Passive Activity Loss Rules for Flow-Through Entities

(edited transcript)

Female Speaker: It is my pleasure to introduce Kelly Myers from Small Business/Self-Employed division. Thank you.

Kelly Myers: So, good morning.

Audience: Good morning.

Kelly Myers: Oh, you guys are awake now. The first session they did that and they were like, "Ugh."

[Laughter]

So, better than in the morning. Again, my name is Kelly Myers. It's a privilege really to talk to you guys today and we're going to talk about passive activity losses. I'm a senior technical analyst with Small Business/Self-Employed for the IRS. I'm one of two people within the IRS that is responsible for IRC 469, so we support other business units as well. In addition to 469, in terms of a bio, I also do 163 Interest, Interest Tracing. We do 280A related to office in the home, vacation rentals, 1031 Exchanges, kind of that whole mixture of items.

All right, so 469 – IRC 469 Passive Activity Loss. Before we get too deep into this, I want to make sure we have some just basic understanding. [IRC] 469 was introduced and legislated in 1986. So, we are nearly – what – 30 years later, some of us are still trying to figure it out; courts are still trying to figure it out. We have court cases that continue to be published on 469 predominately in the real estate arena. [IRC] 469 allows – suspends passive losses, and we get passive losses up to passive income. There's three ways that you are going to get passive losses: you are going to have passive income; you are going to have a qualifying disposition; or with rental real estates, you are going to have a $25,000 special allowance. That's the essence of the Code. It gets, obviously, much more complicated with a couple hundred pages of regulations.

The other thing to keep in mind when it comes to passive activity losses is passive only becomes an issue when you are talking about flow-through entities after the taxpayer passes the hurdles of basis, at risk, ok? Because if they don't have basis or at risk, they don't have any loss to consider at the 1040 level.

All right, so having said that, let's move on to passive activity. Passive activity: a trade or a business which the taxpayer does not – I'm not going to read all the slides to you – a trade or a business where the taxpayer does not materially participate, or any rental activity, per se rentals are passive.

So, the key thing to remember is when you are looking at passive activity loss businesses and rentals, the rules function very differently. Sometimes people will say, “Well, this is the rule I'm going to apply,” and they try and apply a rule, for example, in the 469-4 regs, which predominately apply to businesses. They'll try and apply that to rentals, or they'll apply the -9 regs to businesses where the -9 regs are for rentals. So, you have to realize it applies both to businesses and rentals, but they apply differently. So, that's a big piece you have to make sure to keep in mind.

There are exceptions to 469. Some things, even though you look and go, “Oh, I'm a passive investor,” the rules don't apply to it or they apply differently. And we're not going to go into the details of those, but it's important to keep that in mind that such things as self-rentals have recharacterization rules. We have recharacterization or exceptions for working interest in oil and gas, land rentals, publicly-traded partnerships are contained over in this own little private box. So, there are special rules and exceptions within 469 as well.

[IRC] 469 is activity-based. One thing I always stress to people, whether I'm speaking internally or externally, is we're talking about a passive *activity* law; this is not passive *entity* law. So, we're going to talk more a little bit, kind of the crux of today's discussion, when we talk about entities, be it an S corporation, partnership, or as far as that matters, into a C corp or a trust. We're talking about the activity inside those entities; we're not talking about the entity. We have to materially participate in the activity – in the underlying activity. So, if we're looking at 469 at a 1040 standpoint, which, probably, most of us are reasonably familiar with, right? From a 1040 standpoint, we have 469 that applies to a Schedule C. You have question “G” – I think it is. Question G up on the Schedule C says, “Did the taxpayer materially participate in the activity?” I've had some people ask me, “Why do you have that question on there?” Well, the question has to do with is it passive or not.

So, 469 is going to apply to the Schedule C. We know – everybody, generally, recognizes that it applies to Schedule E page 1 – and also to page 2 – but page 1 with the rental real estate. It also applies to Schedule F, 4835 which is farm rental, and then we have the 8582, which computes the allowable losses for passive activities, business rental, whatever's in that bucket. So, when we start looking at an entity – which is the focus today – when we start looking at entities, we're talking about looking at a K-1 that the 1040 receives or possibly an intervening entity, because you can have a partnership that has ownership in another partnership.

So now, you have this K-1 coming to the taxpayer, and it has multiple items on it. It can have box 1 for trades or businesses, it can have box 2 for rental real estate, it can have box 3 for other rentals, which is typically – other rentals, like equipment rental and things of that nature, go into box 3 commonly. And so you – we're going to talk about that character and the treatment of each one of those and how you need to separate out and you need to know by activity and you have to have by-activity reporting.

And the other thing to keep in mind when you have this K-1 coming to your client and you are looking at it from really – if it's generated in-house or whether it's generated by someone across the country – your client receives a K-1, that K-1 is binding on the taxpayer. Stated differently, you cannot look at the K-1 and go, "Oh, I know that's really not a trade or a business reported on line 1. It's really rental real estate, and I'm just going to treat it as rental real estate." You can't do that. Similarly, if your client is under audit and we, the IRS, know that that's wrong – that the K-1 box 1 is wrong and it should be in box 2, for example – we cannot arbitrarily go, "Oh, we're just going to move it." We have to audit the entity and adjust that K-1 and reissue the K-1 to your taxpayer. Even though the total number flowing to your client has not changed, the character is different because box 1 is different than box 2 is different than box 3 by statute.

So, talking about tiered entities. Material participation is based on the underlying activity. So, again, we're looking at activity-by-activity basis. So, if we have a taxpayer – if you have a client – excuse me when I say "taxpayer"; I used to be on your side of the fence for seven years and I switched, so I still get my terminology flip-flopped sometimes. If you have a client and you are preparing a partnership return – say that partnership has a hotel in it; that partnership also has a car dealership and, for whatever reason, they've got them in the same partnership, and that partnership also has an airplane that's in a single member LLC – it's all going to be reported on that one 1065.

So, your return, when it gets prepared, you are going to take that return and it's going to show box 1 for the hotel and the car dealership profit or loss and, depending on the airplane situation, whether it's a charter or whether it's a rental – if it's a true charter-type activity, that airplane's going to be reported in box 1 along with the hotel and the dealership. If it's a rental, it's going to be in box 3 because it's equipment and it's equipment rental. It gets treated differently. But that K-1 is going to come to your taxpayer – to your client – and now you have this hotel and this dealership both reported on K-1 box 1. What the tax preparer for the partnership is required to do is have an attachment to the K-1 for each partner that says, "Oh, by the way, you have a $100,000 profit, it's your share of the hotel and the car dealership, but oh, by the way, that's made up of a $150,000 profit for the hotel and a $50,000 loss on the car dealership." Those have to be reported separately in a supporting statement to the K-1 because they are each separate activities.

Now, your tax software, in theory – and I would challenge some of you to go back and test your tax software – in theory, your tax software should do that activity-by-activity basis reporting onto the K-1. If your software doesn't do that, then you need to manually put an attachment to the K-1 and file it with the K-1, both with the Service as well as with the recipient, with the shareholder, or the partner. Because that 1040 needs to know, "I had this much income or loss on the dealership, this much income or loss on the hotel, and this much income or loss on the airplane," whether it's a rental or whether it's a trade or a business. Then they can apply the 469 rules and say, "I materially participated in the hotel, I'm passive in the dealership, and statutorily, the airplane rental is passive." So, it doesn't go all into one big basket because it all resides in the partnership.

Does that make sense? I know, like, "Yes, that makes sense," okay. Some of you are looking at me like, going, "I can't believe what I'm hearing." And I suggest you…

[Laughter]

And others of you are going like, "Yeah, I know I've had to deal with that headache, or my software doesn't do it, or I have to manipulate this or that." Just recognize – keep in mind activity by activity is what you have to keep looking at.

Grouping – and I should preface when I talk about 469, or when I cite a Code section or regulation, I'll try and give you the full citation, but if I say “-9” of the regs, I'm talking about 1.469-9 of the regulations. We don't want to eat up a lot of time with all that preface stuff; same thing with the Code.

So, when we're talking about grouping, we have economic grouping – economic grouping is under -4 of the regulations – predominately is driven towards businesses, the grouping of activities of businesses. It's driven by, it has to have – there are five factors in there, and it's – of the five factors, no one factor is load-bearing to say, “This is the critical item” or “It's 20 percent to each of the five.” It's a preponderance of the facts and circumstances. So, you end up with the grouping to determine whether there's an appropriate economic group. We have to look. Is it common control? Is there common ownership? Are there interdependencies? Is there geographic location? And are there similarities?

And from a laymen perspective – and I say laymen, and I've used the term internally, as well – from a laymen perspective, we're thinking about vertical and horizontal integration. If somebody in town – if you have a client that owns all the In and Out Burgers, right, if they own all the In and Out Burgers in a given county, they could say, “Gee, this is an economic group. They are all similar, they all produce the same type of food, they are – I mean, they are just franchised out, right? And if I need an employee from Unit 1 to go over to Unit 6, they can show up the next day because they wear the same hat and the same shirt, and payroll's centralized, ordering's centralized.” It's a common economic group. That would be a very simplistic example. So, the taxpayer could make a decision to either group his five In and Out Burger shops or he could make a decision not to. It's not a mandate, it's an option driven by the taxpayer.

So, rentals as a rule – generally, rentals are not grouped under -4. There's some limited exceptions. You have an insubstantial test in there and it's – it can get involved, so we're not going to go that way. Or – if you have a rental that is owned in the same ownership percentages and used solely by the business, then the business and the rental could be grouped. For example, you could have a medical doctor that has his practice in an S corporation, owned 100 percent by husband and wife. The medical practice building is held over here in a partnership. A lot of tax reasons, a lot of reasons why they may do that. So, they could make a grouping decision to treat the building and the medical practice as one economic unit because the building is used 100 percent by the medical practice and they are owned in identical percentages. If the building is owned with his brother and the practice is a 100 percent by your client, they can't group because it's not identical ownership. So, just keep that in mind.

The grouping – economic grouping – remember, when I say "grouping," we're not talking about real estate grouping – which a lot of you are probably thinking about – we're talking about economic grouping. Economic grouping under -4, the grouping decision has to be made when the activity first arises. So, back to the In and Out Burgers. If somebody opened an In and Out Burger in 2005 and now they say, "Great, I'm going to expand. I'm going to open another one in 2006." In 2006, when they file their tax return, they have to make a decision to say, "Am I going to put Unit 1 and Unit 2 together? Or I'm going to treat them as separate activities." If they treat them together and that's their grouping decision, that grouping decision goes forward and stays together. If they don't make a grouping decision to treat those jointly, then they are going to be separate activities going forward. And then, in 2008, they get Unit 3, and if they've treated them as separate, now they can say, "Okay, Unit 3, do I want to have an economic unit – because it's in the north end of the county and the others are in the south, or whatever – I can treat Unit 3 along with Unit 1 as an economic group, I can treat Unit 3 along with Unit 2 as an economic unit, or I can treat them all three separate." But after you make the decision not to put 1 and 2 together, you can't put them back together even with number 3. Three can go with 2, 3 can go with 1, but they all three can't join together.

I'm trying to paint you a picture here and I wish I had a big white board, but I can't do that, and we don't have all day to talk about it. Again, once they group, they have to stay in that grouping, absent significant change in circumstance, which, quite honestly, there's not been any litigation and, personally in my years of being involved in taxes, – for say, over three decades, been involved in taxes a long time, been around since 469 was enacted – I just can't come across a situation where you have this economic break up. It'd just be a really unique situation. I'm not saying it's out there and not justified, but it'd be difficult to see.

And, again, keep in mind that this is not – we're talking not rental real estate with economic grouping, we're talking businesses. The other thing to keep in mind is with the grouping with the business, a group – a rental activity, even owned in identical percentages, cannot be grouped with a C corporation. Okay. So generally, when we talk about economic grouping of a rental – and again that's just a small exception under -4(d) of the regs. – when we're talking about grouping that, we're talking about taking that partnership building and putting it with that doctor's S corporation. Both of those numbers are going to hit the 1040. But with a C corp – even a closely held C corp – that business operation is not going to flow to the 1040. It's a separate taxable entity. So, that's some of the logic behind it.

I always hold that tax law makes sense. If you stop and think about it, tax law makes sense. It's social policy and there's a lot of things going on behind the scenes, but if you look to the root of it, it makes sense. You may not agree with it, but it makes sense. I mean, they were talking about AMT earlier. Does it make sense? Well, I don't know. But looking back at the legislative history, it makes sense. You look back at 469, when 469 was enacted we had a bunch of tax shelters. People, in 1986, we were getting – what – 17-, 18-year depreciation on buildings. I mean, my gosh people had these huge paper losses, and Congress said, “Let's try and slow that down a little bit.” So, we came up with 469.

Economic grouping, again, as a rule, is a 1040 issue, but it may impact and apply as well at the entity level. You can have an entity that is a partnership. So, if you have a partnership, for example, a partnership could have – I'm going to shift gears a little bit on you – it could have rental real estate because partnerships the vast majority – about 60, 65 percent of partnerships are real-estate related. So, if a partnership has real estate, they may, at the partnership level, decide to group at the entity level; they could group their rentals. So now, when it flows to the 1040 partner, if they have five pieces of rental property in that partnership, when it flows to the 1040, they have to communicate to the partner, “Hey, we've made an election under -4 to group our rental real estate as one rental activity.” So now, when it comes to the 1040, that's binding to the 1040. So now, that taxpayer has, effectively, one rental activity coming from the partnership. And all this is spelled out in the attachment to the K-1, which, let's say, some people don't generate – just trying to be gentle about it. So, you have this statement attached. So, now you have this activity coming down, and now you have these rental properties at the 1040 level or rentals coming from another partnership; now, the 1040 has some decisions it has to make in terms of grouping or aggregation.

So, let's take this from the sense of a real estate professional. A real estate professional, they can group their rentals. They can make an aggregation election under -9 of the regulations. So, if one were doing that, when the rentals flow from the 1065, those five that have really been grouped already at the entity level – now, if they make a grouping election or if they don't, more importantly, they have to group – they cannot ungroup the five. They have to stay as a group. So, now they have to decide, "Am I going to group that entity's five that have already been grouped at the entity level with those at my 1040 level?"

Keep in mind, the only ones that can group rental real estate is a qualifying real estate professional so that they can materially participate in the rentals and have rentals as non-passive. So, if they don't group or don't aggregate at the 1040 level – a real estate professional – now the real estate professional has to meet material participation in the group of five rentals, which has been defined at the entity level as one activity. They have to materially participate in that rental activity and also then apply material participation tests to rentals they may have at the 1040 level or flowing from other flow-through entities.

You can also have economic grouping, say, if a taxpayer has those In and Out Burgers in two different S corporations. So, they have San Diego County and LA County stores, and they make a group – they have both of those in two S corporations – the S corporation for San Diego could make an election to group under -4 all the In and Out Burgers in San Diego County. They could make a similar election – and again, as the activities arise, they have to make that election – they could make a similar election for LA County. And so, now the K-1 is actually flowing from the two S corporations. You now really have two activities, because of the -4 groupings, coming to the 1040, and the 1040 then would have another opportunity to say, "I want to group San Diego and I want to group LA, and I want those to be one economic group at my 1040 level." Now, there are reasons, strategically, why somebody may or may not want to group at the entity level. There may be reasons why you may or may not want to group at the 1040 level. That's called tax planning, right?

Let's think about what this may look like further if we have tiered entities. If we have a tiered entity with businesses, if you have partnership A at the first tier – and that's where your 1040 is getting their K-1 – that partnership, in turn, has invested in partnership B, second tier up. We won't get into percentages because we'll all go a little crazy with that. That partnership may have invested in partnership C so you have these tiered entities – 2, 3, 4 – I've seen them go way up. If I'm sitting here and I'm your client and I get this K-1 from ABC partnership but it has these multiple tiers, I can tell you what I see more times than not is, I see box 1 and box 2 filled out, and that's all you get. And yet you know, it's like, "Man, this partnership is invested here because I had to approve it," or you know they are tiered up.

What one should be receiving is partnership C should be issuing a K-1 to partnership B coming down toward the taxpayer. Partnership C issues one to B that says, "I'm involved in these two activities. I have 1 and 2 activity coming down." Partnership B is going to issue a K-1 stating their proportionate share going to A of not only B's activity – which it may just be a holding entity but if it has an activity – but it also has to separately state activity 1 and 2 coming out of entity C and so forth, down through entity A and down to the 1040. So, what you should have attached to the K-1 is a schedule that says, "Oh, by the way, I have partnership interests here which is partnership $50,000 coming in on box 1 trades or businesses, but oh, by the way, here's the attachment, and what really it's made up of is I have a business activity in partnership A, I have three business activities in partnership B, and I have two coming from partnership C; and here's all my prorata portions of each one of those two, five, six activities."

And why is that important? Because 469 is activity-based. And the taxpayer has to materially participate in C1 and 2; B1, 2, and 3; and A1. All six of those activities have to be addressed on an activity-by-activity basis at the 1040 level. They have to retain their character as they flow through all those intervening entities.

We've known for a long time that when someone makes an economic grouping – when they make a grouping decision – most of the preparers never told the Service what you were doing. Some people would go out and attach a statement and say, "I'm putting these activities together," whether it's at the entity level or at the 1040 level. Regulation said the Service will issue guidance on how to disclose groupings. So, in 2010, we got published out Revenue Procedure 2010-13, which requires for tax years beginning after January 24, 2010 – so if we're talking calendar year, we're talking 2011 tax returns filed in 2012. Hopefully, you've filed them already, or your client. It's not your fault when they are not filed, it's the taxpayer's that didn't get you the information.

So, now what's required is, prospectively, when someone makes an economic grouping decision, there's a required statement to be attached to the tax return for the 1040. So, if someone owns those In and Out Burgers – if they own those In and Out Burgers and they are making another acquisition in 2011 because now they are taking over Orange County – if they make another acquisition and they want to group the Orange County units with one or more other units or activities, they have to make a written disclosure attached to the return saying, "I want to take Orange County number 1 and group it with my previously-grouped San Diego grouping." So, again, it has to be a written disclosure attached to the return. Previously – and this is a problem we have – you know, prior to it, just nobody was telling each other what was going on and we – the IRS would come in and say, "Well, did you make an economic grouping?" Or a new preparer comes along and says, "Did you make an economic grouping with your prior preparer?" And they are like, "I don't know. I paid them to fix the return." And he's not talking to him anymore because – whatever reason. So, those things happen.

So, nobody knew it wasn't documented. It's not like a -9 election for real estate professionals where there's a stated requirement to file a written election. So, now we have this election. Again, what people get confused is the election did not change the rule for grouping. Some – we've had some people say, "Well, I never had to make any grouping disclosure or decision in the past." No, you've had to make a grouping decision in the past. The difference is now you have to disclose it attached to the return. The rules for grouping have not changed. The rules for economic, the relationships, the common control, interdependencies, geographic – all the rules there for -4 did not change. The only thing the Service is saying now under 2010-13, you have to tell us what you are doing. Now, if you don't have a change in the grouping, if you just have – if you have San Diego down here functioning as a group and you have LA functioning as a group and you have Orange County that starts another store and you do not file an election in 2011, what you've done is you've made a grouping decision – your client's made a grouping decision not to group Orange County with those other two groups. Because the statement's not required – if you have no change in groupings, a statement is not required. So, if you don't file a statement in 2011, Orange County comes online as its own group, it stands alone.

Now, we've had a lot of people miss this requirement, and we've discovered it in interactions with taxpayers, otherwise known as audits. We're out there to help you.

[Laughter]

Hey, we answer the phone, right? We answer the phone, we come out to help you, give you face-to-face service. So, service is my middle name. Well, I guess my last name, right?

But the election; what's happening is people are not attaching that election to the return. And then they come back and they go, "Oh, well, I meant to group it with whatever." Well, no, you didn't follow the rules, right? It's like 195: making an election to amortize your startup costs. If you don't make the election on the return as originally filed, you don't get it. That's just the way the law works. You cast the die and it stays there. Now, it can be challenged in court, no doubt, and it probably will be over time.

The economic grouping under 2010-13 does not apply to the entity. It applies to 1040. It does not apply to real estate professionals. Again, that's a -9 grouping, not economic grouping. For partnerships and S corporations, there's already required disclosures imbedded in the instructions and other guidance that say for the entity – for the partnership, S corporation, et cetera – they have to make that written disclosure in the tax return. And again, that's going to trickle down back to this K-1 issue. That's going to trickle down through the K-1 to say yes we have this many groups or no – if you don't say there's any groups, then there's just not any groups. But if you had one S corporation that had both LA and San Diego County operations, they could be all in one S corporation, and that S corporation could make an election to group LA and San Diego as two operating activities and not combined.

So, let's talk a little bit about material participation. And we're not going head deep into this because it's beyond the scope. But material participation just is cornerstone – I would say there are a couple of cornerstones to 469. One cornerstone is you have to understand – what I've said time and time again already this morning – activity. [IRC] 469 is activity-based. Whether you are talking about the material participation, whether you are talking about grouping – all those issues you have to understand the underlying activity. So, if you have a tiered entity, you better be looking through all the tiers back to the core activities – so activity by activity. And that's true whether we're talking about someone that has a portfolio of 50 rental properties, because absent any aggregation they have 50 activities. Or whether somebody has 50 In and Out Burgers because they have 50 activities. Regardless of what entity structure they are in, at the molecular level, you have to look down to that activity, and you have to understand and focus on that.

The other piece you have to look at is the material participation because that's what it's kind of all about. I mean, it just doesn't magically happen. Because one thing we see, sometimes people say, "Well, of course my client materially participates, he owns the business. Where would the business be without my client?" Well, you are right. It's his business, that's why it's reported on his tax return, right? Where would it be without him? "Where would this country be without small business" is what you hear a politician say, right? So, we understand that the business is the owner and who owns it, but ownership is not material participation. So, a lot of people try and get that a little bit blurred. So, again, box 1 you can have these multiple activities. You can have multiple activities in box 2 and box 3.

I want to just digress a minute about real estate professionals because, again, these K-1s come through with a lot of flow-throughs, and you have rental real estate on these flow-throughs. And we continue to, quite honestly, see a lot of noncompliance when it comes to rental real estate. Real estate professional really summed up is it only matters for rental real estate. That's all that it impacts. It only impacts rental real estate. So, for someone to be a real estate professional, they have to spend more than 750 hours and over half of all time working – over half and over 750 hours in the real property trade or business: construction development, acquisition, rentals, management, brokerage, and a couple others. And that's all under 469(c)(7)(C).

So, once somebody meets that status now – and here's where we see a lot of the rub – you find somebody and they are a real estate professional, and a lot of folks go, "Oh, they are a real estate professional. All their rentals are non-passive, right?" No. The only thing a real estate pro does is take down this barrier that many of you – I won't say all – but many of you are out there. In my situation, I can't be a real estate professional because I can't meet those tests because I have a full-time job here. But if I have a rental, my rental's passive. End of story. It doesn't matter whether I manage it, do all the repairs, rebuild it, find all the tenants, toss them, evict them. It doesn't matter; my rental's passive because I'm not a real estate professional.

As opposed to that person that runs a development company. Their rental still has to now go to meet material participation tests. We have many developers out there that may be doing development projects and they are spending all their time developing, paying somebody else to do their management; they fail material participation. Even though they are a real estate professional, their rentals still stay passive. And that's, kind of, the – what I would say, probably – the confusing area that people are just, kind of, overlooking. They don't take it to the next step. They realize their client's a real estate professional, but they don't look to material participation. Now, I'm sure you've all inherited some clients that are the doctors and the lawyers, and they say, “Why are you deducting all your rental real estate?” And they say, “Well, because I manage my property.” “Well, but you are not a real estate professional, so I really don't care what you do with your property.” And those are the – those are just clearly statutorily erroneous reporting when you have somebody that is clearly not a real estate professional claiming rental losses as a real estate professional, that’s just wrong.

So, we have to have material participation in the operations; continual, regular, and substantial. So, back to our first example where we have a taxpayer that has a hotel and a car dealership. The taxpayer has to materially participate, meet one of the material participation tests, absent any grouping, materially participate in the hotel or it's passive, has to materially participate in the car dealership or it's passive. Even though they are both held in the same entity or in a tier of entities, it's an activity-by-activity conclusion.

So, when we talk about material participation, we're talking about one of the seven tests under 469-5T of the regs. And I'm just going to briefly walk through those. The most common one that people think of is Test 1, which is the 500-hour test. The taxpayer works 500 hours. Well, I, kind of, equate that to the doctor that has a medical office, and that's where they go to work every day. Do they have 500 hours in their medical practice? That's a no-brainer, right? Most of you probably deemed to material participate in your accounting practice because you put in 500 hours between February and March, right?

[Laughter]

So that – we don't average it out, you know, it’s not month by month. So, it's a test, it's a test by activity. The issue comes when that doctor owns the hotel and also has an ownership interest in the hotel and also has an ownership interest in the dealership. Running his medical practice, making good money cutting into people's hips and replacing them or whatever he happens to do, and then he says, “Oh, I also materially participate in the dealership.” Well, I'm thinking, “Great, I'm going under surgery for a hip replacement and the doctor's coming in with grease under his nails from working at the dealership.” I mean, it makes me a little nervous.

[Laughter]

I mean you have these people that have the excess resources, they invest in multiple activities – granted not entities, multiple activities. At some point in time, they are going to have such volume, they are going to fail material participation somewhere. And again, that's the part where the grouping comes in because the guy that owns all the In and Out Burgers can't materially participate in three different counties' franchises, but grouped together he could.

So, we have seven tests. Let's just walk through them real quick. We're talking about work performed by the taxpayer. Again, it has to be substantial, has to be ongoing – it has to be work, right? Think about somebody – if you are self-employed and you are hiring somebody to prepare tax returns, are you going to pay them just to sit back and put their feet up on the desk and go, "Yeah, that's an interesting tax form," right?

[Laughter]

No. I mean, they get paid to work, right? You have to produce something. And whether you are paying them by the piece or whether you are paying them by the hour, you expect them to work. Now, the owner may not be getting paid directly, but it has to be meaningful engagement in the activity. So, we talked about Test 1, which is the 500-hour test and that's pretty straightforward. Test 2 – Test 2 is the taxpayer does more than all other people combined. It's – the test really reads substantially all. A recent court case actually pointed to – I generally use this 50-percent marker – if you do more than everybody else combined, it's like yeah, I'm usually pretty good with that. There was a court case just recently – and I don't have the citation for you – the judge really expressed that it was much more than 50 percent. We're talking about substantial. So again, we see that a lot with real estate professionals. If somebody's a real estate pro and now they are managing their rental property and they are managing it and doing handyman repairs, they are materially participating, right? But if you have a management company doing the management, you are going to lose that argument as far as material participation.

Test 3: a 100-hour minimum and no one single individual does more. Test 4 is a SPA test – Significant Participation Activity – and it allows you to aggregate hours. So, when you hear about grouping under 469, what I always ask people when they say, "Well, what about grouping," and I say, "Well, which grouping are you talking about; economic grouping, rental real estate grouping for a real estate pro, or grouping of hours under the SPA test?" So, make sure you keep those clear.

Test 5 is a look-back test. Did you materially participate five out of the prior 10 years? And it could make an activity passive or non-passive. Test 6 is for personal service activities. If you retire out of your accounting business and you still get a K-1; 20 years from now, that K-1 is going to be non-passive because from a personal service activity, if you materially participate in any three years, that activity's always going to be non-passive. Test 7 is a facts and circumstances. I've never seen it – it's never been successfully litigated. It's never been successfully argued through the headquarters level technical advisors and Counsel to my knowledge. And I've been around passive activity, and my predecessor was doing it since about '92, so I've got about two and a half decades of un-success there for Test 7.

All right, partners and shareholders. A lot of times people will say, "My partnership materially participated in those businesses." No. The partnership doesn't materially participate. Just like the taxpayer, your 1040 individual doesn't – that doctor does not materially participate in the partnership; the doctor materially participates in the activity in the entity.

At the entity, they do not materially participate; it's an activity by activity. And again, those limitations apply at the 1040. There's passive loss limitations also at a corporate level, a C corp – closely-held C corp – because 469 applies when there's five or fewer shareholders owning or controlling more than 50 percent. Publicly held – or widely-held C corps are not subject to 469. [IRC] 469 also applies to trusts. We really don't want to go down those roads today. I'll be – well, we'll just leave it there.

Limited partners – limited partners are more restricted under 469. The limited partner under LP – not an LLC, but a limited partner – only has three tests. They only get tests 1, 5, and 6. Now, that's distinguished from an LLC member.

An LLC member has all seven tests they can use. And there's regulations a little bit contrary to that, but it's being amended; but the courts under Newell and Thompson, they've ruled saying that the 469, they have all seven tests for an LLC member because there's lots of LLCs out there. And again, keep in mind LLC versus LP is different.

The Schedule K-1, if it has more than one business activity, they have to have that attachment. You need an attachment to the K-1 that says activity-by-activity-by-activity reporting, all the way up through any tiers.

If your client receives a K-1 and it doesn't have that breakout, you best be on the phone to somebody and say, “I need activity-by-activity breakout.” So, this lady over here's going to ask that question, and she's going to call this gentleman over on this side and go, “Where's the detail?” And he's like, “I don't know, the software didn't print it out, so I guess I can't give it to you.” I mean, whether the software generates it or not, the return has to include it. And again, it's going to be if it's tiered out, you need to look all the way through those tiers because you have to be able to apply 469 by activity.

The rental and income is the same thing. So – and all these items have to be separately stated whether it's 1231 gains, whether it's 1250. Every item on that K-1 virtually has to be separately stated by activity. Because if you have a disposition of activity number six, and you have suspended disposition losses from the 4797, those are going to release when you dispose that activity, right? It isn't just one big bucket of hodgepodge, right?

[Laughter]

Well, it is – for a lot of you, it is, but it shouldn't be, right? But the law says different. And again, rentals you have to know the rental activity, like in box 3, because that's everything from equipment rental to portable storage units, right? I mean, it's all equipment, and those are statutorily passive belonging on box 3. Again, that statement attached to the return. If there are rentals there, they need to know the character of the rental. If I have rental real estate in box 2, I need to know if it is land, I need to know if it's a self-rental. And all those are separately captured when you look at the 8825. We have those characterizations now because profitable self-rentals get recharacterized to non-passive automatically.

Twelve thirty-ones are going to be activity by activity. If you have a disposition activity by activity, and even if it's all the way up in the tiers, right – so you could have a third tier that disposed of an activity – you need to know it was disposed of so those suspended losses that you separately identified, right – you separately identified those activities; they get released because you have a qualifying disposition under 469(g).

The last thing I want to point to – 1411 ACA tax, right – 3.8 percent surtax on net investment income. Fundamentally based on what? Passive activity rules. So, why do you need to know all those activity-by-activity reporting? Because you have to know what goes on that 8960, right? So, three tiers up, does this activity go on the 8960, which drives up or drives down your net investment income tax of 3.8 percent. So, every $1,000 you find, you are saving your client money – well, or costing them money, depending on which way the number goes, right?

[Laughter]

But you have to know activity by activity for the net investment income tax. There's a Fresh Start item within NII where you can do some regrouping. You have to look to the regulations for that. And the regulations for 1411 are about as voluminous as 469. You have to apply – if you do any kind of regrouping, you have to use the 2010-13. You have to make that disclosure: "I'm regrouping, and here's why I'm regrouping, and I qualify." And you only qualify to regroup under NIIT – under IRC 1411 – if you owe NIIT tax. So, if you have somebody with a lower income under 200, they can't go, "Oh, I want to regroup under 1411." Nope, you don't get that fresh start because you don't owe any NIIT.

So, keep in mind just a couple things. Activity – I think I've said it sufficiently, I hope. You probably heard it too much – activity by activity. And you have to understand why that's so critically important. The flow-through coming down through the K-1s has to be activity by activity. If you don't get it on the K-1, push back, say, "Hey, folks, I need it. I need it. I need that breakout." Grouping rules: keep in mind the grouping for rentals, the grouping for businesses, and the grouping of hours under the SPA test under 5T are all separate rules. Grouping for businesses and grouping for rentals function differently. Just don't throw it all together.

Thank you.

[End of Audio]

Glossary

Material Participation – 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. There are seven tests to determine material participation; the most common is participation in the activity for more than 500 hours.

Net Investment Income – Investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer (within the meaning of Code Section 469). To calculate your Net Investment Income, your investment income is reduced by certain expenses properly allocable to the income.

Net Investment Income Tax – The Net Investment Income Tax is imposed by section 1411 of the Internal Revenue Code. The NIIT applies at a rate of 3.8 percent to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts.

Passive Activity – A trade or business in which the taxpayer does not materially participate or any rental without regard to whether or not the taxpayer materially participates. A single entity could have more than one activity.

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