

Not their fathers' retirement

The resource accumulation plans of many are under assault from several directions: Stock and bond portfolios have been damaged or destroyed, home equity values have plummeted, employer contributions to 401(k) are being discontinued or reduced; and even those rare few who have pensions are in dangerous territory. Regardless of whether a client has planned their retirement expenses and set achievable savings goals or has done little or no planning, in this climate, every client is going to need dedicated guidance and assistance to create or salvage their retirement plan.

The basic goal of retirement planning is to accumulate enough funds to last throughout the retirement years, a time frame that is now a lot longer than it used to be. Actuarial studies conclude that men who attain the age of 65 can expect to live an additional 17 years. Enjoying even greater longevity, women who reach the age of 65 can expect to live an additional 19.7 years. This is definitely good news assuming that these longer life spans are being considered when formulating retirement plans.

strategy in and of itself, we also offer tips on dealing with some of them along the way.

PASSIVE-ACTIVITY LOSSES

Code Section 469 provides that individuals, trusts, estates, personal service corporations and closely held C corps may only deduct passive-activity losses from passive-activity income. The rules do not apply to S corps and partnerships, but do apply to their respective shareholders and partners.

Passive activity is trade or business activity in which the taxpayer does not materially participate. Rental activity is passive activity without regard to a taxpayer's material participation, except for real estate professionals, and certain taxpayers primarily providing services and short-term rentals. Individuals who own and actively participate in the management of rental real estate may offset up to \$25,000 of passive-activity loss from rental real estate against active income in any tax year. The offset amount is reduced by 50 percent of the amount by which the taxpayer's adjusted gross income exceeds \$100,000, phasing out completely at \$150,000 of AGI.

Losses from passive activities must be carried forward and applied against income from passive activities in future years. Remaining passive-activity losses are deductible against non-passive income when the taxpayer disposes of the passive activity.

In general, limited partners are not deemed to materially participate in partnership activities. Thus, a limited partner's share of partnership income is passive income. However, general partners or acting general partners may hold limited partnership interests and materially participate in the partnership.

In recent Tax Court opinion, however, the court determined that interests in LLPs and LLCs are not considered limited partnership interests for purposes of the passive-activity loss rules (Garnett, 132 T.C. No. 19, June 30, 2009). As a result, interests in

LLCs and LLPs would not be presumed passive in nature and taxpayers may prove material participation in order to claim any resulting losses. A similar ruling by the U.S. Court of Federal claims (Thompson, FedCI. July 20, 2009) decided that, to be a limited partnership under the passive-activity loss rules, the entity must be treated as a partnership under state law, not merely taxed as one under the Internal Revenue Code. No official response to these rulings has been put forth by the IRS, but tax-payers should be advised that elimination of the presumption will not mean that the IRS will not litigate that the taxpayer's proof of material participation is not adequate.

AT-RISK LOSSES

Code Sec. 465 generally limits a taxpayer's deductible loss applicable to a trade or business or production of income to the amount that the taxpayer has at risk with respect to an activity. The rules apply to individuals and certain closely held corporations. They generally apply separately to each activity, rather than on an aggregated basis, but aggregation is permitted for active management and leases of depreciable personal properties through partnerships and S corporations. Separate rules apply to determine the amount at risk in the activity of holding real property.

Under the at-risk rules, loss deductions are limited to the amount of the taxpayer's cash contribution and the adjusted basis of other property that he contributed to the activity, plus any amounts borrowed for use in the activity if the taxpayer has personal liability for the borrowed amounts or has pledged assets not used in the activity as security.

In CC-2009-027, released in late August, the associate chief counsel advised that the IRS must make at-risk determinations at both the partnership level and at the partner level. Partnership-level items include the partners' shares of partnership liabilities and the character of the liabilities as recourse or non-recourse. Partner-level items include any arrangements with third parties insulating the partner from loss, and whether a partner is a related party under Section 465(b)(3).

A loss that may be determined as deductible under the at-risk rules may still be limited by the passive-activity loss rules.

NET CAPITAL LOSSES

After the netting of long-term and short-term capital gains and losses for any tax year, any remaining net capital loss in excess of \$3,000 (\$1,500 for married taxpayers filing separately) must be carried forward and retains its character as long-term or short-term for netting purposes in that year. One consolation from this carryover rule for higher-bracket taxpayers may be that net capital losses carried over to post-2010 years may get to offset income taxed at higher rates if administration tax proposals move forward as planned.

Under Code Sec. 165(g), taxpayers do not always have to sell a capital asset to deduct a capital loss. If the stock becomes worthless (sadly, not an uncommon

occurrence lately), the taxpayer may treat this loss of values as if they sold the stock on the last day of the tax year. This deemed sale results in a deductible capital loss. The stock must be totally worthless, and its worthlessness must be established by an identifiable event, such as bankruptcy.

Code Sec. 1244 special rules govern losses individuals claim on the sale of small-business stock. A small business is a domestic corporation with aggregate paid-in capital of \$1 million or less. The losses are treated as ordinary loss deduction is limited to \$50,000 (\$100,000 in the case of a husband and wife filing a joint return).

SEC.1231 LOSSES

Code Sec. 1231 makes available the best of both worlds to businesses with a certain combination of capital gains and losses. Net gains from the disposal of Sec. 1231 property are taxed at capital gain rates, while net losses from the disposal of Sec. 1231 property are taxed as ordinary losses. If total Sec. 1231 gains exceed losses for the year, then all gains and losses are capital. If total losses exceed gains for the year, then all gains and losses are ordinary. Recapture rules apply.

Sec. 1231 property is depreciable property and real estate that are held for more than one year and used in the taxpayer's trade or business. Sec. 1231 applies to gains and losses from : the sale or exchange of property used in a trade or business; the compulsory or involuntary conversion (from destruction, theft, seizure or government condemnation) of property used in a trade or business; and the compulsory or involuntary conversion of any capital asset held for more than one year in connection with the trade or business. Such property also includes timber and coal, livestock, and unharvested crops. Sec. 1231 does not include inventory and property held for sale to customers, or copyrights, artistic compositions, and letters or memoranda.

INVESTMENT THEFT LOSSES

Victims of investment schemes or fraud may find themselves under the casualty loss rules, rather than using the net capital loss rules to salvage their position. Sec. 165(e) allows reporting a deduction for theft losses in the year in which a "reasonable taxpayer" discovers that the property was missing.

Revenue Ruling 2009-9 covers the tax treatment of fraudulent investment arrangements under which income amounts that are wholly or partially fictitious have been reported as income to the investors. In it, the IRS clarified that the investor is entitled to an ordinary theft loss, rather than just a capital loss. Next, it determined that the theft is not subject to the \$100 floor (\$500 in 2009)/10 percent AGI limitation because it arose in connection with a transaction entered into for profit and, therefore, is covered by Sec. 165(c)(2), rather than 165(c)(3). Finally, although the investment theft loss is deductible in the year that the fraud is discovered (subject to reduction for amounts for which a reasonable prospect for recovery remains), the investment theft loss forms

part of the taxpayer's net operation loss that may be carried back or forward under normal NOL rules.

PERSONAL CASUALTY LOSSES

Taxpayers may generally deduct losses that are sustained during the tax year and not compensated for by insurance or otherwise (Sec. 165). For individuals, deductible losses must fall within one of three categories: losses incurred in a trade or business; losses incurred in transactions entered into for profit but not connected with a trade or business; and losses incurred as the result of fire, storm, shipwreck or other casualty, or from theft (personal casualty losses).

Special relief is provided for those who sustain losses attributable to a disaster occurring in an area that is later determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Under this provision, a taxpayer may elect to deduct a loss on their return for the immediately preceding tax year (Sec. 165(I)). This in effect allows taxpayers to get a fast refund for their loss. The dollar and AGI floor limitations are also waived.

BAD DEBT LOSS

Code Sec. 166, titled "Bad Debts," generally controls who is entitled to a bad deduction and when a bad debt may be deducted. Sec. 166 conditions treatment generally on whether a bad debt is uncured in a trade or business. Further, Sec. 166 defers to Sec. 165 on the special treatment afforded to worthless securities (discussed earlier).

Non-corporate taxpayers cannot claim a bad debt deduction for non-business debts (debts not created in connection with, or whose loss is not incurred within, a trade or business). Instead, they may claim a short-term capital loss deduction, as if they sold or exchanged the debt or it became worthless and uncollectible – but not before then.

Sec. 166 allows taxpayers a deduction for completely worthless debt, debt which the taxpayer has no reasonable expectation of collecting. The deduction is equal to the taxpayer's basis in the debt instrument. Sec. 166 also allows businesses a deduction for debt that becomes partially worthless. The taxpayer must prove to the satisfaction of the IRS that the debt is partially worthless. Additionally, the amount is limited to the total the taxpayer "charged off" during the year.

ABANDONMENT LOSSES

While a taxpayer conducts a trade or business, one or more items of business property may suddenly stop being useful. For a variety of reasons, the taxpayer may choose to stop conducting business with the property or permanently discard it. The IRS allows these businesses to claim abandonment loss deduction under Reg. A1.165-2(a) for non-depreciable property or under Reg. A1.167(a)-8 for depreciable property.

GAMBLING LOSSES

Sec. 165(d) limits all but professional gamblers from taking losses incurred in a wagering activity to the amount of any gains. As a result, a taxpayer cannot claim a deduction for losses incurred whole gambling or betting in excess of the amount they gained from that activity over the tax year. Excess losses cannot be carried forward into the next the next tax year.

HOBBY LOSSES

Sec. 183 denies loss deductions beyond income earned from activities in which the taxpayer does not intend to make a profit. These deductions are typically referred to as “hobby losses.” Generally, an activity is presumed to be carried on for-profit if it makes a profit in at least three of the last five tax years, including the current year (Sec. 183(d)). If an activity is not for-profit, losses from it may not be used to offset other income. Taxpayers are generally considered to have engaged in an activity for profit based on a nine-factor test.

Taxpayers and the IRS have litigated many hobby loss cases, with the outcome not always in the IRS’s favor. In *Helmick* (TC Memo 2009-220), for example, a horse breeder who racked up more than \$400,000 in claimed tax losses over a nine-year period could convince the court that a long-term goal to realize a profit was legitimate.

NET OPERATING LOSSES

Batting in the cleanup position for tax losses is the net operating loss. Sec. 172(a) allows taxpayers to deduct against a tax year’s income those net operating losses both carried over to the tax year from previous tax years and carried back from later tax years. An NOL basically is the excess of allowed deductions over gross income. It does not include losses, however, that are disallowed because they cannot be further netted.

For 2008 NOLs, qualified small businesses (those having average annual gross receipts of \$15 million or less) have been entitled to carry back NOLs for a three-,four-or five-year period. Generally, however, both businesses and individuals can carry back their NOLs two years and carry them forward up to 20 years. The NOL must be used in the succeeding year, until the NOL is used up.

Individuals as well as corporations may incur NOLs. NOLs may not pass from a C corp to its shareholders (or vice versa). However, when a partnership or S corp incurs an NOL, it passes through to the individual partners or shareholders, who may carry back or carry forward the loss. Disregarded entities and sole proprietorships also impart the NOLs to carry forward from a previous year is limited in the amount it may deduct for them.

CONCLUSION

So while a passive activity loss may also be an at-risk loss, and investment that is passive in nature instead may yield a net capital loss; unless the net capital loss yields an ordinary loss. And while making loans can be considered an investment of sorts, a loan gone bad can result in an ordinary loss if done by a business, but a short-term capital loss if done by a non-corporate taxpayer outside of a business. If a business property that was “invested in the business” goes south, however, and becomes worthless, an abandonment loss deduction may be available. But if someone is gambling, rather than “investing,” those losses can only offset gambling winnings for the year. Finally, if you really enjoy your sideline business, which is far from a passive pursuit, you might find yourself with a nondeductible hobby loss if you can’t make a profit from it fast enough. Some net losses can be carried back or forward to other tax years; other cannot.

Putting each loss into its proper basket is the first step to developing an overall tax strategy. Although losses are to be avoided, and tax losses are not exactly those proverbial lemons that can be turned into lemonade, knowing how best to use them against otherwise taxable income can help a taxpayer’s immediate cash flow and hasten a recovery.