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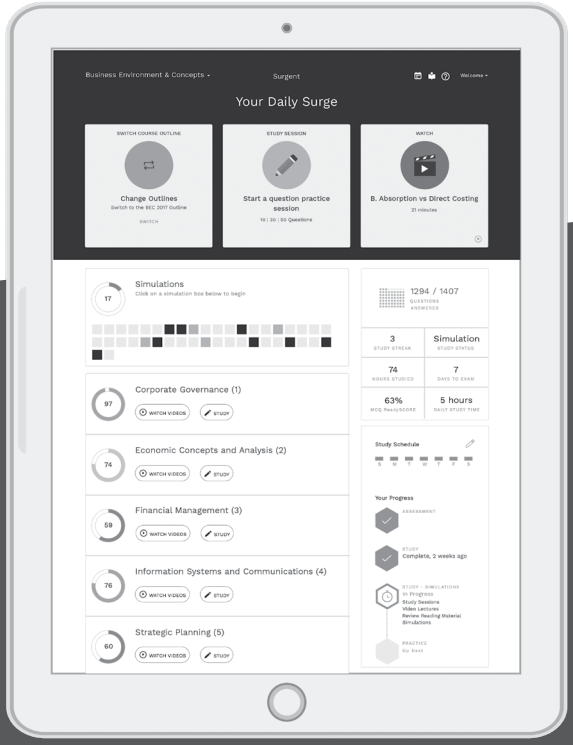


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Revised June 2022

# NOTES

# Hiring Family Members

# Hiring Family Members

## *Learning objectives*

Upon reviewing this chapter, the reader will be able to:

- Identify the advantages of, and the tax issues involved with, employing one's spouse; and
- Discuss the tax issues and strategies that may be applicable to the client in employing one's child to shift income and to avoid kiddie tax issues through earned income.

## *I. All in the family*

### A. Employing the spouse

#### *1. In general*

**Payments made to a spouse as an employee are subject to Social Security tax**. Consequently, whatever W, a self-employed spouse, may save in reduced self-employment taxes will be offset by the burden of FICA that W must pay by hiring the spouse. However, this cost may be offset to a degree if, as noted above, such payments would qualify her husband, H, for certain Social Security benefits to which he might **not** otherwise be entitled. If H pays Social Security taxes for a sufficient period, H would be eligible for retirement and survivor benefits.

#### *2. Social Security*

Because the Social Security benefit is based on the high 35 years of indexed wages, without participation for at least 35 years, the wages for many years will be zero, reducing the benefit. But the wages, while generating new Social Security benefits, will be subject to a full FICA withholding at the full FICA rate, because this involves shifting wages from the taxpayer, presumably subject only to the 2.9-percent rate on wages above the taxable wage base. Thus, shifting compensation or earned income to a spouse generally entails an additional 12.4-percent Social Security charge, while if the compensation paid, if equal to the then-average indexed wages for the years of service, only increases the benefit by 1/35 (about 2.857 percent). The added benefit in some cases **may be worth the cost of funding**. In others, the hiring of the spouse may be justified in terms of **other** benefits.

***Example:*** Jean had previously worked for 20 years and would be entitled to a Social Security benefit of $3,000. If Jean goes back to work and receives compensation of $16,000, assume the benefit increases by $457, while the additional cost to Jean and her husband Gene is $1,984. If Jean were paid the full amount of the taxable wage base, assume her annual benefit increases by $1,000, while the additional Social Security tax rises to $10,788.

***Note:***

The Social Security tax for the year purchases a **life annuity** in the amount of the added benefit. The cost must be compared to the actual benefit to the spouse. Remember that the spouse may already be entitled to an amount equal to 50 percent of the worker's benefit; in some cases, this amount **may still be larger** than the recomputed benefit of the spouse as a worker, and thus, marginally no or a very small life annuity is being purchased by the investment of the additional Social Security benefits.

For example, if Gene were then entitled to an annual benefit of $7,000, Jean in her capacity as a spouse would already be entitled to an annual benefit of $3,500, so she accrues no additional benefit, as $3,500 is greater than $3,457. If she were paid the wage base, the economics are different because now her benefit as a worker ($4,000) would exceed her benefits as a spouse ($3,500); the issue then is whether a $500 life annuity ($4,000 - $3,500) justifies a $10,788 investment in Social Security. But if Gene's benefit were then $9,000, Jean would accrue no additional benefit even if she were paid the maximum wage base.

Related to this issue is the issue of whether the marginal increase in the worker's benefit may be more valuable than the increase in the spouse's benefit (and the spouse is, after all, entitled to 50 percent of the additional benefit that accrues to the worker). Thus, if Gene's benefit would increase by $200 by paying the $16,000 to him rather than her, doing so instead of hiring his spouse results in a $300 increase in benefits ($200 to Gene and $100 to Jean) and saves $1,964 in Social Security tax. In the event that Gene's benefit was (as of the beginning of the year) $6,000 (Jean's spousal benefit is $3,000, the same as her worker's benefit), so that Jean would accrue the entire $457 increase as a new benefit, the net benefit would now by only $157 ($457 increase to Jean over the sum of the $300 increase that would accrue to the couple) at the cost of the $1,964 additional Social Security payment.

### *3. Pension benefits*

Employing a spouse may also be used to provide a spouse with pension benefits.[1] This is particularly important if the owner has already topped out on compensation levels or annual addition contributions.

a. A spouse may be eligible to receive a retirement annuity without regard to the spouse's compensation in a defined-benefit plan if the spouse has never participated in the employer's defined-contribution plan. Of course, the nondiscrimination rules will require that a similar offer be made to all other employees, but it may be well-suited in the case of a sole proprietor.

b. A spouse may have access to §401(k) elective deferrals that can be as much as $20,500 (2022), as much as doubling the amount the couple could defer.

***Note:***

While the rule is generally that the employer contribution (for all employees) cannot exceed 25 percent of participants' compensation, employee contributions are not counted in this calculation; the operable limitation is that the annual addition (which includes both employer contributions and elective deferrals) for the participant cannot exceed 100 percent of compensation. Now, in a §401(k) plan with no employer match or other contributions, the spouse could be "paid" $20,500 (net of employment taxes) and defer the entire amount as an elective contribution. In that case, the spouse has no taxable income. If the spouse is at least 50 years of age, an additional $6,500 catch-up contribution is available without regard to any of these limitations; in that case, the spouse could be "paid" $27,000 (net of employment taxes) and still not incur any income tax.

c. The spouse may have access to a profit-sharing plan, which could defer up to an additional $61,000 (2022) of income.

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[1] The repeal of the family aggregation rules permits the usage of the compensation of all family members up to the maximum compensation that can be taken into account.

***Note:***

The employer contribution to a profit-sharing plan cannot exceed the dollar annual addition limitation for a participant; at the same time, except in certain age-weighted or cross-tested plans discussed later in these materials, the employer cannot deduct a contribution in excess of 25 percent of compensation. This means that the $61,000 would only be available if the spouse were making at least $244,000. For the very serious employment of the spouse, the business owner should consider shifting duties and salary to the spouse. The compensation that can be taken into account for plan purposes cannot exceed $305,000; so in many cases, a business owner can reduce his or her own wages without suffering any reduction in his or her own retirement contribution while reducing the company's (or in the case of an S corporation shareholder/partner/member/proprietor, the individual's own) income tax by reason of the additional contribution. The couple's income otherwise remains the same.

***Note:***

There is one major disparity between corporate plans and Keogh plans concerning employment taxes. While a self-employed person may deduct his or her retirement plan contribution, this deduction is on page one of the Form 1040, not on Schedule C. That contribution is subject to self-employment tax (which in turn is deductible in part). However, the contribution to the retirement plan for employees (including a spouse) is deductible on Schedule C and reduces the self-employment income of the proprietor/partner. Thus, for example, a self-employed person splitting income with a spouse may also benefit from a reduction of the self-employment tax.

d. The spouse may have access to a SIMPLE plan that could defer up to an additional $28,000 in 2022.

***Note:***

The SIMPLE plan operates in a like manner to a §401(k) plan in that the employee makes an elective deferral of salary. The maximum elective deferral for a SIMPLE plan is $14,000 in 2022, and the maximum employer contribution is three percent of compensation. The compensation that may be taken into account is not limited, but the maximum match is the amount of income deferred by the employee.

***Planning point:***

SIMPLE plans are not subject to the special ADP nondiscrimination rules that are applied to §401(k) arrangements, and thus, do not suffer from the potential loss of qualification that can happen to a §401(k) plan when non-highly compensated employees fail to participate in sufficient numbers and relative amounts.

***Caution:***

The limitation on elective deferrals to a SIMPLE or §401(k) plan is applied by an aggregation of all of a participant's SIMPLE and §401(k) plans, regardless of whether the sponsors or employers are related. Thus, if a spouse already has a SIMPLE plan as an employee of an unrelated company to which the maximum deferral has been made, the spouse could only defer $6,500 ($20,500 §401(k) maximum contribution - $14,000 actual SIMPLE contribution) if hired as an employee. If the spouse were a participant in the §401(k) plan of an unrelated employer and had made the maximum $20,500 contribution, no deferral to the spouse's company SIMPLE plan could be made.

### *4. Medical benefits*

A technical advice memorandum again approves of a creative method for obtaining a Schedule C (above-the-line) deduction for a family's medical costs.[2] This will be very helpful for many sole proprietors.

***Example:*** Paula Smith is a well-known jury consultant who operates as a sole proprietor. She is married to Oliver James Smith, a part-time substitute high-school teacher. When Oliver is not teaching, he works for Paula on analyzing jury profiles for murder trials and also performs certain administrative duties. Oliver regularly works more than 30 hours per week for Paula and is paid a reasonable wage for his time. Paula has adopted a written employer-provided accident and health plan that, by its terms, covers all employees of the business. Under the plan, medical insurance and certain medical expense reimbursements are available to the employees (all in accordance with the applicable code requirements). Oliver receives medical insurance (including dependent coverage) and medical-expense reimbursements (including some for his dependents) under the plan during the current year. Under the rulings cited above, the IRS has indicated that both the medical-insurance premiums and the medical-expense reimbursements would be deductible as a business expense on Schedule C. In addition, Oliver does not have to include any of these items in his gross income.

***Note*:**

The example above embodies the basic principles set forth in the cited technical advice memorandum (TAM) and revenue ruling. However, the TAM did not indicate whether the husband's services were full-time or part-time. In addition, the TAM did not indicate the nature of the husband's services, or whether there were other employees. The TAM dealt with the medical-expense-reimbursement plan (MERP) aspect of the above example. The cited revenue ruling involved a sole proprietor with several full-time employees, including the spouse, and the medical-insurance benefits provided to the employees.

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[2] TAM 9409006. See also Rev. Rul. 71-588, 1971-2 C.B. 91.

***Planning point:***

The application of the nondiscrimination rules depends on whether health benefits are provided under a **self-insured medical reimbursement plan** or under an insurance policy provided by an employer through an insurance company. Insured medical plans may benefit top executives or other highly compensated employees **exclusively**. Insured plans are not tested for discrimination. Premium payments by an employer on a policy of accident or health insurance or contributions to a separate trust providing accident or health benefits may be excluded from the gross income of employees if the plan merely covers one or more of the company's employees. Benefits received under the plan are also tax-free, however under ACA such plans that are group health plans may be subject to a penalty for discrimination different from loss of the exclusion. In contrast, self-insured medical-reimbursement plans may not discriminate in favor of **highly compensated employees**, either as to eligibility or as to benefits.[3] A **self-insured medical-reimbursement plan** is a separate written plan designed to reimburse employee medical expenses.[4] A plan is self-insured if reimbursement for expenses is not provided under a policy of accident or health insurance.[5] A **highly compensated employee** means an individual who is one of the following:

- Among the employer's five highest paid officers;
- A shareholder who owns (with the application of §318 attribution rules) more than 10 percent in value of the employer's stock; or
- Among the highest paid 25 percent of all employees (other than **excludable employees** who do not participate).[6]

Now the implications are that one can adopt an insured plan that covers only the spouse and no other employees, but this is not possible in a self-insured plan covering only the owner's spouse. In the case of a C corporation plan there are no further implications (and the spouse could be covered by the insurance policy on the owner). However, in the case of an S corporation, the payment of the medical premiums on behalf of the spouse will still be grossed up in W-2 wages, while avoiding FICA, and be deductible above the line (because the spouse is treated as owning the stock owned by the actual owner). The 100-percent deduction in 2022, however, is limited to the earned income of the participant. If the business is running a loss, it may be advisable to pay the spouse an amount at least equal to the cost of the insurance coverage; otherwise the deduction may be limited to what is deductible below the line with the Schedule A haircut. In the case of an LLC or partnership, the 100 percent of premium payment is not deductible on Schedule C or as a net on a Schedule K-1 but as a separate deduction on page one of Form 1040; this means that the medical premiums paid for the business owner remain subject to self-employment tax, but premiums paid in respect of the spouse (whose coverage may include the owner as the spouse's spouse) would reduce Schedule C income and self-employment income. (This may have a reducing effect on the owner's pension, if any, but also an increasing effect on the spouse's pension.) In addition, if a proprietorship/partnership is operating at a loss, the premium paid for the owner would not be deductible above the line, but a premium for the spouse might be, as a deduction on Schedule C or on Form 1065.

***Note:***

If the spouse is already working for another employer, there may be coordination-of-coverage issues in connection with the policies. In some cases, the business owner may be able to be covered by the spouse's first employer's medical plan; in others, the coverage may be superseded by the availability of coverage from the business owner's own policy. The spouse may not be covered by the business owner's plan if the insurer does not permit coverage of someone covered by another plan, and this, in turn, could perhaps deny the dependent coverage the business owner seeks.

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3 I.R.C. §105(h)(2). Treas. Regs. §1.105-11(c)(1).
4 Treas. Regs. §1.105-11(b)(1).
5 I.R.C. §105(h)(6).
6 I.R.C. §105(h)(5).

### *5. Long-term care*

Long-term-care insurance contracts are taxed similarly to accident and health insurance contracts. Thus, certain benefits received under a long-term insurance contract provided by an employer may be received tax-free. As an insured medical plan, it is not tested for discrimination. If the long-term-care insurance contract is an indemnity policy (one that reimburses actual long-term-care costs), all benefits received under the policy are tax-free. If, on the other hand, the long-term-care insurance contract is a per-diem policy (one that pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of $390 per day or actual daily expenses.

a. A certain amount of the premiums paid on long-term-care insurance contracts qualify as medical expenses for purposes of the medical expense deduction. The qualifying amount in 2022 is limited on the basis of the insured's age, as follows (all ages refer to the insured's age as of the end of the taxable year).[7]

| Age | Annual Limit |
|---|---|
| 40 or less | $450 |
| More than 40 but not more than 50 | $850 |
| More than 50 but not more than 60 | $1,690 |
| More than 60 but not more than 70 | $4.510 |
| More than 70 | $5,640 |

These amounts are indexed for inflation.

***Note:***

With respect to pass-through employers (S corporations, partnerships, and multimember LLCs), the Service has previously ruled that special rules apply. In the case of an S corporation, the payment of such (medical) insurance premiums (as limited by the annual dollar limit in the above table) is treated as taxable income to the more-than-two-percent shareholder and deductible by such shareholder as a medical insurance premium above-the-line (not in excess of the shareholder's share of the earned income of the business, including any wages paid to the shareholder), with any balance deductible below-the-line subject to the Schedule A threshold.

b. Unreimbursed long-term-care expenses qualify as medical expenses for purposes of the medical-expense deduction as long as the long-term-care services are not provided by a relative who is unlicensed to provide such services. Long-term-care expenses include:
   - Expenses for necessary diagnostic, preventative, therapeutic, curative, treatment, mitigative, and rehabilitative services required by a chronically ill individual; and
   - Expenses for maintenance or personal-care services required by a chronically ill individual.

c. For these purposes, a chronically ill insured person is one who has been certified within the previous 12 months by a licensed health-care practitioner as:
   - Being unable to perform, without substantial assistance, at least two activities of daily living for at least 90 days due to a loss of functional capacity;
   - Having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services; or
   - Requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment.

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[7] Rev. Proc 2021-45.

***Note*:**

It is important to note that long-term-care insurance is not merely for the elderly; there are many younger people, unable to care for themselves, who would benefit from this type of insurance.

***Planning point:***

Employer contributions for long-term-care insurance are deductible as business expenses and are not included in the employee's income. However, if an employer provides long-term-care coverage under a cafeteria plan, benefits received are included in the employee's income. In addition, long-term-care coverage cannot be provided under a flexible spending account, although premiums can be paid through the use of Archer medical spending accounts (MSAs).

#### *6. Miscellaneous*

In addition to other benefits, hiring the spouse for the client's business can provide the following.

- Disability coverage for the spouse.
- Dependent care FSAs.
- A second company car can be provided to the spouse as an employee.
- Group-term life insurance can be offered to the spouse as an employee on a tax-free basis to the extent of the premium paid attributable to the first $50,000 of coverage.

## B. Hiring the child

#### *1. In general*

Employing a family member enables:

- The taxpayer to take advantage of the child's full standard deduction;
- The child to make contributions to an IRA; and
- The child to receive money that is not subject to the kiddie tax.

***Question to ponder:***

What non-monetary reasons are there to employ a family member?

Because the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is **not** affected by the kiddie tax.

a. The reasonable compensation standard has been a long-standing obstacle to this **income-shifting** technique. As a practical matter, however, the reasonable compensation standard may no longer be important in such cases. With much lower individual income-tax rates and increasing payroll taxes, generous salary payments from the family corporation to the children may no longer be attractive.

b. The maximum amount of savings can be achieved with salary payments of $12,950. This is the regular standard deduction amount for 2022; after the first $12,950 is paid ($18,950 if an IRA is set up), the income-tax savings to the family unit decline. Note that although substantial salary payments from the family corporation to the child, regardless of age, may not generate substantial income-tax savings, they do offer transfer-tax savings.

c. Therefore, it is generally desirable for a dependent to have earned income of at least $12,950.

### *2. Unearned income*

The **kiddie tax** applies not only to children under age 18 (regardless of any other circumstance) but also to children who are 18 years old or who are full-time students over age 18 but under age 24, but only if such children's earned income does not exceed one-half of the amount of their support. Payroll taxes apply only to employee compensation. The tax rates that now apply to unearned income (as of 2022) are those for the parents' marginal rate. The SECURE Act eliminates the odious TCJA definition of "Kiddie Tax" on children's unearned income in excess of $2,300 (2022) at the highest trust and estate tax rates.

### *3. Coping with the new definition*

a. Keep in mind that the definition of a kiddie, while patterned after the age thresholds for a child to be treated as a qualifying child for purposes of the dependency deduction, does not require that the child in fact be a dependent.

b. Earned income will take on a larger and larger role in consideration of income shifting planning. A child within the suspect age ranges can avoid the kiddie tax if he or she has enough earned income. The accounting problem raised is that the measuring rod is the total amount of support the child has.

***Note:***

> The amount of earned income could be somewhat uncertain if the amount paid is **unreasonable**. In addition, and probably a thornier issue, an accountant must be prepared to substantiate the base amount of **support against which the earned income will be compared**.

c. For planning purposes, the possibilities grow dim if the parent does not own a business through which he can reasonably assure the **child will obtain** such **earned income**. In addition, when an S corporation is involved, the mix between compensation and pass-through income will need to be planned more precisely as the former class will provide a child with earned income, but the latter may well not.

d. At a minimum, the property transferred to a child will move from current ordinary income producing assets like most stocks and bonds to assets held strictly for appreciation, and then perhaps with a plan to realize such gains once the period of enhanced kiddie tax is over. Thus, non-dividend-paying growth stock may be employed if the child will soon emerge from full-student status. And depending on the circumstances, the former student may then be able to use the lower or zero tax rates.

# Recent Developments -- Pass-Throughs

# Recent Developments -- Pass-Throughs

## *Learning objectives*

Upon reviewing this material, the reader will be able to discuss new Schedules K-2 and K-3 as well as new Form 7203.

## *I. Schedules K-2 and K-3 reporting*

### A. Introduction

The IRS introduced new Schedules K-2 and K-3 for the 2021 tax year. The new reporting requirements apply to partnerships, S corporations, and foreign partnerships. Trusts are not subject to the new reporting requirements.

Schedules K-2 and K-3 replace lines 16 and 20 on Schedules K and K-1 (Form 1065) and lines 14 and 17 of Schedule K and boxes 14 and 17 of Schedule K-1 (Form 1120-S). Schedules K-2 and K-3 likely require more detailed information than partnerships and S corporations previously reported.

Both Schedules K-2 and K-3 were created to standardize reporting of items of international tax significance to partners and shareholders. Prior to the 2021 tax year, Schedule K-1 only had a few boxes dedicated to foreign transactions and as a result, many taxpayers had to attach footnotes or additional statements to report the required information. Free-form footnotes were often inconsistent and could result in incorrect reporting by the partner or shareholder. Standardized Schedules K-2 and K-3 reporting provides greater clarity and consistency to partners and shareholders.

Schedule K-2 is an extension of Schedule K and is used to report items of international tax relevance from the operation of the S corporation or partnership. The partnership or S corporation only files one Schedule K-2. Schedule K-3 is an extension of Schedule K-1 and is used to report the partner or shareholder's share of items reported on Schedule K-2. The partnership or S corporation files a separate Schedule K-3 for each partner or shareholder. There are no general de minimis exceptions for filing the schedules.

### *Schedule K Changes:*

**Foreign Transactions**

| | | | |
|---|---|---|---|
| 16a | Name of country or U.S. possession ▶ | | |
| b | Gross income from all sources | 16b | |
| c | Gross income sourced at partner level | 16c | |
| | Foreign gross income sourced at partnership level | | |
| d | Reserved for future use ▶ e Foreign branch category ▶ | 16e | |
| f | Passive category ▶ g General category ▶ h Other (attach statement) ▶ | 16h | |
| | Deductions allocated and apportioned at partner level | | |
| i | Interest expense ▶ j Other ▶ | 16j | |
| | Deductions allocated and apportioned at partnership level to foreign source income | | |
| k | Reserved for future use ▶ l Foreign branch category ▶ | 16l | |
| m | Passive category ▶ n General category ▶ o Other (attach statement) ▶ | 16o | |
| p | Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐ | 16p | |
| q | Reduction in taxes available for credit (attach statement) | 16q | |
| r | Other foreign tax information (attach statement) | | |

**International Transactions**

| | | | |
|---|---|---|---|
| 16 | Attach Schedule K-2 (Form 1065), Partners' Distributive Share Items-International, and check this box to indicate that you are reporting items of international tax relevance ☐ | | |

### *Schedule K-1 Changes:*

651119

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 15 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | 16 | Foreign transactions |
| 4a | Guaranteed payments for services | | |
| 4b | Guaranteed payments for capital | | |
| 4c | Total guaranteed payments | | |
| 5 | Interest income | | |
| 6a | Ordinary dividends | | |
| 6b | Qualified dividends | | |

**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 14 | Self-employment earnings (loss) |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | 15 | Credits |
| 4a | Guaranteed payments for services | | |
| 4b | Guaranteed payments for capital | 16 | Schedule K-3 is attached if checked ▶ ☐ |
| 4c | Total guaranteed payments | 17 | Alternative minimum tax (AMT) items |
| 5 | Interest income | | |
| 6a | Ordinary dividends | | |
| 6b | Qualified dividends | 18 | Tax-exempt income and nondeductible expenses |
| 6c | Dividend equivalents | | |
| 7 | Royalties | | |
| 8 | Net short-term capital gain (loss) | | |
| | | 19 | Distributions |
| 9a | Net long-term capital gain (loss) | | |
| 9b | Collectibles (28%) gain (loss) | | |
| | | 20 | Other information |
| 9c | Unrecaptured section 1250 gain | | |
| 10 | Net section 1231 gain (loss) | | |
| 11 | Other income (loss) | | |
| 12 | Section 179 deduction | 21 | Foreign taxes paid or accrued |

New checkbox for Schedule K-3

New line 21 – Foreign Taxes Paid or Accrued

## B. 2021 Form 1065 and 1120-S Instructions (pre-filing relief)

On January 18, 2022, the IRS released updated Form 1065 and 1120-S instructions, stating:
"A partnership/s corporation with no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued **may still need to report information on Schedules K-2 and K-3**. For example, if the partner/shareholder claims a credit for foreign taxes paid by the partner/shareholder, the partner/shareholder may need certain information from the partnership/s corporation to complete Form 1116. Also, a partnership/s corporation that has only domestic partners/shareholders may still be required to complete Part IX when the partnership/s corporation makes certain deductible payments to foreign related parties of its domestic partners/shareholders. The information reported in Part IX will assist any domestic corporate partner/shareholder in determining the amount of base erosion payments made through the partnership/s corporation, and in determining if the partners/shareholders are subject to the Base Erosion and Anti-Abuse Tax."

Many partnerships and S corporations were under the impression that they would be required to file Schedules K-2 and K-3 as a result of the updated January 18, 2022, instructions. Prior to the updated instructions, many practitioners assumed entities with neither international activities nor foreign partners would not be required to file Schedules K-2 and K-3.

## C. 2021 Transitional filing relief – First round of FAQs[1]

Due to the challenges in meeting the new reporting requirements, the IRS issued transitional filing relief for 2021 in the form of FAQs on February 16, 2022. FAQ #15 states that certain domestic partnerships or S corporations are not required to file Schedules K-2 and K-3 for the 2021 tax year, provided the following requirements are met:

- In tax year 2021, the direct partners in the domestic partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts.
- In tax year 2021, the domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated, or may reasonably be expected to generate foreign source income (see section 1.861-9(g)(3)).
- In tax year 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
  - Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S); and
  - Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (line 17d for Form 1120-S).
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.

Entities that met the requirements for the Schedules K-2 and K-3 filing exception were not required to file Schedules K-2 and K-3 with the IRS or with their partners/shareholders. However, if the partnership or S corporation was subsequently notified by a partner or shareholder that all or part of the information contained on Schedule K-3 was needed to complete their tax return, then the partnership or S corporation had to provide the information to the partner or shareholder. If a partner or shareholder notified the partnership or S corporation before the entity filed its return, the conditions for the exception were not met

[1] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120-S, and 8865).

and the partnership or S corporation must provide the Schedule K-3 to the partner or shareholder and file the Schedules K-2 and K-3 with the IRS.

Some entities may have begun following the January 18, 2022 form instructions prior to the transitional IRS guidance that was released on February 16, 2022. In the event an entity was notified that a partner/shareholder required certain information reported on Schedule K-3, the entity would not be eligible for transitional relief outlined in FAQ #15. The transitional relief applies to the entire Schedules K-2 and K-3 rather than specific parts, and the relief only applies to the 2021 tax year.

The Form 1065 Schedules K-2 and K-3 instructions also provide certain exceptions to completing Schedules K-2 and K-3:

- The partnership need not complete Schedules K-2 and K-3, Parts II and III if it knows that it has no direct or indirect partners eligible to claim a foreign tax credit.
- If a direct or indirect partner is eligible to claim a foreign tax credit, the partnership does not need to complete the Schedules K-2 and K-3, Parts II and III if the partnership knows that the direct and indirect partners are not completing Form 1116 or 1118.
- If the partnership has only U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, and all partners are less-than-10% limited partners, the partnership is not required to complete Schedule K-2, Part II.
    - If the partnership has only U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, Schedule K-3, Part II is not completed for its partners that are less-than-10% limited partners.
- If the partnership knows that all its partners are less-than-10% limited partners, the partnership does not need to complete Schedules K-2 or K-3, Part III, Section 2.
    - The partnership must only complete Schedule K-3, Part III, Section 2 with respect to its partners that are not less-than-10% limited partners.
- If any partner in the partnership holds a 10% or more interest or is a General Partner, Schedule K-2, Parts II and III must be completed.

Lastly, the Form 1120-S Schedules K-2 and K-3 instructions also provide certain exceptions to completing Schedules K-2 and K-3:

- The S corporation need not complete Schedules K-2 and K-3, Parts II and III if it knows that it has no shareholders who are eligible to claim a foreign tax credit.
- S corporations do not need to complete the Schedules K-2 and K-3, Parts II and III, if they know that the shareholder is not completing Form 1116 or 1118.

## D. 2021 Transitional filing relief – Second round of FAQs[2]

The IRS added eight new FAQs regarding Schedules K-2 and K-3 on April 11, 2022. As discussed above, the IRS provided filing relief for partnerships and S corporations in FAQ #15. FAQ #19 references the Schedules K-2 and K-3 instructions and clarifies that partnerships and S corporations that failed to qualify for the exception in FAQ #15 are only required to complete the relevant portions of Schedules K-2 and K-3.

FAQ #20 addresses whether a filer otherwise required to file Forms 5471, 8865, and/or 8858 may qualify for an exception from filing those forms based on the Internal Revenue Code, IRS guidance, and/or instructions to those respective forms. If the filer qualifies for such exception, the filer is not required to complete and attach those forms. However, the filer must still attach to the Forms 1065, 1120-S, and the tax return of the U.S. person filing Form 8865, any required statements to qualify for the exception to filing the Forms 5471, 8865, and/or 8858. Additionally, if the filer qualifies for the Form 5471 multiple filer exception, the partnership or S corporation must provide on the Schedule K-3 to its partners or shareholders any information that the partnership or S corporation receives from the person required to file the Form 5471 and that is requested by the Instructions to the Schedules K-2 and K-3, such as Schedule Q (Form 5471) information, if applicable.

FAQ #21 clarifies that code "RIC" may be entered on certain lines of Parts II and III of Schedules K-2 and K-3 to report gross income and taxes by foreign country or U.S. possessions, including for regulated investment companies.

FAQ #22 discusses when a filer must complete Section 1 of Part III, Schedules K-2 and K-3. FAQ #22 clarifies that a filer is not required to complete Section 1 of Part III unless either the partnership or S corporation incurs research and experimental expense or the partner or shareholder is expected to license, sell, or transfer its intangible property to the partnership or S corporation. The FAQs note that this clarification will be added to the tax year 2022 instructions. However, the FAQs note that filers may choose to follow this clarification for tax year 2021.

FAQ #23 clarifies that if a foreign partnership has Passive Foreign Investment Companies (PFICs) for which a mark-to-market (MTM) election in Treas. Reg. §1.1291-1(c)(4) has been made, the filer of Form 1065 does not need to report information about the PFIC on Part VII of Schedules K-2 and K-3. The FAQ notes that the filer should report the partnership's MTM gain or loss on Schedule K (Form 1065) and report the partners' shares of such amounts on Part III of Schedule K-1 (Form 1065).

FAQ #24 explains that Part VIII (Form 1065) and Part VII (Form 1120-S) are not required to be completed with respect to dormant foreign corporations. The FAQs note that this clarification will be added to the tax year 2022 instructions. However, the FAQs stated that filers may follow this clarification for tax year 2021.

FAQ #25 addresses how a partnership should report its accrued Original Issue Discount (OID) and OID income taxable on a gross basis to a foreign partner on Section 1 of Part X of Schedules K-2 and K-3 of Form 1065. Typically, partnerships report OID on Schedules K and K-1 in the taxable year accrued. The Schedules K-2 and K-3 Form Instructions for Part X require the partnership to report OID only when it is taxable to foreign partners. To reconcile Schedules K-2 and K-3 reporting of OID with Schedules K and

[2] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120-S, and 8865).

K-1 reporting of OID and to provide foreign partners with the information necessary to complete their returns, the IRS recommends the following approach per FAQ #25 for reporting OID on Part X:

- ***Accrued OID Reported on Form 1065:*** *The amount of accrued OID reported on Schedules K (Form 1065) which is not taxable to foreign partners should be reported as interest income in column (f) (U.S. source (other)) of Part X, Schedule K-2. The IRS recommends that the partnership attach a statement to Form 1065 with respect to Part X clarifying that these amounts are not taxable to foreign partners and need not be reported on the foreign partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.*
- ***OID Payments or Gains Taxable on a Gross Basis to a Foreign Partner:*** *When the partnership receives payments on the OID instrument or gain on the sale or exchange of the OID instrument that are taxable on a gross basis to foreign partners, these amounts should be reported in column (e) (U.S. source (fixed, determinable, annual, or periodical - FDAP)) as interest income or gain, as appropriate. These amounts should also be entered as a negative adjustment in column (f) to ensure that the total OID reported on Part X reconciles with OID reported on Schedule K (Form 1065). Additionally, the IRS recommends attaching a statement explaining that the negative adjustment in column (f) is for reconciliation purposes only and is not relevant to the foreign partner's tax liability and therefore need not be reported on the foreign partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.*

FAQ #25 specifies that this approach is only recommended for tax year 2021, and the IRS recognizes that partnerships may have taken other approaches.

FAQ #26 clarifies the reporting on certain lines of Section 3 of Part X of Schedules K-2 and K-3 as follows:

- ***Line 2b:*** *Average worldwide assets. Report the partnership's basis in its average worldwide assets for purposes of Treasury Regulation section 1.882-5(b) using the average amount as defined in Treasury Regulation sections 1.882-5(b)(3) and 1.884-1(d)(3)(ii).*
- ***Line 3a.*** *Average U.S.-booked liabilities of the partnership. Enter the partnership's average U.S.-booked liabilities as defined in Treasury Regulation section 1.882-5(d)(2) using the average defined in Treasury Regulation section 1.882-5(d)(3).*
- ***Line 3b.*** *Directly allocated partnership indebtedness. Enter the portion of the principal amount of the partnership's indebtedness outstanding at year end that meets the requirements of Temporary Regulation section 1.861-10T(b) or (c), as limited by Temporary Regulation section 1.861-10T(d)(1), as described in Treasury Regulation section 1.882-5(a)(1)(ii)(B). See Treasury Regulation section 1.861-10T(d)(2).*

The IRS states that they will clarify this reporting in the tax year 2022 Schedules K-2 and K-3 instructions.

## E. 2021 Reporting

Partnerships and S corporations are only required to complete relevant portions of Schedules K-2 and K-3. Partnerships are not required to obtain information from their direct or indirect partners to determine whether they need to file certain parts of Schedules K-2 and K-3. S corporations are not required to

obtain information from their shareholders to determine whether they need to file certain parts of Schedules K-2 and K-3.

Below are the main parts of Schedules K-2 and K-3:

- **Part I: Current Year International Information**
  - Used to report international tax items not reported elsewhere on Schedule K-2 or K-3.
- **Part II: Foreign Tax Credit Limitation**
  - Used to compute the partnership/S corporation income or loss by source/category and report the partner/shareholder's share of such income or loss. Partners and shareholders use information on Part II to claim a foreign tax credit on Form 1116 or 1118.
  - This section is not required to be completed if the partnership does not have a direct or indirect partner that is eligible to claim a foreign tax credit.
    - A partner that is eligible to claim a foreign tax credit includes, a U.S. citizen or resident, certain nonresident individuals, certain U.S. trusts and estates, a domestic corporation, and certain foreign corporations.
  - If the partnership knows that its only partners are less-than-10% limited partners that do not hold their interest in the ordinary course of the partner's active trade or business, the partnership's foreign source gross income and gross receipts should be reported as passive category income and its deductions allocated and apportioned to foreign source income should be reported as reducing passive category income.
- **Part III: Other Information for Preparation of Form 1116 or 1118**
  - Used to report information necessary for the partner/shareholder to determine the allocation and apportionment of R&E expense, interest expense, and the foreign-derived intangible income (FDII) deduction for the FTC limitation. Also, this section reports foreign taxes paid or accrued by the partnership/s corporation and the partner/shareholder's distributive share of such taxes. For partnerships, this section also reports income adjustments under §743(b) by source. Partners/shareholders use this information to compute the FTC on Form 1116 or 1118.
  - This section is not required to be completed if the partnership does not have a direct or indirect partner that is eligible to claim a Foreign Tax Credit.
- **Part IV:**
  - **Partnerships**: Used to report information necessary for the partner to determine its §250 deduction with respect to FDII. Partners use this information to claim and compute a §250 deduction with respect to FDII on Form 8993, *Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI).*
  - **S corporations**: Used to report information the shareholder needs to determine the amount of each distribution from a foreign corporation that is treated as a dividend or excluded from gross income because the distribution is attributable to Previously Taxed Earnings and Profits (PTEP) in the shareholder's annual PTEP accounts with respect to the foreign corporation, and the amount of foreign currency gain or loss on the PTEP that the shareholder is required to recognize under §986(c).

- **Part V:**
  - **Partnerships**: Used to report information the partner needs to determine the amount of each distribution from a foreign corporation that is treated as a dividend or excluded from gross income because the distribution is attributable to PTEP in the partner's annual PTEP accounts with respect to the foreign corporation, and the amount of foreign currency gain or loss on the PTEP that the partner is required to recognize under §986(c).
  - **S corporations:** Used to report information that the shareholder needs to determine any inclusions under §§951(a)(1) and 951A. Shareholders use this information to complete Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),* and Form 1040, with respect to subpart F income inclusions, §951(a)(1)(B) inclusions, and §951A inclusions.
- **Part VI:**
  - **Partnerships**: Used to report information required by the partner to determine any inclusions under §§951(a)(1) and 951A. Partners will use the information to complete Form 8992*, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, and Forms 1040 and 1120 with respect to subpart F income inclusions, §951(a)(1)(B) inclusions, and §951A inclusions.
  - **S corporations**: Used to report information required by shareholders to complete Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to provide shareholders with information necessary to determine income inclusions with respect to the passive foreign investment company (PFIC).
- **Part VII:**
  - **Partnerships**: Used to report information required by partners to complete Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to provide partners with information necessary to determine income inclusions with respect to the PFIC.
  - **S corporations**: Used to report the foreign corporation's net income in the income groups for purposes of the shareholder's deemed paid taxes computation with respect to inclusions under §§951A and 951(a)(1). Shareholders will use the information to figure and claim a deemed paid foreign tax credit on Form 1118.
- **Part VIII: Partnerships Only**
  - Used to provide the foreign corporation's net income in the income groups for purposes of the partner's deemed paid taxes computation with respect to inclusions under §§951A, 951(a)(1), and 1293(f). Partners use this information to compute and claim a deemed paid foreign tax credit on Form 1118.
- **Part IX: Partnerships Only**
  - Used to provide information for the partner to compute its Base Erosion and Anti-Abuse Tax (BEAT). Partners use this information to complete Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*.
- **Part X: Partnerships Only**
  - Used to provide information for the partner to determine its tax liability with respect to income effectively connected (ECI) with a U.S. trade or business, or with respect to fixed, determinable, annual, or periodical (FDAP) income. Partners utilize this information to compute and report any U.S. tax liability on Forms 1040-NR and 1120-F.

- **Part XI: Partnerships Only**
  - Used to provide certain information to U.S. and foreign partners with respect to §871(m) by a publicly traded partnership that satisfies certain other requirements. Certain partners use the information to determine their U.S. withholding tax obligations and to determine and report any U.S. tax liability on Forms 1042 and 1042-S.
- **Part XII: Partnerships Only**
  - Reserved for future use.
- **Part XIII: Partnerships Only**
  - Used to provide information for a foreign partner to determine its distributive share of deemed sale items on a transfer of the partnership interest. Partners use this information to complete Form 4797 and Form 8949.

## F. Schedules K-2 and K-3 penalty relief

Noncompliance with the new Schedules K-2 and K-3 would typically result in certain penalties, including:

- **Failure to file complete tax return:** This inaction results in a penalty of $210 per partner per month (up to 12 months so maximum $2,520 per partner) for 2021 tax returns filed in 2022.
  - A complete return for a partnership reporting purpose includes Form 1065 and Schedules K-1, K-2, and K-3.
  - A complete return for an S corporation includes Form 1120-S and Schedules K-1, K-2, and K-3.
  - This penalty is not imposed if the failure is due to reasonable cause.
  - For 2022 returns filed in 2023, the penalty increases to $220 per partner per month.
- **Failure to file an information return on or before the required filing date, and failure to report all required information on Schedules K-1 and K-3:** This inaction results in the following penalties:
  - If the failure was non-intentional: $280 per partner (maximum $3,426,000) for 2021 forms filed in 2022.
  - For 2022 forms filed in 2023, the penalty increases to $290 per partner (maximum $3,532,500).
  - If the failure was the result of Intentional disregard: greater of:
    - $570 per partner for 2021 forms filed in 2022 or $580 per partner for 2022 forms filed in 2023; or
    - 10% of the aggregate amount of items required to be reported.

The IRS issued Notice 2021-39, providing penalty relief for taxpayers who make a good faith effort to comply with Schedules K-2 and K-3 for 2021. Specifically, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a U.S. partner required to file Form 8865 will not be subject to penalties for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. If the taxpayer fails to establish a good faith effort, no penalty relief exists. This penalty relief is only in effect for the 2021 tax year.

For purposes of determining whether a good faith effort was made to complete Schedules K-2 and K-3, the following circumstances will be considered:

- The extent to which a Schedule K-2/K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3;
- The extent to which a Schedule K-2/K-3 filer has obtained information from partners, shareholders, or the CFP, or applied reasonable assumptions when information is not obtained; and
- The steps taken by the Schedule K-2/K-3 filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3.

## *II. New Form 7203*

Since 2018, the IRS has required shareholders of an S corporation to disclose a stock and debt basis computation with their tax return if an S corporation shareholder does any of the following:

- Claims a deduction for their share of an aggregate loss;
- Receives a distribution;
- Disposes of stock; or
- Receives a loan repayment from an S corporation.

Until 2021, there was no specified form or format to report the computation of the S corporation shareholder's basis. In prior years, the Form 1120-S, Schedule K-1 instructions contained a 3-part worksheet, *Worksheet for Figuring a Shareholder's Stock and Debt Basis*. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations,* is new for the 2021 tax year, and it is used to determine a shareholder's share of the S corporation's deductions, credits, and other items deducted on his or her return.

Form 7203 must be filed by the following S corporation shareholders:

- Shareholders that are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations);
- Shareholders that received a non-dividend distribution from an S corporation;
- Shareholders that disposed of stock in an S corporation (whether or not gain is recognized); or
- Shareholders that received a loan repayment from an S corporation.

Even though all shareholders are not required to file Form 7203, it may be beneficial for them to complete it, as it ensures that their basis is consistently maintained throughout the years. It is important to emphasize that shareholders, not S corporations, are required to prepare Form 7203. Shareholders who are required to file Form 7203 should attach it to their individual tax return. No forms are attached to Form 1120-S, as S corporations do not prepare Form 7203.

An individual who is a shareholder in multiple S corporations must file a separate Form 7203 for each S corporation. If spouses are shareholders in the same S corporation, each spouse must file a separate Form 7203.

**Components of Form 7203** - Part I: Shareholder Stock Basis

| Part I | Shareholder Stock Basis | | | | |
|---|---|---|---|---|---|
| 1 | Stock basis at the beginning of the corporation's tax year | | | 1 | |
| 2 | Basis from any capital contributions made or additional stock acquired during the tax year | | | 2 | |
| 3a | Ordinary business income (enter losses in Part III) | 3a | | | |
| b | Net rental real estate income (enter losses in Part III) | 3b | | | |
| c | Other net rental income (enter losses in Part III) | 3c | | | |
| d | Interest income | 3d | | | |
| e | Ordinary dividends | 3e | | | |
| f | Royalties | 3f | | | |
| g | Net capital gains (enter losses in Part III) | 3g | | | |
| h | Net section 1231 gain (enter losses in Part III) | 3h | | | |
| i | Other income (enter losses in Part III) | 3i | | | |
| j | Excess depletion adjustment | 3j | | | |
| k | Tax-exempt income | 3k | | | |
| l | Recapture of business credits | 3l | | | |
| m | Other items that increase stock basis | 3m | | | |
| 4 | Add lines 3a through 3m | | | 4 | |
| 5 | Stock basis before distributions. Add lines 1, 2, and 4 | | | 5 | |
| 6 | Distributions (excluding dividend distributions) | | | 6 | |
| | **Note:** If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions. | | | | |
| 7 | Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15 | | | 7 | |
| 8a | Nondeductible expenses | 8a | | | |
| b | Depletion for oil and gas | 8b | | | |
| c | Business credits (sections 50(c)(1) and (5)) | 8c | | | |
| 9 | Add lines 8a through 8c | | | 9 | |
| 10 | Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15 | | | 10 | |
| 11 | Allowable loss and deduction items. Enter the amount from line 47, column (c) | | | 11 | |
| 12 | Debt basis restoration (see net increase in instructions for line 23) | | | 12 | |
| 13 | Other items that decrease stock basis | | | 13 | |
| 14 | Add lines 11, 12, and 13 | | | 14 | |
| 15 | **Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0- | | | 15 | |

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

| Part III | Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 13 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | | |
| 4 | Interest income | | |
| 5a | Ordinary dividends | | |
| 5b | Qualified dividends | 14 | Schedule K-3 is attached if checked ▶ ☐ |
| 6 | Royalties | 15 | Alternative minimum tax (AMT) items |
| 7 | Net short-term capital gain (loss) | | |
| 8a | Net long-term capital gain (loss) | | |
| 8b | Collectibles (28%) gain (loss) | | |
| 8c | Unrecaptured section 1250 gain | | |
| 9 | Net section 1231 gain (loss) | 16 | Items affecting shareholder basis |
| 10 | Other income (loss) | | |
| | | 17 | Other information |
| 11 | Section 179 deduction | | |
| 12 | Other deductions | | |

Whether the taxpayer transfers property to a new corporation or simply transfers property to an existing corporation, typically the corporation issues stock to the transferor and does not otherwise make any payment to the transferor. Absent §351, such a transaction would be treated as a taxable exchange under §1001 and would generate either gain or loss. However, under §351(a), no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation. A person is considered to be in control of the transferee corporation if immediately after the transfer, they own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. If §351(a) does not apply, the receipt of stock is taxable, and the stock's basis would equal its fair market value.

Per §351(b)(1), when consideration received in exchange for property transferred in a §351 transfer includes boot, realized gain is recognized to the extent of the boot's fair market value. Per §358, a shareholder's basis in stock received in a §351 exchange is determined as follows:

$$Basis\ of\ Stock\ Received = Adjusted\ Basis\ of\ the\ Property\ Transferred - Boot\ Received + Gain\ Recognized$$

Per §1.358-2(b)(2), “if more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered shall be allocated to the shares of stock or securities received in the exchange in proportion to the fair market value of the shares of stock or securities received.”

Stock basis is **increased** by the following items:

- Contributions of cash or property;
- Ordinary business income;
- Separately stated income;
- Tax-exempt income; and
- Excess depletion.

Stock basis is **decreased** by the following items:

- Ordinary business loss;
- Separately stated losses;
- Nondeductible expenses;
- Non-dividend distributions*; and
- Depletion for oil and gas.

*Note: Dividend distributions do not decrease stock basis.

Stock basis is adjusted annually in the following order:

1) Increased for income items and excess depletion;
2) Decreased for distributions;
3) Decreased for non-deductible, non-capital expenses and depletion; and
4) Decreased for items of loss and deduction.

**Components of Form 7203** - Part II: Shareholder Debt Basis

**Part II** **Shareholder Debt Basis**

**Section A—Amount of Debt** (If more than three debts, see instructions.)

| | Description | Debt 1<br>☐ Formal note<br>☐ Open account debt | Debt 2<br>☐ Formal note<br>☐ Open account debt | Debt 3<br>☐ Formal note<br>☐ Open account debt | Total |
|---|---|---|---|---|---|
| 16 | Loan balance at the beginning of the corporation's tax year | | | | |
| 17 | Additional loans (see instructions) | | | | |
| 18 | Loan balance before repayment. Combine lines 16 and 17 | | | | |
| 19 | Principal portion of debt repayment (this line doesn't include interest) | ( ) | ( ) | ( ) | ( ) |
| 20 | Loan balance at the end of the corporation's tax year. Combine lines 18 and 19 | | | | |

**Part II** **Shareholder Debt Basis** *(continued)*

| Section B—Adjustments to Debt Basis | | | | |
|---|---|---|---|---|
| **Description** | **Debt 1** | **Debt 2** | **Debt 3** | **Total** |
| **21** Debt basis at the beginning of the corporation's tax year | | | | |
| **22** Enter the amount, if any, from line 17 | | | | |
| **23** Debt basis restoration (see instructions) | | | | |
| **24** Debt basis before repayment. Combine lines 21, 22, and 23 | | | | |
| **25** Divide line 24 by line 18 | | | | |
| **26** Nontaxable debt repayment. Multiply line 25 by line 19 | | | | |
| **27** Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24 | | | | |
| **28** Nondeductible expenses and oil and gas depletion deductions in excess of stock basis | | | | |
| **29** Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0- | | | | |
| **30** Allowable losses in excess of stock basis. Enter the amount from line 47, column (d) | | | | |
| **31** **Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0- | | | | |
| **Section C—Gain on Loan Repayment** | | | | |
| **32** Repayment. Enter the amount from line 19 | | | | |
| **33** Nontaxable repayments. Enter the amount from line 26 | | | | |
| **34** **Reportable gain.** Subtract line 33 from line 32 | | | | |

A shareholder must complete the Shareholder Debt Basis section if they have personally loaned money to the corporation. Debt basis is increased by loans made to the S corporation and decreased by loan repayments made to the shareholder by the S corporation. Per the Form 7203 Instructions, shareholders must account for each formal note, defined as a note with a written instrument, made to the S corporation. Each loan must be reported in a separate column. Open Account Debt is defined as loans made to the S corporation not evidenced by a written instrument and not separately tracked. If an open account debt has a year-end balance of more than $25,000, it will be classified as a formal note at the beginning of the next tax year and must be separately tracked.

Loans that a shareholder guarantees or co-signs are not part of the shareholder's loan basis, except to the extent that the shareholder makes a payment on the guaranteed or co-signed loan. In other words, merely guaranteeing a loan for the S corporation does not increase basis but making a payment on a guaranteed loan increases basis.

Typically, debt basis is restored when a shareholder makes a capital contribution or when income items are passed through to the shareholder. In a year subsequent to a year with excess losses, the S corporation may pass through current year income or gains as well as prior-year carryover losses. When restoring basis, the shareholder will generally first restore basis in the debt to the extent of the amount owed, and then restore basis in the stock.

**Components of Form 7203: Part III**: Shareholder Allowable Loss and Deduction Items

| **Part III** Shareholder Allowable Loss and Deduction Items | | | | | |
|---|---|---|---|---|---|
| **Description** | **(a)** Current year losses and deductions | **(b)** Carryover amounts (column (e)) from the previous year | **(c)** Allowable loss from stock basis | **(d)** Allowable loss from debt basis | **(e)** Carryover amounts |
| **35** Ordinary business loss | | | | | |
| **36** Net rental real estate loss | | | | | |
| **37** Other net rental loss | | | | | |
| **38** Net capital loss | | | | | |
| **39** Net section 1231 loss | | | | | |
| **40** Other loss | | | | | |
| **41** Section 179 deductions | | | | | |
| **42** Charitable contributions | | | | | |
| **43** Investment interest expense | | | | | |
| **44** Section 59(e)(2) expenditures | | | | | |
| **45** Other deductions | | | | | |
| **46** Foreign taxes paid or accrued | | | | | |
| **47** **Total loss.** Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30 | | | | | |

Corporate losses and deduction items are limited to the sum of the shareholder's stock and debt basis. If loss and deduction items exceed a shareholder's stock basis, the shareholder may deduct the excess up to the shareholder's debt basis. If a shareholder claims losses and deduction items in excess of stock basis against his or her debt basis, the debt basis of the shareholder is reduced by the claimed losses and deductions. If there are different types of losses and deduction items that exceed stock or debt basis, the allowable loss and deduction items must be allocated pro rata based on the amount of the particular loss and deduction items. When determining current year allowable losses, current year loss and deduction items are combined with suspended loss and deduction items carried over from the prior year. Losses and deductions in excess of basis are suspended and carried forward to the following tax year. Such losses may only be deducted when basis is increased. Losses and deductions in excess of stock and debt basis retain their character.

S corporation shareholders may acquire stock at different times for different purchase prices, and the price of the stock may vary at different times. Separate basis records must be maintained for each share of stock or block of stock purchased. Generally, the fact that owners have different bases in different blocks of stock does not have tax consequences to the S corporation, but this could have significant tax consequences when stock in an S corporation is subsequently sold or gifted. The gain or loss on a subsequent stock sale may be long-term or short-term depending on the holding period of the particular share or block of shares sold.

# Basis, Passive Loss, and At-Risk

# Basis, Passive Loss, and At-Risk

## *Learning objectives*

Upon reviewing this chapter, the reader will be able to:

- Describe the basis adjustments that are made to reflect LLC operations, with special emphasis on the changes required by changes in the member's share of liabilities;
- Discuss the basis limitation on the current deductibility of losses and the substantial economic effect and built-in gain limitations on how LLC income, gains, and losses may be allocated among members;
- Explain the concept of a passive activity loss and material participation;
- Identify what is an activity and when activities are or may be aggregated;
- Explain the concept of "amount at risk" and to whom it applies;
- Determine the amount at risk;
- Distinguish qualified nonrecourse financing from other nonrecourse financings in the context of the amount at risk; and
- Discuss the requirements for a real estate professional, and the effect of a taxpayer's election to be treated as such for tax purposes.

# *I. The triad*

## A. Basis

### *1. In general*

The ability to deduct losses from a pass-through entity is limited in the first instance by the **basis** in the business. A partner's distributive share of partnership loss is deductible only to the extent of the partner's adjusted basis in the partner's interest at the end of the partnership taxable year in which the loss occurred.[1] Thus, to the extent that the partner's share of loss exceeds the partner's adjusted basis, the loss is nondeductible. Any disallowed loss may be carried forward indefinitely and deducted by the partner in future partnership taxable years to the extent that the partner's adjusted basis at the end of such years exceeds zero.[2] For ease of discussion, the discussion focuses on a partnership; in some cases, an S corporation has a different set of applicable rules.

**Partnerships and LLCs typically use debt a lot, but the rules for allocating the debt among the investors have several layers, in part depending on the kind of partnership and the type of debt.**

In a general partnership, all partners are jointly and severally liable on the partnership's **recourse debt**. In a limited partnership, the limited partners are **not** liable on the partnership's debt even if it is recourse as to the partnership; the same is true of all members of an LLC, although there tend to be few recourse debts in the latter organization, except that substantial creditors may require the security of a **guarantee** and this may in turn convert a nonrecourse debt into a recourse one.

Nonrecourse debt follows a complicated three-tier regime that requires making side calculations each year. Throw in a guarantee by some or all of the investors, and the allocation can shift back to the recourse model.

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1 Rev. Rul. 99-57, 1999-51 I.R.B. 678; Treas. Regs. §1.704-1(d)(1).
2 Treas. Regs. §1.704-1(d)(1).

 

The regulations promulgated under §752 define a liability as recourse to the extent that any member or related person bears the **economic risk of loss for the liability**.[3] A member's share of a recourse LLC liability equals the portion of that liability for which the member or person related to the member bears the economic risk of loss.[4] Thus, a member shares in a recourse liability (and includes the amount of the liability in the member's adjusted basis in the member's LLC interest) only to the extent that the member or a person related to the member bears the economic risk of loss. The concept of economic risk of loss is, therefore, crucial to a determination of a member's share of recourse LLC liabilities. In most cases, the liability of an LLC will be nonrecourse, but a member guarantee can change that.

a. In general, a member bears the economic risk of loss for an LLC liability to the extent that the **member or a related person** makes (or acquires an interest in) a **nonrecourse loan to the LLC** and the economic risk of loss for the liability is not borne by another member.[5]

   (i) A member is considered to bear the economic risk of loss for an LLC liability to the extent of the value of any of the member or related person's **separate property** (other than a direct or indirect interest in the LLC) that is pledged as security for the LLC liability.[6]

   (ii) A member is considered to bear the economic risk of loss for an LLC liability to the extent of the value of any property that the member contributes to the LLC solely for the purpose of securing that LLC liability.

   (iii) A promissory note of the member or related person that is contributed to the LLC shall not be taken into account, unless the note is readily tradable on an established securities market.[7]

b. **It is not true that all LLC liabilities are nonrecourse**. A liability may be recourse in cases of a **deficit restoration obligation**. **Nonrecourse LLC liability** is defined, for purposes of §752, as an LLC liability for which no member or related person bears the economic risk of loss. Under the regulations, members generally share nonrecourse liabilities in accordance with their interests in LLC profits. However, the regulations use a three-tier[8] allocation process that requires the nonrecourse liabilities of an LLC to be allocated between the members first to reflect the following:

   (i) The member's share of LLC **minimum gain** determined in accordance with the rules of §704(b) and the regulations thereunder (the "Tier 1 Allocation");[9]

   (ii) The amount of any **taxable gain** that would be allocated to the member under §704(c) (or in a similar manner if LLC property is revalued) if the LLC disposed of all LLC property subject to one or more nonrecourse LLC liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration (the "Tier 2 Allocation"); and

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3 Treas. Regs. §1.752-1(a)(1).
4 Treas. Regs. §1.752-2(a).
5 Treas. Regs. §1.752-2(c)(1).
6 Treas. Regs. §1.752-2(h)(1).
7 Treas. Regs. §1.752-2(h)(4).
8 Treas. Regs. §1.752-3(a).
9 LLC minimum gain is defined as the gain that an LLC would realize if it disposed of all LLC property subject to nonrecourse liabilities in full satisfaction of the liabilities, and for no other consideration. Treas. Regs. §1.704-2(d)(1).

 

(iii) The member's share (determined by **profit-sharing percentage**) of **excess nonrecourse liabilities** (defined as nonrecourse liabilities not allocated under (i) or (ii) above) (the "Tier 3 Allocation").[10]

### *2. General rule for determining basis*

Because of the many ways in which discrepancies can be created, accountants should not assume that there is a fixed relationship between a partner's capital account and that partner's basis in the partnership. Adjustments in the partners' bases in their interests are also required to reflect decreases and increases in the basis of partnership property resulting from investment-tax credits or recapture. What are they?

a. What was the partner's initial basis?

(i) If the interest was acquired by purchase, gift, bequest, or other transfer, the partner's initial basis is determined under the rules that apply generally to determine the basis of property.[11]

(ii) When the interest is acquired by a contribution to the partnership, the basis equals the sum of:

- The amount of money contributed; and
- The basis of any property contributed.[12]

(iii) If the partnership interest is acquired by a contribution of services, the transaction is treated as if the partner received cash equal to the fair market value of the partnership interest and then purchased the partnership interest with such cash.

(iv) Under established federal income tax principles, a taxpayer's basis in property can exceed the net equity in the property if the property is subject to liabilities or if liabilities are assumed in connection with acquisition of the property.[13] This principle, together with the aggregate (as opposed to entity) principles that govern many aspects of partnership taxation, serve to allocate partnership liabilities among the partners according to the following two rules:

- An increase in a partner's share of partnership liabilities (or in a partner's personal liabilities because of the partner's assumption of partnership liabilities) is treated as a contribution of money by the partner to the partnership;[14] and
- A decrease in a partner's share of partnership liabilities (or in a partner's individual liabilities because of the partnership's assumption of such liabilities) is treated as a partnership distribution of money to the partner.[15]

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10 Generally, the amount of LLC nonrecourse deductions for a given taxable year equals the net increase in LLC minimum gain during the year reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in LLC minimum gain. Treas. Regs. §1.704-2(c).

11 I.R.C. §742; Treas. Regs. §1.742-1.

12 I.R.C. §722.

13 See *Crane v. Commissioner*, 331 U.S. 1 (1947).

14 I.R.C. §752(a).

15 I.R.C. §752(b).

 

(v) Because of these deemed contributions and distributions, changes in a partner's share of partnership liabilities affect the partner's basis in the partnership. These deemed contributions and distributions have the same tax effects as actual contributions and distributions, and a partner can recognize taxable gain from a deemed distribution.

(vi) Note that the accrued but unpaid expenses and accounts payable are not treated as partnership liabilities for these purposes. Accordingly, such liabilities are treated solely as the contributing partner's.[16]

b. What adjustments are required to the basis of a partner's interest to reflect the history of the partner's participation in the partnership under §705(a)?[17]

(i) The basis is increased to reflect additional contributions and the partner's distributive share of partnership income (including nontaxable income).[18]

(ii) The basis is decreased (but not below zero) to reflect partnership distributions[19] and the partner's distributive share of partnership losses (including **nondeductible expenses that are not properly chargeable to capital account**).[20]

***Note:***

The phrase "nondeductible expenditures **not properly chargeable** to capital account" is unfortunate phraseology. It appears to refer only to those expenditures that are not currently deductible or recoverable through depreciation, amortization, inventory, or disposition of a created asset. Thus, the cost of raw land or a depreciable building does not cause a basis decrease. On the other hand, the payment of life insurance premiums (except to the extent it results in a cash-surrender-value increase) by a partnership should reduce the partners' bases.

### *3. Solution*

Most of the errors can be avoided by maintaining historical worksheets[21] for a partner's basis in the partnership. The following begins with a beginning basis at the beginning of the partnership taxable year.

***Note:***

As the grid indicates, there are several basis limitations for distributions, current losses, and carryover losses. The worksheet, in addition to making the basis adjustments required by §705, §733, and §752, determines: (i) the existence and amount of gain recognized by reason of a distribution; (ii) the extent to which current losses are deductible; (iii) the amount and character of any suspended losses; (iv) the extent to which carryover losses are currently deductible; and (v) the amount and character of any carryover losses that remain suspended.

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16 Rev. Rul. 88-77, 1988-2 C.B. 128: "For purposes of computing the adjusted basis of a partner's interest in a cash basis partnership, accrued but unpaid expenses and accounts payable are not liabilities of a partnership" or "partnership liabilities" within the meaning of section 752 of the Code."

17 I.R.C. §705(a).

18 I.R.C. §§705(a)(1)(A) and (B).

19 I.R.C. §705(a)(2).

20 I.R.C. §§705(a)(2)(A) and (B). Note that the adjustment for distributions is made before the adjustments for losses and expenditures. Treas. Regs. §1.705-1(a)(1); Rev. Rul. 66-94, 1966-1 C.B. 166.

21 Fortunately, modern tax software from a reliable vendor automatically produces such a worksheet. As a sidebar, when you accept a client which is already established, it would be wise to suggest that your engagement include determining whether basis is correct from the years before your engagement. Bad basis is like malaria. It never goes away.

 

| Worksheet for Basis in a Partnership | | |
|---|---|---|
| Beginning basis | | 1. _____ |
| Initial share of debt basis | 2. _____ | |
| Ending share of debt basis | 3. _____ | |
| Net change in debt basis (Line 3 - Line 2) | 4. _____ | |
| Taxable income | 5. _____ | |
| Nontaxable income | 6. _____ | |
| Upward adjustments (Line 5 + Line 6 + Line 4 (if positive)) | | 7. _____ |
| Tentative basis (Line 1 + Line 7) for distribution purposes | | 8. _____ |
| Actual distributions (money and adjusted basis of property) | 9. _____ | |
| Net decreases in share of debt basis (Line 4 (if negative)) | 10. _____ | |
| Total distributions (Sum of Lines 9 through 10) | 11. _____ | |
| Downward adjustments (Smaller of Line 8 and Line 11) | | 12. _____ |
| Tentative basis (Line 8 - Line 12) for loss purposes | | 13. _____ |
| Amount realized (Greater of Line 11 and Line 8) | 14. _____ | |
| Gain recognized (Line 14 – Line 8) | 15. _____ | |
| Current deductible losses | 16. _____ | |
| Current nondeductible expenditure not chargeable to capital account | | 17. _____ |
| Total current losses (Sum of Lines 16 through 17) | 18. _____ | |
| Allowable current losses (Smaller of Line 18 and Line 13) | | 19. _____ |
| Tentative basis (Line 13 – Line 19) | 20. | |
| Excess current losses (Line 18 – Line 19) | 21. _____ | |
| Deductible percentage (Line 16/Line 18) | 22. _____ | |
| Nondeductible percentage (Line 17/Line 18) | 23. _____ | |
| Suspended deductible loss (Line 22 x Line 21) | | 24. _____ |
| Suspended nondeductible expenditures (line 23 x Line 21) | | 25. _____ |
| Current allowable deductible loss (Line 16 – Line 24) | 26. _____ | |
| Carryover deductible losses | 27. | |
| Carryover nondeductible expenditure not chargeable to capital account | 28. | |
| Total carryovers (Sum of Lines 26 through 27) | 29. | |
| Allowable carryovers (Smaller of Line 20 and Line 29) | 30. | |
| Ending basis (Line 20 - Line 30) | 31. | |
| Loss carryover to next year (Line 29 - Line 30) | 32. | |
| Deductible percentage (Line 27/Line 29) | 33. | |
| Nondeductible percentage (Line 28/Line 29) | 34. | |
| Suspended deductible loss (Line 33 x Line 32) | 35. | |
| Suspended nondeductible expenditures (line 34 x Line 32) | 36. | |
| Current allowable deductible loss (Line 27 – Line 35) | 37. | |

## B. Passive loss rules

As a result of the COVID-19 pandemic, it is anticipated that more businesses will experience losses than in prior years. As a result, it is important to understand and review loss limitations.

Additionally, Form 1065 and Schedule K-1 instructions require partnerships to indicate if they have aggregated activities for purposes of the at-risk limitation rules under §465. The Schedule K-1 instructions require the partnership to identity the at-risk activity, the items of income, loss, or deduction for the activity, other items of income, loss, or deduction, partnership liabilities, and any other information that relates to the activity, such as distributions and partner loans. This requirement makes it increasingly important for practitioners to understand the at-risk rules.

### *1. Renting to the corporation*

Many taxpayers avoid the potential double tax in a C corporation with respect to real estate by having the shareholder own the property and lease it to the corporation. In a case in which the real estate generates positive net rental income there are several traps that must be considered to be able to use the passive income from the rental to absorb current and suspended passive losses.

a. The Code and regulations have a number of exceptions designed to prevent taxpayers from easily offsetting passive losses by recharacterizing income as nonpassive. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year.[22]

b. While material participation by a shareholder as such, as distinct from by the C corporation, generally does not matter, for these purposes it **does** matter. If the taxpayer, in connection with an activity conducted by a C corporation in which he owns an interest, does sufficient work to qualify as materially participating, then a rental by the taxpayer to the C corporation of property used in that activity is treated as nonpassive income.

***Note:***

This rule, however, does not apply to net losses, so a net rental loss will be treated as passive irrespective of the shareholder's involvement in the business operations of the corporation. The owner of the property will be able to treat the net rental income as passive if he does not materially participate.

c. While there are no attribution rules regarding the ownership of the stock, there are rules regarding the attribution of material participation. In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer must be taken into account.[23] If the owner was already materially participating in the corporation's activities, they would be attributed to his spouse, who now finds the net rental income characterized as nonpassive by reason of her actual ownership interest in the corporation coupled with her deemed material participation in the activities of the corporation.

### *2. Avoiding passive-loss limitations*

Leasing is generally a passive activity. A recent case held that the 50-percent owner of a C corporation could claim a net loss from an equipment-leasing activity on Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, of the federal income tax return because the activity was not treated as leasing.[24] In that case, the corporation engaged both in construction and real estate sales with respect to both of which the taxpayer provided services. When the corporation found itself in a precarious financial condition

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22 Treas. Regs. §1.469-2(f)(6).

23 I.R.C. §469(h)(5).

24 *Blewett v. Commissioner*, T.C. Summary Opinion 2001-174.

 

that precluded it from leasing or purchasing equipment on credit, the shareholders separately purchased the necessary equipment in their individual names and separately leased it to the corporation.

a. A rental activity is generally treated as a passive activity without regard to whether the taxpayer materially participates. However, the regulations permit an activity involving the use of tangible property to be treated as not a rental activity, if the rental of the property is treated as incidental to a nonrental activity of the taxpayer, if it meets three requirements:[25]

(i) The taxpayer owns an interest in the trade or business activity;

(ii) The property was predominantly used in the trade or business activity during the tax year or during at least two of the five tax years that immediately precede the tax year; and

(iii) The gross rental income from the property is less than two percent of the lesser of: (a) the unadjusted basis of the property; and (b) the fair market value of the property.

***Planning point:***

The second item can generally be met under the first option by an exclusive lease during the tax year; but do not forget that it could be met in later years as well.

One of the aggressive features of the first item above in these circumstances is that, contrary to the Service's position, the rental activity and the trade or business activity do not have to be conducted by the same entity.[26] It is irrelevant that the equipment leasing activity of the taxpayer's sole proprietorship was not incidental to any other trade or business activity of the sole proprietorship. The regulations merely require that the taxpayer own **an interest in the trade or business activity**, not that the taxpayer be the sole owner of the trade or business. By reason of ownership of a corporation and involvement in its trade or business activities, the taxpayer's trade or business activities included those of the corporation. The regulations specifically permit a taxpayer to group an activity conducted through a C corporation subject to §469 with another activity of the taxpayer for purposes of determining whether the taxpayer materially or significantly participates in the **other** activity.[27] A C corporation is subject to the passive-loss rules if it is a personal service corporation or closely held corporation. If the taxpayer materially participates in the trade or business activities of the corporation, the material-participation standard is automatically met with respect to the leasing activity. Thus, a taxpayer's losses are not nondeductible passive losses, because the taxpayer is not engaged in a leasing activity; instead the activity is the trade or business of the corporation in which the taxpayer is materially participating.

The third item above is often problematic but can be met by the simple expedient in this case of not charging any rent. There is no requirement that rent be charged.

b. What is the taxpayer doing in this situation? By not charging fair rental, the taxpayer is foregoing current income (in the form of rent) but deferring it to a later year (at least in the case of a C corporation) when the cash not taken will be realized in the form of gain on disposition. This seems to create double taxation by increasing the corporation's income by the amount of the cash not taken, but the shareholder is obtaining the current benefit of depreciation deductions on the leased equipment that can be used to reduce the

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[25] Temp. Regs. §1.469-1T(e)(3)(vi)(C).

[26] The Tax Court rejected in *Blewett* the Service's interpretation of its own regulations that: (i) the taxpayer at least temporarily stops using property in his trade or business and start using the property in a rental activity; and (ii) the exception is not available when the property is used in the rental activity and the trade or business activity simultaneously.

[27] Treas. Regs. §1.469-4(d)(5)(ii).

 

taxpayer's current taxable income without regard to the passive-loss rules. It is necessary to look at the relative tax brackets of the individual and the corporation.

(i) If the corporation is in a zero-percent tax bracket and the shareholder is in the 35-percent bracket, the corporation cannot use the deduction for depreciation anyway (for property used in its trade or business) currently, so the individual taxpayer's benefit must be compared to: (a) the corporation's deferred net-operating-loss (NOL) deduction that it would have had, had it purchased the equipment itself; and (b) the deferred capital-gains tax on the sale by the corporation of the appreciation attributable to the cash the corporation did not pay its shareholder. Even assuming a 15-percent capital-gains tax rate, if the NOL would be utilized in a year in which it covers taxable income that would otherwise be taxable at the 15-percent tax rate, the strategy outlined here produces overall savings.

***Planning point:***

One might press the envelope further. The case only dealt with the application of the passive-activity rules, but it did not dismiss the taxpayer's use of Schedule C. Does this mean that the equipment is trade or business property by reason of the attribution of trade or business activity from the corporation? If so, and neither the court nor the Service raised the issue of Schedule E, then would the taxpayer's interest paid on the financing of such property be trade or business interest? Aggressive planners may be able to leverage the benefits here.

## C. At-risk rules

### *1. It is a risky business*

The most **underused** form in tax practice with respect to business clients is Form 6198. It can uncover a major problem that arises in LLCs and pass-through entities. As noted earlier, the amount of currently deductible losses an owner of such an entity can take is limited by the taxpayer's adjusted basis in the business interest. But it is a mistake to think that the inquiry is over.

In the case of an individual engaged in a trade or business for the production of income, any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is **at risk** for such activity at the close of the taxable year.[28]

The at-risk basis limitations do not apply to the PTEs directly; however, they apply to each PTE owner's allocable share of net losses, deductions, and credits attributable to each activity.

[28] I.R.C. §§465(a)(1), (c)(3)(A).

 

A loss from an activity in excess of the **amount at risk** is disallowed. In the case of an individual engaged in a trade or business for the production of income, any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk for such activity at the close of the taxable year.[29] For these purposes, a loss is defined as the excess of the deductions allowable and allocable to the activity over the income received or accrued by the taxpayer from the activity.[30] Likewise, income for these purposes includes any amount of gross income regardless of character.[31]

***Practice Note:***

Form 1065 and Schedule K-1 instructions require partnerships to indicate if they have aggregated activities for purposes of the at-risk limitation rules under §465. The 2021 Schedule K-1 instructions require the partnership to identity the at-risk activity, the items of income, loss, or deduction for the activity, other items of income, loss, or deduction, partnership liabilities, and any other information that relates to the activity, such as distributions and partner loans. This new requirement makes it increasingly important for practitioners to understand the at-risk rules.

In general, no member of a limited liability company is responsible for any of the LLC's liabilities. In the case of an LLC, the at-risk rules generally apply because the lender cannot look to the members for recourse. LLCs provide broad exculpation from the liabilities of the LLC. There may be some instances in which the structure of certain relationships among the members or the lender may trigger the application of these rules as well.

However, in the case of an LLC, all loans to the entity are generally nonrecourse, because no member is personally liable by definition. Thus, even in cases where the loans are not by their terms nonrecourse, an LLC must pay attention to the at-risk rules generally.

**It is a big mistake to assume that the calculation of the adjusted basis in the business is the same as the amount at risk.**

The amount at risk in an activity includes money contributed to the activity by a taxpayer.[32] A future promise to make a contribution to the activity does **not create an amount at risk** until such contribution is in fact made, even though the partnership or LLC has an enforceable right against the partner or member.[33] The proposed regulations also include the amount paid for an interest in an activity even though this does not represent money "contributed" to the activity.[34] If a partner or member contributes property to an activity, the partner or member is at risk with respect to the adjusted basis of such property.[35]

In the case of real estate, a large part of the venture consists of loan proceeds, and often much of the loss arising from depreciation arises from the basis in the real estate by reason of its investment. If the partner or member is **personally liable** for the loan, the loan amount is considered an amount at risk. Personal liability is not enough. The liability must **not be subject to indemnification**; the partner must be the obligor of last resort. In addition, the obligation must be unconditional and not subject to any

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29 I.R.C. §§465(a)(1), (c)(3)(A).
30 I.R.C. §465(d).
31 Prop. Regs. §1.465-22(c)(1).
32 I.R.C. §465(b)(1)(A).
33 Prop. Regs. §1.465-22(a).
34 Prop. Regs. §1.465-22(d).
35 I.R.C. §465(b)(1)(A).

 

contingencies. If the recourse (personal) nature of the liability could become nonrecourse, the obligation is not unconditional. A contingent obligation is not included in the amount at risk.[36]

The amount at risk is **increased** by the excess of the taxpayer's share of all income, regardless of character, over the taxpayer's share of allocable deductions.[37] As a consequence, the loss disallowed during the taxable year is reduced by the income for the current year.[38] The extent to which the taxpayer is at risk is determined as of the end of the entity's taxable year.[39]

Most real estate is financed by nonrecourse loans, not recourse loans. The general aim of the at-risk rules is to deny an amount at risk for the amount of any nonrecourse loan.[40] This means that tax basis, which includes all nonrecourse liabilities, is not necessarily the same as the amount at risk. But this does not mean that one just adds the capital account (in the case of a partnership) only to the recourse liabilities allocated to the owner.

Some **recourse loans** are **not** an **amount at risk** and some **nonrecourse loans** can give rise to an **amount at risk**.

a. A creditor who also has a financial interest in the activity is viewed as not having a real debt, and the borrower has no amount at risk on account of the loan.[41] The proposed regulations state that an "interest" in the activity means a capital interest or an interest in net profits, and that an interest in gross receipts is not an interest.[42]
b. The problem is that the rule denying at-risk status to such loans extends to lenders who are related to a person with an interest in the activity. A person is related to a person who has an interest in the activity if the relationships are one of those enumerated in §§267(b) and 707(b), using a 10-percent-ownership test rather than a 50-percent-ownership test,[43] or if they are engaged in businesses under common control.[44] So even though the loan may be recourse as to an owner, if a member of the owner's family loaned the money it would not be.
c. Correspondingly, just because there is an amount of nonrecourse liability on the K-1 does not mean that it cannot create an at-risk amount. If such loan is secured by property, there is an amount at risk. This does not apply, however, to property used in the activity.[45]
d. There is, however, one very important exception to the nonrecourse rule that only applies to real estate activity. The amount of a **qualified nonrecourse financing** may be included in the amount at risk.

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36 Prop. Regs. §1.465-6(c).
37 Prop. Regs. §1.465-22(c)(2).
38 Prop. Regs. §§1.465-2(a) and 1.465-11(c).
39 Prop. Regs. §1.465-1(a).
40 I.R.C. §465(b)(2).
41 I.R.C. §465(b)(3)(A).
42 Prop. Regs. §1.465-8(b)(1).
43 I.R.C. §465(b)(3)(C)(i).
44 I.R.C. §465(b)(3)(C)(ii).
45 I.R.C. §465(b)(2)(B); Prop. Regs. §1.465-25.

 

***Note:***

For these purposes, a loan will constitute qualified nonrecourse financing if it meets four conditions.

(i) The taxpayer must borrow the money with respect to the activity of holding real property.[46] A taxpayer will only be considered at risk with respect to its share of qualified nonrecourse financing secured by real property used in the activity of holding real property.[47] For these purposes, the activity of holding the real property includes the holding of personal property and the provision of services that are incidental to such activity if real property is made available as living accommodations.[48]

(ii) The lender must be a federal, state, or local government or government instrumentality; or the guarantor of the loan must be a federal, state, or local government.[49] Alternatively, the lender can be a **qualified person** who meets the following four criteria:[50]

- The lender must be **actively and regularly engaged in the business of lending money**;
- The taxpayer **cannot have acquired the property from the lender** or from a person related to the lender;
- The lender cannot receive a fee with respect to the taxpayer's investment in the real property, or be related to a person who receives such a fee; and
- If the lender is a **related person** with respect to the taxpayer, the financing must be **commercially reasonable** and on **substantially the same terms** as loans involving unrelated persons.[51]

(iii) There is no personal liability for the repayment of the loan.[52]

(iv) The lender cannot convert the debt into an equity interest in the activity of holding the real property.

Partnerships and LLCs as such are not subject to the at-risk rules, but the rules do apply to partnership and LLC distributive losses and deductions at the **partner/member level**. Special rules apply to a partnership or LLC.

- A partner or member is considered at risk with respect to any money contributed to capital to the extent it is allocable to a specific activity.[53] The at-risk amount only arises when the contribution is actually made; a promissory note cannot be treated as at risk unless and until it is paid.[54]
- In the case of a loan to the activity, each partner or member will be at risk only for the portion of the debt that the partner is ultimately responsible for, taking into account any rights of contribution.[55] In the case of a loan to an LLC because no member is ultimately responsible for any portion of the debt, no member is at risk with respect to the loan.

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46 I.R.C. §465(b)(6)(B)(i).
47 I.R.C. §465(b)(6)(A).
48 I.R.C. §465(b)(6)(E)(i).
49 I.R.C. §§465(b)(6)(B)(ii) and 465(b)(6)(D)(i).
50 I.R.C. §465(b)(6)(D)(i); see also I.R.C. §49(a)(1)(D)(iv).
51 I.R.C. §465(b)(6)(D)(ii).
52 I.R.C. §465(b)(6)(B)(iii).
53 Prop. Regs. §1.465-22(a).
54 Prop. Regs. §1.465-22(a).
55 Prop. Regs. §§1.465-6(b) and 1.465-24(a)(2).

 

***Planning point:***

> In the case of a partnership, a member who loans money to the partnership ordinarily has joint and several liability of the members to look to for repayment and is treated as protected against loss to the extent that other partners are liable to him. To increase the amount at risk to the full amount, the loan would have to be fully nonrecourse as against the other partners, such as where recourse is limited to partnership assets.
>
> However, in the case of an LLC, the loan is by definition (absent guarantees) nonrecourse as against other members. Consequently, a loan to an LLC should enable a member to obtain an amount at risk with respect to the full amount of the loan.

Qualified nonrecourse debt must be allocated among the partners or members in the same manner that the partnership or LLC liabilities are allocated among its partners or members.[56] While a loan by a partner or a person related to the partner would not qualify as nonrecourse because the lending member bears the risk of loss, qualified nonrecourse financing will qualify as nonrecourse for partnership liability allocation purposes, if the partner (or a related person who makes the loan) has a 10-percent-or-less interest in each item of income, gain, loss, deduction, or credit of the partnership.[57]

### *2. Recording amount at risk*

Each year, the amount at risk must be calculated to determine the effect of the at-risk rules for that year. This calculation must take into account the **historical record** of the activity and the partner's history. In this respect, it is similar to the historical accounting that must be undertaken for a partner's basis.

- A distribution of money results in a decrease in the amount at risk by the amount of money distributed.[58]
- A distribution of property (perhaps encumbered) from the activity reduces the amount at risk by the adjusted basis of the property.[59]

A taxpayer's amount at risk in an activity is increased by an amount equal to the excess of the taxpayer's share of all items of **income received or accrued** from the activity during the taxable year **over the taxpayer's share of allowable deductions** which are allocable to the activity for the taxable year. A taxpayer's amount at risk in an activity is also increased by the taxpayer's share of tax-exempt receipts from the activity.[60] (For these purposes, the deductions are allowable based solely on the tax basis limitation and without regard to the passive activity loss limitations.)

### *3. Repayments of debt*

In reverse of the rule for incurring debt, if the debt is paid down, there is no change in the amount at risk if the loan is recourse, but if the partner's amount at risk is nonrecourse, the rule is different. To the extent a taxpayer's amount at risk was increased by a portion of a nonrecourse liability, the taxpayer's repayment of that portion of the liability will be treated in the same manner as the repayment of a loan for which the taxpayer is personally liable. However, to the extent the amount of the liability exceeds the net fair market value of property not used in the activity that secures the loan, repayment of that portion of the liability is considered as the repayment of a loan for which the taxpayer is not personally liable and has not pledged property used outside the activity. Repayments of the loan are considered to be made first in respect of the portion of the loan that exceeds the net fair market value of property not used in the activity that

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56 I.R.C. §465(b)(6)(C).
57 Treas. Regs. §1.752-2(e)(4).
58 Prop. Regs. §1.465-22(b).
59 Prop. Regs. §1.465-23(c).
60 Prop. Regs. §1.465-22(c)(1).

 

secures the loan. If a portion of an amount borrowed is used in the activity and a portion is used outside the activity, repayment will be considered made first in respect of the portion used outside the activity.

When a taxpayer's amount at risk was not increased as a result of the rule concerning nonrecourse liabilities, a subsequent repayment of the loan by the taxpayer will increase the taxpayer's amount at risk to the extent of the repayment.

a. However, if the amount used to repay the loan would not have increased the taxpayer's amount at risk in the activity if the amount had been contributed to the activity, the repayment will not increase the taxpayer's amount at risk. Thus, for example, if a nonrecourse loan (the proceeds of which were used in the activity) that did not increase the taxpayer's amount at risk is repaid with money borrowed by the taxpayer with a second nonrecourse loan secured only by property used in the activity, the taxpayer's amount at risk will not be increased by the repayment.

b. When a nonrecourse liability is repaid with assets already used in the activity, the taxpayer's amount at risk will not be affected as a result of the repayment. Therefore, when a partnership incurs such a liability and thereafter repays it with assets used in the activity, no partner's amount at risk is affected upon the incurrence of the liability or upon repayment.

### *4. Recapture*

A major danger in an LLC (and somewhat less so in a partnership) is the potential triggering of income by reason of the at-risk rules where the other applicable income-tax rules would create income.

***Example:*** P owns a partnership interest in a rental real estate project. Last year was the first year of the partnership to which P contributed $60,000 and was allocated liability in the amount of $100,000. The first-year loss was $30,000. Because P had a $160,000 tax basis, there was no apparent problem with taking the deduction, given that P was solely engaged in real property businesses. The liabilities were nonrecourse but not qualified nonrecourse financing. The allocated liabilities do not count as an amount at risk with respect to the partner. P had only $60,000 at risk, but he nonetheless had a $160,000 tax basis. Thus, the prior year’s loss was allowable not just by tax basis but also by the amount at risk.

This year, there was no loss (no income either), but P received a $40,000 distribution from the partnership. The tax basis: $160,000 less $30,000 prior-year loss equals $130,000, so a $40,000 distribution would not create any gain -- it would just reduce tax basis further to $90,000.

Had a Form 6198 been filled out last year, P’s $60,000 amount at risk would have been reduced to $30,000 by reason of that loss. Now even though there is no loss in the current year, the at-risk amount is affected by the distribution. This results in a negative $10,000 at risk. But the amount at risk cannot be reduced below zero.

 

When the amount at risk in an activity is reduced below zero, there is a **recapture** of a previously deducted loss to make books balance.[61] For these purposes, the amount included may not exceed losses from the activity previously claimed by the taxpayer reduced by amounts previously recaptured.[62] Since the tentative amount ($10,000) is less than the $30,000 of prior losses taken, it is fully included. If, in the following year, there was neither income nor loss but P received a distribution of $30,000, the amount at risk ($0, initially) seemingly generates a $30,000 item of income to offset the $30,000 reduction in amount-at-risk by reason of the distribution, but because there are now only $20,000 of previously unrecaptured losses ($30,000 losses - $10,000 recaptured loss in the current year), the amount of income is only $20,000.

**Don't confuse the distribution rule with the recapture rule**. P must include the amount as income from the activity; there is no basis for treating it as capital gain (unless the previous loss was a capital loss). Any gain recognized on the disposition of a partnership, partnership interest, or activity is considered to be income from the activity, and the partner or partners can reduce the gain with any losses that have been suspended under the at-risk rules.[63]

Such amount included in gross income is treated as a deduction allocable to such activity in the following taxable year. As a consequence, if there is a sufficient amount at risk in a succeeding year, P may once again take this deduction. But P's K-1 will not show whether a loss is suspended in the first instance or is recaptured and later available for deduction. It will be found, if at all, only on work papers and completed Form 6198s.

If P's K-1 in the following year reports income from the activity of $10,000, the amount at risk is increased by the $10,000 current year income, resulting in an increase in the amount at risk to $10,000, which can be completely offset by the $10,000 carryover loss from the prior year generated by the recapture. For tax basis purposes, P has already reduced basis by the recaptured loss and thus increases basis only by the then-current-year income. At that time, the loss or deduction will be subject to the passive-loss rules but its character as active or passive will be determined in the year the loss or deduction actually arose.

### *5. Guarantees*

The Service noted that a member who, through a contractual obligation, has ultimate responsibility for the debt is at risk with respect to such amount.[64] Accordingly, if an **LLC member** enters into an agreement with a creditor in his individual capacity, the member is at risk with respect to the liability.[65]

Suppose that each LLC member executed a personal guarantee for the payment of rent due under the lease agreement, and therefore, was jointly and severally liable for the rental obligation. The Service noted that a **guarantor of a partnership liability** is not at risk to the extent there is a right of reimbursement against any partner.[66] Accordingly, the Service concluded that each LLC member was at risk for purposes of §465, except to the extent the member has a right of reimbursement against the remaining members. If each member executed a personal guarantee for the payment of rent due under

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61 I.R.C. §465(e)(1).

62 I.R.C. §465(e)(2).

63 Prop. Regs. §1.465-12(a) **In general.** Income received or accrued from an activity includes gain recognized upon the disposition of the activity or an interest in the activity in accordance with §1.465-66. [Note that gain on disposition would not increase the basis of the interest in the partnership, however.]

64 *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987), *rev'g and remanding 85* T.C. 580 (1985); *Gefen v. Commissioner*. 87 T.C. 1471 (1986); *Abramson v. Commissioner*, 86 T.C. 360 (1986).

65 *Peters v. Commissioner*, 89 T.C. 423 (1987); *Brand v. Commissioner*, 81 T.C. 821 (1983).

66 *Brand v. Commissioner*, 81 T.C. 821 (1983).

 

the lease agreement and therefore was jointly and severally liable for the rental obligation, a guarantor of a partnership liability is not at risk to the extent there is a right of reimbursement against any partner.[67] A partner who, through a contractual obligation, has ultimate responsibility for the debt is at risk with respect to such amount.[68] If a member enters into an agreement with a creditor in his individual capacity, the member is at risk with respect to the liability.[69]

In the case of an individual engaged in a trade or business for the production of income, any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk for such activity at the close of the taxable year.[70] In general, no member of a limited liability company is responsible for any of the LLC's liabilities. In FSA 200025018, the Service concluded that LLC members who either agreed to pay a liability of the LLC in their individual capacities or **guaranteed a liability** are at risk for such amounts except to the extent such LLC members have right of reimbursement against the remaining members.[71]

a. In FSA 200025018, in the first scenario, the LLC entered into a stipulation of settlement, which provided for x number of monthly payments with interest. One member of the LLC executed the stipulation on behalf of the LLC and in his individual capacity. The Service noted that a partner who, through a contractual obligation, has ultimate responsibility for the debt is at-risk with respect to such amount.[72] Accordingly, if an LLC member enters into an agreement with a creditor in his individual capacity, the member is at risk with respect to the liability.[73]

b. In FSA 200025018, in the second scenario, each LLC member executed a personal guarantee for the payment of rent due under the lease agreement, and therefore, was jointly and severally liable for the rental obligation. The Service noted that a guarantor of a partnership liability is not at risk to the extent there is a right of reimbursement against any partner.[74] Accordingly, the Service concluded that each LLC member was at risk for purposes of §465, except to the extent the member has a right of reimbursement against the remaining two members.

c. A taxpayer is considered at risk for an activity with respect to amounts including the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and amounts borrowed with respect to such activity.[75] A taxpayer's amount at risk in an activity is increased by the amount of any liability incurred in the conduct of an activity to the extent the taxpayer is personally liable for repayment of the liability.[76] Also, when a partnership incurs a liability and, under state law, members of the partnership may be held personally liable for repayment of the liability, each partner's amount at risk is increased to the extent the partner is not protected against loss.[77]

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67 *Brand v. Commissioner*, 81 T.C. 821 (1983).
68 *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987), *rev'g and remanding 85* T.C. 580 (1985); *Gefen v. Commissioner*. 87 T.C. 1471 (1986); *Abramson v. Commissioner*, 86 T.C. 360 (1986).
69 *Peters v. Commissioner*, 89 T.C. 423 (1987); *Brand v. Commissioner*, 81 T.C. 821 (1983).
70 I.R.C. §§465(a)(1), (c)(3)(A).
71 FSA 200025018.
72 *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987), *rev'g and remanding 85* T.C. 580 (1985); *Gefen v. Commissioner*. 87 T.C. 1471 (1986); *Abramson v. Commissioner*, 86 T.C. 360 (1986).
73 *Peters v. Commissioner*, 89 T.C. 423 (1987); *Brand v. Commissioner*, 81 T.C. 821 (1983).
74 *Brand v. Commissioner*, 81 T.C. 821 (1983).
75 I.R.C. §465(b)(1)(A).
76 Prop. Regs. §1.465-24(a)(1).
77 Prop. Regs. §1.465-24(a)(2)(i).

 

***Question to ponder:***

What are some examples of ways a partner would be protected against such a loss?

d. A partner who, through a contractual obligation, has ultimate responsibility for the debt is at risk with respect to such amount.[78] If a member enters into an agreement with a creditor in his individual capacity, the member is at risk with respect to the liability.[79]

e. Each member executed a personal guarantee for the payment of rent due under the lease agreement, and therefore, was jointly and severally liable for the rental obligation; a guarantor of a partnership liability is not at risk to the extent there is a right of reimbursement against any partner.[80] Each member was at risk for purposes of §465, except to the extent the member had a right of reimbursement against the remaining two members.

***Note:***

Guarantees do **not** provide tax basis in a partnership or LLC unless and until paid, but the Service has indicated that they do provide at-risk basis in a limited liability company (but not a partnership). Guarantees can also convert a seemingly nonrecourse debt to a recourse debt, so allocation of entity debt can shift from some members to others by reason of this action (if not all of the members guarantee a debt).

### *6. At-risk limitations*

At-risk limitation calculations are much like calculating basis in a partnership interest or S corporation stock, but the nuances and differences primarily relate to the treatment of debt items attributable to the partner/shareholder. It is important to calculate at-risk basis independent of basis in the partnership interest/S corporation stock, as they frequently are not the same. Form 6198 is completed in reporting at-risk limitations. A form is prepared for each activity/group of activities.

Each owner's share of PTE items is dependent on the nature of the activity generating the allocable share of items, and thus, PTEs must report items of income, loss, deduction, and credit for each activity separately. The at-risk rules generally apply to any activity engaged in as a trade or business or to produce income. There is no statutory definition of "activity" prior to the application of any aggregation rule for purposes of §465.

As cited in Chief Counsel Advice (CCA 201805013), the term "activity" included in §465(c)(3) is intended to mean the "smallest indivisible piece or parcel of property, business asset, or integrated business unit in which the taxpayer possesses an ownership interest." With that definition in mind, it serves as a reminder that activities are not limited to filing entities or even EINs. The at-risk rules apply generally to any activity engaged in as a trade or business or to produce income. Each activity is treated as a separate activity for at-risk purposes, meaning losses generated by one activity cannot offset income from another activity. From a practical perspective, it is helpful to think of an activity as a business unit with a separate trial balance or subledger.

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78 *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987), *rev'g and remanding 85* T.C. 580 (1985); *Gefen v. Commissioner*. 87 T.C. 1471 (1986); *Abramson v. Commissioner*, 86 T.C. 360 (1986).

79 *Peters v. Commissioner*, 89 T.C. 423 (1987); *Brand v. Commissioner*, 81 T.C. 821 (1983).

80 *Brand v. Commissioner*, 81 T.C. 821 (1983).

 

Aggregating activities is generally available to the extent the PTE:

- Actively participates in the management of a trade or business; or
- The trade or business is carried on in the PTE where 65% of its losses for the tax year are allocable to person(s) who actively participate in the management of the trade or business.
    - Due to the distinction regarding the allocation of losses to 65% to actively participating individuals, only loss allocation percentages should be considered when making aggregation determination as profit sharing percentages are of no consequence.
    - Also, be on the lookout where waterfall applications apply since the economics of the allocations may change from one year to the next affecting the availability of grouping elections.

Generally, the aggregation rule only applies to activities that are conducted directly by a taxpayer. Since aggregation is based on active participation or the ownership of the PTE, aggregation may change frequently and does not require a statement indicating aggregation reporting changes have occurred. Due to the narrow view of activity for §465, aggregation cannot occur across multiple reporting or filing entities and should only occur within the filing of one tax return. This applies to partners/shareholders as well.

Additions to the amount at risk include:

- Money contributed, unless protected against loss;
- Adjusted basis of property contributed;
- With exceptions, amounts borrowed;
- Excess of the taxpayer's share of all income over the taxpayer's share of deductions from the activity; and
- Taxpayer's share of tax-exempt income from the activity.

Decreases to the amount at risk include:

- Amount of money withdrawn;
- Adjusted basis of property withdrawn from the activity;
- Taxpayer's share of nondeductible expenses relating to production of tax-exempt receipts; and
- Amount of loss allowed as a deduction under the at-risk rules.

**Similarities** between partnership interest/S corporation basis and at-risk basis are outlined below:

- **Contributions of Cash/Other Property:** Basis and at-risk basis are both increased by the amount of unencumbered cash and the adjusted basis of unencumbered property contributed to a partnership or S corporation (§465(b)(1)(A)).
- **Purchase of interest**: Purchasing an additional interest in an activity is treated as a contribution to the activity, and thus, increases at-risk basis in the activity (Prop. Reg. §1.465-22(d)).
- **Income/Gain/Loss/Deduction Adjustments**: Pro rata share of partnership and S corporation items of income, gain, loss, and deduction including tax-exempt income and nondeductible items increase and decrease the at-risk basis in the same manner as it does to the basis in the partnership interest or S corporation stock (Prop. Reg. §1.465-22(c)).

 

- **Carryforward of Disallowed Amounts**: If income/gain from an activity exceeds deduction/loss items, no at-risk limitation will apply. Deductions/losses exceeding income are allowed to the extent of at-risk basis with the remaining disallowed amount being carried forward to the succeeding taxable year with the same character as originally incurred (§465(d); Prop. Reg §1.465-38(b)). Carryforward is indefinite.
    - Effectively, losses and deductions cannot reduce at-risk basis below zero, similar to the general basis limitations.
- **Character of Disallowed Amounts**: Partially allowed deductions/losses and fully disallowed amounts are generally treated on a pro-rata basis to the extent of income.
    - Prop. Reg. §1.465-38(a) suggests ordering the allowed amounts as follows: (1) capital losses, (2) §1231 losses/deduction, (3) deductions that are non-tax preference items under §57, and (4) all items representing tax preferences under §57.
    - While the proposed regulations suggest this, the Form 6198 instructions describe allowing and disallowing amounts on pro rata basis consistent with the basis limitations (Reg §1.704-1(d)(2); Reg. §1.1366-2(a)(5)).
    - Most professional tax software will default to a pro rata treatment. This methodology will likely hold under audit.

**Differences** between partnership interest/S corporation basis interest and at-risk basis are outlined below:

- **Partnership Liabilities**: Partnership basis includes all allocable liabilities to the taxpayer whereas at-risk basis only considers recourse and qualified nonrecourse financing debt (§465(b)(6)).
    - Guarantees of partnership liabilities usually result in the liability allocation being treated as recourse for partnership basis purposes (Reg. §1.752-2). However, at-risk basis is increased only when payment is actually made on a guaranteed loan, and there is no legal right of indemnification for the paying partner(s) (Prop. Reg. §1.465-6(d)).
- **Contributions of Borrowed Funds**: A partner/shareholder cannot be at risk for amounts contributed to the interest/activity if the funds were borrowed from another taxpayer (or person related to another shareholder) with an interest in the same activity (§465(b)(3)).
- **Limited Amount At-Risk From Nonrecourse Liabilities, Guarantees, Stop Loss, and Other Arrangements**: Taxpayers protected against any loss through nonrecourse borrowing are not treated as at-risk to the extent of protection (§465(b)(4)), as excepted for qualified nonrecourse financing (§465(b)(6)).
- **Negative At-Risk Basis/Recapture of Prior Year Losses**: While basis in a partnership interest/shareholder stock cannot be reduced below zero, at-risk basis can be reduced by distributions to a taxpayer, recourse loans subsequently converted to nonrecourse loans, the initiation of a stop loss or similar arrangement (Prop. Reg. §1.465-3(b)).
    - **Negative at-risk basis** results in recapture of the negative at-risk basis for the lesser of (1) absolute value of the negative at-risk amount or (2) the total amount of at-risk losses previously deducted net of amounts previously recaptured (§465(e)(2)).
    - **Recaptured income** is treated as a deduction for the activity in the next taxable year (§465(e)(1)(b)).

 

- There is no guidance as to the character of the recapture, but points can be made that the income should retain the character to which the losses had been allowed. Most professional tax software will adopt a conservative approach and treat the recapture as ordinary income.

- **S corporation shareholder basis (including debt basis) is not necessarily the same as at-risk basis though debt basis is quite restrictive.**
  - Shareholder basis is generally increased by direct loans to the S corporation.
  - At-risk basis is increased only by the direct loans made to the S corporation where the shareholder is: (a) personally liable for the repayments of such amounts or (b) had pledged unencumbered property (not used in the activity) as security for the borrowed amount (§465(b)(2)).
    - A shareholder borrowing funds from a bank and then loaning funds to S corporation creates debt basis but will only create at-risk basis based on the terms of the note providing no indemnity to the borrowing shareholder.

***Example 1 – At-Risk Limitations:*** James Wright has a 50% interest in ABC Partnership. The allocable share of partnership liabilities and partnership activity for Year 3 are outlined below. His adjusted basis in the partnership interest at the beginning of year 3 was $7,000, and James received $2,000 of cash distributions from the partnership during the tax year. The at-risk basis at the beginning of the year was $1,000, and previously allowed at-risk losses totaled $1,500.

| Allocable Share Partnership Liabilities | BOY | EOY |
|---|---|---|
| Nonrecourse | $2,000 | $1,000 |
| Qualified Nonrecourse Financing | $5,000 | $4,200 |
| Recourse | $10,000 | $9,800 |
| Total | $17,000 | $15,000 |

| Allocable Share of K-1 Activity Items | Current Year | Carryover |
|---|---|---|
| Ordinary Income (Loss) | $(5,000) | $- |
| Rental Income (Loss) | $(3,000) | $- |
| Interest Income | $1,000 | $- |
| Charitable Contributions | $500 | $- |
| Nondeductible Expenses | $1,500 | $- |
| Total | $(5,000) | $- |

 

Year 3 allowed losses/deductions/expenses are $4,000, for purposes of basis limitations. The allowed amounts are then considered for at-risk basis purposes.

| Adjusted Basis, BOY | $7,000 |
|---|---|
| Current year income items | $1,000 |
| Current capital contributions | $- |
| Current year change in liabilities | $(2,000) |
| Distributions | $(2,000) |
| Adjusted basis used for basis limitation | $4,000 |

| Losses/Deduction/Expenses | Current Year Loss/Ded/Exp | Prior Year CFWD | Regular Tax Allowed by Basis | Regular Tax CFWD |
|---|---|---|---|---|
| Ordinary Loss | $5,000 | $- | $2,000 | $3,000 |
| Rental Loss | $3,000 | $- | $1,200 | $1,800 |
| Charitable Contributions | $500 | $- | $200 | $300 |
| Nondeductible Expenses | $1,500 | $- | $600 | $900 |
| | $10,000 | $- | $4,000 | $6,000 |

Year 3 allowed at risk losses/deductions/nondeductible items will be as follows:

- Ordinary Loss of $500
- Rental Loss of $300
- Charitable Contributions of $50
- Nondeductible Expenses of $150

Note the current year losses couldn't create negative at-risk basis but distributions and decreases in at-risk liabilities can create negative at-risk basis and create the potential for recapture. The year 3 recapture will be $1,500, which is the amount of prior year at-risk losses allowed.

- Recapture is capped at the lesser of the absolute value of the current year negative at-risk basis and the previous allowed at-risk losses.

Carryforward items are available as a deduction in the subsequent tax year if there is sufficient at-risk regardless of there being sufficient basis in the partnership interest in the subsequent year.

- Because the items were previously allowed subject to the basis limitations, they will not be subsequently disallowed.

 

| Step 1: Determine Current Year Profit (Loss) | |
|---|---|
| Ordinary Loss/Rental Loss (allowed after basis limitation) | $(3,200) |
| Other Income (Interest) | $1,000 |
| Other deductions, expenses, losses, nondeductible items (allowed after basis limitation) | $(800) |
| **Current Year Profit (Loss) from Activity after basis limitations** | **$(3,000)** |
| Net Losses are allowed only to the extent of sufficient At-Risk basis. | |

| Step 2: Determine At-Risk Basis Before Losses/Ded/Exp | |
|---|---|
| Adjusted At-Risk basis, BOY | $1,000 |
| Current year increases | $- |
| Current year decreases: | |
| - Distributions | $(2,000) |
| - Decrease in qualified nonrecourse financing | $(800) |
| - Decrease in recourse | $(200) |
| Subtotal | $(2,000) |
| Recapture the $2,000 to the extent of previous allowed losses. As indicated in the facts, previously allowed losses were $1,500, thus, that is our recapture amount. | |
| **Current Year Increases:** capital contributions, increases in allocable share of recourse and qualified nonrecourse financing, and current year profit from activity | |
| **Current Year Decreases:** distributions, decreases in allocable share of recourse and qualified nonrecourse financing | |

| Step 3: At-Risk Limitations Allocations | | | |
|---|---|---|---|
| **Income Items** | **Total** | **Allowed Loss** | **At-Risk CFWD** |
| Interest Income | $1,000 | | |
| **Losses/Deduction/Expenses** | | | |
| Ordinary Loss | $2,000 | $500 | $1,500 |
| Rental Loss | $1,200 | $300 | $900 |
| Charitable Contributions | $200 | $50 | $150 |
| Nondeductible Expenses | $600 | $150 | $450 |
| Total | $4,000 | $1,000 | $3,000 |
| Current year losses allowed for at-risk purposes to the extent of income in the activity. | | | |
| At-risk carryforward amounts equal the current year loss from the activity due to there being no at-risk basis in the activity after considering decreases and changes in partnership liabilities. | | | |

***Example 2 – At-Risk Basis Limitations:*** Kathy Ferguson owns 30% of the outstanding stock of an S Corporation. The allocable shares of S corporation income, gain, expense, and loss items related to Year 5 activity are outlined below. Kathy received $3,000 in distributions from the S corporation during Year 5. Kathy has a $3,000 outstanding loan to the S corporation; however, her basis in the debt at the beginning of year 5 is $1,000. No payments on the outstanding loan were made to Kathy during the tax year. Additionally, her basis in the S corporation stock is $4,000 at the beginning of the year, and her at-risk basis at the beginning of the year was $2,000. Cumulative allowed at-risk losses are $500.

| Allocable Share of K-1 Activity Items | Current Year | Basis Carryover | At-Risk Carryover |
|---|---|---|---|
| Ordinary Income (Loss) | $(1,000) | $(500) | $(700) |
| Interest Income | $500 | $- | $- |
| Charitable Contributions | $1,000 | $- | $- |
| Nondeductible Expenses | $1,500 | $- | $- |
| Total | $2,000 | $(500) | $(700) |

| Stock Basis | | | Debt basis | |
|---|---|---|---|---|
| | | | Debt Basis, BOY | $1,000 |
| Stock Basis, BOY | $4,000 | | Income used to restore debt basis | $- |
| Current Year Capital Contributions | $- | | Loans made to S corp during year | $- |
| Current Year Income Items | $500 | | Less: Loan Repayments | $- |
| Less: income for debt restoration | $- | | Debt basis used for basis limitation | $1,000 |
| Less: distributions | $(3,000) | | Loss allowed against debt basis | $- |
| **Adj basis for basis limitation** | **$1,500** | | **Debt Basis, end of tax year** | **$1,000** |
| **Total Basis for Loss Limitation** | **$2,500** | | | |

| Losses/Deduction/Expenses | Current Year Loss/Ded/Exp | Prior Year CFWD | Total CY and PY | Total CY and PY % | Regular Tax Allowed by Basis | Regular Tax CFWD |
|---|---|---|---|---|---|---|
| Ordinary Loss | $1,000 | $500 | $1,500 | 60% | $600 | $900 |
| Charitable Contributions | $1,000 | $- | $1,000 | 40% | $400 | $600 |
| Nondeductible Expenses | $1,500 | $- | | | $1,500 | $- |
| Total | $3,500 | $500 | $2,500 | 100% | $2,500 | $1,500 |

Year 5 allowed at-risk losses/deductions/nondeductible items will be as follows:

- Ordinary Loss of $203.
- Charitable Contributions of $63.
- Nondeductible Expenses of $234.

Note the current year losses could not create negative at-risk basis but distributions and decreases in at-risk liabilities can create negative at-risk basis and create the potential for recapture. The year 5 recapture will be $500, which is the amount of prior year at-risk losses allowed.

- Recapture is capped at the lesser of the absolute value of the current year negative at-risk basis and the previous allowed at-risk losses.

Carryforward items are available as a deduction in the subsequent tax year if there is sufficient at-risk basis regardless of there being sufficient basis in the partnership interest in the subsequent year.

- Because the items were previously allowed subject to the basis limitations, they will not be subsequently disallowed due to a basis limitation.

| Step 1: Determine Current Year Profit (Loss) | |
|---|---|
| Ordinary Loss (Current Year and Prior Year Carryforward ($600 + $700)) | $(1,300) |
| Other Income (Interest) | $500 |
| Other deductions/expenses/losses/nondeductible items ($1500 nondeductible + $400 charitable contributions) | $(1,900) |
| Current Year Profit (Loss) from Activity | $(2,700) |
| Net Losses are allowed only to the extent of sufficient At-Risk basis | |

| Step 2: Determine At-Risk Basis Before Losses/Ded/Exp | |
|---|---|
| Adjusted At-Risk basis, BOY | $2,000 |
| Current year increases | $- |
| Current year decreases | |
| - Distributions | $(3,000) |
| - Loan repayment on S corporation debt | |
| Subtotal | $(1,000) |
| Recapture the $1,000 to the extent of previous allowed losses. As indicated in the facts, previously allowed losses not previously recaptured are in the amount of $500, thus, that is our recapture amount. | |
| **Current Year Increases:** capital contributions, additional qualifying loans made to S corp, and current year profit from activity | |
| **Current Year Decreases:** distributions, loan repayments on S corporation debt | |

| Step 3: At-Risk Limitations Allocation | | | |
|---|---|---|---|
| Income Items | Total | Allowed Loss | At-Risk CFWD |
| Interest Income | $500 | | |
| Losses/Deduction/Expenses | | | |
| Ordinary Loss | $1,300 | $203 | $1,097 |
| Charitable Contributions | $400 | $63 | $337 |
| Nondeductible Expenses | $1,500 | $234 | $1,266 |
| Total | $3,200 | $500 | $2,700 |

Since the at-risk basis includes certain debts attributable to PTE owners, these must be allocated to different activities as applicable. Debt basis is included in at-risk basis for PTE owners to the extent of actual contributions to the activity/activities without indemnity. PTE owner's guarantee of activity debt does not represent actual contributions and generally does not result in at-risk basis; payment on the guarantee can increase at-risk basis. Debt contributed to any specific activity(ies) should be noted by the PTE on Schedule K-1 to allow the PTE owner to determine the appropriate at-risk limitations on an activity-by-activity basis. For partnerships with multiple activities, details regarding the K-1 item liability allocations among activities should be provided to the PTE owners.

***§465 At-Risk Activity Reporting Example - Facts:***

Getting to Work HR Partners, LLC (HRP LLC) is a full-service recruiting and professional employer organization (PEO). For tax purposes, HRP LLC is a partnership with two divisions: one division dedicated to providing recruiting services and another division for the PEO services where HRP LLC engages in co-employment arrangements with clients to be the employer of record for its employees and provide administration for payroll and HR services.

HRP LLC is 80% owned by a PE group organized as an LP and does not actively participate in the management of either division, and functions much like a board of directors. The remaining 20% ownership is split 12% to Tammy, the recruiting division's president, and 8% to John, the PEO division's president.

John and Tammy participate in the management and decision making in their respective divisions but not in each other's division. All income, gains, losses, deductions, and credit items are shared according to their partnership percentages. Because the loss allocations are not 65% or more to partners directly involved in the management of HRP LLC, at-risk reporting requirements apply.

The recruiting division contributed 55% to all partnership Schedule K items, and the PEO division contributed 45% to the partnership Schedule K items. Below are samples of statements that should be provided to John and Tammy.

The partnership liabilities for the beginning of the year were 75% attributable to the recruiting activities and 25% attributable to the PEO activities. The partnership liabilities for the end of the year were 65% attributable to the recruiting activities and 35% attributable to the PEO activities. The recourse liability relates to a guarantee of partnership debt attributable to the majority PE owner.

The partnership paid guaranteed payments during the year totaling $310,000. Of the total, $160,000 were paid to Tammy, and the remaining $150,000 were paid to John.

Example of detailed statements that should be provided with the Schedule K-1 are as follows:

 

| HRP LLC Tax Reporting Items | Amounts |
|---|---|
| Box 1: Ordinary Income (Loss) | 400,000 |
| Box 4a: Guaranteed Payments for Services | 310,000 |
| Box 5: Interest Income | 15,000 |
| Box 13a: Charitable Contributions | 10,000 |
| Box 19a: | 20,000 |
| | |
| Nonrecourse Liabilities - Beginning of Year | 150,000 |
| Qualified nonrecourse financing - Beginning of Year | 20,000 |
| Recourse - Beginning of Year | 75,000 |
| | |
| Nonrecourse Liabilities - End of Year | 160,000 |
| Qualified nonrecourse financing - End of Year | 20,000 |
| Recourse - End of Year | 65,000 |

| HRP LLC Tax Reporting Items | Tammy (12%) | | |
|---|---|---|---|
| | Total Activity | Recruiting Division (§465 Activity) | PEO Division (§465 Activity) |
| Box 1: Ordinary Income (Loss) | 48,000 | 26,400 | 21,600 |
| Box 4a: Guaranteed Payments for Services | 160,000 | 160,000 | - |
| Box 5: Interest Income | 1,800 | 990 | 810 |
| Box 13a: Charitable Contributions | 1,200 | 660 | 540 |
| Box 19a: | 2,400 | 1,320 | 1,080 |
| | | | |
| Nonrecourse Liabilities - Beginning of Year | 18,000 | 13,500 | 4,500 |
| Qualified nonrecourse financing - Beginning of Year | 2,400 | 1,800 | 600 |
| Recourse - Beginning of Year | - | - | - |
| | | | |
| Nonrecourse Liabilities - End of Year | 19,200 | 12,480 | 6,720 |
| Qualified nonrecourse financing - End of Year | 2,400 | 1,560 | 840 |
| Recourse - End of Year | - | - | - |

| HRP LLC Tax Reporting Items | John (8%) | | |
|---|---|---|---|
| | Total Activity | Recruiting Division (§465 Activity) | PEO Division (§465 Activity) |
| Box 1: Ordinary Income (Loss) | 32,000 | 17,600 | 14,400 |
| Box 4a: Guaranteed Payments for Services | 150,000 | - | 150,000 |
| Box 5: Interest Income | 1,200 | 660 | 540 |
| Box 13a: Charitable Contributions | 800 | 440 | 360 |
| Box 19a: | 1,600 | 880 | 720 |
| | | | |
| Nonrecourse Liabilities - Beginning of Year | 12,000 | 9,000 | 3,000 |
| Qualified nonrecourse financing - Beginning of Year | 1,600 | 1,200 | 400 |
| Recourse - Beginning of Year | - | - | - |
| | | | |
| Nonrecourse Liabilities - End of Year | 12,800 | 8,320 | 4,480 |
| Qualified nonrecourse financing - End of Year | 1,600 | 1,040 | 560 |
| Recourse - End of Year | - | - | - |

** Note that neither the guaranteed payments nor the recourse debt will be split based on ownership percentage, but rather will be based on the economics.*

** Note the liabilities are not split to activities based on income/loss of activities but based on the percentages relative to that specific item (i.e., 75/25).*

Though the example provides that both activities generated income for the year in question, information must still be reported on an activity-by-activity basis so at-risk basis can be tracked annually and future losses can be considered according to the separate at-risk basis of both activities. If activities are being aggregated for purposes of §465, the appropriate box should be checked on page 1 of Form 1065 and/or Form 1120-S. No statement of aggregated activities is required to be attached to the return.

☐ Aggregated activities for section 465 at-risk purposes

Recently, Form 1065 instructions greatly expanded instructions regarding at-risk activity reporting, particularly regarding liability allocation, compared to those included in previous year instructions, making them a great resource in complying with the reporting obligations.

As previously noted, at-risk activities are not confined to entities with an EIN, and as such, practitioners will need to understand all businesses, service offerings, and the organizational structure of management to determine eligibility for aggregating activities. Using the organizational chart to identify disregarded entities can be a great starting tool, but the practitioner should always have comprehensive conversations annually to address changes within the organization. New at-risk reporting requirements can arise related

 

to M&A activity, whether taxable or nontaxable transactions, so practitioners should be watchful and consider additional implications related to acquisitions. When clients are executing various transactions throughout the year, this is a great opportunity to have a dialogue regarding how the activities will be integrated into the existing business, which can aid in understanding additional reporting requirements.

### *7. Passive Activity Losses (PALs)*

PALs restrict the utilization of losses and deductions along with the allowability of credits to the extent of passive income each year, with any excess amounts carried forward indefinitely.

- If a passive activity is **fully disposed**, the activity no longer meets the definition of a passive activity, and all carryforward items are released for utilization in claiming the carryover losses, deductions, and credits.
- **Portfolio income** (i.e., interest dividends, and capital gains) from passthrough income and directly allocable/related deductions are not considered from a passive activity for purposes of §469.
- **Charitable Contribution Deductions** are not considered in the passive activity loss limitations but are considered for both basis and at-risk basis limitation calculations. Nondeductible items are not considered in the passive activity limitations.
- **Guaranteed payments** (including partner health insurance premiums) are excluded from passive activity calculations and are included in the taxpayer's ordinary income regardless of the other types of income distributed by the partnership. It is worth noting that a partner receiving guaranteed payments will often meet the material participation requirements (as discussed later), and thus, not be subject to the passive loss limitations.

PALs apply to individuals, estates, trusts, closely held C corporations, and personal service corporations (§469(a)(2)). The closely held C corporation definition is the same as it is for the at-risk basis limitations (§465(j)(1)). Personal service corporations are characterized as such where the principal activity is the performance of personal services executed substantially by employee-owners. This definition is similar to the definition included in §269A(b)(1), with further details outlined in the instructions of Form 8810. PALs are calculated and presented on different forms depending on the type of taxpayers. Form 8582 is prepared for individuals, estates, and trusts, whereas Form 8810 is prepared for closely held C corporations and personal service corporations.

So what constitutes a passive activity? A passive activity is one in which the taxpayer did not:

- Materially participate in the activity, OR
- Engage in any rental activity, subject to specific exception.

**Material participation** is met by fulfilling one of the following seven tests (Temp. Reg. §1.469-5T(a)):

- **Test 1**: Participation is more than 500 hours in a given tax year;
- **Test 2**: Participation constitutes substantially all the participation of all individuals (both owners and non-owners);
- **Test 3**: Participates more than 100 hours in a year and more than anyone else;
- **Test 4**: Significant participation in the activity and all significant participation activities in aggregate exceeds 500 hours;
- **Test 5:** Prior year material participation in any five of the preceding ten taxable years;
- **Test 6**: Activity is personal service in nature and the taxpayer material participated in any three preceding taxable years; **OR**
- **Test 7**: Facts and circumstances (last resort, good luck)!

 

Rental Activities are passive activities by default (§469(c)(2)), subject to 8 exceptions outlined below:

- **Exception 1:** Real Estate Professionals (§469(c)(7))
- **Exception 2**: Average customer use of property is seven days or less (e.g., vacation condo) (Temp. Reg. §1.469-1T(e)(3)(II)(A))
- **Exception 3:** Average period of use is 30 days or less and significant personal services are provided (e.g., dude ranch)
- **Exception 4:** Extraordinary personal services are provided (e.g., boarding school dormitories, hospitals)
- **Exception 5**: Rental activity is incidental to the nonrental activity
- **Exception 6:** Property is available to nonexclusive customers during defined business hours (e.g., golf course)
- **Exception 7:** Taxpayer provides the property for use in a partnership, S corporation, or JV which the taxpayer owns an interest in (e.g., taxpayer solely owns warehouse that is used by S corporation distribution company the taxpayer is a shareholder of and provides the warehouse for use to the S corporation distribution company (PLR 9722007)
- **Exception 8**: A special $25,000 loss is allowed for a taxpayer and/or spouse that **actively participated** in a passive rental real estate activity, subject to phaseout rules. Losses in excess of $25,000 are still subject to the passive activity loss limitations.
    - Active participation is different from material participation and is less stringent.
    - IRS Publication 925 is a convenient tool for understanding the applicability of the active participation rules/exception.

Grouping Activities is also available, similar to the at-risk limitations. One or more trade or business activities, including rental activities, can be treated as a single activity/economic unit, which can allow a taxpayer to materially participate across several activities rather than a single activity, and thus, avoid PAL limitations. Grouping can also impact the active participation requirements for rental activities, so if a taxpayer is attempting to group rental activities, he should think holistically regarding the effects of all passive activities.

### *8. PAL limitation mechanics*

PALs are looked at in the aggregate of passive income against passive losses (§469(d)1)). Basis limitations and at-risk basis limitations look at an activity/entity-by-entity basis, while PALs bring all separate, passive activities together to look at a total loss/deduction/credit profile of a taxpayer in a given tax year. PALs are allocated to activities and within activities on a pro-rata basis in accordance with the regulations (§469(j)(4)). The $25,000 special loss allowance is also allocated to and within activities on a pro-rata basis like other passive loss limitations. The character of losses and deductions still apply, like both the basis limitations and the at-risk basis limitations. Closely held C corporations may offset active income to the extent of any net active income (§469(e)(2)). Net active income refers to the taxable income of the taxpayer for a taxable year without consideration for income or loss from a passive activity and portfolio income. Essentially passive activities cannot create an NOL.

The amounts being carried forward for a former passive activity are allowed in subsequent years to the extent of income/regular tax liability for such activity, with the unused balance being carried forward as though the unused losses/credits arose from a passive activity (§469(f)). Passive activity losses/deductions/credits are only completely freed up upon disposal. For the disposition of substantially

 

all of a passive activity, the carryforward amounts of disallowed losses, deductions, and credits are freed up to be used in the year of disposition and no longer carried forward (§469(g)).

Like the at-risk basis limitations, grouping activities is available, as Reg. §1.469-4(c)(1) defines an activity in terms of appropriate economic units. Regulation §1.469-4(c)(2) provides a facts and circumstances test for determining whether activities being grouped results in an appropriate economic unit. Factors to consider include: 1) similarities and differences in types of trades or businesses, (2) the extent of common control, (3) the extent of common ownership, (4) geography of activities, and (5) interdependencies between/among activities. Because grouping activities can result in activities being treated more beneficially than nonpassive activities, consideration should be given to this where a taxpayer has many activities.

Once a PTE groups activities, they should remain in effect unless a clear change in facts and circumstances makes the economic unit unsuitable for future periods.

Grouping may not occur in the following circumstances:

- Rental activities with a trade/business activity unless the rental activity or trade/business activity is an insubstantial activity to the other, or each owner has the same proportionate ownership in the rental activity.
- Rental activities of real property with rental activities of personal property.
- Certain activities related to motion picture films, farming, leasing §1245 property, or certain oil/gas activities.

Section 469 allows a PTE, in its capacity as a partner in another partnership, to group its holdings with each other, activities conducted directly through the PTE, or activities conducted through other PTEs. Groupings for purposes of §469 can occur across multiple entities/groups of entities. Activities grouped by a PTE cannot be treated as separate by the PTE owners. When a PTE chooses to treat activities as separate, this is also treated as a grouping decision, thus requiring a material change in facts and circumstances to choose to group activities in future periods. No election statement is required to be attached to the return to adopt a new grouping election for PTEs.

Anti-abuse provisions allow the IRS, upon audit, to regroup inappropriate economic units if the primary purpose of grouping is for tax avoidance. Grouping activities makes it easier to meet the material participation tests, and because §469 treats grouping based on economic units, grouped activities can be comprised of one activity across several entities or several interrelated activities in one entity. Material participation occurs when the reporting taxpayer/entity participates in the trade/business on a regular, continuous, and substantial basis. The IRS notes in TAM 201634022 that there can be more than one appropriate grouping of activities, and the IRS will only be successful in challenging groupings under §469 if the groupings are clearly inappropriate. The §469 reporting requirements are similar to at-risk reporting requirements from a Schedule K-1 statement/disclosure perspective.

PTEs are required to report the following information for each activity conducted by the PTE:

- Income, guaranteed payments, gain, deduction, loss, and credit items for each activity corresponding to the box numbers included on the face of the respective Schedule K-1;
- Identifying each activity as a trade or business activity, rental real estate activity, non-real estate rental activity, or portfolio activity;
- Identifying portfolio income and directly allocable expenses for each activity; and

 

- Identifying loans between the PTE and the PTE owner along with which activity/activities the loan was used for along with an allocation of self-charged interest between the activities based on the amount of the proceeds used in each activity.

This list is not exhaustive, and the instructions of Form 1065 and/or Form 1120-S should be referenced for additional details.

***§469 Passive Activity Loss Limitations Example 1:*** Moira has ownership interests in three separate distribution companies, Distributor 1, LLC (D1), Distributor 2, LLC (D2), and Distributer 3, S Corp Inc. (D3). Moira treats all activities as separate passive activities. After consideration of all relevant capital/debt basis limitations and at-risk limitations, the allowable income/losses, deductions, etc. are as presented below:

| Category (not representative of Schedule K-1 box numbers) | D1, LLC | D2, LLC | D3, S Corp |
|---|---|---|---|
| 1. Ordinary Income (Loss) | $(11,600) | $(1,200) | $12,000 |
| 2. Guaranteed Payments/Partner Health Insurance Premiums | $10,000 | | |
| 3. Interest income | | $4,000 | |
| 4. Rental Income (Loss) | $(3,600) | | |
| 5. Section 1231 Gain (Loss) Passive | | $(500) | |
| 6. Section 179 | $1,800 | | $4,000 |
| 7. Charitable Contributions | $1,000 | | $500 |
| 8. Nondeductible Expenses | $800 | $700 | $2,500 |
| | | | |
| **Prior Year Unallowed Amounts** | | | |
| 1. Ordinary Income (Loss) | $(1,000) | | $(4,500) |
| 5. Section 1231 Gain (Loss) Passive | | $(300) | |

Step 1 requires that we determine the overall gain or loss from all activities. This will consider current year amounts, and any carried forward disallowed losses/deductions amounts from prior year.

| Category (not representative of Schedule K-1 box numbers) | D1, LLC | D2, LLC | D3, S Corp | Total |
|---|---|---|---|---|
| 1. Ordinary Income (Loss) | $(11,600) | $(1,200) | $12,000 | |
| 2. Guaranteed Payments/Partner Health Insurance Premiums | $10,000 | | | |
| 3. Interest income | | $4,000 | | |
| 4. Rental Income (Loss) | $(3,600) | | | |
| 5. Section 1231 Gain (Loss) Passive | | $(500) | | |
| 6. Section 179 | $1,800 | | $4,000 | |
| 7. Charitable Contributions | $1,000 | | $500 | |
| 8. Nondeductible Expenses | $800 | $700 | $2,500 | |
| | | | | |
| **Activity Net Passive Income (1 + 4 + 5 - 6)** | | | **$8,000** | **$8,000** |
| **Activity Net Passive (Loss) (1+ 4 + 5 - 6)** | **$(17,000)** | **$(1,700)** | | **$(18,700)** |
| | | | | |
| **Prior Year Unallowed Amounts** | | | | |
| 1. Ordinary Income (Loss) | $(1,000) | | $(4,500) | $(5,500) |
| 5. Section 1231 Gain (Loss) Passive | | $(300) | | $(300) |
| **All Passive Activities Net Income (Loss)** | | | | **$(16,500)** |
| **Total Losses Allowed (to the extent of passive income)** | | | | **$8,000** |

Step 2 requires us to allocate allowed losses between activities on a pro rata basis for all loss activities.

| Loss Allocation Between Activities | D1, LLC | D2, LLC | D3, S Corp | Total |
|---|---|---|---|---|
| Overall Loss (Absolute Value) | $18,000 | $2,000 | **N/A Net Passive Income in Activity** | $20,000 |
| Ratio | 90% | 10% | | 100% |
| Unallowed Loss | $(14,850) | $(1,650) | | $(16,500) |
| **Allowed Loss** | **$3,150** | **$350** | **$4,500** | **$8,000** |

Step 3 requires us to allocate allowed losses within activities on a pro rata basis based on category.

| Unallowed Loss Carryforward Allocation within Activities * | D1, LLC | | | | D2, LLC | | | | D3, S Corp | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Total Activity Loss | Pro Rata % | Unallowed Loss | Allowed Loss | Total Activity Loss | Pro Rata % | Unallowed Loss | Allowed Loss | N/A - Net Passive | Total Unallowed Loss by Character |
| 1. Ordinary Loss/Rental Loss (Incl. Section 179) | $18,000 | 100.00% | $14,850 | $3,150 | $1,200 | 100% | $990 | $210 | | $15,840 |
| 2. Section 1231 Loss Passive | $- | | $- | $- | $800 | 0% | $660 | $140 | | $660 |
| **Total Carryforward** | **$18,000** | **100.00%** | **$14,850** | **$3,150** | **$2,000** | **100.00%** | **$1,650** | **$350** | | **$16,500** |

***§469 Passive Activity Loss Limitations Example 2:*** Partnership MP, LLC ("PMP") is in the business of investing in pretzel stands and movie theaters at shopping malls. At a mall in Indianapolis, PMP has a significant ownership interest in both a pretzel stand and movie theater. At another mall in Cincinnati, PMP has significant ownership in a separate pretzel stand and movie theater.

*Can Collin group his activities according to the §469 regulations?*
Yes! Depending on other relevant facts regarding common ownership, all of the following groupings may be permissible:

- **A single activity**: This would be appropriate if all activities have the same proportional ownership and the management between the activities is interrelated.
- **A movie theater activity and a separate bakery activity**: If management and control is treated separately between the movie theater and bakery businesses, a grouping based on similarity of activity may be most appropriate.
- **An Indianapolis activity and a Cincinnati activity**: If the operations and ownership between Indianapolis and Cincinnati businesses are distinct and separate, grouping based on geography may be most appropriate.
- **Four separate activities**: If ownership and management is disaggregated, treating the businesses as separate activities may be most appropriate.

Once PMP makes a group election based on all facts and circumstances, the grouping(s) will remain in effect until:

1. There is a material change in facts and circumstances supporting a change in groupings; or
2. Upon audit, the IRS regroups the activities into more appropriate economic units.

 

***§469 Passive Activity Loss Limitations Example 3:*** Delivering Goods, Inc., ("DGI") an S corporation, is a partner in two separate partnerships. Partnership 1 (P1) sells non-food items to grocery stores. Partnership 2 (P2) is a partnership operated as a trucking business primarily to transport the goods of P1 to grocery stores. P1 and P2 are under common control.

*Can P1 and P2 be grouped as a single economic unit?*
Yes! Consistent with Reg. §1.469-4(c)(2), P1 and P2 can be grouped together into a single activity. Once the election to group these activities is made, it is binding until a material change in facts and circumstances arises or the IRS regroups the activities upon audit. If DGI chooses to treat the activities as separate, the treatment is also treated as a grouping election and is binding unless there is a material change in facts and circumstances or the IRS regroups the activities upon audit.

***§469 Passive Activity Loss Limitations Example 4:*** Head Partnership, LLC (HP) is the single-member, parent company of an apartment management LLC ("GBG"), as well as a partner in over a hundred partnerships holding apartments managed by GBG. GBG was formed primarily to manage apartment projects owned by the various partnerships, and it provided little to no services to entities other than partnerships. The majority of GBG's income is derived by management fees paid by the various partnerships and amounted to $13 million in its initial year. The various apartment complexes had gross income of $115 million in the year GBG was formed. All accounting and operations of GBG and various apartment complexes are integrated into one accounting system.

*Can HP group GBG and the related partnership activities into a single economic unit?*
Tentatively, yes! Generally, rental activities are not permitted to be grouped with non-rental trades/businesses. However, if all the general requirements for grouping are met and the non-rental activity is insubstantial to the rental activity, grouping may be allowed under Reg. §1.469-4(d). The code and regulations do not currently provide a definition of "insubstantial," but temporary regulations (that have now expired), adopted an "80/20" rule in testing of income. Courts have used this as a starting point in several cases even after its expiration along with other qualitative, pertinent factors (as suggested in the preamble of the originally drafted regulations).

Considering the "80/20" rule, the gross income of GBG represents ~10.16% ($13/($13 + $115)) of the income if all activities were considered one group. The "80/20" rule may also consider looking at the fair market value of assets. Qualitative Factors will look to: (1) the role of GBG in relation to the other entities involved and (2) the purpose of formation for GBG. Because GBG is subservient and entirely dependent on the income from the partnerships, the management corporation's activity will likely be considered insubstantial to the economic unit primarily related to rental activities. Additionally, because GBG was formed for the purpose of economies of scale and functional integration, separating GBG from the partnerships would result in tax consequences that could penalize owners of HP. Further rationale for their grouping can be found by examining *Glick v. United States*.

Taxpayers may take steps to convert disallowed PALs into deductible losses, including:

- **Increasing Participation in Passive Activities** -- The taxpayer can increase his or her activity in order to meet the material participation test for the year.
- **Decreasing Participation in Activities Materially Participated In** --The taxpayer can decrease participation in activities materially participated in, therefore making the activity a passive activity for the year.

 

**Disposing of the Passive Activity** -- As previously discussed, selling a passive activity to an unrelated party converts any PALs to deductible losses once the activity is disposed of.

- **Generating additional Passive Income** -- This additional passive income could offset passive losses.

Given the potential for increased M&A on the other side of the pandemic, grouping decisions will be all the more important. The IRS has a specific campaign geared to matching buyers and sellers in taxable asset transactions, which can result in additional attention to how new activities are being grouped into existing activities. Tax year 2019 was the first year where the Form 1065 and Form 1120-S instructions included more comprehensive instructions regarding the reporting of at-risk and passive loss activities, so practitioners should be advised to make ongoing assessments of the groups being reported and make adjustments as appropriate.

To the extent statements are being attached to Schedules K-1 reporting various activities under §465 and §469 to its owners, the appropriate checkboxes should be indicated on the relevant Schedule K-1.

☐ More than one activity for at-risk purposes*
☐ More than one activity for passive activity purposes*

If activities are being grouped for purposes of §469, the appropriate checkbox should be indicated on page 1 of Form 1065 and/or Form 1120-S.

☐ Grouped activities for section 469 passive activity purposes

## *II. The CARES Act -- Modification of excess business losses*

For taxable years beginning after December 31, 2017 and before January 1, 2026, the TCJA provided that "excess business losses" of a taxpayer other than a corporation were not allowed for the taxable year.[81] ARPA extends this provision for one year, to include tax years beginning before January 1, 2027. An "excess business loss" is defined as the excess of aggregate deductions of the taxpayer attributable to trades or businesses over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount ($270,000 for individuals or $540,000 for joint filers, indexed for inflation in 2022).

Since the §461(l) limitation applied solely to taxpayers other than C corporations, it caused a disproportionate impact on small business owners. The CARES Act temporarily modified the loss limitation for noncorporate taxpayers set forth in the TCJA and allowed them to deduct excess business losses arising in a tax year beginning after December 31, 2017 and before January 1, 2021.[82] It also turned off active farming loss rules for tax years beginning after December 31, 2017 and before December 31, 2020.

The CARES Act provided a few additional technical corrections to the TCJA relating to excess business losses. The CARES Act clarified that excess business losses do not include any net operating loss

[81] IRC §461(i)(1).
[82] CARES Act §2304(a).

 

deduction under §172 or qualified business income deductions under §199(A). The §461(l) limitation excludes deductions, gross income, or gains attributable to any trade or business of performing services as an employee. In other words, W-2 income is not considered business income under §461(l). Additionally, the CARES Act specifies that per the NOL rules, capital losses cannot offset ordinary income, and thus capital loss deductions are not taken into account in computing the §461(l) limitation. The amount of capital gain considered in calculating the §461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business or capital gain net income. As a result, taxpayers will no longer have the ability to potentially convert capital losses into NOLs. These technical corrections were retroactive for tax years 2018 and 2019.

# Related-Party Transactions

# Related-Party Transactions

## *Learning objectives*

Upon reviewing this chapter, the reader will be able to:

- Identify who are related parties for purposes of special characterizations of property transactions;
- Explain how and to what extent the gain on the sale of depreciable property will be characterized as ordinary income;
- Describe when a loss will be disallowed on the sale of property, with an emphasis on its effect on basis, the timing of the loss, and the identity of the taxpayer who recognizes the loss; and
- Discuss the circumstances in which the sale of property at a loss to a partnership will be disallowed. A BIG bell should go off with ANY related-party transaction.

## *I. Common transactions*

### A. Sales of depreciable property

One way to capitalize a new business is for an owner to sell property to the business. If the property is appreciated this enables the owner to recognize gain on the sale, and the business to take a higher basis in the property than the lower carryover basis that applies when property is contributed to a partnership or corporation. While this higher basis will reduce the gain to the business that sells the property, it will also, in the case of depreciable property, increase the basis that is written off through future depreciation deductions.

However, all gain resulting from the sale or exchange of property, directly or indirectly, between **related persons** is treated as ordinary income (i.e., not capital gain) if the transferred property qualifies for depreciation in the hands of transferee.[1] Thus, even in the case when there is no depreciation recapture with respect to the property, such as real estate depreciated on a straight-line basis, this transaction deprives the owner of the lower capital gains tax rates.

The concept of a related person takes on many formulations, depending on the transaction. Disregarding transactions involving a trust or an estate, related persons in the context of a sale of depreciable property are persons and controlled entities with respect to such persons. If that business is a controlled entity with respect to the owner the gain recognized on the sale will be treated as ordinary income.

An individual controls a corporation if **more than 50 percent of the value** of its outstanding stock is owned (directly or indirectly) by or for such person.[2] But even if the owner's direct ownership does not exceed this threshold, indirect ownership must be taken into account in making this determination.

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[1] I.R.C. §1239(a).
[2] I.R.C. §1239(c)(2).

The Code provides that constructive ownership of stock is determined in accordance with rules similar to the rules under §267(c).[3] Under those rules, stock is deemed owned by all of the following:

- (1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
- (2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his **family**;
- (3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;
- (4) The **family** of an individual shall include only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants; and
- (5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

**Nowhere are two individuals included as related parties** for these purposes. It is true that the constructive rules of **ownership** under §267 can involve individuals, but this does not make such individuals **related** for purposes of **this provision**. Thus, a sale to an individual will generate capital gain (apart from any depreciation recapture) because the sale to is not to a person who is a related party in **characterizing the gain**.

***Note:***

Generally, the transactions involve business entities (disregarding certain transfers between a trust or estate and its beneficiaries for the moment) that are:

- A shareholder and a corporation that more than 50 percent of the stock of which is owned directly or indirectly by or for that shareholder;[4]
- A partner and a partnership that more than 50 percent of the capital interest or profit interests in which is owned directly or indirectly by or for that partner;[5]
- Two corporations that are members of the same controlled group;[6]
- A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership;[7]
- An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;[8] and
- An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation.[9]

## B. Loss disallowances

Section 267(a) potentially denies or defers the recognition of losses or deductions on transactions between **related parties**. No deduction shall be allowed in respect of any loss from the sale or exchange

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3 I.R.C. §1239(c)(2).
4 I.R.C. §1239(c)(1)(A).
5 I.R.C. §1239(c)(1)(B).
6 I.R.C. §1239(c)(1)(C), applying §267(b)(3).
7 I.R.C. §1239(c)(1)(C), applying §267(b)(10).
8 I.R.C. §1239(c)(1)(C), applying §267(b)(11).
9 I.R.C. §1239(c)(1)(C), applying §267(b)(12).

 

of property, directly or indirectly, between certain related persons,[10] but the rule does not apply to the corporation or its shareholder in the case of a complete liquidation.

In many contexts, a business rents its office space; rent is generally deductible as a business expense. In the case of an accrual method taxpayer, the rent accrues with the passage of time. However, if the rental transaction is with a related party, the payment of rent will be subject to the matching rule. A mismatch will occur, typically, when the related landlord is on the cash method of accounting. Even though the amount of the rental payment is ascertained and the business's liability for it is fixed, the business may not deduct it until such amount is included in the related party's income.[11]

### *1. The matching rule*

If by reason of **the method of accounting of the person to whom the payment is to be made**, the amount thereof is not (unless paid) includable in the gross income of such person, and at the close of the taxable year of the taxpayer for which the amount would be deductible, both the taxpayer and the person to whom the payment is to be made are related persons, then any deduction allowable in respect of such amount is allowable as of the day as of which such amount is includable in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this limitation).[12]

What degrees of relation between parties make them related parties for these purposes? These are generally set forth in §267(b). The relationships between parties to a transaction are further modified by the constructive ownership rules in §267(c), which may cause the stock owned by one related party to be deemed owned by another. Related parties include the following.

- **Members of a family**[13] is defined as only an individual's brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.[14]
- An **individual and a corporation** are considered to be related to the extent that the individual owns, directly or indirectly, **more than 50 percent of the value** of all of the corporation's outstanding stock. Because the constructive ownership rules of §267(c) apply to reattribute direct and indirect ownership of certain other shareholders to the shareholder being tested for related-party status, the total ownership of any shareholder in a corporation may include direct, indirect (such as title held by a straw party), and constructive ownership.
- **Two corporations** are related to the extent they are part of the same controlled group of corporations, as defined in §1563 and modified by §267(f), by substituting "more than 50 percent" for "at least 80 percent" each place it appears in §1563(a).
- **Two partnerships** in which the same persons own, directly or indirectly, **more than 50 percent** of the capital interests or profits interest are considered to be related persons.
- A **corporation and a partnership** if the same persons own **more than 50 percent in value** of the corporation's outstanding stock, and more than 50 percent of the capital interest, or the profits interest, in the partnership.
- Two S corporations are considered to be related for purposes of §267 if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

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10 I.R.C. §267(a)(1).

11 Despite an attempt to match income and expense, the statute would not appear to sanction a cash method taxpayer prematurely recognizing unpaid income in order to permit an accrual method taxpayer to deduct the corresponding expense.

12 I.R.C. §267(a)(2).

13 I.R.C. §267(b)(1).

14 I.R.C. §267(c)(4).

 

- An **S corporation and a C corporation** if the same persons own **more than 50 percent in value** of the outstanding stock of each corporation.

***Note:***

Related parties may include trusts, grantors thereto, fiduciaries thereof, and beneficiaries thereof. Specifically, the following persons are considered related for purposes of §267:

- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust, or by or for the person who is a grantor of the trust.

### *2. Partnerships and individuals*

Section 267(b) does **not include a partnership and its partners as related persons**.[15] However, any transaction described in §267(a) between a partnership and a person other than a partner is considered as occurring **between the other person and each partner separately**. Therefore, if the other person and a partner are within a relationship specified in §267(b), **no deduction** with respect to a transaction between the other person and the partnership is allowed: (i) to the **related partner**, to the extent of his **distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transaction**; or (ii) to the other person, to the extent the related partner acquires an interest in property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction. Thus, if the landlord is not a partner, but is related to a partner, the partnership's rent deduction will not be allowed to the related partner.

***Example 1:*** A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 2021, the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 2021, the partnership accrued its interest liability to the M Corporation and on April 1, 2022, it paid the M Corporation the amount of such accrued interest. The transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of §267 (a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction is allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions.

Still, this does present a problem when no real partner is involved. The Code makes special provisions for pass-through entities (partnerships or S corporations).[16]

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15 But see second sentence of flush language to I.R.C. §707(b)(1)(A).

16 I.R.C. §267(e)(1).

 

In the case of any amount paid or incurred by, to, or on behalf of, a pass-through entity, for purposes of applying the limitation on the deduction of expenses, all of the following are treated as related persons for purposes of §267:

(i) The entity;
- Any person who owns (directly or indirectly) **any capital interest or profits interest of such partnership**; or
- Any person who owns (directly or indirectly) any of the stock of an S corporation;

(ii) Any person who owns (directly or indirectly) **any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest**;[17] and

(iii) Any person related (under the general rules of §267 **or** §707(b)(1)) (which includes a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, and two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests) to a person described by the ownership in such capital or profits interests.[18]

For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles for constructive ownership of stock generally apply, except that there is no attribution on options and interests owned (directly or indirectly) by or for a C corporation, which are considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) five percent or more in the value of the stock of such corporation.[19]

### *3. Transactions between partners and partnerships*

For purposes of expense or loss sales of property, the partnership and all partners in the partnership are considered to be related parties.

If a partner owns more than 50 percent of a capital or profits interest in a partnership, §707 disallows the deduction of losses incurred in a sale or exchange of property between the partner and the partnership.

For transactions between two partnerships, the loss disallowance rule applies if the same persons own, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in both partnerships. The ownership of capital and profits interest in each partnership is determined under constructive ownership rules (other than §267(c)(3)).

The constructive ownership rules determine **if parties to a transaction are related**, but do **not** determine **if a transaction has occurred between related parties**. In other words, the constructive ownership rules do **not** apply to **attribute a transaction to a party who is not actually transacting but is only related to the transacting parties**.

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[17] This applies to a transaction only if such transaction is related either to the operations of the partnership described in such subparagraph or to an interest in such partnership.

[18] I.R.C. §267(e)(1). However, §267 does not apply at all to any guaranteed payment to a partner (which is included in income in the same taxable year the partnership takes it into account under its method of accounting). I.R.C. §267(e)(4).

[19] I.R.C. §267(e)(3).

 

***Example:*** Individual B, the sole beneficiary of Estate X, owns 60 percent of the stock of Corporation P. Estate X owns all the stock of Corporation T, and sells its Corporation T stock to corporation P at a loss. Although Individual B is deemed to constructively own all the Corporation T stock owned by Estate X, Individual B is not deemed to be a party to the formal transaction for purposes of §267.

An individual owning (other than by the application of the family attribution rules) any stock in a corporation is considered to own the stock owned, directly or indirectly, by or for his partner.

#### *4. The basis consequence*

When a taxpayer acquires property by purchase or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of §267(a)(1), any gain realized by the buyer on a sale or other disposition of the property is recognized only to the extent that the gain exceeds the amount of the loss as is properly allocable to the property.[20] This is not the same as "preserving" the loss by reason of basis. There is no authority to create a loss on the transaction when the disallowed loss exceeds gain realized on the sale of the property. The buyer takes a cost basis in the property. Section 267(d) does not affect the basis of property for determining gain. Depreciation and other items which depend on such basis are also not affected.

The full benefit of the loss is available if the property is later sold for more than its basis because the entire amount of the deferred loss can offset the gain (which is greater than or equal to the deferred loss). However, if the property either declines in value or only appreciates to under the seller's basis, there will not be enough gain on the sale against which to apply the deferred loss. In the case of a decline, the deferred loss does not add to the tax loss determined with reference to the buyer's basis in the property; the deferred loss is lost in its entirety. In the case of a modest increase, the buyer will recognize no gain, but he cannot take advantage of any of the deferred loss in excess of the gain realized on the sale.

***Example 1:*** Full use: Arthur sells to his son Henry for $500,000 certain closely held corporate stock with an adjusted basis for determining loss to him of $800,000. The loss of $300,000 is not allowable to Arthur by reason of §267(a)(1). Henry later sells this stock for $1,000,000. Although Henry's realized gain is $500,000 ($1,000,000 minus $500,000, his basis), Henry's recognized gain under §267(d) is only $200,000, the excess of the realized gain of $500,000 over the loss of $300,000 not allowable to Arthur. In determining capital gain or loss, Henry's holding period commences on the date of the sale from Arthur to Henry.

***Example 2:*** Partial use: Assume the same facts as in **Example 1** above, except that Henry later sells his stock for $300,000 instead of $1,000,000. His recognized loss is $200,000, not $500,000 (or $800,000), because §267(d) applies only to the nonrecognition of gain and does **not affect basis**.

## C. Loss on sale at a loss to a partnership

When a property owner sells property to a partnership instead of contributing property, the objective is to recognize the loss. But whenever a person realizes a loss on the sale of property to a partnership that is related to him, the Code **precludes** recognition of that loss.

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[20] I.R.C. §267(d).

 

**No deduction** is allowed for: (i) losses on sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a person who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in the partnership;[21] or for (ii) losses on sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership.[22]

Again, the applicable constructive ownership rules may determine that the seller owns directly and indirectly more than 50 percent interest in capital or profits. So, it is crucial to obtain a "Who's Who" for the investor group. In determining what interest in the partnership will be attributed to the seller, the capital or profits interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries and by members of his family. For these purposes, a person's family includes his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants, but the capital or profits interest that is attributed to a family member may not be reattributed to another person.

Even if the seller is not a partner in the partnership to which the property is sold, the seller may have all or a portion of the loss disallowed by reason of the constructive ownership rules under §267. Such transactions are governed by §707 for the purposes of which the partnership is considered to be an entity separate from the partners. Any transaction described in §267(a) (which includes sales) between a partnership and a **person other than a partner** shall be considered as occurring between the other **person and the members of the partnership separately**.[23] Again "treated as a sale to each of the partners individually" means that finding a member of the seller's family a partner in the purchasing partnership will trigger this disallowance. No deduction is allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of certain relationships.[24] For these purposes, the family of an individual includes only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.

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21 I.R.C. §707(b)(1)(A).
22 I.R.C. §707(b)(1)(B).
23 Treas. Regs. §1.267(b)-1(b)(1).
24 Treas. Regs. 1.267(a)-1(a).

 