

# Introduction to At-Risk Limitations

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# Introduction to At-Risk Limitations

[IRS Form 6198 At-Risk Limitations](#)

[IRS Form 6198 At-Risk Limitations – Instruction Set](#)

[26 U.S. Code § 465 - Deductions limited to amount at risk](#)

[IRS Publication 925 – Passive Activity and At-Risk Rules](#)

[IRS Audit Technique Guide – Passive Activity Loss](#)

The at-risk rules limit your losses from most activities to your amount at risk in the activity. You treat any loss that's disallowed because of the at-risk limits as a deduction from the same activity in the next tax year.

If your losses from an at-risk activity are allowed, they're subject to recapture in later years if your amount at risk is reduced below zero.

## Loss Defined

A loss is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income doesn't include income from the recapture of previous losses (discussed later, under [Recapture Rule](#)).

Use Form 6198 to figure how much loss from an activity you can deduct.

1. You must file Form 6198 with your tax return if:
  - a. You have a loss from any part of an activity that's covered by the at-risk rules, and
  - b. You aren't at risk for some of your investment in the activity.
2. You must file Form 6198 if you're engaged in an activity included in (6) under [Activities Covered by the At-Risk Rules](#), later, and you have borrowed amounts described in [Certain borrowed amounts excluded](#) under *At-Risk Amounts*, later.

## Loss limits for partners and S corporation shareholders

Four separate limits may apply to a partner's or shareholder's distributive share of an item of deduction or loss from a partnership or S corporation, respectively. The limits determine the amount each partner or shareholder can deduct on his or her own return. These limits and the order in which they apply are:

1. The adjusted basis of:
  - a. The partner's partnership interest, or
  - b. The shareholder's stock plus any loans the shareholder makes to the corporation,
2. The excess farm loss rules,
3. The at-risk rules, and
4. The passive activity rules.

*Limitations on Losses, Deductions, and Credits* in Partner's Instructions for Schedule K-1 (Form 1065) and Shareholder's Instructions for Schedule K-1 (Form 1120S).

Who is affected?

The at-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held C corporations.

### Closely Held C Corps

For the at-risk rules, a C corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for five or fewer individuals.

To figure if more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules.

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2. An individual is considered to own the stock owned directly or indirectly by or for his or her family. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
3. If a person holds an option to buy stock, he or she is considered to be the owner of that stock.
4. When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) isn't treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.
5. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

### Activities Covered by the At Risk Rules

If you're involved in one of the following activities as a trade or business or for the production of income, you're subject to the at-risk rules.

1. Holding, producing, or distributing motion picture films or video tapes.
2. Farming.
3. Leasing section 1245 property, including personal property and certain other tangible property that's depreciable or amortizable. See [Section 1245 property](#), later.
4. Exploring for, or exploiting, oil and gas.
5. Exploring for, or exploiting, geothermal deposits (for wells started after September 1978).
6. Any other activity not included in (1) through (5) that's carried on as a trade or business or for the production of income.

## Section 1245 property

Section 1245 property includes any property that is or has been subject to depreciation or amortization and is:

1. Personal property,
2. Other tangible property (other than a building or its structural components) that's:
  - a. Used in manufacturing, production, extraction or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,
  - b. A research facility used for the activities in (a), or
  - c. A facility used in any of the activities in (a) for the bulk storage of fungible commodities,
3. Real property (other than property described in (2)) with an adjusted basis that was reduced by certain amortization deductions listed in section 1245(a)(3)(C) of the Internal Revenue Code,
4. A single purpose agricultural or horticultural structure, or
5. A storage facility (other than a building or its structural components) used for the distribution of petroleum.

The at-risk rules don't apply to the holding of real property placed in service before 1987. They also don't apply to the holding of an interest acquired before 1987 in a pass-through entity engaged in holding real property placed in service before 1987. This exception doesn't apply to holding mineral property.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property.

*For example, making personal property, such as furniture, and services available when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.*

### Exception for equipment leasing by a closely held corporation

If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules.

A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing.

Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that's section 1245 property.

*However, equipment leasing doesn't include the leasing of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs of artwork, or musical tapes.*

*A closely held corporation can't exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.*

The equipment leasing exclusion also isn't available for leasing activities related to other at-risk activities, such as motion picture films and video tapes, farming, oil and gas properties, and geothermal deposits.

For example, if a closely held corporation leases a video tape, it can't exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

### Controlled group of corporations

A controlled group of corporations is subject to special rules for the equipment leasing exclusion. See section 465(c) of the Internal Revenue Code.

### Special Exceptions for qualified corporations

A qualified corporation isn't subject to the at-risk limits for any qualifying business carried on by the corporation. Each qualifying business is treated as a separate activity.

A qualified corporation is a closely held C corporation, defined earlier, that isn't:

- A personal holding company, or
- A personal service corporation (defined in section 269A(b) of the Internal Revenue Code, but determined by substituting 5% for 10%).

A qualifying business is any active business if all of the following apply.

1. During the entire 12-month period ending on the last day of the tax year, the corporation had at least:
  - a. One full-time employee whose services were in the active management of the business, and
  - b. Three full-time nonowner employees whose services were directly related to the business. A nonowner employee is an employee who doesn't own more than 5% in value of the outstanding stock of the corporation at any time during the tax year. (The rules for constructive ownership of stock in section 318 of the Internal Revenue Code apply. However, in applying these rules, an owner of 5% or more, rather than 50% or more, of the value of a corporation's stock is considered to own a proportionate share of any stock owned by the corporation.)
2. Deductions due to the business that are allowable to the corporation as business expenses and as contributions to certain employee benefit plans for the tax year exceed 15% of the gross income from the business.
3. The business isn't an excluded business. Generally, an excluded business means equipment leasing as defined, earlier, under [\*Exception for equipment leasing by a closely held corporation\*](#), and any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

### Separation of Activities

Generally, you treat your activity involving each film or video tape, item of leased section 1245 property, farm, oil and gas property, or geothermal property as a separate activity.

In addition, each investment that isn't a part of a trade or business is treated as a separate activity.

#### Leasing by a partnership or S corporation

For a partnership or S corporation, treat all leasing of section 1245 property that's placed in service in any tax year of the partnership or S corporation as one activity.

#### Aggregation of Activities

Activities described under [\*Activities Covered by the At-Risk Rules\*](#), earlier, that constitute a trade or business are treated as one activity if:

- You actively participate in the management of the trade or business, or
- The trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

Similar rules apply to activities described in (1) through (5) of that earlier discussion.

#### Active Participation

Active participation depends on all the facts and circumstances. Factors that indicate active participation include making decisions involving the operation or management of the activity, performing services for the activity, and hiring and discharging employees. Factors that indicate a lack of active participation include lack of control in managing and operating the activity, having authority only to discharge the manager of the activity, and having a manager of the activity who is an independent contractor rather than an employee.

#### Partners and S corporation shareholders

Partners or shareholders may aggregate activities of their partnership or S corporation within each of the following categories.

- Films and video tapes,
- Farms,
- Oil and gas properties, and
- Geothermal properties.

For example, if a partnership or S corporation produces two films or video tapes, the partners or S corporation shareholders may treat the production of both films or video tapes as one activity for purposes of the at-risk rules.

#### At Risk Amounts

You're at risk in any activity for:

1. The money and adjusted basis of property you contribute to the activity, and
2. Amounts you borrow for use in the activity if:
  - a. You're personally liable for repayment, or
  - b. You pledge property (other than property used in the activity) as security for the loan.

### Amounts Borrowed

You're at risk for amounts borrowed to use in the activity if you're personally liable for repayment.

You're also at risk if the amounts borrowed are secured by property other than property used in the activity.

In this case, the amount considered at risk is the net fair market value of your interest in the pledged property.

The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it's subject.

However, no property will be taken into account as security if it's directly or indirectly financed by debt that's secured by property you contributed to the activity.

If you borrow money to finance a contribution to an activity, you can't increase your amount at risk by the contribution and the amount borrowed to finance the contribution. You may increase your at-risk amount only once.

### Certain borrowed amounts excluded

Even if you're personally liable for the repayment of a borrowed amount or you secure a borrowed amount with property other than property used in the activity, you aren't considered at risk if you borrowed the money from a person having an interest in the activity or from someone related to a person (other than you) having an interest in the activity.

This doesn't apply to:

- Amounts borrowed by a corporation from a person whose only interest in the activity is as a shareholder of the corporation,
- Amounts borrowed from a person having an interest in the activity as a creditor, or
- Amounts borrowed after May 3, 2004, secured by real property used in the activity of holding real property (other than mineral property) that, if nonrecourse, would be qualified nonrecourse financing.

Related persons include:

- Members of a family, but only an individual's brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.);

- Two corporations that are members of the same controlled group of corporations determined by applying a 10% ownership test;
- The fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts;
- A tax-exempt educational or charitable organization and a person who directly or indirectly controls it (or a member of whose family controls it);
- A corporation and an individual who owns directly or indirectly more than 10% of the value of the outstanding stock of the corporation;
- A trust fiduciary and a corporation of which more than 10% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust;
- The grantor and fiduciary, or the fiduciary and beneficiary, of any trust;
- A corporation and a partnership if the same persons own more than 10% in value of the outstanding stock of the corporation and more than 10% of the capital interest or the profits interest in the partnership;
- Two S corporations if the same persons own more than 10% in value of the outstanding stock of each corporation;
- An S corporation and a regular corporation if the same persons own more than 10% in value of the outstanding stock of each corporation;
- A partnership and a person who owns directly or indirectly more than 10% of the capital or profits of the partnership;
- Two partnerships if the same persons directly or indirectly own more than 10% of the capital or profits of each;
- Two persons who are engaged in business under common control; and
- An executor of an estate and a beneficiary of that estate.

To determine the direct or indirect ownership of the outstanding stock of a corporation, apply the following rules.

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.
2. Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. The family of an individual includes only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors, and lineal descendants.
3. Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned directly or indirectly by the individual's partner.
4. When applying rule (1), (2), or (3), stock considered owned by a person under rule (1) is treated as actually owned by that person. But, if a person constructively owns stock because of rule (2) or (3), he or she doesn't own the stock for purposes of applying either rule (2) or (3) to make another person the constructive owner of the same stock.

#### Effect of government price support programs

A government target price program or other government price support programs for a product that you grow doesn't, without agreements limiting your costs, reduce the amount you have at risk.

#### Effect of increasing amounts at risk in subsequent years

Any loss that's allowable in a particular year reduces your at-risk investment (but not below zero) as of the beginning of the next tax year and in all succeeding tax years for that activity.

If you have a loss that's more than your at-risk amount, the loss disallowed won't be allowed in later years unless you increase your at-risk amount.

Losses that are suspended because they're greater than your investment that's at risk are treated as a deduction for the activity in the following year.

Consequently, if your amount at risk increases in later years, you may deduct previously suspended losses to the extent that the increases in your amount at risk exceed your losses in later years.

However, your deduction of suspended losses may be limited by the passive loss rules.

### Amounts Not At Risk

You aren't considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

### Nonrecourse Financing

Nonrecourse financing is financing for which you aren't personally liable.

If you borrow money to contribute to an activity and the lender's only recourse is to your interest in the activity or the property used in the activity, the loan is a nonrecourse loan.

You aren't considered at risk for your share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity.

However, you're considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property.

Qualified nonrecourse financing is financing for which no one is personally liable for repayment and that's:

- Borrowed by you in connection with the activity of holding real property,
- Secured by real property used in the activity,
- Not convertible from a debt obligation to an ownership interest, and
- Loaned or guaranteed by any federal, state, or local government, or borrowed by you from a qualified person.

### Other types of property used as security

The rules in the next two paragraphs apply to any financing incurred after August 3, 1998. You also can choose to apply these rules to financing you obtained before August 4, 1998. If you do that, you must reduce the amounts at risk as a result of applying these rules to years ending before August 4, 1998, to the extent they increase the losses allowed for those years.

In determining whether qualified nonrecourse financing is secured only by real property used in the activity of holding real property, disregard property that's incidental to the activity of holding real property.

Also disregard other property if the total gross fair market value of that property is less than 10% of the total gross fair market value of all the property securing the financing.

For this purpose, treat yourself as owning directly your proportional share of the assets in any partnership in which you own, directly or indirectly, an equity interest.

### Qualified person

A qualified person is a person who actively and regularly engages in the business of lending money.

The most common example is a bank.

However, none of the following persons can be a qualified person.

- A person related to you in one of the ways listed under [Related persons](#), earlier. However, a person related to you may be a qualified person if the nonrecourse financing is commercially reasonable and on the same terms as loans involving unrelated persons.
- A person from which you acquired the property or a person related to that person.
- A person who receives a fee due to your investment in the real property or a person related to that person.

### Other loss limiting arrangements

Any capital you have contributed to an activity isn't at risk if you're protected against economic loss by an agreement or arrangement for compensation or reimbursement.

For example, you aren't at risk if you will be reimbursed for part or all of any loss because of a binding agreement between yourself and another person.

### **Example 1**

Some commercial feedlots reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such stop loss orders, the investor is at risk only for the portion of the investor's capital for which the investor isn't entitled to a reimbursement.

### **Example 2**

You're personally liable for a mortgage, but you separately obtain insurance to compensate you for any payments you must actually make because of your personal liability. You're considered at risk only to the extent of the uninsured portion of the personal liability to which you're exposed. You can include in the amount you have at risk the amount of any premium which you paid from your personal assets for the insurance. However, if you obtain casualty insurance or insurance protecting yourself against tort liability, it doesn't affect the amount you are otherwise considered to have at risk.

## Reductions of amounts At Risk

The amount you have at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. It may also be reduced because of distributions you received from the activity, debts changed from recourse to nonrecourse, or the initiation of a stop loss or similar agreement. If the amount at risk is reduced below zero, your previously allowed losses are subject to recapture, as explained next.

### Recapture Rules

If the amount you have at risk in any activity at the end of any tax year is less than zero, you must recapture at least part of your previously allowed losses. You do this by adding to your income from the activity for that year the lesser of the following amounts.

- The negative at-risk amount (treated as a positive amount), or
- The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts you previously added to your income from that activity under this recapture rule.

Don't use the recapture income to reduce any net loss from the activity for the tax year. Instead, treat the recaptured amount as a deduction for the activity in the next tax year.

### Pre 1979 Activity

If the amount you had at risk in an activity at the end of your tax year that began in 1978 was less than zero, you apply the preceding rule for the recapture of losses by substituting that negative amount for zero. For example, if your at-risk amount for that tax year was minus \$50, you will recapture losses only when your at-risk amount goes below minus \$50.

## IRC 465

### **Deductions limited to amount at risk**

<https://www.law.cornell.edu/uscode/text/26/465>

The IRS has a list of activities covered by at-risk rules including farming, gas, oil, geothermal deposits, but also has a general rule for activities producing income. To determine what deductions are allowed, you must first determine what is at risk. Amounts at-risk must first be determined and any amount left over can cover passive activity losses.

Determining the amount at risk gets most complicated with partnerships and certain types of loans, especially when money is moved in and out of during the tax year.

### **The Evolution of At-Risk Rules**

<http://scholarworks.law.ubalt.edu/cgi/viewcontent.cgi?article=1495&context=ublr>

The at-risk rules were first enacted in the [Tax Reform Act of 1976](#). Prior to this time, taxpayers could deduct losses in excess of the amount of their investments. This was typically done through nonrecourse financing where the taxpayer is not personally liable. Investors were also deferring taxes from other sources of loss. The results, Congress felt, were not equitable and these laws were written to level the playing field.

### **Identifying Activities Covered by the At-risk Rules Partner and Partnership Reporting Requirements**

Originally, the at-risk rules applied to only the following five types of activities:

1. Holding, producing, or distributing motion picture films or video tapes
2. Farming
3. Leasing Section 1245 property (e.g., equipment leasing).
4. Exploring for or exploiting oil and gas resources
5. Exploring for or exploiting geothermal deposits

The Revenue Act of 1978 extended the at-risk rules to cover all activities of carrying on a trade or business, except real estate and certain equipment leasing activities of closely held C corporations.

The legislation was a reaction to the abusive use of nonrecourse financing in tax shelters.

Thanks to a strong lobby, real estate activities were excluded from the at-risk rules for real estate placed in service prior to 1987.

Accordingly, real estate losses continued to be fully deductible without limitations.

From 1978 to 1986, real estate tax shelters continued to create problems for the US Treasury Department.

By 1986, Congress had determined that there were substantial tax shelter abuses in real estate, principally involving nonrecourse real estate financing.

The Tax Reform Act of 1986 (TRA '86) then extended the at-risk rules to real estate activities.

However, the extension applies only to real estate placed in service after 1986.

The rules also apply to any partner who acquires an interest in a partnership holding real property after 1986, even if the underlying property was acquired by the partnership prior to 1987.

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