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TAX RULES THAT CAN BE REPEALED OR MODIFIED DUE TO THE SECTION 469 PASSIVE ACTIVITY LOSS LIMITATION RULES

This proposal was prepared by Annette Nellen.[1] The author thanks reviewers Caroline Chen and Roger Royse for their helpful comments.[2]

Contact Person: Annette Nellen, CPA, Esq.
Professor, Accounting & Finance
College of Business
San José State University
One Washington Square
San José, CA 95192-0066
W (408) 924-3508
annette.nellen@sjsu.edu

[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or its Taxation Section.

[2] Although the author or reviewers on this project might have clients or employers affected by the rules addressed in this paper, no such person has been specifically engaged by a client or employer to participate on this proposal.

EXECUTIVE SUMMARY

IRC Section 469, Passive Activity Losses and Credits Limited, was enacted as part of the Tax Reform Act of 1986. This provision curtailed the tax shelter industry that flourished prior to 1987 to reduce tax liabilities of many individuals. Section 469 has been in existence for over 30 years, and it is long past time to modify or even repeal certain rules that existed prior to its enactment because their purpose is no longer served or needed due to the operation of Section 469. Repeal or modification of these rules is also supported by changes in how many businesses operate today with a greater focus on services and human capital rather than significant fixed assets, and changes made by the Tax Cuts and Jobs Act of 2017 (such as the addition of Section 461(l) excess business loss limitation, and the significant expansion of business use of the cash method of accounting).

Repeal or modification of these rules would also significantly simplify the tax law for many taxpayers without causing inappropriate use of losses against active income (that is, tax sheltering). The provisions that should be repealed or modified due to the operation of Section 469:

- Section 280A(c)(5) disallowance or limitation of deductions for certain rental use of a dwelling unit.
- Section 448(a)(3) limitations on use of the accrual method of accounting by a tax shelter (also relevant to Sections 263A and 471(c)).
- Section 465, Deductions limited to amount at risk.

TAX RULES THAT CAN BE REPEALED OR MODIFIED DUE TO THE SECTION 469 PASSIVE ACTIVITY LOSS LIMITATION RULES

DISCUSSION

I. INTRODUCTION

IRC Section 469, Passive Activity Losses and Credits Limited, was enacted by the Tax Reform Act of 1986 (P.L. 99-514, Oct. 22, 1986). This provision curtailed the tax shelter industry that flourished prior to 1987. This was the intended purpose for enactment as Congress viewed the "increasing prevalence of tax shelters" as not only reducing tax revenues but contributing to "public concerns that the tax system was unfair, and to the belief that tax is paid only by the naïve and the unsophisticated" thereby undermining voluntary compliance and further encouraging the tax shelter industry with funds mostly used for tax avoidance rather than productive economic activity.[3]

The basic rule of Section 469 is that an individual and certain C corporations may only deduct a loss or tax credit from a passive activity against income from a passive activity (or for a passive activity credit, against income tax on passive activity income). Any passive activity loss or credit that cannot be used in the current year is carried forward and is attached to the loss activities for possible use in future years. A passive activity is a trade or business in which the taxpayer does not materially participate or any rental activity. Key rules define activity, rental activity (with six exceptions to the definition), material participation (with seven possible ways to meet this standard), and various special rules such as to recharacterize certain types of passive activity income, possibly allow real estate rentals to be

[3] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)*, JCS-10-87 (May 15, 1987), p. 210.

treated as non-passive for real estate professionals, and rules on how these loss limitations interact with pre-1986 rules such as the Section 280A rules limiting losses from renting a dwelling unit, Section 465 at-risk rules, and passthrough entity loss limitation rules.

Section 469 has been in existence for over 30 years now and it is long past time to modify or even repeal rules that existed prior to the addition of Section 469 because their purpose is no longer served or needed due to the operation of Section 469. Repeal or modification of these rules would also significantly simplify the tax law for many taxpayers. While Section 469 includes some complexity such as definitions, numerous exceptions to those definitions, income recharacterization rules, and more, there is likely widespread understanding of the basics of identifying passive activities and tracking passive activity losses, including with the use of tax preparation software.[4]

The provisions that should be modified or repealed due to operation of Section 469, that are the focus of this paper are:

- Section 280A(c)(5) disallowance or limitation of deductions for certain rental use of a dwelling unit.
- Section 448(a)(3) prohibition on use of simpler tax accounting methods by a limited partnership or Section 1256(e) syndicate which are types of tax shelters.
- Section 465, Deductions limited to amount at risk.

[4] Even the Tax Compliance and Planning (TCP) discipline exam (part of the CPA Exam for those opting for the TCP discipline rather than two other discipline exams) includes questions on calculating PALs, utilization of a PAL upon disposition of a passive activity, and interaction with the Section 465 at-risk rules. See AICPA, Uniform CPA Examination Blueprints, Sept. 2024, page TCP 7. In addition, undergraduate tax textbooks for accounting students are likely to cover Section 469 definitions, loss calculations and tracking, and special rules.

II. SECTION 469 LOSS LIMITATION JUSTIFIES REPEAL OF THE DWELLING UNIT LOSS LIMITATION PROVISION AT SECTION 280A

When a "dwelling unit"—generally a residence, is rented out, such as someone's principal residence or vacation home, the owner must first determine if the limitations at Section 280A(c)(5) or Section 469 will apply.[5] The rules at Section 280A predate rules at Section 469.[6] Because Section 469 applies to most rental activities of taxpayers, Congress could have repealed the dwelling rental rules of Section 280A and left Section 280A to primarily cover what it is best known for – limitations on deductions for office in the home. Instead, in technical corrections to Section 469, Congress added Section 469(j)(10) to provide that if a passive activity involves the use of a dwelling unit to which Section 280A(c)(5) applies for any tax year, the tax treatment of such use is not to be taken into account under Section 469 for that tax year.[7] As described further below, this also means that rental of a dwelling unit might fall under different loss limitation and carryforward rules from one tax year to the next.

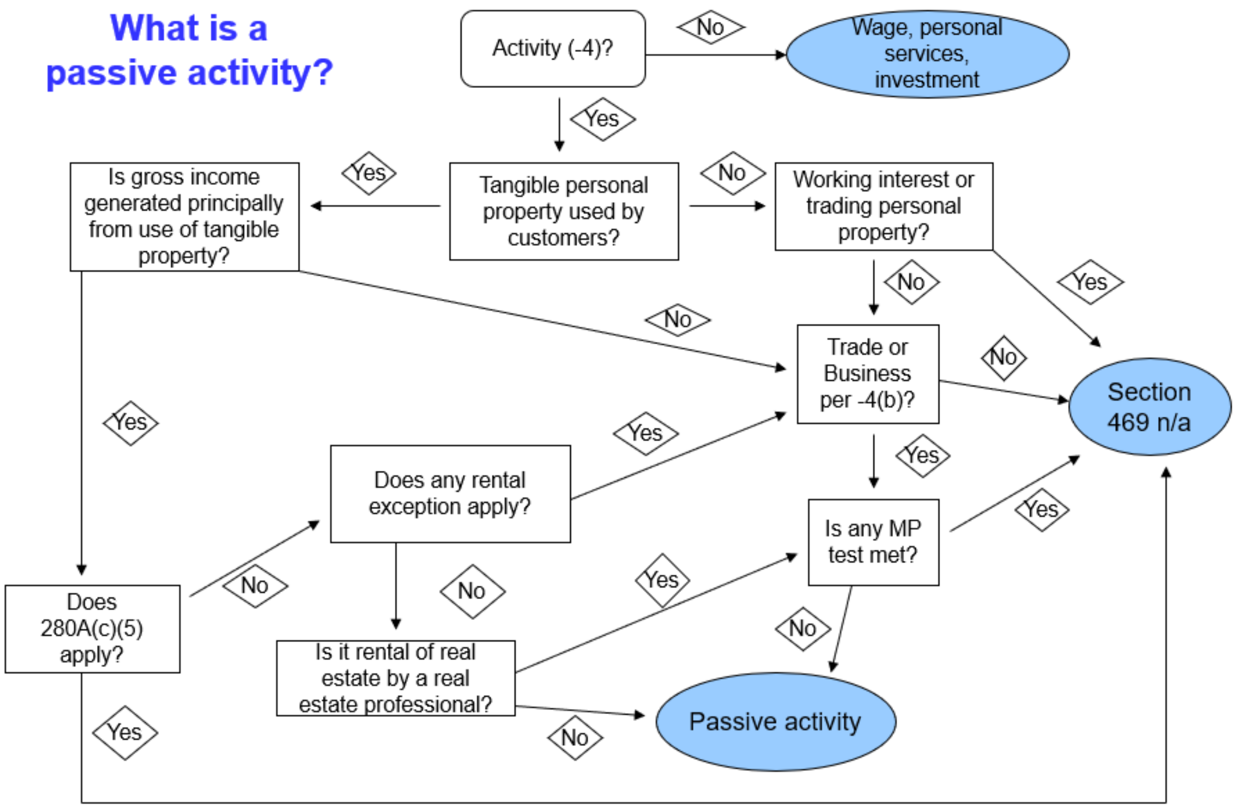
The following flowchart indicates the questions to address to determine if a taxpayer has a passive activity and how Section 280A(c)(5) requires an extra question if a rental is involved. Note that a yes answer to whether Section 280A(c)(5)

[5] There is one more possible rental option when a home is not used as a residence under 280A, has an average rental period of seven days or less so is not a rental (a per se passive activity) under Section 469 (Reg. 1.469-1(e)(3)(ii)(A)) and does not rise to the level of a trade or business for Section 469 purposes. In this situation, the hobby loss rules of Section 183 apply to determine the tax treatment.

[6] Section 280A, Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc., was added by the Tax Reform Act of 1976 (P.L. 94-455, Oct. 4, 1976).

[7] Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (P.L. 100-647, Nov. 10, 1988) added Section 469(j)(10).

applies indicates that Section 469 does not apply. But in this situation, the taxpayer must deal with the more intricate rules and limitations of Section 280A.



Per Section 280A(f)(1), a dwelling unit "includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit."[8] It does not include any portion of a unit that is "used exclusively as a hotel, motel, inn, or similar establishment."[9]

Per Section 280A(c)(3) and (5), if there is rental of a dwelling unit used by the taxpayer during the year as a residence, the deductions allowed under Chapter 1

[8] Per Prop. Reg. 1.280A-1(c), a dwelling unit "provides basic living accommodations such as sleeping space, toilet, and cooking facilities."

[9] While use of a property as a hotel or similar establishment is not a "dwelling unit" so is not subject to the deduction limitations of Section 280A(c)(5), the Section 469 passive activity loss limitation rules may apply to limit any loss. Since the average period of customer use is likely seven days or less, the hotel is not automatically a passive activity as a rental activity. It would only be a passive activity if it is a trade or business, and the individual owner does not materially participate in that business.

of the IRC that are attributable to the rental use may not exceed the excess of the gross income from such rental over the sum of "(i) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used, and (ii) the deductions allocable to the trade or business (or rental activity) in which such use occurs (but which are not allocable to such use) for such taxable year. Any deductions not currently allowed are treated as deductions in the succeeding tax year subject to the same limitations even if the dwelling is not used as a residence in that subsequent tax year.[10]

Per Section 280A(d), a dwelling unit is used as a residence during the year if the taxpayer uses it or a portion of the unit for personal purposes for a number of days which exceeds the greater of:

(A) 14 days, or

(B) 10% of the number of days during the year that the unit is rented as fair rental.

Any use of the unit by the taxpayer, anyone with an interest in the unit or any member of the family (per Section 267(c)(4)), is treated as personal use (even if rent is charged). Personal use also includes use by someone in exchange for the taxpayer using another unit. Rental at below a fair rental rate is also considered personal use.

Example: Amy owns a second home near a beach. She used it seven days during 2023 and allowed relatives to use it for below rental value with such use totaling 12 days during 2023. The home was rented to third parties at market rent for 160 days during 2023. This home is considered "used as a residence" for 2023 because the 19 personal use days exceeds 16 days (the greater of 14 days or 10% of 160 days). Thus, Amy must determine allowable rental expenses using the rules of Section 280A(c)(5) and associated proposed regulations. The Section 469 passive

[10] This rule on the treatment of deductions that exceed the limitations in any year being usable in a future year was added by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (P.L. 100-647, Nov. 10, 1988).

activity loss rules do not apply to this rental for 2023. In 2025, only Amy uses the home for seven personal use days and it is rented for 160 days at fair rental. For 2025, the home is <u>not</u> "used as a residence" because the seven personal use days do not exceed 16 days. For 2025, Amy will apply the Section 469 limitations to determine her deductible rental expenses against the rental income. If Amy carried forward deductions from 2023 under Section 280A, they do not factor into calculations for 2025 because those limitations don't apply for Amy in 2025.

Prop. Reg. 1.280A-1(e)(4) provides that if the owner uses the dwelling unit to perform repair or maintenance work on a "substantially full-time basis," such day does not count as a day of personal use. "An individual will be deemed to have satisfied this condition on any calendar day on which the individual works on the unit for the lesser of 8 hours or 2/3 of the time that the individual is present on the premises. If all individuals on the premises on a calendar day who are capable of working do work on the unit on a substantially full-time basis, incidental use of the unit on the same day by other individuals incapable of working, e.g., small children, shall be disregarded for purposes of paragraph (e)(1) of this section."

This special rule for days of repair under Section 280A adds further complexity in terms of recordkeeping and determining if the work counts as repairs and maintenance (for example, light cleaning versus heavy cleaning and repair). This type of measure is not used for the Section 469 loss limitations that generally count hours of material participation (or active participation for certain rentals under Section 469(i)).

Despite the fact that the Section 280A(c) loss limitations for rental of a dwelling unit were enacted in 1976, guidance for the required calculations is incomplete while it is complete under Section 469. Only proposed regulations (non-binding) exist to calculate the deduction limitations under Section 280A(c)(5) (Prop. Regs. 1.280A-1 to -3). The Section 280A rules on the ordering of deductions to be claimed further complicates matters. Generally, this ordering is (1) items otherwise allowable such as mortgage interest and real estate taxes, (2) items attributable to the generation of rent (for example, utilities), and (3) depreciation.[11] Following is an example of how the Section 280A(c)(5) calculations and limitations apply.

Example:[12]

> Carol owns a second home at the beach. She and her family use the house for 20 days in 2024. Carol has a rental agent rent the home whenever possible during the remainder of the year. There were 100 fair rental days in 2024. Thus, Section 280A(c)(5) applies[13] to determine the income and expenses, categorized and limited as follows per Prop. Reg. 1.280A-3(d):

Gross rental receipts	$15,000
Less expenditure to obtain tenants (such as rental commissions and advertising)	1,200
Gross rental income[14]	13,800
Items otherwise allowable under the Code:[15]	
Mortgage interest	12,000
Property taxes	6,000
Total	18,000
Rental expenses other than depreciation:[16]	
Insurance	1,500
Repairs and maintenance	1,500
Utilities	1,800
Total	4,800

[11] Prop. Reg. 1.280A-3(d)(3).

[12] Example based on one from an article co-authored by Annette Nellen in 1990: "Rental of Residences," *The Tax Adviser*, Sept. 1990, p. 541. This article includes a flowchart of the possible tax rules that can apply when a residence is rented out by the owner (but omits the real estate professional rule of Section 469(c)(7) enacted after the article was written).

[13] The dwelling unit is used as a residence because the number of days of personal use (20) exceeds the greater of 14 days or 10% of the fair rental days (10).

[14] Prop. Reg. 1.280A-3(d)(2).

[15] Prop. Reg. 1.280A-3(d)(3)(i).

[16] Prop. Reg. 1.280A-3(d)(3)(ii).

Depreciation[17]	6,000

Carol owns only a principal residence with a $400,000 mortgage and the beach house. Under the court cases and proposed regulations, the deductions are calculated and allowed in the following order:

Gross rental income	$13,800
Expenses by category:[18]	
Items otherwise allowable under the Code[19] $18,000 x 100/365	(4,931)
Rental expenses other than depreciation $4,800 x 100/120	(4,000)
Depreciation[20] $6,000 x 100/120	(5,000)
Disallowed loss (depreciation category) to be carried forward to 2025	($ 131)

If Section 280A(c)(5) did not exist, Carol would need to determine each year if Section 469 applies. If the average period of customer use exceeds seven days, the Section 469 limits apply (the activity is a rental) and the computations in the example could apply similarly. The Section 469 treatment in such circumstances would be more favorable and simpler in that categories of expenditures would not be needed

[17] Prop. Reg. 1.280A-3(d)(3)(iii).

[18] Section 280A(e)(1) and Prop. Reg. 1.280A-3(d)(3) specify that the portion of expenses attributable to rental use is based on the ratio of fair rental days to the number of days the dwelling is used for any purpose (other than repair or maintenance) during the tax year. Per Section 280A(e)(2), Section 280A(e)(1) does not apply to expenses otherwise allowable under the Code. In this example, the ratio is 100/120 for the rental-type expenses. The Tax Court has allowed the ratio for items otherwise allowable under the Code to be total fair rental days to days in the year since these items accrue ratably during the year, while expenses such as utilities are more closely related to actual use of the dwelling. See *Bolton*, 694 F2d 556 (9th Cir., 1982), *aff'g* 77 TC 104 (1981); *Baker*, TC Memo 1983-61; *McKinney*, 734 F2d 414 (10th Cir., 1983), *aff'g* TC Memo 1981-377. The Tax Court formula was applied in the example.

[19] The balance of these expenditures is allowed as itemized deductions. The beach house mortgage interest attributable to nonrental days is deductible as qualified residence interest since the house qualifies as Carol's second residence and other requirements and limitations for mortgage interest are met.

[20] There is no guidance on whether basis of the beach house is reduced by $5,000 or by the allowed amount for 2024 or only $4,869 ($5,000 less the unused loss from the depreciation category of $131). See Regs. 1.167(a)-10 and 1.183-1(b)(2))ii), Sections 280A(f)(3) and 1016(a)(2); PLR 8029030 (April 22, 1980).

as any loss attributable to rental days would be a passive activity loss that would first be applied against any income from other passive activities that Carol owns with the excess carried forward to the next year as a passive activity loss.

The Section 280A(c)(5) dwelling unit rental loss limitations are even further complicated by special rules at Section 280A(d)(3) for rentals to family members for use as a principal residence or use by the taxpayer as a principal residence. These rules refer to "shared equity financing agreements" which further confuse the determination of what expenses are allowed against rental income of the taxpayer for the dwelling unit. These rules are not used (or needed) under the Section 469 passive activity loss limitations. If the Section 280A dwelling rental rules did not apply, Section 469 would apply (assuming the activity is either a rental under Section 469 or a trade or business in which the taxpayer does not materially participate). The Section 469 rules are simpler than those under Section 280A regarding terminology, identification of deductible versus postponed deductions, and the possibility of claiming deferred deductions in future tax years.

Repeal of the Section 280A dwelling rental limitations: The rules governing rental of residences under Section 280A should be repealed. Limitations would still apply, but they would be those under Section 469, which arguably is a better-known and understood provision. As a transition, any deductions a taxpayer is carrying forward under Section 280A (such as $131 in the earlier example), should be treated as the carryforward of a passive activity loss under Section 469 unless the taxpayer can show that the dwelling rental was not a rental under Section 469 but met the definition of a trade or business under Section 469 and a material participation test was met each year.[21]

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[21] A further simplification for Section 280A that would also improve equity and fairness for real property rentals is to repeal the exclusion for rental income and expenses where the rental period is 14 days or less during the year (Section 280A(g)). See author blog post of Dec. 3, 2023, Odd Exclusion for Home Rental Is Overdue for Repeal, at https://21stcenturytaxation.blogspot.com/2023/12/odd-exclusion-for-home-rental-is.html.

A transition rule should also be provided for the Section 469(i) $25,000 offset for rental real estate activities with active participation. A possible transition rule could allow a taxpayer who was within the AGI limitation or phaseout range of Section 469(i), in at least one of the years when the Section 280A excess deductions arose to claim up to $25,000 of that loss over a three-year period beginning with the year that Section 280A(c)(5) is repealed. This would only apply if the average rental period in such years was greater than seven days (per Treas. Reg. 1.469-1T(e)(3)(ii)(A); if the average rental period is seven days or less, it is not a rental activity and Section 469(i) would not apply).

The elimination of the dwelling unit rental rules under Section 280A would also apply to the special rules on rental of a principal residence. The Section 469 rental rules can readily cover rental of all or a portion of a principal residence. In addition, there are special rules under Section 121, Exclusion of gain from sale of principal residence, that limit gain exclusion for certain rental use of the residence. Rental of a principal residence generally is considered a period of nonqualified use resulting in a reduction of the gain exclusion amount. In addition, upon disposition, depreciation claimed on rental of such residence produces gain that may not be excluded under Section 121 and is taxed at a 25% special capital gain tax rate.[22]

III. SECTION 469 SUPPORTS SIMPLIFICATION OF THE SECTION 448 DEFINITION OF TAX SHELTER TO REMOVE CERTAIN ENTITIES FROM AUTOMATICALLY BEING TAX SHELTERS

Section 448, Limitation on use of cash method of accounting, was added to the law by the Tax Reform Act of 1986 to prevent large C corporations and partnerships

[22] Sections 121(b)(5) and 121(d)(6), and Section 1(h).

with a C corporation partner from using the cash method of accounting even if it clearly reflects income. When enacted, “large” meant an entity with average annual gross receipts in the prior three-year period greater than $5 million (today, that figure is $31 million[23]). When enacted, Congress also provided that a tax shelter as defined under Section 448 must also use the accrual method regardless of its gross receipts level.

The definition of tax shelter for Section 448 purposes is quite broad. Section 448(d)(3) defines tax shelter using the definition at Section 461(i)(3). That definition covers three possible reasons that certain entities are a tax shelter:

> “(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
>
> (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and
>
> (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii)).

Section 1256(e)(3)(B), enacted in 1981,[24] defines a syndicate as “any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)).” Treas. Reg. 1.448-2 explains this definition and uses the term “allocated” rather than “allocable.” This regulation and its preamble explain that an entity can only possibly be a syndicate if it has a loss for the year.[25] The IRS also provides an election that

[23] The $5 million definition of “small” under Section 448 was added by the Tax Reform Act of 1986 without any inflation adjustment. The TCJA modified this definition including increasing it to $25 million of average annual gross receipts with this amount adjusted annually for the effect of inflation.

[24] Economic Recovery Tax Act of 1981 (ERTA) (P.L. 97-34, Aug. 13, 1981), Sec. 503.

[25] In the preamble to TD 9942 (Jan. 5, 2021), the IRS explains that it narrowed the definition of syndicate by changing “allocable” at Section 1256(e) to “allocated” because this change means that an entity can only possibly be a syndicate if it has a loss to allocate for the year.

an entity can make on a year-by-year basis for any year in which it generates a loss. This election provides that the entity will use information from the prior tax year to determine if the definition of a syndicate is met (Treas. Reg. 1.448-2(b)(2)(iii)(B)).

Including "syndicate" as a type of tax shelter is outdated for at least two reasons. First, an LLC can easily meet the definition if over 35 percent of losses are allocable to owners not involved in the entity's operations because, for example, they only provide financing. Such an LLC can be an appropriate financing model for a profit-motivated business that has no features of a tax shelter as most people would generally define this term. The general definition of a tax shelter that most people would offer matches the one at Section 6662(d)(2)(C)(ii) of an entity formed for tax avoidance or evasion purposes.

When the term syndicate was added to the law in 1981 at Section 1256(e)(3) and used by the Tax Reform Act of 1986 to define tax shelter for purposes of Section 448, LLCs did not exist in the majority of states.[26] Likely if Congress were to write a definition of tax shelter today, it would not include an LLC unless it had a tax avoidance purpose.

Another reason that use of the term "syndicate" to define a possible tax shelter is not needed is that under Section 469, individuals owning a trade or business or rental activity either directly or through a passthrough entity, will have losses limited under Section 469. This limitation addresses a key concern of operating a tax shelter – claiming losses against other active and portfolio income. Requiring that entity to also use the accrual method because it may be a tax shelter seems excessive given

[26] Wyoming was the first state to allow LLCs in 1977. In Rev. Rul. 88-76, the IRS held that the Wyoming LLC was classified as a partnership for federal tax purposes. This revenue ruling was obsoleted by Rev. Rul. 98-37 due to coverage of the subject matter in regulations under Section 7701. The 1988 IRS ruling was a likely event leading states to adopt the LLC structure.

that a loss limitation rule was added for passive activities five years after Section 1256 was enacted.[27]

For similar reasons, "any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale," such as a limited partnership, automatically being a tax shelter should also be repealed. A rationale for removing this entity from the definition of a tax shelter includes the Section 469 loss limitation applicable to individuals (such as limited partners) involved with a passive activity that generates a loss, and the broadening of Section 448 by the Tax Cuts and Jobs Act of 2017 (TCJA)[28] to allow many entities to use the cash method of accounting rather than the accrual method. The remaining definition of tax shelter at Section 6662(d)(2)(C)(ii) of an entity or investment plan or arrangement formed with a significant purposes of tax avoidance or evasion is a sufficient description by itself to limit favorable tax provisions such as use of the cash method of accounting.[29]

Modification of the definition of a tax shelter: For various reasons including the existence of LLCs which did not exist in most states before 1987, and the operation of the Section 469 passive activity loss limitations to curtail current loss benefits of passive activities, the definition of tax shelter under Section 448 should be modified to refer only to the definition of tax shelter at Section 6662(d)(2)(C)(ii).

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[27] If the entity is not operating a passive activity or is owned by taxpayers not subject to Section 469, removal of a "syndicate" as a type of tax shelter may seem too favorable by allowing use of the cash method for these entities if below the Section 448 gross receipts threshold. However, if the entity is a C corporation, it would not be a "syndicate" as Section 1256(e) excludes C corporations. For C corporations and passthroughs, the Section 6662(d)(2)(C)(ii) definition of a tax shelter should be sufficient to address any issue of not operating a legitimate business, as well as Section 162 disallowing any expenditures that are not ordinary and necessary.

[28] An Act to provide for reconciliation pursuant to title II and V of the concurrent resolution on the budget for fiscal year 2018, commonly referred to as the Tax Cuts and Jobs Act of 2017 (TCJA) (P.L. 115-97 (Dec. 22, 2017)).

[29] The TCJA also provided favorable accounting methods including not using traditional inventory accounting rules (Section 471(c)) and the Section 263A uniform capitalization rules for small entities other than tax shelters, as defined under Section 448.

IV. SECTION 469 SUPPORTS REPEAL OF THE SECTION 465 AT-RISK LOSS LIMITATION RULE

Today, at least four possible loss limitation rules apply to certain activities of individuals and some other types of taxpayers. The ordering of these loss limitation rules:[30]

1. Basis in a partnership interest (§704(d)) or basis in an S corporation interest (§1366(d)).
2. At risk rule of Section 465.
3. Passive activity loss rules of Section 469.
4. Limitation on excess business losses of noncorporate taxpayers of Section 461(l) (a temporary provision that expires after 2028).[31]

In addition, if a capital asset is disposed of at a loss as part of business operations, the loss limitation rules of Section 1211 will apply to that loss. Also, if an activity does not rise to the level of a trade or business, deductions are limited under Section 183, Activities not engaged in for profit (applicable to individuals and S corporations).[32]

Application of so many loss or deduction limitations results in complexity, confusion that may cause a limitation to be overlooked, and recordkeeping to track annual losses that must be carried forward and the Code section they are carried

[30] Treas. Reg. 1.469-2T(d)(6); also see preamble to TD 8175 (Feb. 25, 1988) at "C. Coordination With Sections 465, 704(d) and 1366(d)."

[31] Section 461(l) was added by the TCJA for 2018 through 2025, later changed to 2021 to 2028. This limitation requires the "excess business loss" to be carried forward subject to similar limitation in the subsequent years. This loss is the excess of trade or business deductions (other than the Section 199A or NOL deductions) over the sum of gross income or gain from these businesses plus $250,000 ($500,000 for taxpayers using the married filing jointly filing status).

[32] There are also loss limitations for farms (Section 461(j)).

forward under so that the taxpayer knows what must be done to use the loss in a future year (such as have sufficient basis in a partnership interest).

These loss limitations were added to the income tax law at different times and to address similar concerns, mainly to prevent tax shelter activity where losses are allowed beyond what a taxpayer has invested in an activity or offsetting losses against other income sources.

For simplification purposes and improved compliance (reducing the possibility of overlooking or misapplying a loss limitation rule), the number of limitations can be reduced. This paper suggests that the Section 465 at-risk limitation be repealed.

Section 465 was added to the tax law in 1976 to prevent taxpayers from deducting losses greater than their economic investment if engaged in farming, oil and gas exploration, motion picture or video tape production or distribution, or equipment leasing. When enacted, the rule applied to all types of taxpayers other than C corporations. Any loss not allowed under this limitation carried forward to the next year subject to the same limitation. At risk amounts included cash and the adjusted basis of property contributed to the activity and debt for which the taxpayer was personally liable.[33]

The Revenue Act of 1978[34] expanded the at-risk limitation rule to all activities other than real estate and to corporations with five or fewer individual shareholders owning over 50% of the stock. The Tax Reform Act of 1986 extended the at-risk rule to an activity of holding real property and added special rules on qualified nonrecourse financing for real property.

For many businesses, the Section 469 passive activity loss limitation rules are sufficient to address tax shelter concerns (an entity formed to produce usable losses

[33] Senate Committee Report to the Tax Reform Act of 1976 (P.L. 94-455, Oct. 4, 1976),

[34] Revenue Act of 1978 (P.L. 95-600 (Nov. 6, 1978)).

for owners). Also, many businesses today have few assets, such as consulting or gig driving businesses, leaving cash used to cover expenditures as the key asset at risk. Thus, the limitation measurement is similar for both the at-risk and passive activity loss limitations.

While non-recourse financing generally does not represent an at-risk amount, the special rule at Section 465(b)(6) on qualified non-recourse financing generally makes non-recourse debt on real property an at-risk amount.

Repeal of the Section 465 at-risk loss limitation: With the exceptions under Section 465 limiting its effect, the loss limitations for owners of partnerships and S corporations, the passive activity loss limits, the temporary business loss limitation of Section 461(l) (generally applicable to higher income individual), and the reality that for many modern businesses their key assets are human capital rather than fixed assets, the Section 465 loss limitations should be repealed. A transition rule can be included to maintain the rule for a few years to apply to taxpayers already carrying forward losses pending future at-risk amounts.

V. SUMMARY

The passive activity loss limitation rules of Section 469, in place for over 30 years, are fairly well known and result in some duplication of purpose with certain rules enacted before 1986. As explained in this paper, the following changes can be supported, resulting in simplification:

- Repeal the Section 280A(c)(5) disallowance or limitation of deductions for certain rental use of a dwelling unit, so that all rental activities are addressed under Section 469, if applicable.
- Simplify the definition of a tax shelter at Section 448(a)(3) to only use the definition at Section 6662(d)(2)(C)(ii) as tax shelter concerns of limited partnerships and syndicates as defined under Section 1256(e) are not

warranted today due to Section 469 and the TCJA expansion of the use of the cash method of accounting.

- Repeal the at-risk limitation of Section 465 because limitations at Sections 704(d), 1366(d), 469 and 461(l) are sufficient to address the concerns raised in 1976 when these rules were added, exceptions under Section 465 reduce its impact, and many businesses today are more driven by human capital than fixed assets making the at-risk rules less relevant.