nonrecourse debt. If the financing is from a related party (other than the seller or promoter), then a loan would be commercially reasonable if there is a written unconditional promise to pay on demand or on a specific date and the interest rate is a reasonable market rate of interest. When applying IRC section 267(b) and IRC section0.html

707(b)(1) to determine if parties are related, 50 percent is replaced with 10 percent. See IRC section 465(b)(3)(C).

Examination Techniques

- Recourse and nonrecourse financing can be found on the partner's K-1 in box M.
- If the activity involves real estate, remember that nonrecourse loans generally enter into the at risk calculation for both general partners and limited partners.
- Ask for the partner's computation of his/her amount at risk.
- Ask if any activities were aggregated for purposes of the at risk rules.
- Consider if there is a reasonable expectation of profit in the activity.
- Consider whether the purchase price of assets may have been inflated.
- Consider whether cash actually changes hands, of if only offsetting bookkeeping entries are made for loan payments.
- Consider whether the transaction has been structured to remove any realistic possibility that the taxpayer will suffer an economic loss if the partnership's activities prove to be unprofitable.
- Determine whether there are any related party loans to the partnership.
- Determine whether there are suspended losses from prior years. Is the character of these losses being carried forward intact?

Issue Identification

- Scrutinize the partner's K-1 Item M for non-recourse debt.
- From the partnership return, attempt to identify the activities of the partnership including investment activities.

Documents to Request

- At-risk computation;
- Aggregation of activities;
- Recourse loan documents to review for any changes in the economic risk of loss with the partners in the last 3 years;
- All notes and other documentation for any related party loans.

Interview Questions

- What type of loans are represented on the partnership tax return?
- Who is the lender?
- Has there been a change in the debt instruments in the last 3 years?
- Did the partner aggregate the activities? What management duties does the partner have?
- Do the partners have at-risk computations available?
- Are there any related party loans?
- Are there provisions in any of the loans which limit the amount of loss to the partner?
- Are there any guarantees?

Supporting Law

IRC, Subchapter K: Section 707
IRC section 465
IRC section 267(b) and 707(b)

Supporting regulation and specific regulations cited above.

Callahan v. Commissioner, 98 T.C. 276 (1992) – The limited partners were required if called upon by the general partners to pay three times the amount of cash contributions. The limited partners had the discretion, by written notice, to elect out of the overcall provisions. It was determined that the limited partners were not at-risk for this amount because the partners' obligations were contingent and illusory.

American Principals Leasing Corp. v. United States, 904 F.2d 477, 482-83 (66 AFTR2d 90-5012), 9th Cir. 1990 - The taxpayers was not at risk in connection with their guarantee of a partnership's obligations under an equipment lease and were therefore not entitled to depreciation deductions.

Hubert Enterprises, Inc. v. Commissioner, 125 T.C. No. 6 (September 21, 2005) – A subsidiary of an LLC that was involved in equipment leasing activities could not increase its at-risk amounts on account of a deficit capital account restoration provision in the LLC's operating agreement.

Resources

IRS Publication 925 – Passive activity and At-Risk Rules
RIA U.S. Tax Reporter – Income Tax
CCH Standard Federal Tax Reporter
Tax Management Portfolio
Practitioners Publishing Co.

ISSUE: AUTOMATIC ADJUSTMENTS DUE TO PASSIVE LOSS LIMITATIONS

Any flow-through adjustment which increases the partner's Modified Adjusted Gross Income (MAGI) over $100,000 could result in an automatic adjustment to rental real estate losses. Under IRC section 469(i), a $25,000 special allowance for rental real estate losses is generally permitted. However, the $25,000 offset is phased out at the rate of 50 cents for every dollar MAGI exceeds $100,000. When the partner's MAGI is greater than $150,000, no rental loss is permitted (unless the taxpayer has passive income, which is relatively rare, or is a real estate professional that materially participated in the rental). MAGI is simply, Adjusted Gross Income (AGI) computed without any passive loss or passive income (plus several minor modifiers). For more information, see the Passive Activity Loss (PAL) Guide or check out the PAL website.

Examination Techniques

Review each partner's return for adjustments which will push AGI over $150,000. If there is any net rental loss on Schedule E line 26, there is a potential automatic adjustment.

If AGI is over $150,000, in most cases, MAGI is also greater than $150,000. In other words, there is generally no need to compute MAGI. Furthermore, if the partner's MAGI exceeds $150,000, there is no need to compute Form 8582. In the absence of passive income, rental losses are simply disallowed.

For the report, simply make a statement to the following effect: Since the taxpayer's MAGI as defined in IRC section 469(i) exceeds $150,000, no loss is allowable in the current year. Losses must be carried forward to the next year and entered on Form 8582 line 1c.

Issue Identification

Check the partner's AGI to see if it is less than $150,000. Then check line 26 of Schedule E to see if there are net rental losses. Also check Form 8582 line 1 to see if there are any rental real estate losses.

If there is a Form 8582 attached to the return, check lines 1a and 3a to see if there is any remaining passive income.   If the figure on line 16 is the same as the sum of line 1a and 3a, the taxpayer has used all his/her passive income. In some cases, Form 8582 is not filed. However, passive income is reflected on Schedule E line 24 and on the back of Schedule E in the passive income column (g).

The examiner can easily tell whether the taxpayer is a real estate professional. If Schedule line 43 has an entry, the taxpayer claimed to be a real estate professional.

Also verify that the taxpayer is not a real estate professional via review of Schedule E line 42. If there is an entry on line 42, the taxpayer may not be subject to the passive loss limitations. See discussion of the real estate professional rules below.

Documents to Request

Partners' Forms 1040.

Interview Questions

None. The adjustment is computational, similar to the medical adjustment.

Supporting Law

IRC section 469(i)(2)
Up to $25,000 in rental real estate losses of an individual may be deducted if the individual actively participates in the activity.

IRC section 469(i)(3)
The $25,000 offset is phased out at the rate of 50 cents for every dollar of MAGI in excess of $100,000.

Resources

Passive Activity Losses, MSSP Audit Guide
PAL Website
Passive Activity Technical Advisor
Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

ISSUE: EQUIPMENT LEASES

Rentals are passive activities, regardless of the taxpayer's level of participation. K-1 line 3 losses from a partnership which leases equipment, computers, office furniture, vehicles and other personal property are generally not deductible by the partners – even if leased back to an entity where the partner works. It does not matter whether the partner materially participates or not. Equipment leasing losses are generally nondeductible in the absence of passive income. For example, if medical equipment is leased at a loss, the loss would generally not be deductible in the absence of passive income.

Neither material participation nor active participation applies for rentals of equipment. Losses are simply not deductible in the absence of passive income. The losses are reported on Form 8582 line 3b and are suspended until such time as the partner has passive income or an entire disposition of his equipment leasing activity.

Examination Techniques

Equipment leasing losses generally should not be reflected on Sch. E in the nonpassive column (which completely avoids the passive loss limitations). Instead, they should be reported on Form 8582 line 3b.

If the partnership itself is a leasing activity, all partner losses have a passive taint. Equipment leasing losses should not be reported on Schedules K and K-1 line 1. Instead, they should be separately stated and reflected on the K-1 line 3.

In some cases, partnerships that conduct business segregate equipment, furniture and fixtures and/or vehicles into a separate entity. That property is then leased back to the partnership.   Losses from the entity which is the lessor of the property should generally be reflected on Schedules k and K-1 line 3. Thus, the investors should be entering those losses on Form 8582 line 3b.

Some taxpayers assume if they materially participate in the leasing activity, rental losses escape the passive taint. However, IRC section 469(c)(2) and (4) explicitly hold that rentals are passive, whether or not the taxpayer materially participates.

Issue Identification

Peruse Blocks A, B and C of Form 1065 for indicators that the partnership activity is leasing activity.

At the initial interview, ask if the partnership conducts any leasing activities.

Review partners' Forms 1040 for equipment leasing losses that may be erroneously entered on the back of Schedule E in the nonpassive column.   Equipment leasing should be reflected on Form 8582 line 3b and are deductible in the passive column only if there is sufficient passive income against which to offset the losses.

Documents to Request

Lease covering the years under examination. If there is no lease, explain the terms of the oral agreements.

Interview Questions

1. Ask at the initial interview if the partnership itself is a leasing activity or if it leases property from another partnership or S corporation.
2. Explain how the leasing activity works and identify the customers.
3. Does the lessee have a recurring right to use the property?
4. Explain who the equipment is leased to and for what period(s) of time.
5. Explain what services, if any, the taxpayer provides with the equipment.

Supporting Law

IRC section 469(a) and (d) - Passive losses are deductible only to the extent of passive income.

IRC section 469(c)(2) and (4) - A rental or leasing activity is passive regardless of whether the taxpayer materially participates.

IRC section 469(j)(8) and Treas. Reg. section 1.469-1T(e)(3)(i) - A rental is any activity where payments are principally for the use of tangible property.

Treas. Reg. section 1.469-1T(e)(3)(ii)(A) -- Activity falls outside rental definition if average customer use is 7 days or less. If the average customer use is 7 days or less, it is treated like a business, subject to material participation (IRC section 469(h) and Treas. Reg. section 1.469-5T(a)).

Treas. Reg. section 1.469-1(e)(3)(iii) Final Reg. - Each period during which a customer has a recurring right to use the property is a separate period. For example, if the property is used only a few hours at a time, but the lessee has a recurring right to use the property all year, the period of customer use is a year. The activity generally will be treated as a rental activity (passive regardless of participation), not a business, subject to material participation. **Review the lease**.

Treas. Reg. section 1.469-1T(e)(3)(ii)(C) - Activity falls outside the rental definition and is treated like a business *if* taxpayer provides extraordinary personal services, that is, the rental is incidental to services provided.

Treas. Reg. section 1.469-1T(e)(3)(ii)(F) -- Property falls outside rental definition if provided for use in a partnership, S corporation or joint venture. Note that there is no exception for property provided to a C corporation. Also note that Treas. Reg. section 1.469-1T(e)(3)(vii) indicates that providing means contributing the property to a partnership or S corporation.

Treas. Reg. section 1.469-4(d)(1)(i) - General rule: rentals may not be grouped with businesses.

Treas. Reg. section 1.469-4(d)(1)(i)(A) and(C) -- Exception: rental can be grouped with business *if* insubstantial or owned in exact same percentage as business and leased back to that business.

Treas. Reg. section 1.469-4(d)(5)(ii) -- No grouping of a rental with a C corporation ever. Rentals can be grouped with a C corporation only to determine material or significant participation. Both standards apply to *businesses*, not to rentals. IRC section 469(c)(1)(B) and Treas. Reg. section 1.469-5T(c)(1)(i).

Resources

Passive Activity Losses, MSSP Audit Guide
PAL Website: http://sbse.web.irs.gov/pal
Passive Activity Technical Advisor
Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

ISSUE: RENTAL REAL ESTATE LOSSES

Rental real estate is a passive activity – unless the partner is a real estate professional and materially participated in the rental activity. Issues on real estate professionals are discussed in the next segment.

For partners who are not real estate professionals, no rental losses may be deducted if the taxpayer's MAGI exceeds $150,000. Furthermore, the $25,000 offset is not available to either limited partners or partners who own less than 10 percent of the partnership.

Examination Techniques

When examining a partnership return, verify that rental real estate losses have not been improperly reflected on Schedules K and K-1 on *line 1* as trade or business losses. Rental real estate losses should be reflected on K-1 *line 2*, as rental activities are generally passive, whether or not the partner materially participated.

It is not uncommon for a partnership to conduct both a trade or business activity and a rental activity. When examining the books and records, be alert to items that are more properly allocated to the partnership's rental activities than to trade or business activities.

Rental income and losses are reflected for partnerships on Form 8825, which is a schedule similar to Schedule E for Form 1040.

If the partnership conducts a rental real estate activity and losses are properly reflected on Schedule K-1 line 2, scrutinize each partner's Form 1040 return for the following:

- Is there an entry in bpx 43 of Schedule E indicating he/she is a real estate professional? If so, losses will be deductible in the nonpassive column, if he/she materially participated in the rental activity conducted by the partnership. Material participation means the partner performed more than 500 hours during the year on the rental or did most of the work or met one of the other tests in Treas. Reg. section 1.469-5T. If the partner does not materially participate, Treas. Reg. section 1.469-9(e)(1) holds that losses remain passive. The losses should be reported on Form 8582 line 1b or 3b. When considering material participation, always check box 4 of the K-1 to see if the taxpayer received a guaranteed payment. Most taxpayers do not work without being compensated for their services!
- If the taxpayer is not a real estate professional (Schedule E line 43 is blank):

  \- Have partnership losses been entered in the nonpassive column of Schedule in error? Rental real estate is a passive activity under IRC section 469(c), whether or not the taxpayer materially participated. Thus losses must be reported on Form 8582 line 1a, if the taxpayer actively participated or line 3b, if not active (the taxpayer is a limited partner or owns less than 10%, for example). Form 8582 limits total rental losses to $25,000 and reduces the $25,000 special allowance to zero, when modified AGI exceeds $150,000.

  \- Have limited partners or those who own less than 10 percent of the partnership entered losses on Form 8582 line 1b, thereby giving himself the benefit of the $25,000 offset in error? Since a limited partner or anyone who owns less than 10 percent cannot be active, losses reported on line 3b. Losses on Form 8582 line 3b are deductible only if there is passive income (which is relatively rare).

Issue Identification

Peruse Blocks A, B and C of Form 1065 for indicators that the partnership activity is rental real estate. Needless to say, if Form 8825 is attached to the 1065, you are probably dealing with rental real estate. If so, check Schedules K-1 for each partner to ascertain who is a limited partner or who owns less the 10 percent.

There are a number of partnerships filed where the Business Code/NAICS Code indicates the activity is a rental activity, yet losses are reflected on K-1 line 1 as business losses. Needless to say, this warrants careful scrutiny.

On the partners' Forms 1040, scrutinize the nonpassive column on the back of Schedule E for K-1 line 2 rental real estate losses which may have been erroneously entered there. Rental real estate, if deductible, generally should be entered on Form 8582 and in the passive loss column on the back of Schedule E. Exception: rental real estate of a real estate professional if the partner materially participated.

Documents to Request

- Copies of each partner's Form 1040.
- Copy of any management agreement with an individual, agency or tenant who might receive free or reduced rent for managing a rental activity.
- If there is both a business and a rental activity being conducted, ask for a breakdown of expenses between the business and the rental.

Interview Questions

1. If it is not clear from the return, ask if the partnership conducts a rental real estate activity or an equipment leasing activity?
2. Ask what the level of involvement is for each partner. Active participation is a liberal standard, requiring only management decisions in a bona fide sense.However, as stated above, limited partners and those with less than 10 percent ownership interest cannot be active.

Supporting Law

IRC section 469(c)(2) -- Rentals are passive activities.
IRC section 469(a) and (d) -- Passive losses are deductible only to the extent of passive income.
IRC section 469(c)(2) and (4) -- A rental (or leasing) activity if passive whether or not the taxpayer materially participated. Exception: rental real estate of a estate professional (IRC section 469(c)(7)).
IRC section 469(c)(7) -- Rental real estate of a qualifying real estate professional is excepted from the passive loss limitations if the taxpayer materially participated in the rental. The taxpayer must rise to all the following tests: (1) more than half his/her personal services must be in real property business and rental real estate; (2) he/she must spend more than 750 hours on real property businesses and real estate rentals during the year; and (3) he/she must materially participate in each separate real estate rental for losses to be fully deductible, i.e. treated as nonpassive.
IRC section 469(i) -- Exception for rental real estate up to $25,000 if MAGI is less than $100,000. Note no exception for any other kind of rental.
IRC section 469(i)(3)(E) -- MAGI for Form 8582 line 6 is determined by computing AGI without any passive loss (excess passive losses after netting with passive income), any rental losses (whether or not allowed by IRC section 469(c)(7)), Individual Retirement Plan (IRA)/Simplified Employee Pension (SEP), taxable social security or one-half of self-employment tax.
IRC section 469(i)(6)(A) -- The taxpayer is not active if his/her ownership interest is less than 10 percent. Losses go on F8582 line 2b (not line 1b); thus the taxpayer receives no $25,000 offset.
IRC section 469(i)(6)(C) -- The taxpayer is not active if he/she is a limited partner. Losses go on F8582 line 2b (not line 1b); thus the taxpayer receives no $25,000 offset.

ISSUE: REAL ESTATE PROFESSIONALS

If a partner spends the majority of his/her time on real property businesses or rentals and more than 750 hours during the year, his/her rental real estate activities are no longer automatically passive. Instead, they are treated like a business. If the taxpayer materially participated in the rental activity, losses are no longer subject to the passive loss rules. Some taxpayers incorrectly assume if they work in a real property business, rental losses are no longer subject to the passive loss limitations.

Treas. Reg. section 1.469-9(e)(1) holds that a real estate professional's rental remains passive unless the taxpayer materially participated.

In the absence of a written election to group all rentals as a single activity, each rental real estate property is a separate activity, in which the partner must prove that he/she materially participated. If the partner owns 50 percent or more of the partnership, each rental conducted by the partnership is deemed a separate activity. Thus, the partner must rise to material participation (work more than 500 hours during the year, perform most of the work or meet one of the other tests in Treas. Reg. section 1.469-5T(a)) for each separate rental activity.

A written election can be made to group rentals as a single activity, making it easier to rise to the 500 hour test for material participation. See Treas. Reg. section 1.469-9(g). The election can be made with any original return and binds all future years. It is not retroactive. As a practical matter, not many elections have been filed.

Examination Techniques

On review of the partnership return –

- Ask who manages or oversees each rental activity.
- Ask if any partner(s) has specific duties in relation to any rental activity.
- Check K-1s for guaranteed payments. Ask what the guaranteed payments were for.

On review of the partner's Form 1040 –

- Check Schedule E line 43 to see if there is an entry indicting that the taxpayer claimed to be a real estate professional.
- Check the occupation beside each spouse's name. Does one or the other appear to be a real estate professional business?
- Note whether the taxpayer and the spouse have full-time jobs and other nonpassive activities.
- Note where the Schedule E rentals are located in proximity to the taxpayer's residence. Ask who performs most of the work on the rentals, husband or wife. Inquire what partner services the Taxpayer performs with his/her rentals.

Because partnerships are not required to take passive losses or credits into account for their taxable year, the passive loss limitation generally is not a partnership item for TEFRA entities. If an individual partner's return is open and the issue is solely meeting the hourly tests for material participation in Treas. Reg. section 1.469-5T(a), there is no need to open the Form 1065. 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. Material participation is based solely on hours worked by the individual investor.

For an open TEFRA partnership, the issue of material participation by partners should be treated as an affected item.

If there is an issue as to the characterization of loss or income, i.e. whether the partnership is conducting a trade or business, or whether it is engaged in a rental activity, or whether income should be characterized as portfolio income, the partnership entity *must* be opened. That is an entity level determination.

Issue Identification

Scrutinize each rental property on Form 8825 and on Schedule E. The following are indictors that the partner does not materially participate:

- Commissions;
- Management fees;
- Large labor or wages;
- Rental property is located a long distance from the partner's residence;
- The taxpayer is a limited partner;
- The taxpayer has a low ownership interest in the partnership.

Documents to Request

1. Partner's Form 1040.
2. Copy of the return with an election the partner may have made to group rentals as a single activity under IRC section 469(c)(7)(A) and Treas. Reg. section 1.469-9(g) and the return with which it was made.While many taxpayers have not grouped, those that did, often made the election with their 1995 Form 1040.
3. If the partnership grouped its rentals under the provisions of Treas. Reg. section 1.469-4(d)(5), a copy of the tax workpapers or any other documentation indicating rentals were grouped.
4. If the taxpayer is a real estate professional and treated rental real estate losses as nonpassive, services performed on each rental activity and hours attributable to those services.

Interview Questions

1. Who monitors the rental? Who collects the rent? Who does the repairs?
2. Does the partnership pay anyone to manage or oversee the rental, handle rental income, deal with problems, etc.?
3. Do you have a real estate agent or manager? Ask for each rental property. Check Form 8825 properties for commissions, management fees or other supervisory expense. Also check for large labor expense; possibly a hired contractor spent more time than the taxpayer. If there is paid management, it is a strong indicator taxpayer did not materially participate.
4. Does a relative or friend manage/monitor the property for free?
5. Does a tenant receive free/reduced rent for managing the rentals, or for caring for the properties? This is common practice with large apartment buildings.

Supporting Law

IRC section 469(c)(7) -- Real estate losses are *nonpassive* if the taxpayer spends more than half his/ her services and more than 750 hours on real property businesses and materially participates in his/her rentals.
IRC section 469(c)(7)(A)(ii) and Treas. Reg. section 1.469-9(e)(3) -- Each rental is a separate activity unless taxpayer elected to group under Treas. Reg. section 1.469-9(g) (not seen often). Thus, even if taxpayer is a real estate professional, he/she still must meet material participation (Treas. Reg. section 1.469-5T(a)) for each separate rental before losses will be fully deductible.
Treas. Reg. section 1.469-9(e) – Even if the taxpayer is a real estate professional, he/she must still materially participate in each separate rental before losses are nonpassive. If the taxpayer does not materially participate, losses remain passive.
Treas. Reg. section 1.469-9(g) -- The taxpayer must file a written election with an original return to group all rentals as a single activity.
Treas. Reg. section 1.469-9(h)(2) -- Each rental in a partnership is a single interest in rental real estate if taxpayer owns 50 percent or more of the entity. The taxpayer may elect to treat all rental real estate interests as a single activity.
Treas. Reg. section 1.469-5T(a) -- Tests to be applied to determine whether the taxpayer materially participates, that is, whether losses are deductible.

ISSUE: MATERIAL PARTICIPATION

In order to deduct losses from a partnership that conducts a trade or business, the partner must prove that he/she works on a regular, continuous and substantial basis in the operations of the activity. Treas. Reg. section 1.469-5T(a) holds that an individual taxpayer materially participates if and only if he/she meets one of seven tests for material participation, the most common of which is the 500-hour test.

The following hours are not counted in the hourly computations for material participation: investor-type activities (reading reports, monitoring as a nonmanger, etc.) and work not customarily done by an owner if the purpose is to avoid the passive loss limitations. Treas. Reg. section 1.469-5T(f)(2).

Examination Techniques

- At the initial interview, ask what services each partner performs for the partnership. Inquire how often each partner is at the partnership's business location.
- Look for guaranteed payments as an indicator that the partner does work on a regular basis in the partnership.Most taxpayers do not work without compensation.
- Note which partners are limited partners or have a smaller ownership interest.
- When perusing the partners' Forms 1040, look for losses in the nonpassive column. If losses are entered in the nonpassive column, the taxpayer is indicating that he/she materially participated in the activity, that is meeting one of seven tests in Treas. Reg. section 1.469-5T(a).

Issue Identification

The following items on a partner's Schedule K-1 are possible indicators that he/she does not materially participate in the partnership's business:

- Limited partnership interest;
- Low ownership interest;
- Partnership is a significant distance from the partner's residence;
- No guaranteed payment on Schedule K-1 line 4.

Documents to Request

1. From partners who do not appear to work regularly in the partnership, ask them to document services performed and hours attributable to those services for the year under examination.
2. Ask if the partnership activity has been grouped with a related business under the "activity" rules in Treas. Reg. section 1.469-4.
3. Request the partnership agreement with portions highlighted that address who manages the entity or any other item that may address the partners' participation.

Interview Questions

1. What services does each partner perform?Approximately how many hours did each partner work?
2. What records does the partner have to substantiate hours worked?
3. Is each partner directly involved in day-to-day management?
4. Is there an on-site manager/supervisor/foreman?
5. Which partners have signatory authority on checks?
6. Which partners have authority to borrow money? Hire/fire personnel?
7. Is work being performed by the partner required or necessary for the activity?
8. Is the partner compensated for participation? If not, why?

Supporting Law

IRC section 469(c)(1) -- Passive activity is a business in which the taxpayer does not materially participate.
IRC section 469(h) -- A taxpayer materially participates only if he/she is involved in the operations of an activity on a regular, continuous, and substantial basis.
Treas. Reg. section 1.469-5T(a) -- Taxpayer materially participates if and only if he/she meets one of 7 tests. Most common: Does he/she work 500 hours in the activity in the year under exam?
Treas. Reg. section 1.469-5T(f)(4) -- Reasonable means for proving hours requires (1) an identification of services provided and (2) hours spent performing those services during the year *based on* appointment books, calendars, narrative summaries.

ISSUE: SELF-RENTED PROPERTY

Passive losses are deductible only to the extent of passive income. Thus, it is important to scrutinize income on a partner's Form 8582 carefully. While the income is always reportable, if it is removed from Form 8582 as it does not constitute passive income, generally an adjustment to passive losses results.

It is common practice for many entities to hold their buildings (and sometimes equipment) in a partnership. The property is then leased back to a C corporation or S corporation in which the partner works (so-called self-rented property). If the partnership leasing the property produces net income, that income is nonpassive. While rental income is generally passive, Treas. Reg. section 1.469-2(f)(6) recharacterizes the income as nonpassive if the individual taxpayer materially participated in the business entity leasing the property.

While there is an exception to the recharacterization if the property is bound by a lease signed before February 19, 1988, as a practical matter, this issue is not being seen as the lease would need to be a 15-year or 20-year lease.

Examination Techniques

When examining a partnership with net income from rental real estate, ask who leased the building, i.e. who the lessee is. Ask if any of the partners work in the business entity that leased the property. Also, ask to see any leases.

Issue Identification

Review Form 8582 with each partner's return to see if Schedule K-1 income was incorrectly entered on line 1a (worksheet 1), thereby triggering unrelated passive losses in error. Since the income is nonpassive, it should be entered only on the back of Schedule E in the nonpassive income column. The income should not be reflected in the passive income column.

Documents to Request

The lease for the year under examination.

Interview Questions

1. Are there any leases?
2. Do any of the partners work in the entity which is the lessee of the property?

Supporting Law

Treas. Reg. section 1.469-2(f)(6) -- Rental income (but not losses) from property leased to an entity where the taxpayer works (that is, materially participates) is nonpassive. In other words, it is not reported on Form 8582 line 1a and cannot be used to trigger unrelated passive losses.

Treas. Reg. section 1.469-11(c)(ii) -- Self-rented income is passive if there is a lease signed before February 19, 1988, which binds the current year.

ISSUE: LOSS LIMITATIONS ON CERTAIN SALES

IRC section 267(a) provides for the disallowance of losses on the sale of property between related parties. However, the loss disallowance under IRC section 267(a) only pertains to parties whose relationships are defined in IRC section 267(b). Not specifically mentioned in IRC section 267(b) is the relationship between a partner and a partnership or between two controlled partnerships. This, however, is covered in IRC sections 707(b)(1)(A) and 707(b)(1)(B).

Essentially, losses on sales of property between a partnership and a related partnership or a person who actually or constructively owns a substantial interest in the partnership are disallowed.

Loss Limitations on Sales between a Partnership and a Related Person

IRC section 707(b)(1)(A) states that no losses will be recognized on a sale or exchange of property between a partnership and a person owning, directly or indirectly, more than 50% of the capital or profits in the partnership.

Example 5-1

Mick and Laura are partners in Ashland Orchard, which operates a fruit orchard on 100 acres of land leased from Mick. Mick has a 65% interest in partnership capital and profits. Laura has a 35% interest in partnership capital and profits

Mick originally purchased the land for $150,000. The land is now worth $100,000. Mick anticipates realizing significant gains from other sources in the near future and would like to generate a loss to offset that income. Mick would like to sell the 100 acres to the partnership in order to generate a $50,000 loss.

Because Mick owns a 65% partnership interest, the proposed transaction is subject to the loss disallowance rules. Although the sale would result in the partnership acquiring the land with a basis equal to its cost, Mick would not be able to recognize the $50,000 tax loss. Ashland Orchard would be entitled to offset Mick's disallowed loss against any gain recognized on a later disposition of the land.

Note: If Mick and Laura were equal partners, and unrelated, Mick would be able to sell the land to the partnership and the loss would be allowed. The loss disallowance only applies when the person involved in the sale or exchange owns directly or indirectly more than 50% of *either* the capital or profits interest in the partnership.

Loss Limitations on Certain Sales between Two Controlled Partnerships

IRC section 707(b)(1)(B) states that no losses will be recognized on a sale or exchange of property between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests.

Example 5-2

Mick owns a 65% interest in the capital and profits of Ashland Orchard. He also owns a 55% interest in the capital and profits of the Windham Orchard. No loss would be allowed if Ashland Orchard sold property at a loss to Windham Orchard.

Related Non-partners

It is important to note that IRC section 707(b)(1)(A) focuses on the disallowance of any loss on a sale between a partnership and a "person". Therefore, the provisions could apply to a person who is not a partner, if, under the constructive ownership rules of IRC section 707(b)(3), the person's interests in *either* capital or profits is greater than 50 percent. In order to determine the extent of a person's constructive ownership in partnership capital or profits, Treas. Reg. section 1.707-1(b)(3) provides that the rules for constructive ownership of stock provided in IRC section 267(c)(1), (2), (4), and (5) are applied. For example, an individual would be considered to own any capital or profits interest owned, directly or indirectly, by or for members of his/her family.

Example 5-3: Application of IRC section 267(c)(2)

Same facts as Example 5-1, except that Mick's mother sells land at a loss to the Ashland Orchard Partnership. Because Mick's mother has a constructive ownership interest of greater than 50 percent in the partnership, the loss is disallowed.

Example 5-4: Application of IRC section 267(c)(5)

Mick's mother has a 50 percent ownership interest in the stock of X Corp. X Corp. has a 70 percent interest in the capital and profits of Windham Orchard Partnership. Mick has a 30 percent interest in the capital and profits of Windham. Under the constructive ownership rules of section 267, Mick is considered to have a 65 percent interest. Any loss on the sale of property between Mick and the partnership would be disallowed under IRC section 707(b)(1).

While the focus of IRC section 707(b)(1)(A) is on the disallowance of any loss between a partnership and a controlling person (a partner or non-partner who actually or constructively owns more than 50 percent of the partnership's capital or profits interest), IRC section 267 may still apply to limit losses between persons specified in IRC section 267(b).

Examination Techniques

Determine if there are any sales or exchanges between the partnership and a person who actually or constructively owns more than 50 percent of *either* the partnership's profits or capital interest.

Issue Identification

Review K-1s and the partnership agreement to determine which partners own greater than 50 percent of the capital or profits of the partnership.

Scrutinize all significant partnership purchases or sales and determine relationships of parties involved. Consider constructive rules of both IRC sections 707(b) and 267.

Documents to Request

- Partnership agreement;
- Related party tax returns;
- All legal documents pertaining to sales or purchases.

Interview Questions

1. Were there any sale and exchange transactions during the year between the partnership and any partner?
2. Were there any sale and exchange transactions during the year between the partnership and a related party of any partner?

Supporting Law

IRC, Subchapter K: Section 707
Treas. Reg. section 1.707-1(b)(3)
IRC section 267

Resources

RIA U.S. Tax Reporter – Income Taxes
CCH Standard Federal Tax Reporter
Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

back to the top

Footnotes:

1 Deficit Restoration Obligations are explained in Chapter 6 of the ATG

2A Field Service Advice was issued in 2000 (FSA 200025018) which indicated that an LLC member who has ultimate responsibility for paying a liability of the LLC would be at risk for such amount. Additionally, the FSA indicated that an LLC member who has guaranteed the debt of an LLC is at risk except to the extent the member has a right of reimbursement against the remaining members. Questions concerning this FSA should be directed to one of the SB/SE or LMSB Partnership Technical Advisors.

3 Prop. Reg. 1.465-1(b)

Page Last Reviewed or Updated: January 25, 2012