¶2980. Passive Loss Rules

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OVERVIEW

The passive loss rules apply to individuals, including partners and S corporation shareholders, estates, closely held C corporations, and personal service corporations. Special rules apply to publicly traded partnerships. Taxpayers subject to the rules must determine which of their undertakings constitute separate activities and whether any of these activities are passive. A passive activity is an activity which involves a trade or business in which the taxpayer does not materially participate. Beginning in 1994, rental activities are treated as passive activities, except to the extent that the taxpayer is engaged in rental real estate activities as a real estate professional.

Material participation requires a taxpayer to be involved in the operations of the activity on a regular, continuous and substantial basis. Under the regulations, a taxpayer will be treated as materially participating in an activity if he satisfies one of several quantitative "safe-harbor" tests. Limited partners are not generally treated as materially participating in an activity.

A taxpayer subject to the passive loss rules who owns an interest in a passive activity during the taxable year must calculate whether he has a passive activity loss or credit for the taxable year. A passive activity loss is the amount by which passive activity deductions for the year exceed passive activity gross income for the year. Passive activity gross income does not include portfolio income (e.g., dividends and interest), personal service income and certain other income for the year. In addition, the regulations contain several rules which recharacterize passive income as either active or portfolio income. A taxpayer who has excess passive deductions and credits is allowed to carry them forward indefinitely.

When a taxpayer completely disposes of his interest in a passive activity in a taxable transaction, all of the suspended losses (but not credits) from the activity are allowed to offset nonpassive income.

Finally, special rules apply to closely held C corporations, personal service corporations and publicly traded partnerships. The passive loss rules are generally effective for years beginning after December 31, 1986, but complex effective date and transitional rules apply.

EXPLANATION

¶2980.01 Introduction

The passive loss rules were enacted as part of the Tax Reform Act of 1986.[1] The rules were intended to prevent taxpayers from using losses and credits from tax shelters to offset income from such sources as wages, interest and dividends.[2] Congress was concerned that the growth of tax shelters created unfairness and caused taxpayers to lose confidence in the federal income tax system. The elimination of tax shelters was also viewed as necessary to generate revenue to help offset the effect of the 1986 TRA's tax rate reduction.

[1] P.L. 99-514 (1986).

[2] S. Rep. No. 313, 99th Cong., 2d Sess. 713-14 (1986) (hereafter "S. Rep. 99-313").

Congress felt that taxpayers who were simply investors in a business activity should use tax benefits only against income from such activities, at least until a complete disposition of an activity demonstrated the taxpayer's true economic loss. On the other hand, taxpayers with substantial involvement in a business activity should be entitled to fully use tax benefits from the activity.[3] Thus, the passive loss rules allow taxpayers who materially participate in an activity (other than rental activities) to use losses from the activities to shelter nonpassive income.

[3] S. Rep. 99-313 at 714-16.

Thus, a passive activity is any trade or business in which the taxpayer does not materially participate and any rental activity without regard to the taxpayer's participation. Deductions and credits from passive activities are limited to the income from such activities. Disallowed deductions or credits from a passive activity may be carried forward indefinitely. Any unused passive activity losses (but not credits) may be used to offset nonpassive income upon a taxpayer's complete disposition of his interest in the passive activity.

The statute grants the Treasury broad regulatory authority to interpret and carry out the passive loss rules.[4]

[4] §469(l).

¶2980.02 Taxpayers Subject to the Passive Loss Rules

¶2980.02.A. Individuals

The passive loss rules apply to all individuals. Thus an individual's share of the loss from a passive activity is subject to the passive loss rules.[5]

[5] §469(a)(2)(A).

¶2980.02.B. Estates

Estates are also subject to the passive loss rules.[6]

6 Id.

Example (1)—*Estate Subject to Rules*

A owns a limited partnership interest in Partnership X. A dies in 1989 and his limited partnership interest passes to his estate. The estate's losses from X are subject to the passive loss rules.

¶2980.02.C. Trusts

The passive loss rules apply to trusts, including inter vivos trusts and testamentary trusts.[7] However, the rules do not apply to grantor trusts because these trusts are treated as pass-through entities.

7 Id.

Example (2)—*Trust Subject to Rules*

B contributes her limited partnership interest to a trust which is not a grantor trust. Any loss attributable to the trust from the partnership is subject to the passive loss rules.

¶2980.02.D. Pass-Through Entities

1. Partnerships

A partnership is not a separate taxpayer. Partners are subject to the passive loss rules because the partnership's items of income, gain, loss, deduction and credit are passed through and taxed at the partner level.

Example (3)—*Partners Subject to the Rules*

A and B each own 50% partnership interests in Partnership X. Although X is not subject to the passive loss rules, A and B are each separately subject to the passive loss rules on items passed through to them from X.

2. S Corporations

An S corporation is also not a separate taxpayer except in certain limited cases.[8] Instead, an S corporation's items of income, gain, loss, deduction and credit are passed through and taxed to the corporation's shareholders. The passive loss rules apply separately to each shareholder of the S corporation.

8 S corporations are discussed in ¶4210 et seq.

Example (4)—*S Corporation Shareholders Subject to the Rules*

A and B are shareholders in an S corporation. Although the S corporation is not subject to the passive loss rules, A and B are subject to the passive loss rules on items passed through to them from the S corporation.

3. Grantor Trusts

A grantor trust's income or loss is taxed at the grantor level rather than the trust level.[9]

[9] See §671 et seq. and the discussion of grantor trusts in ¶6120.

Example (5)—*Grantor Trust Beneficiary Subject to Rules*

A transfers an apartment building to a trust and retains various rights, including the right to terminate the trust and take back the building. A is subject to the passive loss rules rather than the trust because the trust is a grantor trust and A is taxed on its income.

¶2980.02.E. Closely Held C Corporations

1. Definition

The passive loss rules apply to closely held C corporations (CHCs).[10] CHCs are subject to the passive loss rules because of concern that individuals would incorporate their portfolio investments to avoid the limitations.[11] A C corporation is closely held if, at any time during the last half of its taxable year, more than 50% (in value) of its stock is owned, directly or indirectly, by five or fewer individuals.[12]

[10] As discussed in ¶2980.09 below, the passive loss rules prevent a CHC from using its passive losses against portfolio income but permit the losses to be used against active business income.

[11] S. Rep. 99-313 at 722.

[12] §469(j)(1), referring to §465(a)(1)(B); Regs. §1.469-1T(g)(2)(ii), referring to §542(a)(2). A C corporation that meets the definitions of a CHC and of a personal service corporation is treated as a personal service corporation.

Example (6)—*CHC Subject to Rules*

A and B own 40% of the stock of Corporation X and the remainder is widely-held. X is a calendar year corporation. On June 15, 1989, C acquires 11% of X's stock. Corporation X is a CHC because A, B and C together own 51% of Corporation X's stock throughout the remainder of 1989.

This ownership test for CHCs is the same as that used in the at-risk rules and is based on the stock ownership test for personal holding companies. See ¶2970 for a discussion of the at-risk rules and ¶5110 for a discussion of the personal holding company stock ownership test.

2. Attribution of Ownership

In determining whether a C corporation is closely held under the passive loss rules, the stock ownership can be attributed from one related person to another. For this purpose, the personal holding company attribution rules apply, with certain modifications.[13] In particular, these modifications eliminate attribution of ownership from one partner to another.[14]

[13] Regs. §1.469-1T(g)(2)(ii), referring to §465(a)(3).

[14] Id. The modifications also change the language of several of the personal holding company rules to make the rules applicable to CHCs.

↳ **Example (7)—***Elimination of Partner to Partner Attribution*

Eleven unrelated individuals own all of the stock of Corporation Y. A owns 10% of Y's stock and the other individuals (B through K) own 9% each. Y is not a CHC because five or fewer individuals do not own 50% or more of its stock. If A and B are also partners in an accounting firm, the result is the same because partner-to-partner attribution does not apply for CHC purposes.[15]

[15] The stock ownership test for personal holding company purposes is met, however. A owns 19% (including 9% by attribution from B) and C through F own 36%, for a total of 55% held by five individuals.

¶2980.02.F. Personal Service Corporations

A personal service corporation (PSC) is subject to the passive loss rules.[16] Generally, a PSC is a corporation which provides services to others through its employee-owners.

[16] §469(a)(2)(C). As discussed in ¶2980.09, below, a variety of special passive loss rules apply to PSCs.

Special rules permit the IRS to reallocate income, deductions and credits of a PSC if it was formed or used to avoid tax.[17] The passive loss rules use the definition of a PSC developed under the tax avoidance rules, with certain modifications.[18] Under the modified definition, a corporation is a PSC if its principal activity is performing personal services, the services are substantially performed by employee-owners and more than 10% of the corporation's stock is held by employee-owners. An employee-owner is an employee who owns any of the stock of a PSC. As in the case of CHCs, stock ownership attribution rules apply.[19]

[17] §269A.

[18] §469(j)(2), referring to §269A(b).

[19] §469(j)(2), referring to §269A(b)(2) and §318. The attribution rules are modified by §469(j)(2)(B) so that stock can be attributed from a corporation to an individual proportionately if the individual owns any stock in the corporation.

↳ **Example (8)—***PSC Subject to Rules*

C and D are architects and conduct their architecture business through their wholly owned corporation, Z. Z's other employees are clerical staff and its only other activity is investing as a limited partner in a shopping center development. Z is a PSC.

A PSC must use the calendar year as its taxable year unless it has a business purpose for a different year. The taxable year rules incorporate the same modifications to the PSC definition used in the passive loss rules. The passive loss regulations therefore define a PSC by reference to the definition of a PSC used in the taxable year regulations.[20]

[20] Regs. §1.469-1T(g)(2)(i), referring to Regs. §1.441-4T(d).

¶2980.02.G. Publicly Traded Partnerships

1. Definition

A publicly traded partnership (PTP) is subject to particularly adverse treatment under the passive loss rules because the rules apply separately to each PTP interest held by a taxpayer. A PTP, by definition, is one the interests in which are traded on an established securities market or on a secondary market (or the substantial equivalent thereof).[21]

[21] §469(k)(2).

An established securities market includes: (i) a national securities exchange registered under the Securities Exchange Act of 1934 (or exempted from registration because of limited volume); (ii) a foreign securities exchange that satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934; (iii) a regional or local exchange; and (iv) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers.[21.1]

[21.1] Regs. §1.7704-1(b), T.D. 8629 (60 Fed. Reg. 62026 (11/29/95)). Regs. §1.7704-1 is generally effective for taxable years beginning after Dec. 31, 1995. However, for partnerships actively engaged in an activity before Dec. 4, 1995, Regs. §1.7704-1 is generally effective for taxable years beginning after Dec. 31, 2005. See ¶4020 for a further discussion of the PTP regulations.

Partnership interests are readily tradable on a secondary market, or its substantial equivalent, if the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.[21.2] Interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if: (i) such interests are regularly quoted by persons such as brokers or dealers making a market in the interest; (ii) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to such interests and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others; (iii) the holder of an interest has a readily available, regular, and ongoing opportunity to sell or exchange such interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests; or (iv) prospective buyers and sellers have the opportunity to buy, sell, or exchange interests in a time frame and with the regularity and continuity that the existence of a secondary market would provide.[21.3]

[21.2] Regs. §1.7704-1(c)(1).

[21.3] Regs. §1.7704-1(c)(2).

For taxable years beginning after 1987, a newly organized PTP is generally treated as a corporation.[22] However, PTPs existing on December 17, 1987 are not subject to this rule until taxable years beginning after 1997 or until the year in which such existing PTP adds a substantial new line of business, whichever is earlier.[23] Thus, until 1998, existing PTPs are treated as partnerships and partners in existing PTPs remain subject to the passive loss rules. In addition, if 90% of a newly organized PTP's gross income is "passive-type income," it will be treated as a partnership and its partners will be subject to the passive loss rules.[24]

[22] §7704(a).

[23] §10211(c)(1)(B) and (2) of the Revenue Act of 1987; §2004(f) of the Technical and Miscellaneous Revenue Act of 1988 (hereafter "TAMRA").

[24] §7704(c). TAMRA also provides that if an existing PTP ceases to be treated as an existing partnership but satisfies the passive income test, the partnership will not be reclassified as a corporation.

2. Passive-Type Income

Passive-type income includes:

- interest;
- dividends;
- real property rents;
- gain from the sale of real property;
- natural resources income;
- gain from sale of a capital asset held for the production of passive-type income; and
- income from commodities and commodity futures (including options) if the partnership's principal activity is buying and selling commodities.[25]

[25] §7704(d)(1). The IRS issued final regulations under Regs. §1.7704-3 in T.D. 8799, 63 Fed. Reg. 6955 (12/17/98), which generally expanded the types of qualifying income to include certain investment income such as capital gain from the sale of stock, income from holding annuities, income from national principal contracts (as defined in Regs. §1.446-3), and other substantially similar income from ordinary and routine investments to the extent determined by the IRS. However, under Regs. §1.7704-3(a)(2), qualifying income does not include income derived in the ordinary course of a trade or business. Regs. §1.7704-3(b)(2) clarifies that gain recognized with respect to a marked to market position will not fail to be qualifying income solely because there is no sale or disposition. Regs. §1.7704-3(b)(3) also clarifies that certain ordinary income may be qualifying income. Regs. §1.7704-3(b)(4) provides rules for computing qualifying and gross income of a partnership that makes a mixed straddle account election under Regs. §1.1092(b)-4T. Also, Regs. §1.7704-3(b)(1) clarifies that, in general, all losses will be ignored in determining partnership gross income for purposes of §7704(c)(2).

Example (9)—*PTP Subject to Rules*

PTP X has gross income of $10,000,000 in 1989. $9,000,000 of the income is derived from the rental of a shopping mall. X is treated as a partnership and its partners are subject to the passive loss rules in 1989.

3. Relief for Inadvertent Terminations

A partnership will be treated as continuing to meet the 90% passive income test if the Treasury determines that the failure to meet the test was inadvertent, the partnership takes steps within a reasonable time to meet the test and the partnership agrees to make such adjustments as may be required.[26]

[26] §7704(e).

¶2980.03

Definition of an "Activity"

Once it is determined that taxpayer is subject to the passive loss rules, the next step is to determine whether the taxpayer owns an interest in passive activities. To accomplish this, the taxpayer's separate activities must be identified.

¶2980.03.A. Significance of Scope of Activity

Identifying a taxpayer's separate activities is critical under the passive loss rules to determine which activities are passive and to also determine when a taxpayer completely disposes of his interest in a particular activity.[27] Since passive losses can offset only passive income, taxpayers will sometimes prefer a broad definition of activity so that profitable endeavors can be lumped together with losing endeavors.

[27] See ¶2980.08, below.

Example (10)—*Broad Definition of Activity*

A owns a clothing store and a sporting goods store. Assume that in 1990 the sporting goods store would be a passive activity and the clothing store would not be a passive activity if the two businesses were treated separately. If the sporting goods store produces a loss and the clothing store is profitable in 1990, A would prefer that the two businesses constitute one activity so that A could offset the clothing store income with the sporting goods store loss.

A broad definition of "activity" can also benefit a taxpayer under the material participation rules discussed in ¶2980.04

Example (11)—*Broad Activity Definition for Participation Test*

Assume in the above example that A worked 80 hours in the sporting goods store and 450 hours in the clothing store in 1990. If the two businesses are treated as one activity, A would meet the 500-hour test for material participation for both businesses in 1990.

A narrow definition of an activity may be advantageous for purposes of the disposition rule because suspended passive losses may be used when the taxpayer completely disposes of his interests in an activity. It will be more difficult to dispose of an entire interest in an activity if a broad definition applies.

¶2980.03.B. IRS Notice 88-94

The first set of passive loss regulations issued on February 19, 1988 did not include a definition of the term "activity." The IRS issued a notice to provide guidance to taxpayers for filing their 1987 and 1988 tax returns, which allowed taxpayers to determine their activities under "any reasonable method" for taxable years ending before the regulations defining the term "activity" were published in the Federal Register.[28]

[28] Notice 88-94, 1988-2 C.B. 419.

The notice gives several examples of a "reasonable method" and states that it is reasonable to treat operations involving the provision of similar goods and services as part of the same activity.

↳ **Example (12)—***"Reasonable Method"*

A owns a farm on which he raises cows and sheep. All of A's activities on this particular farm may be treated as one activity.

In addition, business operations that are vertically integrated (i.e., manufacturing, wholesaling and retailing substantially similar property) may be treated as part of the same activity although it may also be reasonable to treat these operations as separate activities.

↳ **Example (13)—***Intergration to Determine Activities*

A manufactures sweaters and sells them both at wholesale and at retail. All of A's activities in connection with manufacturing and selling sweaters may be treated as one activity. However, A may be able to establish that these operations are separate activities.

A taxpayer may also treat business operations as part of the same activity if they are conducted at the same location and are owned by substantially the same persons in substantially the same proportions. Furthermore, a taxpayer is allowed to treat rental real estate operations either as a single activity or as multiple activities. However, it is not reasonable to treat rental operations as part of another trade or business activity or to treat nonrental operations as part of a rental activity unless the operations are ancillary to the activity and are insubstantial in comparison to the activity. Thus, the notice indicates that real estate development and construction operations may not be treated as part of a rental activity even if the taxpayer rents the property upon the completion of operations.

These principles apply to activities that are conducted through pass-through entities and activities conducted directly. Thus, a taxpayer may treat operations of a pass-through entity in which he owns an interest in any reasonable manner.

¶2980.03.C. Regulations' Definition of Activity After August 9, 1989 and Before May 11, 1992

1. In General

The Treasury issued final regulations defining the term "activity" on October 3, 1994.[29] These regulations are effective for taxable years ending after May 10, 1992[30] The final "activity" regulations replaced the "building block" approach of the temporary regulations issued in 1989[31] with a "facts and circumstances" approach to identify a taxpayer's activities.

[29] Regs. §1.469-4, T.D. 8565, 59 Fed. Reg. 50485 (10/4/94). These regulations finalized proposed regulations issued in 1992 (PS-01-89, 57 Fed. Reg. 20802 (5/15/92)).

[30] For the first taxable year in which Regs. §1.469-4 applies, taxpayers that are not in compliance with those rules must regroup their activities under those rules, without regard to the manner in which the activities were grouped in prior years. However, for taxable years in which the final regulations apply and that begin before Oct. 4, 1994, a taxpayer may determine its tax liability in accordance with Prop. Regs. §1.469-4.

[31] T.D. 8253, 54 Fed. Reg. 20527 (5/12/89). The temporary regulations provided: (1) rules for identifying the business and rental operations that constitute an undertaking (the "undertaking rules"); (2) rules for identifying the undertaking or undertakings that constitute an activity (the "activity

rules"); and (3) rules that applied only under certain special circumstances (the "special rules").

Taxpayers must apply the temporary regulations for taxable years ending before May 10, 1992. For the taxable year that includes May 10, 1992, taxpayers may choose to apply the rules in the temporary regulations.

2. Undertaking Rules

a. General Rule

An undertaking is the smallest unit that can constitute an activity and it may include diverse business and rental operations.[32] The basic undertaking rule identifies a taxpayer's business and rental operations that constitute an undertaking by reference to location and ownership.[33] Income-producing business and rental operations that are conducted at the same location and are owned by the same person are generally treated as a single undertaking.[34] Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or they are not owned by the same person.

[32] Regs. §1.469-4T(a)(3)(i).

[33] Regs. §1.469-4T(a)(3)(ii).

[34] Regs. §1.469-4T(a)(3)(ii) and Regs. §1.469-4T(c)(1) and Regs. §1.469-4T(a)(2).

Example (14)—*Business Operation With Common Location and Owner*

A is the sole owner of a department store and a restaurant. A conducts both businesses in the same building and both businesses are income-producing operations. The department store and restaurant operations are treated as a separate source of income production and as a single undertaking.[35]

[35] This example is based on Regs. §1.469-4T(c)(4), Ex. (1).

b. Income-Producing Operations

A single undertaking must include an income-producing operation. Income-producing operations are business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of):

- the production of property at the location;
- the sale of property to customers at the location;
- the performance of services for customers at the location;
- transactions in which customers take physical possession at the location of property that is made available for their use; or
- any other transactions that involve the presence of customers at the location.[36]

[36] Regs. §1.469-4T(c)(2)(iv).

Example (15)—*Income Producing Operations*

A conducts income-producing operations at the location because property is sold to customers in the department store and services are performed for customers in the department store and the restaurant.

c. Ownership by the Same Person

Business and rental operations are owned by the same person only if one person is the direct owner of the operations.[37] A "person" for purposes of the undertaking rule means individuals and entities including partnerships and S corporation. Thus, an individual who conducts operations at the same location through two separate partnerships has two undertakings.

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[37] Regs. §1.469-4T(c)(2)(v). *See* TAM 9722007 (Real property leasing activity of taxpayer may not be combined with the trade or business activity to which the real property was leased as activities were not directly owned by the same person; taxpayer indirectly owned trade or business activity through S corporation).

Example (16)—*Common Ownership Through Partnerships*

A, B and C are each equal partners in Partnerships X and Y. X owns an automobile dealership and Y owns an automobile repair shop. The dealership and repair shop operations are conducted in the same physical structure. Since indirect ownership is not taken into account, the dealership and repair shop are not owned by the same person and therefore do not constitute a single undertaking.[38]

In many cases, however, these separate undertakings will be treated as part of the same activity under the activity rules discussed below.

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[38] This example is based on Regs. §1.469-4T(c)(4), Ex. (10).

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d. Location

The term "location" generally means a fixed place of business where operations are conducted.[39] Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another.[40]

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[39] Regs. §1.469-4T(c)(2)(iii)(A).

[40] Regs. §1.469-4T(c)(2)(iii)(B).

Example (17)—*Definition of "Location"*

Assume in Example (16) that A is also the sole owner of an automotive center that services automobiles and sells tires, batteries, motor oil and accessories. A operates the automotive center in a separate structure in the shopping mall in which the department store is located.

Although the automotive center operations and the department store and restaurant operations are not conducted in the same physical structure, they are conducted within close proximity of one another. Thus, the department store, restaurant and automotive center operations are conducted at the same location and are treated as a single undertaking for A.[41]

The regulations provide that oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.[42]

[41] This example is based on Regs. §1.469-4T(c)(4), Ex. (2).
[42] Regs. §1.469-4T(c)(2)(iii)(E).

There are certain business and rental operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business. The regulations treat such operations as conducted at the location with which they are most closely associated.[43] The following relationships between operations conducted at that location and other operations are generally the most significant in determining whether a location is the location with which business and rental operations are most closely associated:

- the extent to which other persons conduct similar operations at one location;
- whether the operations are treated as a unit in the primary accounting records reflecting the results of the operations;
- the extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;
- the extent to which the operations involve products or services that are commonly provided together;
- the extent to which the operations serve the same customers;
- the extent to which the same personnel, facilities or equipment are used to conduct the operations;
- the extent to which the operations are conducted in coordination with or reliance upon each other;
- the extent to which the conduct of any particular operation is incidental to the conduct of the remainder of the operations;
- the extent to which the operations depend on each other for their economic success; and
- whether the operations are conducted under the same trade name.[44]

[43] Regs. §1.469-4T(c)(2)(iii)(C).
[44] Regs. §1.469-4T(c)(3).

Example (18)—*Location With Which Operations Are Most Closely Associated*

A owns and operates a delivery service. The business consists of a central office, retail establishments and messengers who transport packages from one place to another. Customers may bring their packages to a retail establishment for delivery elsewhere or, have packages picked up at their homes or offices by calling the central office. The central office dispatches messengers and coordinates all pickups and deliveries. Customers either pay at the retail establishment or are billed for services rendered.

Although the operations conducted at the central office do not include any income-producing operations, the operations of delivering packages from one location to another are most closely associated with the central office. Thus, the delivery operations are treated as operations that are conducted at the central office and the deliveries are treated as income-producing operations that A conducts at the central office.[45]

[45] This example is based on Regs. §1.469-4T(c)(4), Ex. (11).

e. Support Operations

A special rule applies to "support operations" which are conducted at one location but relate to an undertaking conducted at another location. Support operations are generally operations that are conducted at a location but do not relate to the production of property at the location or to the transaction of business with customers at that location.[46] Instead, support operations involve providing services or property to an undertaking owned by the same person but conducted at another location. Thus, support operations conducted at a location are not treated as part of any undertaking conducted at that location.[47] Rather, the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location are taken into account in determining the income or loss from the activity which includes that undertaking.[48]

[46] Regs. §1.469-4T(c)(2)(ii)(B).
[47] Regs. §1.469-4T(c)(2)(ii)(A)(1).
[48] Regs. §1.469-4T(c)(2)(ii)(A)(2).

Example (19)—*Support Operations*

A is the sole owner of Building I and rents residential, office and retail space in the building to various tenants. A manages these rental operations from an office located in Building 2, which A also owns. A also uses this office to manage rental operations in Building 2. The rental operation in Building 2 is a separate undertaking from the operation of Building 1. Thus, to the extent that operations conducted at the office in Building 2 involve managing Building 1, they are support operations for Building 1 and the costs of the operation are allocable to the Building 1 undertaking.[49]

[49] This example is based on Regs. §1.469-4T(c)(4), Ex. (5).

f. Exception for Rental Undertakings

An exception to the basic undertaking rule requires rental and nonrental operations generally to be treated as a separate undertaking if an undertaking includes both rental and nonrental operations.[50]

[50] Regs. §1.469-4T(d)(1).

Rental operations include all of the undertaking's business and rental operations that involve making tangible property available for use by customers and providing property and services in connection therewith.[51] However, rentals of real property for 30 days or less (e.g., hotel-room rentals) and property licensed during defined business hours for nonexclusive use by various customers (e.g., operating a golf course) are generally treated as nonrental operations.[52]

[51] Regs. §1.469-4T(d)(3)(i).
[52] Regs. §1.469-4T(d)(3)(ii) and Regs. §1.469-4T(d)(3)(iii).

Example (20)—*Rental and Nonrental Operations*

A owns a building in which he rents apartments to tenants and operates a restaurant. A's tenants typically occupy an apartment for at least one year and the services provided to tenants are those customarily provided in residential apartment buildings. Since the average rental period for the apartments exceeds 30 days, A's apartment operations are rental operations. A's restaurant operations do not involve making tangible property available for customer use and therefore are not rental operations. Thus, A has two separate undertakings.

Rental operations are not separated from nonrental operations if more than 80% of the gross income of the undertaking determined under the basic rule is attributable to either the rental or nonrental operations or if the rental operations would not constitute a rental activity if considered as a separate activity.[53]

[53] Regs. §1.469-4T(d)(2). Regs. §1.469-1T(e)(3) and §1.469-1(e)(3) provide several exceptions from the definition of a rental activity. The exceptions are discussed in ¶2980.05, below.

Example (21)—*80% of Gross Income Test*

Assume in the above example that A's operations conducted in the building derive 85% of their gross income from apartment rentals and 15% from the restaurant. Since more than 80% of the basic undertaking's gross income is attributable to the rental operations, the rental operations and the restaurant operations are not treated as two separate undertakings.

g. Oil and Gas Wells

Oil and gas wells are treated as separate undertakings in determining a taxpayer's activities for a taxable year if the following conditions are satisfied:

- The well is drilled or operated pursuant to a working interest and at any time during the year the taxpayer holds the interest directly or through an entity which does not limit the taxpayer's liability with respect to the interest; and

- The taxpayer would not be treated as materially participating for the year in the activity in which the well would be included if the taxpayer's activities were determined without regard to this rule.[54]

[54] Regs. §1.469-4T(e)(1).

Example (22)—*Oil and Gas Wells*

During 1990, A directly owns an undivided interest in a working interest in two oil wells through an entity which does not limit A's liability with respect to the interest. A does not participate in the activity in which the wells would be included if A's activities were determined without regard to this rule. Each well is treated as a separate undertaking in determining activities for 1990.[55]

[55] This example is based on Regs. §1.469-4T(e)(3), Ex. (1).

h. Operations Conducted Through an Entity Other Than a Passthrough Entity

The passive loss rules generally apply separately to entities other than passthrough entities. Therefore, under the temporary regulations, a taxpayer's undertakings and activities do not include any operations that the taxpayer conducts through one or more entities other than passthrough entities.[55.1]

[55.1] Regs. §1.469-4T(b)(2)(ii)(B). *See, e.g.*, TAM 9538006 (Taxpayer's activity conducted through a closely held C corporation may not be aggregated with an activity the taxpayer conducted through an S corporation to determine whether the taxpayer materially participated in the S corporation activity).

Thus, if an individual owns stock in a closely held C corporation that is subject to the passive loss rules, the corporation's operations are not included in any activities (or undertakings) of the individual.[55.2]

[55.2] Regs. §1.469-4T(b)(2)(ii)(B), *Ex.*

Example: T, an individual, owns stock of XYZ, a closely held C corporation that is directly engaged in the conduct of a real estate development business. T participates in XYZ's real estate development business, but does not own any interest in the business other than through ownership of XYZ stock. T's activities do not include the operations of XYZ's real estate business because T's only interest in the business is held through XYZ, and XYZ is not a pass-through entity. Accordingly, T's participation in XYZ's business is not participation in an activity of T, and is not taken into account in determining whether T materially participates or significantly participates in any activity.[55.3]

[55.3] If XYZ were also the general partner in a partnership (P) in which T held a limited partner interest, and T provided services to P through an employment contract with XYZ, his services performed to P through XYZ would count as participation in P's activity. This results from the interaction of Regs. §1.469-5T(f)(1) with Regs. §1.469-4T(b)(2)(ii)(B). Regs. §1.469-5T(f)(1) defines participation as any work performed by an individual (without regard to the capacity in which the individual performs such work) in connection with an activity in which the individual owns an interest at the time the work is done. Thus, T would be treated as materially participating in P's activities (if he works for more than 500 hours during the year pursuant to Regs. §1.469-5T(a)(1) and (e)(2)) because under Regs. §1.469-5T(f)(1), work done in any capacity is treated as participation. However, T's work would not be treated as participation if T did not own a limited partner interest because T's sole interest in the activity would be through a C corporation, namely XYZ.

If an individual owns stock in a corporation that is an S corporation in 1990 and a C corporation in 1991, the corporation's operations are included in the individual's undertakings and activities in 1990 but not in 1991.[55.4]

[55.4] This example assumes that the individual is a calendar year taxpayer and that the corporation changes status on January 1, 1992. If the corporation changes status during the middle of the individual's taxable year, its operations during the portion of the year when it is an S corporation are included in the individual's undertakings and activities.

3. Activity Rules

a. General Rule

The general rule is that each undertaking a taxpayer owns is treated as a separate activity of the taxpayer.[56] However, the regulations provide additional rules which may require or permit taxpayers to aggregate undertakings into a single activity. These activity rules apply in certain circumstances to trade or business undertakings, professional service undertakings and rental real estate undertakings. [57] Each of these categories is discussed below.

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[56] Regs. §1.469-4T(a)(4)(i).
[57] Id.

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b. Business Undertakings That Are Similar and Commonly Controlled

A "trade or business undertaking" is any undertaking in which a taxpayer has an interest other than rental undertakings, certain oil and gas undertakings described above and professional service undertakings described below. [58] A taxpayer's trade or business undertakings that are both similar and controlled by the same interests are treated as part of the same activity if the taxpayer:

- owns interests in each undertaking through the same pass-through entity;
- owns a direct or substantial indirect interest in each undertaking; or
- materially or significantly participates in the activity that would result if the undertakings were treated as part of the same activity. [59]

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[58] Regs. §1.469-4T(f)(1)(ii).
[59] Regs. §1.469-4T(f)(2).

A taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during the year the taxpayer owns more than a 10% interest in the pass-through entity that directly owns the undertaking. [60]

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[60] Regs. §1.469-4T(f)(3)(i).

Example (23)—*Substantial Indirect Interest (1)*

A owns a 5% interest in Partnerships X, Y and Z. Each Partnership owns a single undertaking and the undertakings are trade or business undertakings that are controlled by the same interests. In addition, X and Y's undertakings are similar. A is not related to any of the other partners and does not participate in any of the undertakings. Since A does not own interests in the undertakings through the same pass-through entity, does not own direct or substantial indirect interests in the undertakings and does not materially or significantly participate in the undertakings, A cannot aggregate X, Y and Z's undertakings into a single activity.

Example (24)—*Substantial Indirect Interest (2)*

Assume in the above example that A owns a 25% interest in X, a 15% interest in Y and a 50% interest in Z. A owns a substantial indirect interest in X, Y and Z's undertakings because A owns more than a 10% interest in each Partnership. Since X and Y's undertakings are similar, A's interests in X and Y's undertakings are treated as part of the same activity. [61]

[61] These examples are based on Regs. §1.469-4T(f)(5), Examples (1) and (2).

c. Definition of Similar

Undertakings are similar for purposes of this rule if more than 50% of the undertaking's gross income is attributable to operations in a single line of business or if the undertakings are vertically integrated. [62] An IRS revenue procedure lists operations which are in the same line of business. [63] Business and rental operations that are not included in the lines of business described in the revenue procedure should be categorized as a single line or multiple lines of business on a basis that reasonably reflects (1) similarities and differences in the property or services provided and in the markets to which the property or services are offered and (2) the treatment of operations that are comparable in their similarities and differences within the lines of business established by the IRS. [64]

[62] Regs. §1.469-4T(f)(4).
[63] Rev. Proc. 89-38, 1989-1 C.B. 920.
[64] Regs. §1.469-4T(f)(4)(iv).

Example (25)—*Similar Undertakings*

Undertakings X and Y are trade or business undertakings, each of which involves providing moving services. Undertaking X derives its gross income principally from local moves and undertaking Y derives its gross income principally from long-distance moves. Assume that these lines of business are not in the lines of business established by the IRS revenue procedure and that within the lines of business established by the IRS services that differ only in the distance over which they are performed are generally treated as part of the same line of business.

Undertakings X and Y provide the same types of services to similar customers and the only significant difference in the services provided is the distance over which they are performed. Each undertaking derives more than 50% of its gross income from operations in the moving-services line of business. Undertakings X and Y are similar. [65] If one undertaking (the "supplier undertaking") provides property or services to other undertakings (the "recipient undertakings") special rules apply in determining whether the undertakings are similar. [66] If the supplier undertaking predominantly involves providing property and services to a recipient undertaking that is controlled by the same interests, the supplier undertaking is treated as similar to the recipient undertaking. [67] A supplier undertaking predominantly involves providing property and services to a recipient undertaking for any taxable year in which the recipient undertaking obtains more than 50% (by value) of all property and services provided by the supplier undertaking. [68]

[65] This example is based on Regs. §1.469-4T(f)(5), Example (8).
[66] Regs. §1.469-4T(f)(4)(iii).
[67] Regs. §1.469-4T(f)(4)(iii)(A).

[68] Regs. §1.469-4T(f)(4)(iii)(A)(2).

If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests, the recipient is treated as similar to the supplier undertaking. [69] A supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50% (by value) of all property and services obtained by the recipient undertaking. [70]

[69] Regs. §1.469-4T(f)(4)(iii)(B).
[70] Id.

Example (26)—*Supplier and Recipient Undertakings*

Undertakings 1, 2, 3, 4 and 5 are trade or business undertakings and are controlled by the same interests. Undertakings 1, 2 and 3 derive all of their gross income from retail sales of dairy products. Undertakings 4 and 5 derive all of their gross income from the processing of dairy products. Undertakings 4 and 5 sell less than 10% of their dairy products to undertakings 1, 2 and 3 and sell the remainder to unrelated undertakings. Undertakings 1, 2 and 3 purchase less than 10% of their inventory from undertakings 4 and 5 and purchase the remainder from unrelated undertakings. Assume undertakings 1, 2 and 3 are in the same line of business and undertakings 4 and 5 are in the same line of business.

Undertakings 4 and 5 are supplier undertakings and undertakings 1, 2 and 3 are recipient undertakings. Undertakings 4 and 5, however, sell less than 10% of their dairy products to undertakings 1, 2 and 3 and thus do not predominantly involve providing property and services to recipient undertakings. Similarly, undertakings 4 and 5 are not the predominant providers of property and services to undertakings 1, 2 and 3. Thus, undertakings 1, 2 and 3 are not treated as similar to undertakings 4 and 5. [71]

[71] This example is based on Regs. §1.469-4T(f)(5), Example (9).

Example (27)—*50% of Recipient's Property Test*

Assume in example 24 that undertaking 4 provides 75% of the dairy products sold by undertaking 1 and 60% of the products sold by undertaking 2. Undertaking 4 is treated as similar to undertakings 1 and 2.

d. Control Test

All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests. [72] However, if a group of five or fewer persons owns more than 50% in each of the undertakings, the undertakings are rebuttably presumed to be controlled by the same interests. [73] In applying the 50% test each person's "common ownership percentage" is used. A person's common-ownership percentage for two or more undertakings is the person's smallest ownership percentage in any one of the undertakings. [74] A person's ownership percentage in an undertaking or in a pass-through entity includes any interest in the undertaking or the entity that the person holds directly or indirectly through one or more pass-through entities. [75]

72 Regs. §1.469-4T(j)(1).

73 Regs. §1.469-4T(j)(2)(i).

74 Regs. §1.469-4T(j)(2)(ii).

75 Regs. §1.469-4T(j)(3)(i).

Example (28)—*Common Ownership Test*

Partnerships W, X, Y and Z are each the sole owner of an undertaking (undertakings W, X, Y and Z). A, B and C are partners in each of the four partnerships and the remaining interests in each partnership are owned by a number of unrelated individuals, none of whom own more than a 1% interest in any of the partnerships. The ownership percentages of A, B and C in each partnership are as follows:

Partnership	Partner		
	A	B	C
W	23%	21%	40%
X	19%	30%	22%
Y	25%	25%	20%
Z	8%	4%	2%

The common-ownership percentages of A, B and C in undertakings W, X, Y and Z are as follows:

Partner	Common-Ownership Percentage
A	8%
B	4%
C	2%
	14%

Since the total common-ownership percentage of A, B and C for undertakings W, X, Y and Z is 14% and no other person owns more than a 1% interest in any undertaking, the common-ownership percentage of five or fewer individuals does not exceed 50%. Thus, undertakings W, X, Y and Z are not part of the same common-ownership group and are not rebuttably presumed to be controlled by the same interests.

However, the sum of the common-ownership percentages of A, B and C in undertakings W, X and Y is 60%. Thus, undertakings W, X and Y are part of the same common-ownership group and are rebuttably presumed to be controlled by the same interests. [76]

76 This example is based on Regs. §1.469-4T(j)(5), Example (2).

e. Integrated Businesses

Trade or business undertakings (including undertakings aggregated under the rules described above) are subject to another aggregation rule. Under this rule, a taxpayer's interests in two or more trade or business activities are treated as a single activity if the activities constitute an integrated business and are controlled by the same interests. [77] A "trade or business activity" is any activity that consists of one or more trade or business undertakings. [78]

[77] Regs. §1.469-4T(g)(2).
[78] Regs. §1.469-4T(g)(1)(ii).

All of the facts and circumstances are taken into account in determining whether two or more trade or business activities constitute a single integrated business. [79] The following factors are the most significant:

- whether the operations are conducted at the same location;
- the extent to which other persons conduct similar operations at one location;
- whether the operations are treated as a unit in the primary accounting records reflecting the results of the operations;
- the extent to which other persons treat similar operations as a unit in their primary accounting records;
- whether the operations are owned by the same person;
- the extent to which the operations involve products or services that are commonly provided together;
- the extent to which the operations serve the same customers;
- the extent to which the same personnel, facilities or equipment are used to conduct the operations;
- the extent to which the operations are conducted in coordination with or reliance upon each other;
- the extent to which the conduct of any of the operations is incidental to the conduct of the remainder of the operations;
- the extent to which the operations depend on each other for their economic success; and
- whether the operations are conducted under the same trade name. [80]

[79] Regs. §1.469-4T(g)(3).
[80] Id.

Example (29)—*Integrated Business Test*

A owns five stores that sell stereo equipment and a repair shop that services stereo equipment. All of A's stores are treated as part of the same activity under the general rule for trade or business undertakings. The repair shop is treated as a separate activity. The stores sell stereo equipment produced by manufacturers for which the stores are an authorized distributor. The repair shop's operations principally involve the servicing of stereo equipment produced by the same manufacturers. These operations include repairs on equipment under warranty for which reimbursement is received from the manufacturer and reconditioning of equipment taken as trade-ins by A's stores. The majority of operations, however, involve repairs that are performed for customers and are not covered by a warranty. A's distribution agreements with manufacturers generally require that A repair and service equipment produced by the manufacturer both during and after the warranty period. In some cases, the distribution agreements require that A's repair facility meet the manufacturer's standards and provide for periodic inspections to ensure that these standards are met.

The stores and the repair shop use a common trade name. Sales personnel generally work only in a particular store and stereo technicians work only in the repair shop. The stores and repair shop are, however, managed from a central office which supervises both store and repair-shop operations, provides payroll, financial and other support services to the stores and the repair-shop and establishes pricing and other business policies. In addition, inventory for the stores and supplies for the repair shop are acquired through a central purchasing department and are stored in a single warehouse.

A's operations of the store activity and the repair shop activity constitute an integrated business. Thus, since A controls both activities, they are treated as a single activity. [81]

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81 This example is based on Regs. §1.469-4T(g)(4), Example (2).

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f. Professional Service Undertakings

An undertaking is treated as a professional service undertaking for any taxable year in which the undertaking derives more than 50% of its gross income from providing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. [82] A taxpayer's interests in two or more professional service undertakings are treated as part of the same activity if the undertakings involve significant similar or significant related services or are controlled by the same interests. [83]

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82 Regs. §1.469-4T(h)(1)(ii).

83 Regs. §1.469-4T(h)(2). Control for these purposes is determined under the rules discussed in ¶2980.03.C.3.d, above.

The significant similar services test asks whether two undertakings provide a significant amount of services in the same field. Thus, two professional service undertakings are providing significant similar services if (i) each undertaking is providing "significant professional services" and (ii) the significant professional services provided by each undertaking are similar. An undertaking's services are significant professional services if the services are in a field described above and more than 20% of the undertaking's gross income is attributable to services in such field. [84] Services (other than consulting services) in any field described above are similar to all other services in the same field. [85] All the facts and circumstances must be examined to determine whether consulting services are similar.

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84 Regs. §1.469-4T(h)(3)(iv).

85 Regs. §1.469-4T(h)(3)(i).

Example (30)—*Significant Similar Services*

B is a partner in a law partnership that has offices in various cities. Some of the offices provide a full range of legal services and other offices specialize in a particular area of law. In either case, substantially all of the office's gross income is derived from providing legal services to clients. Each of the law partnership's offices is treated as a single undertaking.

Each office is providing significant professional services because more than 20% of its gross income is derived from providing legal services. In addition, the legal services provided by each office are treated as similar services regardless of the particular area of the law. Thus, each office is providing significant similar services and A's interests in the professional service undertakings are all treated as part of the same activity. [86]

[86] This example is based on Regs. §1.469-4T(h)(4), Example (1).

Professional service undertakings involve significant related services only if one of the undertakings derives more than 20% of its gross income from persons who are customers of the other undertaking. [87]

[87] Regs. §1.469-4T(h)(3)(v).

Example (31)—*20% Gross Income Test*

A is a partner in Partnerships X and Y. X derives substantially all of its gross income from providing engineering services and Y derives substantially all of its gross income from providing architectural services. X derives 40% of its gross income from customers of Y. A's interests in X and Y's undertakings are treated as part of the same activity.

g. Rental Real Estate Undertakings

A taxpayer is generally allowed to treat any combination of rental real estate undertakings as a single activity or as separate activities. [88] A rental real estate undertaking is a rental undertaking in which at least 85% of the total unadjusted basis of the property made available for customers is attributable to real property. [89]

[88] Regs. §1.469-4T(k)(2)(i). To treat a rental real estate undertaking as multiple undertakings for a taxable year or treat multiple undertakings as a single undertaking for a taxable year, the taxpayer should attach a schedule to the taxpayer's tax return. Regs. §1.469-4T(k)(5).

[89] Regs. §1.469-4T(k)(1)(ii).

Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities if the following requirements are met:

- the portion of the leased property can be separately conveyed under state and local law; and
- the taxpayer holds the leased property directly or through one or more pass-through entities which each treat the portion of leased property as a separate activity on the pass-through entity's tax return for the taxpayer's taxable year. [90]

[90] Regs. §1.469-4T(k)(2)(iii).

Example (32)—*Aggregation and Fragmentation of Rental Real Estate Activities*

A directly owns five condominium units (1, 2, 3, 4 and 5) in three different buildings. Units 1, 2 and 3 are in one building and constitute a single rental real estate undertaking. Units 4 and 5 are in the other two buildings and each constitutes a separate rental real estate undertaking. Each of the units can be separately conveyed under applicable state and local law.

A can treat units 1, 2, and 3 as three separate undertakings, can treat two of those units as an undertaking and the remaining one as a separate undertaking or can treat them as a single undertaking. In addition, A, by combining undertakings, can treat all five units as a single activity. Alternatively, A could treat each undertaking as a separate activity or could combine some but not all undertakings. [91]

[91] This example is based on Regs. §1.469-4T(k)(8), Example (1).

The aggregation or fragmentation of rental real estate into separate activities is limited by two consistency requirements. Taxpayers may not aggregate or fragment their rental real estate in a manner that is inconsistent with their treatment in prior taxable years or with the treatment of the property by the pass-through entity through which it is held. [92]

[92] Regs. §1.469-4T(k)(2)(ii) and Regs. §1.469-4T(k)(3).

Example (33)—*Consistency Requirements*

Assume in the above example that A treats all five units as a single activity for 1990 and sells unit 5 in 1991. Since all five units were treated as part of the same activity in 1990, they must be treated that way in 1991. Thus, A's sale of unit 5 cannot be a disposition of A's entire interest in an activity.[93]

[93] The example is based on Regs. §1.469-4T(k)(8), Ex. (2).

These rules do not apply to a rental real estate undertaking if less than 30% of the unadjusted basis of the property used in the undertaking is subject to depreciation.[94] Instead, such an undertaking must be treated as a separate activity.

[94] Regs. §1.469-4T(k)(6). *See, e.g., Wiseman v. Comr.*, T.C. Memo 1995-203 (Taxpayer could not aggregate limited partnership undertaking with joint venture undertaking because less than 30% of the unadjusted basis of the land and improvements owned by the joint venture is subject to an allowance for depreciation). See also the recharacterization rule for renting nondepreciable property which is discussed in ¶2980.07.C, below.

Example (34)—*30% of Unadjusted Basis Test*

B owns a shopping center and a parking lot that are separate rental real estate undertakings. Most of the unadjusted basis of the property used in the shopping center undertaking is depreciable but no depreciable property is used in the parking lot undertaking. B cannot combine these two undertakings into one activity.

However, assume that the shopping center and the parking lot are at the same location and are part of the same rental real estate undertaking. Taking into account both the property used in the shopping center operations and the lot, 50% of the unadjusted basis of the property used in the undertaking is depreciable. Thus, B may combine this undertaking with other rental real estate undertakings as a single activity.[95]

[95] This example is based on Regs. §1.469-4T(k)(8), Exs. (4) and (5).

h. Election for Nonrental Undertakings

An election permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking.[96] To make this election, a written statement must be attached to the taxpayer's tax return.[97]

[96] Regs. §1.469-4T(o)(1) and Regs. §1.469-4T(o)(2).

[97] Regs. §1.469-4T(o)(7). The written statement must (i) state the name, address and taxpayer identification number of the person making the election, (ii) contain a declaration that an election is being made under Regs. §1.469-4T(o), (iii) identify the undertaking and (iv) identify the remainder of the activity in which such undertaking would otherwise be included.

This election is limited by consistency requirements similar to those which apply to rental real estate undertakings. If a person (including a pass-through entity) treats undertakings as part of the same activity on the person's return for a taxable year ending after August 9, 1989, the person may not treat such undertakings as part of different activities under this rule for any subsequent year.[98] In addition, a person must treat interests in two or more undertakings as part of the same activity for a taxable year if any pass-through entity through which the person holds the undertakings treats the undertakings as part of the same activity on the pass-through entity's tax return.[99]

[98] Regs. §1.469-4T(o)(4).

[99] Regs. §1.469-4T(o)(3).

Example (35)—*Aggregation and Fragmentation of Nonrental Activities*

During 1989 A acquires and is the direct owner of ten grocery stores. Each grocery store would be treated as a single undertaking and A's interests in the undertakings would be treated as part of the same activity. However, A can elect to treat each undertaking as a separate activity for 1989. Alternatively, A may combine the undertakings in any manner and treat each combination of undertakings as a separate activity for 1989. In either case, A must elect by attaching a written statement to his 1989 return.[100]

[100] This example is based on Regs. §1.469-4T(o)(8), Ex. (1).

The election to treat a nonrental activity as two or more separate activities does not affect the way the material and significant participation tests are applied to the activity. Thus, if a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.[101]

[101] Regs. §1.469-4T(o)(6). The material and significant participation tests are discussed in

¶2980.04.

Example (36)—*Participation in Fragmented Activities*

Assume in the above example that A elects in 1989 to treat each of the grocery store undertakings as a separate activity. In 1989 A participates for 80 hours in each of the grocery store undertakings. Thus, A participates for 800 hours in the activity in which the undertakings would be included if the election to treat them as separate activities was not made. A therefore is treated as materially participating in each of the grocery store activities for 1989.

4. Special Rules

a. Consolidated Groups

A consolidated group of corporations is treated as one taxpayer in determining its activities and those of its members.[102]

[102] Regs. §1.469-4T(m)(1). The special rules applicable to consolidated groups are discussed in ¶2980.09.E, below.

Example (37)—*Consolidated Groups*

Corporations M, N and O are members of a consolidated group. The consolidated group and its members are treated as closely-held corporations and thus are subject to the passive loss rules. Each member of the group owns a 2% interest in Partnership X and a 2% interest in Partnership Y and owns interests in a number of business undertakings through X and Y. Each of the undertakings is directly owned by X or Y and all the undertakings of X and Y are controlled by the same interests and are similar. The employees of the group and the shareholders of the common parent do not participate in the undertakings that the member corporations own through X and Y.

M, N and O own interests in similar, commonly controlled undertakings through both X and Y and these interests are treated as owned by one taxpayer. Thus, M, N and O's interests in the undertakings owned through X are treated as part of the same activity of the group, and their interests in the undertakings owned through Y are treated similarly.[103]

[103] This example is based on Regs. §1.469-4T(m)(2), Ex. (1).

b. Publicly Traded Partnerships

The activity regulations apply to a taxpayer's interest in business and rental operations held through a PTP as if the taxpayer had no other business and rental operations.[104]

[104] Regs. §1.469-4T(n).

Example (38)—*Publicly Traded Partnerships*

A owns a 20% interest in Partnership X and a 15% interest in Partnership Y. X directly owns a hotel and an office building. Y directly owns two hotels and two office buildings. Each of the three hotels is a separate undertaking and each of the three office buildings is a separate rental real estate undertaking. The three hotel undertakings are similar and are controlled by the same interests. X is not a PTP and Y is a PTP which is not treated as a corporation. The undertakings owned through Y may be treated as part of the same activity but an undertaking owned through Y and an undertaking not owned through Y may not be treated as part of the same activity. Thus, although A's interests in Y's hotel undertakings are treated as part of the same activity, A's interests in X's hotel undertakings cannot be treated as part of that activity.[105]

[105] This example is based on the example in Regs. §1.469-4T(n).

c. Taxable Years Ending Before August 10, 1989

For taxable years ending before August 10, 1989, a taxpayer's business and rental operations may be organized into activities under the regulations or under any other reasonable method.[106] A taxpayer is also permitted to use any reasonable method to allocate disallowed deductions and credits from the taxpayer's last year ending before August 10, 1989, among activities for the first taxable year of the taxpayer ending after August 9, 1989.[107]

[106] Regs. §1.469-4T(p)(1). The regulations specify certain methods as unreasonable. Regs. §1.469-4T(p)(2).

[107] Regs. §1.469-4T(p)(3).

¶2980.03.D. Regulations' Definition of Activity After May 10, 1992

1. Background

Temporary regulations, discussed in ¶2980.03.C, above, provided a series of mechanical rules for determining a taxpayer's activities. The rules were criticized as overly long and complex, burdensome for small taxpayers, and mechanically inflexible. These temporary regulations, issued on May 12, 1989, were permitted to sunset.[108] For taxable years ending after May 10, 1992, the Treasury replaced the temporary regulations with regulations defining the term "activity," which are shorter and more flexible than the rules contained in the temporary regulations.[109] The regulations generally adopt a facts and circumstances approach to identify a taxpayer's activities.

[108] See §7805(e).

[109] See T.D. 8565, 59 Fed. Reg. 50485 (10/4/94). These regulations finalized proposed regulations (see PS-01-89, 57 Fed. Reg. 20747 (5/15/92)), and are generally effective for taxable years ending after May 10, 1992. For taxable years ending on or before May 10, 1992, taxpayers must apply the rules in Regs. §1.469-4T.

Taxpayers may, for the year that includes May 10, 1992, apply the rules in Regs. §1.469-4T rather than the rules in the proposed regulations. See Regs. §1.469-11, finalized by T.D. 8417, 57 Fed. Reg. 20747 (5/15/92).

2. General Rules for Grouping Activities

Under the regulations, one or more trade or business activities[110] or rental activities[111] are treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules.[112]

[110] Trade or business activities are defined as activities, other than rental activities or activities

that are treated as incidental to an activity of holding property for investment under Regs. §1.469-1T(e)(3)(vi)(B), that:
• involve the conduct of a trade or business within the meaning of §162;
• are conducted in anticipation of the commencement of a trade or business; or
• involve research or experimental expenditures that are deductible under §174 (or would be deductible if the taxpayer adopted the method described in §174(a)). Regs. §1.469-4(b)(1). For a discussion of activities that are treated as incidental to an activity of holding property for investment, see ¶2980.05.B.4.a, below.

111 Rental activities are those that constitute rental activities within the meaning of Regs. §1.469-1T(e)(3). For a discussion of rental activities, see ¶2980.05.A, below.

112 Regs. §1.469-4(c)(1).

Whether activities are treated as a single activity depends on all the relevant facts and circumstances.[113] A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities, but the factors listed below are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss:

- similarities and differences in types of business;
- the extent of common control;
- the extent of common ownership;
- geographical location; and
- interdependence between the activities (for example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).[114]

Not all of the factors need to be present for a taxpayer to treat more than one activity as a single activity.[115]

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113 Regs. §1.469-4(c)(2).

114 Id.

115 Id.

Example—*Grouping Activities (1)*

T has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore, and in a bakery and movie theater in Philadelphia. Reasonable methods of applying the facts and circumstances may result in grouping the movie theaters and bakeries into a single activity, into a movie theater activity and a bakery activity, into a Baltimore activity and a Philadelphia activity, or into 4 separate activities.[116]

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116 Regs. §1.469-4(c)(3), Ex. 1.

Example—*Grouping Activities (2)*

T is a partner in a business that sells non-food items to grocery stores (partnership L). T is also a partner in a partnership that owns and operates a trucking company (partnership Q). The 2 partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which T is involved. T treats L's wholesale trade activity and Q's trucking activity as a single activity.[117]

[117] Regs. §1.469-4(c)(3), Ex. 2.

3. Rules for Grouping Rental Activities

A rental activity may not be grouped with a trade or business activity unless either the rental activity is insubstantial in relation to the trade or business activity, or the trade or business activity is insubstantial in relation to the rental activity.[118] In addition, an activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property) may not be treated as a single activity.[119]

[118] Regs. §1.469-4(d)(1). *See, e.g.*, *Glick v. U.S.*, 2000-1 USTC ¶50,372 (S.D. Ind. 2000) (Property management activity could be grouped with rental real estate activities because the property management activity was insubstantial in relation to the rental activities based on comparisons of gross income and fair market asset value). *See also* TAM 200014010 (Because a gasoline supplier's activity of leasing property to convenience store operators is a rental activity that could not be considered insubstantial in relation to the supplier's trade or business of selling gasoline, it may not be grouped with that activity).

[119] Regs. §1.469-4(d)(2).

4. Limitation on Grouping Certain Activities

An anti-abuse rule is provided to prevent the inappropriate aggregation of traditional shelter activities with other activities. Under the rule, a taxpayer who is a limited partner or a limited entrepreneur[120] in certain activities (described below) or designated in a revenue procedure by the IRS may not group that activity with any other activity.[121] The prohibited activities are:

- holding, producing, or distributing motion pictures films or videotapes;
- farming;
- leasing any §1245 property;
- exploring for, or exploiting, oil and gas resources; and
- exploring for, or exploiting, geothermal deposits as a trade or business or for the production of income.[122]

[120] A "limited entrepreneur" is a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of the enterprise. See §464(e)(2).

[121] Regs. §1.469-4(d)(3)(i), which provides that activities described in §465(c)(1) may not be grouped with other activities.

[122] See §465(c)(1).

A taxpayer who is a limited partner or limited entrepreneur in an activity described above may, however, group that activity:

- with another activity described above that is the same type of business if the taxpayer is a limited partner or limited entrepreneur in the other activity; or

- with another activity in the same type of business in which the taxpayer is not a limited partner or limited entrepreneur if the grouping is appropriate under the general facts and circumstances test.[123]

[123] Regs. §1.469-4(d)(3)(i).

5. Consistency Requirement

Once a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.[124] If it is determined that the original grouping was clearly inappropriate or if a material change occurs that makes the original grouping clearly inappropriate, a taxpayer must regroup the activities and must comply with IRS disclosure requirements.[125]

[124] Regs. §1.469-4(e).
[125] Id.

6. Grouping by IRS

The IRS may regroup a taxpayer's activities if the taxpayer's grouping fails to reflect one or more appropriate economic units and one of the primary purposes of the taxpayer's grouping is to circumvent the underlying purposes of the passive loss rules.[126]

[126] Regs. §1.469-4(f).

Example—*Regrouping by the IRS*

Ts are doctors who operate several medical practices, and they all have passive losses. They form a partnership to acquire and operate x-ray equipment. In exchange for equipment contributed to the partnership, Ts receive limited partnership interest. The partnership is managed by a general partner selected by Ts; Ts do not participate in its operations. Substantially all of the partnership's services are provided to Ts or their patients. Ts treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

For each of the Ts, the Ts' own medical practice and the services provided by the partnership constitute an appropriate economic unit. Moreover, one of the primary purposes of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of the passive loss rules. Thus, the IRS may require Ts to treat their medical practices and their interests in the partnership as a single activity.[127]

[127] Regs. §1.469-4(f)(2)(i), Ex.

7. Activities Conducted Through Partnerships or S Corporations

A partnership or S corporation must group its activities under the general rules, using the facts and circumstances analysis. Once a partnership or S corporation determines its activities, a partner or shareholder groups those activities with activities conducted directly by the partner or shareholder or with activities conducted through other partnerships or S corporations in accordance with the general rules.[128]

[128] Regs. §1.469-4(d)(5).

8. Treatment of Partial Dispositions

A taxpayer may treat a disposition of substantially all of an activity as a separate activity of which there was a complete disposition (thus allowing suspended losses) if the taxpayer can establish with reasonable certainty:

- the amount of deductions and credits allocable to that part of the activity for the taxable year; and
- the amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year.[129]

[129] Regs. §1.469-4(g). The amount of deductions and credits allocable to an activity is determined under Regs. §1.469-1(f)(4) (relating to carryover of disallowed deductions and credits).

¶2980.03.E. Passive Activity

1. Definition

A passive activity is (1) any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate for the taxable year or (2) any rental activity.[130] Effective for taxable years beginning after December 31, 1993, however, a rental activity will not be considered a passive activity to the extent that the taxpayer is engaged in rental real estate activities as a real estate professional.[131] A trade or business activity is any activity (other than a rental activity) which involves business or rental operations.[132] Business or rental operations include all endeavors engaged in for profit or the production of income if the endeavors involve

- the conduct of a trade or business or endeavors anticipated to become a trade or business;
- making tangible property available for use by customers;[133] or
- deductible research expenditures;[134]

[130] §469(c)(1) and (2). Material participation is discussed at ¶2980.04, below.

[131] See §469(c)(7), added by §13143 of the Revenue Reconciliation Act of 1993 (P.L. 103-66) (1993 RRA). For a discussion of the real property trade or business exception, see ¶2980.05, below.

[132] Regs. §1.469-1T(e)(2).

[133] Rental property held principally for investment is not a business or rental operation, however. Regs. §1.469-1T(e)(3)(vi)(B), discussed in ¶2980.05.4.A, below.

[134] Regs. §1.469-4T(b)(2)(ii). An endeavor involving deductible research expenditures qualifies as a business operation even if the taxpayer does not in fact elect to deduct research expenditures under §174.

The term "trade or business" also includes any activity involving expenditures for research or experimentation which are deductible research expenses (or would be properly deductible research expenses if the taxpayer elected to deduct such expenses).[135]

[135] §469(c)(5) and §174.

2. Exceptions

a. Qualified Working Interests

The term "passive activity" does not include a qualified working interest in any oil and gas property which the taxpayer holds directly or through an entity which does not limit the taxpayer's liability with respect to the interest.[136] Thus, the passive loss rules do not apply to losses and credits from a working interest without regard to whether the taxpayer materially participates in the activity. However, if a taxpayer has a loss from a working interest which is treated as a loss not from a passive activity, any income from the property in later taxable years is treated as nonpassive income.[137] If the preceding applies, then any credits which are attributable to the property for that year are treated as nonpassive to the extent the amount of such credits do not exceed the taxpayer's regular tax liability allocable to such net income for the tax year.[137.1]

[136] §469(c)(3)(A). A "working interest" is a working or operating mineral interest in any tract or parcel of land under Regs. §1.612-4(a). Regs. §1.469-1(e)(4)(iv).

[137] §469(c)(3)(B). Regs. §1.469-2(c)(6).

[137.1] §469(c)(3)(B) (flush language), as added by §1704(d) of the 1996 Small Business Act, effective for taxable years beginning after 1986. The rule applies for any credit allowable under subpart B (other than the §27(a) foreign tax credit) or subpart D of part IV of subchapter A.

If a taxpayer holds a working interest through a limited liability entity for only a portion of the taxable year, the gross income and deductions relating to the period during which his liability was limited are treated as passive, unless the taxpayer either (1) materially participates in the working interest for the taxable year or (2) does not have a net loss from the property for the taxable year.[138]

[138] Regs. §1.469-1T(e)(4)(ii)(A). Special rules apply to determine the gross income and deductions which relate to the limited liability period. See Regs. §1.469-1T(e)(4)(ii)(C).

b. Trading Personal Property

An activity of trading personal property for the account of the owners of the activity is not a passive activity, without regard to whether the activity constitutes a trade or business.[139] Personal property for this purpose is property of a type that is actually traded, including stocks, bonds, and futures.[140]

[139] Regs. §1.469-1T(e)(6)(i).

[140] Regs. §1.469-1T(e)(6)(ii), which refers to the definition of personal property in §1092(d).

Example (39)—*Trading of Personal Property*

A and B are 50% partners in Partnership X. X is engaged in trading stocks and bonds. The capital employed by X in the trading activity consists of amounts contributed by A and B in exchange for their partnership interests and funds borrowed by X. X derives gross income from the activity in the form of interest, dividends and capital gains. X is treated as conducting an activity of trading personal property for the account of A and B. The activity is not a passive activity.[141]

141 This example is based on the example in Regs. §1.469-1T(e)(6)(iii).

c. Rental Real Estate Activities of Real Estate Professionals

Effective for taxable years beginning after December 31, 1993, the term "passive activity" does not include a taxpayer's rental real estate activities in which the taxpayer materially participates to the extent that the taxpayer meets certain eligibility requirements relating to real property trades or businesses.[142]

142 See §469(c)(7), added by 1993 RRA §13143.

For a discussion of the exception to the passive loss rules for rental real estate activities of real estate professionals, see the rules relating to rental activities at ¶2980.05, below.

¶2980.04 Material Participation

¶2980.04.A. In General

Material participation is one of the key concepts in the passive loss rules because a taxpayer's trade or business is treated as a passive activity only if the taxpayer does not materially participate.[143] Under the statute, a taxpayer materially participates in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous or substantial basis.[144] Although the statute does not define "regular, continuous and substantial," several relevant factors can be identified:

- the taxpayer's involvement in the operations of the activity;
- whether or not the activity is the taxpayer's principal business, which should carry substantial weight in proving material participation;
- the regularity with which the taxpayer participates at the principal location of the activity;
- whether or not the taxpayer has knowledge or experience regarding the activity's business; and
- the taxpayer's performance of management functions in excess of a mere formal and nominal participation.[145]

143 §469(c); *see Chapin v. Comr.*, T.C. Memo 1996-56 (2/14/96) (Annual cleaning of rental property did not constitute material participation in the activity of renting the property, and thus rental expenses are limited by the §469 passive activity loss limitations).

144 §469(h)(1). Note that while the material participation standard of §469 is based on §1402(a) (relating to the self-employment tax) and §2032A (relating to estate tax valuation of farm

property), existing authorities interpreting §1402(a) and 2032A are not intended to be controlling for purposes of the passive loss rules. See S. Rep. No. 313, 99th Cong., 2d Sess. 732 (1986).

145 S. Rep. No. 313, at 732-34.

In addition, the Treasury has provided detailed regulations which set forth tests for taxpayers to determine material participation. The regulations generally provide that a taxpayer materially participates in an activity if he meets any one of seven tests.[146] Six of the seven tests are primarily quantitative tests which focus on factors such as the number of hours that a taxpayer participates in a particular activity in which he owns an interest. The seventh test examines all of the facts and circumstances to determine whether the taxpayer participates in the activity on a regular, continuous and substantial basis during the year.[147]

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146 Regs. §1.469-5T(a).

147 Regs. §1.469-5T(a)(7).

In the case of a married taxpayer, any participation by the taxpayer's spouse in the activity during the taxable year is treated as participation by the taxpayer under all tests for material participation.[148] This rule applies even if the spouse does not own an interest in the activity and even if the spouses do not file a joint return for the taxable year.[149]

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148 §469(h)(5); Regs. §1.469-5T(f)(3). See ¶2980.04.B.1, below, for exceptions.

149 Regs. §1.469-5T(f)(3).

Example (40)—*Spousal Participation Rule*

In 1992, a husband works in an activity for 250 hours and his wife works in the same activity for 275 hours. Even if the husband and wife do not file a joint return for 1992, each one is treated as participating in the activity for 525 hours in 1992.

There is no attribution of hours for work done by other family members.

A special rule permits certain retired individuals and surviving spouses engaged in farming to use the material participation standard applied for estate tax valuation purposes which is generally easier for taxpayers to meet than the passive loss standard.[150]

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150 §469(h)(3); §2032A. Regs. §1.469-5T(h)(2).

¶2980.04.B. Participation

1. In General

It is critical to determine what work constitutes "participation" by an individual to apply the six material participation tests. In general, any work done by an individual in any capacity in connection with an activity in which the individual owns an interest at the time the work is done is treated as participation of the individual in the activity.[151] The individual's ownership interest may be indirect, as long as it is not through a C corporation.

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151 Regs. §1.469-5(f)(1).

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2. Exceptions

There are two important exceptions to the general rule that any work done in any capacity is treated as participation.[152] The first exception is that work done in connection with an activity is not treated as participation if (1) the work is not of a type customarily done by an owner of such an activity and (2) one of the principal purposes for the performance of the work is to avoid the disallowance of losses or credits under the passive loss rules.[153]

[152] Regs. §1.469-5T(f)(2).

[153] Regs. §1.469-5T(f)(2)(i).

Example (41)—*Participation Exceptions*

A is employed full-time as an accountant. A also owns an interest in a professional baseball team that constitutes a business activity. A does no work in connection with the baseball team and anticipates a loss from the baseball team for 1989. If A does not materially participate in 1989, the loss will be disallowed under the passive loss rules. A pays his spouse to work as a receptionist for the baseball team for more than 500 hours during 1989.

Although the hours worked by A's spouse would generally be attributed to A, the work done by A's spouse is not treated as participation because receptionist's work is not work customarily done by an owner of a baseball team, and one of A's principal purposes for paying his wife to do this work is to avoid the disallowance of a passive activity loss. Thus, A did not materially participate in 1989.[154]

[154] This example is based on Regs. §1.469-5T(k), Ex. (7).

The second exception is that work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the day-to-day management of the activity.[155] Work done as an investor in an activity includes, for example, time spent (1) studying and reviewing financial statements or reports on an activity, (2) preparing studies or analyses of the activity's finances or operations for the investor's own use, or (3) monitoring the activity's finances or operations in a nonmanagerial capacity.[156]

[155] Regs. §1.469-5T(f)(2)(ii)(A).

[156] Regs. §1.469-5T(f)(2)(ii)(B).

The statute and regulations do not address many circumstances in which it is difficult to assess whether an individual's time spent in the activity should be counted as participation in an activity.

Example (42)—*Unaddressed Participation Example*

A owns a professional baseball team. A attends all of the baseball team's games but A does not get involved in managing the team. A carefully monitors the performance of the team and is responsible for hiring and firing the team's manager. The regulations do not address whether A's attendance at the games should be treated as participation or as monitoring operations in a nonmanagerial capacity.

3. Proof of Participation

An individual may establish his participation in an activity by any reasonable means. [157] Reasonable means may include, for example, the identification of services performed over a period of time and the number of hours spent performing such services based on appointment books, calendars or narrative summaries. [158] An individual is not required to maintain contemporaneous daily time reports, logs or similar documents, provided he can otherwise substantiate the level of his participation in an activity. [159]

157 Regs. §1.469-5T(f)(4).
158 Id.
159 Id.

Although the substantiation rule appears liberal, taxpayers should keep careful records whenever possible. Taxpayers carry the burden of proving the amount of participation in an activity in litigation and accurate detailed records will help him meet this burden. [160]

160 See Rule 142(a), Tax Court Rules of Practice and Procedure.

¶2980.04.C. Seven Tests for Material Participation

1. 500-Hour Test

An individual is treated as materially participating in an activity if the individual participates for more than 500 hours during the taxable year. [161] This test considers only the number of hours that an individual or his spouse work during the taxable year.

161 Regs. §1.469-5T(a)(1). *See Mordkin v. Comr.*, T.C. Memo 1996-187 (Validity of regulations upheld).

Example (43)—*500-Hour Test*

A works two days per week for 8 hours per day during 1989 and one day per week for 8 hours per day in 1990. Assuming A worked 52 weeks in each year, A worked 832 hours in 1989 and 416 hours in 1990. Thus, A materially participated in the activity in 1989 but not in 1990.

The 500-hour test will likely be met by all full-time employees and by many part-time employees. However, it may be difficult for a taxpayer to satisfy the 500-hour test where an activity is not conducted for the entire taxable year.

Example (44)—*500-Hour Test for Seasonal Occupations*

A owns an interest in a ski resort. The ski resort activity is only open for 12 weeks in 1989 and A works 40 hours per week during those 12 weeks. The 500-hour test is not satisfied for A in 1989 even though A works as a full-time employee in the activity for the entire time the ski resort is open in 1989.

2. 100-Hour Test

Under the second test for material participation, an individual is treated as materially participating in an activity if the individual participates in the activity for more than 100 hours during the taxable year, and his participation is not less than that of any other individual (including individuals who do not own an interest in the activity) during the year.[162] This test focuses on individuals who perform most of the work in an activity but do not satisfy the 500-hour test.

[162] Regs. §1.469-5T(a)(3). For examples of how this test is applied, see *Scheiner v. Comr.*, T.C. Memo 1996-554 (Taxpayer's participation on condominium association's board of directors did not constitute material participation under Regs. §1.469-5T(a)(3), because participation of full-time staff of company hired to manage resort exceeded that of taxpayer's participation); *Serenbetz v. Comr.*, T.C. Memo 1996-510 (Taxpayer did not meet 100-hour requirement; his participation in condominium rental activity, which included preparing his state and federal income tax returns, traveling to and from condominium for annual meeting and party of condominium association, and preparing for association's board meeting, were investor activities or activities of a personal nature that do not qualify as participation in trade or business); TAM 9543003 (Taxpayers did not materially participate in condominium rental activity because there was at least one individual who performed more hours of services in the activity); *Pohaski v. Comr.*, T.C. Memo 1998-17 (In determining participation by others, only time spent by condominium's front desk personnel in actually providing services directly related to taxpayer's rental activities should be counted; IRS misinterpreted holdings in *Goshorn v. Comr.*, T.C. Memo 1993-578, and *Serenbetz v. Comr.*, T.C. Memo 1996-510, when it argued that all time that front desk personnel were available should be counted).

Example (45)—*100-Hour Test*

B works 200 hours in her craft business and C works 150 hours during 1989. No other individuals participate in 1989. B is treated as materially participating in the craft business during 1989 because (1) she participates for more than 100 hours and (2) her participation is greater than C's.

If the only two individuals participating in an activity both work the same number of hours and the amount exceeds 100 hours, both individuals are treated as materially participating because no individual participated more than the other.[163] It will often be difficult, however, to prove hours of participation so precisely.

[163] *Id.*

This test, like the other six, counts work done in the activity by a taxpayer's spouse. However, in determining whether another individual's participation exceeds the taxpayer's, the rules apparently do not require combining participation by that individual's spouse.[164]

[164] Regs. §1.469-5T(f)(3) states that participation by a person's spouse is counted as done by such person "for purposes of applying section 469 to such person." There is no requirement, however, to count work done by another person's spouse in comparing one's own involvement to that of the other person.

Example (46)—*100-Hour Test for Married Taxpayers*

A and B are married to each other and participate in an activity for 75 hours each during 1989. The only other participants in the activity are C and D, who are married to each other and who each participate for 120 hours each during 1989. A and B are allowed to aggregate their hours in 1989. A and B are therefore materially participating because their participation exceeds 100 hours and is not less than that of any other individual. C and D's time is not aggregated for purposes of determining A and B's participation. C and D also materially participate under this test.

3. "Substantially All" Test

The third test generally applies to individuals who operate the activity themselves. An individual is treated as materially participating in an activity if his participation constitutes substantially all of the participation in the activity of all individuals for the taxable year. [165] An individual can therefore meet this test even though he did not participate in the activity more than 500 hours during the taxable year. In applying this test, it is necessary to consider the amount of time spent by individuals who do not own interests in the activity, including employees, independent contractors and all others.

165 Regs. §1.469-5T(a)(2).

Example (47)—*Substantially All Test (1)*

Each summer B conducts guided one-day hikes into a wilderness area. The hikes take place only on Saturdays in July and August and B spends a total of 90 hours in the business activity in 1989. No one else is involved. B materially participates under the substantially all test, even though he does not under the 500-hour or 100-hour tests.

The regulations do not define what is meant by "substantially all" of the participation in the activity. It is therefore not clear whether an individual who performs, for example, 80% of the work in an activity will satisfy this test.

Example (48)—*Substantially All Test (2)*

B works 90 hours in his guide business in 1989 and C works 20 hours in the business during 1989. It is not clear whether B's work constitutes substantially all of the participation in the activity during 1989.

The nature of each individual's participation may be relevant, as well as the time each individual spends in the activity.

4. Significant Participation Activities

The fourth test allows a taxpayer to aggregate certain activities in which the taxpayer does not satisfy the 500-hour test. This test is satisfied for an activity if the activity is a significant participation activity (SPA) for the taxable year and the individual's aggregate participation in all SPAs during the year exceeds 500 hours. [166]

166 Regs. §1.469-5T(a)(4).

An activity is a SPA of an individual if (1) it is a trade or business activity in which the individual participates for more than 100 hours during the taxable year and (2) but for this test the individual would not materially participate in the activity. [167]

167 Regs. §1.469-5T(c).

Example (49)—*Significant Participation Activities*

A owns interests in three activities that are all trade or business activities. In 1989, A spends 150 hours participating in Activity l, 200 hours participating in Activity 2 and 200 hours participating in Activity 3. If A is not materially participating in any of these activities under the other six tests, then Activities 1, 2 and 3 are all SPAs. Thus, A has spent more than 500 hours participating in SPAs in 1989 and is materially participating in all three activities. Assume that A increases his hours spent in Activity 1 to 501 hours. Since A is now materially participating in Activity 1 pursuant to the 500-hour test, Activity 1 is no longer a SPA. Thus, A's time spent on SPAs (Activities 2 and 3) is less than 500 hours and A is no longer materially participating in Activities 2 and 3.

SPAs that fail to satisfy the aggregate 500-hour test are termed significant participation passive activities (SIPPAs) and are subject to a special rule (discussed in ¶2980.07.B.1, below). Under this rule, aggregate income or gain from all SIPPAs is treated as nonpassive, even though an aggregate loss is treated as passive. Thus, a passive loss from other sources could not offset income from a SIPPA but a loss from a SIPPA would be passive and not available against active income. [168]

[168] Regs. §1.469-2T(f)(2).

Example (50)—*Significant Participation Passive Activities*

B is employed full-time as a real estate broker and also owns interests in a restaurant and a shoe store. During 1989, B works 200 hours in the restaurant and 175 hours in the shoe store. Both the restaurant and the shoe store have full-time employees. The restaurant and the shoe store are each a SPA for B and B fails to meet the aggregate 500-hour test. Thus, B's interests in the restaurant and the shoe store are SIPPAs. B's aggregate income from these SIPPAs is nonpassive; however, aggregate loss is passive.

The SPA and SIPPA rules make it important for a taxpayer to closely monitor the hours spent on each activity. For example, if a taxpayer wants to aggregate hours from SPAs to establish material participation in the SPAs, he will want his own participation to exceed 100-hours, but he will need to be certain that he is participating less than some other person in the activity. Otherwise, he will be materially participating under the 100-hour test described in ¶2980.04.C.2, supra, and the activity will not be a SPA. In addition, once a taxpayer has one SPA, he may want to cross the 100-hour line (but not the 500-hour line) in other activities. In this way the taxpayer can materially participate in SPAs in the aggregate and avoid adverse treatment under the SIPPA rule. [169]

[169] The material participation rule which allows a taxpayer to aggregate hours in SPAs is arguably inconsistent with the definition of material participation in the statute. Section 469(h)(1) requires that the taxpayer's involvement in the operations of each activity be regular, continuous and substantial. This standard may be difficult to meet for each SPA.

Example (51)—*Increasing Participation to Avoid SIPPA Recharacterization*

Assume in the preceding example that B also owned an interest in a local ski resort where he worked 90 hours. The resort activity is not a SPA because B worked less than 100 hours. However, if B increased his participation at the resort to 126 hours, the resort would be a

SPA and his participation in all SPA's would aggregate 501 hours, thus avoiding adverse treatment under the SIPPA rules.

5. Five Out Of Ten Year Test

a. In General

This test uses material participation in prior years to determine whether an individual materially participates in the current year. Specifically, if the taxpayer materially participated in an activity (without regard to this provision) for any five of the preceding 10 taxable years, he is treated as materially participating during the current taxable year.[170] The five prior years do not have to be consecutive.

[170] Regs. §1.469-5T(a)(5).

Example (52)—*Five Out of Ten Year Test*

A spends more than 500 hours on an activity in the years 1990 through 1994 but then retires and spends no more time on the activity thereafter. A is treated as materially participating in the activity during the years 1995 through 2000 because A materially participated in the activity for five of the preceding 10 taxable years. A no longer materially participates in the activity beginning in the year 2001.[171]

Under this test, an individual is not treated as materially participating for any taxable year in which he did not own an interest in the activity.

[171] Regs. §1.469-5(k), Ex. (5).

Example (53)—*Ownership Requirement*

Assume A is a full-time employee of an S corporation in the years 1989 through 1993, but does not own any stock in the corporation during those years. If A acquires stock of the S corporation in 1993 he would not be treated as materially participating in the activity until that year. When A retires in 1994, he would have materially participated in the activity only during one prior year (1993) in which he owned an interest. Thus, the five out of 10 year test is not satisfied in 1994 or any years thereafter.[172]

[172] Regs. §1.469-5T(k), Ex. (6).

The five out of 10 year test restricts a taxpayer's ability to change his status from year to year and thus treat an activity as nonpassive when it generates losses and passive when it generates taxable income.[173]

[173] This test may not be supported by the legislative history which states that material participation is determined separately for each taxable year. S. Rep. 99-313 at 731.

Example (54)—*Consistency Requirement*

A is a general partner and materially participates in the partnership's business for the first six years of the partnership. A has used the losses from the partnership to offset other income during those years. In year seven when the partnership's business becomes profitable, A becomes a limited partner and no longer materially participates under the other tests. Nonetheless, A's share of income in year seven is active business income because of the five out of 10 year test.

b. Changes in Activity

As discussed in ¶2980.03, above, the business and rental operations that make up an activity may change from year to year. For purposes of the five out of ten year test, a taxpayer is treated as materially participating in an activity for a prior taxable year if the activity includes an undertaking that involves substantially the same business and rental operations as an undertaking included in an activity in which the taxpayer materially participated during the prior taxable year.[174]

[174] Regs. §1.469-5(j)(1).

c. Pre-1987 Years

The five out of ten year test includes taxable years that began before 1987, the general effective date of the passive loss rules.[175] However, an individual is treated as having materially participated in a taxable year before 1987 only if he participated for more than 500 hours (test one) in that year.[176] Thus, if an individual worked more than 500 hours in an activity for each year from 1982 through 1986, the individual is treated as a material participant for the years 1987 through 1991 regardless of any actual participation in those years.

[175] Regs. §1.469-11(c)(3). The effective date rules are discussed in ¶2980.12, below.

[176] Regs. §1.469-5(j)(2).

6. Three Year Test for a Personal Service Activity

An individual is treated as materially participating in a personal service activity during the current taxable year if the individual materially participated in the activity for any three prior taxable years.[177] A personal service activity is an activity that involves (1) the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, or (2) any other trade or business in which capital is not a material income-producing factor.[178] The regulations do not define an activity in which capital is not a material income-producing factor.[179]

[177] Regs. §1.469-5T(a)(6). The rule described in ¶2980.04.C.5.b, for activities which change from year to year is also applicable for purposes of the three year test.

[178] Regs. §1.469-5T(d).

[179] Although there is no definition in the regulations, other sections of the Code use this term. See §911(d)(2)(B) and regulations and cases under prior §1348 (repealed in 1981), which provided for a maximum tax on earned income. *See, e.g.*, *Mordkin v. Comr.*, T.C. Memo 1996-187 (Rental of condominium hotel is not personal service activity).

Example (55)—*Personal Service Activity Test*

A is a partner in an accounting practice and materially participates in 1980, 1981 and 1983. A is treated as materially participating in the practice in all subsequent taxable years in which A remains a partner. It does not matter how long ago the three years were or whether they were consecutive.

For purposes of this test, the 500-hour test is the only test used to determine whether an individual materially participated in an activity for a taxable year beginning before January 1, 1987.[180]

[180] Regs. §1.469-5(j).

7. Facts and Circumstances Test

a. In General

The six tests discussed above are strictly quantitative. The final test is, however, a subjective one which allows an individual to establish material participation by showing that, based on all the facts and circumstances, the individual's participation in the activity was regular, continuous and substantial.[181] The facts and circumstances test can be used by either the taxpayer or the IRS to prove that a taxpayer materially participates.

[181] Regs. §1.469-5T(a)(7). *E.g.*, *Scheiner v. Comr.*, T.C. Memo 1996-554 (Taxpayer's activities as condominium association board member could not be considered for purposes of Regs. §1.469-5T(a)(7), because, under Regs. §1.469-5T(b)(2)(ii)(A), other individuals provided management services for which they were compensated).

b. Exclusions

The regulations do not elaborate on what is meant by regular, continuous and substantial involvement in the operations of an activity.[182] The regulations do provide, however, that certain situations will not be treated as sufficient participation to satisfy the facts and circumstances test.[183] The fact that an individual satisfies a participation standard under any other statutory provision is generally not taken into account in determining whether the individual materially participates in an activity for purposes of these rules.[184] For example, under the estate tax, material participation is relevant to the application of a special valuation rule for certain farm property.[185] The material participation test is also used for purposes of the tax on earnings from self-employment.[186] Qualification (or failure to qualify) under those tests is not relevant for purposes of the passive loss rules.[187]

[182] Regs. §1.469-5T(b)(1) has been reserved.

[183] Regs. §1.469-5T(b)(2).

[184] Regs. §1.469-5T(b)(2)(i).

[185] *See* §2032A, discussed in ¶6290. However, under §469(h)(3) certain retired individuals and surviving spouses may use the §2032A material participation standard for §469 purposes in connection with their farming activities. The §2032A standard is generally easier for taxpayers to meet than the §469 standard.

[186] §1402(a)(1).

[187] Under Regs. §1.469-5T(b)(2)(i), the only exception to this rule is in the case of certain retired individuals and surviving spouses in relation to farming activities. *See* §469(h)(3).

In addition, a taxpayer's management services in an activity are not taken into account in determining material participation under the facts and circumstances test unless (1) no other person who performs services in connection with the management of the activity receives earned income for such services and (2) no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by the taxpayer.[188] There is no definition of what constitutes management activities for these purposes, but work as an investor will presumably not qualify.[189]

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188 Regs. §1.469-5T(b)(2)(ii). *See Mordkin v. Comr.*, T.C. Memo 1996-187 (Employees' work hours exceed taxpayer's; taxpayer's activities are not material participation); *Pohaski v. Comr.*, T.C. Memo 1998-17 (In determining participation by others, only time spent by condominium's front desk personnel in actually providing services directly related to taxpayer's rental activities should be counted; IRS misinterpreted holdings in *Goshorn v. Comr.*, T.C. Memo 1993-578, and *Serenbetz v. Comr.*, T.C. Memo 1996-510, when it argued that all time that front desk personnel were available should be counted).

189 *See* Regs. §1.469-5T(f)(2)(ii), discussed in ¶2980.04.B.2, above, which provides that work as an investor is not participation.

Example (56)—*Management Services*

F owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter describing proposed decisions on the cattle-feeding operations. The decisions include what kind of feed to purchase, how much to purchase, when to purchase it and when to sell cattle. The letters explain the proposed decisions, emphasize that each decision is solely within the discretion of F and his partners, and ask F to indicate a decision on each proposed action. F's only participation in the cattle-feeding operation is to make these decisions. The general partner receives a fee that is earned income for managing the cattle-feeding operation.

F's management services are not taken into account in determining whether F materially participates in the activity because another person performs services in connection with the management of the activity and receives earned income for such services. Therefore, F is not materially participating in the cattle-feeding operation. [190]

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190 This example is based on Regs. §1.469-5T(k), Example (8).

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c. Minimum Hours

The regulations do establish a minimum number of hours for participation in an activity under the facts and circumstances test. If an individual participates in an activity for 100 hours or less during the taxable year, he cannot be treated as materially participating in the activity for the taxable year under the facts and circumstances test. [191] Thus, an individual who works 100 hours or less in an activity during the taxable year can materially participate in the activity only if (1) the individual satisfies the "substantially all" test or (2) the individual has previously materially participated in the activity.

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191 Regs. §1.469-5T(b)(2)(iii).

Example (57)—*Facts and Circumstances Test*

A participates in an activity for 90 hours during 1990 and B participates for 50 hours. A has not previously materially participated in the activity. A cannot satisfy the facts and circumstances because A worked less than 100 hours and most likely cannot satisfy the "substantially all" test because of B's participation.

¶2980.04.D. Material Participation by Partners

1. General Partners

The passive loss rules apply at the individual partner rather than at the partnership level. Thus, whether or not an individual general partner is materially participating in a partnership activity is determined by the general partner's participation in the activity. The individual's participation is tested separately for each activity of the partnership.

In determining a partner's material participation in a partnership activity, the tests are applied to the partnership's tax year that ends with or within the partner's taxable year. [192]

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192 Regs. §1.469-2T(e)(1). This rule also applies to S corporation shareholders.

Example (58)—*General Partner Participation*

A, a calendar year taxpayer, is a general partner in Partnership X, which has a taxable year ending June 30. During Partnership X's taxable year from July 1, 1989 to June 30, 1990, A materially participates in Partnership X's sole activity. A's share of Partnership X's income and deductions are not treated as passive on A's 1990 return regardless of A's participation in the activity from July 1, 1990 through Dec. 31, 1990. [193]

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193 Id.

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2. Limited Partners

a. General Rule

Limited partners do not materially participate in activities conducted by the partnership except to the extent provided in regulations (discussed below). [194] Thus, a limited partner's share of the partnership's income, gain, loss, deduction or credit from a partnership activity and any gain or loss recognized on sale or exchange of a limited partnership interest will be passive regardless of the material participation tests. [195]

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194 §469(h)(2). Before the regulations were issued, however, the IRS held that a limited partner who works for the partnership on a full-time basis, controls the business and exercises authority on all decisions affecting the day-to-day operations of the partnership is not subject to the passive loss rules with respect to partnership income and loss. See PLR 8810079.

195 Regs. §1.469-5T(e)(1).

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b. Definition of Limited Partner

A partner is a limited partner if (1) the partner's interest is designated as such in the limited partnership agreement or the certificate of limited partnership (even if the partner's liability for partnership obligations is not in fact limited under applicable state law), or (2) the partner's liability for the partnership obligations is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount. [196]

[196] Regs. §1.469-5T(e)(3)(i).

Example (59)—*Definition of a Limited Partner*

A holds an interest in Partnership X. A's liability for Partnership X's debts is limited to A's capital contributions and contractual obligations to make additional capital contributions to Partnership X. A owns a limited partnership interest in Partnership X. [197]

[197] Id.

An individual is not treated as a limited partner for purposes of the passive loss rules if the individual is also a general partner in the partnership at all times during the partnership's taxable year. [198] Whether an individual materially participates in a partnership activity will be determined under the seven tests for material participation in this case.

[198] Regs. §1.469-5T(e)(3)(ii).

c. Exceptions

There are three exceptions to the general rule that a limited partner is treated as not materially participating in the partnership's activities. A limited partner will be treated as materially participating if he satisfies one of the following material participation tests:

- he participates in the activity for more than 500 hours during the taxable year;
- he has materially participated in the activity for any five taxable years during the immediately preceding 10 years; or
- he has materially participated in a personal service activity for any three prior taxable years. [199]

[199] Regs. §1.469-5T(e)(2).

The other tests for material participation do not apply to limited partners. Therefore, it is more difficult for a limited partner to meet the material participation standard than it is for a general partner. Moreover, although both limited partners and S corporation shareholders are protected from the activity's liabilities, the S corporation shareholder may rely on any of the seven tests for material participation while a limited partner is restricted to the three tests listed above. This distinction may be based on the fact that an S shareholder's interest in and control over the activity is not qualitatively less than that of any other owner, while a limited partner's interest inherently suggests a much less active role than that of a general partner. [200]

[200] If this is the relevant distinction, however, then the definition of a limited partner in the regulations should be less concerned with potential exposure to liabilities and more concerned with limitations on control.

Example (60)—*Limited Partner/S Corporation Shareholder Distinction*

Individual A is a limited partner in Partnership X and works 15 hours per week for 52 weeks per year in Partnership X's business. A is treated as materially participating. If A worked 200 hours in the activity during the taxable year and no one else participated, A would not be treated as materially participating because the 100-hour and substantially all tests do not apply to a limited partner. However, if A were a general partner or a shareholder of an S corporation, A would be treated as materially participating.

¶2980.04.E. Material Participation by Legal Entities

1. In General

The passive loss rules apply to two types of C corporations: CHCs and PSCs. The material participation tests are applied differently to C corporations than to other taxpayers. A PSC is treated as materially participating in an activity based on the participation of the corporation's shareholders. The material participation test for a CHC also looks to shareholder participation but participation by employees who are not shareholders is also taken into account in certain circumstances.

2. Closely Held Corporations

a. Shareholder Test

A CHC can satisfy the material participation requirement in two ways. If one or more shareholders who together own more than 50% (by value) of the CHC stock each materially participate, then the CHC materially participates in the activity. [201] The seven material participation tests discussed above are applied in determining whether an individual is treated as materially participating in an activity of the corporation. [202] For this purpose, all of the corporation's activities are treated as activities in which the individual holds an interest. In addition, the individual's participation in all activities other than the corporation's activities is disregarded. [203] Under this rule, a shareholder's SPAs outside the CHC cannot be aggregated with the CHC's SPAs to produce material participation by the CHC.

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201 §469(h)(4)(A); Regs. §1.469-1T(g)(3)(i).

202 See ¶2980.04, above.

203 Regs. §1.469-1T(g)(3)(iii)(B).

Example (61)—*CHC Material Participation Test*

A CHC has three individual shareholders, A, B and C. A and B each own 40% of the CHC's stock and C owns 20%. A and B each participate in the CHC's only business for more than 500 hours in 1989 and C does not participate. The CHC is treated as materially participating in the business in 1989.

It is not clear whether in the above example the CHC would be treated as materially participating under the 100-hour test if A worked 200 hours and B worked 150 hours. Presumably, B would not satisfy the 100-hour test because A worked more hours than B.

b. Employee Test

A CHC is also treated as materially participating in an activity if, for the prior twelve-month period, (1) the CHC has at least one full-time employee who actively manages its business, (2) the CHC has at least three full-time non-shareholder employees who spend substantially all their time working in the business and (3) the deductions for ordinary business expenses attributable to the business exceed 15% of the gross income from the business.[204] This test will permit a true business activity to satisfy the material participation test even if shareholders are not involved in operations.

[204] §469(h)(4)(B). Regs. §1.469-1T(g)(3)(i)(B); §465(c)(7)(C). Both §162 ordinary and necessary business expenses and §404 expenses for contributions to deferred compensation plans may be counted under the 15% test.

Example (62)—*CHC Employee Test*

A and B each own 40% of a CHC's stock and C owns 20%. A and B are not active in the business. However, C is employed full-time by the CHC to manage its only business, selling computers. The CHC also employs three full-time salesmen and other clerical staff. For 1989, the CHC has $1,500,000 of gross income and $1,200,000 (80%) of ordinary business expenses. Thus, the CHC is materially participating in the computer business even though A and B are not active.

3. Personal Service Corporations

A PSC can satisfy the material participation test only if one or more shareholders who together own more than 50% (by value) of the outstanding stock of the PSC each materially participate in the activity.[205] In determining a shareholder's material participation, the shareholder's participation in all activities other than activities of the PSC is disregarded.[206] There is no rule for PSCs equivalent to the CHC employee participation test described above.

[205] Regs. §1.469-1T(g)(3)(i)(A).

[206] Regs. §1.469-1T(g)(3)(iii)(B).

Example (63)—*Personal Service Corporation (1)*

A PSC has two equal individual shareholders, A and B, who are both doctors. A and B spend more than 500 hours in 1990 participating in the PSC's business of providing medical services. The PSC is treated as materially participating in 1990.

There may be situations, however, where it is impossible for a PSC to satisfy the material participation test. This could occur, for example, if the corporation has inactive owners who do not provide services for the corporation. It is therefore important for all corporations involved in providing personal services to avoid classification as a PSC or else make sure that the shareholders adequately participate.

Example (64)—*Personal Service Corporation (2)*

A corporation is engaged in the business of providing medical services. The employees of the corporation own 45% of the PSC's stock. Although the corporation meets the definition of a PSC, it is impossible for the corporation to have more than 50% of the shareholders materially participating in the business. Thus, the PSC can never satisfy the material participation test.

4. Estates and Trusts

An estate or trust that is a separate taxpayer apparently will be treated as materially participating in an activity only if the executor or the trustee is materially participating.[207] The participation of a beneficiary does not appear to be relevant. The regulations do not define material participation for estates and trusts.[208]

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207 S. Rep. No. 313 at 735.

208 Regs. §1.469-5T(g) is reserved for the definition of material participation of trusts and estates.

A trust which materially participates in a trade or business may well be characterized for tax purposes as an association taxable as a corporation.[209]

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209 See discussion of the taxation of trusts and estates at ¶6120.

¶2980.04.F. Short Taxable Year

The regulations do not provide a special rule for determining whether a taxpayer materially participates in an activity in which the taxpayer owns an interest for less than the entire taxable year. There is no rule to prorate the quantitative tests based on hours to reflect the portion of the taxable year that the taxpayer owned an interest in the activity. Thus, a taxpayer will generally have to satisfy the facts and circumstances test, or perhaps the substantially all test.[210]

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210 A taxpayer who sells an interest in an activity in mid-year could also rely on the five out of ten year test or the three year test for PSCs in appropriate circumstances.

Example (65)—*Short Taxable Year Test*

A, a calendar year taxpayer, purchases an interest in a business on July 1, 1989. During the period from July 1, 1989 to Dec. 31, 1989, A works 300 hours in the business. Assume B works 600 hours in the business during the same 6-month period. If the 500-hour test is not prorated to 250-hours, A can only satisfy the material participation standard for 1989 if he establishes that, based on all the facts and circumstances, his participation in the business is regular, continuous and substantial.

¶2980.05
Rental Activities

¶2980.05.A. In General

The passive loss rules treat most rental activities as a passive activity. Rental activities were typically treated as passive because they were often used as tax shelters to produce losses and the amount of work needed to conduct rental activities is often very low compared with other business activities.[211]

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211 S. Rep. No. 313 at 718.

A rental activity is any activity where payments are principally for the use of tangible property.[212] The regulations add to this definition and provide that an activity is a rental activity for a taxable year if (1) during the taxable year tangible property held in connection with the activity is used by, or held for use by, customers, and (2) the gross income from the activity represents amounts paid, or to be paid, principally for the use of such property.[213] This definition applies without regard to whether the use of the property by customers is pursuant to a lease, service contract or other arrangement which is not called a lease.[214]

[212] §469(j)(8).

[213] Regs. §1.469-1T(e)(3)(i).

[214] Id.

¶2980.05.B. Exceptions

There are several exceptions to the definition of a passive rental activity. Thus, if an activity which involves the use of tangible property satisfies one of the exceptions discussed below, the activity is not a passive rental activity.

1. Seven-Day Exception

Short-term rental activities generally receive a high level of owner or employee participation and were not generally used to create tax losses for investors. Thus, an activity is not a rental activity if the average period of customer use of the property is seven days or less.[215]

[215] Regs. §1.469-1T(e)(3)(ii)(A). Note, however, that characterization as a non-rental activity under the seven-day exception will not be to the taxpayer's advantage if the taxpayer intends to take advantage of the rule allowing taxpayers to offset nonpassive income with up to $25,000 of losses from rental real estate. For example, in TAM 9505002, the National Office advised that a married couple renting their timeshare condominium for periods averaging seven days or less were involved in a trade or business activity rather than a rental activity, thus making the couple ineligible for the $25,000 offset.

Example (66)—*Seven-Day Exception*

A owns a store which rents video cassettes. A's activity does not constitute a rental activity because the average period of customer use is two days.

The activity's average period of customer use is computed on a weighted basis to take account of the relative amount of income attributable to different types of property. First, the activity's property is separated into classes; types of property with significantly different daily rentals cannot be grouped in one class. The average period of customer use for each class of property is then determined by dividing (1) the aggregate number of days in all periods of customer use for that class ending during the taxable year or including the last day of the year by (2) the number of such periods of customer use.[216] The average use period for each class is then multiplied by a weighting factor to produce the "average use factor." The weighting factor for a class is the gross rental income from that class divided by the activity's total gross rental income. The activity average period of customer use is the sum of the average factors computed for all of its classes of property.

[216] Regs. §1.469-1(e)(3)(iii).

Example (67)—*Average Period of Customer Use (1)*

B owns a ski rental business and rents both recreational and high performance skis. High performance skis rent for $20 per day and recreational skis rent for $10 per day. This is a significant difference and the skis are therefore separated into two classes of property. The high performance class has an average period of use of 4 days and generates 25% of B's ski rental income. Recreational skis have an average use period of 8 days and generate 75% of B's income. The activity's average period of use is thus 7 days (25% of 4 days plus 75% of 8 days) and it is not a rental activity.

For this purpose, each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity is treated as a separate period of customer use. This is determined without regard to whether the customer uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewals thereof.[217]

[217] Regs. §1.469-1(e)(3)(iii)(D).

Example (68)—*Average Period of Customer Use (2)*

C owns an apartment hotel located in a resort area and rents apartments for reduced rates on a "two-and-two" plan beginning Jan. 1 of each year. Each customer on the plan rents an apartment for two weeks in the spring/summer and two weeks in the fall/winter. Because the customer has a recurring right to use the apartment, each customer on the two-and-two plan has one 28-day period of use, not two 14-day periods.

The duration of a period of use which includes the last day of a taxable year is determined based on reasonable estimates.[218]

[218] Id.

2. 30-Day Exception

An activity is not a rental activity if the activity's average period of customer use of the property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers.[219]

[219] Regs. §1.469-1T(e)(3)(ii)(B).

Example (69)—*30-Day Exception*

A is engaged in the business of leasing one class of equipment. The average period of customer use for the equipment is 23 days. Under the lease agreements, technicians employed by A maintain the equipment and service malfunctioning equipment for no additional charge. Service calls average three times a week and require substantial labor. The value of the maintenance and repair services (measured by the cost to A of employees performing these services) exceeds 50% of the amount charged for the use of the equipment. On these facts, significant personal services are provided in connection with making the equipment available for use by customers and the activity is not a rental activity.[220]

[220] This example is based on Regs. §1.469-1T(e)(3)(viii), Exs. (1) and (2).

Generally, personal services only include services performed by individuals.[221] In determining whether the personal services provided are significant, all of the relevant facts and circumstances are taken into account.[222] Relevant facts include the frequency of services, the type and amount of labor, and the value of the services in comparison to the amount charged for the use of the property.[223]

[221] Regs. §1.469-1T(e)(3)(iv)(A).

[222] Id.

[223] Id.

Significant personal services do not include the following:

- services necessary to permit the lawful use of property;
- services performed in connection with construction of improvements to the property or in connection with repairs that extend the property's useful life substantially beyond the average period of customer use; and
- services provided in connection with the use of improved real property that are similar to those commonly provided in connection with the long-term rental of high-grade commercial and residential real property (e.g., cleaning and maintenance of common areas, repairs, trash collection, elevator service and security).[224]

[224] Regs. §1.469-1T(e)(3)(iv)(B).

An example in the regulations suggests that services are not significant personal services if the value of the services is less than 10% of the total amount charged.

Example (70)—*Significant Personal Services*

The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exits, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10% of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services nor extraordinary personal services [discussed below] are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.[225]

[225] Regs. §1.469-1T(e)(3)(viii), Ex. (4).

Another example in the regulations indicates that a 50% ratio does demonstrate significant personal services.[226]

[226] Regs. §1.469-1T(e)(3)(viii), Ex. (2).

3. Providing Extraordinary Personal Services

An activity is not a rental activity if "extraordinary personal services" are provided by or on behalf of the owner of the property in connection with making the property available to customers.[227] Under this exception, the average period of customer use is irrelevant.

[227] Regs. §1.469-1T(e)(3)(ii)(C).

Services are extraordinary personal services only if (1) they are performed by individuals and (2) use by customers of the property is incidental to their receipt of the services.[228] This standard requires an analysis of the relative importance to the typical user of the property and the service. Apparently, a service is extraordinary if the typical user is purchasing the service and the property is merely a means by which the service is rendered. For example, the use by patients of a hospital's boarding facilities is generally incidental to their receipt of the personal services provided by the hospital's medical and nursing staff.[229]

[228] Regs. §1.469-1T(e)(3)(v).

[229] *Id.* The regulations also state that the dormitory facilities of a boarding school are incidental to the personal services provided by the teaching staff. *See also* Regs. §1.469-1T(e)(3)(viii), Ex. (1), which describes an equipment leasing business in which services are significant but not extraordinary because the lessee wants the use of the equipment and the personal services are necessary only to make the equipment function. In other cases, the equipment can be much less important than the service. *See, e.g.*, TAM 199949036 (Taxpayer's losses from its air transportation business are not losses from a rental activity because the personal services provided (flight crew and maintenance of the jet) are extraordinary personal services). *But see Frank v. Comr.*, T.C. Memo 1996-177 (Taxpayer's losses from its airplane leasing activity are passive losses because maintenance services rendered to the lessee were not the dominant element of the relationship between the taxpayer and its lessee.)

Example (71)—*Extraordinary Personal Services*

B provides tractor-trailers to transport goods for customers under an arrangement in which the tractor-trailers are selected by B and are operated and maintained by drivers and mechanics employed by B. The average period of customer use of the tractor-trailer exceeds 30 days. Under these facts, the use of tractor-trailer by B's customers is incidental to their receipt of personal services provided by B. Accordingly, the services performed in the activity are extraordinary personal services and the activity is not a rental activity.[230]

[230] This example is based on Regs. §1.469-1T(e)(3)(viii), Ex. (3).

4. Rental Incidental to Nonrental Activity

An activity is not a rental activity if the rental is incidental to a nonrental activity.[231] This exception applies only in the following situations.

[231] Regs. §1.469-1T(e)(3)(ii)(D).

a. Rental Incidental to Investment

A rental activity is incidental to a nonrental activity if the taxpayer's principal purpose for holding the property during the taxable year is to realize gain from property's appreciation and the gross rental income from the property for the taxable year is less than 2% of the lesser of the property's unadjusted basis or its fair market value.[232]

[232] Regs. §1.469-1T(e)(3)(vi)(B). "Unadjusted basis" means adjusted basis determined without regard to any adjustments described in §1016 that decreases basis. Regs. §1.469-1(e)(3)(vi)(E).

Example (72)—*Rental Incidental to Investment*

F owns 1,000 acres of unimproved land with a value of $350,000 and a basis of $210,000. F is holding the land principally to realize gain from appreciation. To defray the cost of carrying the land, F leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. The annual gross rental income from the land is less than 2% of the lesser of the fair market value and the unadjusted basis of the land (.02 x $210,000 = $4,200). Accordingly, the rental of the land is not a rental activity because the rental is treated as incidental to an activity of holding the property for investment.[233]

[233] This example is based on Regs. §1.469-1T(e)(3)(viii), Ex. (5).

b. Rental of Business Property

A rental activity is incidental to a nonrental activity if the property is rented to a business in which the taxpayer owns an interest, it meets the above-described 2% test and the property was used predominantly in the business activity during the taxable year (or during two of the five immediately preceding taxable years).[234]

[234] Regs. §1.469-1T(e)(3)(vi)(C).

Example (73)—*Rental of Business Property*

G owns a farming business and owns farmland which was used in the business in 1985 and 1986. The value of the farmland is $350,000 and its basis is $210,000. In 1987, 1988, and 1989, G continues the farming business but does not use the land.

In 1987 and 1988, G leases the land for $4,000 to a rancher who uses the land to graze cattle. For 1987 and 1988, G owns an interest in a business, and the farmland which G leases to the rancher was used in that business for two out of five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than 2% of the lesser of the value or unadjusted basis of the land (.02 x $210,000 = $4,200). Accordingly, G's rental of the land is treated as incidental to G's farming activity and is not a rental activity.

In 1989, G leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. Because G's gross rental income from the land for 1989 ($10,000) is not less than 2% of the lesser of the value or the basis of the land, G's rental of the land in 1989 is not treated as incidental to G's farming activity and is a rental activity.

c. Employer's Convenience

Finally, a rental activity is incidental to a nonrental activity if property is rented to an employee for the employer's convenience.[235]

[235] Regs. §1.469-1(e)(3)(vi)(D). The rules of §119, governing meals and lodging furnished to

employees for the employer's convenience, are applied for this purpose. See discussion of §119 in ¶1130.

5. Non-Exclusive Use

An activity is not a rental activity if the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers.[236]

[236] Regs. §1.469-1T(e)(3)(ii)(E).

Example (74)—*Non-Exclusive Use Test*

A owns and operates a golf course. Some customers of the golf course pay greens fees for each use of the course, while other customers purchase weekly, monthly or annual passes. The golf course is open to all customers every day of the year except for certain holidays and rainy days. A's operation of the golf course is not a rental activity.[237]

[237] This example is based on Regs. §1.469-1T(e)(3)(viii), Ex. (10).

6. Property Rented to a Pass-Through Entity

An activity is not a rental activity if the taxpayer provides property to a partnership or S corporation in which he owns an interest.[238] In order for this exception to apply, the entity must be using the property in a nonrental activity and the taxpayer must be making the property available in his capacity as an owner of an interest in the entity.[239] The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of such interest in a partnership or S corporation is based on all the facts and circumstances.[240]

[238] Regs. §1.469-1T(e)(3)(ii)(F).
[239] Regs. §1.469-1T(e)(3)(vii).
[240] Id.

Example (75)—*Property Rented to Pass-Through Entity*

A makes farmland available to a tenant farmer under a share-crop lease. The tenant is required to use his best efforts to farm the land and produce crops. A agrees to bear 50% of the costs incurred in the farming activity in return for 50% of the crops produced or 50% of the proceeds from marketing the crops. A is treated as having furnished the farmland for use in a farming activity conducted by a joint venture between himself and the tenant. A is therefore not engaged in a rental activity.[241]

[241] This example is based on Regs. §1.469-1T(e)(3)(viii), Ex. (8).

If a partner contributes the use of property to a partnership and does not charge rent, none of the partner's distributive share of partnership income is treated as income from a rental activity unless the partnership is engaged in a rental activity.[242]

[242] Regs. §1.469-1T(e)(3)(vii).

7. Rental of a Residence

An activity involving the rental of a taxpayer's residence is not a rental activity for a taxable year and is per se not a passive activity if the limitations on rental of a residence apply to the taxpayer for that year.[243]

[243] Regs. §1.469-1(e)(5). The rental of a taxpayer's residence is governed by §280A which is discussed at ¶2460.

8. Rental Real Estate Activities of Real Estate Professionals

Effective for taxable years beginning after December 31, 1993, the term "passive activity" does not include a taxpayer's rental real estate activities[244] in which he materially participates[245] to the extent that the taxpayer meets certain eligibility requirements relating to real property trades or businesses.[246]

[244] "Rental real estate" is defined as any real property used by customers or held for use by customers in a rental activity within the meaning of Regs. §1.469-1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under Regs. §1.469-4(d)(1)(i)(A) or (c) is not an interest in rental real estate for purposes of §469(c)(7). Regs. §1.469-9(b)(3), T.D. 8645, 60 Fed. Reg. 66496 (12/22/95). Regs. §1.469-9 applies for taxable years beginning on or after Jan. 1, 1995, and to elections made under Regs. §1.469-9(g) with returns filed on or after Jan. 1, 1995. The regulations also provide transition rules for taxpayers that grouped their activities under earlier rules. Regs. §1.469-11(a)(3)

[245] A taxpayer materially participates in an activity if he meets any one of seven tests set out in Regs. §1.469-5T. Six of the seven tests are primarily quantitative tests which focus on factors such as the number of hours that a taxpayer participates in a particular activity in which he owns an interest. The seventh test examines all of the facts and circumstances to determine whether the taxpayer participates in the activity on a regular, continuous and substantial basis during the year. See ¶2980.04.C., above.

[246] *See* §469(c)(7), added by 1993 RRA §13143.

A taxpayer meets the eligibility requirements if:

- more than half of the personal services performed by the taxpayer in trades or businesses during such taxable year are performed in "real property trades or businesses" (*i.e.*, real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses) in which the taxpayer materially participates;[247] and
- the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which he materially participates.[248]

[247] *See* §469(c)(7)(B)(i) and §469(c)(7)(C) (defining real property trade or business). Under Regs. §1.469-9(b)(1), a trade or business is any trade or business determined by treating the types of activities in Regs. §1.469-4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under §212.

[248] *See* §469(c)(7)(B)(ii).

Example—*Rental Real Estate Professional*

A owns three 75-unit rental apartment buildings. On a regular and continuous basis, A supervises building maintenance, handles advertising, shows vacant apartments, handles all leasing-related activities, collects rents, and performs various other administrative functions. A spends at least 1500 hours per year with respect to the three buildings. A's rental activities would not be considered a passive activity.

A closely held C corporation meets the above eligibility requirements if more than 50% of its gross receipts for the taxable year are derived from real property trades or businesses in which the corporation materially participates. In making this determination, the C corporation's gross receipts do not include items of portfolio income.[249]

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[249] Regs. §1.469-9(c)(2). Portfolio income is defined in Regs. §1.469-2T(c)(3).

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a. Qualifying Taxpayers

To qualify for the rental real estate exception, an eligible taxpayer must own at least one interest in rental real estate.[250] In determining whether a taxpayer qualifies for the exception, the following rules are applied:

- Personal services performed by the taxpayer as an employee are not treated as performed in a real property trade or business unless the taxpayer has more than a 5% ownership interest in the employer.[251] Personal services are defined as any work performed by an individual in connection with a trade or business, but do not include work performed by an individual in the capacity as an investor.[252]

- In the case of a joint return, each spouse's personal services are taken into account separately. However, in determining material participation, the participation of the spouse is taken into account.[253] Thus, for example, a husband and wife filing a joint return satisfy the eligibility requirements during the taxable year if one spouse performs at least half of his or her services in a real property trade or business in which either spouse materially participates.[254]

- The determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services.[255] Once a taxpayer determines the real property trades or businesses in which personal services are provided, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.[256]

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[250] Regs. §1.469-9(b)(6).

[251] *See* §469(c)(7)(D)(ii).

[252] Regs. §1.469-9(b)(4).

[253] *See* §469(c)(7)(B) (flush language). Regs. §1.469-9(c)(4).

[254] *See* Conference Report, H.R. Rep. No. 213, 103d Cong. 1st Sess. 545-47 (1993).

[255] Regs. §1.469-9(d)(1). Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in §469(c)(7). *Id.*

[256] Regs. §1.469-9(d)(2).

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b. Election to Treat All Interests in Rental Real Estate as a Single Rental Real Estate Activity

Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity.[257] If a qualifying taxpayer makes the election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity, the election is binding for the taxable year in which it is made and for all future years in which the taxpayer is also a qualifying taxpayer. However, if there is a material change in a taxpayer's facts and circumstances, the taxpayer may revoke the election.[258]

[257] Regs. §1.469-9(e)(1). PLR 9551030 (Corporation permitted to elect under §469(c)(7)(A) to treat all its interests in rental real estate as one activity).

[258] Regs. §1.469-9(g)(1). The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances. Regs. §1.469-9(g)(2).

For a qualifying taxpayer to make or revoke the election to treat all interests in rental real estate as a single rental real estate activity, the taxpayer must file a statement with the taxpayer's original income tax return for the taxable year.[259] The taxpayer may make this election for any taxable year in which the rental real estate exception is applicable.[259.1] To revoke the election, the taxpayer must file a statement with the original income tax return for that year.[260]

[259] Regs. §1.469-9(g)(3). This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to §469(c)(7)(A). *Id.* For examples of taxpayers that failed to properly elect to aggregate their rental real estate activities, *see Kosonen v. Comr.*, T.C. Memo 2000-107 (Qualifying taxpayer that aggregated his rental losses and reported them as active losses, but did not attach the required statement to his return, did not make §469(c)(7) election), and FSA 199907011 (Taxpayer that did not substantially comply with the provisions of Regs. §1.469-9(g), and failed to pursue administrative relief under Regs. §301.9100-3, is not entitled to a judicial extension of time to file the election).

[259.1] Regs. §1.469-9(g)(3).

[260] The statement must contain a declaration that the taxpayer is revoking the election under §469(c)(7)(A) and an explanation of the nature of the material change in the taxpayer's facts and circumstances. Regs. §1.469-9(g)(3).

c. Treatment of Rental Real Estate Activities

Generally, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation is treated as a single interest in rental real estate if the partnership or S corporation grouped its rental real estate as one rental activity under the activity rules[261] If the partnership or S corporation groups its rental real estate into separate rental activities under the activity rules, each rental activity of the entity will be treated as a separate interest in rental real estate of a qualifying taxpayer. However, a taxpayer may elect to treat all interests in rental real estate, including the rental real estate interests held through partnerships and S corporations, as a single rental real estate activity.[262]

[261] Regs. §1.469-9(h)(1). The activity rules are contained in Regs. §1.469-4.

[262] Regs. §1.469-9(h)(1).

There is a special rule that applies to qualifying taxpayers that hold a 50% or greater interest in a partnership or S corporation. If a qualifying taxpayer holds a 50% or greater interest in the capital, income, gain, loss, deduction or credit of such an entity at any time during the taxable year, each interest in rental real estate held by the partnership or S corporation will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the entity's grouping of activities under the activity rules. However, the taxpayer may make the election to treat all interests in rental real estate, including those held through partnerships and S corporations, as a single rental real estate activity.[263]

[263] Regs. §1.469-9(h)(2).

A qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity.[264]

[264] Regs. §1.469-9(e)(3).

For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, the rental real estate activity will be treated as a former passive activity if disallowed deductions or credits are allocated to the activity.[265]

[265] Regs. §1.469-9(e)(2). *See also* §469(f) (treatment of former passive activities) and Regs. §1.469-1(f)(4) (carryover of disallowed deductions and credits).

d. Treatment of Limited Partnership Interests in Rental Real Estate Activities

If a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest,[266] the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Thus, the taxpayer will not be treated as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests for determining material participation of a limited partner.[267]

[266] *See* Regs. §1.469-5T(e)(3).
[267] Regs. §1.469-9(f)(1).

However, there is a de minimis exception for qualifying taxpayers who elect to treat all interests in rental real estate as a single rental real estate activity. If the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross income from all of the taxpayer's interests in rental real estate for the taxable year, the taxpayer may determine material participation under the seven tests provided in the regulations.[268]

[268] Regs. §1.469-9(f)(2). The tests for material participation are set out in Regs. §1.469-5T(a). See the discussion in ¶2980.04.C.

e. Coordination with $25,000 Offset

In general, a qualifying taxpayer's passive losses and credits from rental real estate activities (including suspended passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under the Code provisions allowing the $25,000 offset for rental real estate activities.[269]

[269] Regs. §1.469-9(j).

Example (76)—*$25,000 Offset for Rental Real Estate of Qualifying Taxpayers*

A owns building X and building Y, both interests in rental real estate. In 1996, A is a qualifying taxpayer who does not elect to treat X and Y as one activity. As a result, X and Y are treated as separate activities for purposes of determining A's material participation. A materially participates in X, which has $100,000 of passive losses disallowed from prior years and produces $20,000 of losses in 1996. A does not materially participate in Y, which produces $40,000 of income in 1996. A also has $50,000 from other nonpassive sources in 1996. A otherwise meets the requirements for the $25,000 offset.

Because building X is not a passive activity in 1996, the $20,000 of losses produced by it in 1996 are nonpassive losses that may be used by A to offset part of the $50,000 of nonpassive income. Thus, A is left with $30,000 ($50,000 minus $20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of X to offset any income from X and other sources. Therefore, A may offset the $40,000 of passive income from Y with $40,000 of passive losses from X.

Because A has $60,000 ($100,00 minus $40,000) of passive losses remaining from X, and meets all the requirements for the $25,000 offset, A may offset up to $25,000 of nonpassive income with passive losses from X. As a result, A has $5,000 ($30,000 minus $25,000) of nonpassive income remaining and disallowed passive losses from X of $35,000 ($60,000 minus $25,000) in 1996.[270]

[270] Regs. §1.469-9(j), Ex.

¶2980.05.C. Active Participation Rule for Rental Real Estate

A special rule allows certain taxpayers to offset nonpassive income with up to $25,000 of losses from rental real estate activities.[271] This rule applies only to rental real estate activities in which the taxpayer "actively participates."[272]

[271] §469(i).

[272] §469(i)(1). See, *e.g.*, *Madler v. Comr.*, T.C. Memo 1998-112 (Taxpayer's agreement with rental management firm to oversee rental of condo unit precluded his active participation).

A taxpayer can actively participate in a rental real estate activity only if he owns (including the interest of his spouse) at least 10% by value of all interests in the activity.[273] If that threshold is met, a taxpayer can satisfy the active participation standard without regular, continuous and substantial involvement in operations, so long as he participates in making management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide manner.[274]

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[273] §469(i)(6)(A).

[274] S. Rep. No. 313 at 737. If a decedent actively participated, then the active participation test is not applied to the decedent's estate for two years after death. §469(i)(4) and (6)(B).

Example (77)—*Active Participation Rule*

A owns a rental apartment building. A makes all management decisions, periodically reviews building maintenance, arranges through brokers for advertising and showing of vacant apartments, and arranges through others for leasing, rent collection and necessary repairs. A incurs a loss from the rental activity of $20,000 in 1990. Although A's rental activity is a passive activity, A can deduct the $20,000 loss under the special $25,000 rule because he actively participates in the rental activity.

To the extent the $25,000 ceiling is not reached by the taxpayer's losses, the taxpayer can use credits from rental real estate activities.[275] The credits used under this rule are limited by the same $25,000 ceiling, but to apply the ceiling the taxpayer must compute the amount of deduction which would produce a tax reduction equal to the credit. In addition, the active participation requirement does not apply to low-income housing and rehabilitation credits.[276]

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[275] §469(i)(1) and §469(j)(5).

[276] §469(i)(6)(B). These credits are allowed under §42 and §47.

Example (78)—*Credits From Active Participation Activities*

Assume that A in the prior example also had $2,000 of credits arising in connection with the rental activity. To the extent ($5,000) that A's losses did not reach the $25,000 ceiling, A could use credits to produce an equivalent tax reduction. For example, if A's marginal tax rate for $5,000 of additional deductions would be 28%, the equivalent tax reduction would be $1,400 and A may use $1,400 of his credits for 1990.

The $25,000 allowance is applied by first netting income and loss from all of the taxpayer's rental real estate activities in which he actively participates. If there is a net loss from these activities for the year, the loss is first applied against the taxpayer's net passive income, if any, with the remainder being eligible for the $25,000 allowance.[277]

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[277] See Conference Report, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-141 (1986) (hereafter referred to as "Conf. Rep. 841").

Example (79)—*Applying the $25,000 Active Income Exception*

In 1990 B has income and losses from passive activities as follows:

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Activity 1  ($25,000)
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Activity 2   $25,000
Activity 3  ($20,000)
            --------
            ($20,000)
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Assume that Activities 1 and 2 are rental real estate activities in which B actively participates. Activity 3 is a nonrental passive activity. Since the loss and income from Activities 1 and 2 are netted to zero, B is not allowed any deduction under the $25,000 special rule. B also has a $20,000 passive loss from Activity 3 which cannot be used to offset nonpassive income.

However, if B did not actively participate in Activity 2, B would be allowed to use the $25,000 loss from Activity 1 to first offset the $5,000 of net passive income (from Activities 1 and 3) and the remaining $20,000 could offset B's nonpassive income.

The benefit of using the $25,000 loss to offset nonpassive income is phased out ratably as a taxpayer's income increases. The $25,000 ceiling is reduced by 50% of the amount by which the taxpayer's adjusted gross income exceeds $100,000.[278] Thus, if the taxpayer has adjusted gross income of $150,000 or more, the $25,000 allowance is completely unavailable. For low-income housing and rehabilitation credits, the phase-out starts at $200,000 of adjusted gross income, rather than $100,000.[279] Taxpayers owning low-income housing projects placed in service after December 31, 1989, or interests in low-income housing projects through pass-thru entities that are acquired after December 31, 1989, are not subject to the phase out of the $25,000 active income exception in taxable years ending after December 31, 1989.[280]

[278] §469(i)(3)(A).

[279] §469(i)(3)(B).

[280] §469(i)(3)(C), as amended by the 1989 RRA.

In the case of married taxpayers filing joint returns, the income of both spouses is counted. In the case of married taxpayers filing separately, each spouse is allowed up to $12,500 of losses if the taxpayers lived apart at all times during the taxable year.[281] For such taxpayers, the phase-out starts at $50,000 of adjusted gross income ($100,000 for low-income housing and rehabilitation credits). If the taxpayers live together for any part of the year, neither one is entitled to any allowance under this rule.

[281] §469(i)(5).

¶2980.06 Passive Activity Loss

¶2980.06.A. In General

1. Computation of Loss

A taxpayer who owns an interest in a passive activity must compute the amount of the loss from the activity which is then subject to the passive loss limitations. For a taxpayer other than a CHC, the passive activity loss (PAL) for any taxable year is the amount by which the passive activity deductions (PADs) for the taxable year exceed the passive activity gross income (PAGI) for the taxable year.[282] A taxpayer must aggregate all PAGI and PADs from his interests in all passive activities in order to determine whether he has an overall PAL for each taxable year. A taxpayer can only determine whether he has a PAL by making annual computations for each separate activity in which he owns an interest.

[282] §469(d)(1); Regs. §1.469-2T(b)(1). CHC's are subject to a special rule. See ¶2980.09.C, below.

Example (80)—*Calculation of PAL*

A owns interests in three activities in which he does not materially participate. For 1990, the activities have gross income and deductions allocable to A as follows:

	PAGI	PADs	Net
Activity 1	$10,000	($15,000)	($5,000)
Activity 2	$15,000	($12,000)	$3,000
Activity 3	$ 5,000	($ 8,000)	($3,000)

			($5,000)

Thus, A's overall PAL for 1990 is $5,000. To the extent a taxpayer has net income from passive activities, passive activity credits (PACs) can be used to offset the tax liability attributable to the net income.[283]

[283] §469(d)(2).

2. Carryover of Loss

If a taxpayer has a PAL for a taxable year, the PADs and PACs that are not allowable because they exceed PAGI from the year are treated as deductions or credits allocable to the same passive activity in subsequent taxable years.[284] Special rules provide for the allocation of suspended losses if the make-up of the taxpayer's activities changes.[285] As discussed in ¶2980.08, below, when a taxpayer disposes of his entire interest in an activity, all suspended PALs (but not PACs) from the activity are generally allowable against all income.

[284] §469(b).

[285] Regs. §1.469-1(f)(4). Specific allocation methods are discussed in Regs. §1.469-1(f)(4), Ex. (3). Special rules also apply if the operations are conducted through a C corporation. Regs. §1.469-1(f)(4)(ii).

¶2980.06.B. Passive Activity Gross Income

1. In General

PAGI for a taxable year generally includes all items of gross income from passive activities.[286] However, as discussed below, certain items of income from passive activities are excluded from PAGI under various special rules. Therefore, a taxpayer must first determine the items of gross income from passive activities and then determine which items of gross income are excluded or recharacterized.

[286] Regs. §1.469-2T(c)(1).

2. Gain From Dispositions

a. Basic Rules

Any gain recognized by a taxpayer on the sale or other disposition of an interest in property used in a passive activity at the time of disposition, or of an interest in a passive activity held through a partnership or an S corporation, is generally treated as PAGI.[287] If the activity is not a passive activity for the taxable year of the disposition, the gain is treated as not from a passive activity.[288]

[287] Regs. §1.469-2T(c)(2)(i)(A)(2).
[288] Regs. §1.469-2T(c)(2)(i)(A)(3).

Gain on disposition of an interest in an activity is characterized as of the time of disposition and is treated as gross income from the activity for the taxable year or years in which it is recognized.[289] Thus, gain which is deferred (for example, in a like-kind exchange) retains its character as PAGI.

[289] Regs. §1.469-2T(c)(2)(i)(A)(1).

Example (81)—*Calculation of PAGI*

A owns an interest in a business in which she has never materially participated. In 1989 A sells equipment that was used exclusively in the activity. A's gain from the sale is PAGI.[290] Assume, however, that A materially participates in the activity in 1990. In 1990 A makes an installment sale of a building that was used in the activity and realizes a gain on the sale. A does not materially participate in the activity in 1991 or any subsequent year. A's gain from the sale in 1990 and all gain thereafter from the installment sale is not PAGI, because A materially participated in the activity in 1990 - the year of the installment sale.[291]

[290] Regs. §1.469-2T(c)(2)(i)(D), Ex. (1).
[291] Regs. §1.469-2T(c)(2)(i)(D), Ex. (2).

A partnership interest or S corporation stock is not treated as property used in an activity for purposes of this rule.[292] Instead, gain recognized on the disposition of a partnership interest or S corporation stock is treated as gain from the disposition of interests in all of the activities in which the partnership or S corporation has an interest.[293] This rule is discussed in ¶2980.06.E, below.

[292] Regs. §1.469-2T(c)(2)(i)(B).
[293] Id.

A special rule applies to property that at some point was only partially used in a passive activity. Any material portion of the property that was used in an activity at a time when the remainder of the property was not so used is treated as a separate interest in property.[294] If property is divided into separate interests, the amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.[295]

[294] Regs. §1.469-2T(c)(2)(i)(C)(1).
[295] Regs. §1.469-2T(c)(2)(i)(C)(2).

The allocation of gain on a disposition can be complex if a portion of the property is used in more than one activity.

Example (82)—*Allocation of Gain on Property Disposition*

B sells a ten-floor office building in 1990. During the three years that B owned the building prior to sale, B used seven floors in his business and rented three floors to tenants. B did not maintain a separate adjusted basis for any part of the building. The amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. If the floors have substantially the same fair market value, a reasonable allocation would be based on the square footage used in each activity.[296]

[296] Regs. §1.469-2T(c)(2)(i)(D), Ex. (4).

If property is sold before a taxpayer places it in service in a passive activity, the gain is not treated as PAGI unless the activity is a passive activity at the time of disposition.

Example (83)—*Gain on Sale of Property Not Used in a Passive Activity*

A enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, A sells all rights under the contract and realizes a gain on the sale. Since A's contract rights are not property used in a rental activity, the gain is not from a rental activity and therefore is not PAGI.[297]

[297] Regs. §1.469-2T(c)(2)(i)(D), Ex. (3).

b. Use in More Than One Activity in 12 Months Before Disposition

A change in the use of property shortly before disposition should not completely change the character of gain from the disposition. A special rule effectively allocates the gain among activities in such circumstances. If an interest in property is disposed of and the property has been used in more than one activity during the 12-month period ending on the date of disposition, the amount realized from the disposition and the adjusted basis of the interest in the property must be allocated among the activities in a way that reasonably reflects the use of the property during the 12-month period.[298]

[298] Regs. §1.469-2T(c)(2)(ii). A similar rule, discussed in ¶2980.06.C.3, below applies to losses from such property.

Example (84)—*Allocation of Gain From Disposition of Property Used in More Than One Activity*

As in the previous example, B owns a 10-floor office building in which, at the time of sale, three floors are rented to tenants and seven floors are used in B's business. Assume that two of the seven floors were also rented until five months before the sale. A reasonable allocation of the amount realized and the adjusted basis of the building would be 30% to the three floors used exclusively in the rental activity, 50% to the five floors used exclusively in the business and 20% to the two floors used first in the rental activity and then in the business activity.

The amount realized and adjusted basis allocated to these two floors would then have to be reallocated on a reasonable basis to reflect use during the 12-month period ending on the date of disposition. Under these facts, an allocation of s 7/12 to the rental activity and s 5/12 to the business is reasonable.[299]

[299] Regs. §1.469-2T(c)(2)(ii), Ex. (1).

An allocation of the amount received on sale and the adjusted basis of property used in several activities during the 12-month period ending on the date of sale which is based on the number of days the property was used in the activity during the year would be respected as reasonable.[300]

[300] Regs. §1.469-2T(c)(2)(ii), Ex. (2).

A simpler approach is available for small sales; the amount realized on a disposition may be allocated solely to the activity in which the property is predominantly used during the 12-month period. This approach applies if the fair market value of the interest in the property does not exceed the lesser of (1) $10,000 or (2) 10% of the fair market value of all property used in the activity immediately before the disposition.[301]

[301] Regs. §1.469-2T(c)(2)(ii).

Example (85)—*Allocation of Gain From Small Sales*

C sells a computer for $8,000. During the 12-month period ending on the date of sale, 70% of C's use of the computer was in a passive activity. If immediately before the sale the fair market value of all property used in the passive activity was $200,000, then all of the gain from the sale could be allocated to the passive activity because (1) the value of the computer does not exceed the lesser of $10,000 or 10% of the value of all property used in the activity immediately before the sale (10% of $200,000 or $20,000) and (2) the computer was used predominantly (70%) in the passive activity.[302]

[302] This example is based on Regs. §1.469-2T(c)(2)(ii), Ex. (3).

c. Substantially Appreciated Property Formerly Used in a Nonpassive Activity

Because passive income can be offset by passive losses, taxpayers could benefit by transferring appreciated property to a passive activity and later selling the property, thus generating passive income. A special rule, discussed in ¶2980.07.B.4, restricts a taxpayer's ability to generate passive income in this manner.

d. Property Held for Sale

Special rules apply to property which is used in a dealing activity when it is sold but which was also used in a nondealing activity at or prior to the time of sale. A dealing activity is an activity in which property is held primarily for sale to customers in the ordinary course of business.[303] These rules are necessary to guarantee that income from the sale of property is properly characterized when the use of the property changes between dealing and nondealing activities prior to the sale or includes both types of activities simultaneously.

[303] Regs. §1.469-2(c)(2)(v)(A)(1)(i)(A).

If the special dealer rules apply to a sale of property held in a dealing activity, then the property is treated as used at the time of sale in the last nondealing activity in which it was used prior to sale.[304] The special dealer rules apply if at the time of disposition the taxpayer holds the property in a dealing activity but the property was used by the taxpayer in a nondealing activity for more than 80% of the time during which the taxpayer held the property.

[304] Regs. §1.469-2(c)(2)(v)(A)(2).

Example (86)—*Special Dealer Rule*

A acquires a rental apartment building on Jan. 1, 1987. Three years later, in Jan. 1990, A converts the building to condominium units. After the conversion, A holds the units for sale to customers. (Assume that this is a separate activity from the rental activity, and that A materially participates in this new activity.) In addition, A continues to use the units in the rental activity until they are sold. The last unit is sold on Dec. 31, 1990.

The apartments were used in a rental activity for the entire period during which they were held by A. Thus, the apartments were used in a nondealing activity for more than 80% of A's holding period, and are therefore treated as used in the rental activity at the time of sale.[305]

[305] This and the following examples are based on Regs. §1.469-2(c)(2)(v)(C), Exs. (1) and (2).

The special dealer rules do not apply, however, if the taxpayer acquired and held the property for the principal purpose of selling the property to customers in the ordinary course of business. In these circumstances, the property is instead treated as held in a dealing activity.

Two quantitative tests can create a rebuttable presumption that the taxpayer acquired and held the property for the principal purpose of selling it to customers. First, if the taxpayer used the property in nondealing activities for 24 months or less (or 20% of the recovery period of the property for depreciation purposes, if shorter) then the rebuttable presumption arises that the taxpayer acquired and held the property for sale to customers.[306] Secondly, the presumption also arises if the property was simultaneously offered for sale to customers and used in a nondealing activity for more than 25% of the period during which the taxpayer used the property in nondealing activities.[307]

[306] Regs. §1.469-2(c)(2)(v)(A)(1)(ii)(A). The recovery period of property is defined in §168, discussed in ¶2370.

[307] Regs. §1.469-2(c)(2)(v)(A)(1)(ii)(B). Property is not offered for sale to customers solely because a lessee of the property has an option to purchase it.

Example (87)—*Property Used in Dealing Activities (1)*

Assume the same facts as in the prior example. A used each apartment in a nondealing activity (the rental activity) for a period of 36 to 48 months (i.e., from Jan. 1, 1987, to the date of sale between Jan. and Dec. 1990.) Thus, the apartments were used in nondealing activities for more than 24 months, and the first rebuttable presumption does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) while the apartments were rented. The percentage obtained by dividing the period during which an apartment was held for sale to customers by the period during which the apartment was used in nondealing activities ranges from zero in the case of apartments sold on Jan. 1, 1990, to 25% (i.e., 12 months/48 months) in the case of any apartment sold on Dec. 31, 1990. Thus, no apartment was offered for sale to customers during more than 25% of the period in which it was used in nonrental activities, and the second rebuttable presumption does not apply.

If the surrounding facts and circumstances do not show that A acquired and held the apartments for the principal purpose of selling the apartments to customers in the ordinary course of business, A does not have a dealing purpose.

If the special dealer rules do not apply to property held in a dealing activity at the time of disposition, then the use of the property in nondealing activities while it is also offered for sale to customers is ignored and the property is treated as used in the dealing activities.[308]

[308] Regs. §1.469-2(c)(2)(v)(B).

Example (88)—*Property Used in Dealing Activities (2)*

Assume instead that A converts the apartments into condominium units on July 1, 1987, and the first unit is sold on Jan. 1, 1988. In this case, all of the apartments were simultaneously offered for sale to customers and used in a nondealing activity of A for more than 25% of the period during which the apartments were used in nondealing activities. Thus, A is rebuttably presumed to have acquired the apartments (including apartments used in the rental activity for more than 24 months) for the principal purpose of selling them to customers in the ordinary course of business. If the facts and circumstances do not rebut this presumption, then A has a dealing purpose, and the use of the property in the rental activity is treated as incidental to its use in the dealing activity. Accordingly, the rental of the apartments after July 1, 1987, is treated as the use of the apartments in the taxpayer's dealing activity.

e. Taxable Acquisitions

If a taxpayer acquires an interest in property in a taxable transaction, the ownership and use of the property before the acquisition are not taken into account in applying the foregoing rules to a later disposition of the property.[309]

[309] Regs. §1.469-2(c)(2)(iv). A taxable transaction is a transaction other than a nonrecognition transaction (i.e., any transaction in which gain or loss is not recognized in whole or in part). §7701(a)(45).

Example (89)—*Taxable Acquisitions*

G, a partner in Partnership X, buys property from X for cash. In a later separate transaction, G sells the property. In applying the disposition rules to gain from the later sale, G's interest in the property as a partner in X is ignored. G is treated as not holding the property until the date that G acquired the property from X.

3. Portfolio Income

In determining the income or loss from a passive activity, portfolio income and portfolio expenses are not taken into account.[310]

[310] Regs. §1.469-2T(c)(3)(i).

Example (90)—*Portfolio Income*

A owns an interest in a rental activity and owns stock in a public corporation. In 1991 A has a passive activity loss from the rental activity of $5,000 and has dividend income from the stock of $5,000. A cannot offset the portfolio dividend income with the passive loss.

a. Definition of Portfolio Income

Portfolio income generally includes all gross income not derived in the ordinary course of a trade or business that is attributable to:

- interest;[311]
- annuities;
- royalties, including fees and other payments for the use of intangible property;
- C corporation dividends and S corporation dividends out of C corporation earnings;
- income from a real estate investment trust;
- regulated investment company income;
- real estate mortgage investment conduit income;
- common trust fund income;
- controlled foreign corporation income;
- qualified electing fund income from a PFIC.[312]
- cooperative income;
- income from the disposition of property that produces income described above; and
- income from the disposition of property held for investment.[313]

[311] Interest for this purpose includes guaranteed payments to a partner under §707(c) for the use of capital. See discussion of §707(c) in ¶4050.

[312] See §1291 et seq.

[313] §469(e)(1); Regs. §1.469-2T(c)(3)(i). *See also* FSA 200002015 (Bank's sale of taxpayer's securities, which taxpayer pledged as collateral for a letter of credit is determined to be nonpassive portfolio income because taxpayer did not purchase the pledged securities in the ordinary course of his insurance activity but rather pledged pre-owned securities to his bank).

b. Items Derived in the Ordinary Course of Business

Any of the items enumerated above are not treated as portfolio income if earned in the ordinary course of a trade or business.[314] The regulations define the term "ordinary course of a trade or business" for purposes of the passive loss rules. Under the regulations, the following items of gross income enumerated above are derived in the ordinary course of a trade or business:

- interest income on loans and investments made in the ordinary course of a business of lending money;

- interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of performing services or selling property, but only if credit is customarily offered to customers of the business;

- income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

- income or gain derived in the ordinary course of trading or dealing in property (but for this purpose inventory property of a dealer does not include property that he held for investment at any time);

- royalties received on a license of intangible property, if the taxpayer created the property or performed substantial services or incurred substantial costs for the development or marketing of the property; or

- amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation based on patronage related to a trade or business of the patron.

- Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business. [315]

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314 §469(e)(1); Regs. §1.469-2T(c)(3)(i).

315 These rules are set out in Regs. §1.469-2T(c)(3)(ii) and (iii). *See e.g.* PLRs 199924020, 199924022 and 199924023, in which the IRS deemed float revenue (interest earned on clients' funds during the time period between taxpayer's receipt of those funds and taxpayer's bank honoring taxpayer's check drawn against those funds) as derived from the ordinary course of trade or business, rather than as portfolio income.

Income or gain from the investment of working capital is portfolio income and cannot be treated as derived in the ordinary course of a trade or business.[316] Working capital includes amounts set aside for present or future business needs.

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316 §469(e)(1)(B).

Example (91)—*Income From Invested Working Capital*

A owns rental real estate. In 1990, A's rental activity has $40,000 of working capital which earns 10% interest. A has $15,000 of rental losses in 1990 which are all treated as passive activity losses. The $4,000 of interest income in 1990 is portfolio income and therefore the interest income cannot be offset by any portion of the passive activity loss.

c. Portfolio Expenses

After a taxpayer has identified all items of portfolio income, it is then necessary to determine what items of expense are allocable to the portfolio income. Those items of expense are treated as not from a passive activity.[317] For purposes of identifying portfolio expenses, interest expense is treated differently from all other expenses.

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317 See §469(e)(1), which refers to deductions but not to credits.

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(1). Portfolio Interest Expense

Portfolio interest expense is interest expense that is properly allocable to the production of portfolio income.[318] This allocation is made by using tracing rules to determine if the interest expense is allocable to an investment or a business activity, or is personal interest.[319] Thus, if a taxpayer borrows money to purchase a portfolio asset, the interest expense paid on the loan is allocable to the gross income from the asset.[320] The allocation of interest expense is not affected by the underlying security for the taxpayer's loan. There is, however, an exception for qualified residence interest which is deductible without regard to the use of the debt proceeds by the taxpayer.[321]

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318 §469(e)(1)(A)(i)(III).

319 Regs. §1.469-2T(d)(3) and Regs. §1.163-8T.

320 Regs. §1.163-8T(a)(3).

321 *See* Regs. §1.163-8T(m)(3).

Example (92)—*Allocation of Portfolio Income*

A buys a portfolio asset with the proceeds of a $10,000 loan which is secured by equipment used in a passive activity. In 1990, A pays $1,000 of interest on the loan. The $1,000 of interest expense is allocable to portfolio rather than passive income.

(2). Other Portfolio Expenses

A different standard applies to portfolio expenses other than interest. These expenses are treated as portfolio expenses if they are clearly and directly allocable to portfolio income.[322] Expenses are clearly and directly allocable to portfolio income if they are incurred as a result of or incident to an activity in which portfolio income is derived or in connection with property from which portfolio income is derived.[323]

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322 Regs. §1.469-2T(d)(2)(i).

323 Regs. §1.469-2T(d)(4).

Example (93)—*Other Portfolio Expenses*

A incurs general and administrative expenses in a passive activity. A invests the income of the passive activity in various portfolio investments. In order for the general and administrative expenses to be portfolio expenses, these expenses must either directly benefit, or be incurred by reason of, the portfolio activity or property.[324]

324 *Id.*

(3). Self-Charged Interest and Other Items

The legislative history of the passive loss rules indicates that certain transactions between related taxpayers should not give rise to expense of one character and income of another.[325] For example, assume a taxpayer charges $100 of interest on a loan to an S corporation engaged exclusively in passive activities in which the taxpayer is the sole shareholder. Under the basic passive loss rules, the taxpayer has a $100 PAD and $100 of portfolio income which cannot be offset by the PAD. Thus, the taxpayer has $100 of taxable income from the transaction despite having effectively paid the interest to himself.

325 Conf. Rep. 99-841 at II-146-47.

The legislative history of the passive loss rules indicated that this result is inappropriate and suggested that the taxpayer be permitted to offset interest income against interest expense to the extent the items represent the same dollars. Treasury was authorized to identify in regulations those situations in which the netting of self-charge interest expense against non-passive income is appropriate.[326]

326 *Id.*

Pursuant to this regulatory authority, on April 5, 1991, Treasury issued proposed regulations which allow a portion of the self-charged interest income received by a taxpayer as a result of a lending transaction between the taxpayer and his passthrough entity (*i.e.*, a partnership or S corporation) to be recharacterized as passive activity gross income.[327] The proposed rules apply to two types of lending transactions: loans to a passthrough entity by its owners, and loans by a passthrough entity to its owners.[328] The proposed regulations recharacterize portfolio income and portfolio deductions only when a lending transaction between an entity and its owners results in a passive deduction for an owner.[329]

327 *See* Prop. Regs. §1.469-7, added by PS-39-89, 56 Fed. Reg. 14034 (4/5/91). The proposed regulations are proposed to be effective for taxable years beginning after Dec. 31, 1986. However, for taxable years beginning before June 4, 1991, taxpayers may use any reasonable method to offset items of interest income and interest expense from lending transactions between a passthrough entity and its owners. The proposed regulations specifically provide that a method that offsets items from nonlending transactions between a passthrough entity and its owners is not a reasonable method. *See* Regs. §1.469-11T(a)(2)(iii). *But see Hillman v. Comr.*, 114 T.C. No. 6 (2/29/00) (Tax Court held that a taxpayer is not prevented from treating management fees as a self-charged item where the IRS failed to issue regulations concerning self-charged situations other than lending transactions).

328 The IRS National Office has advised that the proposed regulations do not apply to loans between passthrough entities owned by the same taxpayers. In TAM 9526001, the National Office stated that taxpayers did not apply a "reasonable method" under Regs. §1.469-11T when they recharacterized their share of interest income from partnerships in which they held interests that had made loans to other partnerships in which the taxpayers held interests. In TAM 9718002, the National Office advised that the proposed regulations and §469(l) do not apply to non-loan transactions, in that case, to a management fee paid by one of the taxpayer's passthrough entities (in which he did not materially participate) to another of his entities (in which he did materially participate).

329 Prop. Regs. §1.469-7(c)(1)(iii). An owner is defined as an owner of a direct interest in an entity (regardless of size) or an owner of 10% or greater interest, held through one or more

passthrough entities, in the capital and profits of a partnership (a "qualifying indirect interest"). Prop. Regs. §1.469-7(b)(2).

The amount of interest income that is recharacterized as passive income is determined by using a fraction (the "applicable percentage").[330] In the case of a loan from an owner to the entity, the numerator of the applicable percentage is the owner's share of the entity's self-charged interest deductions that are treated as passive deductions from the activity, and the denominator is the greater of (1) the owner's share of the entity's self-charged interest deductions (regardless of whether these deductions are treated as passive activity deductions); or (2) the owner's income for the taxable year from interest charged to the entity.[331]

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[330] Prop. Regs. §1.469-7(c)(3). The "applicable percentage" is separately determined for each of the taxpayer's activities. *Id*.

[331] *Id.*

Example (93.1)—*Recharacterization of Self-Charged Interest Income*

B, a 50% partner in a rental partnership (AB), obtains a $10,000 loan from a third-party lender. B pays the lender $1,000 in interest for the taxable year and lends $10,000 to AB, which uses it in the rental activity. AB pays $1,000 of interest to B for the taxable year, and as a 50% partner B incurs $500 of interest expense as his distributive share of AB's interest expense for the year. Under the proposed regulations, the applicable percentage of B's interest income that is recharacterized as passive activity gross income is B's share for the taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity ($500) divided by the greater of (a) B's share for the taxable year of AB's self-charged interest deduction ($500), or (b) B's income for the taxable year from interest charged to AB ($1,000). Thus, B's applicable percentage is 50% ($500/$1,000) and $500 (50% x $1,000) of B's income from interest charged to AB is treated as passive activity gross income.[332]

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[332] This example is based on Prop. Regs. §1.469-7(g), Ex. 2.

The proposed regulations also provide that the applicable percentage of each deduction for the taxable year for interest expense that is properly allocable to the taxpayer's income from interest charged to the borrowing entity is treated as a passive activity deduction from the activity.[333]

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[333] Prop. Regs. §1.469-7(c)(2)(ii). Interest expense is properly allocable to an item of interest income if the interest expense is allocated under Regs. §1.163-8T to an expenditure that is properly chargeable to capital account with respect to the investment producing such item of interest income, or may reasonably be taken into account as a cost of producing such item of interest income. Prop. Regs. §1.469-7(e).

Example (93.2)—*Recharacterization of Deductions*

Assume the same facts as in Example 93.1. The $1,000 of interest expense that B pays to the third-party lender is allocated to an expenditure that is properly chargeable to capital account with respect to the loan to AB. Thus, the expense is properly allocable to the interest income B receives from AB. The applicable percentage of B's deductions for the taxable year for interest expense that is properly allocable to B's interest income charged to AB is recharacterized as a passive activity deduction from AB's rental activity. Accordingly, $500 (50% of B's $1,000 interest expense deduction) interest deduction is treated as a passive activity deduction from the rental activity.[334]

[334] This example is based on Prop. Regs. §1.469-7(g), Ex. 2.

The proposed regulations also recharacterize as passive activity gross income the taxpayer's allocable percentage of his share of an entity's self-charged income from interest charged by the lending entity to owners. The taxpayer's deductions for interest charged by the lending entity must include passive activity deductions for these rules to apply.[335] In the case of a loan from a passthrough entity to an owner, the numerator of the applicable percentage is the owner's deductions for the taxable year for interest charged by the entity to the owner or intermediary passthrough entities, to the extent treated as passive activity deductions from the activity. The denominator of the applicable percentage is the greater of (1) the owner's deductions (whether or not treated as passive deductions from the activity) for interest charged by the entity; or (2) the owner's share of the lending entity's self-charged interest income.[336] The taxpayer's allocable share of the entity's self-charged interest income is multiplied by the applicable percentage to determine the portion of the taxpayer's self-charged interest income that is treated as passive activity gross income.

[335] Prop. Regs. §1.469-7(d)(1)(iii).

[336] Prop. Regs. §1.469-7(d)(3). The taxpayer's applicable percentage of its share for the taxable year of each deduction for interest expense that is properly allocable to the lending entity's self-charged interest income is treated as a passive activity deduction from such activity. Prop. Regs. §1.469-7(d)(2)(ii).

Example (93.3)—*Recharacterization of Entity to Owner Loans*

C owns 50% of the stock of K, a calendar year S corporation. C borrows $30,000 from K and pays $3,000 of interest for the taxable year. C uses $15,000 of loan proceeds to make a personal expenditure and uses $15,000 to make an investment in a trade or business in which he does not materially participate. As a 50% shareholder, C receives $1,500 as his pro rata share of K's interest income from the loan during the taxable year.

Under the proposed regulations, the applicable percentage of C's share of K's self-charged interest income that is recharacterized as passive activity gross income is C's deductions for the taxable year for interest charged by K, to the extent the deductions are treated as passive activity deductions from the activity ($1,500), divided by the greater of (a) C's deductions for the taxable year for interest charged by K, regardless of whether those deductions are treated as passive activity deductions ($3,000), or (b) C's share for the taxable year of K's self-charged interest income ($1,500). Thus, C's applicable percentage is 50% ($1,500/$3,000) and $750 (50% x $1,500) of C's share of K's self-charged interest income is treated as passive activity gross income.[337]

The proposed regulations allow an entity to elect out of the self-charged interest recharacterization provisions by attaching a statement to its return for the entity's taxable year that would apply to all lending transactions between the entity and its owners until revoked. The election can be revoked only with the consent of the IRS.[338]

337 This example is based on Prop. Regs. §1.469-7(g), Ex. 3.

338 Prop. Regs. §1.469-7(f).

4. Personal Service Income

Personal service income is not PAGI.[339]

339 §469(e)(3); Regs. §1.469-2T(c)(4).

Example (94)—*Personal Service Income*

A is a limited partner in Partnership X which operates a plumbing business. In 1990, A is paid $2,000 for accounting services she provides for X. A does not materially participate in the plumbing business and has a $10,000 passive loss from the business in 1990. A's $2,000 of accounting income is personal service income that cannot be offset by the $10,000 passive loss.

Personal service income includes earned income such as wages, salaries, professional fees and other amounts received as compensation for personal services.[340] Earned income also includes guaranteed payments to a partner for his services.[341]

340 Regs. §1.469-2T(c)(4)(i)(A); §911(d)(2)(A).

341 Regs. §1.469-2T(c)(4)(i)(A) and Regs. §1.469-2T(e)(2).

Compensation for personal services also includes the following items of income:

- income from property received for services;
- income from employee trust distributions to beneficiaries and employee annuity payments;
- income paid pursuant to retirement, pension and other arrangements for deferred compensation; and
- social security benefits.[342]

However, no portion of a partner's distributive share of partnership income or a shareholder's share of income from an S corporation is treated as compensation for personal services.[343]

342 Regs. §1.469-2T(c)(4)(i)(B) - Regs. §1.469-2T(c)(4)(i)(E).

343 Regs. §1.469-2T(c)(4)(i) (flush language).

Example (95)—*Compensation for Services*

A owns 50% of the stock of X, an S corporation. X owns rental real estate, which it manages. A receives a salary from X for services performed by A managing X's rental properties. A's share of X's gross rental income is PAGI and the salary paid to A does not constitute PAGI. This is the result even if A is undercompensated for his services.[344]

344 Regs. §1.469-2T(c)(4)(ii), Ex.

The regulations authorize the IRS to identify other income as income derived from personal services.[345]

[345] Regs. §1.469-2T(c)(4)(i)(F).

5. Income From Section 481 Adjustments

A change in a taxpayer's accounting method can result in an increase in taxable income. The income must be allocated among the various activities of the taxpayer to which it relates. The ratable portion of the increase allocated to an activity is treated as giving rise to passive income if the activity is a passive activity in the taxable year in which the change is made.[346]

[346] Regs. §1.469-2T(c)(5)(i). See discussion in ¶3500.

The ratable portion that is treated as PAGI for a year is determined for an activity by multiplying the total positive adjustment for the year by the fraction obtained by dividing:

- the positive adjustment with respect to the activity; by
- the sum of all the positive adjustments with respect to all of the taxpayer's activities.[347]

[347] Regs. §1.469-2T(c)(5)(iii).

Example (96)—*Allocation of Income From Positive Adjustment*

A has 3 activities that are affected by a change from the cash method to the accrual method of accounting. Activities X and Y are passive activities in the year of the change and Activity Z is not. The change in accounting method standing alone generates a positive $1,000 adjustment to X, a positive $2,000 adjustment to Y and a negative $1,500 adjustment to Z. The sum of the adjustments for all 3 activities is $1,500. The $1,500 net positive adjustment is allocated only to X and Y because only those activities produced positive adjustments.

Thus, out of the overall positive adjustment of $1,500, $500 ($1,500 x $1,000/$3,000) is allocated to X and $1,000 ($1,500 x $2,000/$3,000) is allocated to Y. No portion is allocated to Z, which had a negative adjustment in the year.

6. Oil and Gas Properties

PAGI does not include the net passive income from an oil and gas property if any loss from a working interest in the property was treated as not from a passive activity under a special rule concerning qualified working interests.[348] For purposes of this rule, "property" includes not only the oil or gas well that is the qualified working interest but also includes any property whose value was directly enhanced by drilling, logging, testing or other activities where the taxpayer's qualified working interest bore any or all the costs.[349]

[348] §469(c)(3) is discussed in ¶2980.03.D.2.a, above. Regs. §1.469-2(c)(6).
[349] Regs. §1.469-2(c)(6)(iii).

Example (97)—*Working Interest*

A is a general partner in Partnership X and a limited partner in Partnership Y. X and Y own oil and gas working interests in 2 separate tracts of land acquired from 2 different owners. In 1993, X drills a well on its tract and A's distributive share of X's losses from drilling the well are treated as not from a passive activity. In the course of selecting the drilling site and drilling the well, X discovers that the reservoir in which the well was drilled underlies Y's tract as well as X's.

Thus, the value of Y's tract was enhanced by X's drilling. X and Y's tracts are therefore treated as one property. Accordingly, in 1994 and all subsequent years, A's distributive share of both X and Y's income and expenses from their respective tracts is taken into account in computing A's net passive income from the property for purposes of this special rule.[350]

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[350] This example is based on Regs. §1.469-2(c)(6)(iv), Ex. (1).

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7. Other Specifically Excluded Items

PAGI also does not include the following items:

- a taxpayer's income from intangible property such as a patent, copyright or literary, musical or artistic composition if the taxpayer's personal efforts significantly contributed to the creation of the property;

- income from a qualified low-income housing project during any year that transitional relief from the passive loss rules is available;[351]

- income attributable to a refund of any state, local or foreign income, war profits or excess profits tax;

- income attributable to an individual's covenant not to compete;[352]

- income treated as not from a passive activity; [353]

- income attributable to the reimbursement of a loss from fire, storm, shipwreck, other casualty, or theft if the reimbursement is included in the taxpayer's gross income and the deduction for the loss was not a passive activity deduction; and [354]

- income or gain allocable to business or rental use of a dwelling unit for any taxable year that the rule limiting deductions when the dwelling unit is used as a residence [355] applies to the business or rental use.[356]

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[351] The transitional rules for low-income housing are discussed in ¶3150.

[352] Regs. §1.469-2(c)(7)(iv), as finalized by T.D. 8477, 58 Fed. Reg. 11537 (2/26/93), effective for tax years ending after May 10, 1992. *See, e.g.*, *Schaefer v. Comr.*, 105 T.C. No. 16 (9/13/95) (Tax Court upholds as valid former Regs. §1.469-2T(c)(7)(iv), and holds that payments received under a covenant not to compete are *per se* non-passive). *See also Edelberg v. Comr.*, T.C. Memo 1995-386, in which the Tax Court employed similar logic in holding that the payments from the sale of the goodwill of a medical billing firm were not PAGI because it was the payor's trade or business (and not the recipient's) that conducted the activity upon which the payments were based.

[353] Regs. §1.469-2(c)(7)(v), as finalized by T.D. 8477, 58 Fed. Reg. 11537 (2/26/93), effective for tax years ending after May 10, 1992. This applies to gross income that is treated as not from a

passive activity under any provision of the §469 regulations including, but not limited to, Regs. §1.469-1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and Regs. §1.469-2T(f) (relating to recharacterized passive income). Id.

354 Regs. §1.469-2(c)(7)(vi), as finalized by T.D. 8477, 58 Fed. Reg. 11537 (2/26/93), effective for tax years ending after May 10, 1992. The reimbursement must have been included in income under Regs. §1.165-1(d)(2)(ii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year). Id.

355 See §280A(c)(5).

356 Regs. §1.469-2(c)(7)(vii), as finalized by T.D. 8417, 57 Fed. Reg. 20747 (5/15/92), effective for tax years ending after May 10, 1992.

¶2980.06.C. Passive Activity Deductions

1. In General

A taxpayer's PAL for the taxable year is the amount of his PAGI less his PADs. A deduction is a PAD only if the deduction (i) arises in connection with the conduct of an activity that is a passive activity for the taxable year or (ii) is a PAD that is carried over to the taxable year from a prior year.[357]

357 Regs. §1.469-2T(d)(1).

A variety of tax rules may deny a deduction in the year an expense is incurred or a loss suffered and instead delay the deduction to a later year. To determine whether a deduction arises in connection with a passive activity, an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting determined without regard to the passive loss rules and capital loss limitation rules.[358] This rule is discussed in ¶2980.06.C.4, infra.

358 Regs. §1.469-2T(d)(8). The capital loss limitations of §1211 are discussed in ¶1700.

2. Exceptions

Although PADs generally include all deductions that arise in connection with the conduct of a passive activity, the regulations provide a number of exceptions to this general rule.[359]

359 Regs. §1.469-2T(d)(2).

a. Portfolio Expenses

A deduction for an item of expense other than interest that is clearly and directly allocated to portfolio income is not a PAD.[360] The allocation of expenses to portfolio income is discussed in ¶2980.06.B.3, above.

360 Regs. §1.469-2T(d)(2)(i).

b. Disposition of Portfolio Assets

A deduction for a loss from the disposition of property of a type that produces portfolio income is not a PAD.[361]

[361] Regs. §1.469-2T(d)(2)(iv).

Example (98)—*Disposition of Portfolio Assets*

D owns 100 shares of stock of X, a C corporation. The shares have a basis of $8,000. If D sells the shares for $5,000, the resulting $3,000 loss is not a passive loss.

c. Interest Expense

Interest expense is treated as a PAD only if the interest expense is allocated to a passive activity under the interest tracing rules discussed in ¶2980.06.B.3, supra. Qualified residence interest is not a PAD.[362]

[362] Regs. §1.469-2T(d)(2)(iii) and Regs. §1.469-2T(d)(3). See Regs. §1.163-8T and -10T discussed in ¶2330.

d. Dividends Received Deductions

PADs do not include a deduction with respect to any dividend that is not included in PAGI.[363] Thus, most dividends received deductions will not be PADs since most dividends are not included in PAGI.

[363] Regs. §1.469-2T(d)(2)(ii).

Example (99)—*Dividends Received Deduction*

Y, a CHC, owns 1,000 shares of common stock of Z, a publicly traded corporation. Y receives a dividend of $500 on its Z stock in 1989 and claims a dividends received deduction of $350. This deduction is not a PAD.

e. Complete Disposition of Interest

A deduction that is allowed in a year when a taxpayer completely disposes of his interest in a passive activity is not treated as a PAD.[364]

[364] Regs. §1.469-2T(d)(2)(v). See ¶2980.09, below, for a discussion of complete dispositions of a passive activity interest.

f. Taxes

A deduction for any state, local or foreign income, war profits or excess profits tax is not a PAD.[365]

[365] Regs. §1.469-2T(d)(2)(vi).

Example (100)—*Deduction for Taxes*

E, a cash basis taxpayer, is a partner in a magazine publishing venture but does not materially participate in 1989 or 1990. In 1989 E has $50,000 of income from the venture. In 1990 E pays state income taxes of $4,000 on E's 1989 income from the venture. E also has a loss of $10,000 from the venture in 1990 and no passive income. E's PAL for 1990 is $10,000. The $4,000 state tax deduction is not a PAD and thus, subject to the normal rules for such deductions, may be deducted against E's nonpassive income. (Similarly, if E were an accrual basis taxpayer and accrued the state tax deduction in 1989, E's PAGI for 1989 would still be $50,000 because the state taxes are not a PAD and thus do not reduce PAGI.)

g. Miscellaneous Itemized Deductions

A taxpayer's miscellaneous itemized deductions that are subject to disallowance in whole or in part due to the 2% floor on such deductions (discussed in ¶2910) are not PADs.[366]

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[366] Regs. §1.469-2T(d)(2)(vii).

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h. Charitable Contributions

A deduction for a charitable contribution is not a PAD.[367]

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[367] Regs. §1.469-2T(d)(2)(viii).

Example (101)—*Charitable Contributions*

F is a 25% partner in X. F's share of X's income and deductions for 1990 is as follows:

```
Gross Income                 $100,000
Business Deductions         ($ 40,000)
Charitable Contributions      ( 5,000)
                             --------
Net Profit                   $ 55,000
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F's passive income from X for 1990 is $60,000 (not the actual profit of $55,000) because the $5,000 charitable contribution is not a PAD. The charitable contribution may be deducted against F's nonpassive income, subject to the normal rules for such deductions. F may use up to $60,000 of passive losses, if available, to offset the passive income from X.

i. Carryovers and Carrybacks

Items of loss or deduction that are carried to a taxable year under the net operating loss carryover or carryback rules,[368] the percentage depletion limitation rules,[369] and the capital loss carryover or carryback rules[370] are not PADs.[371]

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[368] Under §172(a).

[369] Under §613A(d).

[370] Under §1212(a)(1) in the case of corporations and §1212(b) in the case of taxpayers other than corporations.

[371] Regs. §1.469-2(d)(2)(ix), as finalized by T.D. 8417, 57 Fed. Reg. 20747 (5/15/92), effective for tax years ending after May 10, 1992.

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j. Certain Pre-1987 Items

Certain rules deny a current deduction for an otherwise deductible item. An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987 but for (i) the at-risk rules (discussed in ¶2970), (ii) the basis limitation on a partner's losses (discussed in ¶4050) or (iii) the basis limitation on an S corporation shareholder's losses (discussed in ¶4280) is not a PAD when the deduction later becomes allowable under the foregoing rules.[372] This is because the passive loss rules did not apply when the deduction first arose and the passive loss rules generally do not apply to any loss, deduction or credit carried to a taxable year beginning after December 31, 1986 from a taxable year beginning before January 1, 1987.[373]

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[372] Regs. §1.469-2(d)(2)(x), as finalized by T.D. 8477, 58 Fed. Reg. 11537 (2/26/93), effective for tax years ending after May 10, 1992.

[373] See §501(c)(2) of the 1986 TRA. The effective date and transitional rules are discussed in ¶2980.07, below.

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k. Casualty and Theft Losses

Certain deductions for casualty or theft losses that arise in connection with the conduct of a passive activity are not PADs. Specifically, the exclusion applies to any deduction for a loss from fire, storm, shipwreck, or other casualty, or from theft[374] so long as losses that are similar in cause and severity do not recur regularly in the conduct of the activity.[375]

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[374] As those terms are defined in §165(c)(3).

[375] Regs. §1.469-2(d)(2)(xi), finalized by T.D. 8477, 58 Fed. Reg. 11537 (2/26/93), effective for taxable years ending after May 19, 1992.

Thus, deductions for losses resulting from natural disasters are not limited by the passive loss rules, but deductions for shoplifting losses of a retail store, accident losses typically sustained in operating a fleet of rental cars, and other similar losses that recur regularly in the conduct of the activity are limited.[376]

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[376] For an example of the interaction of this rule with the treatment of casualty and theft losses under §165 and §280B, see Notice 90-21, 1990-1 C.B. 332.

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l. Business/Rental Use of Dwelling Unit

Certain deductions and losses allocable to the business or rental use of a dwelling unit are not PADs. Specifically, the exclusion applies to any deduction or loss allocable to business or rental use of a dwelling unit for any taxable year that the Code section [377] limiting deductions when the dwelling unit is used as a residence applies to the business or rental use.[378]

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[377] See §280A(c)(5).

[378] Regs. §1.469-2(d)(2)(xii), as finalized by T.D. 8417, 57 Fed. Reg. 20747 (5/15/92), effective for tax years ending after May 10, 1992.

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3. Losses from Dispositions of Passive Activity Property

A loss recognized on (i) the sale, exchange or other disposition of an interest in property used in an activity at the time of disposition, (ii) the sale, exchange or other disposition of an interest in an activity held through a partnership or S corporation or (iii) the abandonment or worthlessness of such an interest is treated as a deduction from the activity.[379] A deduction described above is treated as a PAD if the activity is a passive activity of the taxpayer for the taxable year of the disposition or other event giving rise to the deduction.

[379] Regs. .
[380] §1.469-2T(d)(5)(i)(B).

Example (102)—*Selling Property at a Loss*

siness of selling electrical equipment. In 1990 the S corporation sells a building it owns at a loss. A does not materially participate in

treated as a PAD in 1990.

participated in 1989 or 1991, it would potentially benefit A to accelerate or defer the sale to one of those years and thus avoid passive loss tre

A partnership interest or S corporation stock is not property used in an activity for purposes of the above rule. The treatment of the disposition of partnership and S corporation interests is discussed in , below.

[381] §1.469-2T(d)(5)(iii)(B).

disposition and is sold at a loss, the amount of loss realized and the adjusted basis must be allocated among the ac [382]

[382] §1.469-2T(d)(5)(ii). A similar rule, discussed in , above, applies to gain from such property.

a. In General

A deduction from a passive activity that is disallowed for a taxable year under other sections [383] For example, the at-risk limitations and the ied before a deduction is treated as a PAD for purposes of the passive loss rules.

[383] Regs. .
[384]

Example (103)—

A acquires an interest in Partnership *X* terially participates in X's business in 1990 and A's share of X's loss in 1990 is $500. Assume A's basis in her partnership interest is

$200 of deductions allowed in 1990 are not PADs because materially participates in that year. The remaining $300 of loss is carried over to later years.

partnership losses in 1991 is $600 and A does not materially participate that year. In 1991 the partnership basis rules allow A to deduct the entire $600 loss from 1991 and the suspended loss of $300 from 1990. Since A does not materially participate in 1991, the $900 of losses are PADs in 1991.

Thus, A has in effect converted $300 of active losses from 1990 into a passive loss in 1991 by increasing her basis in the later year rather than the earlier year. [385]

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385 This example is based on the example in Regs. §1.469-2T(d)(1).

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b. Disallowance of Partnership Losses

If a partner's share of partnership loss is disallowed under the partnership basis rule, a ratable portion of the partner's share of each item of deduction or loss of the partnership is disallowed for the taxable year for purposes of the passive loss rules. [386] For purposes of applying this rule, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing:

- the amount of partner's distributive share of partnership loss that is disallowed for the taxable year; by
- the sum of the partner's distributive share of all items of deduction and loss of the partnership for the taxable year. [387]

This computation is necessary to determine whether or not the disallowed deduction is a PAD.

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386 See Regs. §1.469-2T(d)(6)(ii).
387 Id.

Example (104)—*Calculating Ratable Portion of Disallowed Deductions*

A is a 25% partner in Partnership X but does not materially participate. In 1990 X has gross income of $5,000 and deductions of $8,000. The deductions consist of $4,000 of rent, $2,000 of salaries and $2,000 of interest expense on borrowings incurred to finance portfolio investments. A's share of X's overall loss in 1990 is $750. Assume A's loss is disallowed for 1990 because A has a zero basis in his partnership interest.

A's share of all the items of deduction and loss for 1990 is $2,000. In order to determine A's share of each item that is suspended, A multiplies his share of each deduction by $750/$2,000. Thus, A's suspended deductions are $375 of rent, $187.50 of salaries and $187.50 of interest.

c. Disallowance of an S Corporation's Loss

Similarly, if an S corporation shareholder's share of an S corporation's loss is disallowed under the basis limitation rule, a ratable portion of the shareholder's share of each item of deduction or loss of the S corporation is disallowed for the taxable year. [388] For purposes of this rule, the ratable portion of each item of deduction or loss is the amount of the item multiplied by the fraction obtained by dividing:

- the amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

- the sum of the shareholder's pro rata shares of all items of deduction and loss of the S

389

This is essentially the same rule that applies to partnerships.

8 Regs. .

389

d. Disallowance Under the At-Risk Rules

If a taxpayer's loss from an activity (as defined under the at-risk rules) is disallowed under the

the taxable year. [390] le, the ratable portion of a deduction or loss is the amount of the item multiplied by the fraction obtained by dividing:

- the sum of all deductions from the activity for the taxable year.

390 Regs . The at-risk rules are discussed in ¶2970

391 Id.

In identifying items of deduction and loss from an activity that may be PADs, a taxpayer is not required to account separately for any deduction or loss unless it may, if separately taken into

if the item were not accounted for

separately. Items of deduction or loss that must be accounted for separately include deductions or losses that:

- arise in a rental real estate activity in which the taxpayer actively participates;

- arose in a taxable year beginning before 1987 and were not allowed for that taxable year under the partnership ba

- are taken into account under the rules governing capital losses and property used in a trade or business; or

- are attributable to interests in activities prior to the enactment of th 394

392 §1.469-2T(d)(6)(v).

§1211 §1231 are discussed in .

394 §1.469-2T(d)(6)(v)(A)-(F).

If a change in accounting method results in a negative adjustment to taxable income, a ratable portion of the negative adjustment from the activity is treated as a PAD if the activity is a passive activity in the year of the change. [395] This rule is similar to the one for a positive adjustment discussed in ¶2980.06.B.5, above.

395 Regs. §1.469-2T(d)(7).

¶2980.06.D. Passive Activity Credits

A taxpayer's PACs for the taxable year are allowed only against tax on income from passive activities. Specifically, the PACs are not allowed to the extent the PACs exceed the taxpayer's regular tax liability allocable to all passive activities for the year. [396]

396 §469(d)(2). Regs. §1.469-3T(a).

PACs are credits which are attributable to the taxable year, arise in connection with the conduct of a passive activity and are credits arising under the following provisions:

- §27(b) (the Puerto Rico and possessions tax credit);
- §29 (nonconventional fuels credit); and
- §38(b) (general business credits, including the investment credit, work opportunity credit (formerly targeted jobs credit), alcohol fuels credit, research credit and low-income housing credit, enhanced oil recovery credit, disabled access credit, renewable electricity production credit, empowerment zone employment credit, Indian employment credit, employer social security credit, clinical drug testing (orphan drug) credit).[397]

The foreign tax credit is not treated as a PAC. [398]

397 Regs. §1.469-3T(b). Also included in the current year general business credit is the credit for unused payments into the Trans-Alaska Pipeline Liability Fund under §4612(e) and the credit for contributions to certain community development corporations under 1993 RRA §13311.

398 §469(d)(2)(A)(ii).

In some cases a variety of limitations are imposed on a taxpayer's ability to claim credits in a particular year. For example, the general business credit is subject to a limit based on the taxpayer's regular and minimum taxes. [399] The character of a credit as passive or nonpassive is determined without regard to these limitations. [400]

399 §38(c).

400 Regs. §1.469-3T(c).

The amount of regular tax liability allocable to all passive activities for the taxable year is the excess of:

- the taxpayer's regular tax liability for the taxable year; over
- the amount of regular tax liability, determined by disregarding both PAGI and PADs for the year. [401]

Regs. §1.469-3T(d)(1)

Example (105)—

A is a general partner in Partnership X, a calendar year partnership. X purchases a building in

placed in service in a rental activity in 1989. X's rehabilitation costs are qualified rehabilitation expenditure

Because the credit is allowable for the taxable year in which the property is placed in service, X's credit for qualified rehabilitation expenditures arises in connection with the
which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for that year if A's
ermined without regard to the limitations on credits and the passive loss rules. Thus, A's distributive share of the credit is subject to the

1989. [402]

This example is based on Regs. §1.469-3T(f)

As discussed in ¶2980.08
allowed on a complete disposition of an activity. However, when the underlying property is sold,

of any prior basis reduction attributable to the credit. This election is also discussed in ¶2980.08.H

¶2980.06.E. Special Rules for Partnerships and S Corporations

1. In General

entities such as partnerships and S corporations. [403]
and deduction allocated to a taxpayer from a partnership or S corporation is determined in any

activity that generated the item. [404] ¶2980.04.D, above.

Regs. §1.469-2T(e .

404 §1.469-2T(e)(1).

a. Payments to a Partner Not in Capacity as a Partner

Under the partnership rules, a partner can engage in a transaction with a partnership outside
[405] These transactions include payments to a partner who performs
rship. The passive loss rules follow the approach of the partnership rules in this regard. Thus, if a transaction is treated under the

than as a partner, then the passive loss rules characterize income or deductions from the transaction in a manner consistent with the treatment under the partnership rules. [406]

[405] See the discussion of §707(a) in ¶4050.

[406] Regs. §1.469-2T(e)(2)(i).

Example (106)—*Transactions Between Partners and Partnerships*

A is a partner in Partnership X and both A and X use the calendar year. X is engaged in a retail business. During 1990 A sells a piece of real property to X. For purposes of determining whether A's income from the sale is PAGI, the characterization of the income under the partnership provisions is applied. Thus, if the sale is respected, the proceeds of the sale are not treated as a distribution of partnership income.

b. Certain Guaranteed Payments

For purposes of the passive loss rules, guaranteed payments to a partner for services or the use of capital are characterized as the payment of compensation for services or as the payment of interest and not as a distributive share of partnership income. In addition, guaranteed payments made in liquidation of the interest of a retiring or deceased partner are also characterized in this manner. [407]

[407] Regs. §1.469-2T(e)(2)(ii). Guaranteed payments to partners under §707(c) and §736(a)(2) are discussed in ¶4040 and ¶4070, respectively.

Example (107)—*Guaranteed Payments*

B is a partner in Partnership Y. During 1990 B receives a guaranteed payment from Y for accounting services provided to Y. The payment to B is treated as personal service income and not as passive income.

An exception applies to payments made in liquidation of a retiring or deceased partner's interest which are attributable to unrealized receivables (within the meaning of §751(c), discussed in ¶4070) or goodwill. [408] This exception is discussed in ¶2980.06.E.2.c, below.

[408] Regs. §1.469-2T(e)(2)(iii).

c. Liquidation Payments

Under the partnership rules, payments made in liquidation of a retiring or deceased partner's interest, to the extent the payments are made in exchange for the partner's interest in partnership property, are considered to be a partnership distribution and not a distributive share of partnership income or a guaranteed payment. [409] Effectively, this rule treats the payment as sale or liquidation proceeds rather than as a share of the partnership's income. Under the passive loss rules, gain or loss of a retiring partner (or a deceased partner's successor in interest) as a result of a payment described above is treated as PAGI or a PAD only to the extent the gain or loss would have been PAGI or a PAD of the retiring (or deceased) partner if it had been recognized at the time the liquidation of the partner's interest began. [410] Thus, the treatment of these payments depends solely on whether the payments would have been PAGI or a PAD if made in the year in which the liquidation of the partner's interest began.

[409] See discussion of §736(b) in ¶4080.

[410] Regs. §1.469-2T(e)(2)(iii).

Example (108)—*Payments Made in Exchange for Partner's Interest in Partnership Property*

B does not materially participate in Partnership Y's activity in 1991 and retires from Y in that year. All of B's gains or losses from payments made to B in exchange for B's interest in Y's property, whether made in 1991 or later, will be treated as PAGI or PADs.

A special rule applies, however, to payments made in liquidation of a retiring or deceased partner's interest if the payments are allocable to unrealized receivables or goodwill of the partnership. [411] In that case the percentage of income treated as PAGI is limited to the percentage of PAGI that the retiring or deceased partner would have recognized if the unrealized receivables and goodwill had been sold at the time the liquidation of the partner's interest began. [412]

[411] Regs. §1.469-2T(e)(2)(iii)(B). Unrealized receivables are defined in §751(c).

[412] The allocation of a payment to unrealized receivables and goodwill is determined under the principles of Regs. §1.736-1(b).

3. Disposition of Interests in Pass-Through Entities

a. In General

When a partner sells his interest in a partnership, the gain or loss must be characterized as passive, active or portfolio. This can be complicated when the partnership is engaged in a number of activities and the gain or loss must be allocated.

Example (109)—*Disposition of Partnership Interest*

A, a partner in Partnership X, sells his interest in X for a gain of $100,000. The character of A's gain depends on X's activities.

The same problems arise when an S corporation shareholder sells some or all of his stock. In such cases, the seller's gain or loss is allocated to each activity in which the entity has an interest. The gain or loss is then treated as passive or non passive depending on whether the particular activity is a passive activity with respect to the individual. [413]

[413] Regs. §1.469-2T(e)(3)(ii).

For purposes of characterizing gain under the passive loss rules, distributions by partnerhips or S corporations in excess of the partner's or shareholder's basis, are treated as either gain from the sale or exchange of a partnership interest or gain from the sale or exchange of stock in an S corporation.[414]

[414] Rev. Rul. 95-5, 1995-2 I.R.B. 5.

b. Allocation Among Activities

treated as gain or loss from disposing of an interest in each trade or business, rental or investment activity in which the pass-through entity owns an
below). [415]
activities that would have produced net gain if the pass-through entity had sold its entire interest in [416] Similarly, a taxpayer's

activities that would have produced a loss. [417]

Regs. §1.469-2T(e)(3)(ii)(A)

416 Regs. . For purposes of these rules, "net gain" is defined as the amount by which the gains from the sale of all property used by, or representing the interest of, t pass-through entity in the activity exceed the losses from the sale. Regs. §1.469-2T(e)(3)(ii)(E)(3)

417 Regs. . "Net loss" is defined as the amount by which the losses from the sale of all property used by, o activity exceed the gains from the sale. Regs. §1.469-2T(e)(3)(ii)(E)(4)

Example (110)—

A is a partner in Partnership X. X owns a shoe manufacturing business, a clothing store and a

If X sold its three activities, its gain or loss would be as follows:

Shoe Manufacturing	$500,000
Store	($100,000)
Apartment Building	$300,000

to characterize the gain as active or passive.

c. Allocation of Gains

determined by multiplying the amount of the net gain by the fraction obtained by dividing:

- the net gain that would have been allocated to the taxpa sold its interest in that separate activity for fair market value on the applicable valuation date; by

had sold its interest in all "appreciated activities" for fair market value on the applicable [418]

418 §1.469-2T(e)(3)(ii)(B)(1).

if the entity sold its entire interest in the activity for fair market value on the applicable valuation date. [419]

[419] Regs. §1.469-2T(e)(3)(ii)(E)(1).

The "applicable valuation date" is elected by the pass-through entity and is either (1) the beginning of the taxable year of the pass-through entity in which the disposition occurs or (2) the date on which the disposition occurs. [420] However, the beginning of the taxable year cannot be used if certain significant events have occurred during the year which might make that date inappropriate. Specifically, the applicable valuation date must be the date immediately preceding the date on which the disposition occurs if during the taxable year and before the date on which the taxpayer's disposition of an interest in the pass-through entity occurs any one of the following occurs:

- the pass-through entity disposes of more than 10% of its interest (by value as of the beginning of the taxable year) in any activity;
- more than 10% of the property (by value as of the beginning of the taxable year) used in any activity of the pass-through entity is disposed of; or
- the taxpayer contributes to the pass-through entity substantially appreciated or substantially depreciated property with a total fair market value or adjusted basis, respectively, that exceeds 10% of the total fair market value of the holder's interest in the pass-through entity as of the beginning of the taxable year. [421]

[420] Regs. §1.469-2T(e)(3)(ii)(D)(1)(i).
[421] Regs. §1.469-2T(e)(3)(ii)(D)(1)(ii).

Property is substantially appreciated if its fair market value exceeds 120% of its adjusted basis, and property is substantially depreciated if its adjusted basis exceeds 120% of its fair market value. [422] The complex rules for allocating gain among the activities of a pass-through entity are illustrated by the following example:

[422] Regs. §1.469-2T(e)(3)(vi)(B) and (C).

Example (111)—*Allocating Gain Among Pass-Thru Entity's Activities*

A owns a 50% interest in Partnership X, a calendar year partnership. In 1993, A sells 50% of his interest (25% of Partnership X) for $50,000 and recognizes a $20,000 gain from the sale. X is engaged in business Activities 1, 2 and 3 and owns marketable securities that are portfolio assets. For 1993, A materially participates in Activity 3 but does not materially participate in Activities 1 and 2.

Assume X selects the beginning of 1993 as the applicable valuation date. At the beginning of 1993, the fair market value and adjusted basis of the property used in X's activities are as follows:

Activity	Adjusted Basis	Fair Market Value
1	$ 68,000	$ 48,000

2	$	
3	$ 20,000	$ 80,000
Securities	$ 2,000	$ 10,000
Total	$120,000	$200,000

A's $20,000 gain must be allocated
3 and the marketable securities). For purposes of this allocation, all of X's marketable securities are treated as a single investment activity.

ties 2 and 3 and the marketable securities on Jan. 1, 1993, A would have been allocated net gains as follows:

2	$ 8,000
3	$15,000

T	

A's gain is allocated among Activities 2, 3 and the marketable securities by multiplying A's total gain ($20,000) times the net gain determined for each Activity over the total net gain
n is allocated to Activity 2, $12,000 to Activity 3 and $1,600 to the marketable securities. The gain allocated to Activity 2 is PAGI. None of the [423]

423 example is based on Regs. §1.469-2T(e)(3)(vii)

d. Allocation of Losses

The rules concerning the allocation of loss on the disposition of an interest in a pass-through

disposition of an interest in a pass-through entity that is allocable to an activity is determined by

- the amount of the net loss that would be allocated to the taxpayer if the pass-through entity sold its interest in the activity
- the total net loss that would be allocated to the taxpayer if the pass-through entity sold its interest in all "depreciated activities" for fair market value on the applicable valuation [424]

424 §1.469-2T(e)(3)(ii)(B)(2).

the pass-through entity sold its entire interest in the activity for fair market value on the applicable

e. Default Rule

The regulations provide a default rule that applies if gain or loss cannot be allocated under the ratable portion rule discussed above. [425] Under the default rule, gain or loss is allocated among a pass-through entity's activities in proportion to the fair market value of the entity's interests in the activities at the applicable valuation date. The gain or loss allocated to each activity of the pass-through entity is treated as gain or loss from the disposition of an interest in the activity. [426]

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[425] Regs. §1.469-2T(e)(3)(ii)(C).
[426] Id.

Example (112)—*Default Rule*

A and B each own a 50% interest in Partnership X which owns interests in Activities 1 and 2. In 1991 A sells his partnership interest for a gain of $50,000. At that time Activity 1 has a fair market value of $100,000 and Activity 2 has a fair market value of $300,000. If the default rule applies, $12,500 of A's gain is allocated to Activity 1 and the remaining $37,500 is allocated to Activity 2.

f. Basis Adjustments

In some circumstances, (in particular, sales of a partnership interest) the basis of partnership property is adjusted as to a specific partner. [427] Such adjustments are taken into account in computing net gain or net loss that would be allocated to the taxpayer if the partnership sold its interest in an activity. [428]

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[427] See §743 and §754, discussed in ¶4070.
[428] Regs. §1.469-2T(e)(3)(ii)(D)(2).

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g. Tiered Pass-Through Entities

A taxpayer may own an interest in a pass-through entity which in turn owns an interest in a second passthrough entity. For example, one partnership may own an interest in another partnership or an S corporation may own a partnership interest. These ownership structures are called "tiered pass-through entities" and the regulations provide rules concerning dispositions of interests in tiered pass-through entities.

If a pass-through entity disposes of an interest in a lower tier pass-through entity (the "subsidiary entity"), gain or loss from the disposition that is taken into account by a person that owns an interest in the first tier entity is allocated among the activities of the subsidiary entity by applying the general rules discussed above. The person that ultimately takes the gain or loss into account is effectively treated as holding an interest in the subsidiary entity and recognizes gain or loss as a result of a disposition of that deemed interest. [429]

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[429] Regs. §1.469-2T(e)(3)(ii)(D)(3).

Example (113)—*Tiered Partnerships*

interest in Y for a $20,000 gain of which $10,000 passes through to A. The ratable portion method is applied in order to determine the character of X's gain which is passed through to A.

Assume Y is involved in Activities 1 and 2 and under the ratable method $5,000 of X's gain is allocated to Activity 1 and $15,000 to Activity 2. A's share of the gain is $2,500 from Activity 1 and $7,500 from Activity 2.

Similarly, if the taxpayer sells an interest in a first tier entity, the allocation of gain or loss to its activities should include any activities conducted by subsidiary entities.

h. Distributions in Excess of Basis

According to the IRS, a distribution that exceeds the adjusted basis of a shareholder's stock in an S corporation, which has no accumulated earnings and profits, is treated as a sale or exchange of an interest in the S corporation for purposes of the passive activity rules.[430]

430 TAM 9501001.

4. Recharacterization Rules

The regulations provide a special recharacterization rule for gain from the disposition of an interest in a pass-through entity when a direct sale of assets by the entity would have been subject to specified recharacterization rules. Under this recharacterization rule, if the taxpayer disposes of an interest in a pass-through entity and:

- gain recognized on the disposition is allocated to a passive activity;
- one of the specified recharacterization rules would have treated the gain as not from a passive activity if the property used in the activity had instead been sold for fair market value; and
- the amount of the taxpayer's gain that would have been recharacterized exceeds 10% of the taxpayer's gain from the disposition of the interest in the passthrough entity;

then an amount of gain from the disposition of the interest (not in excess of the hypothetical gain from the disposition of the property) is treated as gain that is not from a passive activity.[431] The specified recharacterization rules relate to substantially appreciated property (discussed in ¶2980.07.B.4), oil and gas properties (¶2980.06.B.6), property rented incidental to development (¶2980.07.B.2), property rented to a nonpassive activity (¶2980.07.B.3) and entities engaged in licensing (¶2980.07.C.4).[432]

431 Regs. §1.469-2T(e)(3)(iii). For purposes of this rule, the amount of gain that would have been allocated to the holder of the interest if all of the property used in an activity had been sold is determined by taking into account any adjustments to the basis of partnership property made with respect to the holder under the partnership provisions.

432 Regs. §1.469-2(e)(3)(iii)(B).

Example (114)—*Recharacterization Rules*

B owns a 50% interest in Partnership X. In 1993 B sells his interest in X and recognizes a

$100,000 gain which is allocated to a passive activity of X. $50,000 of B's gain is attributable to a building owned by X which has substantially appreciated and if sold by X would result in gain that is not from a passive activity under the recharacterization rules. $50,000 of B's gain in 1993 is treated as active business income.

5. Dispositions Occurring in Taxable Years Beginning Before February 19, 1988

The rules for allocating gain or loss on the disposition of an interest in a pass-through entity generally do not apply to dispositions occurring in a taxable year of the pass-through entity that begins before February 19, 1988.[433] Under this transition rule, any gain or loss recognized from the disposition may be allocated among the activities of the pass-through entity under any reasonable method selected by the pass-through entity.[434] Reasonable methods include the ratable portion method described in ¶2980.06.E.3.c, above, or allocations based on fair market value, cost or the adjusted basis of the property used in the activities.[435]

433 Regs. §1.469-2T(e)(3)(iv)(A). TAM 9501001.

434 Id.

435 Id.

This transition rule does not apply, however, where after February 19, 1988, but before the taxpayer's disposition of the interest, the holder contributes to the pass- through entity (i) substantially appreciated portfolio assets or (ii) any other substantially appreciated property that was used in any trade or business activity of the holder in which the holder materially participated during the taxable year of the holder in which the contribution occurs or the immediately preceding taxable year.[436] Property is substantially appreciated if its fair market value exceeds 120% of its adjusted basis.[437]

436 Regs. §1.469-2T(e)(3)(iv)(B).

437 Regs. §1.469-2T(e)(3)(vi)(B).

¶2980.07 Recharacterization

¶2980.07.A. In General

The passive loss rules generally characterize income or loss as:

- passive income or loss,
- active trade or business income or loss, or
- portfolio income or loss.[438]

438 The term "nonpassive income or loss" is sometimes used to embrace both active business income and portfolio income. Two other categories are personal service and publicly-traded partnership income or loss.

Since passive income can be offset by either passive losses or active business losses, it will often be preferable for taxpayers to have passive income rather than portfolio income or active business income (which cannot be offset by passive losses). Thus, taxpayers have an incentive to

Congress gave the Treasury broad authority to adopt regulations to prevent taxpayers from

portfolio income.[439]
either active or portfolio income. An additional rule, discussed in ¶2980.07.B.4
recharacterizes income from substantially appreciated property.[441]
are also used to recharacterize gain from the sale of an interest in a pass- through entity, if the
¶2980.06.E.4.

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§469(l)(3)
of the passive loss rules which is to prevent "the sheltering of positive income sources through the use

apparently felt that taxpayers would intentionally try to structure certain income producing activities

440 Regs. .
441 ¶2980.07.C, below, discusses the special effective dates for the recharacteriz

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¶2980.07.B. Passive Income Recharacterized as Active Income

Three of the recharacterization rules recharacterize passive income as active business income.

Gross income from a taxpayer's significant participation passive activities (SIPPAs) is recharacterized as active business income to the extent of the taxpayer's aggregate net passive
[442] As discussed in , above, a SIPPA is a nonrental trade or

which the taxpayer does not materially participate.[443]

Regs. §1.469-2T(f)(2)(i)
443 Regs. 469-2T(f)(2)(ii).

SIPPA Recharacterization Rule

B works as manager of a hotel on a full-time basis. B also owns a bar and works part-time as

materially participate as a bartender. B's income from the bar for 1992 is recharacterized as active business income.

allocated among the individual SIPPAs that generated net income. Each SIPPA's ratable portion of net passive income is determined by multiplying net passive income from that SIPPA by

- the aggregate net passive income from all the SIPPAs; by
- the aggreg

not those that produced net passive losses.[445]

[444] Regs. §1.469-2T(f)(2)(i). This allocation is apparently necessary for purposes of the phase-in rules described in ¶2980.07, below.

[445] Id.

Example (116)—*Allocation of SIPPA Recharacterization*

B owns interests in three SIPPAs in 1992. B's net passive income and loss from each activity in 1992 is as follows:

```
Activity  X           ($200)
Activity  Y            $200
Activity  Z            $300
                       ----
Aggregate Net Income   $300
```

The portion of the $300 net income which is allocated to Activities Y and Z is determined by first dividing (i) $300 by (ii) $500, the income of Activities Y and Z and thus applying this ratio to the separate income of Activity Y ($200) and Activity Z ($300). Thus, $120 (3/5 of $200) of the income from Activity Y and $180 (3/5 of $300) of the income from Activity Z is treated as nonpassive income.[446]

[446] See Regs. §1.469-2T(f)(2)(iii), Ex.

2. Rental Incidental to Development Activity

Example (117)—*Incident to Development*

D is a real estate developer. D builds an office building and rents it to various tenants. Ten months later D sells the building. Absent a special rule, the rental income and gain on the sale of the office building would be passive income from a rental activity.

A special recharacterization rule prevents this result. The rule applies to a taxpayer's gross income from the rental or disposition of the property during the taxable year reduced by deductions that are reasonably allocated to the rental activity for the year.[447] This income is recharacterized as active business income if three requirements are satisfied.[448]

[447] Regs. §1.469-2T(f)(9).

[448] Regs. §1.469-2(f)(5)(i).

The first requirement is that there must be gain from the disposition of the property during the taxable year.[449]

[449] Regs. §1.469-2(f)(5)(i)(A).

The second requirement is that the taxpayer either materially participated or participated for more than 100 hours for any taxable year in an activity that involved the performance of services for the purpose of enhancing the value of the property.[450] Services that are treated as enhancing the value of property include, construction, renovation, lease up (unless more than 50% of the property is leased on the date the taxpayer acquires an interest in the property) and development.[451]

[450] Regs. §1.469-2(f)(5)(i)(C).

[451] Regs. §1.469-2(f)(5)(iii), finalized by T.D. 8495, 58 Fed. Reg. 58787 (11/4/93).

Example (118)—*Rental Incident to Development Recharacterization*

B acquires a building on Jan. 1, 1993, when the building is 30% leased. During 1993, B rents the building and materially participates in an activity involving the lease-up of the building, which constitutes the only value-enhancing service. B sells the building on Nov. 1, 1993. B's participation in the lease-up activity constitutes a value-enhancing service because less than 50% of the building was leased when B acquired the property. However, lease-up is not considered a value- enhancing service for purposes of determining the commencement of the use of the property in a rental activity. Therefore, B's use of the property in a rental activity commenced on Jan. 1, 1993. B is subject to the rental incident to development recharacterization rule because the property was disposed of within 12 months of the date B commenced using the building in a rental activity.[452]

[452] See Regs. §1.469-2(f)(5)(iv), Ex. 2.

The final requirement is that the use of the property in the rental activity commenced less than 12 months before the date of disposition.[453] The date of disposition is the first date on which the property is subject to an oral or written agreement that either requires the owner, or gives him an option, to transfer his interest in the property for consideration that is fixed or otherwise determinable on date.[454] Thus, the date of disposition for the 12-month test may be much earlier than the date on which title is actually transferred. The use of the property in a rental activity is deemed to commence when the taxpayer owns an interest in the item of property, substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental), and no significant value-enhancing services remain to be performed.[455]

[453] Regs. §1.469-2(f)(5)(i)(B).

[454] Regs. §1.469-2(f)(5)(i)(B) and (c)(2)(iii)(B).

[455] Regs. §1.469-2(f)(5)(ii)(A). This section of the regulations was amended by T.D. 8318, 1990-2 C.B. 103, and finalized by T.D. 8495, 58 Fed. Reg. 58787 (11/4/93). Value-enhancing services include, but are not limited to construction, renovation and lease-up (unless more than 50% of the property is leased on the date that the taxpayer acquires an interest in the property). Where substantial lease-up remains to be performed, the 12 month period will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out for rent and is in a state of readiness for rental on that date. Regs. §1.469-2(f)(5)(ii)(B) and (iii). The final regulations are effective Nov. 4, 1993, and apply to tax years ending after May 10, 1992.

This recharacterization rule is apparently designed to prohibit a taxpayer from converting income attributable to services into passive income merely by renting the property for less than 12 months prior to sale. A taxpayer who wants to avoid recharacterization under this rule must either rent the property for at least 12 months or not rent the property at all prior to sale.

3. Self-Rented Property

Apparently, Treasury also felt taxpayers could create passive income by renting property to an activity in which they materially participate. To stop this perceived abuse, the net rental income (including income from dispositions) from an item of property rented to a trade or business activity in which the taxpayer materially participates is recharacterized as active business income.[456] This rule does not apply to property that is subject to the recharacterization rule for rental incident to development activity described above.[457]

[456] Regs. §1.469-2(f)(6) and (9). For a discussion of the application of Regs. §1.469-2(f)(6), *see Fransen v. U.S.*, 191 F.3d 599 (5 th Cir. 1999), *aff'g* 98-2 USTC ¶50,776 (E.D. La. 1998) (Self-rental rule in Regs. §1.469-2(f)(6) valid); *Connor v. Comr.*, No. 99-3324 (7th Cir. 7/5/00) (Rental income from lease of taxpayer wife's building to taxpayer husband's personal services corporation was not passive activity income and could not offset passive losses); *Schwalbach v. Comr.*, 111 T.C. 215 (1998) (Regs. §§1.469-2(f)(6) and 1.469-4(a) are valid as applied to recharacterize the rental income for an individual who rents property to a personal service corporation for use in a business in which the individual materially participates); *Krukowski v. Comr.*, 114 T.C. No. 25 (5/22/00) (Citing *Schwalbach* and *Fransen*, court held that taxpayer could not offset income realized on rental of an office building to his subchapter C law firm with the loss realized on his rental of a building to his subchapter C health club).

[457] Regs. §1.469-2(f)(6)(ii).

Example (119)—*Self-Rented Property (1)*

C rents computer equipment to a consulting firm in which C materially participates. C has net rental income of $20,000 in 1999. The $20,000 of income is recharacterized as active business income even though the income is from a rental activity.

Questions may arise as to how much rental income should be recharacterized as active business income. If a taxpayer rents only a portion of the property to a business in which he materially participates or if the taxpayer only owns a percentage of the trade or business, it is unclear under this rule how much passive income should be recharacterized as active.

Example (120)—*Self-Rented Property (2)*

B and C each own a 50% interest in a building. B and C rent five of the 10 floors in the building to B for use in B's consulting business in which he materially participates.

The first issue is whether rental income from the entire building or only the portion attributable to the floors rented to B is recharacterized as active business income. The correct answer should be that only the rental income attributable to the rental to B is recharacterized. The second issue is whether only B's share of the rental income is recharacterized as active business income and C's share of the rental income remains passive. The correct answer should be that only B's share of rental income is recharacterized as active business income.

4. Substantially Appreciated Property

If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition is treated as gain from a passive activity only if the interest in the property was used in a passive activity for either (1) 20% of the period during which the taxpayer held the interest in the property or (2) the entire 24-month period ending on the date of the disposition.[458] For purposes of this rule, an interest in property is substantially appreciated if its fair market value exceeds 120% of its adjusted basis.[459] Property held through a C corporation is treated as held for investment and not as property used in a passive activity.[460]

458 Regs. §1.469-2(c)(2)(iii)(A).

459 Regs. §1.469-2(c)(2)(iii)(C).

460 Regs. §1.469-2(c)(2)(iii)(D).

A special rule applies to determine the date of the disposition. A disposition is deemed to occur on the date that the interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the interest for consideration that is fixed or otherwise determinable on that date.[461] Thus, the date of disposition may occur much earlier than the date on which title is actually transferred.

461 Regs. §1.469-2(c)(2)(iii)(B).

Example (121)—*Date of Disposition*

D acquires a building on Jan. 1, 1987, and uses the building in a business activity in which D materially participates until Mar. 31, 1998. On Apr. 1, 1998, D leases the building to B in a bona fide rental activity. On Dec. 31, 1999, D sells the building. Assume the 120% substantial appreciation test is satisfied. The building would be treated as used in a passive rental activity for 21 months, which is less than 20% of the time (13 years) that D held the building. Thus, the gain from the sale is treated as not from a passive activity.[462] The result would apparently be the same if D merely contracted on Dec. 31, 1999, to sell the building for a fixed price and the closing and transfer of title did not occur until May 1, 2000.

462 See Regs. §1.469-2(c)(2)(iii)(G), Ex. 1.

The rule for substantially appreciated property is applied after the 12-month allocation rule described in ¶2980.06.B.2,b, above, is applied. Thus, the gain is first allocated among activities in which the property was used and then only the portion of the gain that is characterized as gain from a passive activity is subject to the substantially appreciated property rule.[463] Finally, gain that is treated as not from a passive activity under this rule is treated as portfolio income for purposes of the investment interest expense limitation (see discussion in ¶2230, above) if the property was held for investment for more than 50% of the period during which the taxpayer held the property in activities other than passive activities.[464]

463 Regs. §1.469-2(c)(2)(iii)(E).

464 Regs. §1.469-2(c)(2)(iii)(F).

¶2980.07.C. Passive Income Recharacterized as Portfolio Income

1. In General

In the three cases discussed below, passive income is recharacterized as portfolio income.[465]

465 Regs. §1.469-2(f)(10). Income recharacterized under these rules is not treated as portfolio income in determining whether (1) gain or loss from disposition of the property produces portfolio income or income from property held for investment, (2) an expense is treated as clearly and directly

allocable to portfolio income and (3) interest expense is allocated under Regs. §1.163-8T to an investment expenditure or to a passive activity expenditure.

2. Rental of Nondepreciable Property

If less than 30% of the unadjusted basis of property used or held for use by customers in a rental activity is depreciable, the net passive income from the rental activity is recharacterized as portfolio income.[466] Unadjusted basis is defined as adjusted basis without regard to any adjustments that decrease basis.[467] For example, depreciation deductions would not be reflected in unadjusted basis but the capitalized cost of an improvement would be. This recharacterization rule was enacted primarily to deal with ground rents that produce income without significant deductions.[468]

466 Regs. §1.469-2T(f)(3).
467 Regs. §1.469-1(e)(3)(vi)(E).
468 See Conf. Rep. 99-841 at II-147.

Example (122)—*Rental of Nondepreciable Property*

C acquires land for $400,000 and constructs a building on the land for $100,000. C then leases the land and the building to B. Since depreciable property (i.e., the building) accounts for only 20% of the total unadjusted basis, any net income from the rental activity, including any gain on sale, is treated as portfolio income.[469]

469 See Regs. §1.469-2T(f)(3), Ex.

This rule applies separately to each of the taxpayer's separate activities of renting nondepreciable property. Thus, a taxpayer with two parcels of property subject to this rule cannot offset the gain on disposition of one parcel against any loss on the disposition of the other parcel because the gain is portfolio income and the loss is a passive loss.

Example (123)—*Separate Application of Rule*

Assume in the above example that C acquires another parcel of land in the same city for $200,000 and constructs a building on that land for $200,000. C has losses from renting this building. C's losses cannot offset the income from the rental of the first building.

A taxpayer's rental activity is not subject to this rule if the activity satisfies one of the exceptions to the rental activity definition discussed in ¶2980.05.B, above. For example, net rental income from a rental activity in which the property is available for nonexclusive use by customers (e.g., a golf course) will not be recharacterized as portfolio income even if the rental activity is otherwise treated as a passive activity because the taxpayer does not materially participate in the activity.

3. Equity-Financed Lending Activities

Treasury was also concerned that certain lending activities could be used to generate passive income. To prevent this, passive income from an equity-financed lending activity is treated as portfolio income.[470] A lending business is equity-financed if its average outstanding liabilities do not exceed 80% of its average outstanding interest-bearing assets.[471] This test is applied for each taxable year.

[470] Regs. §1.469-2T(f)(4).

[471] Regs. §1.469-2T(f)(4)(ii)(A). The average may be computed on a daily, monthly, or quarterly basis at the taxpayer's option. Regs. §1.469-2T(f)(4)(vii).

The liabilities and assets taken into account for purposes of this recharacterization rule generally include those that bear interest, including loans to customers. [472] Liabilities which are incurred principally for the purpose of exceeding the 80% test are disregarded. [473] In addition, liabilities secured by tangible property used in the activity are disregarded. If the lending business is conducted by an entity in which the taxpayer owns an interest, liabilities on which the entity is not the borrower are also disregarded. [474]

[472] Regs. §1.469-2T(f)(4)(v) and Regs. §1.469-2T(f)(4)(vi).

[473] Regs. §1.469-2T(f)(4)(ii)(B).

[474] Regs. §1.469-2T(f)(4)(vi).

Example (124)—*Equity Financed Leasing Transactions*

A and B are in the business of lending money. During 1990 their business has outstanding loan balances of $200,000 of interest-bearing assets and $100,000 of liabilities for amounts borrowed. A and B's business is an equity-financed lending activity in 1990.

The amount of a taxpayer's gross income from an equity-financed lending activity that is treated as portfolio income is equal to the lesser of (i) the taxpayer's equity-financed interest income from the activity or (ii) the taxpayer's net passive income from the activity. [475] Equity-financed interest income from an activity is determined under a formula based on the ratio of net interest-bearing assets to gross interest-bearing assets. Specifically, the taxpayer's net interest income from the activity is multiplied by the fraction obtained by dividing:

- the excess of the activity's average interest-bearing assets over the activity's average outstanding balance of liabilities; by
- the activity's average interest-bearing assets for the year in the activity. [476]

[475] Regs. §1.469-2T(f)(4)(i).

[476] Regs. §1.469-2T(f)(4)(iii).

Net interest income is gross interest income reduced by expenses that are reasonably allocable to the gross interest income. [477] Interest on liabilities incurred in the activity does not reduce gross interest income for this purpose.

[477] Regs. §1.469-2T(f)(4)(iv).

Example (125)—*Equity-Financed Interest Income*

Assume that the lending business described in Example (123) has $20,000 of net income in 1990. The activity's equity-financed interest income in 1990 is determined as follows:

```
Net Income X Interest-Bearing Assets - Liabilities
             ------------------------------------
                  Interest-Bearing Assets

$20,000 X $200,000 - $100,000 = $10,000
          -------------------
                 $200,000
```

There is $10,000 of equity-financed interest income and therefore only $10,000 of the activity's gross income is treated as portfolio income in 1990.

4. Pass-Through Entity Licensing Intangibles

This recharacterization rules prevent a taxpayer from creating passive royalty income by acquiring an interest in a pass-through entity that has created intangible property or has performed substantial services or incurred substantial costs with respect to the property. [478] In that case, net royalty income is treated as portfolio income.

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[478] Regs. §1.469-2T(f)(7)(i).

Example (126)—*Recharacterization of Licensing Income*

In 1992 A purchases a 50% interest in Partnership X which created a real estate computer program in 1989. Partnership X receives royalty income from sales of the computer program. A's share of the net royalty income in 1992 is $50,000 which will all be treated as portfolio income unless one of the exceptions discussed below applies.

Royalty income from an item of property is a taxpayer's share of gross income (without regard to the recharacterization rules) from licensing or transfer of any right in the property. [479] Net royalty income from an item of property is the excess of (1) gross royalty income over (2) PADs (including suspended PALs from prior years) that are reasonably allocable to such items of property. [480]

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[479] Regs. §1.469-2T(f)(7)(ii)(A).
[480] Regs. §1.469-2T(f)(7)(ii)(B).

There are two exceptions to this recharacterization rule. The exceptions treat the income as passive income if substantial expenditures are incurred by the pass-through entity. Specifically, the rule does not apply where the development or marketing expenditures reasonably incurred by the development entity exceed 50% of the gross royalties for the taxable year. [481] For purposes of the computation required by this exception, a capital expenditure is treated as if deductible in the year that it is property capitalized without regard to the year a deduction for the expenditure is actually allowed. [482]

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[481] Regs. §1.469-2T(f)(7)(iii)(A) and Regs. §1.469-2T(c)(3)(iii)(B)(2)(ii)(a).
[482] Regs. §1.469-2T(c)(3)(iii)(B)(2)(iii) and Regs. §1.469-2T(f)(7)(iv).

Example (127)—*Exceptions to Recharacterization Rule (1)*

Assume in example (125) that in 1993 Partnership X's expenditures for marketing the computer program are $200,000 and X's gross royalties are
because the expenditures of $200,000 exceed 50% of the gross royalties (50% of $300,000 = $150,000). A's share of the net royalty income in 1993 is treated as passive income.

share of reasonably incurred expenditures by the entity for the development or marketing of the property for all taxable years of the entity

the taxpayer's interest in the property at the time he acquired the interest in the entity. A capital expenditure for this purpose is also taken into account as if deductible for the taxable year
lized. [484]

Regs. §1.469-2T(f)(7)(iii)(B)

484 Regs. .

Example (128)—*Exceptions to Recharacterization Rule (2)*

In June 1990 B purchases a 50% interest in Partnership Y which created a computer program in 1988. The fair market value of B's interest in the computer program in June 1990 is $300,000. Y's expenditures for marketing the computer program are $80,000 in 1990 and $90,000 in 1991. B's share of those expenses totals $85,000 which exceeds 25% of the value of his interest in the computer program in June 1990. B's share of Y's net royalty income beginning in 1991 will be treated as passive income.

¶2980.08 Disposition of Passive Activity Interests

¶2980.08.A. In General

Although the general rule is that PALs can only offset passive income, a taxpayer who disposes of his entire interest in a passive activity in a taxable transaction can use his PALs to offset nonpassive income in the year of disposition. [485] In a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the activity for the taxable year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) in excess of any net income or gain from other passive activities for the taxable year is treated as a loss which is not from a passive activity.[485.1] A taxpayer is allowed to use all his suspended PALs on a disposition of the activity because he has clearly suffered a true economic loss at that time. [486] A disposition of a passive activity interest is deemed to take place in the taxable year in which recognition of the gain or loss occurs. [487]

485 §469(g)(1)(A).

485.1 §469(g)(1)(A) as amended by §1704(e) of the 1996 Small Business Job Protection Act effective for taxable years beginning after 1986. *See* TAM 9742002 (Realized loss on the disposition of a passive activity must be offset against net income and gains from other passive activities, including activities with net passive losses).

486 See S. Rep. 99-313 at 725.

[487] §469(g)(1)(A).

Example (129)—*Disposition of Passive Activity Interest*

90 for $100,000. During 1990 and 1991, T incurs $20,000 of suspended PALS.

15, 1992. T's gain on the sale is $20,000 and is included on T's tax return for 1992. The

economics of the rental activity because T did not actually realize an economic gain in 1992.

Example (129A)—*Disposition of Passive Activity Interest*

Assume the same situation as Example 129, except T's gain on the sale was only $15,000. Also, T had passive income of $9,000 and passive losses of $5,000 from other activities. T's gain on the sale of $15,000 is included on his tax return for 1992, but is offset by the $20,000 in suspended PALs. T will also have a non-passive loss of $1,000 from the disposition, which is the excess of amount of the loss in the rental activity after disposition ($5,000) over the net income and losses from other passive activities ($4,000).

The rule allowing full use of losses on disposition includes both losses from the activity during the year of disposition and losses from the disposition itself, in addition to suspended PALs from prior years.

¶2980.08.B. Complete Disposition

A taxpayer is entitled to the benefits of the disposition rule only if he completely disposes of his interest in the passive activity. A complete disposition is a fully taxable disposition of the taxpayer's entire interest in the activity to an unrelated person. [488] Thus, a taxpayer must dispose of all assets that are used in the activity. If a taxpayer owns an interest in an activity through a pass-through entity, the taxpayer must dispose of all his interests in the entity or the entity itself must dispose of all the assets used in the activity. [489]

[488] §469(g)(1).

[489] See S. Rep. 99-313 at 725.

Example (130)—*Complete Disposition*

A owns a limited partnership interest in Partnership X. X is engaged in two activities, a rental activity and a business activity. The rental activity has generated PALs for A. X sells the assets used in the rental activity in 1992. X's sale of the rental activity in 1992 allows A to use his PALs from that activity to offset passive or nonpassive income in 1992. [490]

[490] See Conf. Rep. 99-841 at II-145 (Reversing rule from Senate Report that a limited partner had to dispose of his entire interest in the partnership to get complete disposition treatment losses from any activity conducted by the partnership).

A complete disposition of a taxpayer's interest in an activity can be made by an installment sale. In the case of an installment sale of an entire interest in an activity, the portion of the PALs that are allowable for each taxable year bears the same ratio to all the losses as the gain recognized on the sale during the taxable year bears to the gross profit from the sale. [491]

[491] §469(g)(3).

Example (131)—*Disposition by Installment Sale*

B owns rental property with an adjusted basis of $50,000 and has suspended PALs from the property of $20,000. B sells the property in 1991 for $100,000 and therefore has a gain of $50,000. B receives the following payments from the sale: (i) $50,000 in 1991, (ii) $30,000 in 1992 and (iii) $20,000 in 1993. The purchaser also pays interest on the deferred amounts.

Under the installment method, B recognizes gain of $25,000 in 1991, $15,000 in 1992 and $10,000 in 1993. Thus, B can offset the gain with his suspended PALs of $10,000 ($20,000 x $25,000/$50,000) in 1991, $6,000 ($20,000 x $15,000/$50,000) in 1992 and $4,000 ($20,000 x $10,000/$50,000) in 1993.

If a taxpayer makes an installment sale of his interest in a passive activity, the gain recognized is passive income. Gain from installment sales made before 1987 which is recognized after 1986 is passive income if the taxpayer can prove that the activity would have been a passive activity if the passive loss rules had applied for the year of disposition. [492]

[492] §1005(a)(10) of TAMRA.

¶2980.08.C. Fully Taxable Transaction

The disposition rule applies only if the disposition is a fully taxable transaction. In most cases, a sale or other disposition of property to a third-party in an arm's-length transaction will be a fully taxable disposition. However, an exchange of a taxpayer's interest in an activity in a nonrecognition transaction, such as a like-kind exchange (discussed in ¶1510), a contribution to a corporation under §351 (discussed in ¶4710) a transfer in a tax-free reorganization (discussed in ¶4910), or a contribution to a partnership (discussed in ¶4030), does not allow a taxpayer to use his suspended PALs. [493] If any gain is recognized on the transaction (for example, because boot is received in a like-kind exchange), the gain is treated as passive income that may be offset with passive losses. [494]

[493] See S. Rep. 99-313 at 725-27. *See also* TAM 9739004 (Taxpayers may not deduct passive losses that were suspended due to property sale to son, who subsequently sold it in a §1034 transaction; losses will remain suspended until son disposes of replacement property in a fully taxable transaction).

[494] Id.

Example (132)—*Transfer to Corporation*

B owns a building used in a rental activity. If B transfers the building to a newly formed corporation in exchange for all of the corporation's stock, B cannot use any suspended PALs at that time. If the corporation is an S corporation, B's suspended PALs can offset his share of passive income from the S corporation. If the corporation is a C corporation, B's suspended income is portfolio income, not passive income. [495]

Regs. §1.469-1T(f)(4)(ii) e suspended PALs are still treated in these circumstances as attributable to a passive loss activity, but any dividend income from the C

¶2980.08.D. Related Party Transactions

A taxpayer is not treated as having disposed of his entire interest in a passive activity if he sells [496] In that case, the taxpayer may not use any of his suspended which the interest in the activity is acquired by a person who is not related to the taxpayer. For purposes of this rule, a taxpayer is treated as related to another person if they are related under certain rules limiting losses from transact between related parties. [498] arranging sales simply to trigger suspended losses. Without this rule a taxpayer with significant PALs could sell his entire interest to his daughter the taxpayer cannot use his suspended PALs until his daughter disposes of the interest.

496 §469(g)(1)(B).

Id.

498 §267(b), discussed in , and §707(b)(1) discussed in ¶4040

Example (133)—

Assume in the above example that in 1990 B sells the building to his daughter, C. Despite this disposition, B cannot use his suspended PALs in 1990 to offset active or portfolio income. In sells the building to D, who is unrelated to B. B can use his suspended PALs to offset active or portfolio income in 1991.

A gift by a taxpayer of all or a part of his interest in a passive activity will not result in the allowance of suspended PALs. Rather, suspended PALs are added to the basis of the property [499] Thus, the do PALs in any taxable year. The PALs are in effect recovered by the donee through the stepped-up basis.

§469(j)(6)

Example (134)—

A owns a building used in a rental activity. A has an adjusted basis in the building of $50,000

able to deduct the $25,000 of suspended PALs and B will have a basis in the building of $75,000. If B sells the b

¶2980.08.F. Disposition by Death

If an interest in an activity is transferred by reason of the death of the taxpayer, the suspended PALs are generally allowed on the decedent's final income tax return. However, the suspended PALs are allowed only to the extent that the PALs exceed the step-up in the basis of the transferred interest which is available on the death of the decedent. [500] If the suspended PALs are less than the step-up in basis or if they cannot be used in the decedent's final tax return, the suspended PALs are never allowed. [501]

[500] §469(g)(2). Generally, under §1014 the estate's basis in the decedent's property is stepped-up to its fair market value.

[501] Id.

Example (135)—*Disposition by Death*

A owns a building used in a rental activity. A's basis in the building is $50,000 and A's suspended PALs are $40,000. A dies in 1991 when the building has a fair market value of $75,000. A's estate therefore has a basis of $75,000 in the building. Since the step-up in basis of the building on A's death is $25,000, only $15,000 of A's suspended PALs can be used on A's final tax return.

¶2980.08.G. Dispositions By Estates and Trusts

If an interest in a passive activity is distributed by an estate or trust to a beneficiary, the basis of the interest immediately before the distribution is increased by the amount of suspended PALs allocable to the interest, and the PALs are never allowed as a deduction. [502]

[502] §469(j)(12).

Example (136)—*Dispositions by Trusts and Estates*

Assume in the above example that A's estate does not distribute the building to A's son, B, until 1993. During that period the estate has PALs of $10,000 from the rental activity and the estate's basis in the building is reduced to $70,000. The estate's basis in the building immediately before the distribution to B in 1993 will be increased from $70,000 to $80,000 by the $10,000 of suspended losses and the suspended PALs can never be used by the estate or B.

¶2980.08.H. Treatment of Credits

The complete disposition rule for suspended PALs does not apply to PACs that arose in the activity. The reason for this rule is that a credit does not reflect a true economic loss and thus the disposition cannot demonstrate that it is appropriate to allow the credit. [503] However, for purposes of determining gain or loss from a complete disposition of an interest in a passive activity, the transferor may elect to increase the basis of the property by an amount equal to the portion of any suspended PAC that reduced the basis of the property. If the taxpayer makes this election, the PAC is permanently lost. [504]

[503] See S. Rep. 99-313 at 725.

[504] §469(j)(9)

Example (137)—*Treatment of Credits*

In 1990 B places in service rehabilitation credit property which generates a credit of $10,000. This is the only asset used in a passive activity. B's basis is reduced by $10,000 under the rehabilitation tax credit provisions. Assume B is allowed a credit of only $2,000 against tax liability attributable to passive income in 1990 and B completely disposes of the property in 1991. B can elect in 1991 to increase her basis for the property by $8,000 at the cost of permanently losing the credit.

If property is disposed of in a transaction that is not a complete disposition of the taxpayer's interest in a passive activity, no basis adjustment can be elected. However, the PAC remains available to offset future tax liability attributable to passive income.

¶2980.08.I. Treatment of Former Passive Activities

A "former passive activity" is an activity of a taxpayer which was a passive activity for any prior year but is not a passive activity for the current taxable year.[505] If a taxpayer has any suspended deductions and credits allocable to a former passive activity, the taxpayer may use those deductions and credits to offset the income or the regular tax liability of the same activity in a year that it is nonpassive.[506] However, unlike the complete disposition rule, the suspended deductions and credits retain their character as PADs and PACs and cannot offset a taxpayer's nonpassive income from other activities.[507]

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505 §469(f)(3).

506 §469(f)(1)(A) and §469(f)(1)(B).

507 §469(f)(1)(C).

Example (138)—*Former Passive Activities*

A owns an interest in a manufacturing business. A did not materially participate in the business in 1990, but did materially participate in 1991. A's suspended PALs with respect to the business from 1990 can offset income from the business in 1991 but cannot offset A's portfolio income in 1991.

A former passive activity also arises if a CHC or PSC ceases to be subject to the passive loss rules. This can happen, for example, if the stock ownership of a corporation changes and it no longer meets the CHC stock ownership test. In this case, the passive loss rules continue to apply to losses and credits carried over from preceding taxable years in the same manner as if the corporation continued to be a CHC or PSC.[508]

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508 §469(f)(2).

¶2980.09
Application of the Passive Loss Rules to Corporations

¶2980.09.A. In General

As discussed in ¶2980.02.E and ¶2980.02.F, above, the passive loss rules apply to CHCs and PSCs. However, special rules apply to these corporations to determine material participation, to permit use of a CHC's PALs against active income and to address various consolidated return issues.

¶2980.09.B. Material Participation

The material participation tests apply differently to C corporations than to other taxpayers. For a detailed discussion of the material participation tests for corporations, see ¶2980.04.E, above. Generally, a PSC is treated as materially participating in an activity based on the participation of its shareholders. A CHC is treated as materially participating in an activity based either on shareholder participation or, in certain circumstances, on employee participation.

¶2980.09.C. Calculation of Passive Activity Gross Income

The rules for determining PAGI are the same for C corporations as they are for other taxpayers subject to the passive loss rules. For a detailed discussion of PAGI, see ¶2980.06.B, above.

¶2980.09.D. Special Loss Rules for Closely Held Corporations

In the case of a CHC, the adverse effects of the passive loss rules apply in only a limited way. A CHC may not use PALs to offset portfolio income, but it can use PALs to offset its active business income.

In particular, CHCs are permitted to use PALs to offset "net active income."[509] Similarly, a CHC's PAC may offset its tax liability on net active income.[510] The statute defines net active income as taxable income for the taxable year determined without regard to (1) any income or loss from a passive activity and (2) portfolio income, expense, gain or loss.[511]

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509 §469(e)(2)(A); Regs. §1.469-1T(g)(4)(i). A PSC may not use its PALs against active income. Instead, the passive loss rules limit the PALs of a PSC in the same way as the losses of all other taxpayers subject to the passive loss rules. A corporation which is both a PSC and a CHC is treated like a PSC and cannot use its PALs against active income. Regs. §1.469-1T(g)(2)(ii).

510 Regs. §1.469-1T(g)(5)(i).

511 §469(e)(2)(B). The regulations modify the computation of a CHC's PAL. Under the regulations, a CHC's PAL is generally the amount, if any, by which the CHC's PADs for the taxable year exceed the sum of (1) the CHC's PAGI and (2) the CHC's net active income for the year. Regs. §1.469-1T(g)(4).

The regulations modify the definition of net active income to clarify that it does not include:

- income treated as portfolio income under the recharacterization rules;
- gross income from certain oil and gas properties that is treated as not from a passive activity; and
- gross income from trading personal property but only if the corporation did not materially participate in the activity for the taxable year.[512]

[512] Regs. §1.469-1T(g)(4)(ii); see discussion of gross income from oil and gas properties in ¶2980.06.B.6, above.

Example (139)—*CHC Special Rule*

In 1990, Corporation X, a CHC, is engaged in two activities. One activity is a business in which X materially participates for 1990 and the other is a rental activity. X also holds portfolio investments. In 1990, X has gross income and deductions as follows:

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Gross Income
 Business Income                $100,000
 Rent                             60,000
 Portfolio Income                 35,000
                                --------
                                $195,000
Deductions
 Business Expenses             ($ 80,000)
 Rental Expenses                (100,000)
 Portfolio Interest Expense      (10,000)
 Other Portfolio Expense          (5,000)
                               ---------
                               ($195,000)
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X's net active income for 1990 is $20,000 (business income of $100,000 less business deductions of $80,000) and X's loss from passive activities is $40,000 (rental income of $60,000 less rental deductions of $100,000). X's PAL for 1990 is $20,000, the amount by which X's PADs for 1990 ($100,000) exceed the sum of X's (a) PAGI for the year ($60,000) and (b) net active income for the year ($20,000). X therefore has $20,000 of taxable income in 1990 which is equal to X's net portfolio income that year.[513]

[513] This example in based on Regs. §1.469-1T(g)(4)(iii), Example (1).

¶2980.09.E. Treatment of Affiliated Groups

1. In General

The passive loss rules provide special rules for affiliated groups of corporations that file consolidated tax returns. The rules generally treat the group as one taxpayer.[514] A consolidated group's PAL or PAC is determined by taking into account the PAGI, PADs, net active income and PACs of each member of the group.[515]

[514] Regs. §1.469-1T(h).

[515] Regs. §1.469-1T(h)(3).

Example (140)—*Affiliated Groups*

Corporation X is the common parent of a consolidated group with one subsidiary, Y. Assume that X's group is a CHC. In 1990 X has PAGI of $10,000 and PADs of $15,000 and Y has

PAGI of $20,000, PADs of $20,000 and net active income of $3,000. X's group for 1990 has a suspended PAL of $2,000.

For purposes of determining whether a consolidated group is a CHC or a PSC for a taxable year:

- the members of the group are treated as one corporation;
- only the outstanding stock of the common parent is treated as outstanding stock of the corporation;
- any employee of any member of the group is treated as an employee of the corporation; and
- an activity is treated as the principal activity of the corporation only if it is the principal activity of the consolidated group.[516]

This same rule applies in order to determine whether or not a consolidated group materially participates in any of its activities.[517]

[516] Regs. §1.469-1(h)(4)(ii)(A)-(D).
[517] Id.

Example (141)—*Consolidated Groups*

Corporation X is the common parent of a consolidated group with one subsidiary, Y. X has five equal shareholders, A, B, C, D and E. The group, treated as a single corporation, is a CHC because more than 50% of its (i.e., X's) stock is owned by five or fewer persons. Thus, X and Y are CHCs.

Assume that only A and B materially participate in the only activity of Y. X's consolidated group does not satisfy the material participation test as to Y's activity because A and B do not own more than 50% of X's stock.

A subsidiary may be a member of an affiliated group and join in its consolidated return if it is at least 80% owned by other group members or the common parent. The "one corporation" rule can produce results for such partially-owned subsidiaries which are very different from the results under the attribution rules.

Example (142)—*One Corporation Rule (1)*

A owns 40% of the stock of Corporation X and the remainder is widely held. X is the parent of an affiliated group filing consolidated returns. Thus, neither X nor its wholly owned subsidiaries are CHCs. B owns 20% of Corporation Y and the remainder is owned by X. Under the attribution rules, A owns 32% of Y (40% of 80%) and B owns 20% of Y, and thus Y would be a CHC. Under the one corporation rule for affiliated groups, X and Y are one corporation and only the stock of X is outstanding. Thus Y is not a CHC.

Example (143)—*One Corporation Rule (2)*

A owns 60% of X and the rest is widely held. Thus X and its wholly owned subsidiaries are

CBCs. X owns 80% of Y and the remainder is widely held. Under the attribution rules, A owns only 48% of Y (60% of 80%) and Y would not be a CHC. However, Y is a CHC under the one corporation rule.

2. Apportioning Passive Activity Deductions and Credits

If a consolidated group has suspended PADs and PACs, the PADs and PACs must be apportioned among the members of the consolidated group. The apportionment is done as follows:

- A ratable portion of the PAL of the consolidated group that is disallowed for the taxable year is allocated to each member of the group which had a PAL for the year.

- The disallowed PAL allocated to a member is allocated among that member's activities as if the member were a separate taxpayer.

- The rules for the carryover of disallowed PALs are applied to each member of the group as if it was a separate taxpayer. [518]

A member's ratable portion of the consolidated group's disallowed loss is the amount of the disallowed loss multiplied by the fraction obtained by dividing:

- the PAL of the member that would have been disallowed if the items of gross income and deduction of the member were the only items of the group for the year; by

- the sum of the amounts in (i) above calculated for all members of the group. [519]

518 Regs. §1.469-1T(h)(5).
519 Regs. §1.469-1T(h)(5)(ii).

Example (144)—*Apportioning Passive Activity Losses and Credits*

Corporations X, Y and Z are an affiliated group filing consolidated tax returns. In 1990, X has a passive loss of $10,000, Y has a passive loss of $20,000 and Z has net passive income of $6,000. The consolidated group has an overall passive loss of $24,000 in 1990 of which $8,000 is allocated to X and $16,000 is allocated to Y. None of the loss is allocated to Z because it had net passive income in 1990.

3. Intercompany Transactions

Transactions such as sales between members of the same group require special rules. Generally, the regulations provide that the income or deductions of the selling member in such an intercompany transaction are treated as arising from the activity to which the related deduction of the purchasing member is attributable. [520]

520 Regs. §1.469-1T(h)(6)(ii)(A). The consolidated return regulations and the definition of an intercompany transaction are discussed in ¶5310.

In the case of a deferred intercompany transaction, a similar rule is applied. [521] For example, when depreciable property is sold in an intercompany transaction, the selling member typically takes gain or loss into account as the purchasing member depreciates the property. In these circumstances, gain or loss of the selling member is deemed to arise from the activity to which the depreciation is attributable. Similarly, if deferred gain or loss is triggered into income because the property is sold outside the group or the selling or purchasing member leaves the group, then the selling member's gain or loss is characterized in accordance with the activity in which the property was used immediately before the gain or loss was triggered.

521 Regs. §1.469-1T(h)(6)(iii).

4. Gain on Disposition of a Member's Stock

Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account) is treated as portfolio income. [522] The regulations do not indicate whether the sale of all of a member's stock is considered a complete disposition of that member's activities by the group. As discussed in ¶2980.09, above, when a taxpayer completely disposes of an activity, losses attributable to that activity are no longer limited by the passive loss rules. Arguably, a corporation disposing of all the stock of a subsidiary should be allowed to use any suspended passive losses attributable to that subsidiary's activities in the consolidated tax return for the year of the sale, provided that no other member of the group continues to own an interest in those allocated. [523] Any loss remaining unused would then be allocated to the former subsidiary.

522 Regs. §1.469-1T(h)(7).

523 This is particularly appropriate since the losses have apparently reduced earnings and profits and therefore the basis of the subsidiary's stock under Regs. §1.1502-32. Cf. Regs. §5.1502-45(d).

¶2980.10 Publicly Traded Partnerships

¶2980.10.A. In General

As explained in ¶2980.02.G, above, a publicly traded partnership (PTP) is subject to the passive loss rules if it is treated as a partnership for tax purposes, either because it was in existence on December 17, 1987 or because it meets the passive-type income test. The passive loss rules are applied separately for each PTP in which a taxpayer owns an interest. [524] Thus, PTPs are subject to the passive loss rules on a partnership-by-partnership basis.

524 §469(k)(1). *See also* Regs. §1.469-10(b) which provides that for purposes of §469(k), a partnership is a publicly traded partnership only if the partnership is a publicly traded partnership as defined in Regs. §1.7704-1.

¶2980.10.B. Treatment of PTP Losses

Because PTPs are treated separately, net income from one PTP cannot be offset by losses from any other PTP or by any other passive losses. [525] Thus, a partner with net passive losses from a PTP cannot apply them against any other income.

525 §469(d)(1). Moreover, as explained in ¶2980.03.C.4.b, above, a partner cannot group the undertakings of a PTP with other undertakings in one activity. A partner must group the undertakings

of a PTP into activities as if the partner had no other undertakings.

Example (145)—*Treatment of PTP Losses*

B owns interests in PTP Y and PTP Z. In 1990 B has a loss from Y of $5,000 and net income from Z of $10,000. B cannot offset the income from Z with his loss from Y.

The partner must carry the losses forward and can either (i) use them to offset income from that particular PTP in a later year or (ii) use them when the partner disposes of his entire interest in the PTP.[526] Although income and loss attributable to a taxpayer's interest in the same PTP can generally offset each other, the legislative history indicates that losses from a PTP's trade or business cannot offset portfolio income of the PTP.[527] This rule, which can create a harsh result for a partner in a PTP, was intended to deter a PTP from owning portfolio investments.

526 See H.R. Rep. No. 495, 100th Cong., 1st Sess. (1987) at 951 (hereafter "1987 Conf. Rep.").
527 Id.

Example (146)—*No Offset Against Portfolio Income*

A purchases an interest in a PTP. In 1991 the PTP incurs a loss in its business but the PTP earns dividend income on its stock portfolio and interest on its working capital. A's share of the PTP's dividend and interest income cannot be offset by A's share of the PTP's business losses in 1991.

¶2980.10.C. Treatment of PTP Income

Although the current passive loss rules do not technically treat income from a PTP in the same manner as portfolio income, the IRS has stated that (1) forthcoming regulations will treat the net passive income from a PTP as investment income for purposes of the investment interest limitation rules[528] and (2) until the regulations are issued, an amount of a taxpayer's gross income for a taxable year from a PTP equal to the taxpayer's "net passive income" from the PTP will be treated as investment income.[529] By characterizing income from a PTP as investment income, the IRS permits it to be offset by investment interest and other investment expenses.

528 See the discussion of §163(d) in ¶2330.
529 See Notice 88-75, 1988-2 C.B. 386.

Example (147)—*Characterizing PTP Income as Investment Income*

A's share of a PTP's net passive income for 1991 is $20,000. A also has $10,000 of investment interest expense and $2,000 of other passive losses in 1991. A can deduct the investment interest expense from A's share of the PTP's net passive income. However, A cannot deduct the $2,000 of other passive losses from the remaining $10,000 of PTP net passive income.

¶2980.10.D. General Partners

Although these rules treat interests in PTPs like portfolio investments, a general partner's investment in a PTP is arguably not like that of a limited partner or a shareholder of a corporation. A general partner is more likely to be active in management of a PTP and is liable for all the PTP's debts. Nevertheless, the treatment of PTPs under the passive loss rules is applicable to all partners in a PTP including general partners.

¶2980.11 Interaction of Passive Loss Rules With Other Code Provisions

¶2980.11.A. Business or Rental Use of a Personal Residence

If an activity involves the use of the taxpayer's personal residence and deductions attributable to such use are limited under the rules for business use of a home or rental of vacation homes, any gain, loss, income or deduction allocable to the use of the personal residence is not taken into account for purposes of applying the passive loss rules. [530]

[530] §469(j)(10). See discussion of §280A in ¶2460.

¶2980.11.B. Investment Interest Limitation

A taxpayer's deductions for investment interest are generally limited to the taxpayer's net investment income.[531] The investment interest limitation does not apply to any interest that is taken into account in determining whether there is passive activity income or loss.[532] However, during the phase-in period discussed in ¶2980.12.E, below, the allowance of certain PALs under the transitional rule may reduce net investment income.

[531] See discussion of §163(d) in ¶2330.

[532] §163(d)(3)(B)(ii).

An elective transition rule is available for investment interest that (1) was disallowed under the investment interest limitation rule in pre-1987 taxable years, (2) can be carried forward to the first taxable year beginning after 1986 and (3) is allocable to a passive activity.[533] Under this rule, a taxpayer may elect to treat the carryover investment interest deduction as a PAD subject to the passive loss rules rather than the investment interest limitation rules in the first post-1986 year.[534] The general passive loss phase-in rules do not apply to this amount.

[533] TAMRA §1005(c)(11).

[534] See Notice 89-36, 1989-1 C.B. 677, which provides guidance for making the election.

¶2980.11.C. State and Local Tax Deductions

A taxpayer's deductions for state and local taxes are subject to the passive loss rules if incurred in a passive activity.[535] State and local income taxes, however, are never treated as passive.[536]

[535] See Conf. Rep. 99-841 at II-139.

[536] Regs. §1.469-2T(c)(7)(iii) and Regs. §1.469-2T(d)(2)(vi).

¶2980.11.D. Partnership and S Corporation Basis Rules

If a partner's or an S corporation shareholder's loss is disallowed under the applicable basis limitation rule, a ratable share of the partner's or shareholder's share of each item of deduction or loss of the partnership or S corporation is disallowed for the taxable year under the passive loss rules.[537]

[537] Regs. §1.469-2T(d)(6)(ii). These rules are discussed in more detail in ¶2980.06.C.4.b and c, above.

¶2980.11.E. At-Risk Rules

The determination of a whether a loss is not allowed in a taxable year under the at-risk rules (discussed in ¶2970) is made before the application of the passive loss rules.[538] If a loss is disallowed under the at-risk rules, a ratable portion of each deduction from the activity as defined for at-risk purposes is deemed to have been disallowed.[539] When a loss is allowed under the at-risk rules, it then becomes subject to the passive loss rules if incurred in a passive activity. The character of the activity is determined at that time.[540]

[538] Regs. §1.469-2T(d)(6)(i). This rule is discussed in more detail in ¶2980.06.C.4.d, above.

[539] Regs. §1.469-2T(d)(6)(iii).

[540] Regs. §1.469-2T(d)(8).

¶2980.11.F. Capital Loss Limitation

The capital loss limitation rule (discussed in ¶1610) limits deductions for capital losses to the amount of capital gains, plus $3,000 for individuals. The capital loss limitation is applied after the application of the passive loss rules.[541]

[541] Regs. §1.469-1(d)(2).

Example (148)—*Capital Loss Limitation*

A has a capital loss of $20,000 incurred in a rental activity in 1990. A has no other items of gain or loss from the rental activity and has a $20,000 capital gain from a disposition of property not used in a passive activity in 1990. The $20,000 loss is disallowed under the passive loss rules in 1990.

In 1992, A completely disposes of his interest in the passive activity for a $10,000 gain and has no other items subject to the passive loss or capital loss limitation rules. A's $20,000 loss from 1990 is allowed in full under the passive loss rules. However, under the capital loss limitation rules, only $13,000 of A's loss is allowable in 1992. The remaining loss of $7,000 is available as a carryover to later years.

¶2980.11.G. Net Operating Loss Deduction

Any PAL that is allowable in a taxable year by reason of a complete disposition becomes a net operating loss in that year if the loss exceeds the taxpayer's nonpassive income. The passive loss rules do not again limit this loss in any subsequent year.[542] As discussed in ¶2980.12.A, below, net operating losses carried over from years beginning before January 1, 1987 are not limited under the passive loss rules.[543]

[542] Regs. §1.469-2T(d)(2)(ix).

[543] 1986 TRA §501(c)(2).

¶2980.11.H. Alternative Minimum Tax

The passive loss rules apply in determining alternative minimum taxable income (AMTI) and generally apply in the same way for alternative minimum tax (AMT) as for regular tax purposes. Thus, in computing the AMT, a taxpayer must determine which items of income, loss or credit as determined for AMT purposes must be characterized as PAGI, PADs and PACs. The use of PALs is then limited for AMT purposes as it is for regular tax purposes. However, because the items described above may differ in amount for AMT and regular tax purposes, a taxpayer's regular tax PAL and his AMT PAL may differ. Thus, it is necessary for taxpayers to compute PALs for both regular and minimum tax purposes each year.

In addition, the passive loss rules are applied differently for AMT purposes in two respects. The passive loss phase-in rules, discussed in ¶2980.12.E, below, do not apply for AMT purposes and therefore no passive losses are allowable against nonpassive AMTI.[544] Secondly, the loss disallowed under the passive loss rules as applied for AMT purposes is reduced by the amount by which the taxpayer is insolvent as of the close of the taxable year.[545]

[544] §58(b).

[545] §58(c)(1). A taxpayer is insolvent by the amount that the taxpayer's liabilities exceed the fair market value of his assets.

Once AMT adjustments and preference items relating to a PAL have been accounted for in computing a PAL for AMT purposes, the losses and preference items should not be accounted for again on other lines of the AMT form.[546]

[546] See Form 6251 for individuals, Form 4626 for corporations, Form 8656 for fiduciaries (for years beginning before 1992) and Form 1041 Schedule H for fiduciaries (for years beginning after 1991).

Example (149)—*AMT Calculation of PAL Items*

A uses a PAL of $8000 from a rental activity to offset passive income of $8000. The PAL must be recomputed for AMT purposes. For regular tax purposes, A claims accelerated depreciation of $20,000 on a building used in the rental activity. In recomputing the PAL for AMT purposes, A claims $12,000 under the straight-line method of depreciation. This effectively reduces A's PAL by $8,000 for AMT purposes. If no other items affect A's PAL from the rental activity for AMT purposes, the PAL is reduced to zero. Thus, the $8,000 of passive income will not be offset for AMT purposes and will therefore be subject to AMT.

¶2980.12
Effective Dates and Transition Rules

¶2980.12.A. In General

The passive loss rules generally apply to taxable years beginning after December 31, 1986.[547] However, the passive loss rules do not apply to any loss, deduction or credit carried to a taxable year beginning after December 31, 1986, from a taxable year beginning before January 1, 1987.[548]

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[547] 1986 TRA §501(c)(1); Regs. §1.469-11(a)(3).

[548] 1986 TRA §501(c)(2).

Example (150)—*Effective Date*

A, a calendar year taxpayer, purchased a building used in a rental activity in 1986. A incurred losses from the rental activity of $20,000 in 1986 and $30,000 in 1987. A was not able to use these losses during the years in which they occurred. A's carryover loss from 1986 is not a PAL and can be used to offset any income. A's loss in 1987 is a PAL.

¶2980.12.B. Low-Income Housing

There is a special transition rule for any loss sustained by a "qualified investor" from an interest in a "qualified low-income housing project" if the loss is sustained during the "relief period."[549] The use of this relief provision precludes the use of low-income housing credits.[550]

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[549] 1986 TRA §502.

[550] *But see* Rev. Rul. 97-4, 1997-3 I.R.B. 6, where the IRS ruled that 1986 TRA §502(e)(3) does not prevent a taxpayer from claiming a low-income housing credit under §42(a) for a building purchased in 1995 from a seller who was allowed the transition rule benefits. The IRS observed 1986 TRA §502(e)(3) prevents a taxpayer from obtaining a simultaneous benefit under 1986 TRA §502 and §42(a) by providing that no §42(a) credit is available "with respect to any project with respect to which any person has been allowed to benefit under [Act § 502]." It reasoned that the transition rule benefits are not available to the seller after the taxpayer's credit period began (*i.e.*, in 1996 and future years) and, therefore, no simultaneous tax benefit is available after that date.

A "qualified investor" is a natural person who holds, directly or indirectly, an interest in a qualified low-income housing project, provided that (1) the investor is required to make 50% or more of his required capital contributions after December 31, 1986, (2) the investor holds the interest on December 31, 1986, if the project was placed in service after August 16, 1986, or on August 16, 1986, if the project was placed in service before that date and (3) the investor made his initial investment in the project after December 31, 1983.[551]

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[551] See TAMRA §1005(b)(1).

A "qualified low-income housing project" must satisfy the following requirements:

- it meets certain statutory and certification requirements relating to its low-income status;
- it is constructed or acquired pursuant to a binding written contract entered into on or before August 16, 1986; and
- it is placed in service before January 1, 1989.[552]

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[552] 1986 TRA §502(c).

The "relief period," during which losses from a qualified low-income housing project are not treated as passive, commences with the taxable year in which the taxpayer makes his initial investment and ends on the earliest of (1) the sixth taxable year after the year of the initial investment, (2) the first taxable year after the taxable year in which the taxpayer is obligated to make his last investment or (3) the last taxable year in which the project is a qualified low-income housing project.[553]

[553] 1986 TRA §502(b).

¶2980.12.C. Recharacterization Rules

As discussed in ¶2980.07, above, there are certain rules that recharacterize passive income as either portfolio or active business income. Except for the rule that recharacterizes income from SIPPAs as active income (discussed in ¶2980.07.B.1, above), the other recharacterization rules are not applicable to any taxable year beginning before January 1, 1988.[554] The SIPPA rule applies to all taxable years beginning after December 31, 1986.

[554] Regs. §1.469-11(c)(1)(i).

There is also a special effective date for the recharacterization rule that applies to self-rented property (discussed in ¶2980.07. B.3, above). A taxpayer's net rental activity income from the rental of property for any taxable year beginning after December 31, 1987, does not include the portion of the income that is attributable to the rental of the property pursuant to a written binding contract entered into before February 19, 1988.[555]

[555] Regs. §1.469-11(c)(1)(ii).

¶2980.12.D. Pre-Enactment Events

The treatment for any taxable year beginning after December 31, 1986 of any item of income, gain, loss, deduction or credit as an item of PAGI, PAD or PAC is determined as if the passive loss rules had been in effect for taxable years beginning before January 1, 1987, but without regard to PALs or PACs that would have been disallowed if the rules had been in effect.[556] However, a taxpayer will be treated as materially participating in an activity for years prior to 1987 only if the taxpayer satisfies the 500-hour test discussed in ¶2980.04.C.1, above.[557]

[556] Regs. §1.469-11(c)(3).
[557] Regs. §1.469-5T(j).

¶2980.12.E. Transition Rule

1. In General

The passive loss rules are phased-in for taxable years beginning after December 31, 1986, and before January 1, 1991.[558] For these taxable years, the passive loss rules do not apply to an amount of PALs and PACs from "pre-enactment interests" equal to the "applicable percentage."[559] The applicable percentage of the PAL or PAC is as follows:[560]

```
Taxable Year    Applicable
Beginning In    Percentage
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1987	65%
1988	40%
1989	20%
1990	10%

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558 §469(m). The phase-in does not apply for AMT purposes.
559 §469(m)(1).
560 §469(m)(2).

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2. Pre-Enactment Loss or Credit

A taxpayer's loss from a pre-enactment interest is defined as the lesser of:

- the amount of the PAL for the taxable year; or
- the amount of the PAL for the taxable year taking into account only pre-enactment interests and without regard to any PALs carried over from a prior year.[561]

A similar rule applies for purposes of determining a taxpayer's credits from pre-enactment interests.[562]

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561 §469(m)(3); Regs. §1.469-11T(b)(3). **Note:** Regs. §1.469-11T(b) and Regs. §1.469-11T(c) (regarding pre-enactment losses and credits and pre-enactment activities) were not finalized by T.D. 8417, because these rules related to the application of the phase-in rules of §469(m) which were applicable only for taxable years beginning in 1987 through 1990.
562 Regs. §1.469-11T(b)(4).

Example (151)—*Pre-Enactment Interests*

A owns an interest in two passive activities, X and Y. A's interest in Activity X is a pre-enactment interest while A's interest in Activity Y is not. For 1987 A has a $10,000 loss from Activity X and $9,000 of income from Activity Y. A's pre-enactment loss is $1,000, which is the lesser of the amount of his PAL ($1,000) or his PAL taking into account only pre-enactment interests ($10,000). As a result, A is entitled to treat $650 ($1,000 x .65 (1987 applicable percentage)) as a loss that is not a PAL in 1987.[563]

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563 This example is based on Regs. §1.469-11T(b)(5), Example (1).

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3. Pre-Enactment Interest

The phase-in rule applies only to a "pre-enactment interest." A pre-enactment interest is a "qualified interest" in a "pre-enactment activity."[564] A qualified interest in an activity is an interest that was held by the taxpayer on October 22, 1986, and at all times thereafter, provided that the activity existed on October 22, 1986.[565] In addition, a qualified interest includes an interest in an activity acquired after October 22, 1986, pursuant to a binding written contract to which the taxpayer was a party on October 22, 1986, and held by the taxpayer at all times thereafter.[566] For purposes of this rule, stock in a C corporation is not treated as an interest in an activity. Thus, an activity acquired after October 22, 1986, through the liquidation of a corporation is not a qualified interest.[567]

[564] Regs. §1.469-11T(c)(1).

[565] Regs. §1.469-11T(c)(2)(i)(A). Because the undertakings included in an activity may change, the test is applied to each undertaking. To qualify, an undertaking must continue business or rental operations held on Oct. 22, 1986 and thereafter.

[566] Regs. §1.469-11T(c)(2)(i)(B). This test is also applied to the undertakings included in any activity. A contract is treated as a written binding contract of a person if the contract is enforceable against the person under state law and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). Regs. §1.469-11T(c)(7).

[567] Regs. §1.469-11T(c)(2)(ii).

An activity is a pre-enactment activity if either (1) the business and rental operations of the activity continue to be business and rental operations conducted by any person on October 22, 1986, or (2) at least 50% by value of the property used in the activity during the taxable year was either in existence or under construction on August 16, 1986, or acquired or constructed by a person pursuant to a written binding contract (without regard to whether the taxpayer was a party to the contract) in effect on August 16, 1986.[568] For purposes of applying this rule, it does not matter whether the activity would have been treated as a passive activity of the taxpayer for any taxable year beginning before January 1, 1987.[569]

[568] Regs. §1.469-11T(c)(3)(i).

[569] Regs. §1.469-11T(c)(3)(ii).

Example (152)—*Pre-Enactment Activity*

On Oct. 22, 1986, A owned an interest in property used as a personal residence. After Oct. 22, 1986, A ceased to use the property as a personal residence and began to use it in a rental activity. The rental activity is a pre-enactment activity because the property used in the rental activity was in existence on Aug. 16, 1986. However, A did not hold any interest in the rental activity on Oct. 22, 1986, because the activity did not exist on that date. In addition, A did not acquire an interest in the activity after Oct. 22, 1988, pursuant to a written binding contract to which A was a party on that date. Thus, A's interest in the rental activity is not a qualified interest and A does not have a pre-enactment interest in the rental activity.[570]

[570] This example is based on Regs. §1.469-11T(c)(4), Example (1).

4. Change in Interest

For purposes of the phase-in rule, the taxpayer's pre-enactment interest in the activity can only decrease from the amount of his interest as of October 22, 1986.[571]

[571] Regs. §1.469-11T(c)(5)(i).

Example (153)—*Change in Interest*

A has a 50% interest in an activity on Oct. 22, 1986. Even if A's interest increases to 75% on Jan. 1, 1987, A can only treat 50% as his pre-enactment interest. If A's interest decreases to 30% on Jan. 1, 1987, A's pre-enactment interest is 30%.

A partnership termination due to a sale or exchange within a 12-month period of more than 50%

in capital and profits does not by itself cause a partner's share of any item from a pre-enactment interest to increase or decrease.[572]

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[572] Regs. §1.469-11T(c)(5)(ii). Partnership terminations under §708(b)(1)(B) are discussed in ¶4050.

PRACTICE AIDS

¶2980.100 Client Letter

Classification of Separate Undertakings Under Regs. (Generally effective for taxable years ending after May 10, 1992).

Go to start of chapter

I am writing in response to your inquiry about the effect of the passive loss rules on your investment in a partnership which owns a health club and a sporting goods store. I understand that the health club, taken alone, runs at a loss and the sporting goods store is profitable. This letter summarizes the important factors you should consider in determining the effect of the passive loss rules on your investment in the partnership.

The passive loss rules apply to you as a partner rather than to the partnership. If your ownership of the health club or the sporting goods store is a passive activity, any losses or credits from that activity can be used only against passive income.

In order for the business not to be a passive activity, you must materially participate in the operations of the business. Material participation generally means that your involvement in the business operations is regular, continuous and substantial. The IRS regulations provide quantitative tests for meeting this requirement. For example, you will be materially participating if you work more than 500 hours during the year in the business. You are much more likely to meet the material participation standard under these tests if you make your investment as a general partner. If you invest as a limited partner, only the 500-hour test will be available to you.

Whether the club and the store constitute one or two activities for purposes of the passive loss rules depends on several factors. Some factors are:

• 1. Are the club and the store operated at the same locations or within close proximity of each other?

• 2. Are the club and the store operations similar?

• 3. Do either the club or the store provide any goods or services to each other?

• 4. Are the club and the store operated under the same trade name and do they have the same customers?

If the club and the store constitute one activity, you can use the club's loss against the store's profit. In addition, you can aggregate the time you spend working in either the club or the store to determine whether you meet the material participation standard.

If they are separate activities, one or both of the activities may be passive activities. Since you anticipate having an overall loss form the partnership for several years, we should meet to discuss the details of your investment and to determine whether your losses will be subject to the passive loss limitations.

¶2980.200 Client Letter

Effect of Passive Loss Rules on Choice of Entity

Go to start of chapter

At our meeting last week about incorporating your textile business, we discussed the advantages of electing S corporation status. I also want to explain the effect of the passive loss rules on your decision to incorporate as a C or an S corporation.

If you elect S status, the passive loss rules will apply to you individually as a shareholder rather than to the corporation. Thus, your participation alone will control whether the business is a passive activity with respect to your share of the losses of income from the business.

If the corporation is a C corporation, the corporation itself will be subject to the passive loss rules because four individual shareholders equally own 25% of the corporation's stock. In this case, the corporation's participation depends on the participation of its shareholders and the corporation may not be able to meet the material participation test because of the limited involvement of three of the shareholders. However, there is another test available which looks to participation by employees and we should discuss whether the corporation could meet this test. If the business is a passive activity, the corporation will not be able to use its losses from the business to offset its dividend and interest income. It will be allowed to use its losses to offset any active business income it generates.

The passive loss rules are therefore an additional factor you must consider in deciding whether the corporation should elect S status. We will be happy to discuss these issues with you at your convenience.

¶2980.300

ANNOUNCEMENT 98-12, 1998-8 I.R.B. 43 (2/23/98)

Go to start of chapter

Completing Form 8582 Worksheets for More Than One Passive Activity With Schedule D (Form 1040) Transactions

Announcement 98-12

The 1997 instructions for Form 8582, Passive Activity Loss Limitations, included an example of how to complete the worksheets for Form 8582 when the filer has one passive activity with Schedule D (Form 1040) transactions.

In response to requests for clarification on how to complete the worksheets if the filer has more than one passive activity with Schedule D (Form 1040) transactions, we have developed the following example:

Example of Schedule D (Form 1040) Transactions

The taxpayer had the following Schedule D (Form 1040) transactions from two activities in 1997.

Activity I

A passive activity prior year unallowed long-term capital loss (a 28% rate loss) of ($1,000), and a loss on a May 8, 1997, sale of an asset held more than 12 months (a 20% rate loss) of ($3,000).

Activity II

A loss on a July 30, 1997, sale of an asset held more than 12 months but not more than 18 months (a 28% rate loss) of ($230), and net income of $1,000 from Schedule E (Form 1040).

Worksheet 2

The activities were reported separately on worksheet 2. Activity I had an overall loss of ($4,000) (current year net loss of ($3,000) and a prior year unallowed loss of ($1,000)). Activity II had an overall gain of $870 (current year net income of $1,100 less current year net loss of ($230)). Line 11 of Form 8582 shows a loss allowed of ($1,100).

Worksheet 4

Activity I has an unallowed loss of ($3,130). (Line 3 Form 8582 ($3,130) less line 9 of Form 8582 (-0-) x 100%). All of the ($230) loss is allowed for Activity II.

Worksheet 6

Use Worksheet 6 to figure the portion of the unallowed loss attributable to the 28% rate loss and the portion to the 20% rate loss.

Enter the loss attributable to the 28% rate loss ($1,000) and the loss attributable to the 20% rate loss ($3,000) as separate entries in Worksheet 6 (i.e., as if they were going to be reported on a different form or schedule). Then figure the ratio of each loss to the total of the two losses as follows. $1,000/$4,000 = .25. $3,000/$4,000 = .75. Multiply each of these ratios by the unallowed loss for Activity I shown in column (c) of Worksheet 4 ($3,130).

Unallowed losses for Activity I:

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28% rate loss: .25 x $3,130 = $782.50
20% rate loss: .75 x $3,130 = $2,347.50
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Allowed losses for Activity I:

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28% rate loss: $1,000 - $782.50 = $217.50
20% rate loss: $3,000 - $2,347.50 = $652.50
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The total loss allowed for Activity I ($870.00) is entered in column (f), Part II, Schedule D (Form 1040) and the 28% rate loss ($217.50) is entered in column (g). Keep a record of the unallowed 28% and 20% rate losses to figure the passive activity loss for these transactions next year.

