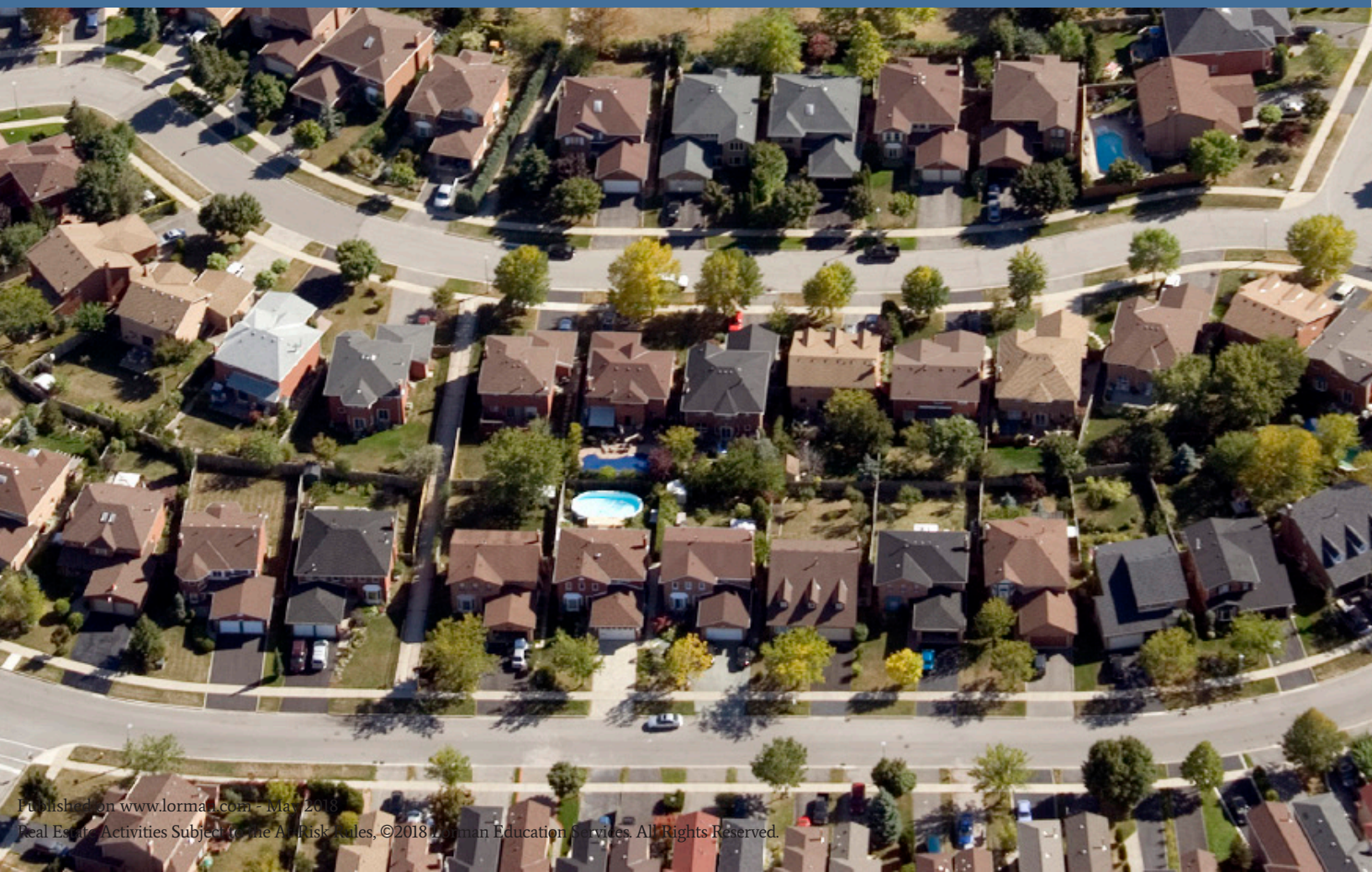
Real Estate Activities Subject to the At-Risk Rules

Prepared by:
John R. Dundon II, E.A.
Taxpayer Advocacy Services Inc.



Published on www.lorman.com - May 2018

INTRODUCING

Lorman's New Approach to Continuing Education

ALL-ACCESS PASS

The All-Access Pass grants you UNLIMITED access to Lorman's ever-growing library of training resources:

- ☑ **Unlimited Live Webinars** - 120 live webinars added every month
- ☑ **Unlimited OnDemand and MP3 Downloads** - Over 1,500 courses available
- ☑ **Videos -** More than 1300 available
- ☑ **Slide Decks -** More than 2300 available
- ☑ White Papers
- ☑ Reports
- ☑ Articles
- ☑ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.

Get Your All-Access Pass Today!

SAVE 20%

Learn more: www.lorman.com/pass/?s=special20

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

*Discount cannot be combined with any other discounts.

Taxpayer Advocacy Services Inc.

John R Dundon II, Enrolled Agent #00085353EA PTIN P00605639
(c) 720-234-1177 John@JohnRDundon.com http://JohnRDundon.com

Real Estate Activities Subject to the At-Risk Rules

Under the "catch-all" provision extending the application of the at-risk rules to any activity engaged in by a taxpayer in carrying on a trade or business or for the production of income, real estate activities are subject to the at-risk rules.

In the case of property placed in service before '87, and an interest in an S corporation, partnership, or other pass-through entity acquired before '87, the holding of real property other than mineral property is treated as a separate activity and the at-risk rule doesn't apply to losses from this activity.

For interests in pass-through entities, the date the interest is acquired is determinative, not the date the real estate is placed in service by the entity.

Thus, the at-risk rules apply to real estate activities where a taxpayer acquired an interest in a partnership or S corporation after Dec. 31, '86, regardless of when the entity placed the real estate in service.

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

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

For purposes of the above rules, a taxpayer wasn't engaged in the holding of real property where arrangements which purported to be purchases of real property had been determined by a state court to be, in fact, loans.

Although the state court litigation arose in the context of a contractual dispute, that determination on this issue controlled for purposes of the at-risk rules.

This exclusion is intended to exclude from application of the at-risk rule situations where a taxpayer owns and operates a hotel or motel and makes available personal property such as furniture and services in conjunction with the renting of the hotel or motel room, or provides personal property and services in renting a furnished apartment.

Where a business involves both the holding of real property and the provision of personal property and services that aren't incidental to making real property available as living accommodations, the holding of the real property is treated as a separate activity that isn't subject to the at-risk rule.

The remainder of the business is treated as a separate activity (or activities) to which the at-risk rule applies.

In these situations, an allocation of the income to the real property equals that amount of income which bears the same ratio to the total amount of income as the real property related deductions bear to the total deductions.

For this purpose, deductions for administrative expenses or general overhead relating to real estate and other activities are reasonably allocated.

If the fair rental value of the real property can be clearly established, taxpayers may instead elect to treat the fair rental value of the real property involved as the amount of income allocable to that property.

Example

Illustration:

G owns and operates a restaurant at a $100,000 loss, as follows: $500,000 gross income, $450,000 restaurant expenses, $150,000 of real estate taxes and other expenses related to the land and the structure.

$125,000 of income is allocated to real property ($150,000/$600,000 × $500,000).

The real property loss of $25,000 isn't subject to at-risk limitations; the $75,000 balance of the loss incurred by the restaurant is subject to the at-risk limitations.

In the case of a nursing home or old age home, the health care and meals provided aren't considered incidental to making the real property available as living accommodations.

Consequently, a separation of the real property activity and the health care and meals activity (or activities) is required.

Real estate placed in service before '87 and used in one of the specific at-risk activities is unaffected by the exclusion of real estate from the at-risk rules.

Thus, real property used in farming is considered a part of the farming activity subject to the at-risk rules.

Activities

(1) Types of activities:

(A) holding, producing, or distributing motion picture films or video tapes

(B) farming

https://www.law.cornell.edu/uscode/text/26/464

- **defined in section 464(e):**

- The term "**farming**" means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals.

- **Trees** (other than trees bearing fruit or nuts) shall **not** be treated as an agricultural or horticultural commodity

(C) leasing any **section 1245 property**

26 U.S. Code § 1245 - Gain from dispositions of certain depreciable property
https://www.law.cornell.edu/uscode/text/26/1245

- **defined section 1245(a)(3):**
  Any property which is or has been property of a character subject to the allowance for depreciation provided in **Section 167 - Depreciation** and is either—

(A) Personal property

(B) Other property (**not** including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments for a period in which:

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage

of fungible commodities (including commodities in a liquid or gaseous state),

(D) Exploring for, or exploiting, oil and gas resources

(E) Exploring for, or exploiting, geothermal deposits

- **26 U.S. Code § 613 - Percentage depletion**
  https://www.law.cornell.edu/uscode/text/26/613
  (as defined in section 613(e)(2)) [1]:
  Geothermal deposit means a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure) as a trade or business or for the production of income

(2) Separate activities

(A) In general

- AGGREGATION OR SEPARATION OF ACTIVITIES
  https://www.irs.gov/pub/irs-pdf/i6198.pdf
  Form 6198 is filed for each separate activity. Each investment that is not part of a trade or business is considered separate. Special rules apply for activities can be considered aggregation activities and clumped together regarding income, gains, losses and deductions.

- A taxpayer's activity with respect to each—

  (i) film or video tape

  (ii) section 1245 property which is leased or held for leasing,

  (iii) farm,

  (iv) oil and gas property (as defined under 26 **U.S. Code § 614 - Definition of property**), or

  (v) geothermal property (as defined under section 614),
  shall be treated as a separate activity.

(B) Aggregation rules

(i) Special rule for leases of section 1245 property by partnerships or S corporations

In the case of any partnership or S corporation, all activities with respect to section 1245 properties shall be treated as a single activity if —

(I) are leased or held for lease, and

(II) are placed in service in any taxable year of the partnership or S corporation,

(3) Extension to other activities

A trade or business shall be treated as **one** activity if the trade or business is carried on by a partnership or an S corporation and **65 percent or more** of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business.

(4) Exclusion for certain equipment leasing by closely-held corporations

(A) In general the activity of **equipment leasing** shall be treated as a separate activity

(B) **50-percent gross receipts test**
A corporation shall not be considered to be actively engaged in equipment leasing unless **50 percent or more** of the gross receipts of the corporation for the taxable year is attributable to equipment leasing.

(C) Component members of controlled group treated as a single corporation shall be treated as a single corporation.

(5) Waiver of controlled group rule where there is substantial leasing activity

(A) In general

In the case of the component members of a qualified leasing group, **50-percent gross receipts test** shall be applied by substituting "**80 percent"** for "**50 percent"**

(B) **Qualified leasing group**

A **controlled group of corporations** which, for the taxable year and each of the 2 immediately preceding taxable years, satisfied each of the following 3 requirements:

(i) At least 3 employees
During the entire year, the group had at least 3 full-time employees substantially all of the services of whom were services directly related to the equipment leasing activity of the qualified leasing members.

(ii) At least 5 separate leasing transactions
During the year, the qualified leasing members in the aggregate entered into at least 5 separate equipment leasing transactions.

(iii) At least $1,000,000 equipment leasing receipts
During the year, the qualified leasing members in the aggregate had at least $1,000,000 in gross receipts from equipment leasing.
The term "**qualified leasing group"** does **not** include any controlled group of corporations.

(C) Qualified leasing member

A corporation shall be treated as a **qualified leasing member** for the taxable year only if it is a component member of the controlled group of corporations, and it meets the requirements t**he 50-percent gross receipts test**

(6) Definitions

(A) Equipment leasing

The leasing of equipment which is section 1245 property (**26 U.S. Code § 1245 - Gain from dispositions of certain depreciable property**), and
the purchasing, servicing, and selling of such equipment.

(B) The term "**equipment leasing"** does **not** include the leasing of master sound recordings, and other similar contractual arrangements with respect to tangible or intangible assets associated with literary, artistic, or musical properties.
(C) Controlled group of corporations; component member

Taxpayer Advocacy Services Inc.

John R Dundon II, Enrolled Agent #00085353EA PTIN P00605639
(c) 720-234-1177 John@JohnRDundon.com http://JohnRDundon.com

26 U.S. Code § 1563 - Definitions and special rules:

https://www.law.cornell.edu/uscode/text/26/1563

The terms "**controlled group of corporations"** and "**component members"** have the same meanings as when used in section 1563

1. Parent-subsidiary controlled group

   One or more chains of corporations connected through stock ownership with a common parent corporation…

2. Brother-sister controlled group
3. Combined group
4. Certain insurance companies

(7) Exclusion of active businesses of qualified C corporations

(A) In general

in the case of a taxpayer which is a **qualified C corporation**—

(i) each **qualifying business** carried on by such taxpayer shall be treated as a separate activity, and

(ii) subsection **((a) Limitation to amount at risk)** shall not apply to losses from such business.

(B) "**Qualified C corporation**" means any corporation that meets:

26 U.S. Code § 542 - Definition of personal holding company

https://www.law.cornell.edu/uscode/text/26/542

(a)(2) **Stock ownership requirement**

At any time during the last half of the taxable year **more than 50 percent** in value of its outstanding stock is owned, directly or indirectly, by not **more than 5** individuals...

Which is -

Engaged in an activity, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount

with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

which is not—

(i) **a personal holding company** (as defined in section 542(a)), or

26 U.S. Code § 542 - Definition of personal holding company
https://www.law.cornell.edu/uscode/text/26/542

- **At least 60 percent** of its adjusted ordinary gross income for the taxable year is personal holding company income
- At any time during the last half of the taxable year **more than 50 percent** in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals...

(ii) **a personal service corporation**

26 U.S. Code § 269A - Personal service corporations formed or availed of to avoid or evade income tax
https://www.law.cornell.edu/uscode/text/26/269A
Defined in section 269A(b)

The term "**personal service corporation"** means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

Determined by substituting "**5 percent"** for "**10 percent"** in section 269A(b)(2)):

- The term "**employee-owner**" means any employee who owns, on any day during the taxable year, **more than 10 percent** of the outstanding stock of the personal service corporation.
- For purposes of the preceding sentence, section 318 shall

apply, except that "**5 percent"** shall be substituted for "**50 percent"** in:

26 U.S. Code § 318 - Constructive ownership of stock
https://www.law.cornell.edu/uscode/text/26/318
318(a)(2)(C):

> If ~~**50 percent**~~ ("**5 percent"**) or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(C) "**Qualifying business**" means any active business if—

(i) During the **entire 12-month** period ending on the last day of the taxable year, such corporation had **at least 1 full-time employee** substantially all the services of whom were in the active management of such business,

(ii) During the **entire 12-month** period, such corporation had **at least 3 full-time, nonowner employees substantially** all of the services of whom were services directly related to such business,

(iii) The amount of the deductions attributable to such business which are allowable to the taxpayer solely by reason of sections 26 **U.S. Code § 162 - Trade or business expenses** and **26 U.S. Code § 404 - Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan** for the taxable year **exceeds 15 percen**t of the gross income from such business for such year, and

(iv) such business is not an excluded business.

Taxpayer Advocacy Services Inc.

John R Dundon II, Enrolled Agent #00085353EA PTIN P00605639
(c) 720-234-1177 John@JohnRDundon.com http://JohnRDundon.com

(D) Special rules for application of "**Qualifying business"**

(i) Partnerships in which taxpayer is a **qualified corporate partner** if—

(I) the taxpayer is a **qualified corporate partner** in the partnership, and

(II) during the **entire 12-month** period ending on the last day of the partnership's taxable year, there was **at least 1 full-time employee** of the partnership (or of a qualified corporate partner) substantially all the services of whom were in the active management of such business,

- The taxpayer's proportionate share (determined on the basis of its profits interest) of the activities of the partnership in such business shall be treated as activities of the taxpayer
- (and clause (i) of subparagraph C - such corporation had at least 1 full-time employee) shall **not** apply in determining whether such business is a qualifying business of the taxpayer.

(ii) "**Qualified corporate partner**" means any corporation if—

(I) such corporation is a general partner in the partnership,

(II) such corporation has an interest of **10 percent or more** in the profits and losses of the partnership, and

(III) such corporation has contributed property to the partnership in an amount **not less than the lesser of $500,000 or 10 percent of the net worth** of the corporation - any contribution of property other than money shall be taken into account at its fair market value.

(iii) Deduction for owner employee compensation **not** taken into account

- There shall not be taken into account any deduction in respect of compensation for personal services rendered by any employee (other than a non-owner employee) of the taxpayer or any member of such employee's family

  26 U.S. Code § 318 - Constructive ownership of stock
  https://www.law.cornell.edu/uscode/text/26/318
  within the meaning of section 318(a)(1):

  - An individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and his children, grandchildren, parents and a legally adopted child of an individual shall be treated as a child of such individual by blood

(iv) Special rule for banks

For purposes of (clause (iii) of subparagraph C - The amount deductible exceeds 15 percent), in the case of a bank (as defined in **26 U.S. Code § 581 - Definition of bank**) or a financial institution to which **26 U.S. Code § 591 - Deduction for dividends paid on deposits** applies—

(I) gross income shall be determined without regard to the exclusion of interest from gross income under **26 U.S. Code § 103 - Interest on State and local bonds**, and

(II) in addition to the deductions described in such clause, there shall also be taken into account the amount of the deductions which are allowable for amounts paid or credited to the accounts of depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts under **26 U.S. Code § 163 -**

Taxpayer Advocacy Services Inc.

John R Dundon II, Enrolled Agent #00085353EA PTIN P00605639
(c) 720-234-1177 John@JohnRDundon.com http://JohnRDundon.com

Interest or **26 U.S. Code § 591 - Deduction for dividends paid on deposits.**

(v) Special rule for life insurance companies

(I) In general
Clause (iii) of subparagraph (C):

- The amount of the deductions attributable to such business which are allowable **exceeds 15 percent** of the gross income from such business for such year,

shall **not** apply to any insurance business of a qualified life insurance company.

(II) "**Insurance business**" means any business which is not a noninsurance business

26 U.S. Code § 806 - Small life insurance company deduction
https://www.law.cornell.edu/uscode/text/26/806
(within the meaning of section 806(b)(3))

The term "**noninsurance business**" means any activity which is not an insurance business.

Certain activities treated as insurance businesses:

- any activity which is not an insurance business shall be treated as an insurance business if—

(i) it is of a type traditionally carried on by life insurance companies for investment purposes, but only if the carrying on of such activity (other than in the case of real estate) does not constitute the active conduct of a trade or business, or

(ii) it involves the performance of administrative services in connection with plans providing life insurance, pension, or accident and health benefits.

(III) "**Qualified life insurance company**" means any company which would be a life insurance company if unearned premiums were not taken into account under

as defined **26 U.S. Code § 816 - Life insurance company defined**
https://www.law.cornell.edu/uscode/text/26/816

subsections (a)(2)

(a)the term "**life insurance company"** means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if—

(2) Comprise **more than 50 percent** of its **total reserves.**

Any company **more than half** of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

subsections (c)(2)

"**Total reserves"** means unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves

(E) Definitions For purposes of this paragraph—

(i) **Non-owner employee** means any employee who does not own, at any time during the taxable year, **more than 5 percent** in value of the outstanding stock of the taxpayer.

For purposes of the preceding sentence, **26 U.S. Code § 318 - Constructive ownership of stock** applies, except that "**5 percent"** shall be substituted for "**50 percent"** in section 318(a)(2)(C):

318(a)(2)(C) **From corporations**
If ~~**50 percent**~~ "**5 percent"** or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(ii) **Excluded business**

- Equipment leasing
- 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.

(iii) Special rules relating to **communications industry**

(I) A business involving the use, exploitation, sale, lease, or other disposition of property are not an excluded business if the taxpayer is at risk with respect to all amounts paid or incurred (or chargeable to capital account) in such business.

(II) the provision of radio, television, cable television, or similar services shall not constitute an excluded business

(F) Affiliated group treated as 1 taxpayer

For purposes of this paragraph—
(i) In general
The component members of an affiliated group of corporations shall be treated as a single taxpayer.
(ii) **Affiliated group of corporations** means an affiliated group (as defined in section 1504(a)) which files or is required to file consolidated income tax returns.
(iii) **Component member** means an includible corporation (as defined in

section 1504) which is a member of the affiliated group.

(G) Loss of 1 member of affiliated group may not offset income of personal holding company or personal service corporation

Nothing in this paragraph shall permit any loss of a member of an affiliated group to be used as an offset against the income of any other member of such group which is a personal holding company (as defined in section 542(a)) or a personal service corporation (as defined in section 269A(b) but determined by substituting "5 percent" for "10 percent" in section 269A(b)(2)).

Special at-risk rules apply to property eligible for the investment credit.

The basis of investment credit property must be reduced by nonqualified, nonrecourse financing determined at the close of the tax year in which the property is placed in business.

To be qualified financing:

1. the property must be acquired from an unrelated party;
2. the nonrecourse financing must not exceed 80% of the investment credit base; and
3. the loan must be from or be guaranteed by a governmental authority, or from an entity that is engaged in the lending business and is unrelated to the purchaser.