

1-1-1991

PAL Rule Clarification Should Aim to Simplify

Annette M. Nellen

San Jose State University, annette.nellen@sjsu.edu

Follow this and additional works at: https://scholarworks.sjsu.edu/acc_fn_pub



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Annette M. Nellen. "PAL Rule Clarification Should Aim to Simplify" *Tax Notes* (1991): 1435-1437.

This Article is brought to you for free and open access by the Accounting and Finance at SJSU ScholarWorks. It has been accepted for inclusion in Faculty Publications by an authorized administrator of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.



letters to the editor

PAL RULE CLARIFICATION SHOULD AIM TO SIMPLIFY

To the Editor:

The "problem" with IRC section 469(g) regarding the treatment of losses from dispositions of passive activities has certainly "triggered" some opinions, to which I would like to add some comments. This commentary began with Professor Stephen Allen's March 25, 1991, special report, "Fixing the Passive Activity Loss Rules" and was followed by letters of rebuttal from Professor Gary W. Carter and Michael J. Grace.¹ The differences in interpretation are significant. In Professor Allen's example, he derives a \$20 usable loss, which reduces the taxpayer income for the year.² I would like to add an explanation for the statutory interpretation problem and point out another potential statutory problem with section 469(g), as well as provide some comments on Professor Allen's suggestion that the no-netting rule for publicly traded partnerships at section 469(k) be expanded to cover all passive activities.

The portion of IRC section 469(g)(1) pertinent to this discussion states:

If during the taxable year, a taxpayer disposes of his entire interest in any passive activity . . .

(A) If all gain or loss realized on such disposition is recognized, the excess of —

(i) the sum of —

(I) any loss from such activity for such taxable year (determined after application of subsection (b)), plus

(II) any loss realized on such disposition, over

(ii) net income or gain for such taxable year from all passive activities (determined without regard to losses described in clause (i)),

shall be treated as a loss which is not from a passive activity.

The significance of such a loss not being treated as a loss from a passive activity is that its use does not depend on the taxpayer having sufficient passive activity income. Also, as such loss is not a passive activity loss (PAL), it reduces a taxpayer's AGI in applying the specific rule for rental real estate losses at section 469(i).

To summarize the problem brought out by the commentary, view #1 (Allen) is that clause (i)(I) includes only the operating loss from the activity for the year of disposition and not the disposition loss. Instead, the disposition loss is taken into account in clause (i)(II). View #1 states that if the disposition loss were to be included in (i)(I), (i)(II) would be redundant. In view #1, gain from disposition is not taken into account in clause (I), potentially leaving it available to offset other PALs, while the operating loss from the disposed activity (even though disposed of at a gain) is "triggered" (fully usable). View #2 (Carter and Grace) accepts that clause (i)(II) may indeed be redundant, but the legislative history and the regulatory definition of passive activity deductions (PAD) and passive activity gross income (PAGI), requires disposition gain to be included in (i)(I). Basically, if the disposition gain exceeds the operating loss from the disposed activity, there would be no loss. This position is supported by the regulations at section 1.469-2T(c)(2), which include gain from disposition of a passive activity as PAGI, unless specifically excluded, or recharacterized. PADs, which include losses carried forward from prior years (section 1.469-1T(f)(4)(i)(B) and 1.469-2T(d)(1)(ii)), are subtracted from PAGI to derive the net loss or net income from the activity for the year. Per view #2, if there is net income after applying these rules to the disposed activity, then section 469(g) is not applicable as there is no loss to trigger (that is, there is no excess loss to use against other than passive activity income).

The significance of such a loss not being treated as a loss from a passive activity is that its use does not depend on the taxpayer having sufficient passive activity income.

I support view #2 (and the opinion that the statute is unclear), for the same reasons stated by Professor Carter and Mr. Grace.³ I would like to add the following to the discussion:

³I will not restate their position. Instead, please see *Tax Notes* 247 (April 15, 1991), 651 (May 6, 1991).

¹*Tax Notes* 1419 (March 25, 1991), 247 (April 15, 1991), 651 (May 6, 1991), and 1319 (June 10, 1991).

²*Tax Notes*, June 10, 1991, page 1319.

COMMENTARY / LETTER TO THE EDITOR

- lack of a statutory definition of “any loss from such activity” as used in clause (I) adds to the confusion;
- the needed clarification to section 469(g), possibly goes beyond that mentioned in the earlier commentary.

First, section 469 is an accounting method⁴ which generally provides that a taxpayer subject to the rules may only take a loss or credit from a passive activity in a year in which they have income from a passive activity. The PAL for the year is disallowed and carried forward to the next year. The only definition of a PAL is found at section 469(d), providing that a PAL (the amount to be carried forward to the next year) is the excess of the total losses from all passive activities for the year. The statute does not fully explain how to calculate the losses and income from the passive activities and does not define “any loss from such activity” as used at clause (I). The IRS provided clarification in the first set of regulations (T.D. 8175, 2-19-88), by defining PAL as the excess of PADs over PAGI (section 1.469-2T(b)). The definitions of PAGI and PAL at section 1.469-2T(c) and (d) are quite explicit in explaining what items are included, excluded, and possibly recharacterized. The regulations provide that PAGI includes gain from disposition of passive activities and property used in a passive activity (section 1.469-2T(c)), unless recharacterized. PADs include disposition loss, unless such loss is treated as a deduction that is not a PAD under section 469(g) (section 1.469-2T(d)(2)(v)). Thus, to the extent the disposition loss is triggered, which per view #2 occurs when operating and disposition losses from the activity exceed PAGI for the year, the excess is not a PAD and its use is thus not limited by section 469.

One explanation for the seemingly redundant clauses at section 469(g)(1)(A)(i)(I) and (II) is that (I) includes the loss from the year after considering PAGI (including disposition gain), but excluding the disposition loss. The disposition loss is excluded from (I), but not from (II). Under this interpretation, it is excluded from (I) because if it is triggered under section 469(g), it would not be treated as a PAD per section 1.469-2T(d)(2)(v), but should still, per legislative intent, be considered in the section 469(g) netting as it must be offset by net income or gain from all other passive activities. Under this interpretation, the language at clauses (I) and (II) is not redundant, it is just not fully in line with the regulations. However, this may be fixed by the IRS in future regulations.

The language at clauses (I) and (II) is not redundant, it is just not fully in line with the regulations.

Another problem with the separate clause at (II), which warrants clarification, is that the wording may be too broad. It could include a loss from the disposition of the passive activity, even though it is not a PAD under the regulations. For example, section 1.469-2T(d)(5)(ii) provides a 12-month lookback rule to determine if a loss from

disposition of passive activity property is a PAD. Under this rule, such loss is a PAD provided the property was used in a passive activity for the 12 months preceding disposition.

Suppose that a passive activity is disposed of in a fully taxable transaction resulting in a realized loss of \$12,000. Without further clarification, this would appear to be “any loss realized on such disposition” per clause (II). However, if the disposed activity was only a passive activity for five of the prior 12 months, only \$5,000 of the loss would be a PAD. Under a literal interpretation of clause (II), the entire \$12,000 loss would be considered. This gives the impression that even the active loss is triggered under section 469(g) when section 469(g) should not apply to the active loss; it should only apply to the net passive activity loss. If the taxpayer also has \$9,000 of income from other passive activities, the entire \$5,000 of loss is usable, with \$4,000 of remaining passive activity income and section 469(g) should not even apply as there is no net PAL. The active part of the disposition loss is also usable, but not because of section 469(g). Clause (II) will not cause an erroneous result in this example, but could be confusing because the language at (II) is too broad. Query—is there a fact pattern that would yield an erroneous result due to the language being too broad?

Hopefully, the confusion resulting in the two differing views of section 469(g) will be resolved when the IRS issues the disposition regulations.

Hopefully, the confusion resulting in the two different views of section 469(g) will be resolved when the IRS issues the disposition regulations (currently “reserved” at section 1.469-6T). I believe the problem can be fixed by clarifying that for purposes of section 469(g), the disposition loss is not considered in calculating “the loss from such activity for the taxable year” under clause (I). Instead, the disposition loss is included in clause (II). This would both remove the redundancy and be consistent with the regulation provision that a PAD does not include a loss triggered under section 469(g). In addition, the regulations should clarify that clause (I) *does* include the gain from disposition losses that are PADs or triggerable disposition losses (per section 1.469-2T(d)(2)(v)). Basically, definitions of the clause (I) phrase, “any loss from such activity” and the clause (II) phrase, “any loss realized on such disposition” which consider the above comments should eliminate the current confusion.

Regarding Professor Allen’s suggestion that section 469(k) be extended to cover passive activities that are not publicly traded partnerships, this might simplify calculations under section 469, but would not eliminate the definitions which constitute the bulk of the regulations and the complexities. As Allen notes, his proposal would raise revenue by further limiting a taxpayer’s ability to use PALs currently. However, taxpayers subject to section 469 would certainly prefer to have their lives simplified in ways that won’t also increase their current tax liabilities. Apparently, under Allen’s proposal, the loss from an activity would only be usable against future income from that particular activity. Thus, we would still need a definition of activity that leads us through the

⁴IRC section 469 is part of Chapter 1, Subchapter E, Accounting Periods and Methods of Accounting.

complexities at section 1.469-4T defining "activity." Once the activity is identified, we would need to apply the definitions of "rental activity," "trade or business" and "material participation" to determine if the activity's losses are even subject to section 469 limitations. The income recharacterization rules (such as those at section 1.469-2T(f)) would be unnecessary under Allen's proposal as no real abuse could take place to warrant them. For example, there would be no desire for a taxpayer to try to convert active income from an activity into passive activity income, since he would still not be able to use PALs from other activities against that income. However, other potential forms of abuse would be meaningful such as trying to get income and loss activities combined into one activity as that would be the only way to currently use the loss if it is a PAL.

IRC section 469(g) certainly should be clarified so that readers won't be able to come up with two different results in applying it.

The proposal goes beyond legislative intent. Congress intended to limit the timing of losses from passive activities until such time that the taxpayer had income from passive activities. If it wanted a more restrictive rule, it could have easily come up with a rule similar to that at section 280A(c)(5) which only allows losses from rental of a dwelling unit against income from the same dwelling unit, with unused losses carried forward. That type of rule would be even more restrictive than section 469 as there is no provision to trigger losses upon disposition. Congress' goal was to limit the expansion of tax shelters. As section 469 meets that goal, a more restrictive provision does not appear warranted, unless Congress wants to raise additional revenue using section 469.

Other solutions to simplify section 469 would likely be more agreeable to taxpayers. For example, allowing taxpayers to group activities in any reasonable manner (similar to the old rule in Notice 88-94, 1988-2 CB 419), would avoid subjecting them to the complexities under section 1.469-4T. The proposal in the Tax Simplification Act of 1991 requiring large partnerships to group ac-

tivities at the partnership level and report just one passive activity loss or income number to the partners would also simplify application of section 469 by reducing a partner's number of passive activities that need to be dealt with in performing the loss limitation calculations and completing Form 8582 (assuming the partnership has more than one activity).⁵

In conclusion, IRC section 469(g) certainly should be clarified so that readers won't be able to come up with two different results in applying it. Hopefully, regulations will soon exist to solve this issue, as well as address numerous other questions regarding dispositions.⁶ So far as the proposal to extend section 469(k) to all passive activities, I would prefer to see simplification proposals that will not further limit a taxpayer's passive activity losses, and will indeed simplify their lives by not subjecting them to complex and lengthy definitions and special rules. While Professor Carter's proposal to remove section 469 from the IRC⁷ would lead to simplicity, the revenue effect unfortunately precludes it as a viable measure. Perhaps, a solution can be found that will not hurt us more than we are at present, but will help taxpayers get through the calculations without having to worry about complex definitions and recharacterization rules that serve as traps for the weary and unwary.

Sincerely,

Annette Bomyea Nellen
Tax Lecturer
San Jose State University
August 30, 1991

⁵H.R. 2777, S. 1394, section 201.

⁶Examples of these questions include how section 469(g)(1)(C) will work; what happens to a PAL that remains with a taxpayer after a disposition to a related party, if the taxpayer dies before using the PAL; whether creation of a bankruptcy estate constitutes a disposition; whether a taxpayer's PAL is triggered when the ex-spouse sells the related passive activity; and clarification of the installment sale calculation of section 469(g)(3) as the language in the statute does not exactly match the 1990 Form 8582 instructions at page 6.

⁷*Tax Notes* 247 (April 15, 1991).

**Make Your Tax Connections Easier With the Most
Complete Directory to Tax Officials**

The Tax Directory

**Call toll-free today to begin your
annual subscription.**

(800) 955-2444

Outside the U.S. or in the Metropolitan D.C. area, call (703) 533-4600.