



# Segregation and Aggregation of Activities

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## **Segregation and Aggregation of Activities**

The following lists which activities must be segregated or aggregated for purposes of applying the at-risk rules.

1. Original Five At-risk Activities. Each of the original five at-risk activities is considered to be a separate at-risk activity. Additionally, each oil and gas property, film, etc., within the five listed activities is considered a separate activity. However, IRC Sec. 465 allows aggregation of activities in the following circumstances:

- a. Partnerships and S corporations engaged in equipment leasing are required to aggregate all Section 1245 equipment placed in service during a tax year [IRC Sec. 465(c)(2)(B)].
- b. Taxpayers are required to aggregate all activities constituting a separate trade or business in which the taxpayer actively participates in management. (Partnerships and S corporations are deemed to meet the active participation requirement if 65% of all losses are allocated to taxpayers who actively participate in the business.) [IRC Sec. 465(c)(3)(B).]
- c. Partnerships and S corporations can choose to aggregate all activities conducted within any of the original five at-risk activities except equipment leasing. For example, all the oil and gas wells owned by a partnership can be aggregated as one activity—however, farming activities cannot be aggregated with oil and gas wells.

### **Trade or Business Activities Other Than the Original Five At-risk Activities and Real Estate**

Activities constituting a taxpayer's single trade or business are required to be aggregated if the taxpayer actively participates in the business.

(Partnerships and S corporations are deemed to meet the active participation requirement if 65% of all losses are allocated to taxpayers who actively participate in the management of the trade or business.)

### **Real Estate**

All real estate held by a taxpayer is considered a single activity.

This rule does not apply to real estate held in connection with an activity described in Item 1 or 2.

In other words, if real estate is held in connection with an oil and gas activity, or an active trade or business, it is included in that activity rather than in the activity of holding real property.

**Observation:** While a partner or partnership will often want to treat activities as separate under the passive activity loss (PAL) rules, it is generally preferable to aggregate activities for at-risk purposes.





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In many cases, the result of such aggregation will be calculating the at-risk limit with respect to an entire partnership interest rather than activity-by-activity.

This provides the partner with the largest at-risk amount against which losses can be deducted.

## **Examples**

### **Example 1: Aggregation of equipment leasing activities.**

**Risky Business Partners** is a general partnership owned 20% each by Ann, Betty, Carol, Denise, and Eloise.

All partnership income and expenses are related to equipment leasing. The partnership has a \$50,000 taxable loss in 2016, allocable to each partner as follows:

	Property Placed in Service during 2011	Property Placed in Service during 2013	Property Placed in Service during 2015	Total
Rental income	\$ 6,000	\$ 8,000	\$ 8,000	\$ 22,000
Depreciation expense	—	(32,000)	(20,000)	(52,000)
Interest expense	—	(10,000)	(10,000)	(20,000)
Taxable income (loss)	\$ 6,000	\$ (34,000)	\$ (22,000)	\$ (50,000)

Since the partnership must aggregate as a single activity all of the equipment placed in service during a tax year, it has three at-risk activities with taxable income (loss) of \$6,000, \$(34,000), and \$(22,000).

The deductibility of the losses for property placed in service in 2013 and 2015 is determined separately.

Assume Ann has \$15,000 at risk in Risky Business, and \$5,000 is allocated to each activity.

Even though her total amount at risk exceeds her share of loss (\$10,000), \$1,800 of the loss will be suspended because Ann's \$6,800 share of the loss related to property placed in service during 2013 exceeds her amount at risk (\$5,000) in that activity.

**Observation:** The difficulty arises in determining the amount at risk for each partner in each activity.

If the money borrowed to finance the equipment is recourse debt and is secured by the property, the allocation of the amount at risk from debt is relatively simple.

However, if all equipment purchases are financed through a line of credit, how is the amount at risk from debt allocated?

Also, how are partner capital contributions allocated among the various activities?

Since there is little guidance on the actual application of the at-risk provisions, it seems any reasonable method can be used, as long as it is used consistently.



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For example, the practitioner might assume all capital contributions made in 2015 were used to finance the acquisition of property placed in service in 2015, or all money funded with the line of credit in 2015 was used to fund property acquisitions.

If a partnership has more than one at-risk activity, the determination of the amount at risk for each activity is done after the fact.

If the partners make cash contributions during the year and some of the partnership activities show a profit while others show a loss, it is reasonable to allocate all cash contributions to the activities showing the loss.

In fact, the activities generating losses probably did absorb the cash contributed.

### **Example 2: Aggregation of original five at-risk activities.**

Assume the same basic facts as in Example 1.

In the current year, Risky Business Partners decides to diversify beyond equipment leasing.

The partnership acquires three oil wells and the rights to distribute two motion pictures.

For 2016, the partnership must continue to treat all equipment placed in service during the same tax year as a separate activity, as in Example 1.

With respect to the new activities, the partnership has an option to either aggregate the three oil wells or treat each well as a separate activity.

The same option exists with regard to the two movie deals—the partnership can treat the two movies as two separate activities or aggregate them into one activity.

## **Applying the At-risk Limits**

### **Separate Computations May Be Required for Each Activity.**

When a partnership is involved in more than one activity and one or more of the activities incurs a loss for the year, each activity's profit and loss is computed separately.

The partnership must provide each partner with a schedule that reflects the allocable gross income and deductions for each activity, to allow testing of the at-risk amount separately for each activity at the partner level.

### **Example: Separate computations for multiple activities within a partnership.**



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Barry is a partner in a partnership that conducts two unrelated activities—a retail clothing store and a wholesale hardware distributorship.

Barry is not active in either business.

For the current year, the retailing activity produces income of \$50,000 and the hardware distributorship results in a loss of \$40,000.

For at-risk purposes, Barry must consider each of these activities separately.

This could result in postponement of deductibility of the \$40,000 hardware distribution loss if Barry does not have sufficient at-risk investment in this activity.

It appears Barry should apply tracing principles to determine his at-risk amount in each of the two activities [although there is no specific guidance on this in either the regulations or IRS Publication 925 (Passive Activity and At-Risk Rules)].

The rule that each activity within a partnership is tested separately under the at-risk rules has two exceptions when there is active participation in management.

IRC Sec. 465(c)(3)(B) holds that all activities that constitute a trade or business are treated as a single activity if—

1. the taxpayer actively participates in the management of the trade or business, or
2. the trade or business is carried on by a partnership or an S corporation and 65% or more of the losses for the year are allocable to persons who actively participate in the management of the trade or business.

Note: Active participation for purposes of applying the at-risk rules of IRC Sec. 465 has nothing to do with the degree of participation that is considered for purposes of applying the PAL rules of IRC Sec. 469.

Although the IRS has issued no specific guidance, the Committee Report [H. Rep. No. 95-1445 (P.L. 96-600), 1978-3 Vol. 1 CB 241, at 243] states that the factors indicating active participation for at-risk purposes are—

1. participation in decisions involving the operation or management of the trade or business,
2. performing services for the trade or business, or
3. hiring and discharging employees (versus the authority to do so only for the person who is in charge of the trade or business).

Similarly, the Committee Report states that the factors indicating a lack of active participation for purposes of the at-risk rules are—

1. lack of control of management and operation of the trade or business,



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2. authority only to discharge the manager of the trade or business, or
3. having an independent contractor (rather than an employee) as the manager of the trade or business.

### **Example 4: Separate reporting not required when the 65% rule applies.**

Artco Partnership operates a refrigerated warehouse in a southern state and provides commercial transportation of frozen goods.

In a western state it has a separate activity that hauls bulk oil.

Artco is owned 25% each by Andy, Bob, Charlie, and Dave.

The first three partners actively participate in the management of Artco, while Dave is simply a passive investor.

Because 75% (i.e., at least 65%) of any Artco losses are allocable to individuals who actively participate in management, all activities comprising Artco's transportation business are to be aggregated for at-risk purposes.

All partners, including Dave, receive the benefit of aggregation under the at-risk rules.

Conversely, if less than 65% of the losses were allocable to active participants, only those partners actively participating in management would be entitled to aggregate the activities for at-risk purposes.

### **Calculating At-risk Limit for Single or Aggregated Activities.**

As mentioned earlier in this key issue, the at-risk limit calculation may be done (or may be required to be done) using an activity-by-activity concept or an aggregated activity concept.

Subject to the allocation issues, the calculation of the amount at risk on the measurement date (usually the last day of the partnership's tax year) is done for a single activity or an aggregated group of activities as follows:

1. Add the cumulative amount of cash contributed to the partnership with respect to the single activity or aggregated group of activities.
2. Add the cumulative adjusted basis of property contributed to the partnership with respect to the single activity or aggregated group of activities.
3. Add the cumulative allocations of income and gains with respect to the single activity or aggregated group of activities.
4. Add a general partner's share of partnership recourse debt with respect to the single activity or aggregated group of activities.
5. Add the partner's share of any other partnership debt with respect to the single activity or aggregated group of activities for which the partner is ultimately liable.



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6. Add the partner's share of partnership qualified nonrecourse financing (Key Issue 29D) with respect to the single activity or aggregated group of activities.
7. Subtract cumulative distributions of cash and cumulative tax basis (in the partner's hands) of property distributions (Chapter 33) with respect to the single activity or aggregated group of activities.
8. Subtract cumulative allocations of losses and deductions previously allowed under the at-risk rules with respect to the single activity or aggregated group of activities.

The result of this calculation is the partner's amount at risk in the single activity or aggregated group of activities as of the measurement date.



**W112: Carryforward Worksheet for Determining Partner's Amount at Risk**

Client Name/ID:   
 Prepared by:   
 Reviewed by:

Tax Year Ended:   
 Date Prepared:   
 Date Reviewed:

**Partner's Name:**       **Year**       **Year**       **Year**       **Year**

1. Amount at risk at end of previous tax year.      \$  \$  \$  \$
2. Cash contributed to the partnership.
3. The adjusted basis (to the partner) of property contributed to the partnership, less debt encumbering the property for which the partner is not personally liable.
4. Income or gain of the partnership allocable to the partner.
5. Current-year additions to partnership recourse loans for which the partner is liable under the terms of the partnership agreement or under the operation of state law, assuming the answers to the following two questions are "yes."
  - a. Repayment is not contingent on another event (except default).  
     Yes                      No
  - b. The creditor has no interest in the activity other than as a creditor and the activity is one of the original five at-risk activities.  
     Yes                      No
6. Current-year additions to partnership nonrecourse loans to the extent they constitute "qualified nonrecourse financing," i.e., the loan is:
  - a. made with respect to holding real property.
  - b. made by a person regularly engaged in lending money.
  - c. not made by the person from whom the property was acquired.
  - d. not made by a person who received a fee with respect to the investment in the property.
  - e. not made by a related person on commercially unreasonable terms.
  - f. not the personal liability of any person.
  - g. not convertible debt.
7. Current-year additions to nonrecourse partnership debt under which the personal liability of the partner meets all the requirements of a recourse loan, e.g., it is a nonrecourse loan made by the partner to the partnership.
8. The FMV of property (not used in the at-risk activity) that has been pledged by the partner during the current year as security for a partnership nonrecourse loan (the proceeds of which will be used in the activity).
9. Cash distributions from the partnership.      (  ) (  ) (  ) (  )
10. Property distributions from the partnership to the extent of the property's adjusted basis (to the partner), less debt encumbering the property.      (  ) (  ) (  ) (  )
11. Current-year repayments of a partnership loan described at 5, 6, or 7.      (  ) (  ) (  ) (  )
12. Proceeds of any loan borrowed by the partner or the partnership for use outside the at-risk activity but secured by property used in the activity.      (  ) (  ) (  ) (  )
13. Partnership losses allocable to the partner.      (  ) (  ) (  ) (  )
14. Total amount at risk at end of year. (If negative, that amount is not allowed due to at-risk limitations.)      \$  0 \$  0 \$  0 \$  0

Caution: This worksheet is not an all-inclusive analysis of items that might affect a partner's amount at risk. See IRC Sec. 465 and Prop. Regs. 1.465-1 through -95.



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## **Observation:**

In many cases, it will be allowable and desirable to aggregate all of the partnership's activities for purposes of making the at-risk limit calculation.

In such cases, the at-risk limit calculation is effectively done for the entire partnership interest and is similar to calculating the partner's tax basis in the partnership interest.

## **Partner Recordkeeping and Reporting**

A partner must maintain a record of his or her at-risk amount if the investment involves—

1. nonrecourse loans, either to finance the investment in the partnership or to acquire the partnership interest;
2. cash, property, or borrowed funds used in the activity that are protected against loss by a guarantee, stop-loss agreement, or other similar arrangement; or
3. amounts borrowed for use in the activity from a person who has an interest in the activity (other than as a creditor) or who is related to a person with such interest.

If the partner is exposed to the at-risk limitations because of any such investments, Form 6198 (At-Risk Limitations) must be filed with the partner's tax return to calculate the partner's at-risk amount and annual deductible loss.

If the partner is also subject to the PAL rules, Form 6198 is completed first, and any allowable loss is generally carried to Form 8582 (Passive Activity Loss Limitations) for testing under the PAL rules.

A partner is allowed to increase his or her amount at risk for the current year's income or gains (whether taxable or nontaxable), cash and the adjusted basis of other property contributed to the activity during the year, payments on nonrecourse notes involved with the activity, loans used to finance the activity on which the taxpayer is personally liable, and the net fair market value of property (other than property used in the activity) pledged as security against nonrecourse loans involved in the activity.

Decreases to the partner's at-risk amount include the proportionate share of losses and deductions, including nondeductible expenses not properly chargeable to capital, distributions during the tax year, nonrecourse loans used to provide cash or property contributed to the activity, and amounts borrowed from a person who has an interest in the activity.

According to Prop. Reg. 1.465-39, factors that increase or decrease the amount at risk are taken into account before the net current year loss is considered.

This approach is apparent in the calculation of the at-risk limit on Form 6198.



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A separate Form 6198 must be completed for each at-risk activity.

### **Example 5: Increases and decreases in amount at risk.**

Bud Clair is a partner in Bigco Partnership, a partnership involved in manufacturing.

Bud became a general partner last year when Mr. Big offered him a 10% partnership capital and profits interest for \$5,000 financed by a nonrecourse note secured only by Bud's interest in Bigco.

Even though the note gives Bud basis in his partnership interest, he is not considered at risk for the loan because it is nonrecourse. His prior year pass-through loss of \$5,000 is suspended under the at-risk limitations and carries over to the following tax year.

In the current year, Bud is allocated a \$2,000 ordinary loss on his Schedule K-1 from Bigco and also receives a \$1,000 pass-through Section 1231 gain.

Also, Bud makes a \$2,000 principal payment on the nonrecourse note.

For the Form 6198 Bud uses to calculate his current year amount at risk.

Bud completes both the simplified computation of amount at risk (Part II) and the detailed computation (Part III) and, in both instances, is allowed a net deductible loss for the current year equal to his \$2,000 amount at risk.

Temporary regulations under the Section 469 PAL rules state that at-risk limitation will be allocated to losses and deductions on a prorata basis.

The instructions to Form 6198 also take this prorata approach.

### **Example 6: Prorating at-risk limit among different types of losses.**

Assume that Bud has no suspended at-risk loss carryover and is allocated a current year Schedule K-1 ordinary loss of \$4,500 and a Section 1231 loss of \$1,500 (\$6,000 total loss).

Bud is allowed a current year net deduction of \$2,000 under the at-risk rules due to his \$2,000 principal payment on the note.

Bud prorates his \$2,000 allowable at-risk loss, claiming 75% ( $\$4,500 \div \$6,000$ ), or \$1,500, on Schedule E as an ordinary loss and 25%, or \$500, on Form 4797 (Sales of Business Property) as a Section 1231 loss.

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