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Passive Activity Loss Rules for Flow-Through Entities



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Passive Activity

- A **trade or business** in which the taxpayer does not materially participate
- Any **rental** without regard to whether or not the taxpayer materially participates
- A single entity could have more than one activity



Tiered Entities

- Material participation is based on the underlying activity
- Character of income/loss and separately stated items is maintained through tiers



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Economic Grouping

- Appropriate Economic Unit
- Generally, a **rental** activity may **not** be grouped with a business; Reg. 1.469-4(d)
- Once activities are grouped, regrouping in subsequent tax years is generally not permitted; Reg. 1.469-4(e)



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Economic Grouping

- An S corp or partnership may group activities under the rules of Reg. 1.469-4
- A shareholder or partner may **not** treat activities grouped together by an S corp or partnership as separate activities



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Economic Grouping

- Rev. Proc. 2010-13
- Original groupings, regroupings and additions within groupings must be disclosed for tax years starting after January 24, 2010



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Material Participation

- Requires a taxpayer to be involved in the **operations** of the activity on a **regular, continuous and substantial** basis
- Generally, material participation is not applicable to rentals



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Material Participation

- Seven material participation tests; Reg. 1.469-5T(a)
- The most common is participation in the activity for more than 500 hours



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Partners and Shareholders

- Partnership/S corporation cannot materially participate
- Individual Partner/Shareholder must materially participate
- Passive loss limitations are applied at the 1040 level



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Schedule K-1

- Box 1 has more than one business activity, an attachment to K-1 is required
- Rental activities must be separately stated on K-1 in Box 2 or 3
- If more than one rental activity, an attachment to K-1 is required



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Schedule K-1

Activities need to be separated because:

- Material participation tests are applied separately by activity;
- The section 1231 rules are applied for each activity;
- Disposition of an interest applies by activity



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Net Investment Income

- Existing principles in section 469 are relied upon in defining net investment income; IRC 1411
- Opportunity for activity “fresh start” regrouping