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The Honorable Al Franken
United States Senator
60 East Plato Blvd
Suite 220
St. Paul, MN 55107

Attention:

Dear Senator Franken:

This letter responds to your request for information dated October 21, 2009. You asked whether mortgage or bank companies can take passive loss deductions, and if so whether mortgages that they own that go into foreclosure would apply.

The passive activity loss rules generally do not allow passive losses to offset income that is not derived from passive activities, such as salaries, interest, dividends, and active business income. The rules apply to individuals, estates, trusts, closely-held C corporations, and personal service corporations. Losses from a passive activity are limited to the taxpayer's net income from passive activities until the taxpayer disposes of his or her entire interest in the activity. (Section 469 of the Internal Revenue Code)

The passive activity loss rules also limit losses from activities that are conducted through passthrough entities such as general and limited partnerships, S corporations, and limited liability companies that the law treats as partnerships for federal tax purposes. However, for passthrough entities, we apply the passive activity loss rules at the individual owner level, and not at the entity level.

The passive activity loss rules do not apply to C corporations that are neither closely-held C corporations nor personal service corporations. A closely-held C corporation has 5 or fewer shareholders who own more than 50 percent of the corporation's stock. A personal service corporation is a C corporation whose principal activity is the performance of personal services by employee-owners in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

For closely-held C corporations, the application of the passive activity loss rules is significantly different than for other taxpayers subject to these rules. Most taxpayers are

allowed to offset passive losses only with income from passive activities. A closely-held C corporation, however, may also offset passive losses with net income derived from the corporation's active trades or businesses.

A passive activity is any rental activity or any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. We treat a taxpayer as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. The regulations under section 469 provide seven safe-harbor tests for determining material participation generally based on the number of hours the taxpayer devotes to the activity. See section 1.469-5T(a) of the Income Tax Regulations.

Accordingly, the passive activity loss rules generally will apply to a mortgage or banking activity if the taxpayer conducts the activity through a closely-held C corporation or passthrough entity. If a closely-held C corporation conducts the activity, the corporation can deduct passive losses from the mortgage or banking activity only to the extent it has passive income or net income from its active trades or businesses, or until the corporation disposes of its entire interest in the mortgage or banking activity.

If the taxpayer conducts the mortgage or banking activity through a passthrough entity, the passive activity loss rules will apply at the individual owner level, and the losses will be disallowed only for those individual owners who do not materially participate in the mortgage or banking activity. Those individual owners cannot deduct the passive losses on their individual returns until they recognize income from the mortgage or banking activity, recognize passive income from other sources, or dispose of their entire interest in the mortgage or banking activity.

Assuming that a mortgage or banking company owns a portfolio of mortgages as part of its trade or business which produces passive losses, the fact that one or more of the mortgages go into foreclosure likely will not allow the company to deduct its passive losses. Depending on the circumstances of each case, we would likely treat the mortgage or banking company as being engaged in a single trade or business activity which includes making, holding, or servicing the portfolio of mortgages.

To the extent that the taxpayer may dispose of a portion of the mortgage portfolio through the foreclosure process, the mortgage or banking company (or its owners) probably would not be treated as disposing of its entire interest in the mortgage or banking activity. Instead, the losses attributable to those particular mortgages likely would remain "suspended" and attributable to the mortgage or banking activity of the company. The company (or its owners) therefore could deduct passive losses only to the extent income is recognized from the mortgage or banking activity, to the extent passive income is recognized from other sources, or upon the disposition of the entire interest in the mortgage or banking activity.

I hope this information is helpful. If you have any additional questions, please contact me at or at .

Sincerely,

Melissa C. Liquerman
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Passthroughs & Special Industries)