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STATE OF MICHIGAN

DEPARTMENT OF TREASURY

TREASURY BUILDING

LANSING, MICHIGAN 48922

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INCOME TAX TREATMENT OF PASSIVE ACTIVITY LOSSES

RAB-90-8. This Bulletin describes the Michigan income tax treatment of allowable passive activity losses (PAL) included in adjusted gross income under section 469 of the Internal Revenue Code (IRC). This Bulletin focuses on adjustments to adjusted gross income and on the determination of household income for tax credit purposes under Chapter 9 of the Income Tax Act.

FEDERAL TREATMENT

The Tax Reform Act of 1986 added section 469 which defines and limits losses from passive activities for individuals, estates or trusts that can be deducted in computing federal adjusted gross income.

Under section 469 of the IRC, a taxpayer may claim a deduction of passive losses only to the extent of passive income during the tax year. Any passive losses in excess of passive income may be carried forward and offset against passive income in future tax years.

If during the taxable year a taxpayer disposes of an entire interest in a passive activity, any prior unused passive activity losses, as well as current losses from the activity and losses from the disposition of the activity, are allowed in full in the computation of adjusted gross income pursuant to section 469(g) of the IRC.

Special rules exist for passive activities involving rental real estate and, for a limited time, interest in passive activities acquired before October 23, 1986. A taxpayer who acquires interests in publicly traded partnerships (PTP) is required to separately state the income and losses from each PTP. Details concerning these items can be found in section 469 of the IRC.

Definitions

Passive Activity. A "passive activity" is defined in section 469(c) of the IRC as any activity that involves the conduct of a trade or business (within the meaning of section 162 of the IRC) in which the taxpayer does not materially participate and any rental activity.

Passive Income. "Passive income" is income derived from a passive activity. Passive income does not include personal service income or portfolio income, such as interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Gains or losses from the disposition of property that produces portfolio income or that is held for investment are not included in passive income.

MICHIGAN INCOME TAX TREATMENT

Adjustments to Adjusted Gross Income

Michigan taxable income means adjusted gross income (AGI) as defined in the IRC subject to certain adjustments per MCL 206.30(1). Adjusted gross income is defined in section 62(a) of the IRC as gross income minus certain deductions. These deductions include allowable trade or business deductions from passive activities. Passive activity losses included in AGI will be included in Michigan taxable income to the extent they are allowed by the following sections of the Michigan Income Tax Act ("Act").

MCL 206.102 states: "In the case of taxable income of a taxpayer whose income-producing activities are confined solely to this state, the entire taxable income of such taxpayer shall be allocated to this state, except as otherwise expressly provided in this act."

MCL 206.103 states: "Any taxpayer having income from business activity which is taxable both within and without this state, other than the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this act."

MCL 206.115 states: "All business income, other than income from transportation services shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3."

MCL 206.271 states: "A taxpayer subject to the tax levied by section 51 and whose income received after September 30, 1967, is increased or diminished by the disposition of property acquired before October 1, 1967, which is described in and subject to subchapter P of the internal revenue code, may elect to recompute taxable income by excluding therefrom the proportional gain or loss incurred before October 1, 1967."

Example 1: Current Year Passive Activity Both Within and Without Michigan

Taxpayer's Federal return for the 1989 tax year reflects the following:

Wages (earned in Michigan)	$ 45,000
Passive Activity Income from out-of-state partnership	5,000
PAL from non-rental real estate located in Michigan. Total current year loss is ($12,000), but deduction is limited to ($5,000) per PAL rules.	(5,000)
Federal AGI	$ 45,000

Calculation of Michigan taxable income for the 1989 tax year:

Federal AGI	$ 45,000
Subtract: Out-of-state income included in AGI	- 5,000
Michigan Taxable Income	$ 40,000

Note: The $7,000 suspended Passive Activity Loss ($12,000 current year loss minus $5,000 allowed as a currrent year deduction per PAL rules) may be used to offset Passive Activity Income in subsequent years.

Example 2: All Business Income Allocated to Michigan

Included in Taxpayer's AGI for the 1989 tax year is an allowable $20,000 PAL from Partnership X. The loss is composed of suspended losses from 1987 and 1988 and the allowable 1989 PAL. All business activity from Partnership X is confined solely to Michigan. The following chart shows the amount of PAL to be included in Michigan taxable income for the 1989 tax year.

	Suspended from 1987	Suspended from 1988	Allowable 1989 PAL	Total PAL in 1989 AGI	Total PAL in 1989 Michigan Taxable Income
Partnership X Losses	($4,000)	($3,000)	($13,000)	($20,000)	NA
Michigan Apportionment	100%	100%	100%	NA	NA
PAL Apportioned to MI	($4,000)	($3,000)	($13,000)	NA	($20,000)

There would be no adjustment to AGI since all of the PAL is allocated to Michigan.

Example 3: Apportionment Factor of Business Income Varies From Year to Year

If the business income apportionment factor varies from year to year, the taxpayer must apportion the PAL deduction using the same apportionment percentage determined in the originating loss year.

A taxpayer had $100,000 AGI for the 1989 tax year. Included in AGI is a $30,000 PAL from Partnership Y, $14,000 of passive income from rental real estate in California and $25,000 of passive income from Partnership Z. The loss is composed of suspended losses from 1987 and 1988 and a 1989 allowable PAL. Partnership Y had 30%, 40% and 50% business activity apportioned to Michigan for the 1987, 1988 and 1989 tax years, respectively. Partnership Z had 100% business activity in Michigan. The following chart shows the amount of PAL to be included in Michigan taxable income for the 1989 tax year.

	Suspended from 1987	Suspended from 1988	Allowable 1989 PAL	Total PAL in 1989 AGI	Total PAL in 1989 Michigan Taxable Income
Partnership Y Losses	($5,000)	($7,000)	($18,000)	($30,000)	
Michigan Apportionment	30%	40%	50%		
PAL Apportioned to MI	($1,500)	($2,800)	($9,000)	NA	($13,300)

The adjustments to AGI are as follows:

> Of the $30,000 PAL from Partnership Y, $16,700 ($30,000 - $13,300) must be ADDED back to AGI. The $14,000 out-of-state PAI from rental real estate would be subtracted from AGI to determine Michigan taxable income. There is no adjustment for partnership Z since all income is apportioned to Michigan.

Calculation of Michigan Taxable Income:

AGI	$100,000
Add: Out-of-state losses	16,700
Subtract: Out-of-state income	14,000
Michigan Taxable Income	$102,700

Effect of Passive Activity Losses on Household Income

MCL 206.510 defines income as ". . . the sum of federal adjusted gross income as defined in the internal revenue code plus all income specifically excluded or exempt from the computations of the federal adjusted gross income . . . ."

Income specifically excluded or exempt from the computations of the federal AGI is generally income (or losses) that will not be subject to tax in the year actually or constructively received or in a subsequent taxable year under the IRC. (See generally Revenue Administrative Bulletin 1988-46.)

This section allows only those passive activity losses that are included in AGI for a given tax year to be included in household income. Any suspended PAL will be included in household income in the year it is reflected in federal AGI.