

# Can You Deduct Your S Corporation Losses?

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## Passive Activity Loss Rules

*The second in a series on the rules governing deductions for S corporation losses*

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Under PAL rules, losses from a passive activity are deductible only to the extent of the income related to that or another passive activity.

S corporations are “flow-through” tax entities, meaning income, deductions, credits and other activity are allocated to shareholders to be reported on their individual tax returns. If you are a shareholder and allocated losses from an S corporation, you can use the losses to offset income from other sources — if the losses pass three tests: stock basis, at-risk limitation rules, and the subject of this article, passive activity loss (PAL) rules.

One of the goals of The Tax Reform Act of 1986 was to eliminate certain shelters for individuals investing in businesses that generated tax losses, which it did by adding Section 469, the PAL rules, to the Internal Revenue Code. Under PAL rules, losses from a passive activity are deductible only to the extent of the income related to that or another passive activity. As a result, if a taxpayer’s total losses from all passive activities exceed the total income, those losses cannot be used to offset non-passive income.

There are two categories of passive activities as addressed by the rules: businesses in which the taxpayer does not materially participate, and rental activities.

### MATERIAL PARTICIPATION

To materially participate in a trade or business, you must be involved in the activity’s operations on a “regular, continuous and substantial basis,” which Treasury Regulations determine through several tests. Passing any one of the seven constitutes material participation:

- 1) Did you participate in the activity for more than 500 hours during the tax year?
- 2) Was your participation substantially all of the participation in such activity – that is, were you doing most of the work?
- 3) Did you participate in the activity for more than 100 hours during the year and was that at least as much time as anyone else, an owner or not, spent on the business?
- 4) Did you spend more than 100 hours in the business and other significant participation activities during the year that totaled more than 500 hours?
- 5) Have you materially participated in the activity for at least five of the 10 taxable years immediately preceding the taxable year?

- 6) Is the activity a personal service (where capital isn't the significant income producer) and you materially participated in the activity for any three taxable years, consecutive or not, preceding the taxable year?
- 7) Based on all facts and circumstances, did you participate in the activity on a regular, continuous, and substantial basis during the year?

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## RENTALS

Income from rental activities conducted by an S corporation is generally considered passive regardless of the shareholder's participation. There are exceptions to the rule for certain rental activities in which:

- Significant services are provided (like a chartered boat or jet).
- The average period of rental is less than seven days (hotel rooms, cars, etc.).
- The owner is a real estate professional.
- The rentals are grouped with other non-passive activities.
- They are "self-rentals" (rented to a trade or business in which the owner materially participates).

## TO SUMMARIZE

If you are a shareholder in an S corporation that has incurred a loss during the tax year and you pass the stock basis and at-risk tests, you are two-thirds of the way home in terms of being able to deduct your losses. You will next need to determine if the activity is passive, that is, it is either a rental activity or the taxpayer does not materially participate. If it is a passive activity, you can only deduct the loss against income from other passive activities. If your total passive losses exceed non-passive income, only the losses up to the amount of passive income can be deducted; the excess will be suspended and carried forward to offset future passive income. Unused losses become deductible when the taxpayer disposes of the activity.



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