CHAPTER 7
LOSSES - DEDUCTIONS AND LIMITATIONS

I. Nature of a Loss

A. Annual (Activity) Loss

1. Results from deductions in excess of income

B. Transaction Losses

1. Results from a disposition at less than basis

   a. Amount Realized < Basis (Adjusted Basis)

C. On returns, losses are categorized as deductions

D. Concepts

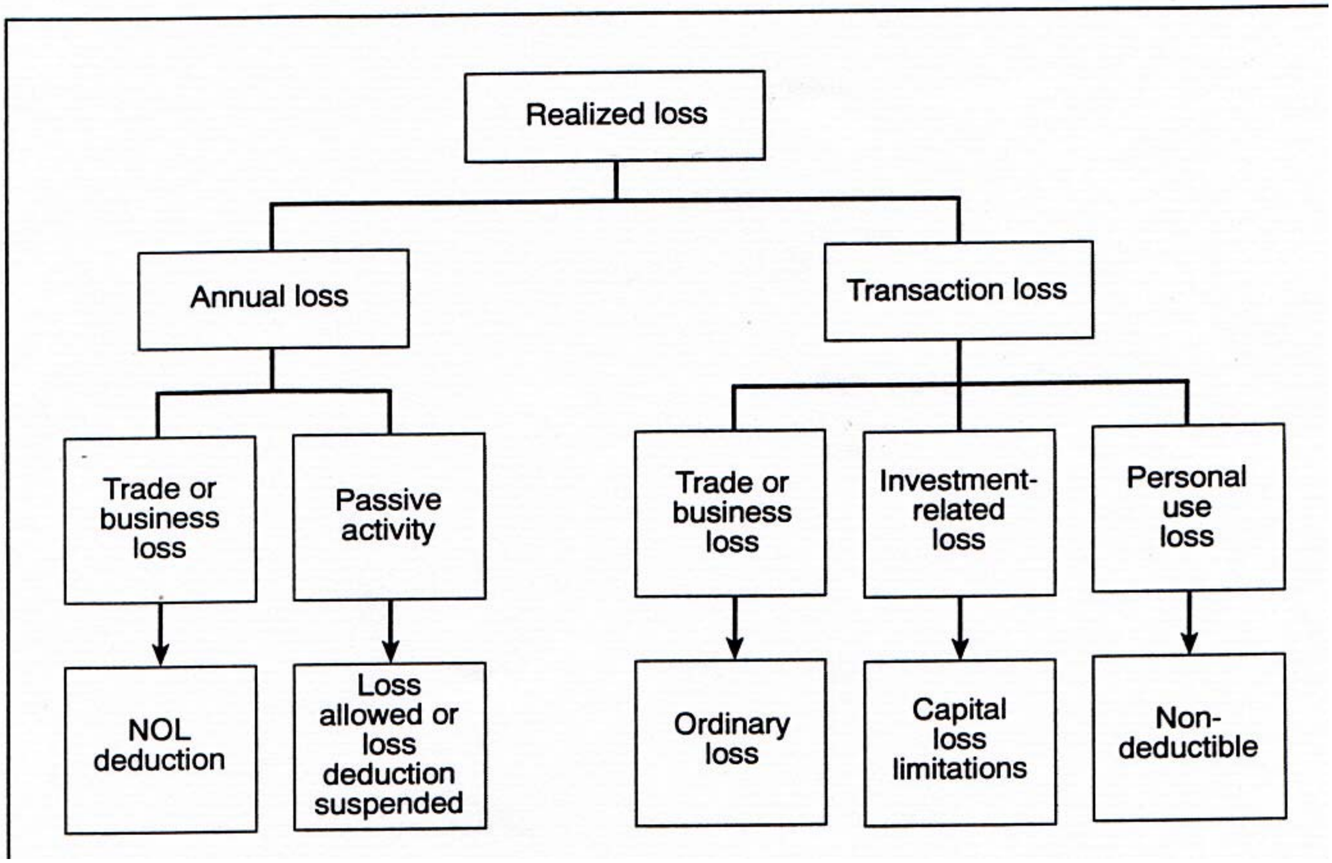
1. Overall - Ability to Pay
2. Legislative Grace
3. Realization
4. Capital Recovery

E. Categorization of Losses (Figure 7-1)

1. Trade or Business
2. Production of Income
3. Personal Use

■ *Figure 7.1*

General Scheme for Treatment of Losses



II. Annual (Activity) Losses (Figure 7-2)

A. Net Operating Losses (NOL)

1. **Effect of ANNUAL ACCOUNTING PERIOD**

2. **NOL provisions are restricted to Business Losses**

   a. **Personal Casualty Losses are considered business losses for NOL purposes.**

3. **Conduit Entities**

   a. **Losses flow to owners**

4. **Treatment of NOL's**

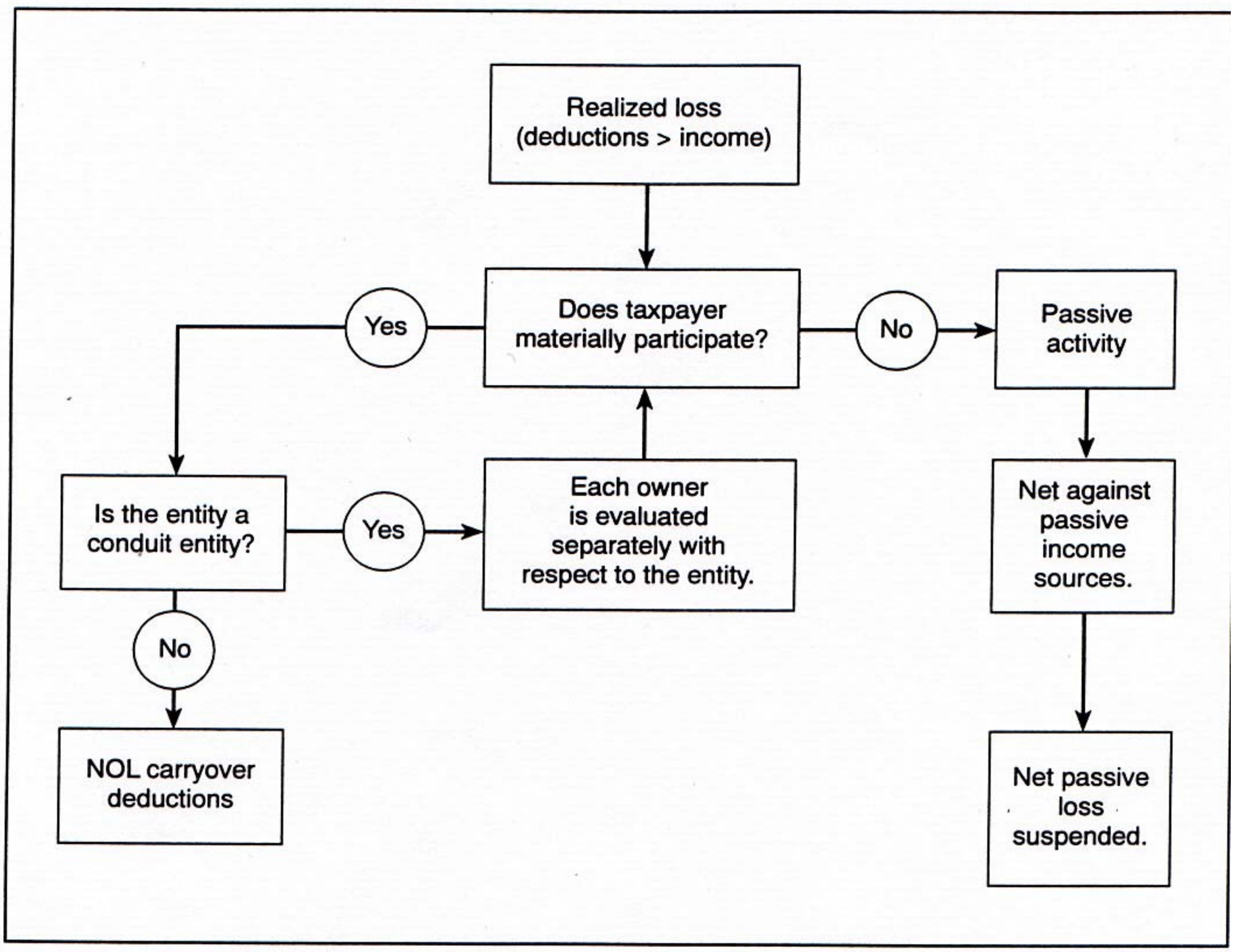
   a. **Carryback 2 years/then forward 20 years to offset income.**
   b. **May elect not to carryback**

5. Limitation - Corporate Acquisitions

a. Use of NOL deduction is restricted when there has been an ownership change in excess of 50% during the last three years.

Figure 7.2

Treatment of Annual Losses



III. Tax Shelter Losses

A. At-Risk Rules

1. Designed to limit the amount of loss a taxpayer can deduct from an activity to the taxpayer's economic investment in the activity. Note adjustment for debt which the taxpayer is personally liable for.

2. Calculation of Amount At-Risk (Exhibit 7-1) -- Basically, the maximum amount of personal funds (assets) that could be lost if the activity failed. Amount at risk is also adjusted for the taxpayer's share of the income (loss) from the activity and reduced by withdrawls from the activity. When the activity has income that is taxed to the taxpayer, the income becomes subject to loss, and thus, increases the taxpayer's amount at risk.

3. Weakness in rules - allowance of nonrecourse debt on real property as an increase of the amount at-risk. Nonrecourse debt is a liability that is secured only by the underlying property. The borrower is not personally liable for the debt. After 1987, nonrecourse financing is considered at risk if the taxpayer is either engaged in the trade or business of holding real property or is holding the real property for the production of income.

3. NOTE: Losses from activities must be deductible under the at-risk rules before the passive activity loss rules are applied to passive activities.

Exhibit 7.1

Computation of Amount at Risk

Items That Increase Amount at Risk:	
Cash invested by the taxpayer in the activity	$XXX
Adjusted basis of property contributed to the activity	XXX
Amounts borrowed for use in the activity for which the taxpayer is personally liable	XXX
Amounts borrowed for use in the activity for which the taxpayer has pledged property not used in the activity as security	XXX
The taxpayer's share of any income produced by the activity	XXX
Items That Decrease Amount at Risk:	
The taxpayer's share of any loss produced by the activity	(XXX)
Withdrawals of assets from the activity	(XXX)
Equals: The amount at risk in the activity	$XXX

B. Passive Activity Losses (PAL's)

1. **Definition - The conduct of any Trade or Business in which the taxpayer does not "materially participate."**

2. **All noncorporate taxpayers (individuals, estates, trusts) are subject to the passive activity rules.**

    a. **Publicly held corporations are not subject to passive activity rules.**

    b. **Closely-held corporations can offset passive losses against active business income of the corporation, but not against portfolio income.**

        1) **A closely-held corporation is one in which five or less shareholders own 50% or more of the stock during the last half of the year.**

3. **Statutorily Defined Passive Activities**

    a. **Rental Activities are passive (with 2 exceptions).**
    b. **Limited Partnership interests are passive.**

c. Working interests in oil and gas are active.
d. Low-income housing projects are active.

e. "Material Participants" in real estate activities are allowed to use losses from rental real estate activities as deductions against active and portfolio income. To qualify:

1) material participation in the activity (500 hour test)
2) more than 50% of the taxpayer's total personal services are in real property trades or businesses in which the taxpayer materially participates
3) more than 750 hours per year in real property trades or businesses in which the taxpayer materially participates
4) real property trade or business - any real property development, redevelopment, construction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. An employee of such a business must have > 5% ownership

4. Types of income - portfolio, active, passive

a. Portfolio v. Activity (Active & Passive)

1) Portfolio - dividends, interest, royalties, annuities, etc. from assets held as investments as well as gains (losses) from the sale of such investments. Key feature - taxpayer receives income, but is not liable for expenses of production of the income.

b. Active v. Passive - Depends on Material Participation (MP)

1) MP - In General - you are considered to MP in an activity if you are involved in the operations of the activity on a regular, continuous, and substantial basis.

2) Regulations provide 7 mechanical tests for MP (500 hour test/100 hour test)

5. General Rule - Passive activity losses are only deductible to the extent of passive activity income - i.e. you cannot use net losses from passive activities to reduce taxes on active or portfolio income.

a. **Any passive losses not currently deductible are suspended and carried forward to subsequent years for deduction against passive income in those years.**

b. **Suspended losses are deductible in full in the year in which the entire activity is disposed of in a "taxable" transaction.**

c. **"Active Participants" in Rental Real Estate Activities (RRE) can deduct up to $25,000 per year against portfolio and active forms of income.**

1) Active Participant - must own at least a 10% interest and have significant and bona-fide involvement in the activity. Less stringent than MP.

2) If the individuals Adjusted Gross Income is > $100,000, the $25,000 deduction is reduced by 50% of each dollar of AGI in excess of $100,000. i.e. At AGI of $150,000 you are not longer eligible for a deduction under this special rule.

6. **Dispositions by death - Only the net amount of suspended loss that would have been deductible if the activity had been sold at the date of death is deductible in the year of death.**

7. **Dispositions by Gift - Suspended losses on the activity are added to the basis of the donee; no suspended loss deduction is allowed for the donor.**

III. Transaction Losses

A. Business Losses

1. **Losses on dispositions of business assets are ordinary losses.**

2. **Business Casualty & Theft Losses (Involuntary Conversions)**

a. **Definition - Results from some sudden, unexpected or unusual event. Damage to property must occur.**

3. **Full Destruction (Theft)**

a. **Measure of Loss is Adjusted Basis.**

b. Loss is reduced by any insurance proceeds received.

4. Partial Destruction

a. Measure of loss is the lesser of:

1. Decrease in the FMV of the Asset (FMV before - FMV After)

or

2. Adjusted Basis of the Asset.

b. Use of repair costs to estimate decrease in FMV.

c. Loss is reduced by any insurance proceeds received.

B. Investment Related Losses (Capital Losses)

1. Definition of Capital Asset - All assets other than

a. Receivables
b. Inventories
c. Depreciable property & real estate used in a trade or business.

2. For individuals, the primary capital assets are personal use assets (cars, furniture, clothing, residence) and investment assets (stocks, bonds, land held for investment)

a. Note: Sales of personal use assets at a gain are includible in gross income. Losses on sales of personal use assets are not deductible and do not enter the capital gain/loss calculation.

3. Treatment - Individuals - Net Capital Losses for the year are limited to $3,000. For purposes of this loss deduction, capital gains are netted against capital losses for the year. If a net gain results, the gain is included in gross income. If a loss results, the net loss is subject to the limitation.

a. Any net loss in excess of $3,000 is carried forward and netted against capital gains in subsequent years.

4. Treatment - Corporations - are only allowed to deduct capital losses against capital gains. A net capital loss is never deductible against

other types of income.

a. Corporations are allowed to carry back capital losses three years and use the losses to offset capital gains in the carryback years. If there are no (or insufficient) capital gains in the carryback period to absorb the losses, a carry forward of five years is allowed.

5. Special Treatments

a. Small Business Stock

1) Losses on qualifying Small Business Stock are entitled to ordinary loss treatment on the first $50,000 ($100,000 married) of loss incurred during the year.

b. Losses on Related Party Sales

1) Losses on Sales to Related Parties are disallowed.

2) Upon subsequent sale to an unrelated party, the purchaser may use the disallowed loss to offset gain. However, the disallowed loss cannot be used to create a loss (or make a loss larger) on the second sale.

3) Note: This applies to all related party sales, not just sales of capital assets.

c. Wash Sales

1) Any sale of a security at a loss when substantially identical securities have been purchased within 30 days of the loss sale (before & after) is disallowed as a wash sale (no change in economic position).

a) The disallowed loss on a wash sale is added to the basis of the shares repurchased.

C. Personal Use Losses

1. **In general, losses on personal use assets are disallowed.**

    a. **Remember that gains remain taxable as capital gains**

2. **Personal Casualty and Theft Losses**

    a. **All losses measured as the lesser of:**

        1) **Decrease in the FMV of the Asset**

    or

        2) **Adjusted Basis of the Asset.**

3. **Each individual loss (event) incurred is reduced by:**

    a. **Insurance proceeds received.**

    b. **$100 per event (statutory floor)**

4. **Reporting**

    a. **Personal casualty and theft losses are allowed as itemized deductions. The total of all losses occurring during the year is reduced by 10% of the taxpayer's adjusted gross income.**