



Taxpayers Who May Have At-Risk Deductions

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Taxpayers Who May have At-Risk Deductions

<https://www.irs.gov/pub/irs-pdf/i6198.pdf>

- Sole Proprietors, or individuals who own a business and are responsible for all profits, losses and liabilities and file **Schedule C**
- Taxpayers who file **Schedule E** for income from:

Rental real estate

Royalties

Partnerships

S corporations

Estates

Trusts

Residual interests in REMICs

<https://www.law.cornell.edu/uscode/text/26/860D#>

Real estate mortgage investment conduits

An entity that holds a fixed pool of mortgages and issues multiple classes of interests in itself to investors treated like a partnership for Federal income tax purposes with its income passed through to its interest holders

- Taxpayers who file **Schedule F - Profit or Loss from Farming**
- **Closely held C Corporations** - discussed in detail later

Limitation to amount at risk

In General - An individual and a closely held C corporation

- Any loss shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is **at risk** (below).
- With respect to which the stock ownership requirement of **section 542(a)2** is met



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

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

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...

Deduction in succeeding year

Any loss from an activity not allowed for the taxable year (or any unused losses) shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

For Example:

Year #1: You invest \$10,000 but lose \$25,000 in a partnership

You deduct \$10,000

Year #2: The suspended amount \$15,000 can be deducted if you invest \$15,000

The resulting at-risk amount will be \$0. If you invest \$20,000 instead of \$15,000, the resulting at-risk amount will be \$5,000.

Special rules

- The LIMITATION TO AMOUNT AT RISK shall be applied as if Section 544(a)(2) did **not** contain the phrase “**or by or for his partner**” in

26 U.S. Code § 544 - Rules for determining stock ownership:

<https://www.law.cornell.edu/uscode/text/26/544>

544(a) Constructive ownership: For purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership

544(a)(2) Family and partnership ownership

An individual shall be considered as owning the stock owned, directly or



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indirectly, by or for his family ~~or by or for his partner...~~

- The LIMITATION TO AMOUNT AT RISK

Substitute **“the corporation meet the stock ownership requirements of section 542(a)(2)”** for **“the corporation a personal holding company”** in Section 544(a)(4)(A) and Section 544(b)(1):

26 U.S. Code § 544 - Rules for determining stock ownership

<https://www.law.cornell.edu/uscode/text/26/544>

- **Section 544(a)(4)(A)**

544(a)(4) Constructive ownership - For purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership...

544(a)(4)(A) for purposes of the stock ownership requirement provided in section 542(a)(2), if, but only if, the effect is to make ~~the corporation a personal holding company~~ **“the corporation meet the stock ownership requirements of section 542(a)(2)”**

- **Section 544(b)(1)**

544(b) Convertible securities - Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock

544(b)(1) for purposes of the stock ownership requirement provided in section 542(a)(2), but only if the effect of the inclusion of all such securities is to make ~~the corporation a personal holding company~~ **“the corporation meet the stock ownership requirements of section 542(a)(2)”**



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Determining taxpayer's loss from an activity subject to the at-risk limitations.

Under the at-risk loss limitation rules, the losses that are limited to at-risk capital are the excess of the deductions allocable to the specific activity that would be allowed for the year (disregarding the “at-risk” limitation), over the income received or accrued by the taxpayer during the year from that same activity.

Under proposed regulations, deductions would be allowed to the extent of income from the activity even where the taxpayer has no (or a negative) amount at-risk.

The at-risk limitations would only apply to the loss, which is the excess of deductions over income.

Illustration:

Before taking into account gain or loss from the year, C has a negative amount at-risk in an at-risk activity.

For the year, there is income from the activity of \$15,000 and deductions of \$10,000.

There is no loss from the activity limited by the at-risk rules for the year because income exceeds deductions. Thus, the \$10,000 of deductions could be taken despite the negative at-risk amount.

The deductions entering into the computation of loss for the tax year include losses from earlier years which are treated as deductions in the current year.

Under proposed regulations, allowable deductions would be those which are otherwise allowable deductions incurred in a trade or business or for the production of income from the activity.

Capital losses would be treated as deductions without regard to the limitations on their deductibility.

Under proposed regulations, in computing deductions from an at-risk activity, proper allocations would be required where assets or personnel are used in more than one separate at-risk activity or in an at-risk activity and an activity not subject to the at-risk rules. Deductions attributable to the use of the assets or personnel would be allocated between the activities on a reasonable basis.

In determining the excess of expense deductions over income, the expenses are those which aren't disallowed by some other section of the Code.

For example, to the extent that prepaid interest must be deferred, it is NOT treated as a current expense in computing the at-risk limitation until the deferred interest becomes deductible.

SPECIAL NOTES

The at-risk limitation is to apply on the basis of the facts existing at the end of each year and applies



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regardless of the kind of accounting used or the kind of deductible expenses involved.

The Tax Court held that deduction of interest expense incurred in connection with an at-risk activity is subject to the at-risk limitation.

The “losses” affected by Code Sec. 465 don't include credits. Code Sec. 465 doesn't limit the allowance of credits. Code Sec. 49, however, does apply an at-risk limitation to certain credits.

Income treated as passive and offset by passive losses can NOT at the same time be treated as income that increases taxpayer's at-risk amount to allow access to losses limited by the at-risk limitations

At-risk capital reduced by losses allowed.

After determining the amount at-risk in a current year, that amount is reduced by any losses allowed under the at-risk limitation in earlier years.

Under proposed regulations, losses allowed for a tax year would NOT be able to reduce a taxpayer's at-risk amount below zero.

While allowable losses will never reduce a taxpayer's at-risk amount below zero, other factors may.

Under proposed regulations:

1. A taxpayer's amount at-risk would decrease by the amount of loss allowed as a deduction to the taxpayer under the at-risk limitations.
2. A loss would reduce the taxpayer's at-risk amount in the activity at the close of the tax year after the tax year for which the loss is allowable.
3. The taxpayer's at-risk amount would be decreased by his or her share of expenses relating to the production of tax-exempt receipts which are not deductible in determining taxable income.

Effect of at-risk limitation rule on assets' basis.

The at-risk limitation rule merely limits the amount of losses which can be deducted. *It doesn't apply for other purposes, such as the determination of basis.*

Thus, depreciation which is disallowed under the at-risk provision still reduces basis of the taxpayer's asset. Generally this means a partner's basis in his partnership interest will generally be unaffected by these at-risk disallowances.

Loss deductions from certain activities are limited to taxpayer's year-end “at-risk amount.”

In the case of a taxpayer subject to the at-risk rules who is engaged in an at-risk activity, any loss from the activity for the tax year is allowed only to the extent the taxpayer is at-risk with respect to the



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activity at the close of the tax year.

Losses limited under the at-risk rules are carried over.

The at-risk limitation has no effect if the activity is profitable.

The profit or loss of the activity is first calculated with all capital, risk and non-risk, taken into consideration.

Only if a loss results does the at-risk limitation apply.

Further, the at-risk limitation cannot create income (except in the case of recapture), it can only limit loss.

Form 6198 must be filed by taxpayers who have a loss from an at-risk activity in which they have invested amounts for which they aren't at risk.

Additionally, individuals, estates, and trusts reporting a loss from a business check off on Schedule C, Form 1040 (or Schedule F, for farming), whether "all investment is at risk" or "some investment is not at risk."

Under proposed regulations, where the activity is engaged in by an entity separate from the taxpayer, e.g., a partnership, the determination of the taxpayer's at-risk amount would be made as of the close of the tax year of the entity.

Coordination of passive loss rules with at-risk rules and partnership and S corporation deduction limitations.

An item of deduction from a passive activity that is disallowed under the at-risk rules or under the rules that limit deductions to a partner's basis in his partnership interest or an S corporation shareholder's basis in stock or debt of the S corporation is not a passive activity deduction for the tax year.

Thus, the at-risk rules must be applied before the passive activity rules in figuring allowable losses from an activity.

This means that only amounts that are not suspended under the basis limitation rules or the at-risk rules are subject to the passive activity limitations for the tax year.

Presumably, those suspended amounts will become subject to the passive activity limitations in later years when they are no longer suspended, i.e., when the taxpayer has additional basis or becomes at risk in the activity.

The following rules apply to determine the extent to which items of deduction from a passive activity are disallowed for a tax year under the basis limitation or at-risk rules:

- (1) If any amount of a partner's distributive share of a partnership's loss for the tax year is disallowed because the amount of the loss exceeds the adjusted basis of the partner's interest in the partnership, a ratable portion of the partner's share of each item of deduction or loss of the partnership is disallowed for the tax year.
- (2) The ratable portion is the amount of an item of deduction or loss multiplied by a fraction whose numerator is the amount of the partner's distributive share of partnership loss that is disallowed for the tax year and whose denominator is the sum of the partner's distributive shares of all



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items of deduction and loss of the partnership for the tax year.

Ordering Examples:

Example 1 – A, a partner in Partnership P has a basis of \$20,000 in her partnership interest before losses for the tax year are taken into account. Her share of P's losses for the tax year is \$25,000. Of this amount, \$5,000 cannot be deducted by A because the total loss exceeds her basis in her partnership interest.

The losses passed through to A consist of \$10,000 from passive activities and \$15,000 from non-passive activities. Twenty percent (the percentage that \$5,000 is of \$25,000) of the \$10,000 loss from passive activities (or \$2,000) is suspended under the basis limitation rules and is not treated as a passive activity deduction for the tax year.

Example 2 - If any part of an S corporation shareholder's pro rata share of the S corporation's loss for a tax year is disallowed because the amount of the loss exceeds the adjusted basis of the shareholder's interest in the stock or debt of the S corporation, a ratable portion of the shareholder's pro rata share of each item of deduction or loss of the S corporation is disallowed for the tax year.

The ratable portion is the amount of an item of deduction or loss multiplied by a fraction whose numerator is the amount of the S corporation shareholder's pro rata share of S corporation loss that is disallowed for the tax year and whose denominator is the sum of the shareholder's pro rata shares of all items of deduction and loss of the S corporation for the tax year.

Example 3 - If any amount of a taxpayer's loss from an activity is disallowed under the at-risk rules for the tax year, a ratable portion of each item of deduction or loss from the activity is disallowed for the tax year.

The ratable portion is the amount of an item of deduction or loss multiplied by a fraction whose numerator is the amount of the loss from the activity that is disallowed for the tax year and whose denominator is the sum of all deductions from the activity for the tax year.

Example 4 - Any part of an item of deduction or loss disallowed under the basis limitation rules is not taken into account in determining the loss from an activity to which the at-risk rules apply.

Example 5 - In identifying the items of deduction and loss from an activity that are not disallowed under the partnership and S corporation basis limitation rules and the at-risk rules and that therefore may be treated as passive activity deductions, the taxpayer need not account separately for any item of deduction or loss unless the item may, if separately taken into account, change his tax liability.

Items of deduction or loss that must be accounted for separately include items that:

- are attributable to separate activities
- arise in a rental real estate activity in which the taxpayer actively participates
- arise in a rental real estate activity in which the taxpayer doesn't actively participate;
- arose in a tax year beginning before '87 and were not allowed as a deduction under the



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partnership and S corporation basis limitation rules and the at-risk rules above; or

- are taken into account under:
 - i) [Code Sec. 613A\(d\)](#) (relating to limitations on percentage depletion deductions)
 - ii) [Code Sec. 1211](#) (relating to limitations on capital losses)
 - iii) [Code Sec. 1231](#) (relating to property used in a trade or business and involuntary conversions).

The Court of Federal Claims held that losses treated as suspended under the at-risk rules in a closing agreement entered into by taxpayer and IRS remained subject to the passive loss restrictions despite language in the agreement that the losses could be used to offset “any income.”

Specifically, the agreement provided that the losses disallowed to taxpayer were to be treated as suspended under the at-risk rules and could be used to offset “any income in accordance with the operation of [Code Sec. 465](#).”

Taxpayer carried the losses to years in which they would be allowed under Code Sec. 465 and sought to use them without regard to the passive loss restrictions. That is, taxpayer argued the phrase “any income” should be given its literal meaning. But the court disagreed, reasoning that the suspended losses could only be used “in accordance with the operation of Code Sec. 465,” and losses used in this fashion are generally subject to the passive loss restrictions. Absent a clear statement that the passive loss rules wouldn't apply, the court refused to exclude their application.

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