Passive Activity Losses

This letter is sent in response to your question about how the rules on passive activity losses can limit the benefits you may be able to claim from passive investments. The so-called "passive activity loss rules" have developed into a complicated set of guidelines since their inception in the mid-1980s. However, if you keep in mind the general principles that drive loss limitations in this area, you will have a good foundation for selecting investment strategies that take full advantage of, rather than solely react to, the current tax rules.

Generally, losses from passive activities may not be deducted from other types of income (for example, wages, interest, or dividends). To the extent that the total deductions from passive activities exceed the total income from these activities for the tax year, the excess (the passive activity loss) is not allowed as a deduction for that year. A disallowed loss is suspended and carried forward as a deduction from any passive activity in the next succeeding tax year. Any unused suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity in a fully taxable transaction.

Special rules apply to rental real estate activities in which a taxpayer actively participates. Losses and credits that are attributable to limited partnership interests are generally treated as arising from a passive activity. However, losses from working interests in oil and gas property are not subject to the limitation.

Definitions. A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. Any rental activity is a passive activity whether or not the taxpayer materially participates. However, there are special rules for real estate rental activities and real estate professionals.

Generally, to be considered as materially participating in an activity during a tax year an individual must satisfy any one of the following tests: (1) he participates more than 500 hours; (2) his participation constitutes substantially all of the participation in the activity; (3) he participates for more than 100 hours and this participation is not less than the participation of any other individual; (4) the activity is a "significant participation activity" and his participation in all such activities exceeds 500 hours; (5) he materially participated in the activity for any five years of the 10 years that preceded the year in question; (6) the activity is a "personal service activity" and he materially participated in the activity for any three years preceding the tax year in question; or (7) he satisfies a facts and circumstances test that requires him to show that he participated on a regular, continuous, and substantial basis.

A significant participation activity is one in which the taxpayer participates more than 100 hours during the tax year but does not materially participate under any of the other six tests set forth above.

A personal service activity involves the performance of personal service in (1) the fields of health, engineering, architecture, accounting, actuarial services, the performing arts, or consulting, or (2) any other trade or business in which capital is not a material income-producing factor.

Portfolio income is not treated as income from a passive activity; it must be accounted for separately, and passive losses and credits generally may not be applied against it. The term "portfolio income" includes interest, dividends, annuities and royalties, as well as gain or loss from the disposition of income-producing or investment property that is not derived in the ordinary course of a trade or business.

How losses are deducted. Generally, a loss arising from a passive activity is deductible against the net income of another passive activity. Losses that are not deductible for a particular tax year because there is insufficient passive activity income to offset them (suspended losses) are carried forward indefinitely and are allowed as deductions against passive income in subsequent years. Unused suspended losses are allowed in full upon a fully taxable disposition of the taxpayer's entire interest in the activity.

Please do not hesitate to contact us if you have any questions about how the passive activity loss limitations apply to any particular investment activity in which you may be involved now, or in the future.