Passive Activity Losses Under the Internal Revenue Code of 1986

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PASSIVE ACTIVITY LOSSES
UNDER THE INTERNAL REVENUE CODE OF 1986

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PASSIVE ACTIVITY LOSSES
UNDER THE INTERNAL REVENUE CODE OF 1986

I. OVERVIEW.

The purpose of the rules concerning passive activity losses ("PALs") is to disallow the utilization of deductions and credits from passive activities to offset income which is not from passive activities, e.g., salaries, interest, dividends, and “active” business income. Passive activities generally include (A) any trade or business activity in which the taxpayer does not materially participate and (B) any rental activity. The PAL rules apply to individuals, estates, trusts, certain closely-held C corporations and certain personal service corporations. Deductions from passive activities can only offset the income from other passive activities until the taxpayer disposes of his interest in the passive activity. In addition, there are numerous special rules, including rules for the recharacterization of income, the treatment of oil and gas wells and publicly traded partnerships, and certain rental real estate activities in which certain taxpayers actively participate. A phase-in rule affects the utilization of PALs with respect to any passive activity in which the taxpayer owned an interest prior to the date of enactment.

The economic impact of the PAL rules is substantial. According to the IRS Statistics of Income Study, during 1987, partners in partnerships had $10 billion of losses disallowed by the PAL rules. See 90 TNT 106-33 (SOI Bulletin, Winter 1989-90, vol. 9, no. 3). This number should significantly increase as the PAL rules are fully phased in with respect to activities acquired prior to 1987.

This outline generally follows the steps which a taxpayer or his tax advisor must take in applying the PAL rules. This outline reflects the first set of PAL regulations issued in February 1988 (the “February 1988 Regulations”) and the second set issued in May of 1989 (the “May 1989 Regulations”). The regulations issued to date are temporary and proposed regulations which include the following topics:

C. Treas. Reg. Section 1.469-3T, Passive Activity Credit.
D. Treas. Reg. Section 1.469-4T, Definition of Activity.
F. Treas. Reg. Section 1.469-11T, Effective Date and Transition.

II. TAXPAYERS SUBJECT TO THE PAL RULES.

A. In General. The first question that must be asked in analyzing the PAL rules is whether a taxpayer is subject to Section 469. See Section 469(a)(2). The PAL rules generally apply to:

1. Individuals;
2. Estates;
3. Trusts;
4. Closely-Held C Corporations; and
5. Personal Service Corporations.

1. Widely Held C Corporations. It is noteworthy that widely-held C corporations are not subject to the PAL rules. Such corporations will be the natural purchasers of tax advantaged investments. Congress examined this question and purposefully left tax advantaged investments available for such corporations. If the passive loss rules prove workable for individuals, however, application to widely-held corporations could be a logical next step for Congress.

B. Partnerships and S Corporations. The application of the PAL rules to individuals generally includes activities conducted through pass-through entities such as partnerships (both general and limited) and S corporations.
C. Closely-Held Corporations. A C corporation is considered closely-held and thereby subject to the PAL rules if it meets the stock ownership requirements of Section 542(a)(2) as modified by Section 465(a)(3). Treas. Reg. Section 1.469-1T(g)(2)(ii). Generally, corporations with 5 or fewer shareholders who own more than 50 percent of the stock in the corporation will satisfy this test. See Section 465(a)(1)(B) and Section 542(a)(2). For purposes of meeting this standard, certain attribution rules apply. See Section 544(a) and Section 465(a)(3). As explained below, the application of the PAL rules is significantly different for closely-held corporations than for other taxpayers subject to the PAL rules.

D. Personal Service Corporations. A personal service corporation is a C corporation the principal activity of which is the performance of personal services by any employee-owners, provided that such employee-owners own at least 10 percent, by value, of the corporation's stock. Section 469(j)(2); Treas. Reg. Sections 1.469-1T(g)(2)(i) and 1.441-4T(d).

1. Attribution. The attribution of ownership rules of Section 318 apply in modified form for purposes of determining personal service corporations. Section 469(j)(2); Section 269A(b)(2).

2. Employee Stock Ownership. A problem concerning personal service corporations is that stock owned by all employees, no matter how small the interest, is counted for purposes of the 10 percent requirement. Thus, a corporation that provides personal services and provides stock ownership to its employees could be subject to Section 469.

3. Personal Services Defined. A corporation is not a personal service corporation unless its principal activity is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. Treas. Reg. Section 1.469-1T(g)(2)(i).

E. Corporate Change in Status. A change in status (e.g., if a corporation ceases to be a closely held corporation) does not relieve the taxpayer from application of the PAL limitations with respect to losses and credits incurred during the period in which the taxpayer was subject to the PAL rule.

F. Affiliated Groups. The PAL rules will generally apply on a consolidated basis to an affiliated group of corporations filing a consolidated return. Section 469(j)(11); Treas. Reg. Section 1.469-1T(h)(1).

G. Taxable v. Tax-Exempt Corporation. The PAL rules do not distinguish between corporations that are taxable entities and those that are exempt from taxation.

H. Special Classes of Corporations. If a corporation satisfies the definition of either a closely held corporation or a personal service corporation (Treas. Reg. Section 1.469-1T(g)(2)), the corporation will be subject to Section 469 even if other special rules apply to the corporation. Thus, Section 469 could apply to cooperatives, banks, trusts, foreign corporations, and other special types of corporations.

I. Trusts. Section 469 applies to all trusts except grantor trusts described in Section 671. Treas. Reg. Section 1.469-1T(b)(3). Grantor trusts are generally treated the same as other pass-through entities, i.e., the Section 469 limitations are applied directly to the grantor. But compare Treas. Reg. Section 1.469-2T(e) which contains special computational rules that apply to partnerships and S corporations but not to grantor trusts.

III. DEFINITION OF ACTIVITY.

A. Background.

1. Determination of Activities. If a taxpayer is subject to the PAL rules, the next step is to determine the "activities" in which the taxpayer is engaged. Each taxpayer will have to calculate the taxable income or loss from each of his activities. The activity concept is the cornerstone of Section 469. In order to apply the PAL rules, the scope of a taxpayer's activities first must be identified by determining which operations of the taxpayer are attributable to which
activities. Next, the activity must be classified as either (a) a rental activity, or (b) a trade or business activity. Once the scope and classification of the activity has been identified, the initial determination of the character of such income or loss from the activity can be made.


4. ABA Suggests Simpler Approach. The American Bar Association Section of Taxation has proposed two alternatives for a simplified version of the activity definition, each of which is discussed below. Both proposed alternatives are dramatically shorter than Treas. Reg. Section 1.469-4T, which exceeds 200 typewritten pages, double-spaced.

B. Statutory / Legislative History Definition of Activity. Section 469 does not provide an explicit definition of "activity." The guidance obtained from the legislative history has not necessarily been followed in the May 1989 Regulations. According to the Senate Finance Committee Report, S.Rep. No. 99-313 98th Cong., 2d Sess., reprinted in 1986-3 C.B. Vol. 3 ("’86 Sen. Rep.") at page 739, an activity consists of the "undertakings [which] consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss."

1. Facts and Circumstances. The determination of what makes up an activity is to be made on the basis of all of the facts and circumstances. See ’86 Sen. Rep. at 738-741.

2. Section 183. Analogy is made in the ’86 Sen. Rep. at page 739 to the rules under Section 183 to determine whether an activity constitutes a hobby. The provision in Treas. Reg. Section 1.183-1(d)(1) that a taxpayer's characterization will apply unless it is unduly artificial, however, will not be applied for PAL purposes. ’86 Sen. Rep. at 739.

3. Different Products and Services. Providing two or more substantially different products or services generally results in two or more activities. ’86 Sen. Rep. at 739. Different stages in the production and sale of a product that are not carried out in an integrated fashion generally are separate activities. The appliance and clothing sections of a department store, however, would be treated as one activity. Id.

4. Common Management. The existence of common management does not establish that separate types of undertakings should be treated as a single activity. ’86 Sen. Rep. at 740. Thus, two stores in different locations would not be presumed to be a single activity even if the stores share management.


6. Real Estate Projects. Each separate rental real estate project (including an integrated group of buildings) will generally be treated as a separate activity. ’86 Sen. Rep. at 740. Thus, for example, a taxpayer who owns two rental office buildings in separate locations is engaged in two activities. The construction and development phase of a real estate project, however, is treated as a separate activity from owning and leasing the developed property. ’86 Sen. Rep. at page 743. Management of a real estate project may also give rise to a separate activity.

a. Integrated Project. An integrated apartment project or shopping center generally will be treated as a single activity. ’86 Sen. Rep. at 740.
7. Special Treatment Undertaking. Any undertaking that is accorded special treatment under Section 469 is not treated as part of the same activity as any undertaking that does not receive such treatment. '86 Sen. Rep. at page 741. For example, a rental activity cannot be part of the same activity as a working interest in oil and gas. According to the Explanation of the Tax Reform Act of 1986 by the Joint Committee on Taxation (the “Blue Book”), this rule extends to any income received for providing services as an employee, which is intrinsically not a passive activity. Blue Book, at 247.

8. Impact of Legal Entities. According to the '86 Sen. Rep., legal entities are disregarded in determining what constitutes an activity. SFC at page 740. As discussed below, the May 1989 Regulations, however, do not disregard legal entities and in fact create separate undertakings whenever a separate entity is present. A single partnership could be involved in numerous activities. Conversely, a single activity could be conducted by several legal entities. The material participation and rental activity test, discussed below, are applied on an activity-by-activity basis. Every pass-through entity apparently will need to separately report to its investors each “activity” in which it is engaged. A partnership will be required to report each activity separately on its schedule K-1. See Tax Notes (Feb. 8, 1988) at 543.

9. Incidental Activities. Whether an activity is separate from a related activity depends upon whether the former is incidental to the latter.

C. Broad v. Narrow Definition of Activity. The difference between a broad definition of activity and a narrow one is of critical importance to taxpayers. The legislative history indicates that a narrow definition of activity may be appropriate. See '86 Sen. Rep. at 736-740. Such a narrow definition makes it more difficult for taxpayers to create active losses. On the other hand, prior to issuance of the May 1989 Regulations, IRS and Treasury officials indicated that they were considering a relatively broad definition that would be easier to administer and would make it more difficult for taxpayers to create passive income.

Taxpayers with trade or business losses generally desire a broad definition of activity so that the time they spend in various operations of that activity will count toward satisfying the material participation tests. For example, assume that a taxpayer spends 501 hours participating in one grocery store and 50 hours participating in a second grocery store. The easiest way to create active losses from the second grocery store would be to identify the two grocery stores as one activity, not two. Likewise, farmers generally want a broad definition of an activity so that the losses from multiple fields or crops can be treated as active losses.

On the other hand, if a taxpayer desired passive income or had suspended passive losses he would like to use, a narrow definition of activity would be desired. For example, in the grocery store example above, if the taxpayer had income from the 50 hour participation grocery store and rental passive losses from two apartment buildings, the taxpayer would desire a narrow definition of activity. A narrow definition of activity would allow the 50 hour participation grocery store to be a separate trade or business activity in which the taxpayer would not materially participate. Thus, the income from the 50 hour participation grocery store would be passive. Second, if the taxpayer sold one of his two rental buildings, he would want a narrow definition of activity. If each building were a separate activity, any suspended losses attributable to a particular rental building could be freed upon disposition of that single rental building without regard to whether the taxpayer disposed of the other rental building. If the two buildings were treated as a single activity, disposition of both buildings would be required to free suspended losses from either building.

1. The Curious Predicament of the Real Estate Entrepreneur. Losses generated by rental real estate activities are per se passive losses. At the same time, income from non-rental real estate activities (i.e., fee generating undertakings such as management, construction and development) will be active income to any taxpayer who materially participates in those activities. Thus, a real estate entrepreneur will be able to offset passive losses from his rental activities against income from his non-rental activities only if he does not significantly or materially participate in his non-rental real estate activities. In other words, by materially or significantly participating in his real estate business, a real estate entrepreneur may be foreclosed from offsetting his real estate income with his real estate losses. This applies to not only depreciation and other non-recourse debt funded losses, but also to out-of-pocket cash funded losses of the taxpayer.
a. Narrow Definition Desired. A real estate entrepreneur would desire a narrow definition of activity. For example, if each project that a real estate entrepreneur manages, develops or constructs were a separate activity, income from each project would be passive if the real estate entrepreneur spends 100 or less hours in each activity. With a narrow definition of activity, the real estate entrepreneur would have passive income to offset passive losses from rental activities. If, however, all non-rental real estate operations of a real estate entrepreneur are one activity, it would be virtually certain that a full-time real estate entrepreneur would significantly or materially participate in that single non-rental real estate activity. Thus, his income from non-rental real estate activities would be active income, while his losses from rental real estate would be passive. For a full-time rental real estate entrepreneur, therefore, a broad definition of activity could be disastrous.

b. Possible Legislative Relief. Two bills introduced in 1990, H. R. 3732 and S. B. 2384, would provide relief for real estate entrepreneurs by modifying the per-se passive rule for rental properties. Under the bills, full-time real estate entrepreneurs would be permitted to combine rental real estate operations with commonly controlled fee generating non-rental real estate operations, thus avoiding the mismatch of passive rental losses and active fee income.

2. Elective Broad Definition of Activity. It was suggested prior to issuance of the May 1989 Regulations that a narrow definition of an activity, consistent with the '86 Sen. Rep., could be coupled with an elective provision to permit taxpayers (with the consent of the Service) to treat several activities as one. This elective approach would prevent abuses yet recognize the impact of a narrow definition of an activity when coupled with the test for material participation. See Lipton & Evaul, TaxNotes (Dec. 8, 1986) at 969; Lipton & Evaul, TaxNotes (June 15, 1987) at 1139; Evaul & Lipton, Tax Notes (Jan. 16, 1989) at 337; American Bar Association Section of Taxation, Comments on Passive Activity Losses Regulations, reprinted in Tax Notes Highlights & Documents (Nov. 14, 1988) at 1263.

a. Example. Suppose a taxpayer owned three grocery stores as in the above examples. Under a narrow definition of activity, each store would probably be treated as a separate activity. The taxpayer, however, could demonstrate that treatment of the stores as one activity for purposes of Section 469 would not be contrary to the Congressional intent behind Section 469. In such a case, the owner of the three grocery stores could elect a broad definition of activity and the Service would consent to the election. The real estate entrepreneur, however, could choose the narrow definition of activity as indicated in the legislative history and would have an opportunity to offset rental real estate losses against his fee income generating non-rental real estate activities.

D. Transitional Rule Definition of Activity for Tax Years Ending Before August 10, 1989. For taxable years ending before August 10, 1989, a taxpayer may use any reasonable method to define an activity. See Notice 88-94, 1988-2 C.B. 419 (August 29, 1988) and Treas. Reg. Section 1.469-4T(p). See Lipton: “A Flexible Transitional Rule for the Definition of an Activity,” 66 Taxes 658 (1988). Thus, a taxpayer appears to have the ability under the transitional rule to pick a definition anywhere between the narrow one proposed by the legislative history and the broad one articulated by Treasury and IRS officials. The relatively broad definition found in the May 1989 Regulations is clearly a reasonable definition.

1. Unreasonable Methods. Treas. Reg. Section 1.469-4T(p)(2) provides that a taxpayer’s method of defining activities will be unreasonable under any of the following five tests:

a. Rental / Trade or Business. A method is unreasonable if (d)(3) rental operations are treated as a part of a trade or business activity, unless such (d)(3) rental operations are ancillary to such trade or business activity.

b. Trade or Business / Rental. A method is unreasonable if non-(d)(3) rental operations are treated as a part of a rental activity, unless such non-(d)(3) rental operations are ancillary to a rental activity.

c. Oil and Gas Qualified Working Interest. A method is unreasonable if it includes in a passive activity an oil and gas well which would be a separate undertaking pursuant to Treas. Reg. Section 1.469-4T(e)(1).

d. Dwelling Unit. A method is unreasonable if it includes in a passive activity a dwelling unit that would be a separate activity under Treas. Reg. Section 1.469-4T(k)(7).
Inconsistent. A method is unreasonable if it is inconsistent with the method utilized in the taxpayer's first taxable year beginning after December 31, 1986. Thus, the positions taken on the taxpayer's 1987 and 1988 return must be consistent.

Planning Considerations. The transitional rule does not prioritize among the various options available. Thus, one taxpayer could properly determine that providing similar goods or services at various locations constitutes a single activity, while another taxpayer would be equally justified in determining that each location constitutes a separate activity. A taxpayer who owns a plant which manufactures machinery, and who also has a sales force which sells the machinery, would be justified in treating the business as one or two (or possibly more) activities. Similarly, a real estate developer who has construction projects in two separate locations could treat the projects as one or two activities. The owner of rental properties could treat each building as a separate activity, or he could combine all of the buildings into a single activity. A multifaceted real estate developer engaged in numerous potentially horizontally integrated operations (e.g., management, leasing, land sales, home sales, etc.) apparently could treat these operations as one activity or as separate activities.

Return Positions. For taxpayers who have made investments which are subject to Section 469, the transitional rule is an extremely important tool. There is, however, no universal planning prescription. Each taxpayer will have to examine his individual circumstances in order to determine the optimal definition of an activity for that taxpayer. A taxpayer should be able to construct reasonable "activities" which will minimize his ultimate tax liability for taxable years ending before August 10, 1989.

Taxpayer Considerations. What will a taxpayer need to consider in determining the separate activities in which the taxpayer has an interest? First, taxpayers who have excess passive losses will generally want to generate passive income. In such situations, a taxpayer may want to adopt a narrow definition of an activity for any profitable trade or business activities, thereby causing the income from such activities to be passive. On the other hand, if a trade or business activity incurs a loss, a taxpayer will often want to utilize a broad definition of an activity, thereby increasing the likelihood that the material participation test will be satisfied.

Separation Example. Assume that taxpayer X owns ten convenience stores and works an equal number of hours at each store. Altogether, X works 800 hours per year in the 10 stores combined. The ten convenience stores are each profitable. X also owns rental property which generates a loss. If X treats all ten convenience stores as a single activity, X will materially participate in the single activity. Thus, the income from the ten convenience stores will be active. As such, the income from the convenience stores cannot be offset by the loss from his rental activity. On the other hand, if X treats each convenience store as a separate activity and he works 80 hours or less in each store during the taxable year, the income from the passive stores will be passive activities which can be offset by the passive rental loss.

Aggregation Example. There will also be situations where taxpayers will want to aggregate activities. For example, assume that individual Y owns three separate farms on which he works 150 hours per year, and a fourth farm on which he works for 60 hours; each farm incurs a loss for tax purposes. If each farm were treated as a separate activity, the losses would all be passive. On the other hand, if Y treats the farms as a single activity, his participation level in the activity will exceed 500 hours. Thus, losses from the farming activity would be active losses which could offset any type of income.

Real Estate Considerations. The transitional activity definition may be most important to persons involved in the real estate industry. The per se treatment of rental activities as passive creates a problem for entrepreneurs, in that losses from rental activities cannot be utilized to offset income from construction and development activities in which the entrepreneurs materially participate.

Real Estate Example. For example, if a developer owns a rental activity that incurs a loss and is also involved in the construction of 10 office buildings for which the developer receives fees, the developer would want to offset the rental losses against the fee income. If the developer separates the construction business into 10 separate
activities, he may be able to establish that he does not materially participate in one or more of the developments, thereby causing those fees to be passive income that can be offset by the rental losses.

5. Amended Returns. What about taxpayers who have already filed their tax returns for 1987 and 1988? Because the transitional rule applies to all taxable years ending prior to August 10, 1989, such taxpayers appear to be entitled to file amended returns which adopt any reasonable definition of an activity. Thus, if X had treated his 10 convenience stores as a single activity in his 1987 and 1988 returns, X would be permitted to amend his return and adopt a different treatment.

6. Consistency. While the transitional rule reasonable definition of activity standard is flexible, it has limits. As noted above, the most serious is that an otherwise reasonable position must be consistent with that taken in the first taxable year beginning after December 31, 1986. Thus, a taxpayer could not group 3 stores together in 1987 to create an active loss and then separate the same 3 stores in 1988 to create passive income. A taxpayer who has taken an inconsistent position, however, should be able to amend his returns for taxable years ending before August 10, 1989 to create the required consistency.

7. Short Fiscal Year. As the transitional rule will apply for taxable years ending before August 10, 1989, will it be possible to generate income prior to such date and then terminate the flow-through entity? Will the transitional rule apply to partial years ending before August 10, 1989?


1. A Building Block Approach. The May 1989 Regulations provided the long awaited definition of “activity.” The Regulations provide a narrow definition of activity in certain circumstances, but for most taxpayers the definition is substantially broader than one might anticipate under the legislative history of Section 469. Treas. Reg. Section 1.469-4T defines the scope and character of a taxpayer’s activities by a building block process: “operations” are combined to form “undertakings,” and then “undertakings” are combined to form “activities.” Because the Regulations involve certain counterintuitive rules, it is necessary to follow the building block process step by step. Consider, for example, that “rental operations” can become part of a trade or business activity, while clearly non-rental operations can become part of a rental activity.

2. Identification of Operations. The threshold step in determining a taxpayer’s activities is the classification of each entity’s operations.

a. Business and Rental Operations. Only “business and rental operations” are subject to Section 469. In general, business and rental operations include all endeavors engaged in for profit other than investment endeavors. Included within business and rental operations are all endeavors that constitute a trade or business, endeavors conducted in anticipation of a trade or business, and endeavors in which taxable property is made available for use by customers. Treas. Reg. Section 1.469-2T(b)(2)(ii)(A).

b. Income-Producing v. Support Operations. The second step concerning operations is to divide business and rental operations (which may be subject to Section 469) into “income-producing operations” and “support operations.”

i. Income-Producing Operations. The income-producing operations of an entity are the business and rental operations at a location that relate to (or are conducted in reasonable anticipation of):

(A) The production of property at such location;

(B) The sale of property to customers at such location;

(C) The performance of services for customers at such location;
(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or

(E) Any other transactions that involve the presence of customers at such location. Treas. Reg. Section 1.469-4T(c)(2)(iv).

ii. Support Operations. Business and rental operations of an entity at a location are support operations if they involve the provision of property or services to operations of the same entity at a different location and are not otherwise income-producing operations. Treas. Reg. Section 1.469-4T(c)(2)(ii)(B).

iii. Mixed Income-Producing and Support Operations. In some situations, an entity’s operations at a single location will have to be divided into income-producing operations and support operations. See Treas. Reg. Section 1.469-4T(c)(4), Example (7).

3. Identification of Undertakings. Undertakings are the basic building blocks from which activities are constructed. There are five basic types of undertakings.

a. Rental Undertakings
   i. Rental real estate undertakings.
   ii. Other rental undertakings (created in the Regulations by negative inference only).

b. Trade or Business Undertakings
   i. Oil and gas working interest undertakings.
   ii. Professional service undertakings.
   iii. Other trade or business undertakings (referred to in the Regulations as “trade or business undertakings”).

Subject to the aggregation, integration and separation rules found in the activity identification process, the general rule is that a single undertaking will be a single activity. If aggregation or integration are appropriate, only undertakings of the same classification will be aggregated or integrated to create a single activity.

4. Identifying Undertakings: A Four (4) Step Process. Conceptually, it would appear logical that the scope of an undertaking would first be identified and then the undertaking would be classified. The undertaking identification process in the Regulations, however, is considerably more complex. Identification of the scope and class of an undertaking are so interrelated that it is easiest to follow a single process which identifies the scope and class of an undertaking. This outline analyzes the undertaking identification process as a four (4) step process.

a. Step One: Basic Rule - Identify Same Location, Same Entity Income-Producing Operations. First, identify all the income-producing operations of a single entity at the same location. Unless subdivided or aggregated below, all the same location, same entity income-producing operations will be a single undertaking. Thus, it is not possible to take the position that a single entity is engaged in numerous nonrental undertakings at a single location. In order to possibly create separate undertakings, multiple entities must be used.

b. Step Two: Exceptions to Basic Rule - Separate Certain Income-Producing Operations.
   i. Oil and Gas Working Interest Undertaking. Oil and gas wells subject to the qualified working interest rules are separated out to form a separate oil and gas working interest undertaking.
ii. Separated Rental Undertakings (80/20 Test). The (d)(3) rental operations of an entity at a location will be separated out to form a separate rental undertaking, but only if such (d)(3) rental operations generate between 20% to 80% of total gross income and would be a rental activity if tested separately. Same location, same entity (d)(3) rental operations generating in excess of 80% of total gross income are not separated out and are classified pursuant to step three, below.

c. Step Three: Classify Remaining Income-Producing Operations. Classify any remaining same location, same entity income-producing operations as (i) rental undertakings, (ii) professional service undertakings or (iii) other trade or business undertakings.

d. Step Four: Subclassify Rental Undertakings. Subclassify rental undertakings as (i) rental real estate undertakings, or (ii) other rental undertakings.

5. Identifying Activities. For Section 469 purposes generally, activities are either "rental activities" or "trade or business activities." For purposes of identifying activities, it is appropriate to subclassify rental activities and trade or business activities into five types of activities, each corresponding to and constructed from only one type of undertaking:

a. Rental Activities
   i. Rental real estate activities.
   ii. Other rental activities.

b. Trade or Business Activities
   i. Oil and gas working interest activities.
   ii. Professional services activities.
   iii. Other trade or business activities.

The rental activities are per se passive activities under Section 469(c)(2). Whether one of the three (3) types of trade or business activities is passive or active depends on the participation level of the taxpayer under Section 469(c)(1).

6. Identify Scope and Classification of Taxpayer's Activities. Each activity is composed of one or more undertakings of the same type. Except as provided below, each undertaking is a separate activity. For each of the five types of undertakings, however, there are special rules for aggregating undertakings of that type to create an activity of that type.

a. Rental Real Estate Activities. Each rental real estate undertaking is a separate rental real estate activity, but the taxpayer may elect to aggregate separate rental real estate undertakings into a single rental real estate activity.

b. Other Rental Activities. Each other rental undertaking, i.e., each rental undertaking which is not a rental real estate undertaking, is a separate other rental activity.

c. Oil and Gas Working Interest Activities. Each oil and gas working interest undertaking is a separate oil and gas working interest activity.

d. Professional Services Activities. Generally, each professional service undertaking is a separate activity. Multiple professional service undertakings, however, must be aggregated into a single activity, if any of the following three tests is met: (1) control, (2) same field/similar services, or (3) 20% same customers.
e. Other Trade or Business Activities (Aggregation). Generally, each other trade or business activity is a separate activity. Multiple other trade or business undertakings, however, are aggregated into a single activity, if each of the following three tests is met: (i) the separate undertakings are commonly controlled; (ii) the separate undertakings are vertically-integrated or in the same line of business; and (iii) the taxpayer has significant ownership in each undertaking or would materially or significantly participate in the combined undertakings.

f. Other Trade or Business Activities (Integration). Following aggregation of other trade or business undertakings, other trade or business activities must be integrated into a single activity, if (i) common control exists and (ii) the activity is economically integrated under a facts and circumstances test.

7. Elections. After a taxpayer has determined the various activities in which the taxpayer has an interest, the taxpayer must then decide whether the taxpayer will make an election to treat such activities differently (primarily for disposition purposes).

a. Elect Rental Real Estate Undertaking Subdivision or Aggregation. Each pass-through entity may elect to subdivide a rental real estate undertaking into multiple rental real estate undertakings, provided such subdivided real estate undertakings could be separately conveyed under local law. Also, each pass-through entity may elect to aggregate multiple rental real estate undertakings into a single rental real estate undertaking. A taxpayer owning an interest in an entity subject to this election is bound by the elections made by the entity. In addition, the taxpayer may elect to further aggregate rental real estate undertakings. To the extent not inconsistent with elections made by a pass-through entity through which a taxpayer owns an interest, a taxpayer may make the same elections.

i. Commentary. Under the Regulations as presently written, the election to separate rental units in a multi-unit building or project could be read as being available only if the building or project were presently subject to a condominium regime (and therefore separately conveyable at the time the election is made). Thus, the election would have little utility. It may be a better reading of the Regulations, however, to view the requirement of being conveyable under local law as met where a condominium regime could be granted under local law, whether or not the condominium regime was in place during the year in which the election is made.

b. Non-Rental Real Estate Activity Undertakings Disaggregation Election (Disposition Only). A pass-through entity may elect to treat each undertaking as a separate activity for disposition purposes only. To the extent not inconsistent with elections made by a pass-through entity through which a taxpayer owns an interest, a taxpayer may make the same elections. The election in no way impacts the definition of activity for purposes of determining the taxpayer's participation level.

8. Special Rules. Special rules apply to a taxpayer's operations conducted through non-pass-through entities, consolidated groups of corporations, and publicly traded partnerships.

9. Terminology Comment. While the structure of the Regulations appears to be largely sound, in a few cases confusingly similar terms are used for distinct concepts. For example, the Regulations discuss "rental operations," "rental undertakings," and "rental activities;" yet rental operations may never become part of a rental undertaking, while rental undertakings always become part of rental activities. To minimize such confusion, this outline modifies the terminology of the Regulations in a few particularly confusing cases described below:

a. "Business and Rental Operations." Treas. Reg. Section 1.469-4T(b) defines "business and rental operations." Despite the name, however, "business and rental operations" are divisible not into business operations and rental operations, but rather into income-producing operations and support operations. "Rental operations" are later defined, but business operations are not. Indeed, the term "business and rental operations" is best viewed as indicating the taxpayer's endeavors to which the limitations of Section 469 might apply.
b. Refer to “(d)(3) Rental Operations” Instead of “Rental Operations.” Treas. Reg. Section 1.469-4T(d)(3) defines “rental operations.” Since rental activities are made up of rental undertakings, one might incorrectly assume that rental undertakings are made up of rental operations. To the contrary, however, even an undertaking which is 100% rental operations may not qualify as a rental undertaking. This outline therefore modifies the term “rental operations” to be “(d)(3) rental operations.”

c. Refer to “Other Trade or Business Undertaking” Instead of “Trade or Business Undertaking.” Treas. Reg. Section 1.469-4T(f)(1)(ii) defines “Trade or Business Undertakings.” Since rental activities are made up of only rental undertakings, one might incorrectly assume that trade or business activities are made up of only trade or business undertakings. To the contrary, however, “trade or business undertakings” are just one of three types of undertakings which can make up a trade or business activity. As indicated above, a trade or business undertaking can be one of three types of undertakings: (a) professional service undertaking; (b) oil and gas working interest undertaking; or (c) other trade or business undertaking. This outline therefore modifies the term “trade or business undertaking” to be “other trade or business undertaking,” a term more indicative of the fact that this is the residual category of undertakings.

d. Refer to “Other Trade or Business Activity” Instead of “Trade or Business Activity (For Integration Purposes).” Treas. Reg. Section 1.469-4T(g)(1)(ii) defines “trade or business activity” to mean, solely for purposes of Section 1.469-4T(g) (the Integration Rules), an activity composed of what this outline refers to as other trade or business undertakings. The term “trade or business activity” has a well-established meaning under Section 469: an activity which is not a rental activity or investment activity. To use the same term to refer to a much narrower category of activities is to invite confusion. This outline avoids the confusion by referring to the narrower group of activities affected by the integration rules as “other trade or business activities.”

10. ABA Suggests Simpler Alternatives. The ABA Section of Taxation has proposed two alternatives for a simplified version of the activity definition, each of which would be dramatically shorter than Treas. Reg. Section 1.469-4T. The “line of business approach” alternative maintains the general pattern of grouping rental operations by location and non-rental operations by line of business and control, while providing a limited facts and circumstances override. The “integrated business approach” alternative more closely follows the facts and circumstances, economic reality approach suggested by the legislative history. In addition, both versions offer relief for moderate income taxpayers.

F. Identifying Operations. The first step in determining activities involves classifying operations, which are the smallest building blocks of activities. Each entity must (1) determine which of its operations are “business and rental operations” that are subject to Section 469, and then (2) divide such business and rental operations into “income-producing operations” and “support operations.”

1. Business and Rental Operations. Business and rental operations are all endeavors that are engaged in for profit or the production of income that are:

   a. endeavors involving conduct of a Section 162 trade or business; or
   b. endeavors conducted in anticipation of a Section 162 trade or business; or
   c. endeavors which involve making tangible property available for use by customers; or
   d. endeavors in which research or experiments would be deductible upon Section 174. Treas. Reg. Section 1.469-4T(b)(2)(ii).

Operations which do not fall into any of the above categories will be part of a taxpayer’s personal and investment operations. It is not clear why the Regulations introduce the term “endeavor,” which term is nowhere defined. The singular of operations, i.e., operation, would appear to accomplish the same distinction with perhaps less confusion.
2. **Income-Producing Operations.** The next step, after an entity has determined its business and rental operations subject to Section 469, is to divide such operations into “income-producing operations” and “support operations.” Income-producing operations are those operations conducted at a particular location which relate to or are conducted in anticipation of any of:

   a. production of property at that location; or  
   b. sale of property to customers at that location; or  
   c. performance of services for customers at that location; or  
   d. transactions in which customers take physical possession at that location of property made available for their use; or  
   e. any other transactions that involve the presence of customers at that location. Treas. Reg. Section 1.469-4T(c)(2)(iv).

It is noteworthy that operations may be income-producing operations even if they produce no income. For example, income-producing operations include the production of property which will later be used to produce income, or even work done in anticipation of such production.

3. **Support Operations.** Support operations are those operations which provide services or property at one location for the benefit of operations of the same entity at a different location. Treas. Reg. Section 1.469-4T(c)(2)(ii)(B). Operations which benefit other operations at the same location or which benefit operations of a different legal entity are income-producing operations, not support operations. Note, however, that when operations are income-producing operations (e.g., production of property), those operations will not be support operations even if they provide property or services to operations at another location. Treas. Reg. Section 1.469-4T(c)(2)(ii)(B)(3).

   a. **Not Part of Undertaking.** Support operations do not become part of any undertaking; rather, income and expenses from support operations are allocated to various activities after the activity definition process is complete. Treas. Reg. Section 1.469-4T(c)(2)(ii)(A).

   b. **Warehouse Example.** Suppose an entity has at different locations six separate field offices where goods are sold to customers, a warehouse where goods are kept, and a central administrative office at which accounting, payroll and personnel functions are performed. Assuming that the warehouse and administrative office do no business with third parties, the operations of the warehouse and administrative office should be support operations. There would be no undertaking at either the warehouse location or the administrative location. If, however, the warehouse sold and stored goods for third parties, its third-party operations would be income-producing operations. Thus, there would be an undertaking at the warehouse location, which undertaking would include only the third-party operations and not the support operations for the six field offices. Cf. Treas. Reg. Section 1.469-4T(c)(4), Ex. 6-7. While the support operations are ignored in the undertaking identification process, in the activity identification process the expenses and income from support operations will be allocated to activities. In this case, for example, expenses from the warehouse support operations and central office support operations will be allocated to the activity or activities which include the field office operations.

   c. **Rental Example.** Suppose an entity owns two office buildings, building A and building B, at different locations. The entity uses an office in building A to manage rental operations for both buildings. There are income-producing operations (rental of office space) at each location. The management office operations in building A which relate to building B should be support operations because they consist of providing services at one location for the benefit of income-producing operations of the same entity at a different location. On the other hand, the management office operations in building A which relate to building A are not support operations since they do not relate to a different location. Instead, they are part of the income-producing operations at building A. Thus, the management office
operations are split into two parts, one consists of support operations and the other one consists of income-producing operations. Cf. Treas. Reg. Section 1.469-4T(c)(4), Ex. 5.

d. Income-Producing Example. Suppose an entity owns a sawmill and a lumberyard at different locations. The sawmill provides finished lumber to the lumberyard (property) and also does some finishing work for the lumberyard (services). Although these lumberyard-related services appear to be support operations because they constitute provision of property and services to operations at a different location, they also appear to satisfy the definition of income-producing operations because they involve production of property. Classification as income-producing operations takes precedence, so the lumberyard-related operations are income-producing operations, not support operations. Cf. Treas. Reg. Section 1.469-4T(c)(4), Ex. 12(iii).

4. The “Black Hole.” The definitions of support operations and income-producing operations may not cover the entire universe of business and rental operations. For example, if an individual taxpayer owns a restaurant in one S corporation and sets up a warehouse to supply the restaurant, which warehouse is owned by a different S corporation, the warehouse will clearly not be a support operation (because it is not owned by the same legal entity) and may not constitute an income-producing operation (because it does not produce property or perform services for “customers”). Operations which are neither support operations nor income-producing operations are not addressed in the regulations; they are in a “black hole.” Arguably, such operations can never be treated as “activities” subject to Section 469.

a. ABA Comments. This potential flaw in the regulations was noted in the comments submitted by the ABA Section of Taxation.

G. Identifying Undertakings. To eventually determine the scope and classification of a taxpayer’s activities, the undertakings of each entity owned by the taxpayer must first be identified. Undertakings are entity-specific. If a taxpayer has operations through three different entities, the taxpayer must contend with at least three undertakings. See Treas. Reg. Section 1.469-4T(c)(2)(i), (v). Thus, undertaking is an entity-specific concept, whereas activity is a taxpayer-specific concept. Compare Treas. Reg. Section 1.469-4T(k)(2)(i) with Treas. Reg. Section 1.469-4T(c)(2)(i). There are five types of undertakings:

Rental Undertakings

i. Rental real estate undertakings.

ii. Other rental undertakings.

Trade or Business Undertakings

i. Oil and gas working interest undertakings.

ii. Professional service undertakings.

iii. Other trade or business undertakings.

A separate undertaking is a single activity of the taxpayer, unless otherwise aggregated, integrated or separated under the activity identification rules discussed below. In no event, however, does an activity consist of more than one type of undertaking. For example, a professional service undertaking will only become a part of a professional service activity and cannot become part of another activity. The following is a four (4) step process by which the undertakings of a taxpayer’s entities are identified as to scope and type.
1. **Step One: Basic Rule - Identify Same Location, Same Entity Income-Producing Operations.** Except as specifically adjusted below for oil and gas working interest undertakings, rental undertakings and rental real estate undertakings, all the income-producing operations conducted by the same entity at the same location constitute a single undertaking. Treas. Reg. Section 1.469-4T(c)(1), (2)(i).

   a. **Income-Producing Operations Only.** Only income-producing operations can become part of an undertaking. Support operations and operations not subject to Section 469 (e.g., investment or personal operations) are ignored in the undertaking identification process.

   b. **Same Entity Income-Producing Operations.** Only those income-producing operations which are directly owned by a single Section 7701(a) person (e.g., individual, partnership, estate, trust or corporation) are included in the same undertaking. Treas. Reg. Section 1.469-4T(c)(2)(v). This makes the undertaking an entity-specific rather than a taxpayer-specific concept. Since the Section 7701(a) definition of person includes trusts, one might ask whether a grantor trust is treated as a separate person from the grantor. There is no answer to this question in the Regulations, although the Service might contend that a grantor trust is not a separate person from its grantor.

   i. **No Attribution.** Attribution rules do not apply for purposes of determining the "person" that owns an interest in operations; for this reason, changing entities may be an effective tool to separate operations into multiple undertakings. On the other hand, attribution is applied for purposes of the "common control" test in the aggregation and integration rules discussed below. Treas. Reg. Section 1.469-4T(j)(3)(iii). Thus, in the final analysis, the multiple undertakings so created would likely be treated as a single activity.

   (A) Example. Smith owns two restaurants at one location. In order to create multiple undertakings, he transfers one of the restaurants to an S corporation of which he is sole shareholder. Smith would be able to treat each restaurant as a separate undertaking. The two undertakings would likely be presumed to be commonly controlled, however, for purposes of applying the aggregation rule in Treas. Reg. Section 1.469-4T(f).

   c. **Same Location Income-Producing Operations.** Only income-producing operations conducted at the same location are included in the same undertaking. Income-producing operations are conducted at the same location if they are conducted (1) in the same physical structure, or (2) within close proximity. Treas. Reg. Section 1.469-4T(c)(2)(iii)(B). Examples in the Regulations indicate that buildings "several blocks" apart are not at the same location. Treas. Reg. Section 1.469-4T, Ex. 3. Buildings in the same block or across the street from each other may be in close proximity and thus at the same location. The Regulations, however, provide no precise guidelines for close proximity.

   i. **Special Rule Where Location Not Fixed.** Where income-producing operations are not regularly conducted at a fixed place of business or are conducted on the customers' premises, such income-producing operations are treated as occurring at the location (other than customers' premises) with which they are most closely associated, considering all facts and circumstances. Treas. Reg. Section 1.469-4T(c)(2)(ii)(C). The Regulations list ten factors that are described as generally the most significant in evaluating facts and circumstances:

   (A) The extent to which other persons conduct similar income-producing operations at one location;

   (B) Whether such income-producing operations are treated as a unit in the primary accounting records reflecting the results of such operations;

   (C) The extent to which the persons treat similar income-producing operations as a unit in the primary accounting records reflecting the results of such similar operations;

   (D) The extent to which such income-producing operations involve products or services that are commonly provided together;
(E) The extent to which such income-producing operations serve the same customers;

(F) The extent to which the same personnel, facilities, or equipment are used to conduct such income-producing operations;

(G) The extent to which such income-producing operations are conducted in coordination with or reliance upon each other;

(H) The extent to which the conduct of any such income-producing operations is incidental to the conduct of the remainder of such operations;

(I) The extent to which such income-producing operations depend on each other for their economic success; and

(J) Whether such income-producing operations are conducted under the same trade name.”

Treas. Reg. Section 1.469-4T(c)(3).

ii. Location Not Fixed Example. The Regulations consider a delivery service where employees collect packages at the customers’ premises on instructions from a central office. The Regulations conclude that the deliveries of packages are income-producing operations and that the central office is the location with which such income-producing operations are most closely associated. Treas. Reg. Section 1.469-4T(c)(4), Ex. 11.

iii. Special Rule for Oil and Gas Operations. Oil and gas income-producing operations conducted for development of a common reservoir are treated as occurring at the same location. Treas. Reg. Section 1.469-4T(c)(2)(iii)(e). In addition, the common reservoir rule ensures that expenses of development wells can offset income from producing wells on the same reservoir, at least so long as a single entity is used.

d. Compare Support Operations. Business and rental operations of an entity at a location are support operations if they involve the provision of property or services to operations of the same entity at a different location and are not otherwise income-producing operations. Treas. Reg. Section 1.469-4T(c)(2)(ii)(B). In some situations, an entity’s operations at a single location will have to be divided into income-producing operations and support operations. See Treas. Reg. Section 1.469-4T(c)(4), Ex. (7).


a. Oil and Gas Working Interest Undertaking. From the same location, same entity undertakings determined in step one, any income-producing operations that involve a qualified working interest must be separated. Treas. Reg. Section 1.469-4T(e)(1)(i). This effectively separates any interest that might be non-passive under the qualified working interest exception of Section 469(c)(3)(A) and Treas. Reg. Section 1.469-4T(e)(4)(i). Each well separated under this rule is a separate “oil and gas working interest undertaking.”

i. Exception: Material Participation in Combined Operations. If the well would otherwise become part of an activity in which the taxpayer would materially participate, however, the well is not separated into a new undertaking. Treas. Reg. Section 1.469-4T(e)(1)(ii).

(A) Example. Suppose a partnership owns interests in wells A and B, each of which drains the same reservoir. The partnership owns a qualified working interest in A but a non-qualified interest in B. The partnership’s operations on A and B are a single undertaking under the same location, same entity operations basic rule. If none of the partners would materially participate in any activity including the AB undertaking, well A is split off into a separate oil and gas working interest undertaking. If, however, partner X spends 450 hours on well A, 60 hours on well B and no other time on any oil and gas operations, X would materially participate in the activity including the AB undertaking, since he spends more than 500 hours on A and B combined. Thus as to partner X, well B should not be separated out and thus the AB undertaking should be left intact. As to all other partners, well B should be made a separate undertaking.
b. Separated Rental Undertakings. From the undertakings determined above, (d)(3) rental operations should be separated as a rental undertaking, but if and only if the (d)(3) rental operations generate between 20% and 80% of the undertaking's gross income and the (d)(3) rental operations would qualify as a rental activity, if tested as a separate activity. Treas. Reg. Section 1.469-4T(d)(1)(i), (2). Any separate undertaking created by this segregation of (d)(3) rental operations will be a rental undertaking. Treas. Reg. Section 1.469-4T(d)(1)(iii).

i. (d)(3) Rental Operations. The (d)(3) rental operations are all income-producing operations which involve making tangible property available for use by customers, including provision of related services and property, except for short-term real property rentals and non-exclusive use rentals. The Regulations refer to (d)(3) rental operations as "rental operations," an unfortunately confusing term. Treas. Reg. Section 1.469-4T(d)(3). For purposes of this outline, however, the term "(d)(3) rental operations" is adopted.

(A) Short-Term Real Property Rentals. If any entity makes real property of a particular "type" available to customers for an average period of customer use of 30 days or less, income-producing operations with respect to that type of property are not (d)(3) rental operations unless those operations would qualify as a rental activity if tested as a separate activity. Treas. Reg. Section 1.469-4T(d)(3)(ii). Thus, most hotel operations and parking garage operations are not (d)(3) rental operations. Note, however, that short-term rental of personal property is not excluded from the definition of (d)(3) rental operations. See, e.g., Treas. Reg. Section 1.469-4T(d)(4), Ex. 7(ii), 8(ii).

(1) Example. Suppose an entity owns a building in which it rents retail space, executive suites, meeting rooms and parking spaces. Each "type" of real property must be separately tested to see if operations with respect to that type are (d)(3) rental operations. Suppose the average periods of customer use are one year for retail space, eight days for executive suites, one day for meeting rooms and eight hours for parking spaces. Because the average period of customer use for retail space exceeds 30 days, operations relating to the retail space are (d)(3) rental operations (if not subject to any other exception). Because the average period of customer use for meeting rooms and parking spaces is less than 30 days, operations relating to meeting rooms and parking spaces would not be a rental activity if tested as a separate activity. Treas. Reg. Section 1.469-1T(e)(3)(i)(A). Thus, operations relating to executive suites and parking spaces are not (d)(3) rental operations as a result of the short-term real property exception. On the other hand, for executive suites the average period of customer use exceeds seven days and assuming no significant personal services or extraordinary personal services are provided to the occupants of the suites, operations relating to the executive suites would qualify as a rental activity if tested as a separate activity. Treas. Reg. Section 1.469-1T(e)(3)(i), (ii). Thus, the executive suites are (d)(3) rental operations despite having an average period of customer use of less than 30 days. Accordingly, operations relating to executive suites and parking spaces are not (d)(3) rental operations, but operations relating to retail space and executive suites are (d)(3) rental operations. Cf. Treas. Reg. Section 1.469-4T(d)(4), Ex. 3.

(B) Non-Exclusive Use Exception. Income-producing operations that involve making tangible property available for non-exclusive use by customers during defined business hours are not (d)(3) rental operations. Treas. Reg. Section 1.469-4T(d)(3)(iii). Thus, for example, operations at a golf course or health club may not qualify as (d)(3) rental operations. In each case, the customer is given non-exclusive use of the property since others can use the golf course or health club at the same time. In addition, the use is generally limited to particular business hours.

ii. 80/20 Gross Income Test. Unless the (d)(3) rental operations generate between 20% and 80% of the gross income of the undivided undertaking, separation is improper. If more than 80% or less than 20% of the gross income of an undertaking is from (d)(3) rental operations, the (d)(3) rental operations are not separated. Treas. Reg. Section 1.469-4T(d)(2)(ii), (iii). Instead, the undertaking is left intact and classified in step three below.

iii. Rental Activity Test. Even if between 20% and 80% of an undertaking's gross income is from (d)(3) rental operations, the (d)(3) rental operations will not always be separated. Separation to create a new undertaking will occur only if the (d)(3) rental operations would qualify as a rental activity when tested as a separate activity. Thus, an undertaking may have substantial (d)(3) rental operations, but not be a rental undertaking.
Example. Assume that an entity owns a nursing home and a dry-cleaning store located in the same building. 70% of the entity’s income comes from (d)(3) rental operations (the nursing home operations) and 30% from other operations (the dry cleaning operations). The (d)(3) rental operations provide between 20% and 80% of the undertaking’s gross income, satisfying the first test for separation. If the nursing home operations include the provision of extraordinary services, however, the (d)(3) rental operations would not qualify as a rental activity if tested as a separate activity. Treas. Reg. Section 1.469-1T(e)(3)(ii)(C). Thus, separation of the (d)(3) rental operations is improper. Moreover, the undivided undertaking will not be a rental undertaking; because extraordinary services are supplied, the undivided undertaking would not be a rental activity if tested as a separate activity. Instead, the unseparated undertaking will be classified in step four below as a professional service undertaking or an other trade or business undertaking.

(B) Example. Suppose an entity has car rental operations and car wash operations at the same location. The car rental operations generate 70% of the gross income from the location. The car rental operations are (d)(3) rental operations and the 80/20 test is satisfied. Separation, however, may not be proper. For example, assume that the average period of customer use for the car rental operations is less than 7 days. Therefore, the car rental operations would not be a rental activity, if tested as a separate activity. Treas. Reg. Section 1.469-1T(e)(3)(ii)(A). Thus, separation of the (d)(3) rental operations is improper. Moreover, the undivided undertaking is not a rental undertaking. Instead, the undivided undertaking will be classified in step three below as a professional service undertaking or an other trade or business undertaking.

iv. Unseparated (d)(3) Rental Operations. Same location, same entity (d)(3) rental operations generating in excess of 80% of the total gross income are not separated out. Same location, same entity (d)(3) rental operations generating less than 20% of the total gross income are not separated out. Similarly, (d)(3) rental operations which generate between 20% and 80% of the total gross income of an entity at a location but would not be a rental activity when tested separately are not separated out. Same location, same entity income-producing operations not separated out under this basic rule exception remain part of a same location, same entity undertaking which is classified in step three, below.

3. Step Three: Classify Any Remaining Income-Producing Operations. Any undertakings not already separated and classified above as rental undertakings or oil and gas working interest undertakings must be classified as rental undertakings, professional service undertakings or other trade or business undertakings. See Treas. Reg. Section 1.469-4T(f)(1), (g) and (h).

a. Unseparated Rental Undertakings. A rental undertaking is any undertaking which would be a rental activity if tested as a separate activity. Treas. Reg. Section 1.469-4T(d)(1)(iii). In practice, this test need only be applied to an undertaking which derived more than 80% of its gross income from rental operations and thus was not separated out because of the 80/20 test.

i. Example. Assume that an entity has at the same location apartments for rent and a dry cleaning store, with 90% of gross income coming from the apartment operations. The apartment operations are (d)(3) rental operations and the dry cleaning income-producing operations are not. The apartment and dry cleaning operations are a single undertaking because the 80/20 gross income test for separating (d)(3) rental operations is not satisfied. Viewing the undertaking as a whole, however, the undertaking would be a rental activity if tested as a separate activity. See Treas. Reg. Section 1.469-1T(e)(3). Thus, the undertaking is classified as a rental undertaking under Treas. Reg. Section 1.469-4T(d)(1)(iii).

b. Professional Service Undertakings. A professional service undertaking is any undertaking which derives more than 50% of its gross income from the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. Treas. Reg. Section 1.469-4T(h)(1)(ii). Services are treated as performed in these fields only if so treated under Section 448(d)(2)(A).
i. Example: Suppose an entity operates a nursing home and a geriatric clinic at the same location. Assume that the nursing home operations are not separated out as (d)(3) rental operations because the (d)(3) rental operations involve provision of extraordinary personal services, thus failing to satisfy the requirement that (d)(3) rental operations would be a rental activity if tested separately. If 55% of the undertaking’s gross income is derived from the geriatric clinic, the undertaking is a professional service undertaking. If, however, only 45% of gross income comes from the geriatric clinic and 55% comes from the nursing home, the undertaking is an other trade or business undertaking and not a professional service undertaking. See Treas. Reg. Section 1.469-4T(d)(4), Ex. 6. It is noteworthy that different aggregation rules will apply to other trade or business undertakings than to professional service undertakings, and that activity integration will apply only to other trade or business undertakings.

c. Other Trade or Business Undertakings. Any non-rental undertaking not otherwise classified above as an oil and gas working interest undertaking or as a professional service undertaking is classified as an other trade or business undertaking. Treas. Reg. Section 1.469-4T(f)(1). (i) Terminology Comment. The Regulations refer to such undertakings as trade or business undertakings, a term which is incredibly confusing, since “trade or business activities” as defined under Treas. Reg. Section 1.469-1(e)(2) can include professional service undertakings or oil and gas working interest undertakings. The term “other trade or business undertakings” as utilized in this outline more clearly reflects the residual nature of this category.

4. Step Four: Subclassify Rental Undertakings. Any rental undertaking must be classified as either a rental real estate undertaking or an other rental undertaking. See Treas. Reg. Section 1.469-4T(k).

a. Rental Real Estate Undertakings. A rental undertaking is a rental real estate undertaking if real estate constitutes more than 85% of the unadjusted basis of the assets which the undertaking makes available to customers. Treas. Reg. Section 1.469-4T(k)(1). (i) Coordination with Non-Depreciable Rental Property Recharacterization Rule. If depreciable property constitutes less than 30% of the unadjusted basis of the assets used or held for use by customers, an activity consisting only of the rental real estate undertaking would be subject to the non-depreciable rental property recharacterization rule of Treas. Reg. Section 1.469-2T(f)(3), which recharacterizes net passive income as portfolio income. As discussed below, at the election of the taxpayer, rental real estate undertakings may be aggregated or subdivided under Treas. Reg. Section 1.469-4T(k). If the taxpayer were permitted to aggregate or subdivide a greater than 30% non-depreciable property undertaking, the taxpayer might be able to avoid the force of the recharacterization rule. To prevent such avoidance, any rental real estate undertaking with less than 30% depreciable assets is in effect re-classified as a portfolio activity. Treas. Reg. Section 1.469-4T(k)(6).

(A) Example. Assume a partnership owns a shopping center and also owns a vacant lot which it leases to a parking lot operator. The land underlying the shopping center cost $500,000 and depreciable property costing $1,000,000 was added to the land. The land underlying the parking lot cost $100,000. If the shopping center and the parking lot are at different locations, each will be a separate rental undertaking. The shopping center undertaking will be a rental real estate undertaking. The parking lot undertaking, however, will not be a rental real estate undertaking because depreciable property constitutes less than 30% of the unadjusted basis of property made available to the lessee. Treas. Reg. Section 1.469-4T(k)(8), Ex. 4. On the other hand, if the shopping center and the parking lot are at the same location, they will constitute a single undertaking. Moreover, that undertaking will be a rental real estate undertaking since depreciable property exceeds 30% of total unadjusted basis ($1,000,000/$1,600,000). Treas. Reg. Section 1.469-4T(k)(8), Ex. 5.

(ii) Coordination with Taxpayer Dwelling Unit Rules. Code Sec. 280A provides detailed rules for the treatment of dwelling units used both as a residence and for business purposes. If such a dwelling unit were part of a rental real estate undertaking, a taxpayer could avoid the impact of Code Sec. 280A by judicious subdivision or
aggregation of rental real estate undertakings. Treas. Reg. Section 1.469-4T(k) therefore provides that a taxpayer's interest in a dwelling unit that is subject to Code Sec. 280A(c) is not part of a rental real estate undertaking, but instead is a separate activity of that taxpayer.

b. Other Rental Undertakings. Any rental undertaking which is not a rental real estate undertaking is classified as an other rental undertaking. Other rental undertakings mostly include any undertakings involving rental of personal property. Note, however, that undertakings with substantial amounts of real property but less than 85% would also be other rental undertakings.

H. Identifying Activities. The ultimate goal of the activity identification process is to classify each of a taxpayer’s activities as either a rental activity or a trade or business activity. As an intermediate step, it is helpful to think of five types of activities, each corresponding to and constructed from one and only one type of undertaking. “Rental activities” are either: (a) rental real estate activities or (b) other rental activities. “Trade or business activities” are: (a) oil and gas working interest activities, (b) professional services activities, or (c) other trade or business activities.

Basic Activity Rule: Except as specifically aggregated or subdivided below, each separate undertaking will be a separate activity.

1. Rental Real Estate Activities. Each rental real estate undertaking is a separate rental real estate activity, except that the taxpayer may elect to aggregate two or more rental real estate undertakings into a single rental real estate activity. Treas. Reg. Section 1.469-4T(d)(2)(i). The election is discussed below.

2. Other Rental Activities. Each other rental undertaking is a separate other rental activity.

3. Other Trade or Business Activities (Aggregation). Each other trade or business undertaking is a separate other trade or business activity, except as aggregated under this paragraph 3 or integrated under paragraph 4 below. Other trade or business undertakings must be aggregated to form a single other trade or business activity if: (i) the undertakings are controlled by the same interests; (ii) the undertakings are similar; and (iii) the taxpayer has substantial ownership or participation in the undertakings. Treas. Reg. Section 1.469-4T(f)(2).

a. Controlled by the Same Interests. Whether undertakings are controlled by the same interests is determined under all facts and circumstances. Treas. Reg. Section 1.469-4T(j)(1). There is a rebuttable presumption of control by the same interests, however, if two undertakings are part of a “common-ownership group.” Treas. Reg. Section 1.469-4T(j)(2).

i. Rebuttable Presumption (5 persons/50%). Two undertakings are part of the same common-ownership group if the common-ownership percentages of five or fewer persons exceeds 50% (the 50%/5 person presumption”). Treas. Reg. Section 1.469-4T(j)(2)(ii). The common-ownership percentage of any person is the smallest ownership percentage of that person in any of the undertakings being tested. Treas. Reg. Section 1.469-4T(j)(3)(i). For example, if taxpayer X owns 50% of undertaking A, 35% of undertaking B and 20% of undertaking C, X’s common-ownership percentage for purposes of determining whether A, B and C are commonly controlled is 20%. For purposes of determining whether A and B are commonly controlled, X’s common ownership percentage is 35%.

(A) Percentage Ownership. Ownership percentage is defined differently depending on the entity through which the taxpayer owns his interest in an undertaking:

(1) Proprietorship or Co-ownership: use the percentage owned.

(2) S Corporation: use the percentage of stock owned.
(3) Partnership: use the greater of percentage interest in capital (by value) or the largest distributive share of any item of income or gain (disregarding guaranteed payments). This formulation is ambiguous if distributive shares change from year to year. The distributive share language could be read to refer to the distributive shares in the current year or the highest percentage from any taxable year, past, present or future, of the partnership. Only items of income or gain are considered in evaluating ownership; allocations of loss or expense have no effect.

(4) Estate or Trust: use zero as the ownership percentage of any beneficiary. Treas. Reg. Section 1.469-4T(j)(3). Note, however, that the attribution rules will cause ownership by a trust to be treated as ownership by the grantor of the trust and also as ownership by the beneficiary of the trust. Treas. Reg. Section 1.469-4T(c)(3)(6); Section 267(b)(4), (6).

These rules for determining ownership percentages for partnerships offer planning opportunities as well as pitfalls. For example, measuring ownership by largest distributive share of any item of gain or income could cause a partnership investor with a preferred return and associated gross income allocation to have a high ownership percentage, thereby creating a common ownership group. Conversely, if the gross income allocation can be deferred until disposition, the rebuttable presumption of control may be avoided. On the other hand, if the taxpayer wishes to aggregate undertakings (e.g., to ensure material participation in loss operations), a special partnership allocation of a partnership item may avoid the rebuttable presumption of aggregation. Nonetheless, the ultimate facts and circumstances test of control, however, remains unaffected by this presumption.

(B) Example of Common-Ownership Percentage. Suppose partnership X owns undertaking X and partnership Y owns undertaking Y. The only partners in X and Y are A, B, C, D, and E. The percentage ownership of each partner in each undertaking and the common-ownership percentages are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Undertaking X</th>
<th>Undertaking Y</th>
<th>Common-Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>15%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>B</td>
<td>10%</td>
<td>60%</td>
<td>10%</td>
</tr>
<tr>
<td>C</td>
<td>10%</td>
<td>20%</td>
<td>10%</td>
</tr>
<tr>
<td>D</td>
<td>77%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>E</td>
<td>8%</td>
<td>20%</td>
<td>8%</td>
</tr>
<tr>
<td>Totals</td>
<td>120%</td>
<td>117%</td>
<td>45%</td>
</tr>
</tbody>
</table>

In this example, the ownership percentages total more than 100%. This is possible because for a partnership, ownership percentage is based on the partner's largest interest in capital or in any item of income or gain. Because the common-ownership percentages total only 45%, undertaking X and Y are presumptively not controlled by the same interests. Note, however, that if the ownership percentages in undertaking Y were switched for A and E (i.e., A had a percentage ownership of 20% while E had one of 5%), the common-ownership percentages would total 52%, so that undertakings X and Y would presumptively be controlled by the same interests. See Treas. Reg. Section 1.469-4T(j)(5), Ex. 1. Even if there is no presumption of common control, the Service or the taxpayer can attempt to show that partnerships X and Y are commonly controlled based on the facts and circumstances reality of control test.

(C) Attribution Rules. Attribution rules apply in determining ownership percentages in passthrough entities: a person is treated as owning any interest owned by any person related for purposes of Section 267(b) or Section 707(b)(1). Treas. Reg. Section 1.469-4T(j)(3) (iii)(C). Thus, for example, an individual is treated as owning any interest owned by his son, or owned by a corporation of which he owns 50% of the stock by value, or owned by any trust of which he is grantor, or owned by any partnership of which he owns 50% of the capital or profits interest. To avoid double counting, if two people are related, only the one with the higher common-ownership
percentage is counted. Treas. Reg. Section 1.469-4T(iii)(B). These attribution rules prevent avoidance of the common ownership group rules by use of trusts and corporations. For example, if a father transfers an interest to a grantor trust, he is treated as continuing to own that interest.

(1) Example of Attribution Rules. Suppose individual A and individual B are related to individual C but not to each other. (For example, C could be A's wife and B's sister; A and B are not "related" for these purposes. See Section 267(b)(1), (c)(4)). Individual D is unrelated to A, B and C. A, B, C and D own the following interests in undertakings X and Y, without regard to attribution rules:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Undertaking X</th>
<th>Undertaking Y</th>
<th>Common-Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>30%</td>
<td>—</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>—</td>
<td>30%</td>
<td>0%</td>
</tr>
<tr>
<td>C</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>D</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Assuming A, B, C and D are not related to any other owners of X and Y, applying the attribution rules yields the following ownership percentages:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Undertaking X</th>
<th>Undertaking Y</th>
<th>Common-Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>40%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>B</td>
<td>10%</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>C</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>D</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
</tr>
</tbody>
</table>

To avoid double counting, A and C should not both be counted. Since C has the higher common-ownership percentage, only C is counted and A is not counted. Similarly, B and C should not both be counted, and so only C is counted. Thus, only C and D are counted. Cf. Treas. Reg. Section 1.469-4T(j)(5), Ex. 3. Because the common-ownership percentages of C and D total 55%, undertakings X and Y are presumptively controlled by the same interests. Yet this result occurred only because of attribution rules. Now consider that X may in reality be controlled by A, while Y is controlled by B. If so, the taxpayer may be able to rebut the presumption and thus treat X and Y as parts of separate activities.

(D) One Undertaking in Two Common-Ownership Groups. In addition, if one undertaking is part of two common-ownership groups, then both groups are treated as a single common-ownership group. Treas. Reg. Section 1.469-4T(j)(2)(iii). For example, suppose individuals A, B and C have the following ownership percentages in undertakings X, Y and Z:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Undertaking X</th>
<th>Undertaking Y</th>
<th>Common-Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>B</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>C</td>
<td>—</td>
<td>30%</td>
<td>30%</td>
</tr>
</tbody>
</table>

X and Y are part of common ownership group because of A and B's interests; Y and Z are part of a common ownership group because of A and C's interests. Because Y is a part of two common ownership groups, all three undertakings are treated as part of the same common-ownership group.

ii. Reality of Control - Facts and Circumstances. Under the 50%/5 or fewer test of control, aggregation is only a rebuttable presumption. The issue is “whether undertakings are controlled by the same interests.” Treas. Reg. Section 1.469-4T(j)(1). The facts and circumstances nature of the question is described only as follows:
(A) No Additional Guidance. There is no additional guidance in the Regulations, not even a facts and circumstances example. It is interesting to note, however, that identical language is employed in the Section 482 Regulations. Treas. Reg. Section 1.482-1(a)(3). Section 482 may therefore provide useful analogies in determining the reality of control.

(B) Possible Types of Control. The Regulations do not indicate what type of “control” is relevant for aggregation purposes. For example, in a typical corporation the shareholders may have control over capital transactions and mergers (ultimate control), the CEO or Board of Directors may have full control over strategic matters (strategic control), and the Vice President for Operations may have full control over day-to-day operations (operational control). Absent any regulatory guidance, the taxpayer could argue that any of these types of control is relevant for aggregation purposes.

(C) Operational Control Example. Assume that taxpayers A, B, C & D are 25% owners of partnerships No. 1 and No. 2, which are each engaged in similar undertakings. A makes all of the partnership No. 1 operational decisions. In a given year, such operational decisions are 90% of the decisions which are important to the success of partnership No. 1. The partners, A, B, C & D, vote on the remaining 10% of decisions, the non-day-to-day decisions. For partnership No. 2, B makes the operational decisions and such decisions are again 90% of the important decisions for partnership No. 2, decisions with A, B, C and D voting equally on the remaining decisions. It is arguable that partnerships No. 1 and No. 2 are not controlled by the same interests.

(1) Different General Partners. Suppose A, B and C own 90% of the limited partnership interests in partnerships X and Y. D is the 10% general partner of X and E is the 10% general partner of Y. E and D are completely unrelated parties. Partnerships X and Y will be presumed to be commonly controlled under the 50%/5 test. If operational control were the proper test (and this is not clear under the Regulations) and operational control indeed was in the hands of general partners D and E, partnerships X and Y would not be commonly controlled under the facts and circumstances reality of control test.

(D) Reality of Control Example. Assume that A owns an activity as a sole proprietor and is an equal 10% general partner in a general partnership with 9 of A’s sole proprietorship employees. The employees are completely dependent for their employment on A’s sole proprietorship. The employees therefore are completely subservient to A’s will. The same interests therefore control the sole proprietorship and the partnership. If employees B, C, D, E and F quit their employment and the partnership requires majority votes for decisions by its general partners, the common control no longer should exist.

b. Similar Undertakings. Even if there is control by the same interests, two other trade or business undertakings will not be aggregated unless the undertakings are “similar.” Two undertakings are similar if either (A) more than 50% of the gross income of each undertaking arises from operations in the same line of business; or (B) the two undertakings are vertically-integrated undertakings. Treas. Reg. Section 1.469-4T(f)(4)(i), (iii). The vertical integration similarity rule overrides the line of business similarity rule. Thus, if A and B each derive 50% of gross income from the same line of business, and A but not B is vertically integrated into C, A will be similar to C and A will not be similar to B. Treas. Reg. Section 1.469-4T(f)(4)(iii)(C)(2), (3).

i. 50% Same Line of Business. Except as provided in the rules concerning vertical integration (discussed below), two or more undertakings are subject to aggregation as “similar” undertakings if the predominant operations in each undertaking are in the same line of business. Treas. Reg. Section 1.469-4T(f)(4)(i). There are predominant operations in an undertaking if more than 50% of the undertaking’s gross income is attributable to operations in a single line of business. Treas. Reg. Section 1.469-4T(f)(4)(ii). Therefore, two or more undertakings are similar if more than 50% of the gross income of each arises from the same line of business.
(A) Lines of Business. Whether operations whose predominant operations are in the same line of business is determined using the "lines of business" described in Rev. Proc. 89-38, 1989-1 C.B. 920. Rev. Proc. 89-38 sets forth only 79 lines of business based on the Standard Industrial Classification Manual, some of which are quite broad. For example, line of business 7 ("Real Estate Development and Services") would include all of the following: building skyscrapers, building single family homes; building factories; managing apartment complexes; providing title insurance; and appraising properties for foreclosure. Similarly, all undertakings in mass media (television, radio, newspapers) are in a single line of business, as are all varieties of agricultural operations. On the other hand, hotel management is in a different line of business from hotel construction. If operations do not fall into one of the 79 lines of business defined in Rev. Proc. 89-38, such operations still must be assigned to a line of business based on all the facts and circumstances. Treas. Reg. Section 1.469-4T(f)(4)(iv). The only example in the Regulations which assumes that businesses are not in a defined line of business concludes that long-distance moving and short-distance moving operations are in the same line of business because they involve the same type of services and similar customers, differing only in the distance involved. Treas. Reg. Section 1.469-4T(f)(5), Ex. 8.

(B) No "Predominant" Line of Business. If no single line of business accounts for more than 50% of an undertaking's gross income, the undertaking cannot be aggregated because it has no "predominant operations." Treas. Reg. Section 1.469-4T(f)(4)(i)(A).  

(1) Example. Taxpayer owns a single building in which the taxpayer operates a retail store, a theater and a restaurant, which have annual gross income of $35, $35 and $30, respectively. The store, restaurant and theater are a single undertaking which lacks predominant operations and, therefore, cannot be treated as similar to any other undertakings of the taxpayer under this rule. Treas. Reg. Section 1.469-4T(f)(5), Ex. (5)(iv). In contrast, if the gross income of the store, the restaurant and the theater were $35, $10 and $55, respectively, the predominant operations of the undertaking would be as a theater. Therefore, the undertaking could be treated as similar to other undertakings in such line of business. Treas. Reg. Section 1.469-4T(f)(5), Ex. (5)(v).

ii. Vertically-Integrated Undertakings. Two or more undertakings will also be similar if they are vertically-integrated undertakings. Treas. Reg. Section 1.469-4T(f)(4)(iii). Although simple in basic concept, vertical integration becomes complex because of necessary coordination among the vertical integration rules themselves and between the vertical integration rules and line of business rules. See Treas. Reg. Section 1.469-4T(f)(4)(iii)(C). Application of the vertical integration rules and the coordination rules can be viewed as a three-stage process. Assume at the outset that each undertaking is "tied" to other undertakings which are similar under the line of business test. First, captive supplier or captive recipient undertakings are tied to the undertakings on which they depend economically ("master" undertakings). Treas. Reg. Section 1.469-4T(f)(4)(iii)(A), (B). Second, some captive recipient undertakings are untied from their master undertakings because of coordination rules among the vertical integration rules. Treas. Reg. Section 1.469-4T(f)(4)(iii)(C)(1). Third, each remaining captive undertaking is untied from other undertakings in the same line of business, remaining tied only to the master undertaking. Treas. Reg. Section 1.469-4T(f)(4)(iii)(C)(2), (3).

(A) Basic Concept. In a broad sense, vertical integration is a rule about economic dependence. Suppose an undertaking sells more than 50% by value of its output of goods and services ("captive supplier") to another commonly-controlled undertaking ("master recipient"). The captive supplier is economically dependent on the master recipient and logically should be aggregated into any activity which otherwise includes the master recipient. See Treas. Reg. Section 1.469-4T(f)(4)(iii)(A). Similarly, suppose an undertaking obtains more than 50% by value of its requirements for goods and services ("captive recipient") from another commonly controlled undertaking ("master supplier"). The captive recipient is economically dependent on the master supplier and should be aggregated into any activity which otherwise includes the master supplier. See Treas. Reg. Section 1.469-4T(f)(4)(iii)(B). In either case, the captive undertaking "follows" its master to an activity, regardless of the activity into which the captive would otherwise fall. Thus, if the master recipient or master supplier is similar to another undertaking under the line of business test, the captive supplier or recipient is similar to that undertaking. The reverse, however, is not true. Once a captive is grouped together with a master, it ceases to be similar to undertakings in the captive's line of business. This simple "captive/master" concept is complicated, however, by the need to coordinate rules.
(B) Multiple Master Recipients. In determining whether an undertaking is a captive supplier, multiple recipients are treated as a single recipient if commonly controlled and “similar” under the line of business test. In other words, if a supplier sells more than 50% of its output to a group of similar, commonly controlled recipients, the supplier is a captive supplier to the whole group. Treas. Reg. Section 1.469-4T(f)(4)(iii)(A)(1). For example, suppose sawmill undertaking A sells 20% of its output to each of lumberyard undertakings B, C and D. If B, C and D are commonly controlled with A and in the same line of business, A will be a captive to B, C and D. (Interestingly, there is no similar group rule for determining captive recipients. If commonly controlled sawmills W, X and Y each supply 20% of the requirements of lumberyard Z, Z is not a captive recipient. See Treas. Reg. Section 1.469-4T(f)(4)(iii)(B).)

(C) Captive Supplier Rule Overrides Captive Recipient Rule. The vertical integration rules are two separate similarity rules: a captive supplier is “tied” to its master (the “captive supplier rule”) and a captive recipient is tied to its master (the “captive recipient rule”). Because the captive supplier rule and captive recipient rule operate independently, the same undertaking could be both a captive supplier and a captive recipient or could be a master to both a captive supplier and a captive recipient. Such a overlap could lead to strange results (see examples below). The Regulations prevent these strange results by generally overriding the captive recipient rule wherever a captive supplier is involved. In particular, if S is a supplier undertaking and R is a recipient undertaking, the captive recipient rule will not apply and thus R cannot be a captive recipient if (1) S is a captive supplier of any undertaking; (2) R is a captive supplier of any undertaking; or (3) R has a captive supplier other than S. Treas. Reg. Section 1.469-4T(f)(4)(iii)(C)(1).

(1) Example. Suppose ice cream manufacturer R obtains 100% of its requirements from dairy S. Dairy S, however, sells only 1% of its milk to R, and sells 90% of its milk to milk retailer X. If the captive recipient rules applied, R would be similar to S, S would be similar to X and thus R would be similar to X. Because S is a captive supplier to X, however, the captive recipient rules do not apply. Thus, S is similar to X, but R is not similar to S or X.

(2) Example. Suppose sawmill S sells 40% of its output to lumberyard R and the rest of its output to third parties. Lumberyard R, however, gets 100% of its requirements from S. Lumberyard R then sells 95% of its output to homebuilder X. R is a captive supplier to X. If the captive recipient rules applied, R would be a captive recipient of S. That would make S similar to R, R similar to X and thus S similar to X, a strange result since S sells most of its output to third parties. Because R is a captive supplier, however, the captive recipient rules do not apply. Thus, R is similar to X, but S is not similar to R or X.

(3) Example. Suppose clothing store R obtains 60% of its total requirements by value from suit manufacturer S. Suit manufacturer S sells 40% of its output to R and 60% to unrelated third parties. Handkerchief manufacturer Z sells 100% of its output to R, although these handkerchiefs only amount to 1% of R’s total requirements. Because Z is a captive supplier to R, the captive recipient rules do not apply to R and S. Thus, R is similar to Z but not to S. This result is less compelling than in the two above examples, and suggests substantial opportunities for planning to avoid the vertical integration rules.

(D) Captive Similar Only to its Master. The interaction of the vertical integration similarity rules with the line of business similarity rules is governed by a simple rule: a captive undertaking is similar to its master undertaking but is not similar to undertakings that are in the captive’s line of business. Thus, the line of business rule is overridden by the vertical integration similarity rule. Treas. Reg. Section 1.469-4T(f)(4)(iii)(C)(2), (3). This amounts to a policy judgment that economic dependence (vertical integration) is a more important grouping principle than line of business. For example, suppose that under the line of business similarity test, C is similar to X and M is similar to Y and Z. If C is a captive undertaking to M, then C will be treated as similar to M (and thus to Y and Z) but C will not be treated as similar to X. Without this rule for coordination between the vertical integration similarity rule and the line of business similarity test, making C similar to M would require making X similar to Y and Z.

(E) Comment. The vertical integration rules are a complex set of mechanical rules. As such, they offer numerous planning opportunities and numerous traps for the unwary. The ultimate question is whether the “problem” is worth adding another layer of complexity to an already complicated process. In many situations in which
the vertical integration rules apply, activity integration would accomplish the same goal with a facts and circumstances test. The principal case in which the vertical integration rules would have an effect which activity integration would not is where a taxpayer has numerous undertakings in line of business A, numerous undertakings in line of business B, and only a few captive relationships between the A and B undertakings. The result is still two large activities, but with some alteration in which undertakings go in each.

(F) Ann Landers Comments. In response to a letter from an accountant who complained about the incomprehensibility of the vertical integration rules, Ann Landers was sympathetic. She encouraged readers to write to her, promising to forward the letters to House Ways and Means Chairman Rostenkawski. "You can bet your bottom dollar that Danny Boy will put an end to this craziness," the advice columnist declared. See The Washington Post (Apr. 8, 1990) at F-8; Tax Notes (Apr. 30, 1990) at 619.

c. Substantial Ownership or Participation Test. Even if undertakings are controlled by the same interests and are similar, aggregation is not proper unless the taxpayer has significant ownership or participation. A taxpayer has significant ownership or participation in two undertakings if (a) he owns both undertakings directly; (b) he owns both undertakings through the same passthrough entity; (c) he indirectly owns through passthrough entities a 10% interest in each undertaking; or (d) he would materially or significantly participate in the combined undertakings. Treas. Reg. Section 1.469-4T(f)(2). To coordinate these types of significant ownership or participation, if a taxpayer indirectly owns more than 10% of any undertaking, any other undertaking owned through the same passthrough entity is treated as if the taxpayer indirectly owned 10% of that other undertaking. Treas. Reg. Section 1.469-4T(f)(3).ii.

i. Example. Suppose A owns 1% of each of ten partnerships, each partnership owning a single undertaking. The undertakings are commonly controlled and each undertaking derives 50% of its income from operations in the same line of business. Suppose further that A spends 60 hours in each undertaking. If each undertaking was treated as a single activity, A would not materially or significantly participate in any of the ten, and thus would have passive loss or income. Because A would have 600 hours in the combined undertakings, however, A would materially participate in the combined undertakings. Thus, aggregation is required, making A’s otherwise passive income or loss from each of the ten partnerships active.

ii. Example. Suppose B owns 1% of partnership X and 1% of partnership Y. Each partnership has a single undertaking. The two undertakings are commonly controlled and each undertaking derives 50% of its income from operations in the same line of business. B devotes 550 hours to partnership X, which generates a loss of $1,000. B devotes no time at all to partnership Y, which generates taxable income of $2,000. Absent the aggregation rules, each partnership’s undertaking would belong to a different activity. Thus, B would have an active loss of $10 from undertaking X, because he materially participates. B would have passive income of $20 from undertaking Y, because he does not materially participate. Because B would materially participate in the combined undertakings X and Y, however, aggregation is required. Thus B has $10 net active income ($20 income from Y and $10 loss from X) instead of $20 of passive income and $10 of active loss. Cf. Treas. Reg. Section 1.469-4T(f)(5), Ex. 3(i).

iii. Example. Suppose a taxpayer owns 1% of partnership P, which has interests in undertakings A and B. The taxpayer also owns a 15% interest in undertaking B and a 20% interest in undertaking C. Undertakings A, B and C are controlled by the same interests and “similar.” Because the taxpayer indirectly owns more than 10% of undertaking B and owns both A and B through the same passthrough entity, under the coordination rules the taxpayer is treated as indirectly owning more than 10% of undertaking A. Treas. Reg. Section 1.469-4T(f)(3)(ii). Hence the taxpayer is treated as indirectly owning more than 10% of each of A, B and C. This permits aggregating undertakings A, B and C into a single activity, even though the taxpayer owns only a nominal interest in undertaking A. Cf. Treas. Reg. Section 1.469-4T(f)(5), Ex. 4(iv).

4. Other Trade or Business Activities (Integration). After applying the aggregation rules of 3. above, various other trade or business activities have been identified. Such other trade or business activities will be integrated into a single other trade or business activity if (i) the activities are controlled by the same interests; and (ii) considering all the facts and circumstances, the activities are parts of a single integrated business. Treas. Reg. Section 1.469-4T(g)(2). Note the integration rule (unlike the aggregation rule) technically combines activities, not undertakings.
Thus if two other trade or business undertakings are aggregated into a single activity under the vertical integration and/or line of business tests, the resulting activity may also be tested for integration and be further combined with additional other trade or business activities.

a. Controlled by the Same Interests. In determining whether two other trade or business activities are controlled by the same interests, a facts and circumstances test is used in conjunction with a 50%/5 person rebuttable presumption. The control test for activity integration is the same as that discussed above for undertaking aggregation to create activities. Treas. Reg. Section 1.469-4T(g)(2)(ii), (j).

b. Single Integrated Business. Although a facts and circumstances test is applied in determining whether two activities are part of a single integrated business, the May 1989 Regulations list twelve factors which are "generally the most significant" facts and circumstances:

(A) whether such operations are conducted at the same location;

(B) the extent to which other persons conduct similar operations at one location;

(C) whether such operations are treated as a unit in the primary accounting records reflecting the results of such similar operations;

(D) the extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(E) whether such operations are owned by the same person;

(F) the extent to which such operations involve products or services that are commonly provided together;

(G) the extent to which such operations serve the same customers;

(H) the extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(I) the extent to which such operations are conducted in coordination with or reliance upon each other;

(J) the extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(K) the extent to which such operations depend on each other for their economic success; and

(L) whether such operations are conducted under the same trade name." Treas. Reg. Section 1.469-4T(g)(3).

c. Examples. Because of the "facts and circumstances" nature of the integration tests, it is difficult to provide definitive examples other than those examples given in the Regulations. Caution should be exercised in using the examples in the Regulations, however, since small variations in facts could lead to different results.

i. Example: Department Store and Auto Supply Store. A department store activity and an auto supply store activity were integrated where: a common trade name was used; marketing was coordinated; the same credit cards were used; common non-sales personnel were used; common regional managers administered both activities; inventory was centrally purchased and stored; and a single central office supplied payroll and other support services to both activities. Treas. Reg. Section 1.469-4T(g)(4), Ex. 1.
ii. Example: Stereo Sales and Repair. A stereo sales activity and a stereo repair activity were integrated where: each activity worked with the same manufacturers' products; the same customers often patronized both activities; a common trade name was used; inventory was centrally purchased and stored; and a single central office supplied payroll and other support services to both activities. Treas. Reg. Section 1.469-4T(g)(4), Ex. 2.

iii. Example: Television Station, Movie Studio and Sports Franchise Not Integrated. In the only example in the Regulations in which integration was not required, separate partnerships owned a television station, a motion picture production company, and a professional sports franchise. The taxpayer controlled all three undertakings, but had some different minority partners in each. Although the television station broadcast some of the sports franchise's games and the motion picture company's movies, each partnership had separate personnel, separate management, separate financial reports, and separate trade names. During periods of peak activity or emergency, support staff for one activity might assist with another activity. In addition, the taxpayer's interests in the three activities were cross-collateralized in some cases, and the taxpayer sometimes arranged financing for several activities from one source. Nevertheless, the Regulations conclude that integration is inappropriate. Treas. Reg. Section 1.469-4T(g)(4), Ex. 3.

d. Coordination with Aggregation Rules. Other trade or business undertakings are first subjected to the aggregation rules and only then subjected to the integration rules. The order of these steps could make a difference. Suppose, for example, that taxpayer X has a controlling interest in undertakings A1, A2, A3 and A4, and in undertakings B1, B2, B3 and B4. Each undertaking has $100 of gross income from a single line of business. A1, A2, A3 and A4 are in the same line of business, and B1 through B4 are in another line of business. Further suppose that A1 and B1 are part of a single, integrated business, considering all the facts and circumstances. If integration occurred first, taxpayer A would have three activities: A1-B1, B2-B3-B4, and A2-A3-A4. Under the Regulations, however, aggregation occurs first, giving activities A1-A2-A3-A4 and B1-B2-B3-B4. If the vertical integration similarity rules apply to A1 and B1, either A1 will be grouped with the B's or B1 will be grouped with the A's, but there will still be two activities.

e. Comment. While the regulations do not foreclose the possibility of integrating activity A into B and activity B into C where A and C would not be integrated, it appears to the authors that this must be the case. If B is integrated as a part of the business of A under an economic facts and circumstances relationship standard, the authors can imagine no circumstances where A would integrate into B, B into C but C would not integrate into A.

5. Professional Service Activities. Each professional service undertaking is a separate professional service activity, except that any chain of "linked" professional service undertakings is aggregated into a single professional service activity. Two professional service undertakings are "linked" if related in any one of three ways: (1) the undertakings are controlled by the same interests; (2) each undertaking derives 20% of its gross income from services in the same field or similar consulting; or (3) one undertaking derives 20% of its gross income from common customers. Treas. Reg. Section 1.469-4T(h)(2). Once professional service undertakings are "linked" under one of these three rules, they can become part of a longer chain of professional service undertakings which are linked under the other two rules. For example, if A and B are controlled by the same interests, B and C each derive 25% of their gross income from accounting services, and D derives 25% of its gross income from customers of C, all of A, B, C and D are part of the same professional service activity, even if A and D have no relationship at all. This extremely broad aggregation rule can have surprising results.

a. Controlled by the Same Interests. In determining whether two professional service undertakings are controlled by the same interests, a facts and circumstances test is used in conjunction with a 50%-5 person presumption, just as with other trade or business undertakings, as discussed above. Treas. Reg. Section 1.469-4T(h)(2)(i), (j).

i. Example. Suppose partners owning 60% of an accounting firm own 60% of a management consulting firm. Under the rebuttable presumption for common control, both firms are presumed controlled by the same interests. Thus, the two firms will be linked.
b. 20% Same Field or Similar Consulting. Professional services are defined to include only services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. Treas. Reg. Section 1.469-4T(h)(1)(ii). Other than consulting, services within each of these broad categories are treated as within the same field. Treas. Reg. Section 1.469-4T(h)(3)(i). For example, the practice of tax law and the practice of patent law fall within the same field. Whether consulting services are similar is determined under all the facts and circumstances. Treas. Reg. Section 1.469-4T(h)(3)(ii).

i. Example. Suppose the taxpayer is a physician practicing internal medicine in Boston through partnership A. The taxpayer also is a passive investor in partnership B, which operates a radiology laboratory in Tampa. Partnerships A and B are not controlled by the same interests. Each partnership owns a single undertaking, and each undertaking derives all of its income from services in the field of health. Thus, the taxpayer has interests in two professional service undertakings, each of which derives more than 20% of its gross income from the same field. The two undertakings are linked. Cf. Treas. Reg. Section 1.469-4T(h)(4), Ex. 1.

ii. Example. Suppose the taxpayer is a partner in two partnerships. Partnership X derives 75% of its gross income from consulting relating to employee benefits and 25% of its gross income from providing accounting services. Partnership Y derives 75% of its gross income from consulting relating to inventory cost control and 25% of its gross income from providing accounting services. Each partnership owns a single undertaking. Each undertaking is a professional service undertaking and each derives more than 20% of its gross income from accounting services. Thus, the two undertakings are linked.

c. 20% Common Customers. Two undertakings are also “linked” if 20% of the gross income of one is derived from customers of the other. Treas. Reg. Section 1.469-4T(h)(3)(v). This rule could apply, for example, if an accounting firm regularly referred its customers to a particular consulting firm. It could also apply, however, without any intentional cross-selling provided that common clients occur. If 20% of A’s gross income comes from customers of B, A and B are linked whether or not 20% of B’s gross income comes from customers of A.

i. Example. Suppose the taxpayer is a partner in partnerships A and C. Partnership A derives 100% of its gross income from accounting services and partnership C derives 100% of its gross income from management consulting. Each partnership’s operations constitute a single professional service undertaking. Partners in A own approximately 30% of partnership C and thus refer substantial management business to C. If 20% of C’s gross income comes from customers of A, A and C will be linked.

ii. Example. Suppose the taxpayer is a 25% partner in partnership D, which provides dental services in the town of Passiveville (population 500). Partnership D is the only firm offering dental services in Passiveville, and the entire population of the town are customers. The taxpayer buys a 5% interest in a new partnership X, which will offer cabaret-style live entertainment to the inhabitants of Passiveville and surrounding towns. At least 20% of the income of cabaret X comes from inhabitants of Passiveville (who are necessarily customers of partnership D). Thus, X and D are linked.

d. Cross-Linking. Once professional service undertakings are “linked” under one of these three rules, they can become part of a longer chain of professional service undertakings which are linked under the other two rules. For example, if A and B are controlled by the same interests, B and C each derive 25% of gross income from accounting services, and D derives 25% of its gross income from customers of C, all of A, B, C and D are part of the same professional service activity, even if A and D have no relationship at all. This extremely broad aggregation rule can have surprising results.

e. Linked Groups Treated as a Single Professional Service Undertaking. Once groups of professional service undertakings have been linked under the common control rule, same field or similar consulting rule or common customers rule, each group can be linked with other groups or single professional service undertakings under the same rules. Treas. Reg. Section 1.469-4T(h)(2)(iii)(A). This will be most significant for purposes of the common
customers rule: if professional service undertakings A through Y are linked under the same field rule, all of the combined customers of A through Y must be examined to see if professional service undertaking Z derives 20% of its gross income from the combined customers.

i. Example. Suppose professional service undertakings A, B and C each derive more than 20% of their gross income from accounting services. Undertaking D derives 100% of its gross income from management consulting services. Undertaking D is not controlled by the same interests as A, B and C. If D derives 10% of its income from customers of each of A, B and C, however, D will be linked to A, B and C. Cf. Treas. Reg. Section 1.469-4T(h)(4), Exs. 4 (vi), 5.

ii. Example. Suppose A, B and C are each professional service undertakings. Undertaking A derives 100% of its gross income from engineering services, and undertaking B derives 100% of its gross income from architectural services. Undertaking C derives 30% of its gross income from engineering, 30% from architecture, and 40% from construction management. Undertakings A and C each derive 20% of gross income from engineering and thus are linked. Similarly, undertakings B and C each derive 20% of gross income from architectural services and thus should be linked; but it could be argued that once A and C are linked, B should be compared to the combination of A and C. A and C combined may derive less than 20% of combined gross income from architectural services; if so, is B not linked to A and C? No, because treating linked groups as a single undertaking will not prevent linkage which would otherwise have occurred. Treas. Reg. Section 1.469-4T(h)(2)(iii)(B); Cf. Treas. Reg. Section 1.469-4T(h)(4), Ex. 6.

f. Aggregation Across Tax Years. The examples in the Regulations indicate that professional service undertakings can be aggregated across tax years, causing perverse results to arise from the interaction of broad professional service aggregation rules with the material participation rules. For example, suppose a taxpayer is a material participant in medical partnership X from 1975 to 1989, then retires but invests in 1990 as a passive investor in partnership Y, which also provides medical services. Because each derives 20% of gross income from health services, X and Y are treated as part of the same activity. Thus, the taxpayer is treated as materially participating in Y since he participated in the same activity for the three previous years. Treas. Reg. Section 1.469-4T(h)(4), Ex. 3.

g. Comment: Overly Broad Aggregation. In an effort to prevent use of professional services activities to create passive income, the Regulations provide overly broad aggregation rules. There is no theoretical justification for using a 20% threshold and an unlimited time horizon for aggregative professional service undertaking but not for any other type of undertaking. Moreover, the absence of any facts and circumstances rule to override this mechanical rule is striking given the wide use of such rules elsewhere in the activity regulations. Ironically, the broad aggregation rules may provide opportunities for planning to create professional services tax shelters.

h. Planning Opportunity: Creating Passive Income. It has been noted that the special rules for professional service undertakings permit professionals to generate passive income merely by segregating their non-professional functions into a separate legal entity. For example, if a law firm were to transfer its photocopying operations to a separate partnership (owned by the same individuals who own the law firm), the net income from the photocopying partnership would be passive, assuming that the lawyers do not materially participate in the operation of the copying machines, because the integration rules of Treas Reg. Section 1.469-4T(g) do not apply to professional service undertakings.

6. Oil and Gas Working Interest Activities. Each oil and gas working interest undertaking is a separate oil and gas working interest activity. Treas. Reg. Section 1.469-4T(3),(f)(1)(ii) (B). Since an oil and gas working interest activity is per se active, aggregation rules are unnecessary.

a. Exception. The wells in an oil and gas working interest, however, should never be separated into a new undertaking if the taxpayer would otherwise materially participate in an activity including those wells. Thus, oil and gas wells in a qualifying working interest may in effect be "aggregated" with other wells to form an activity, if aggregation would help the taxpayer to materially participate. This can be viewed as a recharacterization rule.
i. Example. Assume that taxpayer A owns oil and gas producing operations at a single location which include oil and gas working interest operations. Assume that A spends 501 hours a year on such oil and gas working interest operations and 60 hours on the remaining income-producing operations. By not separating the oil and gas working interest operations into a separate undertaking, the other oil and gas operations will be included in an activity in which A materially participates. Thus, the other oil and gas operations are in substance recharacterized as active activities.

7. Support Operations Added to Activities. Support operations of an entity are not part of any undertaking, but rather the income and expenses of support operations are added to the activities which they support. Treas. Reg. Section 1.469-4T(c)(2)(ii)(B). This may be significant because income from support operations is not included in any of the percentage of gross income tests used in classifying undertakings (e.g., the 80/20 rules for (d)(3) rental operations, the 50% rule for professional service undertakings, etc.).

I. Elections. After applying all of the foregoing rules, each entity and taxpayer subject to Section 469 will need to consider certain elections.

1. Entity Aggregation or Subdivision of Rental Real Estate Undertakings. Each pass-through entity may elect (1) to treat multiple rental real estate undertakings as a single undertaking; and (2) to subdivide a single rental real estate undertaking into multiple undertakings, provided the real estate underlying each portion can be separately conveyed under state law. Treas. Reg. Section 1.469-4T(k)(2)(ii) and (iii)(B).

a. Example. Assume that a partnership owns three separately conveyable condominium units at one location (A, B and C) plus two separately conveyable units at another location (D and E). Absent the rental real estate elections, the partnership would have two rental real estate undertakings, one composed of A, B and C and the other composed of D and E. Because of these elections, however, the partnership can elect to treat each of A, B, C, D and E as separate undertakings, and then can aggregate these five undertakings into fewer undertakings (e.g., two activities, ACE and BD). In effect, the partnership can mix and match these units in any way it wishes.

b. Mechanics of Election. Apparently, no separate election form must be filed to make the rental real estate elections, but the elections must be reflected by a schedule attached to the entity's tax return. Treas. Reg. Section 1.469-4T(k)(4), (5).

c. Consistency Requirement. Any two undertakings which have been aggregated into the same undertaking on the entity return for a given year must also be treated as part of the same undertaking for subsequent years. Treas. Reg. Section 1.469-4T(k)(3). Thus, if an entity wishes to fragment a rental real estate undertaking into several undertakings, it must elect to do so on its first return after the August 9, 1989 effective date in which it owns the undertaking. See, e.g., Treas. Reg. Section 1.469-4T(k)(8), Ex. 2, 3. On the face of the regulations, however, such an election could be made by amended return, and IRS officials have informally agreed that election by amended return is possible. If an amended return is not possible, it may be possible to achieve the same result by transferring the property to a new entity, thereby creating a new undertaking. This consistency requirement only prevents separating undertakings that were aggregated in an earlier year; it should not preclude further aggregation in subsequent years. For example, suppose in 1989 an entity elects to treat undertakings A and B as a single undertaking ("AB") and C and D as a single undertaking ("CD"). In 1990, the entity cannot treat each of A, B, C and D as separate undertakings. It could, however, treat them all as a single undertaking ("ABCD").

d. Subdivision to Create Non-Rental Undertaking. The technical language of the rental real estate subdivision rule appears to require only that the property separated out qualify as a rental real estate undertaking, without requiring that the property left behind so qualify. Treas. Reg. Section 1.469-4T(i)(2)(iii). This permits use of subdivision to create a non-rental undertaking.
Example. Suppose partnership P owns undeveloped land held for development adjacent to a developed rental property. Both properties are part of a single rental real estate undertaking. By using the subdivision rule to separate out the developed property, P creates a separate undertaking for the undeveloped land. The undeveloped land undertaking may then become part of an active non-rental real estate development activity.

(ii) Technical Correction Possible. At an ABA/AICPA/IRS Tax Practitioners Roundtable in May of 1990, IRS officials identified the rental real estate subdivision rule as a likely candidate for technical correction in the next set of regulations. See 90 TNT 98-9. There was, however, apparently no mention of this particular issue.

e. Aggregation to Secure Phase-Out. It has been reported that some partnerships have used elective rental real estate aggregation to group properties acquired after 1986 into the same undertaking as pre-1986 properties, thus securing phase-out benefits for the post-1986 properties. IRS officials have announced, however, that a retroactive technical correction will be made to preclude such tactics. See Tax Notes (Mar. 5, 1990) at 1113.

2. Taxpayer Aggregation of Rental Real Estate Undertakings. After an entity makes its elections with respect to a rental real estate undertaking, each taxpayer has the ability to make elections. Each entity is permitted to elect to treat multiple rental real estate undertakings as a single rental real estate undertaking. Treas. Reg. Section 1.469-4T(k)(2)(ii). If the taxpayer owns through an electing entity, he must abide by this entity-level aggregation. Treas. Reg. Section 1.469-4T(k)(2)(ii). Similarly, each entity may elect to subdivide a single rental real estate undertaking into multiple rental real estate undertakings, if the real estate comprising each part can be conveyed separately. If the taxpayer owns through an electing entity, he can use these subdivided undertakings, but if his entity does not elect, the taxpayer cannot subdivide. Treas. Reg. Section 1.469-4T(k)(2)(iii)(B). Therefore, a taxpayer owning through a pass through entity cannot subdivide the undertakings determined by the entity; he can only further aggregate the undertakings determined by the entity.

a. Example. Assume that the taxpayer has an interest in a partnership which owns 5 separately conveyable condominium units (A, B, C, D and E). A, B and C are at one location and D and E are at another location. If the partnership elects to treat each unit as a separate undertaking, the taxpayer could mix and match as he wished: ABC as one activity and DE as another; AC as one activity, BD as another and C as another; each unit as a different activity; etc. If, however, the partnership elects to treat ABC as one undertaking and DE as another, the taxpayer's options are limited: he can treat all five as one activity or treat each ABC as one activity and DE as another.

3. Disaggregation Election for Disposition Purposes Only. Each taxpayer may elect to treat each undertaking (except any rental real estate undertaking) as a separate activity for all purposes except determination of whether the taxpayer materially participates. Treas. Reg. Section 1.469-4T(o)(2), (6). This election can be referred to as the "activity separation election." As in the case of rental real estate activities, this election may be made by taxpayers only to the extent such election is consistent with that of the pass through entity through which an interest is owned.

a. Election Usually Beneficial. The activity separation election will almost always be beneficial since suspended passive losses can then be freed upon disposition of each undertaking.

i. Example. Suppose A has an interest in three grocery stores at different locations. Absent any aggregation rules, each store would be a separate undertaking. Suppose that under the aggregation rules, however, the three stores are treated as a single activity. Each store generates a $100 passive loss to A in 1989 and 1990, which losses are suspended. In 1991, one of the stores is sold. If A has not made the activity separation election, no suspended losses are freed in 1991 because A has not disposed of his entire interest in the activity. If A has made the election, however, then the sale of one store is treated as a disposition of an entire activity. Thus, A would have $200 in losses freed up to offset other income.

i. Election Made by Written Statement. Treas. Reg. Section 1.469-4T(o)(7) provides that the disaggregation election with respect to an undertaking is to be made by attaching a written statement to the taxpayer's return. This statement must (a) include the taxpayer's name, address and identification number; (b) declare that an election is being made under Treas. Reg. Section 1.469-4T(o); (c) identify the undertaking with respect to which the election is made; and (d) identify the remainder of the activity in which it would otherwise be included. Treas. Reg. Section 1.469-4T(o)(7)(ii).

ii. Time Deadline. Any undertakings which are aggregated on a taxpayer's first return after August 9, 1989 are not subject to the activity separation election. Treas. Reg. Section 1.469-4T(o)(4). As with elections relating to rental real estate undertaking, however, it should be possible to make the disaggregation election by amended return.

c. "Anti-Abuse" Regulations Possible. The Preamble to the May 1989 Regulations states as follows:

In some cases, an undertaking may be conducted in a manner that enhances the value of other undertakings to the detriment of its own value. In such cases, the economic income or loss from an undertaking cannot be accurately measured at the time of its disposition. Accordingly, the Service is considering a rule that could provide in such cases that a disposition of a taxpayer's interest in such an undertaking is not treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g). If adopted, this rule would be contained in the regulations to be issued under section 1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities). T.D. 8253, Preamble to the May 1989 Regulations at part II(E).

In light of this language, any regulations on this point might well be retroactive.

d. Trap for the Unwary. As noted above, the activity separation election is almost always beneficial. The strict consistency rules will generally require, however, that individual taxpayers make this election on their 1989 tax returns. The result is a trap for the unwary; taxpayers who fail to make the election this year will forever be deprived of its benefits. This result is harsh, to say the least; it would be better to allow the election on the sale of an undertaking, but make the taxpayer prove that the suspended losses have been appropriately allocated to the undertaking that was sold.

e. Passthrough Entities. Individual taxpayers cannot make an activity separation election if the election is not made by a passthrough entity through which the taxpayer owns the undertaking. Thus, the need for an activity separation election at both the taxpayer and the entity level is an additional trap for the unwary.

J. Special Rules for Corporations and PTP's.

1. C Corporations and Other Non-Passthrough Entities. The operations of a non-passthrough entity are part of the activities of that entity and not part of the activities of the entity's owners. Treas. Reg. Section 1.469-4T(b)(2)(ii)(B). This result follows from the general nature of undertakings and activities as entity-level and taxpayer-level concepts respectively, but is emphasized by a special rule in the Regulations.

a. Comparison to Treas. Reg. Section 1.469-5T(f)(1). Prior to its amendment in May of 1989, Treas. Reg. Section 1.469-5T(f)(1) accomplished the same result for C corporations as does the new rule on non-passthrough entities. Prior to amendment, Treas. Reg. Section 1.469-5T(f)(1) provided that

work done by an individual (without regard to the capacity in which the individual does such work) in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest... shall be treated for purposes of this section as participation of such individual in the activity. [Emphasis added].

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Further suppose X spends 600 hours a year on Activity A, all of it in his capacity as President of Corporation C. If C were an S corporation, Treas. Reg. Section 1.469-5T(f)(1) would mean that X materially participated in activity A. If C were a C corporation, however, the parenthetical in old Treas. Reg. Section 1.469-5T(f)(1) would mean that X's work did not make him a participant in activity A. Since the May 1989 amendments removed the parenthetical, Treas. Reg. Section 1.469-5T(f)(1) no longer prevents X from being a material participant. Instead, the May 1989 Regulations clarify that activity A is not an activity of X at all, and thus his work on activity A does not make X a material participant. Treas. Reg. Section 1.469-4T(b)(2)(ii)(B).

2. Consolidated Groups. The activities of a consolidated group are determined as if all group members were a single taxpayer. Treas. Reg. Section 1.469-4T(m)(1).

3. Publicly Traded Partnerships. In determining the activities of a taxpayer, operations of a publicly traded partnership cannot be combined with the operations of any other entity. Treas. Reg. Section 1.469-4T(n).

   a. Example. If a taxpayer was the general partner of a real estate management services PTP in which he spent 500 hours and was a general partner participating for 50 hours in a non-PTP partnership which managed real estate (i.e., was in the same line of business and was controlled by the same interests as the PTP), the income or loss from the PTP would be active and the income or loss from the non-PTP partnership would be passive.

K. Effective Date. As discussed above in D., taxpayers may determine the activities in which they had an interest for taxable years ending before August 10, 1989, using “any reasonable method” under Notice 88-94. Treas. Reg. Section 1.469-4T(p)(1). For all taxable years ending on or after August 10, 1989, taxpayers must define their activities using the rules in Treas. Reg. Sections 1.469-4T(b) through (n).

   1. Fiscal Years. According to Treasury officials, the relevant year for purposes of the effective date rules is the taxable year of the taxpayer (usually an individual) and not the taxable year of any pass-through entity in which the taxpayer has an interest. Thus, if an individual taxpayer has an interest in an S corporation with a June 30 taxable year, for purposes of applying the passive loss rules to the individual’s 1989 return, the activities conducted through the S corporation must be determined using the new definition of an activity in Treas. Reg. Sections 1.469-4T(b) through (n).

   a. Coordination with Fiscal Years for Participation. This result occurs even though the individual’s hours of participation are measured by reference to his participation during the fiscal year of the S corporation. Treas. Reg. Section 1.469-2T(e)(1).

IV. PASSIVE ACTIVITY.

A. In General. Once a determination has been made as to the various activities of the taxpayer, the passive activities of the taxpayer must be identified. A passive activity in general is any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate. Section 469(c)(1). Additionally, without regard to material participation, a rental activity is a passive activity. Section 469(c)(2). Also included within the scope of passive activities, but subject to even more restrictive rules, are publicly traded partnership activities that involve either a rental activity or a trade or business activity in which the taxpayer does not materially participate. See Section 469(k).

B. Non-Passive Activities. To properly understand what a passive activity is, it is helpful to identify what a passive activity is not. The following activities are not passive activities:

   1. Active Activities. Trade or business activities from which the taxpayer receives only personal service income or in which the taxpayer materially participates.

   2. Portfolio Activities. Activities in which the taxpayers holds property for investment.
3. Personal Activities. Activities engaged in for personal purposes and not for a trade or business or investment purposes.

C. Pre-1987 Installment Sales.

1. Revenue Notice 87-8. Revenue Notice 87-8, 1987-1 C.B. 421, provided that gains from pre-1987 installment sales would be treated as gains from non-passive activities when gains were recognized on the installment basis in post-1986 taxable years. Thus, sale of rental property with a basis of $500,000 in 1986 for $100,000 down and $900,000 in 1987 under the installment sale method would result in $450,000 of active income in 1987. The theory underlying Notice 87-8 was that passive activities did not exist prior to 1987. This position was criticized by certain commentators. See Lipton & Eavul, Tax Notes, April 20, 1987, page 306.


D. Selected Special Rules.

1. Rental of Dwelling Units. An activity involving the rental of a dwelling unit is not a passive activity for any taxable year in which Section 280A(c)(5), relating to use of the dwelling unit as a residence, is applicable. Treas. Reg. Section 1.469-1T(e)(5).

   a. Example. Lou owns a condominium in Aspen which Lou uses three weeks each year for personal purposes; the condominium is rented for an additional ten weeks. Any profit from the rentals is not income from a passive activity.

2. Trading Personal Property. An activity of trading personal property for the account of owners of interest in the activity is not a passive activity (without regarding to whether such activity is a trade or business activity). For purposes of this rule, personal property means personal property within the meaning of Section 1092(d), e.g., securities or commodities futures, without regard to paragraph (3) thereof. Treas. Reg. Sec. 1.469-1T(e)(6).

   a. Example. A partnership is a trader of stocks and bonds; the partnership derives gross income from the activity in the form of interest, dividends and capital gains. The capital employed by the partnership consists of amounts contributed by the partners and funds borrowed by the partnership. The partnership is treated as conducting an activity of trading personal property for the account of its partners, which is not a passive activity.

3. Oil and Gas Working Interests. See part XVI for special rules concerning the treatment of oil and gas working interests.

V. ACTIVE ACTIVITY.

Section 469 itself supplies no direct definition of an active activity. By subtraction of concepts, an active activity is any trade or business activity in which the taxpayer materially participates. Active activities are not subject to Section 469. Thus, active losses may offset any type of income and are therefore the most desirable type of losses. Active income, however, is less desirable than passive income because passive income can be offset by passive losses and active income cannot be so offset. If a taxpayer has investment interest deductions available, portfolio income is also more beneficial than active income. Active income is treated the same as personal service income, but the tests for each are different and it is best to keep the concepts of active income and personal service income separate.
VI. TRADE OR BUSINESS ACTIVITY.

A. In General. The first question in determining whether a non-rental activity is a passive activity is the presence of a trade or business. In order to be a passive activity other than a rental activity, there must be a trade or business. Similarly, an active activity would require the presence of a trade or business. The term “trade or business activity” includes endeavors that involve the conduct of a trade or business within the meaning of Section 162 or involves Section 174 endeavors, provided that such activity is not a rental activity. Treas. Reg. Sections 1.469-1T(e)(2) and -4T(b)(2)(A). As a result of the definition of “business and rental operations” in Treas. Reg. Section 1.469-4T(b)(2)(A)(i)(1), a trade or business activity also includes endeavors conducted “in anticipation” of such endeavors becoming a trade or business.

B. Research and Experimental Expenditures. Activities which include Expenditures paid or incurred with respect to research or experimentation which are deductible under Section 174 (or would be deductible under Section 174 if the method described in Section 174(a) were adopted) are also trade or business activities. Section 469(c)(5) and Treas. Reg. Section 1.469-1T(e)(2)(A)(2).

C. Section 162 Endeavors Trade or Business Activities v. Portfolio Activities. There are a number of activities that generally appear to be Section 162 trade or business activities, but under Section 469 are treated as portfolio activities. In addition, there are a number of activities which appear to be portfolio, but are treated as trade or business activities. The following discusses these situations.

1. Anticipated Section 162 Activities. Treas. Reg. Sections 1.469-4T(b)(2)(ii)(A)(1) and 1T(e)(2)(ii) recharacterize Section 212 activities as passive or active activities by treating activities conducted in anticipation of a Section 162 trade or business activity. Thus, if the taxpayer materially participates, the activity is recharacterized as an active activity and if the taxpayer does not materially participate, the activity is a passive activity.

   a. Raw Land Held for Development. Assume that taxpayer A is a partner in a partnership which holds raw land with the specific intent to develop the property beginning in 3 years. Holding such raw land prior to development is an anticipated Section 162 activity and is therefore a trade or business activity for Section 469 purposes. The interest expense on the raw land prior to development will therefore be either passive or active, depending on A’s participation level. If A is a material participant in the anticipated Section 162 activity, the interest will be active. If A is not a material participant in the activity, the interest will be passive.

      i. Compare Raw Land Held for Investment. If raw land is held for investment with no intent to develop, it is not held in anticipation of Section 162 activities. Thus, the interest attributable thereto should be deductible subject to the Section 163(d) investment interest rules.

   b. Effective Date. The anticipated Section 162 endeavors rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a).

2. Qualified Working Interest. Pursuant to Section 469(c)(3), a qualified working interest in an oil and gas property is not a passive activity. Pursuant to Section 163(d)(5)(A)(ii) a qualified working interest with respect to which a taxpayer does not materially participate is a portfolio activity. See Special Rules for Oil and Gas Activities, below, for a more detailed discussion of the qualified working interest rule.


   b. Qualified Working Interest Undertaking Separation. The Regulations provide a special provision for defining an “activity” that involves a working interest in an oil and gas property. Under Treas. Reg. Section 1.469-4T(e)(1)(ii), certain oil and gas working interest operations are treated as a separate activity from other same location, same entity income-producing operations. The separation rule, however, does not apply if the taxpayer is a material
participant in the unseparated income-producing operation. Treas. Reg. Section 1.469-4T(e)(1)(ii). This separation rule acts as a recharacterization rule which can effect both qualified working interests and other trade or business undertakings. A more detailed discussion of this rule is found in Special Rules for Oil and Gas Activities, below.

i. Example. Assume that taxpayer A owns oil and gas income-producing operations at a single location which includes oil and gas working interest operations. Assume that A spends 501 hours a year on such oil and gas working interest operations and 60 hours on the remaining income-producing operations. By not separating the oil and gas working interest operations, the other oil and gas operations are in substance recharacterized as active activities.

ii. Effective Date. This qualified working interest undertaking separation recharacterization rule is effective for taxable years beginning after August 9, 1989. Treas. Reg. Section 1.469-4T(p). Additionally, for tax years beginning after December 31, 1986 and before August 10, 1989, the rule is available but not required as a reasonable method of defining an activity. Treas. Reg. Section 1.469-4T(p).

3. Trading Personal Property. Treas. Reg. Section 1.469-1T(e)(6) provides that the trading of personal property (as defined by Section 1092(d) without regard to paragraph (d)(3) thereof) for the account of owners in such activity is not a passive activity without regard to whether the activity is a trade or business. As such, the activity is recharacterized as a portfolio activity under the trading personal property recharacterization rule.

a. Example. Partners A and B form a personal property trading partnership in which A is a full-time participant as the general partner with a 50% partnership interest in profits and losses. B is the non-participating limited partner with a 50% partnership interest in profits and losses. In 1988, the partnership has $200 of net income. Thus, A has $100 of active income and B has $100 of portfolio income. In 1989, the partnership has a $300 net loss. A has a $150 active loss and B has a $150 portfolio loss. Thus, for the partner who materially participates, the activity is a trade or business; but for the partner who does not, the activity is portfolio.


4. Disposition of a Passive Activity. Disposition of a passive activity interest, such as the sale of a nonpublicly traded limited partnership interest in a hotel, could in theory be viewed as a disposition of portfolio property. The last sentence of Section 469(e)(1)(A), however, clarifies this issue by stating that any interest in a passive activity shall not be treated as property held for investment.

5. Incidental Dealing. Treas. Reg. Section 1.469-2T(c)(2)(v) provides an incidental dealing recharacterization rule for dealing activities which are incidental to trade or business, rental or portfolio activities. Thus, the passive or active activities of such trade or business incidental dealing is recharacterized as a passive, active or portfolio activity. See discussion of this rule in Computation and Treatment of PALs, below.


6. 12 Month Disposition. Under Treas. Reg. Section 1.469-2T(c)(2)(ii), if property which is used in only one activity at the time of disposition has been used in more than one activity during the 12 month period preceding the disposition, the gain generally must be allocated among the activities. A de minimis exception exists for situations in which the fair market value of the interest in property does not exceed the lesser of (i) $10,000 or (ii) 10% of the fair market value of all property (including the property subject of the disposition) used in the activity immediately before the disposition.

7. Self-Charged Interest. The self-charged interest rules discussed below in Section XIV, self-charged rules may result in portfolio interest income or expense being recharacterized as passive income or expense in certain situations where a taxpayer is viewed as charging himself interest.

D. Ordinary Course of Trade or Business Income. The threshold issue that must be addressed in order to determine whether income is passive or portfolio is whether such income is from a trade or business. Even if income is of a nature generally viewed as portfolio, if it is earned in the ordinary course of a trade or business, such income is not portfolio. Section 469(c)(1) and (e)(1); Senate Report at 729. The regulations also state that such income will not be portfolio when it is earned in the ordinary course of a trade or business. Treas. Reg. Section 1.469-2T(c)(3)(i). The "ordinary course of a trade or business" is a concept that is well defined under existing tax law. The regulations under Section 469, however, completely redefine what is meant by the term "gross income derived in the ordinary course of a trade or business." By modifying the traditional Section 162 meaning of the phrase "in the ordinary course of a trade or business," Treas. Reg. Section 1.469-2T(c)(3)(ii) becomes an unlabeled recharacterization rule transforming passive income (where the taxpayer does not materially participate) or active income (where the taxpayer does materially participate) into portfolio income. Activities that are not included in Treas. Reg. Section 1.469-2T(c)(3)(ii)(A-F) as part of the ordinary course of a trade or business must be approved by the Commissioner. Without approval of the Commissioner, any income described in Treas. Reg. Section 1.469-2T(c)(3)(i), such as interest, dividends, royalties and the like, is portfolio even if under Section 162 principles such income is earned in a trade or business activity.

I. Lending Money Income. As a general rule, loans and investments made in the ordinary course of the trade or business of lending money is treated as a trade or business activity. Treas. Reg. Section 1.469-2T(c)(3)(ii)(A). But see Treas. Reg. Section 1.469-2T(f)(4), discussed below, wherein gross interest income from passive equity-financed lending activities may be recharacterized as portfolio income. Loans that are not made in the ordinary course of a trade or business of lending money would not be treated as part of a trade or business activity.

a. Mineral Production Payments (Interest Portion). Mineral production payments are treated as interest payments to the extent such payments are interest equivalents under Section 636. Treas. Reg. Section 1.469-2T(c)(3)(C)(1). Since the interest payments are not in the ordinary course of a trade or business interest payments under Treas. Reg. Section 1.469-2T(c)(3)(A) or (B), such mineral production payment is indirectly recharacterized as portfolio income. Furthermore, if a mineral production payment is not treated as a loan under Section 636, payments in discharge of a mineral production payment are treated as royalties and again indirectly recharacterized as portfolio income under Treas. Reg. Section 1.469-2T(c)(3)(i). See Treas. Reg. Section 1.469-2T(c)(3)(C) and discussion of Mineral Royalties, below.

i. Effective Date. The mineral production payments recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

b. Installment Sales. A frequently asked question following passage of the Tax Reform Act of 1986 has been whether interest income on an installment sale of passive activity property is passive or portfolio. In general, installment sale interest income is portfolio income. See Treas. Reg. Section 1.469-2T(c)(3) definition of portfolio income. Only in two narrow circumstances is the interest income passive. First, under the regulations, interest income earned in the trade or business of lending money can be passive to a nonmaterial participant in a money lending trade or business. Treas. Reg. Section 1.469-2T(c)(3)(ii)(A). With respect to an installment sale of property, passive treatment can arise where a lender obtained rental real estate by foreclosure or deed-in-lieu and then sold the property on an installment basis. The interest payments in such installment note may be passive to a nonmaterial participant in the lending business. The second circumstance is discussed below for Accounts Receivable.

2. Accounts Receivable. Accounts receivable arising from the ordinary course of performing business services or property sales are part of a trade or business activity, but only if credit is customarily offered to customers. Treas. Reg. Section 1.469-2T(c)(3)(ii)(B).
a. Interest. The regulations also provide that interest on customers accounts receivable can be earned in the ordinary course of a trade or business, but only if credit is customarily offered to customers of the business. Treas. Reg. Section 1.469-2T(c)(3)(ii)(B). Thus, for this exception to apply and for portfolio interest to be avoided, the taxpayer must be a passive participant in the ordinary trade or business of selling such property to customers, and the credit must be customarily offered to customers.

3. Trading or Dealing in Property. Trading or dealing in property can be treated as a trade or business activity. Treas. Reg. Section 1.469-2T(c)(3)(i)(C).

a. Former Investment Property. Under Treas. Reg. Section 1.469-2T(c)(3)(iii)(A), the sale of property in the ordinary course of a dealer’s trade or business is treated as a trade or business activity, but gain or income from such sales is subject to recharacterization as portfolio income if the dealer held the property for investment at any time prior to recognition of the income or gain. Apparently, losses and expenses with respect to such property also would be portfolio. See Treas. Reg. Section 1.469-2T(d)(2).

i. Limited Scope. This rule only applies to the extent that the “dealer exception” of Treas. Reg. Sec. 1.469-2T(c)(3)(ii) is necessary to prevent the income from being portfolio income under Treas. Reg. Section 1.469-2T(c)(3)(i). As a result, this special rule applies only to property that produces income described in Treas. Reg. Sec. 1.469-2T(c)(3)(i)(A), (B), (C) or (D), such as interest, dividends and royalties. Thus, this rule will apply to sales by a dealer of stocks or bonds previously held for investment, but should not apply to sales of land formerly held for investment by a dealer. Treas. Reg. Sec. 1.469-2T(c)(3)(i) and (iii).


4. Annuity and Life Insurance Income. Investment in the trade or business of furnishing life insurance, annuities or reinsuring insurance company losses is treated as a trade or business activity. Treas. Reg. Section 1.469-2T(c)(3)(i).

5. Royalty Income. Royalties received with respect to a license or other transfer of any rights in intangible property are received in the ordinary course of a trade or business activity if received by the person creating the property or if the person performs substantial services or has incurred substantial costs with respect to the marketing or development of the property. Treas. Reg. Sections 1.469-2T(c)(3)(iii)(B) and 2T(c)(3)(iii)(E).

a. Licensing Royalties. Under Treas. Reg. Section 1.469-2T(c)(3)(iii)(B), royalties received pursuant to a license or other transfer of intangible property rights is treated as derived in the ordinary course of a trade or business only if the person receiving such royalties (i) created the property, or (ii) performed substantial services or incurred substantial costs in developing or marketing the property. A royalty that otherwise would be treated as derived in the ordinary course of a trade or business but that does not meet the substantial services or costs test will be treated as not derived in the ordinary course of a trade or business. Thus, under Treas. Reg. Section 1.469-2T(c)(3)(iii)(B), such royalty income will indirectly be recharacterized as portfolio income. Without the indirect recharacterization, such income would be active (if the taxpayer materially participates in the activity) or passive (if the taxpayer does not materially participate in the activity). Pursuant to Treas. Reg. Sections 1.469-2T(d)(2),(3) and (4), expenses with respect to recharacterized royalty income will be treated as attributable to portfolio income. Thus, the end result of Treas. Reg. Section 1.469-2T(c)(3)(iii)(B), royalties from licensing intangibles recharacterization rule, is that the activity producing royalties without the requisite criterion, substantial services or costs of the taxpayer, is recharacterized as a portfolio activity.

i. Substantial Services or Costs. The issue of substantial services or costs is a facts and circumstances question. Treas. Reg. Section 1.469-2T(c)(3)(iii)(B)(2)(i).

iii. Interplay with Intangible Licensing Pass-Through Entity Acquisition Recharacterization Rule. The interplay between the intangible licensing pass-through recharacterization rule and the licensing royalties recharacterization rule is crucial to understanding each rule. The licensing royalties recharacterization rule of Treas. Reg. Section 1.469-2T(c)(3)(ii)(C) provides that royalty income otherwise from a trade or business generally will be recharacterized as portfolio income if the recipient (i.e., the taxpayer or, in the case of a pass-through entity, the entity) (i) created the property, or performed substantial services or incurred substantial costs in developing or marketing the property. Such rule, however, is not protective enough of the interests of Treasury where the taxpayer purchases an interest in a pass-through entity which has already created the property, incurred the development or marketing costs or performed the marketing or development services. See Preamble of the February 1988 Regulations at XVI.C.3. Thus, the intangible licensing pass-through entity acquisition recharacterization rule applies where the taxpayer acquires a pass-through entity interest after the entity has created the property, performed the services or incurred the costs. Treas. Reg. Section 1.469-2T(f)(7).

6. Patronage Dividend Income. A patronage dividend received from a cooperative under Section 1381(a) (without regard to paragraph 2(A) or (C) thereof) is received with respect to a trade or business if received by reason of payment or allocation based on patronage with respect to a trade or business of the patron. Treas. Reg. Section 1.469-2T(c)(3)(ii)(F).

a. Patron Participation. From this reference to cooperatives, it appears that trade or business patronage dividends received by an individual would be treated as passive or active income. The unanswered question about cooperatives, however, is how to measure the participation of a patron.

7. Other Commissioner Identified Income. Treas. Reg. Section 1.469-2T(c)(3)(ii)(G) provides that income not otherwise specifically identified in Treas. Reg. Section 1.469-2T(c)(3)(ii) (i.e., paragraphs 1-6, above) is income in the ordinary course of a trade or business only if identified as such by the Commissioner.

a. Mineral Royalty Income. If a taxpayer is in the trade or business of dealing or trading in mineral royalties, royalty income is treated as earned in the ordinary course of a trade or business and will be passive or active depending upon the level of the taxpayer’s participation. Treas. Reg. Sections 1.469-2T(c)(3)(ii)(D) and (c)(3)(iv), Example (4). The only other mineral royalties under the regulations which can be derived in the ordinary course of a trade or business are those identified by the Commissioner pursuant to Treas. Reg. Section 1.469-2T(c)(3)(ii)(G). In Section X(C) of the Preamble to the February 1988 Regulations, Treasury indicated that the only way to get the Commissioner’s approval would be to request a ruling. It was further indicated in the Preamble that Treasury believed there were cases in which such a ruling would be appropriate, but that in certain cases a portion of royalty income from a transfer could be deemed the equivalent of portfolio interest income from an installment sale. For example, royalty income from the transfer of mineral properties by a partnership in the trade or business of oil and gas development would be subject to a proration which would treat part of the royalty stream as sale proceeds and part as portfolio interest income. See Preamble Section X(C). Treasury in Preamble Section X(C) has requested comments on such distinctions in general and in particular on how to allocate depletion deductions between trade or business royalty income and portfolio royalty income.

i. Effective Date. The effective date for the mineral royalties rule is for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

b. Mineral Production Payments (Royalty Portion). Mineral production payments are treated as interest payments to the extent such payments are interest equivalents under Section 636. Treas. Reg. Section 1.469-2T(c)(3)(ii)(C)(l). Since the interest payments are not in the ordinary course of a trade or business interest payments under Treas. Reg. Sections 1.469-2T(c)(ii)(A) or (B), such mineral production payment is indirectly recharacterized as portfolio income. Furthermore, if a mineral production payment is not treated as a loan under Section 636, payments in discharge of a mineral production payment are treated as royalties and again indirectly recharacterized as portfolio income under Treas. Reg. Section 1.469-2T(c)(3)(ii). See Treas. Reg. Section 1.469-2T(c)(3)(iii)(C)(2).

8. Working Capital Income. Section 469(e)(1)(B) provides that any income or gain from the investment of working capital is not derived in the ordinary course of a trade or business for purposes of determining portfolio income. In substance, the working capital rule is a recharacterization rule which recharacterizes active or passive activities as portfolio activities. The regulations implement this rule by treating such working capital interest as not being earned in a trade or business.

a. Example. Assume that taxpayer A is a limited partner who does not participate in a motel limited partnership, X, which has a $10,000 average cash checking account in 1992 which has an average of 6% interest for 1992. The $10,000 cash average was not only necessary working capital of X, but was indeed below what its accountant and financial adviser have recommended as working capital. If the hotel limited partnership interest of A incurs an operating loss (determined without interest income) of $5,000 and interest income is $600, A's interest income would be portfolio income. The loss, however, is passive and cannot offset the interest income.

b. Comment. The working capital interest recharacterization rule was apparently adopted by Congress for administrative convenience. This rule can work to the taxpayer's advantage. If the taxpayer is seeking investment (portfolio) income for purposes of Section 163(d), he can create working capital in an otherwise passive activity (such as rental real estate) and the income earned on the working capital should be treated as portfolio income.

c. Effective Date. The working capital interest recharacterization rule is effective for taxable years beginning after December 31, 1986. TRA '86, Section 501(a).

9. Losses and Expenses Attributable to Paragraphs 1-8 Income. Pursuant to Treas. Reg. Section 1.469-2T(d) generally provides that expenses and deductions attributable to the generation of portfolio income will be a portfolio expense or deduction. Thus, each of the above rules 1-8 operates in economic substance to recharacterize the activity, not just the income as portfolio.

10. Former Investment Property. Under Treas. Reg. Section 1.469-2T(c)(3)(iii)(A), the sale of property in the ordinary course of a dealer's trade or business is treated as a trade or business activity, but gain or income from such sales is subject to recharacterization as portfolio income if the dealer held the property for investment at any time prior to recognition of the income or gain. Apparently, losses and expenses with respect to such property also would be portfolio. See Treas. Reg. Section 1.469-2T(d)(2).

a. Limited Scope. This rule only applies to the extent that the "dealer exception" of Treas. Reg. Sec. 1.469-2T(c)(3)(ii) is necessary to prevent the income from being portfolio income under Treas. Reg. Sec. 1.469-2T(c)(3)(i). As a result, this special rule applies only to property that produces income described in Treas. Reg. Sec. 1.469-2T(c)(3)(i)(A), (B), (C) or (D), such as interest, dividends and royalties. Thus, this rule will apply to sales by a dealer of stocks or bonds previously held for investment, but this rule should not apply to sales of land formerly held for investment by a dealer. Treas. Reg. Sec. 1.469-2T(c)(3)(i) and (iii).


E. Income Only Recharacterized. Certain recharacterization rules discussed below operates only to recharacterize income from trade or business into portfolio.

1. Intangible Licensing Pass-Through. Under Treas. Reg. Section 1.469-2T(f)(7), if a taxpayer acquires an interest in a development entity which is a pass-through entity after creation of an intangible property item or after performance of substantial services with respect to development or marketing of such an item, gross royalty income of the taxpayer equal to net royalty income from such item of property is recharacterized under the intangible licensing
pass-through recharacterization rule as portfolio income. Thus, investment in a royalty producing trade or business entity after the creation, development and marketing of the royalty producing property will result in portfolio royalty income.


b. **Interplay between the Rules on Intangible Licensing.** The interplay between the intangible licensing pass-through recharacterization rule and the licensing royalties recharacterization rule is crucial to understanding each rule. The licensing royalties recharacterization rule of Treas. Reg. Section 1.469-2T(c)(3)(iii)(C) provides that royalty income otherwise from a trade or business generally will be recharacterized as portfolio income if the recipient (i.e., the taxpayer or, in the case of a pass-through entity, the entity) (i) created the property, (ii) performed substantial services or incurred substantial costs in developing or marketing the property. Such rule, however, is not protective enough of the interests of Treasury where the taxpayer purchases an interest in a pass-through entity which has already created the property, incurred the development or marketing costs or performed the marketing or development services. See Preamble of the February 1988 Regulations at XVI.C.3. Thus, the intangible licensing pass-through entity acquisition recharacterization rule applies where the taxpayer acquires a pass-through entity interest after the entity has created the property, performed the services or incurred the costs. Treas. Reg. Section 1.469-2T(f)(7).

2. **Former Qualified Working Interest.** If a taxpayer utilized the qualified working interest exception of Section 469(c)(3) to take any active loss with respect to an oil and gas property for a taxable year beginning after December 31, 1986, gross income from such oil and gas property will be nonpassive income to the extent of the net income therefrom for such taxable year. Treas. Reg. Section 1.469-2T(c)(6). Thus, even if the taxpayer converts his qualified working interest into an interest in a limited liability entity, gross income from the activity will be recharacterized. Although not so stated in the Regulations, this nonpassive income is treated as investment income for purposes of Section 163(d). Thus, it is better to view this income as portfolio income, although it is not labeled explicitly as such. A more detailed discussion of qualified working interests is found, below, in *Special Rules for Oil and Gas Working Interests.*

a. **Example.** Individual A converts his working interest in an oil and gas property into an S corporation in 1988. In 1987, the working interest produced an active loss under the qualified working interest exception. In 1988, any net income from the property will be recharacterized as nonpassive income. Losses that might occur following transfer into the S corporation would be passive, assuming that A did not materially participate in the activity. Once a taxpayer takes advantage of the qualified working interest exception to treat losses as active, income from the property is perpetually tainted as nonpassive. The income will be investment income for purposes of Section 163(d).

b. **Definition of Property.** For purposes of the former qualified working interest recharacterization rule, the term “property” means property the value of which is directly enhanced by any drilling, logging, seismic testing, or any other activity, a part of the cost of which was incurred by the taxpayer as a result of holding a qualified working interest. Treas. Reg. Section 1.469-2T(c)(6)(iii). This definition of property is broader than the applicable definition for the qualified working interest, which is determined on a well-by-well basis.

i. **Example.** Taxpayer A drills a well as a qualified working interest owner in 1987, and the logging, seismic, or drilling information from that well is used to directly enhance the value of a 1988 limited partnership investment of A. The losses from the limited partnership are passive, but gross income in excess of deductions from such limited partnership (such deductions including any suspended PALs from the activity) is active income.

c. **Effective Date.** The effective date of the former qualified working interest recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

3. **Substantially Appreciated Property.** Under Treas. Reg. Section 1.469-2T(c)(2)(iii), gain from a disposition of an interest in substantially appreciated property (i.e., an interest in property in which the fair market value exceeds 120% of the adjusted basis of such interest) is recharacterized as active income unless such property was used
in a passive activity for either (i) 20% of the taxpayer's holding period, or (ii) the entire 24 months prior to disposition. If the taxpayer held the property for investment purposes for more than 50% of his holding period, see paragraph b, below.

a. Substantially Appreciated Former Investment Property. Under Treas. Reg. Section 1.469-2T(c)(2)(iii)(E), if substantially appreciated property was held for investment purposes more than 50% of the taxpayer's holding period, and the gain from disposition of the property is otherwise subject to recharacterization as set forth above in Treas. Reg. Section 1.469-2T(c)(2)(iii), the gain is recharacterized as portfolio income.

b. Acquired Property. For purposes of the foregoing rules concerning substantially appreciated property, if a taxpayer acquired any property in a transaction other than a nonrecognition transaction, any prior ownership or use of the property is not taken into account. Treas. Reg. Section 1.469-1T(c)(2)(iv). Thus, for example, if A is a partner in partnership AB, which acquires an interest in property in 1990 for $1, and A purchases the property from AB in 1995 for $20, the sale of the same property by A in 1996 for $22 will not be subject to these rules concerning substantially appreciated property.

c. Effective Date. The substantially appreciated property recharacterization rule is effective for dispositions after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(i).

4. Equity Financed Lending Activity. Under Treas. Reg. Section 1.469-2T(f)(4), passive income from an equity-financed lending activity is recharacterized as portfolio income. An equity-financed lending activity must be an activity involving the trade or business of lending money. Treas. Reg. Section 1.469-2T(f)(4)(ii)(A)(2). The trade or business of lending money is an equity-financed lending activity only if the average outstanding balance of liabilities incurred does not exceed 80% of the average outstanding balance of interest bearing assets held in the activity during the taxable year. Treas. Reg. Section 1.469-2T(f)(4)(ii)(A)(1). An amount of the taxpayer's gross income from the equity-financed lending activity is recharacterized as portfolio income to the extent of the lesser of (i) the taxpayer's equity-financed interest income, or (ii) the taxpayer's net passive income from the activity in such taxable year. Treas. Reg. Section 1.469-2T(f)(4)(i). This rule was intended to stop the equity syndication of mortgage pools, pursuant to which passive income was thought to have been generated by virtue of making loans in the ordinary course of business.


5. Preferred and Guaranteed Returns. The legislative history of Section 469 provides that a guaranteed return that was structured to provide passive income would be an appropriate subject for recharacterization as portfolio income. A guaranteed return appears to be one that is not subject to the entrepreneurial risk of a rental or trade or business activity. The regulations as presently drafted, however, do not recharacterize a guaranteed return. While the regulations have probably been too generous on the guaranteed return issue, the Preamble to the Regulations indicates that Treasury remains concerned with the issue and is reviewing the question of whether partnership preferred returns may also be subject to recharacterizations once guaranteed return regulations are issued. The Preamble does indicate, however, that such preferred returns recharacterizations would be dependent on circumstances such as the type of investments made by the partnership.

The treatment of preferred returns opens a variety of potential issues. For example, an eight percent preferred return that simply allocates to those who provide capital the first income from a trade or business activity should not be subject to recharacterization. Such income is preferred in nature, but is not guaranteed; it is subject to the entrepreneurial risk of the trade or business enterprise. On the other hand, assume that an investment partnership that had a triple A credit rated general partner guaranteed an eight percent annual return to investors without respect to the success or failure of the underlying trade or business activity. The investment of the taxpayer, by virtue of the guarantee, is without entrepreneurial risk of loss and is similar to a certificate of deposit in its investment nature.
a. Comment. The authors believe that it would be better to distinguish between "guaranteed" and "preferred" returns. If a return is guaranteed, the income should be portfolio. On the other hand, a preferred return which bears entrepreneurial risk of loss should not give rise to portfolio income.

b. Potential Effective Date. Whatever rules are eventually set forth in regulations or other IRS announcements with respect to guaranteed or preferred returns, it is anticipated that such rules will be prospective. Even if the rules are prospective, however, it is not clear that previously structured and acquired guaranteed or preferred returns will be grandfathered for tax periods following issuance of such regulations or announcements.

VII. MATERIAL PARTICIPATION.

A. Background.

1. Trade or Business Activity. If a taxpayer owns a rental activity, the activity is per se passive. If a taxpayer owns a trade or business activity, however, the participation level of the taxpayer is determinative. If the taxpayer materially participates, the activity is an active activity. If not, the activity is passive.

2. Statute / Legislative History (Subjective Test). The statute and legislative history indicate a subjective test for material participation: regular, continuous and substantial involvement in the operations of an activity. Section 469(h) and SFC at pages 733-745.

3. Regulations (Objective Rules). Treas. Reg. Section 1.469-5T, however, takes an altogether different approach in providing six objective rules to determine when a taxpayer materially participates. A seventh rule is provided that in relatively narrow situations will apply a facts and circumstances test to determine whether a taxpayer materially participates as a result of regular, continuous or substantial participation. The general rule of the statute and legislative history is relegated to a secondary role in the regulations as a narrow subjective exception to the six objective ways to materially participate.

a. Seven Ways to Materially Participate. Under the regulations a taxpayer has the following seven ways to materially participate:

   i. 500 hour rule;
   ii. Substantially all participation rule;
   iii. Not less than any other participant rule;
   iv. Significant participation activity rule;
   v. Five out of ten year rule;
   vi. Three year personal service rule;
   vii. Facts and circumstances rule.

B. Statutory / Legislative History Subjective Approach. The approach in the regulations to the material participation test discussed below is dramatically different than that contemplated by the statute. For perspective, the following discussion is added to highlight the difference in the approaches. Neither the statute nor the Committee Reports specifically define what constitutes "regular, continuous and substantial" involvement in an activity. The Senate Finance Committee Report ("86 Sen. Rep.") at pages 733-745, however, provided several examples for purposes of applying this qualitative, "facts and circumstances" test.
1. **Movies.** In the case of a movie, an individual materially participates if the individual writes, reads or selects screenplays, negotiates with agents or talent, directs, distribution or production. "86 Sen. Rep. at 732.

2. **Principal Business.** A taxpayer is most likely to have materially participated in an activity where involvement in the activity is the taxpayers' principal business. For example, an individual who devotes 35 hours per week (1820 hours per year) to operating a grocery store would be treated as materially participating in that business. "86 Sen. Rep. at 733.

3. **Horse Breeding.** Regular contract, standing alone, is not sufficient for material participation. For example, a taxpayer who invested in a horse breeding activity which he visited regularly would not satisfy the regular, continuous and substantial test unless he was involved in the operations of the activity, for example, by hiring and from time to time supervising those responsible for taking care of the horses, along with making decisions (and not merely ratifying decisions) regarding the purchase, sale and breeding of horses. "86 Sen. Rep. at 733.

4. **Mississippi Barge.** An investor in a barge that transports grain would be treated as materially participating if he traveled with the barge and performed substantial services with respect to transporting the grain. Alternatively, the investor could be involved on a regular basis in finding new customers and negotiating terms with such customers. "86 Sen. Rep. at 733.

5. **Management.** One of the problems addressed in the legislative history concerning the application of the material participation test relates to individuals involved in management.

   a. **SFC Report.** The "86 Sen. Rep. at page 734 provides that the performance of management functions generally is treated no differently than rendering other services. Thus, an intermittent role in management would not establish material participation. The owner of an interest in an activity usually would have the right to make some management decisions. The "86 Sen. Rep. at page 734 states that the genuineness and substantiality of management roles are difficult to verify.

   b. **Conference Report.** The treatment of management was clouded, however, by the "line of business" concept proposed in the Conference Committee Report at pages II 147-148:

   Under the conference agreement, material participation has the same meaning as that set forth in the Senate Report. It is clarified that an individual who works full-time in a line of business consisting of one or more business activities generally is likely to be materially participating in those activities (except to the extent provided otherwise in the case of rental activities), even if the individual’s role is in management rather than operations.

   This clarification is not intended to alter the description of material participation in the Senate Report in any respect. Rather, it recognizes the substantial likelihood that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and bona fide, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment. Conference Committee Report at II 147-148.

   c. **Blue Book.** The Blue Book effectively reversed the "line of business" proposal in the Conference Report. The Blue Book states:

   The fact that an individual works full-time in a line of business consisting of one or more business activities does not determine his material participation in a particular activity, although his work may rise to the level of material participation with respect to one or more of the activities. An individual's material participation in any activity is determined on the basis of his regular, continuous and substantial involvement in the operations of the activity. His involvement in the operations of other
activities is not determinative. Thus, for example, a taxpayer's material participation in a rental activity (which is treated as passive without regard to the taxpayer's material participation) does not affect his material participation, if any, in other activities. Blue Book at 240.

C. Regulatory Objective Approach. Treas. Reg. Section 1.469-5T provides the definition of material participation. The regulations generally reject the "facts and circumstances" approach set forth in the legislative history and adopt a quantitative definition of material participation. The regulations have reduced the quantitative test to a standard which is considerably lower than a reading of the statute and legislative history would appear to indicate.

1. Seven Ways to Materially Participate. Subject to special rules for their application to limited partners and certain retired farmers and surviving spouses of retired or disabled farmers, the following seven rules determine who materially participates in an activity. A taxpayer materially participates in an activity if any one of these seven tests are satisfied. The seven ways to materially participate are:

a. 500 hour rule;
b. Substantially all participation rule;
c. Not less than any other participant rule;
d. Significant participation activity rule;
e. Five out of ten year rule;
f. Three year personal service rule;
g. Facts and circumstances rule.

For purposes of the application of these seven tests, it must be emphasized that a taxpayer will need first to determine the "activities" in which the taxpayer has an interest (discussed above) as a prerequisite to determining whether one of these material participation tests are met.

a. 500 Hour Rule. An individual materially participates in an activity in which he participates for more than 500 hours during the taxable year. Treas. Reg. Section 1.469-5T(a)(1).

i. Short Taxable Years. There is no exception to the 500-hour rule for short taxable years. Thus, it is unlikely that this test will be satisfied for any calendar-year trade or business activity which commenced operation towards the end of the year.

ii. Special Businesses. What if a business is open for only 2 months (e.g., a summer resort) or requires little or no participation (tree growing)? The 500-hour rule provides no relief in such situations. Affected taxpayers will need to establish material participation under one of the other rules of Treas. Reg. Section 1.469-5T.

iii. Effect of Activity Definition. If a taxpayer participates for 200 hours per year in each of three grocery stores that the taxpayer owns and controls, the taxpayer will satisfy the 500-hour rule because the three stores will be aggregated into a single activity. Therefore, all of the hours of participation in the grocery store will be added together in determining the taxpayer's level of participation in single "activity."

b. Substantially All Participation Rule. An individual materially participates in an activity if he does substantially all of the participation therein (including the participation of non-owners in the activity). Treas. Reg. Section 1.469-5T(a)(2).
i. **Example.** Individual A spends 50 hours a year in a non-rental trade or business activity in which he earns $5,000. No other individual participated in the activity. A has $5,000 of active income. If, however, A hired employee B for 25 hours a year for services rendered with respect to such activity, A would then have $5,000 of passive income. Presumably the same result would occur if B were an independent contractor.

ii. **Effect of Activity Definition.** At first blush it might appear that the general rule that each undertaking constitutes a separate activity would increase the application of this rule. The broad definition of an “activity” resulting from the aggregation and integration rules (discussed above in the definition of an activity) may reduce, however, the impact of this material participation rule except in situations involving an isolated trade or business. For example, if a taxpayer who provided repair services in his basement “fix it” shop also owned part of an auto repair shop, the two undertakings would likely be treated as a single activity under the aggregation rule, making it much harder to satisfy the substantially all participation test than if the basement operations were a separate activity.

(A) **Limited Application.** The substantially all participation rule will most likely apply only if the individual does not own an interest in another undertaking or activity which could be combined under the aggregation or integration rule, respectively. For example, if the taxpayer who has a “fix it” shop in his basement is merely an employee at the automobile repair shop, this material participation rule could be applicable.

c. **Not Less Than Any Other Participant Rule.** An individual materially participates in any activity in which he participates for more than 100 hours if he participates in the activity not less than any other individual (including non-owner participation). Treas. Reg. Section 1.469-5T(a)(3).

i. **Example.** Individual C spends 110 hours a year in a non-rental trade or business which he owns. If C has one employee in the trade or business, the treatment of income or loss from the activity will depend upon the number of hours the employee works. If the employee works 110 hours or less, all income or loss from the activity will be active. On the other hand, if the employee works more than 110 hours, all loss from the activity would be passive; net income would be recharacterized as active under the recharacterization rule for income from significant participation activities in Treas. Reg. Section 1.469-2T(f)(2).

ii. **Effect of Activity Definition.** As with the substantially all participation rule, the broad definition of any “activity” resulting from the aggregation and integration rules (discussed above in the activity definition) may reduce the impact of the “not less than any other participant” rule. For example, if the owner of ten repair shops works 110 hours per year in each repair shop, and the employees of each repair shop work 105 hours per year, the likelihood is that the owner should be treated as materially participating in each of these undertakings as a result of the treatment of the multiple undertakings as part of a single activity under the aggregation or integration rules rather than as a result of the application of the not less than any other participant rule for material participation.

d. **Significant Participation Activity Rule.** If the individual cannot otherwise qualify as a material participant under any other rule and the aggregate hours spent in significant participation activities is in excess of 500 hours, then the individual materially participates in each of those significant participation activities. Treas. Reg. Section 1.469-5T(a)(4). A significant participation activity is one in which the individual participates for more than 100 hours but does not materially participate under any other rule. Treas. Reg. Section 1.469-5T(c). Significant participation activities therefore could never include activities in which the taxpayer had more than 500 hours of participation.

i. **Not More Than 500 Hours.** If the individual does not have a total of significant participation activities hours in excess of 500 hours, he is subject to a heads the government wins, tails the taxpayers loses rule which recharacterizes gross income equal to net income from any such significant participation activity as active income. Treas. Reg. Section 1.469-2T(f)(2).

ii. **Example.** Assume taxpayer A has 101 hours of participation in non-rental trade or business activity #1, and 250 hours in non-rental trade or business activity #2, as general partner in both activities. By investing in non-rental trade or business activity #3 as a general partner who participates 150 hours, he has insured material participation treatment for each of the 3 activities because he has a total of 501 hours in these activities, each of which is in excess of 100 hours.
iii. Government Trap for Unwary. Individual A has 101 hours of participation in trade or business activity #1. A has 490 hours of management services in trade or business activity #2 (and no other individual participates in, or is compensated for, management services provided to the activity). Activities #1 and #2 both produce losses. A adds the participation time in activities #1 and #2 and concludes that he has in excess of 500 hours of significant participation in activities #1 and #2. Taxpayer does not materially participate under any rule, except by significant participation, and potentially by the facts and circumstances rule. The taxpayer would take the position that activities #1 and #2 losses were active. The Service, however, might take the position that the taxpayer materially participated in activity #2 under the facts and circumstances test. Thus, the taxpayer could not count activity #2 as a significant participation activity and would only have 101 significant participation hours. While the activity #2 losses would remain active, the activity #1 losses would be passive. Note that to the extent another individual was compensated pursuant to Section 911(d)(2)(A) for management services or if another individual participated in more management hours than the taxpayer, management hours of the individual would not count for purposes of applying the facts and circumstances test. See Treas. Reg. Section 1.469-5T(b)(2)(ii).

iv. Treatment of Limited Partners. As discussed below, a limited partner cannot rely on Treas. Reg. Section 1.469-5T(a)(4) to satisfy the material participation test. Hours of participation by a taxpayer who is a limited partner in significant participation activities, however, are included in determining whether that taxpayer has more than 500 hours of participation in significant participation activities.

v. Effect of Activity Definition. The broad definition of an “activity” resulting from the aggregation and integration rules (discussed above in the activity definition) may reduce the impact of this rule. For example, if the owner of 3 grocery stores works 200 hours in each store, he will be treated as materially participating pursuant to the 500-hour rule in the single “activity” formed under the aggregation rule. The taxpayer will not be subject to the significant participation activity rule because he otherwise materially participates in the activity.

e. Five out of Ten Years Rule. An individual materially participates in an activity if he materially participated therein during any 5 of the 10 years immediately preceding the tax year in question. Treas. Reg. Section 1.469-5T(a)(5). In determining material participation in prior years, however, material participation which existed under the five out of ten rule only is deemed to not be a year of prior material participation. Additionally, for any year prior to 1987, material participation must be determined only under the 500 hour rule. Treas. Reg. Section 1.469-5T(j)(2).

i. Example. Assume A, a general partner, does not otherwise materially participate in partnership X, but in precisely 5 of the previous 10 years he has materially participated under the 500 hour rule. He, therefore, materially participated in the present taxable year. If, however, in one of the previous 5 years he materially participated only because of the five out of ten rule, he does not materially participate in the present taxable year. Additionally, any pre-1987 year in which material participation could not be found without the 500 hour rule would not be treated as a prior material participation year.

ii. Determination of Participation in Prior Years. For purposes of applying the 5 out of 10 years material participation rule, a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated (determined without regard to this rule) for such preceding taxable year. Treas. Reg. Section 1.469-5T(j)(1).

(A) Example. If a taxpayer owns and materially participates for 6 years at a restaurant in Chicago, and at the beginning of the next taxable year the taxpayer sells his Chicago restaurant and purchases a restaurant in Dallas in which he does not otherwise materially participate, the taxpayer would not be treated as materially participating in the Dallas restaurant under the 5 out of 10 year rule. This result occurs because the Dallas restaurant undertaking would not be part of the activity that included the same business and rental operations as the Chicago restaurant undertaking that was in a different location.
(B) Effect of Activity Definition. On the other hand, if in year 7 the taxpayer did not sell the Chicago restaurant and the taxpayer purchased a Dallas restaurant, and assuming that the taxpayer did not participate in either restaurant in that year, the taxpayer would nonetheless be treated as materially participating in both restaurants because the "activity," as broadly defined under the aggregation rule (discussed above in the activity definition), would include both undertakings.

f. Three Year Personal Service Activity Rule. An individual materially participates in a personal service activity in which he has materially participated in any three taxable years prior to the present taxable year. Treas. Reg. Section 1.469-5T(a)(6). Consecutive years are not required.

i. Personal Service Activity. For purposes of the three year personal service activity rule, "personal service activity" is defined to be an activity which involves performing of personal services in (A) health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or (B) any other trade or business in which capital is not a material income producing factor. Treas. Reg. Section 1.469-5T(d). Service as a non-owner employee will not count under the three year rule, because participation is defined to include only work done by an owner-employee or spouse. Treas. Reg. Section 1.469-5T(f)(2)(ii).

(A) Comment. The rule treating any activity in which capital is a material income-producing factor as a personal service activity is an open-ended invitation to litigation. Either the Service (if an activity is profitable) or the taxpayer (if losses occur) may want to utilize this rule to claim that the taxpayer materially participates in an activity long after the taxpayer ceases to be active therein.

ii. Determination of Participation in Prior Taxable Years. For purposes of applying the three year personal service activity rule, a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated for such preceding taxable year.

(A) Comparison with the 5 out of 10 Year Rule. As discussed above in connection with the 5 out of 10 year rule, an undertaking is location-specific, so that material participation in a trade or business undertaking in one location will not necessarily be treated as participation in a trade or business undertaking at a different location in a subsequent year. In contrast, under the rules that define professional service undertakings, such undertakings are treated as part of the same activity if they are commonly controlled or involve significant similar services or significant related services, without regard to temporal concepts. Treas. Reg. Sections 1.469-4T(h)(2) and (4), Example (3). Thus, all professional service undertakings in the same field would be treated as included in the same activity.

(B) Example. A doctor materially participates for 6 years in a clinic in Chicago, and at the beginning of the next year the doctor sells his interest in the Chicago clinic and purchases an interest in a Dallas clinic in which he does not participate. The Chicago clinic and the Dallas clinic will be treated as undertakings that are included in the single professional services "activity" of the doctor, so that the doctor would be treated as materially participating in the Dallas clinic under the 3 year personal service activity rule. In contrast, as discussed above in the example for the 5 out of 10 year rule, if the undertakings in Chicago and Dallas were restaurants, the doctor would not materially participate in the Dallas restaurant.

g. Facts and Circumstances Rule. An individual materially participates in an activity if, based on all of the facts and circumstances, the individual participates during the taxable year in the activity on a regular, continuous and substantial basis. Treas. Reg. Section 1.469-5T(b)(a)(7). General guidance on what constitutes appropriate facts and circumstances is not yet available. Such guidance is reserved for future regulations. See Preamble to the February 1988 Regulations Section XVIII.D. Treas. Reg. Section 1.469-5T(b)(2), however, does set forth specific rules which leave the facts and circumstances rule quite narrow even without further guidance. For example, only a taxpayer whose participation exceeds 100 hours in a year is subject to the facts and circumstances test. Treas. Reg. Section 1.469-5T(b)(2)(iii).
The Service might take the position that the facts and circumstances test is not available for taxpayers or the Service until the general guidance is available. Such a position, however, should have been the subject of an effective date rule and no such rule exists under present regulations. See Treas. Reg. Sections 1.469-5T(b) and -11T. Thus, it appears that the facts and circumstances rule is now available for the Service and taxpayers to argue the presence of material participation. In making any facts and circumstances material participation argument, reference must be made to the rules in Treas. Reg. Section 1.469-5T(b)(2) concerning what cannot constitute material participation under the facts and circumstances rule.

i. Non-Section 469 Material Participation Standards. Except as provided by Sections 469(h)(3) and Treas. Reg. Section 1.469-5T(h)(2) (see Section 2032A, material participation in a farming activity), participation qualifying as "material participation" under any provision of the Code other than Section 469 shall not be taken into account in determining whether an individual materially participates under the facts and circumstances rule. Treas. Reg. Section 1.469-5T(b)(2)(i).

ii. Certain Management Undertakings. Management undertakings cannot be taken into account for a determination of material participation under the facts and circumstances rule unless (A) no person other than the individual receives Section 911(d)(2)(A) compensation for management services and (B) no individual performs hours of service in connection with management of the activity which exceed the hours of service performed by the individual. Treas. Reg. Section 1.469-5T(b)(2)(ii).

(A) Example. During 1990, individual partner A spends 101 hours in a partnership X manufacturing activity and individual partner B spends 102 hours on the same partnership X manufacturing activity. B materially participates and A does not under the not-less-than-any-other-participant rule of Treas. Reg. Section 1.469-5T(a)(3). If B was an employee instead of a partner, A would still not materially participate because employees and other non-owners must be compared in determining if an individual participates no less than another individual. Presumably, under the facts and circumstances rule of Treas. Reg. Section 1.469-5T(a)(7), however, both A and B would materially participate. Unfortunately, if the hours of service performed by A were in connection with management, the facts and circumstances test would not apply unless (i) A is the only individual in the activity who is Section 911(d)(2)(A) compensated for management and (ii) A performs at least as many management hours with respect to the activity as any other individual. See Treas. Reg. Section 1.469-5T(b)(2)(ii). Thus, the mere presence of one other paid manager could prevent A from satisfying the facts and circumstances test.

(B) Effect of Activity Definition. The determination whether a taxpayer participates under the facts and circumstances test will have to be made with reference to the broadly-defined activity determined under the aggregation and integration rules (discussed above in the activity definition). The broad definition of activity is especially significant for a taxpayer who participates only as a manager, because the broadly-defined activity could include undertakings in which other individuals are involved in management.

(1) Example. An individual owns a 5% interest in a partnership that owns a restaurant in which, on the basis of all of the facts and circumstances, such individual would materially participate because of his role as the manager of the restaurant. The individual also owns 5% of a different partnership that owns a restaurant with a full-time manager. Assuming that the two partnerships are commonly controlled, the individual would be required to treat both as a single trade or business activity pursuant to the aggregation rule if the individual would materially participate in the resulting single activity. Treas. Reg. Section 1.469-4T(f).

iii. More than 100 Hours of Participation. A taxpayer cannot materially participate under the facts and circumstances rule if he does not participate in the activity for more than 100 hours during the taxable year. Treas. Reg. Section 1.469-5T(b)(2)(iii). This rule may prevent the facts-and-circumstances test from applying to short taxable years or past-year activities. Thus, if a taxpayer and an employee each work 80 hours per year (2 weeks) at a country fair, the activity cannot satisfy any material participation test.
(A) Effect of Activity Definition. For purposes of satisfying this 100-hour threshold, the broad
definition of activity would apply. Thus, if a taxpayer works 60 hours at a county fair in Iowa and 60 hours at a county
fair in Illinois, and the taxpayer controls both undertakings, the two undertakings will be treated as a single activity under
the aggregation rules. Thus the taxpayer would be treated as satisfying the 100-hour requirement for application of the
facts and circumstances test.

h. Inability to Materially Participate. One of the problems with the "objective" tests for material
participation is that there are some activities in which it will be impossible for a taxpayer to materially participate. This
problem arises in activities that only extend for a short period during the taxable year or which do not require substantial
hours.

i. Seasonal Example. A gift shop at the State Fair may be open for only one week, and because
he uses employees, the owner may not perform substantially all of the work. If the owner's hours of participation are
fewer than 100, there is no way for the owner to materially participate in the activity.

ii. Timber Example. Owners of timber have complained that the presence of contract maintenance
workers makes it virtually impossible for the timber owner to materially participate in the timber activity; legislative
relief has been requested, so far without success.

2. Participation. In general, any work done in any capacity by an individual in connection with an activity
in which the individual owns an interest at the time the work is performed is treated as participation of the individual
in such activities. Treas. Reg. Section 1.469-5T(f)(1). Thus, for example, if individual A owns an interest as a limited
partner in partnership ABC, and A works as an employee for the corporate general partner of ABC in an activity of ABC,
A's work as an employee will be treated as participation by A in such activity. Treas. Reg. Section 1.469-5T(k),
Example (1).

a. Participation in C Corporation Activities. The first set of regulations provided that work done in
a C corporation owned by the taxpayer was not participation. Unamended Treas. Reg. Section 1.469-5T(f)(1). The
May 1989 Regulations delete the C corporation reference in Treas. Reg. Section 1.469-5T(f)(1). The result of the C
corporation participation rule, however, is retained under the May 1989 Regulations. The May 1989 Regulations
provide in Treas. Reg. Section 1.469-4T(b)(2)(B) that a taxpayer's activities do not include any activities conducted
through entities other than pass-through entities. Thus, C corporation activities are activities of the C corporation, not
activities of its shareholders.

b. Exception - Work Not Customarily Done By Owners. Where a taxpayer does work which has as
one of its principal purposes the avoidance of Section 469 rules disallowing use of a loss or credit, and where such work
is not of a type customarily done by an owner of such activity, such work is not participation for purposes of determining

i. Example. A is the sole shareholder of an S corporation, X, in which he does not participate. A's
tax advisor explains that if A materially participated he would be able to use losses from X to shelter A's portfolio
dividend income. A takes a job at X and spends in excess of 500 hours mailing out firm brochures. Assuming such
services are not those customarily done by an owner, the losses from the activity of X are still passive losses to A.

c. Exception - Participation as an Investor. Work done in the capacity of an investor is not
participation for material participation purposes, unless such individual is directly involved in day-to-day management
an investor includes:

i. study or review of financial statements or reports regarding activity operations;

ii. preparing or compiling summaries or analysis of activity finances or operations for individual's
own use; and

d. Participation of Spouse. Participation of a spouse is treated as participation of an individual. Section 469(h)(5).

e. Methods of Proof. Any reasonable method of proof may be used to establish participation. Time records are not required. Appointment books, calendars and itineraries may be reasonable proof. Treas. Reg. Section 1.469-5T(f)(4). This proof requirement is similar to the old Cohan rule for substantiating business expenses. Nonetheless, taxpayers would be well advised to keep time records in order to satisfy their burden of proof.

f. Participation by Independent Contractors. Work done by independent contractors who are also owners of an activity will be treated as participation in such activity. Treas. Reg. Section 1.469-5T(f)(1). The legislative history indicates that as a general rule work done by an independent contractor should not be viewed as participation. See '86 Sen. Rep. at 735. Thus, a lawyer who owned a 1% interest as a limited partner in a trade or business would be treated as materially participating in an activity of the partnership for which the lawyer provided 500 hours of services as an independent contractor. This rule may be a surprise for taxpayers, particularly in light of the recharacterization rule for significant participation activities under Treas. Reg. Section 1.469-2T(f)(2).

i. Example. Lawyer L works on a number of transactions for client C, which work includes setting up a limited partnership for each transaction; L purchases a one percent interest as a limited partner in each separate partnership. L works for 70 hours on each of the partnerships. Assuming that C controls each partnership and that all of the partnerships are in the same line of business, L must treat all of the partnerships as a single activity. L would then materially participate in the activity, even though his only participation was as an independent contractor.

3. Treatment of Limited Partners. Unless an individual materially participates under (a) the 500 hour rule, (b) the five out of ten rule, or (c) the personal service activity three year rule, his interest as a limited partner will be treated as one through which he can not materially participate. Treas. Reg. Section 1.469-5T(e)(1) and (2). See Section 469(k)(2). If the individual materially participates under the above named three rules, his status as a limited partner will be ignored and he will be treated as a material participant in such activity.

a. Definition of a Limited Partner. Treas. Reg. Section 1.469-5T(f)(3) defines what is a limited partnership interest for applying the above stated material participation rules to limited partners. First, without regard to liability limitations under state law, any interest labeled a limited partnership interest in the partnership agreement or certificate is a limited partnership interest. Treas. Reg. Section 1.469-5T(e)(3)(i)(A). Second, any interest is a limited partnership interest if the liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership). Treas. Reg. Section 1.469-5T(e)(3)(i)(B).

b. Limited Partner Also a General Partner. A partnership interest is not a limited partnership interest for a taxable year if the individual is also a general partner at all times during the taxable year of the partnership ending with or within the individual's taxable year or that portion of the partnership taxable year during which the individual
directly or indirectly owns such limited partnership interest. Treas. Reg. Section 1.469-5T(e)(3)(ii). There appears, however, to be no attribution rule for an individual who is the sole shareholder of a corporate (S or C) general partner, even where the individual is an officer of the corporation.

i. Example. Individual A is a 1% general partner and a 50% limited partner in a non-rental trade or business activity partnership in which he participates 75 hours, but does everything which is required in the partnership. As a general partner he materially participates under Treas. Reg. Section 1.469-5T(a)(2), the substantially all participation rule. Both of A's partnership interests would be treated as general partner interests. If, however, A's attorney had advised him to own his 1% general partnership interest through a wholly owned S corporation for liability purposes, his income with respect to his limited partnership interest would be passive under Treas. Reg. Sections 1.469-5T(e)(3)(i)(B) and (ii). A would be only a limited partner, not a general partner, and only (1) the 500 hour rule, (2) the 5 out of 10 rule and (3) the 3 year personal service activity material participation rule would apply. Since A materially participated only under the substantially all participation rule, A does not materially participate to the extent A is not a general partner in his individual capacity.

c. Application of Recharacterization to Limited Partners. The recharacterization rule for significant participation activities is not affected by the general partner/limited partner distinction. Treas. Reg. Section 1.469-2T(f)(2). In fact, if a limited partner who is not a general partner has in excess of 100 but not more than 500 participation hours, he is in a worse situation than that of a general partner. Such a limited partner is not a material participant; he is, however, a significant participant. Thus, his losses are passive and his income is recharacterized as active. This would apply even if the taxpayer has done substantially all of the participation in the activity or if the taxpayer has other significant participation activities that aggregate more than 500 hours. While he would not materially participate, he would significantly participate and his losses would be passive and his income active.

d. Corporate Limited Partners. The application of the material participation test to corporate limited partners is rife with contradictions and confusion. Except in situations in which the owners of more than 50% of the stock of the corporation materially participate in the activity, the material participation test is difficult for any corporate limited partner to satisfy. See Lipton, "Material Participation by Corporations," Corporate Taxation, page 5 (March/April 1989).


a. Prior Year Material Participation Under Look Back Rules. For purposes of the 3 year personal services and 5 out of 10 year look back rules, a taxpayer has materially participated in an activity for a preceding taxable year if the taxpayer participates in a present year activity that involves substantially the same operations as an undertaking that was included in the preceding tax year activity in which the taxpayer materially participated. Treas. Reg. Section 1.469-5T(f).

i. Example. If a taxpayer materially participated in restaurant A undertaking in years 1 through 6, and in year 7 the taxpayer owned but did not participate in restaurant B undertaking (restaurants A and B are at different locations), the look-back rule would not apply because the restaurant B activity does not carry on the operations of the activity that included restaurant A. On the other hand, if the taxpayer owned both restaurants A and B in year 7, even if the taxpayer did not participate in either restaurant, the taxpayer would be treated as materially participating in both restaurants under the look-back rule because under the aggregation rule the restaurant activity includes the operations (restaurant A) in which the taxpayer materially participated for 5 of the preceding 10 taxable years.

b. Transition Rule. While it is not crystal clear from the regulations, IRS and Treasury officials have indicated that pre-1989 activity definitions of an activity under Notice 88-94 will be respected in applying this rule.

i. Example. Assume that the taxpayer in 1980-1988 spent 50 hours in each of 10 grocery stores and in 1980-1988 treated each store as a separate activity. In 1989, the taxpayer retires and the 10 grocery stores are aggregated into a single activity. If the 1989 definition of activity were applied to the 1980-1988 years in testing the
5 out of 10 year look back rule, the taxpayer would be viewed as materially participating in the 1989 aggregated grocery store activity for each year beginning in 1980. The better reading of the rule, however, will respect the 1980-1988 transitional rule definition of activity and treat the taxpayer as never materially participating in the 1980-1988 separated grocery store activities and therefore not in the 1989 grocery store activity.

VIII. RENTAL ACTIVITY.

Rental activities are per se passive activities without regard to the participation level of a taxpayer. Section 469(c)(2). There is a limited exception for moderate income level taxpayers owning rental real estate activities in which such individuals actively participate. Section 469(i).

A. Statute. A “rental activity” is any activity in which the payments are principally for the use of tangible property. Section 469(j)(8).

B. Regulations. The regulations provide a fairly precise set of rules for interpreting the rather broad statutory definition of a rental activity.

1. In General. As a general rule, a rental activity exists for a taxable year if
   a. tangible property held in connection with an activity is used or held for use by customers during the taxable year, and
   b. gross income from the activity during the taxable year represents amounts paid or to be paid principally for use of such tangible property.

The form of the transaction as a lease, service contract or other arrangement is irrelevant. Substance controls over form. The issue is whether payments are made or to be made principally for the use of tangible property. See Treas. Reg. Section 1.469-1T(e)(3)(i).

2. Exceptions. The mechanism by which the regulations determine whether payments are received principally for the use of properties involves six tests. If any one of these tests is satisfied, payments are deemed not to be principally for the use of property. Thus, if one of these tests is not met, any payments made principally for the use of property will be considered a rental activity.

   a. Less than Seven Days Use. Rental of tangible property for an average period of customers use of seven days or less is not a rental activity. Treas. Reg. Section 1.469-1T(e)(3)(ii)(A).

      i. Average Period of Customer Use. The average period of customer use is a weighted average reflecting not only average use of each class of property, but also the rental income of each class of property. Treas. Reg. Section 1.469-1T(e)(3)(iii)(A). Weighting the average minimizes the risk that an item producing a small amount of income will distort the average period of use. See T.D. 8253 (May 11, 1989). Mechanically, the activity’s property is first divided into classes in any reasonable manner, as long as the same class does not include items for which daily rentals differs significantly. Treas. Reg. Section 1.469-1T(e)(3)(iii)(E). The average period of customer use is the sum of the average use factors for each class. Treas. Reg. Section 1.469-1T(e)(3)(iii)(A). For each class, the average use factor is the average period of customer use for such class times the percentage of the activity’s total gross rental income attributable to that class of property. Treas. Reg. Section 1.469-1T(e)(3)(iii)(B). The average period of customer use for a class is determined by dividing (a) the aggregate number of days in all periods of customer use ending during the taxable year, by (b) the number of periods of customer use. Treas. Reg. Section 1.469-1T(e)(3)(iii)(C). For purposes of this determination, each period during which a customer has a continuous or recurring right to use an item of property (without regard to whether there is a single agreement or to renewals) is treated as a separate period of customer use. Treas. Reg. Section 1.469-1T(e)(3)(iii)(D).
(A) Example. As part of a single activity, a resort leases 100 apartments with an average lease lasting 30 days, resulting in income of $900,000 per year. In addition, the resort leases sports equipment for an average period of 2 days each, resulting in income of $100,000 per year. Assuming that the apartments and sports equipment are different classes of property, the average use factors for the apartments will be 27 days \((900,000/1,000,000 \times 30)\), and the average use factor for the sports equipment will be .2 days \((100,000/1,000,000 \times 2)\). Therefore, the average period of customer use for the rentals in this activity would be 27.2 days.

(B) Example. Suppose an activity both leases cars for the long-term user and rents cars on a day-by-day basis. Further suppose that cars are either leased on a 3-year, closed-end lease or rented for a period averaging 3 days. If the average daily rental price differs significantly between long-term leases and short-term rentals, the taxpayer must divide its cars into two classes, one for long-term and one for short-term rentals. (In practice, there might be dozens of classes, one for each car or group of cars for which the daily rental price is similar.) If 30% of the activity’s gross income comes from the long-term class and 70% comes from the short-term class, the average period of customer use is \(\frac{30\%}{3} \times 3 \text{ years} + \frac{70\%}{3} \times 3 \text{ days}\), or roughly 330 days. Therefore, the activity does not fall within the seven-day use exception, and may be a rental activity (if no other exception applies). Note that in this example, even if the class of long-term leased property supplies only 0.5% of the activity’s gross income, the seven-day use exception will not apply: \(\frac{0.5\%}{3} \times 3 \text{ years} + \frac{99.5\%}{3} \times 3 \text{ days}\) is over 8 days. Note, however, that if the average period of customer use were only 8 days, the activity might not constitute a rental activity because of the exception concerning significant personal services, discussed below.

(C) Example. Suppose an activity rents apartments for $50 per day and also rents lawn mowers for $50 per day. The average period of customer use for apartments is two weeks and the average period for lawn mowers is eight hours. 99% of the activity’s gross income is derived from apartment rentals. If lawn mowers and apartments are included in the same class, perverse results could occur. The activity is not required, however, to include all items rented at similar prices in the same class. Instead, items of property are placed in different classes under any reasonable method, so long as items with different rental prices are not included in the same class. It is probably reasonable to place apartments and lawn mowers in different classes. The average period of use is thus over thirteen days \(\frac{99\%}{14} \times 8 \text{ hours} + \frac{1\%}{8} \times 8 \text{ hours}\). Therefore, the activity does not fall within the seven-day use exception, and may be a rental activity (if no other exception applies).

ii. Comment. The emphasis in Treas. Reg. Section 1.469-1T(e)(3)(iii) on the period for which property is in fact used could be a difficult standard to apply from an administrative standpoint. For example, the mere “right” of the lessee to extend the rental period is apparently to be considered for determining the average period of customer use. Thus, a car rental that can be renewed at the customer’s option (upon payment of a fee) could have an indefinite life. In the event of renewals, it seems odd that the lessor’s tax consequences should be determined by the lessee’s renewal decisions. These and other questions arise due to the quantitative “average period of customer use” test adopted in the regulations.

b. Significant Personal Services. Rental of tangible property for an average period of customer use of thirty days or less is not a rental activity if significant personal services are provided in connection with making the property available for customer use. Treas. Reg. Section 1.469-1T(e)(3) (ii)(B). Significant personal services are defined to include only services, other than excluded services, provided by an individual.

i. Facts and Circumstances. The question of whether non-excluded personal services are significant is one of facts and circumstances. Relevant facts and circumstances include:

(A) frequency of services;

(B) type and amount of labor required to provide services; and 500 hours participation in a year and might be less than significant participation (100 hours).

(C) value of services related to amount charged for use of property. Treas. Reg. Section 1.469-2T(e)(3) (iv)(A).
Although the regulations refer to a variety of factors for determining whether personal services are “significant,” the examples in the regulations place primary emphasis on the cost to the taxpayers of the employees who provide the services. Thus, in Treas. Reg. Section 1.469-1T(e)(3)(viii), Example (2), personal services for photocopying equipment were significant where the cost of such services exceeded 50% of the amount charged for the use of the equipment; in Example (4), maid and linen service provided by an apartment hotel were not significant personal services where the cost of such services was less than 10% of the amount charged to tenants for occupancy of apartments.

ii. Excluded Services. Excluded services means, with respect to property made available for use by customers:

(A) services needed for lawful use of the property;

(B) services in connection with property construction or repairs that extend the useful life for a period longer than the average period of customers use; and

(C) services commonly provided in long-term rentals of high-grade commercial or rental property.

Examples of such excluded services include cleaning and maintenance of common areas, routine repairs, trash collection, elevator service and entrance or perimeter security. Treas. Reg. Section 1.469-1T(e)(3)(iv)(B).

c. Extraordinary Personal Services. Rental of tangible property (without regard to average period of customer use) in which extraordinary personal services are provided is not a rental activity. Treas. Reg. Section 1.469-1T(e)(3)(ii)(C). Extraordinary personal services are services performed only by individuals where the rental of tangible property is incidental to the receipt of services. Treas. Reg. Section 1.469-1T(e)(3)(v).

i. Examples of Incidental Use of Property. Use of hospital rooms by patients is incidental to the other services performed by doctors and nurses in the hospital. Treas. Reg. Section 1.469-1T(e)(3)(v). Similarly, use of a dormitory at a boarding school is incidental to other boarding school personal services generally provided by school teachers. Treas. Reg. Section 1.469-1T(e)(3)(v).

ii. Extraordinary Services Performed by Individuals. A corporation or partnership cannot perform extraordinary services. Apparently, the requirement that services be furnished by individuals simply eliminates the argument that services are provided by tangible personal property. Thus, computer operations which result in a service to a customer would not be services provided by an individual and thus not extraordinary services.

d. Incidental Rental. The rental of tangible property which is incidental to a non-rental activity is not a rental activity. Treas. Reg. Section 1.469-1T(e)(3)(ii)(D). The impact of this rule is that, if applicable, the rental of property is not treated as a separate activity.

i. Property Held for Investment. Rental of property is incidental to an investment activity if and only if (A) the principal purpose for holding the property during the taxable year is to realize gain from appreciation, and (B) the gross rental income is less than 2% of the lower of the property’s (1) unadjusted basis or (2) fair market value. Treas. Reg. Section 1.469-1T(e)(3)(vi)(B).

(A) Example. Assume that taxpayer A owns unimproved land with an unadjusted basis of $200,000. The land has a fair market value of $300,000 in 1990 and a fair market value in 1991 of $325,000. A holds the land for the principal purpose of realizing gain from appreciation. A rents the land on a hunting lease for $3,500 in 1990 and $4,500 in 1991. In 1990 the hunting lease is not a rental activity, because $3,500 is less than $4,000 (i.e., 2% of $200,000). In 1991, the hunting lease is a rental activity separate from the holding of the land for appreciation, because $4,500 is not less than $4,000 (i.e., 2% of $200,000).
ii. Property Used in a Trade or Business. Rental of property is incidental to a trade or business activity if and only if (A) the taxpayer owns an interest in the trade or business; (B) the property was predominantly used in the trade or business for 2 of the previous 5 taxable years; and (C) the gross rental income from such property is 2% of the lesser of the property’s (1) unadjusted basis or (2) fair market value. Treas. Reg. Section 1.469-2T(e)(3)(vi)(C).

(A) Example. Assume that property, which was used in a non-rental trade or business owned by taxpayer A for 2 of the preceding 5 years is rented outside the scope of the trade or business activity to an unrelated third party in 1990 and in 1991. The gross rental income for 1990 is $3,000 and for 1991 is $4,000. The unadjusted basis in the property is $200,000 and the fair market value is $200,000 in 1990 and $150,000 in 1991. In 1990, the rental is incidental, because the $3,000 gross rental income is less than 2% of $200,000, (i.e., $4,000). In 1991, however, the rental income is not incidental because the $4,000 of gross rental income is not less than 2% of $150,000 (i.e., $3,000).

(B) Separate Rental Activity. The rule concerning a rental activity that is incidental to a trade or business activity applies only if the rentals are treated as a separate rental activity under Treas. Reg. Section 1.469-4T(d). Thus, if the rental of property at the same location as a trade or business activity is treated as part of the same undertaking as the trade or business operations under Treas. Reg. Section 1.469-4T(d)(2)(ii), the so-called 80/20 rule, the rule concerning incidental rental activities will not come into play.

(1) Example. At a single location, an individual rents property used for 2 out of the preceding 5 years in the individual’s trade or business for an average period of customer use of 50 days and also sells such property. The gross income from the rentals is $10,000 per year, whereas the gross income from the sales is $100,000 per year, and the fair market value of the property is $10 million. In this situation, the rentals would not be treated as a separate activity under Treas. Reg. Section 1.469-4T(d)(2)(ii). On the other hand, if the income from the rentals was $50,000 per year, the rentals would be treated as a separate rental undertaking under Treas. Reg. Section 1.469-4T(d) if the rentals constitute a rental activity. Treas. Reg. Section 1.469-4T(d)(1)(iii). The rentals would not be treated as a rental activity under the incidental rule (Treas. Reg. Section 1.469-1T(e)(3)(vi)(C)), so that the requirements of Treas. Reg. Section 1.469-4T(d) would not be satisfied. Therefore, the rentals would not be a separate rental undertaking.

iii. Property Held for Sale to Customers. In the year in which property is sold, any rental income from property which is held primarily for sale to customers in the ordinary course of a trade or business at the time it is sold will be treated as rental income to the extent that the rental is treated as a separate rental undertaking under Treas. Reg. Section 1.469-4T(d). Income from any sale of such property will be treated as income from a rental activity in accordance with the rules relating to property held for sale, Treas. Reg. Section 1.469-2T(c)(2)(v), discussed below.

iv. Employee Lodging. Employee or spouse lodging supplied for the employee’s convenience under Section 119 is incidental to the activity of the employer in which the employee performs. Treas. Reg. Section 1.469-1T(e)(3)(vi)(D).

v. 80/20 Rule. In applying the incidental rental rule of Treas. Reg. Section 1.469-1T(e)(3)(vi), it must be remembered that this rule is applied after the 80/20 rule for separating undertakings under Treas. Reg. Section 1.469-4T(d)(2). Thus, if the income from the rentals is not sufficient to constitute a separate rental undertaking under the 80/20 rule, the application of the incidental rental activity rule will not be at issue. In situations, however, in which there is no trade or business conducted at the location, or if the rental gross income exceeds 20% and is less than 80% of the combined income, the incidental rental rule could apply.

e. Nonexclusive Customer Use. Tangible personal property customarily made available during defined business hours for nonexclusive use by various customers is not a rental activity. Treas. Reg. Section 1.469-1T(e)(3)(iii)(E). This rule would apply to a golf course open to customers who purchase daily, weekly, monthly or annual passes.
f. **Property Made Available.** Tangible property of a taxpayer who owns an interest in an S corporation, partnership or joint venture, which property is provided by the taxpayer to a non-rental activity of such entity in his capacity as an owner of such entity, is not a rental activity. The question of the capacity in which property is provided by the taxpayer is one of facts and circumstances. Treas. Reg. Sections 1.469-1T(e)(3)(ii)(F) and (vii). This rule could apply to a taxpayer who makes farmland available to a farmer under a “cropshare lease.” Treas. Reg. Section 1.469-1T(e)(3)(viii).

C. **Ground Rents.** In some situations, a rental activity might be recharacterized as giving rise to portfolio income where the income is produced by nondepreciable property. Treas. Reg. Section 1.469-2T(f)(3).

D. **Active Participation Rental Real Estate Activities.**

1. **In General.** There is a limited exception to the disallowance of PALs involving losses and credits incurred by certain individuals and estates from rental real estate activities in which the taxpayer actively participates. Section 469(i)(1). Such losses and credits are allowed in an amount not to exceed the equivalent of $25,000 in losses, with a phase-out of such allowance for taxpayers with adjusted gross income in excess of $100,000 (or $200,000 in the case of low income housing and rehabilitation credits). Section 469(i).

2. **Computation.** This special rule is applied by first netting the taxpayer’s income and losses from all of the taxpayer’s rental real estate activities in which the taxpayer actively participates. If there is a net loss for the taxable year, net passive income (if any) is then applied against such loss. Only if there is a loss after (i) netting rental real estate activities, and (ii) offsetting the resulting loss (if any) against passive income (if any), can the taxpayer utilize such loss to offset other income.

3. **Amount of Loss.** The amount of the loss which can be utilized is limited to $25,000 per annum. Section 469(i)(2). This amount is reduced to $12,500 for married individuals filing separately. Section 469(i)(5)(A).

   a. **Married Filing Separate Returns.** No deduction is allowed to a taxpayer who is a married individual filing separate returns who does not live apart from his spouse at all times during the taxable year. Section 469(i)(5)(B). If a taxpayer were separated on the last day of the taxable year and filed a separate return, he would not be eligible for any deduction under this provision.

4. **Phase-Out.** The amount of the loss which can be utilized is phased out for taxpayers with adjusted gross income over $100,000. The amount is reduced by 50 percent of the amount of which the taxpayer’s adjusted gross income exceeds $100,000.

   a. **Impact.** The effect of this provision is to disallow the excess PAL to any taxpayer with adjusted gross income over $150,000.

   b. **Adjusted Gross Income.** For purposes of this provision, adjusted gross income is determined without regard to IRA contributions, taxable social security benefits, excluded interest on savings bonds used to pay tuition and PALs. Section 469(i)(3)(E).

5. **Active Participation.** The definition of "active participation" in a rental real estate activity is not the same as material participation for PAL purposes. Active participation can occur without regular, continuous and substantial involvement in operations if the taxpayer participates in the activity in a significant and bona fide sense. Such participation could involve, for example, making management decisions or arranging for others to provide services.

   a. **Management Decisions.** Relevant management decisions include approving new tenants, deciding on rental terms and approving capital and repair expenditures.

   b. **Example.** Assume a taxpayer who owns and rents out an apartment may be treated as actively participating even if he hires a rental agent, so long as he participates in the decision-making process.
c. Compare Material Participation. The definition of "active participation" is also interesting in light of the definition in Treas. Reg. Section 1.469-5T of "material participation," which is a higher standard for the taxpayer to satisfy. Active participation would certainly require fewer than 500 hours participation in a year and might be less than significant participation (100 hours).

6. Limited Partner. Except as provided by regulations, a limited partner does not satisfy the active participation test to the extent of his limited partnership interest. Section 469(i)(6)(C).

7. Less than 10% Interest. An individual is not treated as actively participating with respect to any interest in any rental real estate activity if at any time during the taxable year (or shorter relevant period that the taxpayer holds an interest in the activity) the taxpayer's interest (together with his spouse, even in the absence of a joint return) is less than 10% by value of all interests in the activity. Section 469(i)(6)(A).

a. Definition of Partner's Interest. One of the practical problems with this rule is that there is no definition of the partner's "interest." Does this require an interest in current cash flow of 10% or more, or would a liquidation preference of 10% suffice? What if a taxpayer has a 20% interest in some items of income or deductions, but only a 5% interest in other items? What about mandatory allocations of income under Section 704(c)? A cross-reference to the rules under Section 704(b) would probably not be sufficient, since the partner's interest in the partnership is not determined under such provision unless an allocation lacks substantial economic effect.

8. Estates. In the case of an estate of a taxpayer who, in the taxable year in which he died, owned an interest in a rental real estate activity in which he actively participated, the estate is deemed to actively participate for two years following the death of the taxpayer. Section 469(i)(4).

9. Credits.

a. Participation Not Required. Under the Conference Committee compromise, the rehabilitation and low-income housing credits may offset tax on up to $25,000 of active income regardless of the taxpayer's participation. Section 469(i)(6)(B). As in the case of the active participation exception, however, this relief provision is phased out for taxpayers whose adjusted gross income (determined without regard to IRA contributions and losses from passive activities) exceeds $200,000. For taxpayers whose adjusted gross income exceeds $250,000, the exception for rehabilitation credits is entirely phased out.

b. No Phase-Out for Low Income Housing Credits. For low income housing credits, up to $25,000 of active income can be offset not only without regard to participation, but also without regard to the taxpayer's income. Section 469(i)(3)(C). This special rule applies only to property placed in service after December 31, 1989, in tax years ending after that date. See Revenue Reconciliation Act of 1989 Section 7109(b)(1). Moreover, for an interest owned through a partnership, the exception does not apply unless the partnership interest was acquired after December 31, 1989. Id. Section 7109(b)(2).

10. Regulations. No regulations were promulgated in the first set of temporary and proposed regulations released in February of 1988 or the second set released in May of 1989. When published, the Active Participation Rental Real Estate Activity regulations will be found in Treas. Reg. Section 1.469-8T.

E. Rental of Residence. An activity involving the rental of a dwelling unit is not a passive activity for any taxable year in which Section 280A(c)(5), relating to use of the dwelling unit as a residence, is applicable. Treas. Reg. Section 1.469-1T(e)(5).

1. Example. Lou owns a condominium in Aspen which Lou uses three weeks each year for personal purposes; the condominium is rented for an additional ten weeks. Any profit from the rentals is not income from a passive activity.
IX. PUBLICLY TRADED PARTNERSHIP ACTIVITY.

A. In General. The Omnibus Budget Reconciliation Act of 1987 ("OBRA") added new Section 469(k), which relates to publicly traded partnership ("PTPs"). Under this provision, Section 469 is applied separately with respect to items attributable to each publicly traded partnership.

B. Impact of Section 469(k). The separate application of Section 469 to each PTP means that the PALs for each PTP are determined separately and are separately limited under Section 469(a). Thus, the PALs from one PTP cannot be utilized to offset the passive activity income from another PTP. This treatment of PTPs is different than the treatment of other activities for which the amount of the passive activity loss for the taxable year is determined by netting all passive activity income and loss from all activities. Section 469(d)(1).

1. PTP Offset Rules. PTP loss can only offset PTP income from the same PTP. Thus, PTP losses cannot offset income from other PTPs, other passive income, personal service income or active income. Likewise, PTP income cannot be offset by losses from another PTP or by other passive losses. As discussed below, however, PTP income will be treated as investment income for purposes of Section 163(d), so that PTP income can be offset by investment interest deductions. In addition, active losses can offset PTP income.

2. Portfolio Income from a PTP. A PTP which owns an interest in a passive activity may also generate portfolio income, such as working capital interest income. Such portfolio income is not subject to a special PTP rule. Under Section 469(e), such portfolio income is simply treated as income not earned in a passive activity. Portfolio expenses would be similarly treated.

3. Treatment of PTP Income as Portfolio Income. The legislative history of Section 469(k) states that the net income of a PTP is portfolio income. This characterization is technically incorrect under Section 469(k) as written, however, because Section 469(k) does not provide that net income from a PTP is described in Section 469(e).

4. Passive v. Portfolio Treatment. The issue whether PTP income is passive income or portfolio income is an important one. The net income from a PTP would be subject to taxation (and could not be offset with passive losses from other activities or PTPs) in either case. The distinction between portfolio income and PTP income is that portfolio income is statutorily defined to constitute investment income for purposes of Section 163(d), whereas PTP income is not.

a. Example. The impact of this distinction can be illustrated with a simple example. Assume that a taxpayer has $10,000 to invest and the taxpayer also has $1,000 of investment interest deductions and $1,000 of PALs. The taxpayer’s investment choices consist of (i) a passive activity (other than a PTP) which will generate $1,000 of passive income, (ii) corporate stock which will yield $1,000 of dividend income, or (iii) an interest in a PTP which will result in $1,000 of net PTP income. If the taxpayer elects either of the first two choices, he will be able to offset his income with either the PALs or investment interest deductions, respectively. In contrast, if the taxpayer purchases an interest in a PTP, under Section 469(k) as written and under Section 163(d) without regulatory expansion, the net income could not be offset with either the taxpayer’s PALs or his investment interest deductions.

5. Notice 88-75. In Notice 88-75, 1988-2 C.B. 386, the Service addressed the treatment of PTP income under Section 163(d). The Service noted first, as discussed above, that a taxpayer’s net passive income for a taxable year from a PTP could not be offset by the taxpayer’s losses from other passive activities (including losses from passive activities held through other PTPs). The Service stated that this rule was intended to treat an investor’s net passive income from a PTP in a manner similar to a corporate shareholder’s dividend income, which constitutes portfolio income for purposes of the passive loss limitations and therefore cannot be sheltered by passive activity deductions. See Loffman, Presant & Lipton, "The Impact of Notice 88-75 Concerning Publicly Traded Partnerships," Tax Notes (Aug. 15, 1988) at 747.
a. Section 163(d). Section 163(d)(4)(B) generally provides that investment income means the sum of (i) gross income from property held for investment and (ii) any net gain attributable to the disposition of property held for investment. Under Sections 163(d)(5)(A) and 469(e)(1), dividends on corporate stock that are not derived in the ordinary course of a trade or business are treated as gross income from property held for investment and, thus, are investment income for purposes of Section 163(d).

b. PTP Income as Investment Income. In Notice 88-75, the Service announced that forthcoming regulations will treat the net passive income from a PTP as investment income for purposes of Section 163(d). Until such regulations are issued, an amount of a taxpayer's gross income for a taxable year from any PTP equal to the taxpayer's net passive income from such PTP for the year will be treated as investment income for purposes of Section 163(d). The taxpayer's net income from the PTP is determined by applying all of the other rules applicable to passive activities. Thus, a deduction for interest is allocated to the PTP if and only if such interest expense is allocable to those activities under Treas. Reg. Section 1.163-8T, Notice 88-20, 1988-1 C.B. 487, or Notice 88-37, 1988-1 C.B. 522.

c. Example. Turning to the above example, without Notice 88-75 the $1,000 net income from a PTP could not be offset by either the taxpayer's PALs or his investment interest deductions. As a result of Notice 88-75, the net income from the PTP would be treated as investment income which could be offset by the taxpayer's investment interest deductions; the PTP income still could not be offset by the taxpayer's PALs. Thus, the effect of Notice 88-75 is to treat the net income from the PTP in the same manner as dividend income on corporate stock for purposes of Section 163(d).

d. PTP Income is not Portfolio Income. It is important to note that Notice 88-75 does not treat PTP income as portfolio income for purposes of Section 469. Instead, Notice 88-75 takes the more limited position that income from a PTP will be treated as investment income for purposes of applying the limitation on investment interest deductions. This distinction is important in applying provisions in the passive loss regulations which relate specifically to portfolio income. See e.g., Treas. Reg. Section 1.469-2T(d)(2)(i), relating to expenses clearly and directly allocable to portfolio income.

6. Dispositions. Suspended PALs from an activity of a PTP will be recognized only when the taxpayer disposes of his entire interest in the PTP. Section 469(k)(3).

a. Comment. This special treatment of dispositions of interests in PTPs is similar to the original Senate proposal concerning the disposition of interests in all limited partnerships. That provision was rejected by the Conference Committee on the grounds that it would not be appropriate to disallow a true economic loss realized upon the disposition of the taxpayer's entire interest in an activity by reason of the taxpayer's form of ownership. Conference Report at II-145. It is troubling to see this provision, which is similar to the limitation on artificial losses (LAL) rule that was proposed and rejected in 1975, being reintroduced into the Code through a narrow provision aimed at PTPs.

7. Reporting. Because the income or loss from one PTP is not commingled with the income or loss from any other passive activity (including any other PTPs) in order to determine the amount of the taxpayer's PAL for the taxable year, it will be necessary for the holder of an interest in a PTP to report each PTP separately. Thus, the holder of an interest in several PTPs may be required to file a separate Form 8582, "Passive Activity Loss Limitations," for each PTP in which he owns an interest.

C. PTP Definition. Under Section 469(k)(2), a PTP is defined as a partnership the interest in which is (1) traded on an established securities market or (2) readily tradable on a secondary market or the substantial equivalent thereof. These terms, including particularly the definition of a secondary market of the substantial equivalent thereof, need explanation.

1. PTP Legislative History. The legislative history of OBRA discusses the circumstances under which interests in a partnership will be treated as readily tradable on a secondary market or the substantial equivalent thereof. The Conference Report indicates that a secondary market exists if investors are readily able to buy, sell or exchange their partnership interests in a manner that is economically comparable to trading on established securities markets.
Thus, a secondary market is generally indicated by the existence of a person standing ready to make a market in the interest. An interest is treated as readily tradable if the interest is regularly quoted by persons such as brokers or dealers who are making a market in the partnership interest. The substantial equivalent of a secondary market exists if there is not an identifiable market maker but either (a) the holder of an interest has a readily available, regular and ongoing opportunity to sell or exchange his partnership interest through a public means of obtaining or providing information or offers to buy, sell or exchange interests or (b) 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 market maker would provide.

On the other hand, interests in a partnership are not treated as readily tradable in the substantial equivalent of a secondary market if offers to buy or sell such interests are normally not accepted in a secondary market. Further, occasional purchases of interests by the partnership or the general partner will not constitute public trading, and public trading does not occur solely because the underwriter that handled the issuance of the partnership interests or the general partner occasionally arranges transfers between partners without offering to buy or redeem interests or to issue additional interests to such partners. A regular plan of redemptions or repurchases, however, may constitute public trading where holders of interests have readily available and ongoing opportunities to dispose of their partnership interests.

2. Regulations. Regulations which define what constitutes a publicly traded partnership have not yet been issued. According to Notice 88-75, when the regulations are issued they will include the safe harbors discussed below. The failure to satisfy these safe harbors does not establish, however, that an interest in a partnership is treated as readily tradable on a secondary market or the substantial equivalent thereof. Furthermore, even if a transaction fails to satisfy the safe harbors, transactions that relate to transfers not involving trading, qualifying matching services and qualifying redemption and repurchase agreements (discussed below) will be disregarded for purposes of determining whether interests in the partnership are to be considered readily tradable on a secondary market or the substantial equivalent thereof.

3. Safe Harbors. Notice 88-75 sets forth a series of safe harbors for purposes of determining whether an interest in a partnership is readily tradable on a secondary market or the substantial equivalent thereof. If any of these safe harbors is satisfied, the partnership does not constitute a PTP. See Lofman, Presant & Lipton, supra.

a. Private Placements. Interests in a partnership will not be considered readily tradable on a secondary market or the substantial equivalent thereof if (i) all interests in such partnerships were issued in a transaction (or transactions) that was not registered under the Securities Act of 1933, and (ii) either (A) the partnership does not have more than 500 partners, or (B) the initial offering price of each unit of partnership interest is at least $20,000 and no units may be subdivided into smaller resale units. For purposes of determining the number of partners, each person indirectly owning an interest through a partnership, grantor trust or an S corporation is treated as a partner. In addition, partnerships will be aggregated for purposes of determining the number of partners in order to prevent potential abuses.

b. Transfers Not Involving Trading. For purposes of determining whether interests in a partnership are to be considered readily tradable in a secondary market or the substantial equivalent thereof, the following transfers will be disregarded:

i. Carryover basis transfers.

ii. Transfers at death.

iii. Transfers between members of a family.

iv. The issuance of interests by or on behalf of the partnership in exchange for cash, property or services.

v. Block transfers, which are defined as the transfer by a partner in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than 5 percent of the total interest in partnership capital or profits.
vi. Transfers pursuant to a right of redemption or repurchase that is exercisable only (I) upon the
death, complete disability or mental incompetence of the partner, or (II) upon the retirement or
complete termination of the performance of services of an individual who actively participates
in the management of or performs services on a full-time basis for the partnership.

vii. Qualifying redemptions and repurchases in closed end partnerships described below.

c. Five Percent Safe Harbor. Interests in a partnership will not be considered readily tradable on a
secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or
profits represented by partnership interests that are sold or otherwise disposed of (including purchases by a partnership
of its own interests) during the taxable year does not exceed 5 percent of the total interest in partnership capital. For
purposes of applying this rule, transfers not involving trading (discussed above) are disregarded.

i. Example. Assume that ABC limited partnership has 9,000 units of limited partnership interest
outstanding at all times during 1989, representing 95 percent of the total interest in capital and profits of ABC; the
remaining 5 percent is held by the general partner. Assume further that during 1989, 450 units are sold through the use
of a qualifying matching service (described below), 100 units are sold between members of a family, and 800 units are
sold in a block transfer. The family member transfer and block transfer must be disregarded in applying the 5 percent
safe harbor. Therefore, the total sales during the taxable year are 450/9000 X .95 = 4.75%, so that the 5 percent safe
harbor would be applicable.

d. Two Percent Safe Harbor. Interests in a partnership will not be considered readily tradable on a
secondary market or the substantial equivalent thereof if (i) the 5 percent requirement discussed above were reduced
to 2 percent and (ii) sales through a qualifying matching service and qualifying redemptions and repurchases from open-
ended partnerships were disregarded.

i. Example. In 1990, partnership ABC has 800 units sold through the use of a qualifying matching
services 50 units sold through a matching service which is not qualifying and 500 units sold in a block transfer. Under
the two percent safe harbor, only the sale of the 50 units is considered. The total sales during the taxable year which
are considered are 50/9000 x .95 = 0.528%, so that the 2 percent safe harbor would apply.

e. Qualifying Matching Service. A matching service typically involves the use of a list of customers’
bid or ask prices, and may be provided by the general partner or some third party ("operator"). Usually, a person
who wishes to sell an interest (the "listing customer") contacts the operator in order to have his interest placed on the
operator’s list, to be circulated to potential buyers; the operator does not regularly quote prices at which the operator
will buy or sell interests, or buy or sell for the operator’s own account.

i. Safe Harbor. A matching service is treated as qualifying for purposes of the 2 percent safe harbor
only if:

(A) At least a 15 calendar day delay occurs between the day the operator receives written
confirmation from the listing customer that an interest in a partnership is available for sale
(the "contract date") and the earlier of (A) the day information is made available to potential
buyers or (B) the day information is made available to the listing customer regarding the
existence of any outstanding bids to purchase an interest in the partnership at a stated price.

(B) The closing of the sale effected through the matching service does not occur prior to the 45th
calendar day after the contact date.

(C) The listing customer’s information is removed from the matching service within 120 days
after the contact day.
(D) Following any removal of the listing customer's information, no interest in the partnership is entered into the matching service by the same listing customer for at least 60 calendar days.

(E) The sum of the percentage interests sold through the matching service (other than in transfers not involving trading) during the taxable year of the partnership does not exceed 10 percent of the total interest in partnership capital or profits.

f. Qualifying Open-Ended Partnership Redemption and Repurchase Agreements. If a partnership is open-ended, i.e., additional interests in the partnership may be sold by the partnership, any transfer of an interest in the partnership by means of redemption or repurchase will be treated as qualifying and will be disregarded for purposes of applying the two percent safe harbor only if:

i. The redemption or repurchase agreement requires receipt of written notice by the partnership or the general partner at least 60 calendar days before the redemption or repurchase date.

ii. Either (i) the redemption or repurchase agreement requires that the redemption or repurchase price not be established until at least 60 calendar days after receipt of notification of the sale, or (ii) the redemption or repurchase price is established not more than 4 times during the partnership's taxable year.

iii. The sum of the percentage interests in partnership capital and profits that are sold or otherwise disposed of (including redemptions) other than in transfers not involving trading does not exceed 10 percent of the total interest in partnership capital or profits.

g. Qualifying Close-Ended Partnership Redemptions and Repurchases. The transfer of a partnership interest pursuant to a redemption agreement will be disregarded for purposes of determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if the partnership does not issue any interest after the initial offering and the general partner or a person related to the general partner (within the meaning of either Section 267(b) or Section 707(b)(1)) does not provide contemporaneous opportunities to acquire interests in similar or related partnerships which represent substantially identical investments. The issuance of additional interests by a partnership prior to August 5, 1988, is disregarded for purposes of this rule.

h. General Rules. In applying the safe harbor, the total interest in partnership capital and profits is determined by reference to all interests in the partnership, including the interest of the general partner(s), unless the general partner(s) own in the aggregate more than 10 percent of the total interests in partnership capital or profits at any one time. The percentage interests which are transferred or sold are determined each calendar month using any reasonable convention adopted by the partnership, including reference to the beginning of the month, the 15th day or the end of the month.

4. Transition Rule. If prior to November 2, 1988, all of the steps are taken that are necessary to ensure that an existing matching service or an existing redemption or repurchase agreement for an open-ended partnership satisfies the rules of Notice 88-75, transfers of partnership interests before November 2, 1988, will be deemed to have met such requirements.

D. Definition of Activity. Treas. Reg. Section 1.469-4T(n) provides that the definition of activity rules shall be applied to each PTP of the taxpayer as if the taxpayer owned no activity other than the PTP. Thus, for example, in applying the material participation tests to a PTP, only the hours of participation in that PTP are considered.

1. Example. For example, if a taxpayer was the general partner of a real estate management services PTP in which he spent 501 hours and was a general partner participating for 50 hours in a non-PTP partnership which managed real estate (i.e., was in the same line of business and was controlled by the same interests as the PTP, the taxpayer), the separation of the PTP activity would create an unexpected result. The income or loss from the PTP would be active and the income or loss from the non-PTP partnership would be passive.
2. Comment. Section 469 only applies a limitation on the losses from passive activities. As such, in the view of the authors, the regulations' special treatment of PTPs should be restricted to passive activities of a PTP and should not treat active or portfolio activities of a PTP any differently than those of a non-PTP partnership. Although the regulations are justified by the literal statutory language, in many other situations the statute and the legislative history did not appear to constrain the drafters of the regulations.

X. PERSONAL SERVICE INCOME / EARNED INCOME

A. In General. Personal services income, i.e., income received as compensation for services performed or to be performed at any time, is not income from a passive activity. Treas. Reg. Section 1.469-2T(c)(4)(i). Such income is treated the same as income from a nonpassive activity.

B. Section 911(d)(2)(A)-Earned Income. In general, earned income within the meaning of Section 911(d)(2)(A) is personal service income. Treas. Reg. Sections 469(e)(3) and 1.469-2T(c)(4)(i)(A). (Note there is no reference to Section 911(d)(2)(B) which refers to a taxpayer engaged in a trade or business in which both services and capital are material income producing factors.)

C. Payments under Sections 707(a) and 707(c). To the extent a payment is received pursuant to Sections 707(a) or 707(c) as compensation for services, such payments are treated as personal service income. Treas. Reg. Sections 1.469-2T(c)(4)(i)(A) and -2T(e)(2).

1. Example. A, a general partner in a manufacturing partnership, X, does not materially participate in the manufacturing activity of the partnership. A receives $10,000 in 1990 as a Section 707(c) guaranteed payment for consulting services rendered to the partnership. That $10,000 is personal services income and not passive income. Additional moneys received by A as his distributive share of partnership income result in passive income.

D. Section 736(a)(2) Payments. Payments made to a retiring partner are treated under Section 736 as either payments for a partner's interest in partnership assets (i.e., Section 736(b) payments) or as other payments (i.e., Section 736(a) payments). Section 736(a) payments are in turn classified as a distributive share, to the extent determined with reference to partnership income (i.e., Section 736(a)(1) payments), or as a guaranteed payment for services or use of capital if determined without regard to partnership income (i.e., Section 736(a)(2) payments). To the extent Section 736(a)(2) payments are attributable to services, they constitute personal services income. Treas. Reg. Section 1.469-2T(e)(2)(ii).

E. Section 83. Amounts received as compensation income under Section 83 are treated as personal service income. Treas. Reg. Section 1.469-2T(c)(4)(i)(B).

1. Property Received for Future Services. Treas. Reg. Section 1.469-2T(c)(4)(i) refers to services to be performed at any time. If an individual receives property in exchange for future services, the receipt of the property is treated as personal service income under Section 83. If the property is a partnership interest, only the receipt of the interest (and not future income with respect thereto) should be treated as personal service income. The treatment of future income from such interests should depend upon the general rules of Section 469, e.g., did the taxpayer materially participate in the activity when income is recognized.

F. Sections 402 and 403, Social Security and Other Deferred Compensation for Services Arrangements. Income under Sections 402 and 403, Social Security benefits, and retirement, pension or other deferred compensation arrangements are personal service activity income. Treas. Reg. Sections 1.469-2T(c)(4)(i)(C), (D) and (E).

G. Partner Distributive Share and S Corporation Pro Rata Share of Income. No portion of a partner's distributive share of partnership income and no portion of the pro rata income share of a shareholder in an S corporation is treated as personal service income. Treas. Reg. Section 1.469-2T(c)(4)(i).
1. **Example.** A is a general partner in a rental activity partnership, X. A has a 50% share of net profit and loss interest in X. A is paid in 1990 a management fee of $5,000 a year for the management services A performed and such services have a fair market value of $40,000. Additionally, A receives a net profit from rents of $50,000 as a partner in 1990. A has $5,000 of personal service income and $50,000 of passive rental activity income in 1990. $35,000 of the $50,000 net rental income in theory could be treated as personal services income. Under the regulation, however, no such recharacterization occurs.

2. **Planning.** This rule concerning the treatment of distributive shares of partnership income and a shareholder's pro rata share of S corporation income can be a useful planning tool. Passive income is always preferable to personal service income. Therefore, as long as the service provider is confident that he will receive the same amount of income and is not a material participant, the service provider will want to forego a salary and receive net income from the pass-through entity.

H. **Creation Efforts.** Gross income of an individual from intangible property such as a patent, copyright, or a literary, musical or artistic composition is personal service income if the taxpayer's personal efforts significantly contributed to the creation of such property. See Treas. Reg. Section 1.469-2T(d)(7)(i).

I. **Covenant Not to Compete.** Gross income from a covenant not to compete is personal service income. See Treas. Reg. Section 1.469-2T(d)(7)(iv).

**XI. PORTFOLIO ACTIVITY.**

A. **In General.** Under Section 469(e)(1), in determining the income or loss from any activity, there is not taken into account any gross income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business, as well as gain or loss from property producing such income or any other property held for investment. This income is commonly referred to as "portfolio income".

B. **Separate Portfolio Activities.** The operations that make up activities consist only of the endeavors that involve the conduct of a trade or business or are conducted in anticipation of a trade or business (including any rental operations). Therefore, the mere ownership of assets for investment purposes would not be a business and rental operation and could not become part of an activity for purposes of Section 469. Thus, if a taxpayer subject to Section 469 owns interests that are not business and rental operations, the income therefrom cannot be treated as passive activity gross income.

C. **Separating Portfolio Income.** Difficult problems arise when a single entity (such as a partnership) has business and rental operations as well as portfolio income. In that event, Treas. Reg. Section 1.469-2T(c)(3)(i) provides that passive activity gross income does not include portfolio income. Portfolio income is defined as gross income, other than from the ordinary course of a trade or business, that is attributable to:

1. Interest (including Section 707(c) interest payments on partner's capital);
2. Annuities;
3. Royalties (including fees and other payments for the use of intangible property);
4. C corporation dividends;
5. REIT income (including dividends from a Section 856 trust);
6. Regulated investment company (RIC) income from a Section 851 company;
7. Real estate mortgage investment conduit (REMIC) income from a Section 850D conduit;
8. Common trust fund income from a Section 584 fund;

9. Controlled foreign corporation income from a Section 957 corporation;

10. Qualified electing fund income from a Section 1295(d) fund;

11. Cooperative income from a Section 1381(a) cooperative (but not trade or business patronage dividends from an ordinary course of a trade or business activity of the patron);

12. Income attributable to dispositions of property producing paragraph 1-11 income;

13. Section 1368(c)(2) S corporation dividends;

14. The disposition of property held for investment within the meaning of Section 163(d);

15. Income attributable to the passive activity of trading in personal property (See Treas. Reg. Section 1.469-1T(e)(6) and Treas. Reg. Section 1.469-2T(c)(3)(i)(7));


D. Compare Trade or Business Activity. The above listed items of income are portfolio only if they are not earned in the ordinary course of a trade or business. The question of what is or is not in the ordinary course of a trade or business is substantially limited under Section 469(e)(1) and Treas. Reg. Section 1.469-2T(c)(3)(ii) and (iii). These limitations are discussed above in Trade or Business Activities. Additionally, there are a number of activity recharacterization and income recharacterization rules which impact the treatment of an activity as portfolio or trade or business. The rules are also discussed above in Trade or Business Activities.

E. Cross Reference to Section 163(d). The cross reference by Treas. Reg. Section 1.469-2T(c)(3)(i)(D) to Section 163(d) and the definition of “property held for investment” is a classic “catch 22” example. The Section 163(d)(5) definition of net investment activity is generally a cross reference back to Section 469(e), the incomplete statutory definition of portfolio income. The interaction between Section 163(d) and portfolio activities remains unclarified. While Treasury appears to have the power to remedy this do-loop, to date no guidance has been provided.

XII. RECHARACTERIZATION IN GENERAL.

A. Authority. Section 469(1) in pertinent part provides that:

(1) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations-

(1) ...

(2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and treatment of expenses allocable to such income),

(3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,

(4) .... and

(5) ....

66
Under Section 469(1), the Secretary is granted the authority to prescribe regulations as may be necessary or appropriate to carry out the provisions of Section 469. Such regulatory authority clearly includes the recharacterization of passive income as portfolio or active income, where it is necessary or appropriate to carry out the provisions of Section 469. In addition, the statute can be viewed as providing four recharacterization rules without regard to the regulations. See the qualified working interest recharacterization rule in Section 469(c)(3), the active rental real estate recharacterization rule in Section 469(i), the low income housing credit recharacterization rule in Section 469(i)(3)(C) and the working capital recharacterization rule in Section 469(e)(1)(B).

1. Six Labeled Recharacterization Rules. The Service adopted numerous recharacterization rules in the February 1988 Regulations. Under Treas. Reg. Section 1.469-2T(f), Recharacterization of Passive Income in Certain Situations, passive income is formally recharacterized under 6 separate rules as either active income (2T(f)(2), 2T(f)(5) and 2T(f)(6)) or portfolio income (2T(f)(3), 2T(f)(4) and 2T(f)(7)). These 6 labeled recharacterization rules, however, are not the only rules in the regulations which are founded on the Secretary's authority to recharacterize income or loss.

2. 31 Unlabeled Recharacterization Rules. There are at least an additional 31 unlabeled regulatory and statutory rules, which are not designated as recharacterization rules, but which in substance can be viewed as such. For example, under the substantially appreciated property recharacterization rules of Section 1.469-2T(c)(2)(iii), passive gain from a disposition of property may be recharacterized as portfolio or active income. Furthermore, the additional recharacterization rules are not limited to income or gain recharacterizations. For example, under the tax avoidance participation recharacterization rule of Treas. Reg. Section 1.469-5T(f)(2), active loss is recharacterized as passive loss. In addition, the statute can be viewed as providing four recharacterization rules without regard to the regulations. See the qualified working interest recharacterization rule in Section 469(c)(3), the active rental real estate recharacterization rule in Section 469(i), the low income housing credit recharacterization rule in Section 469(i)(3)(C), and the working capital recharacterization rule in Section 469(e)(1)(B).

3. Purpose of Recharacterization Rules. The emphasis of the recharacterization rules, however, is the recharacterization of passive income into active or portfolio income. In fact, when viewed in total, the regulations have as their primary focus policing the creation of passive income, while the statute has as its primary focus the limitation on passive losses.

B. Six Labeled Regulatory Recharacterization Rules - Common Concepts and Definitions. As set forth below there are six recharacterization rules in the regulations which are formally labeled as such. The significant participation, self-enhanced rental property, and self-rented property recharacterization rules each recharacterize passive income into active income. The rental of non-depreciable property, equity-financed lending activity, and intangible licensing pass-through recharacterization rules each recharacterize passive income into portfolio income. A number of concepts are set forth in the regulations which are applicable to more than one of the 2T(f) formal recharacterization rules. See Treas. Reg. Section 1.469-2T(f)(8-II). These common rules are discussed below in paragraphs (a-f).

1. Overlap of Recharacterization Rules. Treas. Reg. Section 1.469-2T(f)(8) provides that recharacterization under 2T(f)(2-4) will not exceed the greatest amount recharacterized under any one of the 2T(f)(2-4) rules. This limitation certainly appears equitable. The interesting aspect of this rule, however, is what is not set forth. Clearly this limitation on recharacterization does not apply to rules 2T(f)(5-7). Thus, if recharacterization occurs under one of the 2T(f)(2-4) rules and one of the 2T(f)(5-7) rules, the limitation does not apply.

If recharacterization rules that convert passive income into both active and portfolio income apply, the portfolio recharacterization rule will govern. Each of the recharacterization rules states that income in certain circumstances is not passive. Treas. Reg. Section 1.469-2T(f)(10), however, specifically provides portfolio treatment for 2T(f)(3,4 & 7). By process of elimination, income subject to 2T(f)(2,5 & 6) are recharacterized as active. First, such income is not passive under the 2T(f)(2,5 & 6) rules; next such income is not portfolio under Treas. Reg. Section 1.469-2T(c)(3) or the 2T(f)(10) rule. The 2T(f)(2,5 & 6) rules, therefore, produce active income.
2. **Net Passive Income.** In applying the 2T(f)(2-4) rules, the term "net passive income," with respect to an activity, is the amount by which passive activity gross income therefrom exceeds the amount of passive activity deductions from such activity (without regard to the recharacterization rules of 2T(f)(2-4)) Treas. Reg. Section 1.469-2T(f)(9)(i).

3. **Net Passive Loss.** In applying the 2T(f)(2-4) rule, the term "net passive loss," with respect to one activity is the amount by which passive activity losses therefrom exceeds passive activity gross income from such activity (without regard to the recharacterization rules of 2T(f)(2-4)). Treas. Reg. Section 1.469-2T(f)(9)(ii).

4. **Gross Rental Activity Income.** Gross rental activity income for an item of property is passive activity rental income from rental or disposition (computed without regard to the 2T(f)(2-6) recharacterization rules) that:
   i. is income for such year from rental or disposition of the item of property; and
   ii. if such income is disposition income, is income from an activity that involved the rental of such property during the 12 month period ending on the date of disposition. Treas. Reg. Section 1.469-2T(f)(9)(iii).

5. **Net Rental Activity Income.** Net rental activity income from an item of property is the excess of gross rental activity income over passive activity deductions (including suspended PALs from prior years) that are reasonably allocable to such income. Treas. Reg. Section 1.469-2T(f)(9)(iv).

6. **Coordination with Section 163(d).** The interplay between Section 163(d) and the recharacterization rules is discussed above in the discussion of the treatment of portfolio activities; see Treas. Reg. Section 1.469-2T(f)(10).

**XIII. 37 SPECIFIC RECHARACTERIZATION RULES.**

A. **Passive Income Recharacterized as Active Income.**

1. **Significant Participation Recharacterization Rule.** Under Treas. Reg. Section 1.469-2T(f)(2)(i), gross income from significant participation passive activities of the taxpayer is recharacterized as active income in an amount equal to the ratable portion of net passive income attributable to each significant participation passive activity.

   a. **Significant Participation Passive Activity Definition.** A significant participation passive activity is a non-rental trade or business activity in which the taxpayer significantly participates (i.e., participates in excess of 100 hours) and in which the taxpayer does not materially participate. Treas. Reg. Section 1.469-2T(f)(2)(ii).

   i. **Example.** Assume that taxpayer A has a full-time job as an employee and has a part-time limousine service activity in which he participates on weekends for more than 100 hours but for 500 hours or less. Assume further that A does not materially participate in the limousine activity and that A has taxable income in 1992 of $10,000 from the limousine activity. Under the significant participation passive activity recharacterization rule, A's $10,000 of limousine activity income is recharacterized as active income. If, however, A had a $5,000 loss in 1993, that loss would be passive and no recharacterization rule would apply.

   ii. **Example - The Interplay of the Significant Participation Recharacterization Rule and the 500 Hours/Significant Participation Material Participation Rule.** Assume that taxpayer A has six separate activities in 1992: (I) a rental activity; (II) a trade or business activity in which A participates 100 hours; (III) a trade or business activity in which A participates 200 hours; (IV) a trade or business activity in which A participates 150 hours; (V) a trade or business activity in which A participates 101 hours; and (VI) a trade or business activity in which the taxpayer participates 501 hours. Activities I, II and VI clearly are not significant participation passive activities. Activity I is a rental activity and therefore cannot be a significant participation passive activity. Activity II is a 100 hour
or less activity and therefore cannot be a significant participation passive activity. Activity VI is a material participation activity of the taxpayer under the 500 hour rule and therefore cannot be a significant participation passive activity.

Activities III, IV and V may be significant participation passive activities depending on whether they are activities in which the taxpayer materially participates. If we assume that A does not otherwise materially participate in activities III, IV and V, the issue is whether A materially participates under the 500 hour/significant participation material participation rule. Treas. Reg. Section 1.469-5T(a)(4).

The 500 hour/significant participation material participation rule in Treas. Reg. Section 1.469-5T(a)(4) is similar, but not identical, to the significant participation recharacterization rule of Treas. Reg. Section 1.469-2T(f)(2). Under the 500 hour/significant participation material participation rule, a taxpayer materially participates in each significant participation activity (i.e., more than 100 hours not more than 500 hours; and not otherwise materially participating) of the taxpayer when the aggregate participation in all significant participation activities of the taxpayer for the taxable year exceeds 500 hours. Treas. Reg. Section 1.469-5T(a)(4).

Because the sum of participation in activities III, IV and V is 500 hours or less, A does not materially participate under the 500 hour/significant participation material participation rule. Thus, activities III, IV and V are significant participation passive activities. Net income from these activities would be subject to recharacterization as active income under Treas. Reg. Section 1.469-2T(f)(2); the significant participation recharacterization rule.

If, however, A participates 200 hours instead of 101 hours in activity V, A would materially participate in activities III, IV and V under the 500 hour/significant participation material participation rule and therefore activities III, IV and V would not be significant participation passive activities. As a result, any income or losses generated would be treated as active income or losses.

b. Ratable Portion of Net Passive Income Attributable to Each Significant Participation Passive Activity. Where there is more than one significant participation passive activity, the question arises as to how much of the gross income recharacterized under the significant participation recharacterization rule is attributable to each significant participation passive activity. The regulations provide that gross income equal to a ratable portion of net passive income from such significant participation passive activity shall be recharacterized. A ratable portion of net passive income is determined by multiplying net passive income from a significant participation passive activity by the fraction obtained by dividing the aggregate net passive activity income from all of the taxpayer's significant participation passive activities by the aggregate net passive income from only those significant participation passive activities which produced net passive income and excluding those which produced net passive losses. See Treas. Reg. Section 1.469-2T(f)(2)(i).

c. Significant Participation Activities in Excess of 500 Hours. If the total hours of participation by a taxpayer in significant participation activities exceeds 500 hours, the taxpayer will be deemed to materially participate in each activity in which he significantly participates. Treas. Reg. Section 1.469-5T(a)(4). Because the taxpayer is deemed to materially participate in such activities, the income from such activities is not subject to recharacterization under Treas. Reg. Section 1.469-2T(f)(2). This rule does not apply to limited partners who are not general partners, except that significant participation activities of a limited partner are counted towards the 500-hour threshold. Treas. Reg. Section 1.469-5T(e)(2).

d. Application to Limited Partners. Although the significant participation material participation rule of Treas. Reg. Section 1.469-5T(a)(4) does not apply to limited partners who are not also general partners, the general rule concerning recharacterization of income from significant participation passive activities does apply to limited partners. Thus, a limited partner could have active income from an activity in which he is unable to materially participate.

e. Application to Corporations. An activity of a corporation is treated as a significant participation passive activity subject to Treas. Reg. Section 1.469-2T(f)(2) if (i) the corporation is not treated as materially participating in such activity for the taxable year, and (ii) one or more individuals, each of whom is treated as
significantly participating in the activity (under Treas. Reg. Sections 1.469-1T(g)(3)(iii) and 1.469-5T) hold in the aggregate, directly or indirectly, more than 50 percent of the value of the outstanding stock of the corporation. Treas. Reg. Section 1.469-1T(g)(3)(ii).

f. Effective Date. Unlike the other five labeled recharacterization rules of Treas. Reg. Section 1.469-2T(f), the significant participation recharacterization rule is effective retroactively for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11(a)(2).

2. Self-Enhanced Rental Property Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(f)(5)(i), gross rental income equal to the net rental income (including gain from dispositions, see Treas. Reg. Section 1.469-2T(f)(9)(iii)) from rental property items for the taxable year is recharacterized as active income if three tests are met. First, there must be gain from disposition of the item in the taxable year. Second, use of the item in the rental activity must have commenced (i.e., substantially all of the property is first held out for rent and the performance of enhancement activities has been completed) less than 12 months before the date of the disposition. Third, the taxpayer must have materially (without special rules for limited partners) or significantly participated (i.e., more than 100 hours) for any taxable year in an activity, a purpose of which was to perform services which enhance the value of the item. Enhancement activities include, but are not limited to: (a) construction, (b) renovation, (c) lease-up (to the extent a substantial portion of the item was not leased at the time the taxpayer acquired an interest in the property), and (d) development. Treas. Reg. Sections 1.469-2T(f)(5)(iii) and (iv).

a. Purpose. The self-enhanced rental property recharacterization rule appears to be founded upon at least two premises. First, there appears to be an anti-abuse concern that a dealer in real property will simply convert his property to rental property prior to an impending sale to create passive income. Second, there appears to be a concern that value created in non-rental type activities which enhance the value of rental property should be taxed as active income to taxpayers who materially or significantly participated in such non-rental activities. The rule, however, operates mechanically without respect to whether either of these premises is furthered by application of the self-enhanced rental property recharacterization rule. The self-enhanced rental property recharacterization rule is an arbitrary rule. No matter what the cause of the gain, be it inflation, a lucky location, or a buyer with more cash than grey matter, the entire net rental income including gain from disposition is recharacterized.

b. Example - The “hard luck developer”. Assume a real estate developer has built ten projects over a ten year period and has never been a dealer under present case law. The last project the developer built is sold within six months of the beginning of its use as a rental activity. The project in question was completed after 18 months of construction and during that 18 month period, the real estate industry suffered a severe downturn. In order to pay the cash flow requirements of all of his projects, the taxpayer had to sell one of the projects at a gain. Taxpayer contacted an investment banker and offered to sell any of his ten projects to a willing buyer. The investment banker found an investor willing to purchase the newest project and the transaction was consummated within 12 months of the commencement of use of the project as a rental activity. The gain on the sale of the project is recharacterized as active income under the self-enhanced rental property recharacterization rule.

c. Example - The “I got lucky basket”. Assume that Taxpayer A is a significant participant in a sign painting business in Chicago, and his partner B paints a sign for an apartment complex in Houston. A, through his local investment banker, purchases a non-publicly traded partnership interest in the Houston apartment complex in December of 1992. In June of 1993, a Fortune 500 company buys the land next to the Houston apartment complex and then buys the apartment complex for 3 times the cost basis. A’s share of 1993 net rental income (including gain from the disposition) is recharacterized as active income under the 12 month self-enhanced rental property recharacterization rule. There is no abuse in the status in which the taxpayer held the property. There is no correlation of the value added by the sign painter to the amount of income recharacterized upon a self-enhanced rental property recharacterization rule disposition. The gain, however, is still recharacterized as active income.

d. Date of Sale. The self-enhanced rental property recharacterization rule applies when a binding contract (oral or written) is entered into to sell the property, and not when the property is actually sold.
e. Participation Capacity. This recharacterization rule applies to anyone who significantly participated for any taxable year in any capacity. Thus, a limited partner or an independent contractor who works for as few as 101 hours in the pre-construction stage of a development project could have all of his income from the activity recharacterized, even if there is no relationship between the services performed by the taxpayer and his income from the disposition of the property.

f. Twenty-Four Months vs. Twelve Months. When the February 1988 Regulations were issued, the 12 month time period was a 24 month time period. As a result of consistent critical commentary, this time period was reduced to 12 months in the May 1989 Regulations which amended Treas. Reg. Section 1.469-2T(f)(5)(i). See Lipton & Evaul, Passive Activity Losses (CCH, Sept. 1988) §1004.025; Tucker, National Realty Committee letter to O. Donald Chapoton dated January 10, 1989, Tax Notes Highlights and Documents, (Feb. 16, 1989) at page 1677; and American Bar Association Section of Taxation, Comments on Passive Activity Loss Regulations, (May 31, 1988) 107-110. The effective date of this change is retroactive to taxable years beginning after December 31, 1987. While the theoretical concerns with the self-enhanced rental property rule remain after reduction from 24 to 12 months, the concerns are weakened and the practical impact of the rule is dramatically lessened.

g. Commencement of Use. Prior to amendment, the February 1988 Regulations clearly stated that the holding period for self-enhanced rental property commenced when the property was first held out for rent in a state of readiness for rental. An amendment in the May 1989 Regulations added that the “commencement of use” begins only when the enhancement activities referred to in Treas. Reg. Section 1.469-2T(f)(5)(i)(C) are completed. This provision could be misinterpreted to mean that the 12-month holding period would not commence while a taxpayer was engaged in any attempt to lease the property, since “lease-up” is an enhancement activity. Such a misinterpretation would defeat the purpose for changing the holding period from 24 months to 12 months, and it can be assumed that the regulations will not be interpreted to lead to such an absurd result. The better view is that the lease-up period includes only the activities prior to the property being first held for rent in a state of readiness for rental. The added requirement that enhancement activities be completed is best viewed as an attempt by Treasury to emphasize that the self-enhanced rental property recharacterization rule is a property-by-property rule. For example, renovation of half of a commercial office building could result in the 12 month period beginning for the renovated half of the building, but not the unrenovated half.

i. Regulations to be Clarified. IRS officials have indicated that a classification of the commencement of use rule will be issued which will resolve this ambiguity.

h. Other Amendments to the Self-Developed Property Rule. In addition to the reduction from 24 to 12 months, Treas. Reg. Sections 1.469-2T(f)(5)(i) and (f)(9)(iii) were amended to clarify its application to installment gains received in years after the taxpayer completely disposed of the activity. Prior to this amendment, such gains recognized in taxable years occurring after the year of disposition were not recharacterized. This amendment is effective for taxable years beginning after December 31, 1987. It had been suggested that the effect of this recharacterization rule could be avoided by selling an interest in a partnership or other pass-through entity rather than selling the underlying property. That possibility is now foreclosed by Treas. Reg. Section 1.469-2T(e)(3)(iii)(B), as amended in May 1989.


3. Self-Rented Property Recharacterization Rule (Section 1.469-2T(f)(6)). Under Treas. Reg. Section 1.469-2T(f)(6), gross rental income equal to net rental income (including income from dispositions, see Treas. Reg. Section 1.469-2T(f)(9)) from an item of property rented to a trade or business activity in which the taxpayer materially participates and which property is not property described in the 12 month self-enhanced recharacterization rule is recharacterized as active income.
a. **Example.** Taxpayer A rents a building to an S corporation for use in an activity in which he is a material participant for fair market value and has net rental income of $5,000 in 1992. If the S corporation had rented the property from a third party, the third party would have passive rental income. Gross rental income of the taxpayer, however, equal to $5,000 is recharacterized as active income under the self-rental property recharacterization rule.

b. **Self-Rented Recharacterization Rule Does Not Apply To C Corporation Activities.** Under Section 1.469-4T(b)(2)(ii)(B), an individual cannot participate in an activity in which the taxpayer’s sole interest in the activity is owned through a C corporation in which the taxpayer is a shareholder. Rather, the individual’s work with respect to the C corporation activities is referred to in order to determine whether the C corporation materially participates in an activity. Thus, the self-rented property recharacterization rule does not apply to rentals to C corporations. For example, if taxpayer B rents equipment to his wholly-owned C corporation law firm for a rent far in excess of fair market value, the self-rented property rule does not apply.

c. **Self-Rented Recharacterization Rule Does Not Apply to Significant Participation Passive Activities.** The net income from a significant participation passive activity is recharacterized as active income under the significant participation passive activity recharacterization rule of Treas. Reg. Section 1.469-2T(f)(2). The self-rented recharacterization rule only applies to activities in which the lessor materially participates. Thus, even though net income from a significant participation passive activity is treated the same as net income from an activity in which the taxpayer materially participates, the self-rented recharacterization rule does not apply to significant participation passive activities. This creates a “planning opportunity” to decrease active income and increase passive income by renting property to an activity in which the taxpayer significantly participates.

d. **Self-Rented Recharacterization Rule Does Not Apply to Related Parties.** A taxpayer must be a material participant in the activity or the self-rented property recharacterization rule does not apply. Thus, for example, the daughter of a partner in a law firm could rent property to the law firm, but the partner could not, without application of the self-rented property recharacterization rule.

e. **Item of Property Subject to Recharacterization.**

i. **Part of Property.** Assume that taxpayer B rents one story of a 50 story building to an actuarial sciences partnership in which he materially participates. The issue is whether income from the entire building is recharacterized as active income or just the income attributable to the self-rented floor. The better view is that the self-rented property recharacterization rule only applies to the item of property self-rented, i.e., the self-rented floor. If the term used in Treas. Reg. Section 1.469-2T(f)(6) was “property” and not “item of property,” the whole building would be subject to recharacterization.

ii. **Partnership Interests.** It had been suggested that the effect of this recharacterization rule could be avoided by selling an interest in a partnership or other pass-through entity rather than selling the underlying property. That possibility is now foreclosed by Treas. Reg. Section 1.469-2T(e)(3)(iii)(B), as amended in May 1989.

f. **Example - Self-Rented Property Only Applies to Income Share of Material Participant.** Assume that A is a 10% partner in a partnership, X, which owns a building and rents it to A for use in A’s trade or business. Only A’s 10% share of net rental income should be recharacterized as active; the remaining 90% interest of other partners in X should remain passive.

g. **Example - Rental Loss Property.** Assume that A self-rents a building to a partnership in which A is a partner. Each year of the rental activity, however, A recognizes a loss and therefore no recharacterization under the self-rented property recharacterization rule is required. After 10 years of losses, A sells the building for enough profit to offset the previously suspended passive activity losses and to receive an additional $1,000,000 gain. The $1,000,000 gain is active under the self-rented recharacterization rule. It is hard to imagine any abuse inherent in such a transaction; nonetheless, the gain is recharacterized.
h. Installment Sale. Under the regulations issued in February of 1988, installment gain recognized from the sale of self-rented property and recognized in a year following the disposition technically was not covered by the self-rented property rule. Amendments to Treas. Reg. Section 1.469-2T(f)(6) in the May 1989 Regulations, however, clarify that such installment gain is subject to the self-rented property recharacterization rule. This amendment is effective for rentals entered into on or after February 19, 1988.

i. Effective Date. The self-rented property recharacterization rule is effective for rentals pursuant to binding written contracts entered on or after February 19, 1988. Treas. Reg. Section 1.469-11T(a)(2)(ii). Presumably, any material modification to the lease which occurs on or after February 19, 1988, will cause the lease to be viewed by the Service as entered on or after February 19, 1988, and subject to the self-rented property recharacterization rule. On the other hand, a renewal of a lease under terms of a renewal option found in a lease entered before February 19, 1988, arguably is a lease entered into before February 19, 1988.

4. Creator Intangible Property Rule. Pursuant to Treas. Reg. Section 1.469-2(c)(7)(ii), gross income of an individual from intangible property (such as a patent or copyright) is recharacterized from passive to active income, if the taxpayers efforts significantly contribute to creator of the property.


5. Casualty Loss Reimbursement Rule. Pursuant to Treas. Reg. Section 1.469-2T(c)(7), gross income attributable to certain reimbursements of Section 165 casualty losses from a passive activity is recharacterized as active. (This provision is a companion to Treas. Reg. Section 1.469-2T(d)(2)(xi), which recharacterizes otherwise passive casualty losses as active losses.) The gross income is recharacterized only if (A) the income is included in gross income under Treas. Reg. Section 1.165-1(d)(2)(iii) and (B) the corresponding casualty loss was non-passive.

a. Comment. Although Treasury's desire to avoid unfortunate tax consequences to victims of earthquakes and hurricanes is laudable, there appears to be little support in the statute or legislative history for providing such relief. It has been suggested that a technical correction to the statute may be necessary to validate the regulatory relief. See American Bar Association Section of Taxation, Comments on Notice 90-21 (June 13, 1990); Lipton, "IRS Eases Passive Loss Limitation for Casualty Losses," 68 Taxes 363 (1990).

b. Effective Date. Although the casualty loss recharacterization rules were promulgated only in February of 1990, following earthquakes in California, they are effective as if published in the first set of regulations. See T.D. 8290 and Notice 90-21, 1990-12 I.R.B. 1. Thus, the casualty loss reimbursement rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a).

B. Passive Income Recharacterized as Portfolio Income.

1. Non-Depreciable Rental Property Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(f)(3), if less than 30% of the unadjusted basis (without regard to Section 1016) of property used or held for use by customers in a rental activity is subject to Section 167 depreciation, an amount of gross rental income (including gain from disposition, see Treas. Reg. Section 1.469-2T(f)(9)) from such activity equal to net passive income therefrom is recharacterized as portfolio income. This rule is an outgrowth of the suggestion of the Conference Report at page II-147 that use of the recharacterization authority of the Secretary be appropriate where there are "ground rents that produce income without significant expenses."

a. Example. Ground rents are clearly recharacterized as portfolio income under the rental of nondepreciable property recharacterization rule. The more difficult issue arises where improvements exist on leased land. Treas. Reg. Section 1.469-2T(f)(3), Example, explains how the Rental of Non-Depreciable Property Recharacterization Rule operates where improvements are rented with land.
C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25% of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3) [Rental of Non-Depreciable Property Recharacterization Rule], an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

b. Definition of Activity. This rule concerning nondepreciable property applies only if less than 30% of the unadjusted basis of property used in the activity is depreciable. For purposes of determining a taxpayer's activities, each rental real estate undertaking in which less than 30% of the property is depreciable must be treated as a separate activity. Treas. Reg. Section 1.469-4T(k)(6). Thus, a taxpayer cannot escape the application of this rule by combining various rental real estate undertakings into a single activity.


2. Equity-Financed Lending Activity Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(f)(4), passive income from an equity-financed lending activity is recharacterized as portfolio income. An equity-financed lending activity must be an activity involving the trade or business of lending money. Treas. Reg. Section 1.469-2T(f)(4)(ii)(A)(2). The trade or business of lending money is an equity-financed lending activity only if the average outstanding balance of liabilities incurred does not exceed 80% of the average outstanding balance of interest bearing assets held in the activity during the taxable year. Treas. Reg. Section 1.469-2T(f)(4)(ii)(A)(l). An amount of the taxpayer's gross income from the equity-financed lending activity is recharacterized as portfolio income to the extent of the lesser of (i) the taxpayer's equity-financed interest income, or (ii) the taxpayer's net passive income from the activity in such taxable year. Treas. Reg. Section 1.469-2T(f)(4)(i). This rule was intended to stop the equity syndication of mortgage pools, pursuant to which passive income was thought to have been generated by virtue of making loans in the ordinary course of business.


3. Intangible Licensing Pass-Through Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(f)(7), if a taxpayer acquires an interest in a development entity which is a pass-through entity after creation of an intangible property item or after performance of substantial services with respect to development or marketing of such an item, gross royalty income of the taxpayer equal to net royalty income from such item of property is recharacterized under the intangible licensing pass-through recharacterization rule as portfolio income. Thus, investment in a royalty producing trade or business entity after the creation, development and marketing of the royalty producing property will result in portfolio royalty income.


b. Interplay between the Rules on Intangible Licensing. The interplay between the intangible licensing pass-through recharacterization rule and the licensing royalties recharacterization rule is crucial to understanding each rule. The licensing royalties recharacterization rule of Treas. Reg. Section 1.469-2T(c)(3)(iii)(C) provides that royalty income otherwise from a trade or business generally will be recharacterized as portfolio income if the recipient (i.e., the taxpayer or, in the case of a pass-through entity, the entity) (i) created the property, or performed substantial services or incurred substantial costs in developing or marketing the property. Such rule, however, is not protective enough of the interests of Treasury where the taxpayer purchases an interest in a pass-through entity which has already created the property, incurred the development or marketing costs or performed the marketing or
development services. See Preamble of the February 1988 Regulations at XVI.C.3. Thus, the intangible licensing pass-through entity acquisition recharacterization rule applies where the taxpayer acquires a pass-through entity interest after the entity has created the property, performed the services or incurred the costs. Treas. Reg. Section 1.469-2T(f)(7).

c. Sale of Partnership Interest. It had been suggested that the effect of this recharacterization rule could be avoided by selling an interest in a partnership or other pass-through entity rather than selling the underlying property. That possibility is now foreclosed by Treas. Reg. Section 1.469-2T(e)(3)(iii)(B), as amended in May 1989.

4. Former Qualified Working Interest Recharacterization Rule. If a taxpayer utilized the qualified working interest exception of Section 469(c)(3) to take any active loss with respect to an oil and gas property for a taxable year beginning after December 31, 1986, gross income from such oil and gas property will be nonpassive income to the extent of the net income therefrom for such taxable year. Treas. Reg. Section 1.469-2T(c)(6). Thus, even if the taxpayer converts his qualified working interest into an interest in a limited liability entity, gross income from the activity will be recharacterized. Although not so stated in the Regulations, this nonpassive income is treated as investment income for purposes of Section 163(d). Thus, it is better to view this income as portfolio income, although it is not labelled explicitly as such. A more detailed discussion of qualified working interests is found, below, in Special Rules for Oil and Gas.

a. Example: Individual A converts his working interest in an oil and gas property into an S corporation in 1988. In 1987, the working interest produced an active loss under the qualified working interest exception. In 1988, any net income from the property will be recharacterized as nonpassive income. Losses that might occur following transfer into the S corporation would be passive, assuming that A did not materially participate in the activity. Once a taxpayer takes advantage of the qualified working interest exception to treat losses as active, income from the property is perpetually tainted as nonpassive. The income will be investment income for purposes of Section 163(d).

b. Definition of Property. For purposes of the former qualified working interest recharacterization rule, the term “property” means property the value of which is directly enhanced by any drilling, logging, seismic testing, or any other activity, a part of the cost of which was incurred by the taxpayer as a result of holding a qualified working interest. Treas. Reg. Section 1.469-2T(c)(6)(iii). This definition of property is broader than the applicable definition for the qualified working interest, which is determined on a well-by-well basis.

i. Example: Taxpayer A drills a well as a qualified working interest owner in 1987, and the logging, seismic, or drilling information from that well is used to directly enhance the value of a 1988 limited partnership investment of A. The losses from the limited partnership are passive, but gross income in excess of deductions from such limited partnership (such deductions including any suspended PALs from the activity) is active income.

c. Sale of Partnership Interest. It had been suggested that the effect of this recharacterization rule could be avoided by selling an interest in a partnership or other pass-through entity rather than selling the underlying property. That possibility is now foreclosed by Treas. Reg. Section 1.469-2T(e)(3)(iii)(B), as amended in May 1989.

d. Effective Date. The effective date of the former qualified working interest recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

5. Preferred and Guaranteed Returns. The legislative history of Section 469 provides that a guaranteed return that was structured as passive income would be an appropriate subject for recharacterization as portfolio income. A guaranteed return appears to be one that is not subject to the entrepreneurial risk of a rental or trade or business activity. The regulations as presently drafted, however, do not recharacterize a guaranteed return. The Preamble to the Regulations indicates that Treasury remains concerned with the issue and is reviewing the question of whether partnership preferred returns may also be subject to recharacterizations once guaranteed return regulations are issued. The Preamble does indicate, however, that such preferred returns recharacterizations would be dependent on circumstances such as the type of investments made by the partnership.
The treatment of preferred returns opens a variety of potential issues. For example, an eight percent preferred return that simply allocates to those who provide capital the first income from a trade or business activity should not be subject to recharacterization. Such income is preferred in nature, but is not guaranteed; it is subject to the entrepreneurial risk of the trade or business enterprise. On the other hand, assume that an investment partnership that had a triple A credit rated general partner guaranteed an eight percent annual return to investors without respect to the success or failure of the underlying trade or business activity. The investment of the taxpayer, by virtue of the guarantee, is without entrepreneurial risk of loss and is similar to a certificate of deposit in its investment nature.

a. Comment. The authors believe that it would be better to distinguish between “guaranteed” and “preferred” returns. If a return is guaranteed, the income should be portfolio. On the other hand, a preferred return which bears entrepreneurial risk of loss should not give use to portfolio income.

b. Potential Effective Date. Whatever rules are eventually set forth in regulations or other IRS announcements with respect to guaranteed or preferred returns, it is anticipated that such rules will be prospective. It is not clear that previously structured and acquired guaranteed or preferred returns will be grandfathered for tax periods following issuance of such regulations or announcements.

C. Passive Income Recharacterized as Active or Portfolio Income.

1. Substantially Appreciated Property Recharacterization Rule.

a. Substantially Appreciated Former Active Property. Under Treas. Reg. Section 1.469-2T(c)(2)(iii), gain from a disposition of an interest in substantially appreciated property (i.e., an interest in property in which the fair market value exceeds 120% of the adjusted basis of such interest) is recharacterized as active income unless such property was used in a passive activity for either (i) 20% of the taxpayer’s holding period, or (ii) the entire 24 months prior to disposition. If the taxpayer held the property for investment purposes for more than 50% of his holding period, see paragraph b, below.

b. Substantially Appreciated Former Investment Property. Under Treas. Reg. Section 1.469-2T(c)(2)(iii)(E), if substantially appreciated property was held for investment purposes more than 50% of the taxpayer’s holding period, and the gain from disposition of the property is otherwise subject to recharacterization as set forth above in Treas. Reg. Section 1.469-2T(c)(2)(iii), the gain is recharacterized as portfolio income.

c. Acquired Property. For purposes of the foregoing rules concerning substantially appreciated property, if a taxpayer acquired any property in a transaction other than a nonrecognition transaction, any prior ownership or use of the property is not taken into account. Treas. Reg. Section 1.469-1T(c)(2)(iv). Thus, for example, if A is a partner in partnership AB, which acquires an interest in property in 1990 for $1, and A purchases the property from AB in 1995 for $20, the sale of the same property by A in 1996 for $22 will not be subject to these rules concerning substantially appreciated property.

d. Effective Date. The substantially appreciated property recharacterization rule is effective for dispositions after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

D. Passive Loss Recharacterized as Active Loss.

1. Active Participation Rental Real Estate Recharacterization Rule. Section 469(i)(1)-(2) recharacterizes from passive to active up to $25,000 of losses or equivalent credits from rental real estate activities in which an individual taxpayer actively participates.

a. Phase-out. This recharacterization rule is phased-out, however, for taxpayers with adjusted gross incomes of $100,000-$150,000. Section 469(i)(3)(A). For tax years ending after December 31, 1989, the benefit of the recharacterization rule for rehabilitation investment and low income housing credits is phased out beginning at adjusted gross incomes of $200,000. Section 469(i)(3)(B); Revenue Reconciliation Act of 1989 Section 7109.
b. Active Participation. Active participation will be defined by regulations not yet issued. See Treas. Reg. § 1.469-9T (reserved). A taxpayer does not actively participate, however, if his interest in the activity is less than 10% by value or is held through a limited partnership. Section 469(i)(6)(A), (C).

c. Active Participation Not Required. The recharacterization rule applies to rehabilitation investment credits and low income housing credits from rental activities without regard to whether the taxpayer actively participates. Section 469(i)(6)(B).


2. Low Income Housing Credit Recharacterization Rule. Section 469(i)(1)-(2) also recharacterizes from passive to active up to the deduction equivalent of $25,000 in low income housing credits from rental activities.

a. No Phase-Out or Participation Requirement. Unlike the active participation rental real estate recharacterization rule, the low income housing credit recharacterization rule is not subject to a phase-out based on taxpayer income. Section 469(i)(3)(C). Moreover, no participation level is required to obtain the benefits of recharacterization. Section 469(i)(6)(B).

b. Effective Date. The low income housing credit recharacterization rule is effective for property placed in service after December 31, 1989, in tax years ending after that date. See Revenue Reconciliation Act of 1989 Section 7109(b)(1). For interests owned through a partnership, the recharacterization rule does not apply unless the partnership interest was also acquired after December 31, 1989. Id. Section 7109(b)(2). If the low income housing credit recharacterization rule does not apply, however, the active participation rental real estate recharacterization rule may still transform low income housing credits from passive to active, subject to a phase-out for high-income taxpayers.

3. Casualty Loss Recharacterization Rule. Pursuant to Treas. Reg. Section 1.469-27(d)(2)(xi), deductions which qualify as casualty losses under Section 165 am recharacterized as non-passive if losses that are similar in cause and severity do not recur regularly in the conduct of the activity. (A companion provision recharacterizes as non-passive any reimbursements of casualty losses subject to this rule. See Treas. Reg. Section 1.469-2T(c)(7).)

a. Comment. Although Treasury's desire to avoid unfortunate tax consequences to victims of earthquakes and hurricanes is certainly laudable, there does not appear to be any authority in the statute or legislative history for providing any relief. It has been suggested that a technical correction to the statute is necessary to validate the regulatory relief. See American Bar Association Section of Taxation, Comments on Notice 90-21 (June 13, 1990); Lipton, "IRS Eases Passive Loss Limitation for Casualty Losses," 68 Taxes 363 (1990).

b. Effective Date. The casualty loss recharacterization rule is effective for losses sustained in years beginning after December 31, 1989, but taxpayers may elect to apply the rule to prior years by treating the loss as non-passive on the taxpayer's return or amended return. See Treas. Reg. Section 1.469-2T(d)(2)(xi)(A)-(B). If the election is made, the regulations are effective as if published in the first set of regulations, i.e., for taxable years beginning after December 31, 1987. See T.D. 8290 and Notice 90-21 1990-12 I.R.B. 1; Treas. Reg. Section 1.469-11T(a).

4. Former Passive Activity. Section 469(f)(1) provides that suspended passive loss and credit carryovers of a non-passive activity which was a passive activity for a prior year (a "former passive activity") (a) may offset any current year (active) income from the former passive activity; and (b) the excess remaining after such offset is treated as passive. This can be viewed as recharacterizing otherwise active deductions as passive. Note that regulations on the former passive activity rules have yet to be issued. See Treas. Reg. Section 1.469-1T(k) (reserved).

E. Active Loss Recharacterized as Passive Loss.

1. Tax Avoidance Participation Recharacterization Rule. In general, any work done by an individual in connection with an activity in which the individual owns (directly or indirectly other than as a C corporation shareholder) an interest at the time the work is performed is treated as participation of the individual in such activity. Under Treas. Reg. Section 1.469-5T(j)(2)(ii), where a taxpayer does work which has as one of its principal purposes the avoidance of Section 469 rules and where such work is not of a type customarily done by an owner of such activity, such work is not participation for purposes of determining material participation.

   a. Example. Assume that A is the sole shareholder of an S corporation, X, in which he does not participate. A’s tax advisor explains that if A materially participated he would be able to use losses from X to shelter A’s portfolio dividend income. A takes a job at X as the public relations director and spends in excess of 500 hours mailing out firm brochures and having lunch with prospective buyers. Assuming such services are not those customarily done by an owner, the losses from the activity of X are still passive losses to A.

   b. Effective Date. The effective date for the tax avoidance participation recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

F. Passive Activity Recharacterized as Active Activity.

1. Dwelling Unit Rental Recharacterization Rule. Under Treas. Reg. Section 1.469-1T(e)(5), an activity which involved the rental of a dwelling unit used by the taxpayer as a residence in a taxable year in which Section 280(c)(5) applies to the taxpayer’s use of such dwelling unit is recharacterized as an active activity.

   a. Example. Lou owns a condominium in Aspen which Lou uses three weeks each year for personal purposes; the condominium is rented for an additional ten weeks. Any profit from the rentals is not passive income.

   b. Effective Date. The rental of a dwelling unit recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

2. Not-Less-Than-Other Participants Rule. An individual materially participates in any activity in which he participates for more than 100 hours if he participates in an activity not less than any other individual (including nonowner participation). Treas. Reg. Section 1.469-5T(a)(3). This rule is a material participation discussed in detail, above in Material Participation. In the view of the authors, however, the rule is an unlabeled recharacterization rule.

   a. Effective Date. This rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

3. 500 Hour/Significant Participation Rule. If the individual cannot otherwise qualify as a material participant under any other rule and the aggregate hours spent in significant participation activities is in excess of 500 hours, then the individual materially participates in each of those significant participation activities. Treas. Reg. Section 1.469-5T(a)(4). A significant participation activity is one in which the individual participates for more than 100 hours but less than 500 hours. Treas. Reg. Section 1.469-5T(c). This rule is a material participation discussed in detail, above in Material Participation. In the view of the authors, however, the rule is an unlabeled recharacterization rule.

   a. Effective Date. This rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

4. Five-Out-of-Ten-Years Rule. An individual materially participates in an activity if he materially participated therein during any five of the ten years immediately preceding the tax year in question. Treas. Reg. Section 1.469-5T(a)(5). However, in determining material participation in prior years, material participation that existed under the five-out-of-ten years rule only is deemed to not be material participation. In order to consider the individual’s
material participation in an activity in a year prior to 1987, the prior year’s material participation must be determined only under the 500-hour rule. Treas. Reg. Section 1.469-5T(j). This rule is a material participation discussed in detail, above in *Material Participation*. In the view of the authors, however, the rule is an unlabeled recharacterization rule.

a. **Effective Date.** This rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

5. **Three Year Personal Service Activity Rule.** An individual materially participates in a personal service activity in which he has materially participated in any three taxable years prior to the present taxable year. Treas. Reg. Section 1.469-5T(a)(6). Consecutive years are not required. Additionally, for any year prior to 1987, the prior year’s material participation must be determined only under the 500-hour rule. Treas. Reg. Section 1.469-5T(j). This rule is a material participation discussed in detail, above in *Material Participation*. In the view of the authors, however, the rule is an unlabeled recharacterization rule.

a. **Effective Date.** This rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

6. **Limited Partners Rule.** Unless an individual materially participates under (1) the 500-hour rule, (2) the five-out-of-ten rule, or (3) the personal service activity three-year, his interest as a limited partner will be treated as one through which he can not materially participate. Treas. Reg. Sections 1.469-5T(e)(1) and (2). If the individual materially participates under the above-named three rules, his status as a limited partner will be ignored, and he will be treated as a material participant in such activity. This rule is a material participation discussed in detail, above in Material Participation. In the view of the authors, however, the rule is an unlabeled recharacterization rule.

a. **Effective Date.** This rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a)(1).

7. **Other Trade or Business Undertaking Aggregation Recharacterization Rule.** Under Treas. Reg. Section 1.469-4T(f)(2) other trade or business undertakings which are (a) similar and (b) controlled by the same interests may be aggregated into a single activity, (c) if one of three conditions is met. The third condition is that if the undertakings were combined, the taxpayer would significantly or materially participate in the combined activity. Treas. Reg. Section 1.469-4T(f)(92)(iii).

a. **Example.** A taxpayer has two other business undertakings which are similar and are controlled by the same interests. In each other business undertaking, No. 1 and No. 2, the taxpayer participates 60 hours. Under the other business undertaking aggregation recharacterization rule, the taxpayer is treated as significantly participating in the aggregated undertaking and if the aggregated undertaking produces net income, such income is recharacterized by the significant participation activity recharacterization rule as active income. Without the other business undertaking aggregation recharacterization rule, the undertaking would have been separate activity with 60 hours of participation. As such, the net income from each undertaking would have been passive.

b. **Effective Date.** The other trade or business undertaking aggregation recharacterization rule is effective for taxable years beginning after August 9, 1989. Treas. Reg. Section 1.469-4T(p). Additionally, for tax years beginning after December 31, 1986 and before August 10, 1989, the rule is available but not required as a reasonable method of defining an activity. Treas. Reg. Section 1.469-4T(p).

G. **Passive Activity Recharacterization as Portfolio Activity.**

1. **Trading Personal Property Recharacterization Rule.** Treas. Reg. Section 1.469-1T(e)(6) provides that the trading of personal property (as defined by Section 1092(d) without regard to paragraph (d)(3) thereof) for the account of owners in such activity is not a passive activity without regard to whether the activity is a trade or business. As such, the activity is recharacterized as a portfolio activity under the trading personal property recharacterization rule.
a. Example. Partners A and B form a personal property trading partnership in which A is a full-time participant as the general partner with a 50% partnership interest in profits and losses. B is the non-participating limited partner with a 50% partnership interest in profits and losses. In 1988, the partnership has $200 of net income. Thus, A has $100 of active income and B has $100 of portfolio income. In 1989, the partnership has a $300 net loss. A has a $150 active loss and B has a $150 portfolio loss. Thus, for the partner who materially participates, the activity is a trade or business; but for the partner who does not, the activity is portfolio.

b. Effective Date. The trading personal property recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1IT(a)(1).

2. Qualified Working Interest Recharacterization Rule. Pursuant to Section 469(c)(3), a qualified working interest in an oil and gas property is not a passive activity. Pursuant to Section 163(d)(5)(A)(ii) a qualified working interest with respect to which a taxpayer does not materially participate is a portfolio activity. See Special Rules for Oil and Gas Activities, below, for a more detailed discussion of the qualified working interest rule.

a. Effective Date. The qualified working interest recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1IT(a)(1).

H. Passive or Portfolio Activities Recharacterized as Active Activities.

1. Qualified Working Interest Undertaking Separation Recharacterization Rule. The Regulations provide a special provision for defining an “activity” that involves a working interest in an oil and gas property. Under Treas. Reg. Section 1.469-4T(e)(1)(ii), certain oil and gas working interest operations are treated as a separate activity from other same location, same entity income-producing operations. The separation rule, however, does not apply if the taxpayer is a material participant in the unseparated income-producing operation. Treas. Reg. Section 1.469-4T(e)(1)(ii). This separation rule acts as a recharacterization rule which can effect both qualified working interests and other trade or business undertakings. A more detailed discussion of this rule is found in Special Rules for Oil and Gas Activities, below.

a. Example. Assume that taxpayer A owns oil and gas income-producing operations at a single location which includes oil and gas working interest operations. Assume that A spends 501 hours a year on such oil and gas working interest operations and 60 hours on the remaining income-producing operations. By not separating the oil and gas working interest operations, the other oil and gas operations are in substance recharacterized as active activities.

b. Effective Date. This qualified working interest undertaking separation recharacterization rule is effective for taxable years beginning after August 9, 1989. Treas. Reg. Section 1.469-4T(p). Additionally for tax years beginning after December 31, 1986 and before August 10, 1989, the rule is available but not required as a reasonable method of defining an activity. Treas. Reg. Section 1.469-4T(p).

I. Passive, Active or Portfolio Activity Pro Rata Recharacterized as a Different Activity.

1. 12 Month Disposition Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(c)(2)(ii), if property which is used in only one activity at the time of disposition has been used in more than one activity during the 12 month period preceding the disposition, the gain generally must be allocated among the activities. A de minimis exception exists for situations in which the fair market value of the interest in property does not exceed the lesser of (i) $10,000 or (ii) 10% of the fair market value of all property (including the property subject of the disposition) used in the activity immediately before the disposition.


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J. Passive or Active Activity Recharacterized as Portfolio Activity.

1. Ordinary Course of a Trade or Business Recharacterization Rule. For purposes of defining portfolio income as gross income not derived in the ordinary course of a trade or business, Treas. Reg. Section 1.469-2T(c)(3)(ii) redefines the meaning of the phrase “ordinary course of trade or business” to include only the following:

   a. [Trade or Business of Lending Money] Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

   b. [Accounts Receivable Interest] Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

   c. [Insurance Investment Income] Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contacts or reinsuring risks underwritten by insurance companies;

   d. [Trade or Dealing Property] Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) [Income From Property Held For Investment By Dealer] of this section);

   e. [Royalties] Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) [Royalties Derived In The Ordinary Course Of The Trade Or Business Of Licensing Intangible Property] of this section);

   f. [Cooperative Patron Income] Amounts included in the gross income of a patron of a cooperative (within the meaning of Section 138 (a), without regard to paragraph (2) (A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

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

By modifying the traditional Section 162 meaning of the phrase “in the ordinary course of a trade or business,” Treas. Reg. Section 1.469-2T(c)(3)(ii) becomes an unlabeled recharacterization rule for trade or business activities transforming passive income (if the taxpayer does not materially participate) or active income (if the taxpayer does materially participate) into portfolio income. Activities which are not included in Treas. Reg. Section 1.469-2T(c)(3)(ii)(A-F) as part of the ordinary course of a trade or business must be approved by the Commissioner. Without approval of the Commissioner, any income described in Treas. Reg. Section 1.469-2T(c)(2)(i) (such as interest, dividends, royalties, etc.) will be portfolio even if under Section 162 principles such income would be earned in a trade or business activity. Subject to the special licensing royalty recharacterization rule discussed below, and the intangible licensing pass-through recharacterization rule, royalties derived in the ordinary course of a trade or business of licensing intangible property are not derived in a portfolio activity. Treas. Reg. Section 1.469-2T(c)(3)(ii)(E).

2. Working Capital Recharacterization Rule. Section 469(e)(1)(B) provides that any income or gain from the investment of working capital is not derived in the ordinary course of a trade or business for purposes of determining portfolio income. In substance, the working capital rule is a recharacterization rule which recharacterizes active or passive activities as portfolio activities. The regulations implement this rule by treating such working capital interest as not being earned in a trade or business.

   a. Example. Assume that taxpayer A is a sole proprietor of rental real estate who has a $10,000 average cash checking account in 1992 which has an average of 6% interest for 1992. The $10,000 cash average was not only necessary working capital of A, but was indeed below what his accountant and financial adviser have recommended
as a working capital. If the rental activity incurs an operating loss (determined without interest income) of $5,000 and interest income is $600, the interest income would be portfolio income. The rental loss, assuming no active participation rental real estate recharacterization rule application, however, is per se passive and cannot offset the interest income.

b. Comment. The working capital interest recharacterization rule was apparently adopted by Congress for administrative convenience. This rule can work to the taxpayer’s advantage. If the taxpayer is seeking investment (portfolio) income for purposes of Section 163(d), he can create working capital in an otherwise passive activity (such as rental real estate) and the income earned on the working capital will be treated as portfolio income.

c. Effective Date. The working capital interest recharacterization rule is effective for taxable years beginning after December 31, 1986. TRA ’86, Section 501(a).

3. Mineral Royalties Recharacterization Rule. If a taxpayer is in the trade or business of dealing or trading in mineral royalties, royalty income is treated as earned in the ordinary course of a trade or business and will be passive or active depending upon the level of the taxpayer’s participation. Treas. Reg. Sections 1.469-2T(c)(3)(i)(D) and (c)(3)(iv), Example (4). Otherwise, mineral royalty income is portfolio except for royalties identified by the Commissioner pursuant to Treas. Reg. Section 1.469-2T(c)(3) (ii)(G). In Section X(C) of the Preamble to the February 1988 Regulations, Treasury indicated that the only way to get the Commissioner’s approval would be to request a ruling. It was further indicated in the Preamble that Treasury believed there were cases in which such a ruling would be appropriate, but that in certain cases a portion of royalty income from a transfer could be deemed the equivalent of portfolio interest income from an installment sale. For example, royalty income from the transfer of mineral properties by a partnership in the trade or business of oil and gas development would be subject to a proration which would treat part of the royalty stream as sale proceeds and part as portfolio interest income. See Preamble Section X(C). Treasury in Preamble Section X(C) has requested comments on such distinctions in general and in particular on how to allocate depletion deductions between trade or business royalty income and portfolio royalty income.

a. Effective Date. The effective date for the mineral royalties recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1IT(a)(1).

4. Licensing Royalties Recharacterization Rule.

a. General Rule. Under Treas. Reg. Section 1.469-2T(c)(3)(iii)(B), royalties received pursuant to a license or other transfer of intangible property rights is treated as derived in the ordinary course of a trade or business only if the person receiving such royalties (i) created the property, or (ii) performed substantial services or incurred substantial costs in developing or marketing the property. A royalty that otherwise would be treated as derived in the ordinary course of a trade or business but that does not meet the substantial services or costs test will be treated as not derived in the ordinary course of a trade or business. Thus, under Treas. Reg. Section 1.469-2T(c)(3)(iii)(B), such royalty income will indirectly be recharacterized as portfolio income. Without the indirect recharacterization, such income would be active (if the taxpayer materially participates in the activity) or passive (if the taxpayer does not materially participate in the activity). Pursuant to Treas. Reg. Sections 1.469-2T(d)(2),(3) and (4), expenses with respect to recharacterized royalty income will be treated as attributable to portfolio income. Thus, the end result of Treas. Reg. Section 1.469-2T(c)(iii)(B), royalties from licensing intangibles recharacterization rule, is that the activity producing royalties without the requisite criterion, substantial services or costs of the taxpayer, is recharacterized as a portfolio activity.

b. Substantial Services or Costs. The issue of substantial services or costs is a facts and circumstances question. Treas. Reg. Section 1.469-2T(c)(3)(ii)(B)(2)(i).

c. Effective Date. The licensing royalties recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1IT(a)(1).
d. Interplay with Intangible Licensing Pass-Through Entity Acquisition Recharacterization Rule. The interplay with the intangible licensing pass-through recharacterization rule explained above is crucial to the understanding of each rule. See Preamble to the February 1988 Regulations at Section XVI.C.3.

5. Former Investment Property of a Dealer Recharacterization Rule. Under Treas. Reg. Section 1.469-2T(c)(3)(ii)(D), the sale of property in the ordinary course of a dealer's trade or business is treated as a trade or business activity, but gain or income from such sales is subject to characterization as portfolio income if the dealer held the property for investment at any time prior to recognition of the income or gain. Treas. Reg. Section 1.469-2T(c)(3)(iii)(A). Apparently, losses and expenses with respect to such property also would be portfolio. See Treas. Reg. Section 1.469-2T(d)(2).

   a. Limited Scope. This rule only applies to the extent that the "dealer exception" of Treas. Reg. Sec. 1.469-2T(c)(3)(ii)(A) is necessary to prevent the income from being portfolio income under Treas. Reg. Sec. 1.469-2T(c)(3)(i). As a result, this special rule applies only to property that produces income described in Treas. Reg. Sec. 1.469-2T(c)(3)(i)(A), (B), (C) or (D), such as interest, dividends and royalties. Thus, this rule will apply to sales by a dealer of stocks or bonds previously held for investment, but this rule should not apply to sales of land formerly held for investment by a dealer. Treas. Reg. Sec. 1.469-2T(c)(3)(i) and (iii).

   b. Effective Date. The former investment property recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

6. Mineral Production Payments Recharacterization Rule. Mineral production payments are treated as interest payments to the extent such payments are interest equivalents under Section 636. Treas. Reg. Section 1.469-2T(c)(3)(ii)(C)(ii). Since the interest payments are not in the ordinary course of a trade or business interest payments under Treas. Reg. Sections 1.469-2T(c)(ii)(A) or (B), such mineral production payment is indirectly recharacterized as portfolio income. Furthermore, if a mineral production payment is not treated as a loan under Section 636, payments in discharge of a mineral production payment are treated as royalties and again indirectly recharacterized as portfolio income under Treas. Reg. Section 1.469-2T(c)(3)(ii). See Treas. Reg. Section 1.469-2T(c)(3)(iii)(C)(2).

   a. Effective Date. The mineral production payments recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

K. Passive or Active Activity Recharacterized as Passive, Active or Portfolio.

   1. Incidental Dealing. Treas. Reg. Section 1.469-2T(c)(2)(v) provides an incidental dealing recharacterization rule for dealing activities which are incidental to rental, trade, business or portfolio activities. Thus, the passive or active activities of such trade or business incidental dealing is recharacterized as a passive, active or portfolio activity. See discussion of this rule in Computation and Treatment of PALs, below.

   a. Effective Date. The incidental dealing recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a)(1).

L. Portfolio Activity Recharacterized as Passive or Active Activity.

   1. Anticipated Section 162 Endeavors. Treas. Reg. Sections 1.469-4T(b)(2)(ii)(A)(1) and 1T(c)(2)(ii) recharacterize Section 212 activities as passive or active activities by treating activities conducted in anticipation of a Section 162 trade or business activity. Thus, if the taxpayer materially participates, the activity is recharacterized as an active activity and if the taxpayer does not materially participate, the activity is a passive activity.

   a. Raw Land Held for Development. Assume that taxpayer A is a partner in a partnership which holds raw land with the specific intent to develop the property beginning in 3 years. Holding such raw land prior to development is an anticipated Section 162 activity and is therefore a trade or business activity for Section 469 purposes.
The interest expense on the raw land prior to development will therefore be either passive or active, depending on A's participation level. If A is a material participant in the anticipated Section 162 activity, the interest will be active. If A is not a material participant in the activity, the interest will be passive.

i. Compare Raw Land Held for Investment. If raw land is held for investment with no intent to develop, it is not held in anticipation of Section 162 activities. Thus, the interest attributable thereto should be deductible subject to the Section 163(d) investment interest rules.

b. Effective Date. The anticipated Section 162 endeavors rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-1T(a).

M. Self-Charged Recharacterization Rules. The self-charged rules discussed below will effectively result in the recharacterization of income and/or loss.

XIV. SELF-CHARGED RULES.

A. Legislative History Concept. The legislative history of Section 469 states that the regulations are to provide rules concerning self-charged items. There are several ways in which such self-charged items could arise.

i. Self-Charged Interest. A self-charged situation arises, for example, if an individual receives interest income on debt of a pass-through entity in which he owns an interest. In substance the taxpayer has paid interest to himself, so that the treatment of the interest as portfolio income would not make economic sense. Conference Report at II-146.

a. Offset Indicated. The Conference Report indicates that it is not appropriate to treat such a transaction as giving rise both to portfolio interest income and passive interest expense. Rather, the taxpayer should be allowed an offset for the "self-charged" item. This matter is to be addressed in the regulations.

b. Related Party Interest Payments. Self-charged interest would arise not only in partner-partnership transactions, but in any related-party situation, e.g., if one partnership pays interest to a related partnership. The interest deduction would be limited by the PAL rule, but the interest income would, but for the self-charged interest rule, be treated as portfolio income.

c. Practical Issues. This provision could give rise to practical problems for partnerships. For example, assume that an individual who has a 40% interest in a partnership, which interest is a passive activity to such partner, makes a loan to the partnership on which the partnership pays $100 interest per year. Under the self-charged interest rule, the partner's share of the interest expense ($40) can be offset against $40 of the interest income he receives. The remaining 60% of the partner's income on the loan from the partnership would be treated as portfolio income.

d. Cash Contributions v. Notes. This rule could have a significant impact if some partners make a cash contribution to a partnership and others contribute their notes. The partners who made a cash contribution could have portfolio income (as a result of the interest paid on the other partners' notes), whereas the partners who contributed their notes would have interest expense to offset their income (although a portion of the interest expense might be disallowed under the investment interest rules). Thus, partnerships might require all partners to make their contributions in the same manner.

e. Pro Rata Partner Loans. What if two 50% partners each loan $100 to the partnership? At first blush, it would appear that interest income would be offset by interest expenses under the self-charged interest rule. Treasury, however, has indicated that it is considering a position that only 50% of the interest expense allocated to each partner relates to that partner's loan; the balance would relate to the other partner's loan and not constitute self-charged interest. Could this problem be resolved by a special allocation of interest expense?
i. Special Allocations. The Blue Book indicates that a special allocation would not be effective to solve this problem. Blue Book at 233-234. The policy underlying this position is questionable, however, if the allocation otherwise has substantial economic effect under Section 704(b).

f. Regulations. Regulations are to be issued to address this problem, as well as other situations in which netting would be appropriate for related entities. These regulations will be found in Treas. Reg. Section 1.469-7T. The Service takes the position that self-charged rules do not exist unless and until such regulations are issued.

2. Self-Charged Fees. Other situations to which self-charged rules might apply include, for example, a development fee paid to one partner, treated as "active" income by that partner, which fee is capitalized into the basis of a rental activity in which the partner has an interest. If the self-charged interest rule is also applied to fees, presumably the affected partner could treat his portion of the depreciation allocable to such development fee as an "active" loss, assuming that the partner could determine his share of such depreciation.

a. Consolidated Returns. This rule will also apply in the consolidated return context, permitting one affiliated entity to offset its deductions against the related income of another member of the group.

3. Self-Charged Rent. If a taxpayer rents property at a profit to an activity in which he materially participates, the net profit is recharacterized as active income under Treas. Reg. Section 1.469-2T(f)(6). If the rental results in a loss, however, the loss is passive (whereas income from the activity is not). It might be appropriate to apply the self-charged rules in such situations as well. See Blue Book at page 237.

4. Consolidated Returns. The self-charged rule will also apply in the consolidated return context, permitting one affiliated entity to offset its deductions against the related income of another member of the group.

XV. CORPORATIONS.

A. In General. As discussed above concerning taxpayers subject to Section 469, only certain C corporations are closely held corporations or personal service corporations subject to Section 469. See Treas. Reg. Section 1.469-IT(g)(2). If a C corporation is subject to Section 469, it will be subject to special rules relating to material participation and the application of the passive loss limitation.

B. Closely Held Corporations. Generally, a closely held corporation is a C corporation more than 50% of the stock of which is owned, directly or indirectly, at any time during the last half of the taxable year by not more than 5 individuals. Section 469(h)(4).

1. Material Participation by Closely Held Corporations. There are two ways for a closely held corporation to satisfy the material participation test.

a. Shareholder Participation. A closely held corporation materially participates in an activity if one or more individuals who own, directly or indirectly, more than 50% of the stock of the corporation participate in such activity. Section 469(h)(4)(A); Treas. Reg. Section 1.469-1T(g)(3)(i)(A).

b. Section 465(c)(7). A closely held corporation materially participates in an activity if the requirements of Section 465(c)(7)(C) (determined without subsection (iv)) are met with respect to the activity. Section 469(h)(4)(B); Treas. Reg. Section 1.469-1T(g)(3)(i)(B). These requirements are generally satisfied if, for the prior 12-month period: (i) at least one full-time employee of the corporation provides sufficient services in active management of the activity; (ii) three full-time non-owner employees provide sufficient services in the activity; and (iii) business deductions by the taxpayer attributable to the activity exceed 15% of gross income from the activity during the taxable year. See Section 465(c)(7)(C).
i. **Limited Partners.** If the corporation is a limited partner, Section 465(c)(7)(D) must also be satisfied. For a discussion of the impact of this rule, see Lipton, “Material Participation by Corporations,” *Corporate Taxation* (March 1989).

c. **Participation.** For purposes of determining whether an individual shareholder materially participates in an activity of a corporation, all activities of the corporation are treated as activities in which the individual holds an interest. Treas. Reg. Section 1.469-1T(g)(3)(iii). In addition, the individual’s participation in all activities other than activities of the corporation is disregarded. Thus, for example, assume that individual A is a limited partner in partnership X, which owns and operates a restaurant, and that A is also an employee of the corporate general partner, Z. If A works for over 500 hours per year as an employee of Z in managing X’s restaurant, A will be treated as materially participating in X (with respect to A’s limited partnership interest), and so will Z with respect to its interest as a general partner. Thus, A’s participation will be counted twice. Treas. Reg. Section 1.469-5T(k), Examples (1) and (2).

d. **Impact.** The material participation rules for closely held corporations are somewhat more liberal than the rules applicable to individuals. The material participation test, however, may still be difficult to satisfy if the corporation is involved in multiple activities, if the corporation is a limited partner, or if the corporation has significant shareholders who are not regularly involved in operations of the business. If, however, the shareholders are related, the 50% of direct or indirect ownership may be quite easy to meet.

2. **Application of Section 469 Limitation.** A closely held corporation is entitled under Section 469(e)(2) to utilize its PALs to offset its net active income. Net active income is generally defined as the corporation’s taxable income, determined without regard to (A) passive activity gross income, (B) passive activity deductions, (C) portfolio income, (D) income from trading personal property if the corporation did not materially participate in such activity, and (E) deductions and interest expense allocable to portfolio income. Treas. Reg. Section 1.469-1T(g)(4)(ii). The effect of this provision is that PALs of a closely held corporation can offset all of its income other than portfolio income.

a. **Example.** A closely held corporation has passive activity gross income of $1,000, passive activity deductions of $1,500, net income from an active trade or business of $300 and $150 of portfolio income. The corporation can use its passive loss of $500 to offset its active income ($300), resulting in taxable income of $150. In contrast, if the taxpayer were an individual, the passive loss could not offset net active income, so that the individual’s taxable income would be $450.

3. **Publicly Traded Partnerships.** If a closely held corporation owns an interest in a PTP, the income from the PTP cannot be offset by losses from other PTPs or other passive activities. It is unclear, however, whether losses from a PTP can offset net active income. See Lofman, Presant & Lipton, “The Impact of Notice 88-75 Concerning Publicly Traded Partnerships,” *Tax Notes* (Aug. 15, 1988) at 747, 755.

C. **Personal Service Corporations.** Generally, a personal service corporation is a C corporation the principal activity of which is the performance of personal services by employee owners, provided that such employee owners own at least 10%, by value, of the corporation’s stock. The principal activity of a personal service corporation must be involved in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. Treas. Reg. Section 1.469-1T(g)(2)(i).

1. **Material Participation by Personal Service Corporations.** A personal service corporation is treated as materially participating in an activity only if one or more shareholders owning more than 50% by value of the outstanding stock of the corporation materially participate in such activity. Section 469(h)(2)(A); Treas. Reg. Section 1.469-1T(g)(3)(i)(A). See Lipton, “Material Participation by Corporations,” *Corporate Taxation* (March 1989). Thus, a personal service corporation cannot avail itself of the relief afforded to closely held corporations, which may materially participate in an activity if the requirements of Section 465(c)(7) are satisfied.

2. **Application of Section 469 Limitations.** The limitation on PALs in Section 469 (a) is applied to personal service corporations in the same manner as applies to individuals; personal service corporations are not entitled to utilize PALs to offset the net active income of the corporation. Section 469(e)(2).
a. Example. In the above example in which a taxpayer had passive activity gross income of $1,000, passive activity deductions of $1,500, net income from an active trade or business of $300 and portfolio income of $150, if the taxpayer were a personal service corporation, its taxable income would be $450. In contrast, a closely held corporation has taxable income of $150 in this situation.

D. Consolidated Returns. The determination of whether an affiliated group of corporations filing a consolidated return (the consolidated group) is subject to Section 469 is made on a consolidated basis; the members of the consolidated group are treated as one corporation, and only stock of the common parent is considered. Treas. Reg. Section 1.469-1T(h)(4)(i). Thus, for example, if a closely held consolidated group contains both a personal service corporation and a corporation engaged in manufacturing, all of the corporations in the group will be either a personal service corporation or a closely held corporation; the activities of each separate member of the group are relevant only in determining the status of the overall consolidated group.

1. Material Participation. The material participation test is applied to a consolidated group by treating the members of the consolidated group as one corporation, and by referring only to the stock of the common parent. Treas. Reg. Section 1.469-1T(h)(4)(ii).

a. Example. If the holders of more than 50% of the stock of the common parent participate in an activity of the group, the material participation test will be satisfied for that activity. On the other hand, if 40% of the shareholders of the common parent and the 19% shareholder of a subsidiary materially participate in the activity of that subsidiary, the material participation test would not be met.

2. Activity. For purposes of the definition of activity, the activities of a consolidated group and each member are determined as if the consolidated group was a single taxpayer. Treas. Reg. Section 1.469-4T(m).

3. Intercompany Transactions. The regulations contain complex rules relating to the treatment of items of income and deduction attributable to transactions between members of the consolidated group. Treas. Reg. Section 1.469-1T(h)(6).

4. Sale of Stock of Member. Any gain recognized by a member upon the disposition of stock of a subsidiary is treated as portfolio income. Treas. Reg. Section 1.469-1T(h)(7). This result occurs even if the subsidiary corporation has an excess loss account generated by passive losses.

XVI. SPECIAL RULES FOR OIL AND GAS.

A. Overview. There are three sets of special rules that apply only to oil and gas operations. First, Section 469(c)(3) provides that a qualified working interest in an oil and gas property cannot be part of a passive activity. Many of the special rules relating to oil and gas operations arise from this "qualified working interest exception." Second, special rules govern the activity definition for oil and gas businesses. Third, certain types of oil and gas income (royalties, delay rentals, etc.) are recharacterized as portfolio or active. For a more detailed discussion of the oil and gas impact of the passive loss rules, see Wallace, Aldridge & Eval, "Oil and Gas PALS After the Activity Regulations," 38 Oil & Gas Tax Qtrly. 461 (March 1990).

B. Rules Relating to Qualified Working Interests.

1. Qualified Working Interest Income and Loss.

a. Statutory Rule. Section 469(c)(3) generally provides that the term "passive activity" does not include (i) any working interest, (ii) in any oil and gas property, (iii) which the taxpayer holds directly or indirectly through an entity which does not limit the liability of the taxpayer. Such a full liability working interest in an oil and gas property is generally referred to herein as a "qualified working interest."
i. **Example.** Assume taxpayer T owns a 1/8 working interest in an oil and gas property through an entity that does not limit T's liability (e.g., a general partnership). Under Section 469(c)(3)(A), any losses or deductions incurred by T with respect to that working interest will not be subject to the passive loss limitation and thus may be freely offset against income, except as provided by other provisions of the Code (e.g., the investment interest limitation of Section 163(d)).

b. **Regulatory Implementation.** The Regulations implement the statutory exception of Section 469(c)(3)(A) by providing that "an interest in an oil or gas well drilled or operated pursuant to a working interest... is not an interest in a passive activity" if the working interest is a qualified working interest. Treas. Reg. Section 1.469-1T(c)(4)(i) [emphasis added].

i. **Well-by-Well Approach.** Unlike the statute, the Regulations limit application of the qualified working interest to an interest in a "well." This raises doubts as to the character of deductions and interest incurred with respect to a qualified working interest prior to the drilling of a well (e.g., delay rentals).

ii. **Working Interest.** For purposes of Section 469, a working interest is defined as a working or operating mineral interest in any tract or parcel of land (as determined under Treas. Reg. Section 1.612-4(a)). Treas. Reg. Section 1.469-1T(e)(4)(iv) (as amended by the May 1989 Regulations).

iii. **Entities That Do Not Limit Liability.** If an entity limits the liability of the taxpayer with respect to the drilling or operation of a well, an interest in the entity is not a qualified working interest. Section 469(c)(3); Treas. Reg. Section 1.469-1T(e)(4)(i).

(A) **Entities Which Limit Liability.** Entities which limit liability include:

1. A limited partnership in which the taxpayer is not a general partner;
2. A corporation;
3. Any entity which limits the liability of the taxpayer for the entity’s obligations under state law to a determinable fixed amount. Treas. Reg. Section 1.469-1T(e)(4)(v)(A).

(B) **Disregarded Limitations.** The following protections from loss are not to be regarded as a limitation on liability for purposes of applying the qualified working interest exception:

1. Indemnification agreement;
2. Stop loss arrangement;
3. Insurance; and
4. Any similar arrangement or combination thereof.

Treas. Reg. Section 1.469-1T(e)(4)(v)(A). Note, however, that such arrangements may cause the taxpayer to fail to be at risk under Section 465, often negating the benefits of non-passive treatment.

(C) **Trusts and Estates.** It is not clear whether estates or trusts are considered entities which limit liability. The authors believe that as to their beneficiaries, trusts and estates should be treated as entities which limit liability. As to the tax positions of the trusts and estates themselves, however, liability should be treated as unlimited for purposes of the qualified working interest exception.
c. Exception for Deductions Attributable to a Limited Liability Period. If (A) a taxpayer has deductions with respect to a well which are non-passive because of the qualified working interest exception did not apply; and (B) economic performance with respect to such deductions does not occur until a year in which the taxpayer's working interest is held through an entity which limits liability, two things occur. First, the deductions ("disqualified deductions") are recharacterized as passive deductions. Second, a ratable portion of gross income from the oil or gas well is treated as passive income. Treas. Reg. Section 1.469-1T(e)(4)(ii). The ratable portion of gross income from the qualified working interest well equals gross income times disqualified deductions divided by total deductions attributable to the taxable year. Treas. Reg. Section 1.469-1T(e)(4)(ii)(C)(4). The effect of these two adjustments is to prevent taxpayers from exploring timing differences between tax deductibility and state law liability. Without such a rule, taxpayers could make deductions non-passive under the qualified working interest exception while avoiding actual liability with respect to those expenses by transfer to a limited liability entity.

i. Example. In 1987, taxpayer A buys an interest in a general partnership owning a working interest. In December of 1987, the partnership contracts with an independent drilling contractor to drill a well. The partnership pays the contractor $15,000 in 1987 and deducts the entire amount in 1987, although for some $5,000 of expenses "economic performance" does not occur until 1988. On January 1, 1988, taxpayer A converts his general partnership interest to a limited partnership interest, or otherwise acts to limit his liability. For 1988, assume that A's income from the well will be passive. A has $5,000 in disqualified deductions for 1987 which will be recharacterized as passive. In addition, if A had any gross income from the well in 1987, one-third of that income ($5,000 disallowed deductions/$15,000 total deductions) would be recharacterized as passive gross income.

d. Character of Income and Loss as Active or Portfolio. The qualified working interest exception of Section 469(c)(3) and Treas. Reg. Section 1.469-1T(e)(4)(i) provides that income or loss from a qualified working interest is not passive, but does not determine whether such income or loss is active or portfolio. If the qualified working interest income or loss arises in an activity in which the taxpayer materially participates, the income or loss will be active. If not, the character of income or loss is complex.

i. Gain on Sale of Non-Active QWI Portfolio. Gain on sale of a qualified working interest is probably portfolio for Section 469 purposes and is clearly investment income for Section 163(d) purposes. Section 163(d)(5)(A)(ii) expressly identifies non-active qualified working interests as property held for investment. Gain on sale is thus net investment income for Section 163(d). Section 163(d)(4)(B)(ii). Moreover, gain on sale is portfolio for Section 469 purposes unless derived in the ordinary course of a trade or business. Treas. Reg. Section 1.469-2T(c)(3)(i)(D). For some oil and gas producers, it may be possible to argue that isolated sales or exchanges of working interests are a routine part of their trade or business, thus permitting non-portfolio treatment. See Treas. Reg. Sections 1.469-2T(c)(3)(ii)(D), (iii)(A).

ii. Income from Non-Active QWI Probably "Active". While gain from sale of property held for investment (such as non-active qualified working interests) is portfolio, regulations do not indicate that income from such property is, except for income of specified types. See Treas. Reg. Section 1.469-2T(c)(3)(i). Moreover, operating income from oil wells is apparently non-portfolio because it is derived in the ordinary course of a trade or business of trading in crude oil or gas. Treas. Reg. Sections 1.469-2T(c)(3)(ii)(D), (iii)(A). This suggests that operating income from qualified working interests is non-passive and non-portfolio, making it active by default. For section 163(d) purposes, however, such income is net investment income. Section 163(d)(4)(B)(i).

iii. Effect on Closely-Held C Corporations. For individual taxpayers, treatment of operating income from non-active qualified working interests as "non-portfolio" is irrelevant; such income is investment income for Section 163(d) purposes, and does not affect the passive loss limitation of Section 469, whatever it is labeled. For closely-held C corporations, Section 163(d) does not apply, but non-portfolio treatment is beneficial because non-portfolio income becomes part of net active income which can be offset by passive losses. See Treas. Reg. Section 1.469-1T(g)(4)(ii).
iv. Impact of Definition of Activity. The character of qualified working interest income as active or portfolio ultimately depends on the definition of an activity. In general, if under the general definition of an activity the well producing qualified working interest income would be part of an activity in which the taxpayer materially participates, the well will be left in that activity. Because it is part of an active activity, income and deductions from the well will be active income or deductions. See Treas. Reg. Section 1.469-4T(e)(1)(ii). If, however, the well would not be part of such a material participation activity, the well will be separated out to form a special oil and gas working interest undertaking. As part of a separate activity in which the taxpayer does not materially participate, income and deductions from the well will be portfolio rather than active. Treas. Reg. Section 1.469-4T(e)(1). Thus, the scope of the activity (and hence the character of the qualified working interest income or loss) may depend on the taxpayer’s participation in non-working interest operations.


a. Statutory Rule. Section 469(c)(3)(B) provides that if a taxpayer has any loss from an oil or gas property which is non-passive because of the qualified working interest exception of Section 469(c)(3)(A), any net income from that property in later taxable years will be non-passive. In addition, net income from any property whose basis is determined in whole or in part by reference to the loss property will be non-passive. In effect, once a taxpayer takes advantage of the qualified working interest exception to treat losses as active, income from the property is perpetually “tainted” as non-passive.

i. Example. Assume that individual A owns a qualified working interest in an oil and gas property in 1987, but transfers it to an S corporation in 1988. In 1987, the working interest produced a portfolio loss under the qualified working interest exception. In 1988, any net income from the working interest will be recharacterized as non-passive income (and can be offset by investment interest deductions). Losses that might occur following transfer into the S corporation would still be passive, however, so long as A does not materially participate in the activity.

b. Regulatory Implementation. Treas. Reg. Section 1.469-2T(c)(6) provides that if a taxpayer’s loss from a particular oil or gas well was non-passive solely by reason of the qualified working interest exception, net passive income from the entire property containing the well will be recharacterized as nonpassive. Moreover, for these purposes the “property” from which income is recharacterized includes (I) any property containing the well, and (II) any other item of property the value of which was “directly enhanced” by drilling, logging, seismic testing or other activities whose cost was included in determining income or loss from that well. Treas. Reg. Section 1.469-2T(c)(6)(i), (iii).

i. Well vs. Property. Note that under the Regulations, the loss from a particular “well” is treated as non-passive under the qualified working interest rules, whereas net income from the entire “property” (including “directly enhanced property”) is recharacterized as non-passive. This distinction is a transparent attempt to secure a result of “heads the Treasury wins, tails the taxpayer loses.” There is certainly no justification for this distinction in the statute, which refers to income and loss from an oil and gas “property” in each case. Treasury’s well/property distinction has been deservedly criticized. See, e.g., American Bar Association Section of Taxation Comments on Passive Activity Loss Regulations, reprinted in Tax Notes Highlights & Documents, November 14, 1988, page 1263.

ii. “Directly Enhanced” Property. Another significant departure of the Regulations from the statutory text is the inclusion as tainted property of property whose value is “directly enhanced” by the qualified working interest well. “Direct enhancement” is a new concept for oil and gas taxation, but is explained in the Regulations only by three examples.

(A) Basic Example. Suppose a taxpayer owns an interest in tract 1 that is a qualified working interest, and also holds an interest in tract 2 that is not a qualified working interest (e.g., because the taxpayer’s liability is limited). In drilling a well on tract 1, it is discovered that the reservoir underlying tract 1 also underlies tract 2. If the taxpayer has a non-passive loss from the well on tract 1 in 1989, income from the combined property of tract 1/tract 2 will be forever tainted. Thus, any net passive income from tract 1 and tract 2 combined will be recharacterized as non-passive. Cf. Treas. Reg. Section 1.469-2T(c)(6)(iv), ex. 1.
(B) Deep Formation Example. Assume the facts are as in the example above, except that in drilling a well on tract 1 into a deep formation, it is discovered that a shallower formation underlies both tract 1 and tract 2. A well is subsequently drilled on tract 2 to develop the shallow formation. Even though the shallow formation and the deep formation might be considered separate properties for purposes of Section 614(a), for purposes of the qualified working interest exception both tracts are treated as one property. Thus net passive income from tracts 1 and 2 combined, including the income from the well into the shallow formation, will be recharacterized as non-passive. Cf. Treas. Reg. Section 1.469-2T(c)(6)(iv), ex. 2.

(C) Not Directly Enhanced Example. Suppose a taxpayer owns a qualified working interest in tract 1 and a non-qualifying interest in tract 2. Tract 1 and tract 2 are located in the same county. As a result of drilling on tract 1, information is discovered indicating a significant possibility that substantial oil and gas reserves underlie the entire county. At the same time, the information obtained does not indicate the reservoir underlying tract 1 also underlies tract 2. The value of tract 2 is not directly enhanced by the well on tract 1 and thus tract 1 and tract 2 are not part of the same property for purposes of the qualified working interest taint. Cf. Treas. Reg. Section 1.469-2T(c)(6)(iv), ex. 3.

(D) Comment on “Directly Enhanced.” The “directly enhanced” formulation in the definition of property is ill-advised. Direct enhancement is not an established concept in oil and gas taxation, and its use requires many fine distinctions. For example, information developed in drilling on tract 1 may suggest that oil (1) possibly, (2) probably, (3) very probably, or (4) certainly underlies tract 2. It may also suggest that the same reservoir (1) possibly underlies both tracts, (2) probably underlies both tracts, or (3) probably does not underlie both properties, but might possibly. Where is the line for direct enhancement to be drawn? Moreover, given the necessary imprecision of petroleum geology, how are disagreements of experts to be resolved? At best, the “directly enhanced” rule is an “invitation to litigation.” American Bar Association Section of Taxation, Comments on Passive Activity Loss Regulations, reprinted in Tax Notes Highlights & Documents, November 14, 1988, page 1263.

iii. Solely by Reason of Qualified Working Interest Rule. Note that under the Regulations, the qualified working interest “taint” on net income is not imposed unless the taxpayer’s loss from the qualified working interest well was non-passive solely because of the qualified working interest exception. See Treas. Reg. Section 1.469-2T(c)(6)(i)(A). If the loss is non-passive for another reason, e.g., because the taxpayer materially participates, the “taint” does not attach to the property.

iv. Impact on Closely-Held C Corporations. Unlike other taxpayers subject to Section 469, closely-held C corporations may utilize passive losses to offset “net active income,” a term which encompasses most active (but not portfolio) income. See Treas. Reg. Section 1.469-1T(g)(4)(i). Unfortunately, however, “tainted” income from a former qualified working interest does not qualify as “net active income” and thus cannot be offset by passive losses. Treas. Reg. Section 1.469-1T(g)(4)(ii)(D). While this result is not unreasonable if the tainted income is recharacterized as portfolio, it seems unfair when the tainted income is active because of material participation. Compare Treas. Reg. Section 1.469-1T(g)(4)(ii)(C) (portfolio income not net active income) with (g)(4)(ii)(E) (trade or business income is net active income if the taxpayer materially participates).

3. Planning Opportunities.

a. Convert Non-Qualified Interest to Qualified Working Interest. Suppose taxpayer A is a limited partner in drilling partnership P. A has $5000 of suspended passive losses from P’s drilling activities. In 1990, P drills a successful well which will generate $500 of passive income for A each year. If the situation is unchanged, A will need 10 years to use up his suspended losses. A converts his limited partnership interest to a general partnership interest, making the well a qualified working interest well. Suspended passive losses will be allocated among P’s 1990 activities, and the $5000 should be allocated to the activity including the successful well. Because of the qualified working interest exception, however, that activity will be non-passive. Hence, the $5000 suspended passive loss becomes a current $5000 active or portfolio loss in 1990. Cf. Treas. Reg. Section 1.469-1T(f)(4)(iii), ex. 4. Note, however, that Treasury has warned that the reserved Section 1.469-1T(k) Regulations could retroactively alter this result. Id., ex. 4(iv).
C. Determination of Activities.

1. Overview: Three Types of Oil and Gas Activities. A full-time oil and gas business may include constituent parts which are treated differently under the passive loss rules, resulting in an inability to offset oil and gas income against oil and gas expenses. For example, an oil and gas business could consist of at least three types of activities:

   a. qualified working interest activities generating portfolio income and loss,
   b. other trade or business activities generating active or passive income and loss, and
   c. rental activities consisting of delay rental properties, generating portfolio income and passive loss.

Thus, the scope and classification of an oil and gas investor's activities may be important.

2. Location: The Common Reservoir Rule. Generally, an undertaking consists of all income-producing operations of a single entity at a single “location.” For oil and gas operations, a special rule (the “common reservoir rule”) applies: all operations conducted for the development of a common reservoir are treated as occurring at the same location. Treas. Reg. Section 1.469-4T(c)(2)(iii)(E). This rule apparently applies in addition to (and not instead of) the general rule that operations conducted within “close proximity” are at the same location. Treas. Reg. Section 1.469-4T(c)(2)(iii)(B).

   a. Example. Suppose that with respect to a single reservoir, but on non-contiguous tracts, limited partnership P has the following sources of income for the year: (i) $5,000 of gross income from a working interest; and (ii) $1,000 of delay rentals. All of these operations will be treated as part of a single undertaking. The significance of single undertaking treatment is that the properties producing delay rentals would, if treated as a separate undertaking, constitute a rental undertaking. Income from such a rental activity would be recharacterized as portfolio income under the nondepreciable property recharacterization rule of Treas. Reg. Section 1.469-2T(d)(3). Operations at the same location, however, will be a single undertaking, and because delay rentals generate less than 20% of total gross income, the delay rental operations will not be separated out to form a separate rental undertaking. See Treas. Reg. Section 1.469-4T(d)(2)(ii). Treating all the operations as part of a single undertaking, then, may change delay rental income from active to passive.

   b. Definition of “Common Reservoir.” The phrase “common reservoir” is not defined by the Regulations. Obvious uncertainties could arise where multiple strata of uncertain communicability are involved, and where the existence of one or two reservoirs is uncertain.

   c. Definition of Close Proximity Generally. Other uncertainties are raised by the general rule that operations conducted in close proximity occur at the same location. For example, is proximity determined by surface proximity or subsurface proximity and communicability? Well 1 and Well 2 may be within 500 yards of each other and yet drain completely distinct, non-communicating reservoirs: are they in close proximity (based on surface location) or not (based on subsurface)? Such problems may be especially acute for non-hydrocarbon mining, to which the common reservoir rule does not apply.

   d. Interaction of Common Reservoir Rule with Close Proximity Rule. Another uncertainty is the interaction of the common reservoir rule with general principles of close proximity. For example, suppose a partnership has three wells: Wells 1 and 2 are adjacent on the surface, Wells 2 and 3 drain a single common reservoir, but Wells 1 and 3 are not physically adjacent and do not drain a single reservoir. It could be argued that Wells 1, 2 and 3 are at a single location because Wells 1 and 2 are at the same location while Wells 2 and 3 are at the same location.

   e. Planning Opportunities. Unless and until the uncertainties outlined above are resolved by Treasury, taxpayers should be able to use any reasonable interpretation of the Regulations. This permits some planning opportunities for geographically proximate oil and gas operations. Planning is particularly important where properties
producing delay rentals are involved, since putting delay rental operations into a larger undertaking may convert active income into passive income or passive loss into active loss.

3. Qualified Working Interest Undertakings. Treas. Reg. Section 1.469-4T(e)(1) (the "qualified working interest undertaking rule") provides that an oil or gas well will be treated as a separate undertaking if (i.) the well is drilled or operated pursuant to a qualified working interest, and (ii.) assuming activities were determined without regard to this rule, the taxpayer would not materially participate in an activity including such a well. Moreover, Treas. Reg. Section 1.469-4T(f)(1) provides that any well treated as a separated undertaking under the special rule cannot be aggregated with other trade or business undertakings. At first glance, the qualified working interest undertaking rule appears to be a straightforward attempt to preserve the integrity of the qualified working interest exception of Section 469(c)(3)(A). On closer examination, however, the hypothetical test for material participation in the qualified working interest undertaking rule creates a complex mechanism for recharacterizing the income and deductions from oil and gas wells.

a. Significance: Classification of Undertakings. While the qualified working interest undertaking rule will sometimes separate a well from other wells at the same location, it may be more important that it classifies undertakings as different from other trade or business undertakings. Thus, oil and gas extraction businesses may include two dissimilar types of undertakings: oil and gas working interest undertakings created by the qualified working interest undertaking rule, and other trade or business undertakings in all other cases. Being of different types, such undertakings cannot be aggregated together into a single activity.

b. Recharacterization Effects. The complex mechanism of the qualified working interest undertaking rule has results that are not unreasonable. In broad outline, income and loss from a qualified working interest should be active if the taxpayer participates heavily in the oil and gas extraction field, and portfolio if he does not so participate. In addition, sufficient participation on a working interest may convert the taxpayer's other oil and gas extraction activities from passive to active. Neither result is unreasonable. To achieve these results, however, the Regulations follow a tortuous and unintuitive path.

i. Examples. In all of the following examples, Smith owns a limited liability interest in an Alaska oil well (the "Alaska non-QWI well"). Smith also owns a qualified working interest in a Texas oil well (the "Texas QWI well"). Smith owns no interest in any other oil and gas undertakings. Each of the wells is controlled by the same interests. But for the presence of a qualified working interest, the two wells would be separate undertakings aggregated into one activity under Treas. Reg. Section 1.469-4T(f). The examples are summarized in Figure 1, below.

<table>
<thead>
<tr>
<th>Example</th>
<th>Alaska Non-QWI</th>
<th>Texas Well QWI</th>
<th>Character of Income or Loss from Well</th>
<th>Effect of Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>0 hrs.</td>
<td>0 hrs.</td>
<td>Alaska passive; Texas portfolio</td>
<td>N/A</td>
</tr>
<tr>
<td>B</td>
<td>600 hrs.</td>
<td>0 hrs.</td>
<td>Both active</td>
<td>Changed Texas (QWI) from portfolio to active</td>
</tr>
<tr>
<td>C</td>
<td>0 hrs.</td>
<td>600 hrs.</td>
<td>Both active</td>
<td>Changed Alaska (non-QWI) from passive to active</td>
</tr>
</tbody>
</table>
D 300 hrs. 300 hrs. Both active Changed Alaska (non-QWI) from passive to active; Changed Texas (QWI) from portfolio to active

E 60 hrs. 60 hrs. Both active if >380 hours in other significant participation Changed Alaska (non-QWI) from passive to active; Changed Texas (QWI) activities from portfolio to active

(A) Suppose Smith has no participation in either the Alaska (non-QWI) well or the Texas (QWI) well. Since Smith would not materially participate in the combined undertakings, the Texas (QWI) well undertaking and the Alaska (non-QWI) undertaking will be two separate activities. Income from the Texas (QWI) well will thus be portfolio income and deductions will be portfolio deductions. See Sections 163(d) and 469(c)(3). On the other hand, income and deductions from the Alaska (non-QWI) well will be passive. See Figure 1.

(B) Suppose Smith spends 600 hours on the Alaska (non-QWI) well and zero hours on the Texas (QWI) well. Absent the qualified working interest undertaking rule of Treas. Reg. Section 1.469-4T(e), the Alaska well undertaking and the Texas well undertaking would be aggregated to form a single activity. Both are commonly controlled; both have predominant operations in the “oil and gas extraction” line of business; and Smith would materially participate in the combined undertakings. See Treas. Reg. Section 1.469-4T(f)(2)(iii). Assuming activities were defined without regard to the qualified working interest undertaking rule, Smith would materially participate in an activity including the Texas (QWI) well. Therefore, the working interest undertaking rule does not apply. See Treas. Reg. Section 1.469-4T(e)(1)(ii). The Alaska (non-QWI) well and the Texas (QWI) well are thus part of a single active activity, making income and deductions from both active. By comparison to Example 1, it is clear that Smith’s participation in Alaska has converted the Texas (QWI) well from portfolio to active.

(C) Suppose Smith spends zero hours on the Alaska (non-QWI) well but spends 600 hours on the Texas (QWI) well. The analysis is the same as in Example 2: The Alaska well undertaking and the Texas well undertaking are aggregated into a single active activity. By comparison to Example 1, it is clear that Smith’s participation in Texas has converted the Alaska (non-QWI) well from passive to active.

(D) Suppose Smith spends 300 hours on the Alaska (non-QWI) well and 300 hours on the Texas (non-QWI) well. Again, the Alaska well undertaking and the Texas well undertaking will be aggregated into a single active activity because Smith would materially participate in the combined undertakings. By comparison to Example 1, it is clear that the combination of Smith’s participation in Alaska and in Texas has converted the Alaska (non-QWI) well from passive to active and the Texas (QWI) well from portfolio to active.

(E) Suppose Smith spends 60 hours on the Alaska (non-QWI) well and 60 hours on the Texas (QWI) well. In addition, Smith devotes 400 hours to his family’s candy store business but does not materially participate therein. Absent the qualified working interest undertaking rule, the Alaska well undertaking and the Texas well undertaking would be combined because Smith would significantly participate in the combined undertakings. Treas. Reg. Section 1.469-4T(f)(2)(iii). Smith would then have more than 500 hours of participation in significant participation activities, 120 hours from the wells and 400 hours from the candy store, so Smith would materially participate in the wells undertaking. Treas. Reg. Section 1.469-5T(a)(4). Therefore, the qualified working interest undertaking rule does not apply. Treas. Reg. Section 1.469-4T(e)(1)(ii). The two wells are thus part of the same active activity, making income and deductions from both active. Note that Smith’s participation in the candy store has converted the Alaska well from passive to active and the Texas well from portfolio to active. Without the candy store participation, the qualified working interest undertaking rule would have applied, resulting in two activities for the two wells.
c. One or Two Undertakings? The above results are not obvious on the face of Treas. Reg. Section 1.469-4T(e), but are rather reasonable results after one works through the rules. Still, the Regulations in their current form lead to conceptual confusion and reporting difficulties.

i. Example. Assume the Smith-Jones partnership owns both a qualified working interest well and a well which does not qualify for the working interest exception, both at the same location. Smith spends 600 hours on the combined operations, while Jones has zero participation. As to Smith, the partnership was an interest in only one undertaking; the qualified working interest well is separated from the other well because of Smith's material participation. See Treas. Reg. Section 1.469-4T(e)(1)(ii). As to Jones, however, the partnership was an interest in two undertakings; the qualified working interest well is not separated from the other well because Jones does not materially participate. Therefore, the partnership has one undertaking and has two undertakings, at the same time. There is no other situation in which the Regulations produce this bizarre duality.

ii. Reporting Difficulties. Consider again the Smith-Jones partnership: on its K-1's, should it show one undertaking or two? Must it construct a different form of K-1 for Smith than for Jones? Worse still, consider that even if neither Smith nor Jones has any participation in the partnership, Smith's participation in another commonly controlled oil and gas undertaking (or even in his family candy store) could mean that separation was improper as to him. Thus, the Smith-Jones partnership may lack the information needed to know whether there is one undertaking or two, even as to Smith.

d. Proposed Simplification. A simpler approach might be as follows:

i. Always separate a well subject to a working interest into a separate undertaking from other wells at the same location;

ii. Aggregate a working interest undertaking with other undertakings in the oil and gas extraction business only if the taxpayer would materially participate in the combined undertakings.

This approach would simplify Treas. Reg. Section 1.469-4T(e)(1) by removing the hypothetical test for material participation therefrom and would simplify the entire scheme of Section 1.469-4T by treating oil and gas working interest undertakings the same as other trade or business undertakings.

4. Aggregation of Undertakings. Except as provided in the vertical integration rules, two or more other trade or business undertakings will be aggregated together into a single activity only if (a) the undertakings are commonly controlled; (b) 50% of the income of each undertaking is derived from the same line of business, and (c) the taxpayer has substantial ownership or participation in the combined activities. Oil and gas businesses pose special problems for each of the three elements required for aggregation.

a. Common Control: Role of Operators. A key unanswered question in the definition of control is what type of control is being tested for: control over day-to-day operations? control over significant transactions? control over overall strategic hire and fire? In the oil and gas business, the theoretical issue has a sharp focus: are all projects with a single operator commonly controlled, even though the project lacks significant common ownership? Conversely, are projects with similar ownership but different operators commonly controlled? The authors believe that almost any position on these issues is reasonable. Tax planners should not reject any of the possible answers.

b. Line of Business. Under Rev. Proc. 89-38, oil and gas businesses will generally fall into one of six lines of business. All production operations and oil field services will fall into class 05, "Oil and Gas Extraction." Pipelines and transmission will fall into class 36, "Electric, Gas and Sanitary Services" (for natural gas), or class 33 "Transportation - Pipelines" (for other fuels). Refining operations will generally fall into class 18, "Manufacturing - Petroleum and Coal Products." Retail and whole distribution will fall into class 51, "Fuel Dealers," or class 55, "Auto Dealers and Service Stations."
c. Significant Ownership or Control. Undertakings that are similar and commonly controlled will be aggregated if the taxpayer has significant ownership or participation. A taxpayer has significant ownership or participation in two undertakings if (1) he owns both undertakings directly; (ii) he owns both undertakings through the same pass-through entity; (iii) he indirectly owns through pass-through entities a 10% interest in each undertaking; or (iv) he would materially or significantly participate in the combined undertakings. Treas. Reg. Section 1.469-4T(f)(2). It is arguably unclear how these tests apply if the taxpayer owns “directly” a small, undivided interest in an oil and gas property.

i. Example: 1/16 Working Interest. Assume taxpayer T owns a 1/16 working interest in an oil or gas property, and enters into a joint operating agreement and division orders with owners of the other 15/16 interests. The interest owners choose to elect out of subchapter K under Section 761. T does not participate in any oil and gas activity. Arguably, T owns his interest “directly” under local law, since he could technically withdraw from his agreements and drill his own well on the property. Under this view, T’s interest could be aggregated with other commonly controlled oil and gas undertakings. At the same time, arguably the joint operating agreement creates a partnership for tax purposes so that T owns a less than 10% interest through a pass-through entity; the election out of subchapter K does not prevent the existence of a partnership but only prevents application of subchapter K. Under this view, T’s interest could not be aggregated because none of the four significant ownership or control tests can be met.

ii. Comment. The authors believe that T’s 1/16 working interest is properly treated as held indirectly through a pass-through entity. The real economic unit is the entire 16/16 interest as jointly operated, and the passive loss regulations deal with the real economic unit where possible. Still, there may be room for argument on this point, permitting aggressive tax planners to treat such interests as “directly held” and thus to aggregate undertakings.

5. Disaggregation Election for Disposition Purposes and Dry Holes. As noted above, taxpayers should generally make an election under Treas. Reg. Section 1.469-4T(o) to treat each undertaking as a separate activity for disposition purposes. In an oil and gas context, the election may be especially important to permit deduction of dry hole and abandonment costs.

D. Recharacterization of Oil and Gas Income.

1. Royalties Recharacterized as Portfolio. The February 1988 Regulations took a preliminary and tentative approach to the characterization of mineral royalties. No special rules for mineral royalties were included. Generally, however, Treas. Reg. Section 1.469-2T(c)(3)(i)(A) indicates that royalties are portfolio income unless an exception applies.

a. Significance. The importance of recharacterization of mineral royalties as portfolio income is that even a full-time oil and gas operator may be able to offset royalty income with passive losses. Suppose X is a full-time oil and gas developer with $1000 of royalty income and $2000 of drilling losses. Further suppose X’s drilling losses are passive because X does not materially participate in the drilling activity. X’s royalty income is portfolio, but his drilling losses are passive and thus cannot offset portfolio income. X will then pay tax on his $1000 royalty income even though he has a net loss in all his oil and gas operations.

b. Exception: Dealer in Royalty Interests. Treas. Reg. Section 1.469-2T(c)(3)(ii)(D) provides that income derived in the ordinary course of a dealer activity is trade or business income rather than portfolio income. An example in the Regulations applies this rule to conclude that mineral royalty income derived from an activity of trading or dealing in mineral royalty interests is not portfolio. Treas. Reg. Section 1.469-2T(c)(3)(iv), ex. 4.

c. No Other Exception Other than by Ruling. After explaining the exception from portfolio classification of royalties for dealers, the Preamble to the February 1988 Regulations states:
Under Section 1.469-2T(c)(3)(ii), the only other mineral royalties treated as income derived in the ordinary course of a trade or business are those identified by the Commissioner. Therefore, unless and until these regulations are amended, taxpayers may not treat mineral royalties (other than royalties derived from a trade or business of trading or dealing in royalty interests) as derived in the ordinary course of a trade or business without obtaining a ruling. Preamble to February 1988 Regulations, Section X(C).

d. Royalties Retained on Sale of Working Interest. Despite taking a hard-line position on exceptions to recharacterizing mineral royalties as portfolio, Treasury has recognized that recharacterization is improper in some cases and has requested public comments:

Nonetheless, the Service believes that it may be appropriate to treat a portion of a mineral royalty payment as derived in the ordinary course of a trade or business in some cases not involving a trade or business of trading or dealing in royalty interests. Assume, for example, that royalty income is derived from an overriding royalty interest created on the transfer of a working interest by a partnership engaged in the trade or business of oil and gas development, and that the partnership is not taxed upon receipt of the royalty interest. In such a case, it may be appropriate to treat the royalty payments by analogy to sections 483 and 1274, as deferred payments with respect to the sale of the working interest. Under this approach, the portion of each royalty payment that represents consideration paid to the partnership for the working interest would be treated as income derived in the ordinary course of a trade or business, and only the interest element in the payments would be treated as portfolio income. The Service invites public comment on whether and how such distinctions should be made, and how depletion deductions should be allocated between portfolio and nonportfolio components of royalty payments. Preamble to February 1988 Regulations, Section X(C).

e. Expenses Attributable to Royalty Income. While Treas. Reg. Section 1.469-2T(c)(3)(i) only purports to recharacterize income derived from royalties, expenses attributable to producing royalty income will likewise be recharacterized as portfolio. See Sections 163(d)(4)(C), (d)(5)(B).

2. Production Payments Recharacterized as Portfolio. Treas. Reg. Section 1.469-2T(c)(3)(iii)(C) provides that for Section 469 purposes production payments will be treated in one of two ways: (i.) if the production payment is treated as a loan under Section 636, as interest to the extent the payment is the equivalent of interest, or (ii.) if the production payment is not treated as a loan under Section 636, as royalties. Note that either interest or royalties income will generally be recharacterized as portfolio income, subject to limited exceptions for dealers. See Treas. Reg. Section 1.469-2T(c)(3)(i)(A).

a. Exceptions. Note that as to a production payment which is treated as a loan, payments treated as principal rather than interest could be passive or active income to the seller. In addition, as to a dealer in mineral royalties, a production payment not treated as a loan could be passive or active income.

3. Delay Rentals Recharacterized as Portfolio. Treas. Reg. Section 1.469-2T(f)(3) provides that net passive income derived from a rental activity is portfolio income to the extent less than 30% of the unadjusted basis is depreciable under Section 167. On its face, the nondepreciable property recharacterization rule seems to apply to a rental activity consisting of oil and gas properties producing delay rentals. Thus, net income from delay rentals should be recharacterized as portfolio.

a. Recharacterization Only if Activity is a Rental Activity. The non-depreciable property recharacterization rule applies only to income from a rental activity. Thus, delay rental income from an undertaking which includes substantial non-rental operations may not be recharacterized. For example, suppose a partnership owns two oil and gas properties which are in close proximity. One property generates $1000 of gross income from delay rentals; the other generates $5000 of gross income from working interest proceeds. The two properties constitute a single undertaking because they are owned by the same entity at the same location. Moreover, the delay rental
operations will not be separated out to form a separate rental undertaking because rentals generate less than 20% ($1000/$6000) of gross income. Treas. Reg. Section 1.469-4T(d)(2)(ii). The undertaking will be an other trade or business undertakings, and thus cannot become part of a rental activity. Therefore, the $1000 of delay rental income will not be recharacterized as portfolio because it does not arise in a rental undertaking.

b. Expenses Attributable to Delay Rentals. The nondepreciable property recharacterization rule of Treas. Reg. Section 1.469-2T(f)(3) operates to recharacterize only the net income from the rental activity. Thus, expenses attributable to delay rental income (e.g., expenses of carrying delay rental properties) can offset the delay rental income prior to recharacterization. Indeed, any expenses in the same activity may be offset against delay rental income prior to recharacterization.

c. Losses Still Passive. Note that the non-depreciable property recharacterization rule recharacterizes only income, not loss. Thus, an activity producing only delay rentals will produce portfolio income but passive losses.

4. Lease Bonus: Character Unclear. The character of lease bonuses and other possible interests produced by entering into an oil and gas lease are unclear. The only guidance given by Treasury was in the Preamble to the February 1988 Regulations.

Assume, for example, that royalty income is derived from an overriding royalty interest created on the transfer of a working interest by a partnership engaged in the trade or business of oil and gas development, and that the partnership is not taxed upon receipt of the royalty interest. In such a case, it may be appropriate to treat the royalty payments by analogy to sections 483 and 1274, as deferred payments with respect to the sale of the working interest. Under this approach, the portion of each royalty payment that represents consideration paid to the partnership for the working interest would be treated as income derived in the ordinary course of a trade or business, and only the interest element in the payments would be treated as portfolio income. The Service invites public comment on whether and how such distinctions should be made, and how depletion deductions should be allocated between portfolio and nonportfolio components of royalty payments. Preamble to February 1988 Regulations, Section X(C).

By analogy to this approach, lease bonuses would be treated as an immediate payment for a sub-lease sale of a working interest to the lessee. See Anderson v. Helvering, 40-1 U.S.T.C. ¶ 9474 (U.S. 1940). This would suggest that lease bonus income would be active or passive, depending on the taxpayer's participation level in the oil and gas activity prior to the lease or farmout.

5. Alaska Permanent Fund Dividends. The Alaska Permanent Fund receives a portion of Alaska's mineral royalty income and distributes part of its income to all eligible Alaska residents each year. In Rev. Rul. 90-56, the Service held that "dividends" distributed to Alaska residents are neither passive nor portfolio.

XVII. SPOUSES FILING JOINT RETURNS.

A. In General. As a general rule, spouses filing jointly are treated as one taxpayer for purposes of Section 469. Treas. Reg. Section 1.469-1T(j)(1).

B. Exceptions.

1. Disallowed Deductions and Credits. Suspended credits and losses are each accounted for separately for spouses filing a joint return. Treas. Reg. Section 1.469-1T(j)(2)(i).

2. Sections 704(d), 1366(d) and 465 Disallowed Deductions. Sections 704(d), 1366(d) and 465 apply without regard to Section 469 for purposes of taxpayers filing joint returns. Treas. Reg. Section 1.469-1T(j)(2)(ii).
3. **Qualified Working Interest Losses and Credits.** Qualified working interest losses and credits rules are applied separately to spouses including those filing a separate return. Treas. Reg. Section 1.469-1T(j)(2)(iii).

C. **Change from Joint Return to Separate Returns.**

1. **Suspended Passive Losses.** If a person who previously filed a joint return files a separate return, his suspended passive loss carryovers to the separate return year are determined based on his interests in passive activities for the immediately preceding year. Treas. Reg. Section 1.469-2T(j)(3).

D. **Effects of Divorce.**

1. **Suspended Passive Losses.** In a divorce, interests in a passive activity may be partitioned to or directly transferred to one of the spouses. If the interest in the passive activity was previously owned jointly or as community property, what happens to the suspended passive losses of the non-recipient spouse?

   a. **Section 1041.** Section 1041(a) provides for non-recognition of gain or loss on a transfer of property from an individual to a spouse, or to former spouse if the transfer is incident to divorce. Section 1041(b) further provides that the transferred property is to "be treated as acquired by the transferee by gift," with the transferee taking a carryover basis.

   b. **Non-Section 1041 Transfers.** Prior to the enactment of Section 1041, transfers incident to divorce were taxable, but partitions of community property and possibly joint tenancy property were not taxable. Compare United States v. Davis, 370 U.S. 65 (1962) with United States v. Bosch, 590 F.2d 165 (5th Cir. 1979). It is not clear whether partitions of community property or jointly owned property should be non-taxable transfers under Section 1041 under prior law.

   c. **Possible Capitalization of Suspended Passive Losses.** If an interest in a passive activity is transferred by gift, any suspended passive losses allocable to such interest are capitalized, i.e., added to basis. Section 469(j)(6). If a Section 1041 transfer between spouses or former spouses is "treated as a gift," suspended passive losses would be capitalized.

   d. **Result if No Capitalization.** If suspended passive losses are not capitalized, the authors believe passive losses attributable to an activity should follow the property and pass to the spouse receiving the interest in that activity. To do otherwise would create an unnecessary mismatch between losses from an activity and income from the same activity.

2. **Material Participation.** Although participation by a spouse is treated as participation by the taxpayer, participation by an ex-spouse presumably does not. Section 469(h)(5). The ex-spouse of a material participant, however, may continue to be a material participant for up to five years, without regard to his or her own participation level as a result of the five-out-of-ten-years material participation rule. Treas. Reg. Section 1.469-5T(a)(5).

XVIII. **COMPUTATION AND TREATMENT OF PALS.**

A. **In General.** The goal of Section 469 is to determine the amount of the taxpayer's PALS which are subject to the limitation provided by Section 469(a). The Code and regulations set forth complex computational rules for determining the amount of a taxpayer's PALS. Once the amount of the PAL has been determined, the effect of the limitation on PALS must be considered.

B. **Definition of PALS.** Under Section 469(d)(1), the term "passive activity loss" means the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive
activities for such year. This general rule is modified in the regulations, which provide that the passive activity loss for the taxable year is the amount, if any, by which the "passive activity deductions" for the taxable year exceed the "passive activity gross income" for such year. Treas. Reg. Section 1.469-2T(b).

C. Passive Activity Gross Income. The key concept for determining the amount of a taxpayer's PAL is passive activity gross income ("PAGI"). As a general rule, PAGI includes all items of gross income from a passive activity. Treas. Reg. Section 1.469-2T(c)(I). Under the regulations, however, various items of income which are derived from a passive activity are not included in PAGI.

1. Dispositions of Property. In general, any gain recognized upon the disposition of property used in an activity at the time of the disposition is included in PAGI if the activity is a passive activity. Treas. Reg. Section 1.469-2T(c)(2). If property is used in more than one activity, the gain must be allocated among the activities in a reasonable manner. For example, if three floors of an office building were used in a rental activity and seven floors in a trade or business, and assuming that the rentals are treated as a separate rental undertaking (after application of the 80/20 rule of Treas. Reg. Section 1.469-4T(d)(2)), 3/10 of the gain from the disposition could be allocated to the rental activity.

   a. Use During 12 Months Before Disposition. If property which is used in only one activity at the time of disposition has been used in more than one activity during the 12-month period preceding the disposition, the gain must be allocated among the activities in a reasonable manner unless the fair market value of the interest in property does not exceed the lesser of $10,000 or 10% of the fair market value of all property (including the property subject of the disposition) used in the activity immediately before the disposition. Treas. Reg. Section 1.469-2T(c)(2)(ii). There is a similar rule if the disposition results in a loss.

   b. Partnership Interest or S Corporation Stock. A partnership interest or S corporation stock is not treated as property used in an activity. Treas. Reg. Section 1.469-2T(c)(2)(i)(B). The treatment of gain and loss from the disposition of such interests is discussed below.

2. Disposition of Substantially Appreciated Property. Gain on the disposition of property which is substantially appreciated is not treated as PAGI unless the property was used in a passive activity for either (a) 20% of the period during which the taxpayer held such interest in property, or (b) 24 months. For purposes of this rule, property is substantially appreciated if the fair market value of the property exceeds 120% of the adjusted basis of such property. Treas. Reg. Section 1.469-2T(c)(2)(iii).

   a. Active v. Portfolio Income. Gain from the sale of substantially appreciated property is treated as portfolio income if the property was held for investment for more than 50% of the period during which the taxpayer held such interest in property in non-passive activities. Otherwise, recharacterized gain is treated as active income. This distinction is important if an individual taxpayer has investment interest deductions under Section 163(d). There is no corresponding rule for losses incurred on the disposition of substantially depreciated property. For purposes of this rule, property is treated as held for investment for any period during which such interest is held through a C corporation or a similar entity. Treas. Reg. Section 1.469-2T(c)(2)(iii)(D).

3. Property Acquired in Taxable Transactions. For purposes of the preceding rules concerning dispositions of (a) property used in more than one activity during the 12-month period, and (b) substantially appreciated property, any use of the property before an acquisition of the property in a taxable transaction is not taken into account. Treas. Reg. Section 1.469-2T(c)(2)(iv). For example, if a taxpayer acquired property in a taxable transaction from a partnership in which the taxpayer has an interest, the property will not be treated as owned by the taxpayer until after the acquisition.

4. Property Held for Sale. In certain situations, it is necessary to determine whether a taxpayer holds property as a dealer at the time of sale. If the following three tests are met, the dealing activity will not be taken into account and the property will be treated as used by the taxpayer in the last nondealing activity in which the taxpayer held the property (Treas. Reg. Section 1.469-2T(c)(2)(v)).
i. Dealing Activity. At the time of the disposition, the taxpayer holds the property as a dealer (a "dealing activity").

ii. Nondealing Activities. One or more other activities of the taxpayer do not involve holding similar property as a dealer (a "nondealing activity") and the property was used in the nondealing activity for more than 80 percent of the period during which the taxpayer held such property, and

iii. Nondealer Intent. The interest in property was not acquired and held by the taxpayer for the principal purpose of selling such property in a dealing activity.

   a. Rebuttable Presumption. A taxpayer is rebuttably presumed to have acquired and held property for the principal purpose of selling such property in a dealing activity if (i) the period during which the interest in property was used in a nondealing activity does not exceed the lesser of 24 months or 20 percent of the recovery period for the property, or (ii) the property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which such property in used in the nondealing activity. Treas. Reg. Section 1.469-2T(c)(2)(v)(A)(1)(ii).

   b. Example. A taxpayer acquired a residential apartment building on January 1, 1987 and used it in a rental activity until January 1990, when the taxpayer converts the apartments into condominium units. The units are held for sale from January 1, 1990 until the last units are sold on December 31, 1990, although the units are rented until they are sold. Neither rebuttable presumption applies because (1) the units were used in a nondealing activity for more than 24 months, and (2) the period during which the property was held for sale did not exceed 25 percent of the period during which the property was used in a rental activity. Treas. Reg. Section 1.469-2T(c)(2)(iv)(C), Example (1). In contrast, if the last unit were sold in 1991, the taxpayer would be rebuttably presumed to have acquired the apartments sold in 1991 for sale, so that if the presumption were not rebutted, gain from the sales in 1991 would not be gain from the disposition of a rental activity. Treas. Reg. Section 1.469-2T(c)(2)(v)(C), Example (3).

5. Portfolio Income. All items of portfolio income are excluded from PAGI. Treas. Reg. Section 1.469-2T(c)(3).

6. Personal Service Income. All items of personal service income are excluded from PAGI. Treas. Reg. Section 1.469-2T(c)(4).

7. Section 481 Adjustments. If a change in accounting method results in a positive Section 481 adjustment with respect to an activity, a ratable portion of the amount taken into account for a taxable year as a net positive Section 481 adjustment will be treated as PAGI if the activity is a passive activity for the year of the change (within the meaning of Section 481). Treas. Reg. Section 1.469-2T(c)(5).

8. Gross Income from Certain Oil and Gas Properties. PAGI does not include any gross income for any taxable year from any oil and gas property if any loss from a working interest in such property was not treated as a PAL under Section 469(c)(3). Any oil or gas property the value of which was enhanced by activities the costs of which were borne through the working interest is subject to this rule. Thus, for example, if the drilling of a well on one tract reveals that a single reservoir underlies that tract and another tract, the income from both properties would not be PAGI if any portion of the cost of drilling the well resulted in a loss which was not treated as a PAL under Section 469(c)(3). Treas. Reg. Section 1.469-2T(c)(6).

9. Recharacterized Items. PAGI does not include items of income which are recharacterized under Treas. Reg. Section 1.469-2T(f).

10. Other Excluded Items. PAGI does not include various other items pursuant to Treas. Reg. Section 1.469-2T(c)(7):
a. **Intangible Property.** Gross 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 such property;

b. **Qualified Low Income Housing.** Gross income from a qualified low income housing project during the Transition period in which Section 469 does not apply;

c. **State, Local or Foreign Income, War Profits or Excess Profits Taxes.** Gross income attributable to a refund of any state, local or foreign income, war profits or excess profits tax;

d. **Covenant Not to Compete.** Gross income of an individual from a covenant not to compete; and

e. **Casualty Loss Reimbursement.** Gross income from reimbursement of casualty losses, if the corresponding casualty losses were treated as non-passive. See Lipton, "IRS Eases Passive Loss Limitation for Casualty Losses," 68 Taxes 363 (1990).

D. **Passive Activity Deductions.** Passive activity deductions ("PADs") generally include all deductions which arise in connection with a passive activity in the taxable year, or are disallowed PADs carried over under Section 469(b) to the taxable year. Treas. Reg. Section 1.469-2T(d)(1).

1. **Exceptions.** Treas. Reg. Section 1.469-2T(d)(2) provides a list of exceptions to PADs:

   a. **Portfolio Deductions.** Items of expense (other than interest) clearly and directly allocable to portfolio income;

   b. **Dividend Deductions.** Deductions allowed under Section 243, 244 or 245 with respect to any dividend not included in PAGI;

   c. **Non-Passive Allocated Interest Deductions.** Interest expense not allocated to the passive activity under Treas. Reg. Section 1.163-8T;

   d. **Dispositions Deductions.** Deductions which are not treated as PADs under the rules relating to dispositions of interests in activities in Section 469(g);

   e. **State, Local or Foreign Income, War Profits or Excess Profits Taxes Deductions.** A deduction for any state, local or foreign income, war profits or excess profits tax;

   f. **Miscellaneous Itemized Deductions.** A miscellaneous itemized deduction that is subject to disallowance in whole or in part under Section 67(a);

   g. **Charitable Contributions.** A deduction for a charitable contribution;

   h. **Sections 172 and 1212.** An item of loss or deduction carried to the taxable year under Section 172 or 1212;

   i. **Pre-1987 Section 704(d), 1366 or 465.** An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for Section 704(d), 1366 or 465. Any pre-1987 deductions which were suspended under these provisions can be utilized against any income when the taxpayer increases basis or his at-risk amount, as the case may be; and

   j. **Casualty Losses.** A deduction for casualty losses under Section 165, if similar losses do not regularly recur in the activity.
2. **Interest Expense.** Interest expense is taken into account as a PAD if and only if such interest expense is allocated to a passive activity under Treas. Reg. Section 1.469-8T (allocation of interest) and is not qualified residence interest (under Treas. Reg. Section 1.163-10T) or capitalized (under Treas. Reg. Section 1.163-8T(m)(7)). The allocation rules for interest expense under Treas. Reg. Section 1.163-8T utilize the so-called tracing concept. See, e.g., Notice 89-35, concerning the allocation of interest expense incurred to purchase interests in and borrowings by pass-through entities. These rules are beyond the scope of this outline, but they are an important planning tool.

   a. **Example.** An individual taxpayer borrows $10,000 to purchase a rental property, on which he pays $1,000 interest per year; the loan is secured by a mortgage on the building. The rental activity breaks even from a tax standpoint before interest expense is considered. The taxpayer also owns a T-bill worth $10,000 which generates $1,000 interest income. In this situation, the taxpayer would have to pay tax on his portfolio income of $1,000 which could not be offset by the passive loss in the same amount.

      To solve this problem, the taxpayer could (1) sell the T-bill for $10,000, (2) pay off the mortgage, (3) re-borrow $10,000 against the property, and (4) use the proceeds of the loan to buy another $10,000 T-bill. When the dust settles the taxpayer is in the same position as before, except that under the tracing rules of Treas. Reg. Section 1.163-8T, the interest deduction has been transformed from passive into portfolio.

3. **Losses from Dispositions of Property.** Any loss upon the disposition of an interest in property used in a passive activity at the time of sale is treated as a PAD. The loss must be allocated among the activities in which the property was used according to the same general rules which apply to gains from the disposition of property used in passive activities. Treas. Reg. Section 1.469-2T(d)(5). There is no special rule, however, relating to losses incurred in the disposition of substantially depreciated property.

   a. **Dealing v. Non-Dealing Activity.** For purposes of determining whether property was held in a dealing or nondealing activity, the rules in Treas. Reg. Section 1.469-2T(c)(2)(v) are applied. Treas. Reg. Section 1.469-2T(d)(5)(iii)(A).

   b. **Property Used in an Activity.** A partnership interest or S corporation stock is not property used in an activity. Treas. Reg. Section 1.469-2T(d)(5)(iii)(B).

4. **Section 481 Adjustments.** If a change in accounting method results in a negative Section 481 adjustment with respect to an activity, a ratable portion of the amount taken into account as a net negative Section 481 adjustment is treated as a PAD if the activity is a passive activity for the year of the change (within the meaning of Section 481). Treas. Reg. Section 1.469-2T(d)(7).

5. **Coordination with Other Limitations.** An item of deduction from a passive activity that is disallowed for a taxable year under Section 704(d), 1366(d) or 465 is not a PAD for a taxable year. If any amount of a partner's distributive share of a partnership's loss is so disallowed, a ratable portion of the partner's distributive share of each item of deduction is not treated as a PAD for such year. Treas. Reg. Section 1.469-2T(d)(6).

   a. **Planning Opportunity.** Because a taxpayer can control the basis of his interest in a partnership or an S corporation, or his at-risk amount in an activity, this provision allows a taxpayer to plan for the timing of deductions. This could be particularly important if, for example, the taxpayer needs to increase the deductions for significant participation activities so as to reduce the amount of income from such activities which is recharacterized. For purposes of this rule, items of deduction that are separately taken into account, including deductions subject to the limitations under Sections 613A, 1211 or 1231 are not considered. Treas. Reg. Section 1.469-2T(d)(6)(v).

E. **Special Rules for Partners and S Corporation Shareholders.** The regulations contain special rules for the treatment of income and loss from pass-through entities. Treas. Reg. Section 1.469-2T(e).
1. **In General.** The character as an item of passive activity gross income (PAGI) or passive activity deduction (PAD) from a pass-through entity will be determined by reference to the participation of the taxpayer in the activity. This determination is made using the taxable year of the entity and not the taxable year of the taxpayer. Thus, for example, if the entity uses a fiscal year and the taxpayer a calendar year, the participation of the taxpayer in the entity will depend upon his participation during the fiscal year. Treas. Reg. Section 1.469-2T(e)(1).

2. **Payments under Sections 707(a), 707(c) and 736(b).** Items of gross income and deduction referred to in these sections are characterized according to special rules. Treas. Reg. Section 1.469-2T(e)(2).

   a. **Section 707(a).** Any item of gross income or deduction attributable to a transaction that is treated under Section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a partner is characterized for purposes of Section 469 in a manner consistent with Section 707(a). Thus, for example, if income is characterized as from a sale of property held for investment under Section 707(a), it will be treated as portfolio income for purposes of Section 469.

   b. **Section 707(c).** If a payment to a partner is treated as a payment for the performance of services or the use of property under Section 707(c), it will be recharacterized in the same manner for purposes of Section 469.

   c. **Section 736(a).** If a payment described in Section 736(a) is made in liquidation of a retiring or deceased partner's interest, to the extent that any such income is attributable to unrealized receivables or goodwill, the percentage of such income that is PAGI will not exceed the percentage of PAGI that would be included in the gross income that such retiring or deceased partner would have recognized if such unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest commenced. Treas. Reg. Section 1.469-2T(e)(2)(iii)(B).

      i. **Significant Participation.** The effect of this rule is that if the retiring or deceased partner significantly participated in activities of the partnership at the time the liquidation of the partner’s interest commenced, a portion of the income from unrealized receivables and goodwill is recharacterized under Treas. Reg. Section 1.469-2T(f)(2).

   d. **Section 736(b).** Any gain or loss taken into account by a retiring partner or a deceased partner's successor in interest as a result of a payment under Section 736(b) is treated as PAGI or a PAD only to the extent that the gain or loss would have been so treated if it had been recognized at the time that the liquidation of the partner's interest commenced. Thus, if the partner materially participated in the activity at such time, the gain or loss would not be treated as from a passive activity.

      i. **Significant Participation.** What if the taxpayer significantly participated in the activity in the year in which the liquidation commenced? Section 736(b) payments would be subject to recharacterization because such payments were not PAGI in the year the liquidation commenced.

3. **Dispositions of Interest in Partnerships and S Corporations.** Generally, gain or loss from the disposition of an interest in a pass-through entity must be allocated ratably among the activities of such entity in proportion to the amounts of gain or loss, respectively, that would have been allocated to the holder by the pass-through entity if the entity had sold its interests in such activities on the applicable valuation date. Treas. Reg. Section 1.469-2T(e)(3).

   a. **Valuation Date.** The applicable valuation date is either the beginning of the taxable year or the date of the disposition. If, however, since the beginning of the taxable year the entity has sold more than 10% of its property, or if the holder has contributed substantially appreciated or substantially depreciated property which exceed 10% of the total fair market value of the holder’s interest in the entity as of the beginning of such taxable year, then the applicable valuation date is the day before the date of sale.
b. Allocation of Gain or Loss. The allocation of gain or loss ratably among the activities of the entity is determined using the net gain or loss, respectively, on the applicable valuation date or, if such net gain or loss cannot be determined, the fair market value of the activities on the applicable valuation date.

i. Effect of Netting. This ratable allocation method effectively requires a taxpayer to net the gain and loss from all activities before allocating the resulting net gain or loss among the activities. This could have a significant impact if the taxpayer materially participated in some but not all of the activities of the entity, or if the entity has any portfolio activities.

c. Gain Not PAGI. If more than 10 percent of the gain from the disposition of an interest in a pass-through entity results from the disposition of

i. substantially appreciated property formerly used in a nonpassive activity,

ii. oil and gas properties subject to the working interest exception,

iii. self-developed rental property,

iv. property rented to a nonpassive activity, or

v. interests in a pass-through entity engaged in the trade or business of licensing intangible property,

then to the extent that gain from the sale of such property would not have been treated as PAGI if the property had been sold immediately prior to the disposition of the partnership interest, the gain from the disposition of the partnership interest will not be treated as PAGI. Treas. Reg. Section 1.469-2T(e)(3)(iii)(B).

d. Pre-February 19, 1988 Taxable Years. For taxable years beginning before February 19, 1988, gain or loss from a disposition of an interest in a pass-through entity may be allocated in any manner in which the taxpayer elects, except that this rule does not apply if the taxpayer contributes either substantially appreciated portfolio assets or other substantially appreciated assets that were used in a trade or business in which the taxpayer materially participated.

F. Treatment of PALs. Under Section 469(a) and Treas. Reg. Section 1.469-IT(a), the PAL for the taxable year is not allowed as a deduction. The disallowed PAL is allocated among the activities to which it relates and carried over to future taxable years. Treas. Reg. Section 1.469-1T(f).

1. Allocation of Disallowed PALs Among Activities. If any portion of a taxpayer’s PAL is disallowed under Section 469(a), it is necessary to allocate the disallowed PAL among the activities in which the taxpayer has an interest. This allocation is made to each activity by multiplying the PAL that is disallowed for all activities by the fraction the numerator of which is the loss from the activity, and the denominator of which is the sum of the losses for the taxable year from all activities having losses. Treas. Reg. Section 1.469-1T(f)(2).

a. Example. Assume that an individual holds interests in three passive activities, A, B, and C. The gross income and deduction from these activities for the taxable year are as follows:

<table>
<thead>
<tr>
<th>Activity</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>7</td>
<td>4</td>
<td>12</td>
<td>$23</td>
</tr>
<tr>
<td>Deductions</td>
<td>(16)</td>
<td>(20)</td>
<td>(8)</td>
<td>($44)</td>
</tr>
<tr>
<td>Net Income</td>
<td>(9)</td>
<td>(16)</td>
<td>4</td>
<td>($21)</td>
</tr>
</tbody>
</table>
The allocation of this PAL of $21 among the activities is determined as follows:

A: $21 \times \frac{9}{25} = $7.56 \text{ PAL disallowed}

B: $21 \times \frac{16}{25} = $13.44 \text{ PAL disallowed}

TOTAL = $21.00 \text{ PAL disallowed.}


b. Significant Participation Passive Activity Recharacterization. For purposes of determining this allocation, if any portion of the gross income from the significant participation passive activities of the taxpayer is recharacterized under Treas. Reg. Section 1.469-2T(f)(2), all of the taxpayer's significant participation passive activities will be treated as a single activity that does not have a loss for the taxable year. Treas. Reg. Section 1.469-1T(f)(2)(i)(C).


2. Allocation within Loss Activities. If any portion of the PAL for an activity is disallowed, a ratable portion of each deduction of the activity is disallowed. However, the taxpayer needs to separately account for deductions only if separate accounting would result in different tax liability. Deductions which must be taken into account separately include capital losses and deductions related to rental real estate activities in which the taxpayer actively participates. Treas. Reg. Section 1.469-1T(f)(2)(ii).

3. Disallowed Credits. Disallowed PACs are allocated ratably in a manner similar to that which applies to disallowed PALs. Treas. Reg. Section 1.469-1T(f)(3).

4. Carryover of Disallowed PALs. Any deduction or credit from an activity that is disallowed is treated as a deduction or credit, as the case may be, from such activity for the taxpayer's immediately succeeding taxable year. Thus, in the above example, the loss of $7.56 from activity A and the loss of $13.44 from activity B which were disallowed would be treated as deductions in the following year. Treas. Reg. Section 1.469-1T(f)(4). This rule concerning the carryover of PALs follows the literal language of Section 469(b). The rule is important primarily for allocating PALs among activities in the year to which the disallowed losses have been carried.

5. Allocation of Disallowed PALs to Another Activity. The general rule set forth above is that disallowed deductions or credits are carried over to the next taxable year for the activity. What if the activity has been divided into multiple activities, or if the activity does not continue to exist? In that event, the disallowed deductions or credits are allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity. Treas. Reg. Section 1.469-1T(f)(4)(i)(A).

a. Example. A restaurant and a catering service in which the taxpayer owns an interest are conducted at one location and treated as a single activity for two years, but then divided into two locations and two activities in the third year. Any disallowed PALs must be allocated among the two activities. Treas. Reg. Section 1.469-1T(f)(4)(iii), Example (2).

c. C Corporations. To the extent that a taxpayer continues part or all of the business and rental operations that generated PALs through a C corporation or similar activity, the taxpayer's interest in such entity is treated as an interest in a passive activity that continues such operations. Treas. Reg. Section 1.469-1T(f)(4)(ii)(A). Nonetheless, the disallowed PALs that are carried forward cannot be utilized to offset any portfolio income, including dividends from the C corporation. Treas. Reg. Section 1.469-1T(f)(4)(iii), Example (5).

G. Coordination with Other Sections. Neither the provisions of Section 469 nor the characterization of income or deductions as PAGI or PADs affects the treatment of such items for purposes of any other provision of the Code. Treas. Reg. Section 1.469-1T(d)(1).

1. Capital Gains of Passive Activities. Assume an individual taxpayer has $10,000 capital gain from passive activity X and a $12,000 ordinary loss from passive activity Y, as well as an unrelated capital loss of $10,000 that is not derived from a passive activity. The taxpayer would be treated as having a $2,000 PAL. In addition, the taxpayer would have a $10,000 capital loss which is allowed as a result of the $10,000 capital gain from activity X.

2. Capital Losses of Passive Activities. A passive activity deduction that is not disallowed under Section 469 is nonetheless subject to Section 1211. Thus, for example, if an individual has $10,000 ordinary income from passive activity F and a $12,000 capital loss from passive activity G, the taxpayer would have a $2,000 PAL for the taxable year and a capital loss carryover of $7,000. Treas. Reg. Section 1.469-1T(d)(2).

3. Percentage Depletion Limitation. Similarly, the percentage depletion limitations under Section 613A(d) are still applicable.

4. Treatment of Disallowed Deductions. A deduction that is disallowed for a taxable year under Section 469 is generally not taken into account for any other purposes. For example, such deductions would not be considered in determining net earnings from self-employment subject to tax under Section 1401. Treas. Reg. Section 1.469-1T(d)(3).

H. Former Passive Activities. Section 469(f) provides special rules for former passive activities. These rules reflect the possibility that, under the material participation test and the definition of taxpayers subject to Section 469, there could be changes in status.

1. Change in Participation. The primary situation in which the rule concerning former passive activities will apply is when there is a change in the level of participation, i.e., a taxpayer does not materially participate in the activity in one year but does materially participate in a subsequent year. In that event, any previously-disallowed PALs may be utilized to offset active income from the same activity. Section 469(f)(1).

a. Same Activity. This rule applies only to the extent that the income arises in the same activity which generated the PAL. If there has been a significant change in the activity (so that it is no longer the same activity), or if the activity was disposed of in a transaction in which all gain or loss was not recognized, this special relief provision would not be applicable. '86 Sen. Rep. at 727-28.

2. Change in Nature of Activity. A change in the nature of an activity is not treated as a disposition; the effects of a disposition are discussed below.

3. Change in Corporate Status. The determination whether a corporation is a closely held corporation or a personal service corporation for any taxable year will often depend upon stock ownership. See Treas. Reg. Section 1.469-1T(g)(2). If a corporation ceases for any taxable year to be a closely held corporation or a personal service corporation, any previously disallowed PALs will remain subject to the restrictions of Section 469. Section 469(f)(2).
Impact. In the case of a closely held corporation, this provision is not that onerous because PALs can be utilized to offset net active income. Treas. Reg. Section 1.469-1T(g)(4). In contrast, in the case of a personal service corporation, a change in status could result in disallowance until the activity which generated the PALs is disposed of, as discussed below.

4. Regulations. The Service has reserved regulations relating to former passive activities and changes in status of corporations. Treas. Reg. Section 1.469-1T(k).

XIX. DISPOSITIONS.

A. In General. Suspended PALs may be utilized by a taxpayer when the taxpayer disposes of his entire interest in the activity in a transaction in which all gain or loss is recognized.

B. Statutory Mechanism. Under Section 469(g)(1) as amended by TAMRA, if all gain or loss realized on the disposition is recognized, the excess of (i) the sum of any loss from the activity for the taxable year (including deductions carried over from prior years) plus any loss realized on the disposition, over (ii) net income or gain for such taxable year from all passive activities, is treated as a loss which is not from a passive activity. Thus, such excess loss can be utilized to offset any income. Section 469(g)(1)(A). This rule only applies if there is a complete disposition of the taxpayer's entire interest in the "activity." For purposes of this rule, to the extent provided in regulations, income or gain from the activity for preceding taxable years is taken into account to the extent necessary to prevent tax avoidance. Section 469(g)(1)(C).

C. Importance of Activity Definitions. The application of Section 469(g) depends upon what constitutes the "activity" in which the taxpayer has an interest, because suspended losses are available only when there is a complete disposition of the taxpayer's entire interest in the "activity." Under the May 1989 Regulations, there is a broad definition of an activity for trade or business undertakings unless the taxpayer makes the activity separation election under Treas. Reg. Section 1.469-4T(o).

1. Example. Assume a taxpayer owns and controls 2 restaurants that are treated as a single activity under the aggregation rule in Treas. Reg. Section 1.469-4T(f). If the taxpayer sells one of the restaurants and the taxpayer has not made a timely activity separation election, any suspended losses attributable to the restaurant that is sold would remain suspended because there was not a complete disposition of the taxpayer's entire interest in the activity. On the other hand, if the taxpayer had made a timely activity separation election, the sale of one restaurant, a separate undertaking, would trigger all suspended losses allocable to that restaurant.

2. Rental Real Estate Example. The same issue arises for rental real estate undertakings. If a taxpayer owns a rental building and sells one unit (as a condominium), this sale would not be a complete disposition that triggers suspended passive losses unless the taxpayer has "elected" to treat the unit that is sold as a separate activity under the special rule for rental real estate undertakings in Treas. Reg. Section 1.469-4T(k).

3. Planning. Because of the requirement of a complete disposition of the taxpayer's entire interest in an activity, most taxpayers will want to utilize as narrow of a definition of an activity as possible under either the special rule for rental real estate undertakings or the activity separation election.

i. Rental Real Estate. In the case of rental real estate undertakings, however, a taxpayer with property acquired both before and after October 22, 1986 may prefer to treat multiple properties as a single activity so as to benefit from the phase-in rule.

D. Disposition Regulations. The Service has not yet issued regulations explaining the disposition rules. See Treas. Reg. Section 1.469-6T.
E. Effect of Section 469(g)(1). The allowance of previously-disallowed PALs upon a disposition only permits a taxpayer to receive the benefit of "true economic losses." Depreciation deductions almost become meaningless if the taxpayer has no source of passive income.

1. Example. Assume that a taxpayer owns a rental property with a cost basis of $100. If the property has income of $10, out-of-pocket expenses of $10, and depreciation deductions of $5 in year 1, the taxpayer will have a PAL of $5 for that year. If the taxpayer then sells the rental property for $100, the gain on the sale ($5) will be offset by the carry-over PAL. The depreciation deduction from year 1 is effectively eliminated.

2. Example. Assume the same facts as in the above example, except that the building sold for only $97. The gain on sale ($2) will be offset by an equal amount of PAL leaving the balance of the PAL from year 1 ($3) to be treated as a loss which is not a loss from a passive activity. This loss reflects the true economic loss from depreciation of the property.

3. Credits. Credits are not allowed upon a qualifying disposition because a credit does not reflect a true economic loss with respect to the activity.

F. Related Party Transactions. The allowance of losses on the disposition of a taxpayer's entire interest in a passive activity does not apply if the transferee is related to the taxpayer within the meaning of Section 267(b) or 707(b)(1). Section 469(g)(1)(B). The loss is allowed to the transferor when the related transferee completely disposes of his interest in the property.

1. Transferor No Longer in Existence. This rule could be difficult to apply if the transferor is no longer in existence, e.g., what happens if a trust distributes the passive activity to a beneficiary? Under Section 469(j)(12), as added by TAMRA, if any interest in a passive activity is distributed by an estate or trust, the basis of the property is increased by previously-disallowed PALs, which are thereby eliminated. This provision does not resolve problems that arise if the related party is a corporation, e.g., if a corporation sells an activity to a shareholder at a loss, what happens when the corporation is liquidated?

G. Abandonment. An abandonment of an interest in an activity is treated as a fully-taxable disposition for purposes of Section 469(g)(1).

H. Disposition by Death. If an interest in an activity is transferred by reason of the death of a taxpayer, PALs may be utilized only to the extent that the basis of the property in the hands of the transferee exceeds its adjusted basis immediately before the death of the taxpayer. Section 469(g)(2). The effect of this rule is to eliminate losses in an amount equal to the "step up" in the basis of assets at death.

I. Disposition by Gift. In the case of a disposition by gift, the basis of the interest immediately before the transfer is increased by the amount of previously-disallowed PALs allocable to such interest, and the PALs are not allowable as a deduction. Section 469(j)(6).

1. Planning Opportunities. This provision could result in interesting tax planning opportunities where the PALs are not needed by the donor, but the donee could utilize the losses which would result from depreciation of the property after a step up in basis.

J. Divorce. See the discussion at XVII, D. for a discussion of dispositions incident to a divorce.

K. Installment Sales. In the case of an installment sale of an entire interest in an activity, PALs are allowed in the same ratio to all losses as the ratio of the gain recognized on the sale bears to the gross profit. Section 469(g)(3). The rules which accelerate the recognition of gain due to depreciation recapture would generally accelerate the recognition of PALs as well.
L. Limited Partnerships. The Conference Committee changed the provision in the Senate bill under which a taxpayer had to dispose of his entire interest in a limited partnership in order to utilize any previously-suspended PALs. Instead, under Section 469(g)(1), a limited partner will be able to utilize suspended PALs when the partnership disposes of its entire interest in the activity in a qualifying disposition.

1. Publicly Traded Partnerships. A complete disposition of an interest in a PTP is required to recognize suspended PALs. Section 469(k)(3).

M. Basis Step Up Due to Unutilized Credits. For purposes of determining gain or loss from a disposition of any property, the transferor may elect to increase the basis of such property immediately before the transfer by an amount equal to the portion of any unused credit which reduced the basis of such property for the taxable year in which the credit arose. Section 469(j)(9). The purpose of this provision is to permit the taxpayer to recognize economic gain or loss, taking into account the full cost of property for which no credit was allowed. This provision also takes into account the fact that PACs are not allowed upon the disposition of an interest in a passive activity.

XX. TRUSTS AND ESTATES.

A. Overview: Conceptual Difficulties

1. Trusts and Estates as “Semi-Passthroughs.” For a passthrough entity, Section 469 generally looks through the entity, determining the passive/active character of income by ignoring the entity and focusing on the ultimate owners. Thus, activities and material participation are defined by reference to the ultimate owners. Conversely, for a non-passthrough such as a C corporation, passive/active determinations are made primarily by ignoring the owners and focusing on the entity; activities are determined without regard to other interests of the owners; and material participation may exist even if owners do not participate. Trust and estates, however, have characteristics of both passthroughs and non-passthroughs. At one extreme, a grantor trust or a simple trust (i.e., one distributing all its income) is a practically pure passthrough for tax purposes. At the other extreme, a complex spray trust, accumulating income and making discretionary distributions among multiple beneficiaries, more closely resembles a non-passthrough entity, with both significant entity-level tax and a significant economic identity independent of its beneficiaries. The universe of trusts and estates is scattered along a continuum between these two extremes. A persistent conceptual problem for the passive loss rules is whether to treat trusts and estates as passthroughs, as non-passthroughs, or as both.

2. General Lack of Authority. The application of Section 469 to trusts and estates is highly uncertain because of the general absence of any authority. The statute provides no guidance; the legislative history provides guidance in only one area, and then does so confusingly; and regulations have not been issued.

a. ABA and AICPA Comments. Although they do not constitute authority, suggestions made to Treasury by the American Bar Association and the American Institute of Certified Public Accountants may be influential in shaping future regulations. At a minimum, these suggestions (discussed below) are guidance as to reasonable methods to use pending issuance of regulations. For a summary and comparison of the two group’s suggestions, see Abbin, “The Unsolved Dilemma: PALs, PIGs and Subchapter J,” Trusts and Estates 16 (Aug. 1988). In broad outline, the AICPA comments recommend treating a trust primarily as a non-passthrough entity, while the ABA comments take a more complicated hybrid approach.

3. The Planner’s Dilemma. The combination of no clear guidance with a thorny conceptual problem leaves tax planners and return preparers in a quandary. Trustees and executors are held to a high fiduciary standard and thus may favor conservative tax return positions; in the current state of affairs, however, there may be no conservative position to take.
4. Proposal: Any Reasonable Method. Given the difficulty of this subject area, the authors would hope that future regulations will permit taxpayers to use any reasonable method for resolving these questions for years prior to the publication of regulations. Cf. Notice 88-94, 1988-2 C.B. 419, and Treas. Reg. Section 1.469-4T(p) (for years prior to issuance of regulations on definition of activity, taxpayers may use any reasonable method). Without such regulations, taxpayers and practitioners will be forced to proceed at their own risk.

B. Trusts and Estates Subject to Section 469.

1. In General. Generally, the passive loss rules apply to all trusts and all estates. See Section 469(a)(2)(A).

2. Grantor Trusts. The regulations state that grantor trusts are not subject to Section 469; instead, the grantor is taxed on the income and loss therefrom and is himself subject to Section 469. Treas. Reg. Section 1.469-1T(b)(2). It is not completely clear, however, that the regulations follow this flow-through approach consistently. See, e.g., Treas. Reg. Section 1.469-4T (each trust as defined in Section 7702 is a separate person for purposes of grouping operations into undertakings; no exception for grantor trusts). Moreover, interesting problems would arise when a grantor trust becomes a non-grantor trust or when the income of a trust becomes attributable to a different person.

C. Definition of Activity.

1. Determining Activities.

a. Determining Undertakings. The undertaking determination is an entity-level process. Thus if a trust and a beneficiary each have independently run operations at a single location, the operations of each will be a separate undertaking. See Treas. Reg. Section 1.469-4T(c)(2)(v). If the trust and beneficiary own interests in the same entity, however, the operations of that entity will be a single undertaking.

b. Determining Activities: Common Control. For purposes of grouping undertakings to form activities, it is often important to determine whether two undertakings are controlled by the same interests. See, e.g., Treas. Reg. Sections 1.469-4T(f)(3), (j). While common control ultimately depends on facts and circumstances, common control is rebuttably presumed if two undertakings have a common-ownership percentage exceeding 50%. For purposes of determining common-ownership percentage, a beneficiary is treated as owning no part of any interest owned by a trust or estate for his benefit. Treas. Reg. Section 1.469-4T(j)(3)(ii)(c). At the same time, under applicable attribution rules, a trust is treated as owning any interest owned by the trust’s settlor and vice versa. Treas. Reg. Section 1.469-4T(j)(3)(iii)(c). Thus, for purposes of determining common control, a trust’s interests will be treated as owned by the settlor but not by the beneficiary.

2. Activities of Trust or Estate vs. Activities of Beneficiary. The income or loss of a trust or estate from an undertaking may be taxed on the trust or estate’s own tax return, but it also may flow through to a beneficiary’s return. Trust T’s income from undertaking U may be taxed to the trust, but under the pro rata rule of Sections 652(b) and 662(b), beneficiary B may arguably treat a percentage of his distributions from trust T as income from undertaking U. In theory, undertaking U could be part of one activity as to trust T but part of a different activity as to beneficiary B.

a. Example. Trust T and its sole beneficiary, B, each own a qualified working interest in well W. Trust T has no other assets. As to trust T, income from well W is therefore portfolio. See Treas. Reg. Section 1.469-4T(e)(1). Beneficiary B, however, has extensive interests in oil and gas undertakings and well W would be part of an oil and gas activity in which B materially participates. As to B, then, income from his directly-owned working interest in well W is active income. See Treas. Reg. Section 1.469-4T(e)(1)(i). Trust T distributes half of its net taxable income and is taxed on the other half. For purposes of trust T’s tax return, trust T’s income from well W is portfolio. For purposes of beneficiary B’s tax return, however, is the distribution from trust T (all derived from well W) portfolio or active? The regulations do not resolve this issue.
b. Example. Trust T and beneficiary B each own one-half of a parking lot. T owns no assets except its interest in the parking lot; B also owns the adjacent shopping mall. As to trust T, net income from the parking lot is recharacterized as active income under the non-depreciable rental real estate recharacterization rule of Treas. Reg. Section 1.469-2T(f)(3). Beneficiary B, however, also owns a portion of the adjacent shopping mall; as to him, the shopping mall and the parking lot are part of a single undertaking, and the non-depreciable rental real estate recharacterization rule does not apply to the activity including that undertaking. As to B, then, income from B's direct interest in the parking lot is passive. Can B argue that his distribution from trust T is passive income to the degree it is attributable to the parking lot?

c. Comment: Activity as to Whom? As the above examples illustrate, when determining the activity from which trust or estate income arises, one may need to distinguish between activities with respect to the trust or estate itself and activities with respect to a beneficiary of the trust or estate. Ultimately, legislation is probably necessary to clarify this issue. Because there is legitimate doubt on this issue, planners may be able to take several different positions. Assuming regulations that allow any reasonable method, this is a planning opportunity. There is, however, no way to predict if such regulatory flexibility will be granted.

D. Material Participation.

1. Legislative History.

a. Senate Report: Participation by Fiduciary. The '86 Senate Finance Committee Report states that a trust or estate is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if its fiduciary or executor, in his capacity as such, is so participating. '86 Sen. Rep. at 735. The Senate Report does not provide that this should be the only test of material participation. By implication, however, participation by the fiduciary in his individual capacity should not count as participation by the trust or estate.

b. Blue Book: No Rule Since Always Passive. The 1986 Blue Book states that “no special rule is provided for determining material participation by a trust.” '86 Blue Book at 242 n.33. This position is explained by the remarkable comment that no rule is needed because a trust is usually not engaged in the conduct of a business for profit. Id. Practitioners would certainly take issue with the Blue Book's reasoning. At the same time, the Blue Book's rejection of the Senate position casts some doubt of the authoritative nature of the Senate Report's comment.

2. Regulations: No Guidance. The regulations concerning material participation give no guidance on participation for trusts and estates. See Treas. Reg. Section 1.469-5T(g) (subject reserved for future regulations).

3. The Real Issue: Beneficiary Participation. Assuming that the Blue Book is wrong in concluding that a trust can never materially participate in a trade or business, the real issue is whether the activity level of the fiduciary or that of the beneficiaries should be controlling. If the trustee or executor devotes 600 hours to an activity, should income from the activity be active even though the beneficiaries do not participate? Conversely, if the beneficiaries devote 600 hours to an activity, perhaps in their individual capacity, should the trust or estate's income from the activity be active even though the fiduciary is inactive in the business?

a. AICPA Proposal. The AICPA comments recommend that only participation of the fiduciary count.

b. ABA Proposal. The ABA comments sidestep the issue of material participation by suggesting that for purposes of the trust or estate's return, income be classified according to the fiduciary's participation, while for purposes of a beneficiary's return, income would be classified according to the particular beneficiary's participation. While conceptually reasonable, this proposal may complicate the application of Section 469 to trusts and estates.

4. Comment: Both Fiduciary and Beneficiary Participation Should Count. As noted above, the ABA proposes to determine material participation differently for taxation of the trust or estate than for income taxed to a beneficiary. As to taxation of the trust or estate, it is the authors' view that the participation rule for trusts and estates should parallel that for corporations. A trust or estate should be treated as materially participating if either (a)
participation by a majority in interest of the beneficiaries exceeds required levels, or (b) participation by fiduciaries (the analogues of a corporation's full-time employees) exceeds required levels. Cf. Treas. Reg. Section 1.469-1T(g)(3). Refusing to give effect to beneficiary participation would be unfair in cases where the trust or estate is most like a passthrough, e.g., for an estate owning a controlling interest in a family business in which the heirs work full-time. At the same time, refusing to give effect to fiduciary participation would be unfair in cases where the trust or estate is most like a non-passthrough, e.g., for a long-lived discretionary trust operating an ongoing business.

E. Income Taxable to Trust or Estate.

1. Focus on Income Taxed to Trust or Estate. This sub-section deals with the computational effects of Section 469 on the tax paid by trusts and estates themselves, as opposed to effects on beneficiaries.

2. Computing Distributable Net Income (DNI). Section 643(a) defines distributable net income (DNI) as taxable income subject to certain adjustments. None of these adjustments directly relate to passive losses. In general, the effect of disallowing a net passive loss under Section 469 is to increase DNI.

   a. Example. Suppose trust T has $80,000 of net portfolio income and $30,000 of passive loss, with no depreciation, depletion or amortization deductions. Absent the passive loss limitation, trust T would have DNI of $50,000. Thus, a distribution of $50,000 would leave T with no taxable income. Because of Section 469(a), however, trust T has $80,000 of DNI. If all income and losses are cash items, then, trust T would pay income tax even if it distributed all $50,000 available cash flow.

   b. Interaction with Allocations Between Principal and Income. The passive loss limitation is ultimately only a timing shift, disallowing a loss in one year but allowing the loss to be taken when the taxpayer's interest in the activity is sold in a later year. Because disallowing a passive loss increases DNI, however, the passive loss disallowance enables an income beneficiary to receive funds from a trust in an earlier year. Ideally, the income beneficiary will suffer from decreased DNI in a subsequent year when allowance of suspended losses decreases taxable income (and thus DNI). The net effect is to "front-load" distributions to income beneficiaries. The results may be more complicated, however, if passive losses or income are allocated by the trustee to principal rather than to income.

      i. Basic Example. Trust T has net income of $10,000 in 1989 and all subsequent years if passive loss rules are ignored. In 1989, Trust T has a net passive loss of $2,000 which is suspended. The suspended passive loss is used in 1990. With no passive loss limitation, Trust T would have had DNI of $10,000 each year. Because of the passive loss limitation, however, DNI is $12,000 in 1989 and $8,000 in 1990. If the trustee makes distributions each year equal to DNI, the income beneficiary will receive $12,000 in 1989 and $8,000 in 1990. The income beneficiary thus received $2,000 "early."

      ii. Example of Allocating to Principal. Suppose in the basic example that the trustee properly treats the $2,000 net passive loss as a charge to principal rather than income. Thus the trust's net income for 1989 will be $12,000 rather than $10,000. See Section 643(b) (defining "income" for Subchapter J purposes). DNI will still be $12,000 for 1989. Thus by distributing $12,000, the trust will owe no tax in 1989. For 1990, the $2,000 suspended PAL should probably be charged to principal as well. Thus trust income will be $10,000 and DNI will be $10,000 for 1990. The income beneficiary received $12,000 in 1989 and $10,000 in 1990. Thus the income beneficiary received an "extra" $2,000 at the expense of the remainderman, as would be expected if the burden of the passive loss was borne by principal.

   c. ABA Proposal. The ABA comments recommend that passive losses be from deductible to trusts solely for purposes of conducting DNI. This proposal would prevent unexpected effects between income beneficiaries and principal beneficiaries. The fisc should not adversely affected because both trusts and beneficiaries would remain subject to passive loss limits in computing taxable income. The authors agree with this proposal.

   a. Active Participation in Rental Real Estate. For the taxable years ending within two years of the decedent’s death, an estate may utilize the special $25,000 exception to the passive loss rules for active participants in rental real estate activities. See Section 469(i)(4). The $25,000 exemption amount must be reduced, however, by any amount used by the decedent’s widow in that year. Section 469(i)(4)(B).

   b. Suspended Passive Losses of Decedent. The death of a taxpayer is treated as a disposition of his entire interest in all his passive activities, freeing up suspended passive losses from prior years. Such suspended passive losses may be used, however, only to the extent they exceed the step-up in basis on death, i.e., the difference between basis to the transferee (estate or heir) over basis to the decedent. Section 469(g)(2).

4. Effect of Distributions of Passive Activities. If a trust or estate distributes to beneficiaries an interest in a passive activity, any suspended passive losses of the trust or estate attributable to that activity are capitalized, i.e., added to basis but made unavailable for use as passive losses. Section 469(j)(12).

F. Income Taxable to Beneficiaries.

1. Focus on Income Taxed to Beneficiaries. This sub-section deals with the computational effects of Section 469 as the tax paid by beneficiaries, as opposed to income taxed to the trusts or estates themselves.

2. Character of Distributions. Sections 652(b) and 662(b) provide that income included by a beneficiary because of a distribution from a trust or estate have the same character in the hands of the beneficiary as in the hands of the trust or estate. Regulations clarify that the character of each dollar of distribution is identical; in other words, distributions are treated as made pro rata out of ordinary income, capital gains, etc. of the trust or estate. This gives trusts and estates a partial passthrough nature. There is no reason to suppose that pro-ration does not apply to passive income as well. While it is not clear how this principle applies to passive income, it may permit beneficiaries with excess passive losses to benefit from passive income of a trust or estate.

   a. Example. Suppose trust T has $50,000 of net portfolio income, $30,000 of net passive income and $20,000 of net active income. Beneficiary B receives a $10,000 distribution from trust T. B can argue that under Section 652(b) or 662(b), B has $5,000 of portfolio income, $3,000 of net passive income, and $2,000 of net active income. This might permit B to use up to $3,000 of otherwise unusable passive losses and up to $5,000 of otherwise unusable investment interest deductions.

   b. Netting v. Gross-Up. Sections 652(b) and 662(b) generally apply only on a net basis. Although it would be more conceptually clean to have trust distributions carry through gross income and deductions, there is authority for such a position.

   i. ABA Proposal. The ABA comments suggest that distributions in excess of DNI be grossed-up, i.e., treated as pulling with them a pro-rata portion of gross income and gross deductions from each activity. This approach has been criticized as overly complex and without statutory authority.

3. Passthrough Deductions. Although losses of a trust or estate do not normally pass through to beneficiaries, deductions for depreciation, depletion and amortization for trust assets are generally available to beneficiaries rather than to the trust. See Sections 167(b), 611(b), 642(e) and 642(f). Such deductions must be classified as passive, active or portfolio as to the beneficiary.

   a. What Participation Counts? It is unclear whether such deductions are characterized according to the activities and participation of the trust or those of the beneficiary. In comments to Treasury, the American Bar Association has proposed that the character of deductions allocated to a beneficiary be determined with reference to the beneficiary’s activities and participation, while the AICPA would look only to participation by fiduciaries.
4. Distributions in Kind. If a trust or estate distributes to beneficiaries an interest in a passive activity, any suspended passive losses allocable to that interest are capitalized, i.e., are added to basis but are not available for use to offset income. See Section 469(j)(12). Note that this rule applies to distributions of part of a trust or estate's interest as well as to distributions of the entire interest. This rule parallels the general rule for dispositions by gift. Cf. Section 469(j)(6).

5. Distributions Subject to Throwback. If a trust which has undistributed net income ("UNI") for a previous year makes a distribution in excess of the current year's DNI, the taxes on the distribution are generally determined under the throwback rules of Sections 665 to 667. The throwback rules are already a source of some of the most ferociously complicated calculations in the income tax world; passive losses could further complicate the process. The American Bar Association has proposed that passive loss rules be ignored in computing tax under the throwback rules.

XXI. INSOLVENCY AND WORKOUTS.

A. Cancellation of Indebtedness Income. Forgiveness of a debt generally gives rise to cancellation of indebtedness income under Section 61(a)(12). While there is no specific authority, the authors believe that cancellation of indebtedness income should have the same Section 469 character as the interest deductions attributable to the cancelled debt: if all interest deductions are passive under Treas. Reg. Section 1.163-8T, cancellation of indebtedness income should likewise be passive. Where a debt is treated as mixed (e.g., part passive and part portfolio) under Treas. Reg. Section 1.163-8T, the cancellation of indebtedness income should be mixed in the same proportions.

B. Section 108. Section 108(a) provides that cancellation of indebtedness income is excluded from income for bankrupt taxpayers, or for insolvent taxpayers to the extent of insolvency. The price for this exclusion is a reduction of NOLs, depreciable basis and other tax attributes. See Sections 108(b) and 1017. Suspended passive losses, however, apparently are not reduced by Section 108. See Section 108(b)(2). Thus, for an insolvent or bankrupt taxpayer, passive losses may be more valuable than active losses (NOLs).

C. AMT Recharacterization. For purposes of the alternative minimum tax, passive losses of an insolvent taxpayer are treated as active to the extent of insolvency. Section 58(c)(1).

1. Interaction with Section 108. While the AMT recharacterization is usually beneficial, it is detrimental for a taxpayer excluding cancellation of indebtedness income under Section 108, since it converts AMT suspended PALs (not subject to Section 108 attribute reduction) into AMT NOLs (subject to such attribute reduction).

D. Bankruptcy Estate. Section 1398(g) provides that the bankruptcy estate succeeds to certain specified tax attributes of the debtor, and to other tax attributes to the extent provided in regulations. No regulations have been issued under Section 1398; thus the taxpayer apparently retains any suspended passive losses. Future regulations, however, retroactively invalidate such a position.

XXII. FUTURE REGULATIONS.

Future Regulations will include the following:

A. Treas. Reg. Section 1.469-6T, Dispositions;

B. Treas. Reg. Section 1.469-7T, Self-Charged Items;

C. Treas. Reg. Section 1.469-8T, Estate and Trust Rules;

D. Treas. Reg. Section 1.469-9T, Active Participation Rental Real Estate Activities;
E. Treas. Reg. Section 1.469-10T, Publicly Traded Partnerships; and

F. Treas. Reg. Section 1.469-1T(k), Former Passive Activities.

At a public forum in May 1990, IRS officials indicated that then-pending Section 469 regulations projects were likely to be issued in the following order: (1) technical corrections to the previously issued regulations, including particularly the self-enhanced rented profits recharacterization will, (2) self-charged interest rules, (3) disposition rules, and (4) estate and trust rules. See 90 TNT 98-9.

XXIII. EFFECTIVE DATES AND TRANSITION RULES.

A. In General. Section 469 and the regulations thereunder generally apply to taxable years beginning after December 31, 1986. The regulations provide exceptions, however, to the retroactive application of certain provisions. In addition, the regulations also specify how the transition rule of Section 469(m) is to be applied.

B. Effective Date. Except as otherwise explicitly provided, all provisions in the regulations apply for all taxable years beginning after December 31, 1986. Treas. Reg. Section 1.469-11T(a). Thus, for example, the rule concerning recharacterization of income from significant participation passive activities as active income would apply to income recognized in 1987.

1. Exception. An exception is provided to the extent that income is recharacterized under certain provisions in the regulations. Gross income from a passive activity will not be recharacterized under the rules relating to the rental of nondepreciable property, equity-financed lending activities, self-developed rental property, self-rented property or pass-through entities licensing intangible property for any taxable year beginning before January 1, 1988. Treas. Reg. Section 1.469-11T(a)(2). In addition, the self-rented property rule will not apply to any income that is attributable to the rental of property pursuant to a written contract entered into before February 19, 1988. Treas. Reg. Section 1.469-11T(a)(2)(ii).

2. Pre-1987 Events. The regulations also provide that the treatment for any post 1986 taxable year of any item of income, gain, loss, deduction or credit shall be determined as if Section 469 had been in effect prior to 1987. Treas. Reg. Section 1.469-11T(a)(4). In this regard, several of the rules concerning material participation also require a taxpayer to consider events which occurred prior to 1987 (i.e., the "five out of ten years" rule and the "any three year personal service activity" rule). For purposes of these rules, a taxpayer is treated as materially participating in a pre-1987 taxable year only if the 500 hour rule is satisfied. Treas. Reg. Section 1.469-11T(a)(2)(ii).

C. Transition Rule. Section 469(m) provides for the phasing in of the disallowance of PALs and PACs under Section 469. For taxable years beginning after December 31, 1986 and before January 1, 1991, the disallowance rules of Section 469 do not apply to the "applicable percentage" of the "pre-enactment" loss or credit. The applicable percentage of the pre-enactment loss or credit, i.e., the portion of the PAL or PAC which is allowed, is as follows:

<table>
<thead>
<tr>
<th>Year beginning in:</th>
<th>Applicable percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>65%</td>
</tr>
<tr>
<td>1988</td>
<td>40%</td>
</tr>
<tr>
<td>1989</td>
<td>20%</td>
</tr>
<tr>
<td>1990</td>
<td>10%</td>
</tr>
</tbody>
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1. Pre-enactment Loss or Credit. The pre-enactment loss or credit is determined by reference to pre-enactment interests in passive activities. Under the regulations, a pre-enactment interest is one which was held by the taxpayer on October 22, 1986, or acquired after such date pursuant to a binding contract to which the taxpayer was then
a party. Treas. Reg. Section 1.469-11T(c). In this regard, the portion of the loss or credit attributable to a pre-enactment interest cannot be increased by changes in his interest in the activity after such date, but it is reduced to the lowest amount to which the taxpayer's interest is reduced. Treas. Reg. Section 1.469-11T(c)(5)(i). Thus, for example, if a taxpayer has a 10% pre-enactment interest in a partnership and increases such interest to 15% on January 1, 1988, his pre-enactment interest would remain at 10%; if the interest were reduced to 5% on January 1, 1988, his pre-enactment interest in that year would be 5%. A taxpayer's interest is not treated as having increased or decreased, however, as a result of a partnership termination under Section 708(b)(1)(B). Treas. Reg. Section 1.469-11T(c)(5)(ii).

a. Operations Acquired after October 22, 1986. A pre-enactment interest includes the operations that are part of an undertaking that continues operations that were conducted by a person on October 22, 1986. Treas. Reg. Section 1.469-11T(c)(3)(i)(A). As a result, operations acquired after that date could be treated as pre-enactment interests if they are part of an undertaking in which the taxpayer had an interest on October 22, 1986. IRS officials have indicated, however, that retroactive technical corrections to the regulations will prevent such "stuffing" techniques. See Tax Notes (Mar. 5, 1990) at 1113.

b. Rental Real Estate Undertakings. Under Treas. Reg. Section 1.469-4T(k)(2), a taxpayer may elect to treat multiple rental real estate undertakings as a single activity. If a taxpayer makes such election with respect to rental real estate undertakings acquired both before and after October 22, 1986, the effect is to qualify the leases from the post enactment undertakings for phase-in relief. Again, however, retroactive technical correction may preclude this approach.

2. Termination of Partnerships. A taxpayer's pre-enactment interest in an activity is not treated as having increased or decreased solely as a result of a partnership termination after October 22, 1986 under Section 708(b)(1)(B). Treas. Reg. Section 1.469-11T(c)(5)(ii). Thus, a constructive termination of a partnership will not cause a pre-October 22, 1986 partner to lose his favored status.

3. Transfers to Estates or Trusts. If a taxpayer died after October 22, 1986, the transfer of the taxpayer's interest in an activity would terminate pre-enactment status because the estate or trust is a different taxable entity. Treas. Reg. Section 1.469-11T(c)(4), Example (4). Similarly, a gift of a pre-enactment interest after October 22, 1986 causes the donee to lose this favored status.

a. Distribution. In contrast, a trust or estate can distribute a pre-enactment interest to a beneficiary without altering the status of the interest. Treas. Reg. Section 1.469-11T(c)(b)(ii).

4. S Corporation Elections. If a C corporation elects S corporation status after October 22, 1986, or if an S corporation terminates such an election after that date, any pre-enactment interests of the corporation will lose such status.

5. Alternative Minimum Tax. The phase-in relief of Section 469(m) applies only for regular tax purposes. Thus, a taxpayer who is permitted to utilize a portion of his post 1986 PALs from an activity under this provision could be subject to a significant tax liability under the alternative minimum tax ("AMT").

6. Pre-1987 Investment Interest Deduction Carryovers. Prior to 1986, Section 163(d) limited a noncorporate taxpayer's deduction for investment interest to $10,000 plus an amount equal to the taxpayer's net investment income. Investment interest was defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment, including property subject to a net lease. Net investment income was the excess of investment income over investment expenses. Investment income was generally income from property held for investment (such as stocks or bonds), including any property subject to a net lease; investment expenses were deductions other than interest. Any investment interest expense that was disallowed for a taxable year under Section 163(d) was treated as investment interest paid or accrued in the next taxable year.
a. 1986 Amendment. In 1986, Section 163(d) was amended to provide that the amount allowed as a deduction for investment interest for any taxable year shall not exceed the taxpayer's net investment income. Section 163(d)(3)(B)(ii) provides that investment interest shall not include any interest that is taken into account under Section 469 in computing income or loss from a passive activity. In addition, under Section 163(d)(5), property held for investment does not include any interest held by a taxpayer in an activity which is a passive activity for purposes of Section 469. Because all rental activities are per se passive activities under Section 469, property subject to a net lease would be treated as a passive activity and not as property held for investment.

b. Interaction of PAL and Section 163(d) Limitation. Although the limitations on PALs and investment interest each stand alone, a problem arises concerning the interaction of the limitation on PALs and the carryover of pre-1987 investment interest deductions. Activities that will be treated as passive activities in post-1986 taxable years include activities that were treated as giving rise to investment interest in pre-1987 taxable years, including property that is subject to net leases. If a taxpayer purchased property prior to 1986 and used such property in a net lease, any interest deductions would have been treated as investment interest prior to 1986. As a result of the changes in Section 163(d) and 469, however, interest deductions and income from a net lease would be treated as passive activity deductions and income, respectively, in 1987 and thereafter. Furthermore, any gain on the sale of the property would be treated as passive activity gross income. The investment interest deductions incurred in pre-1987 taxable years would not, however, be treated as passive activity deductions and could not offset any gain on the sale of the property.

i. Example. Assume that on January 1, 1983, a taxpayer purchased property that it leased on a net-lease basis to an unrelated third party. The purchase price for the property was $10 million, and the taxpayer incurred interest expense of $1 million per year. Because the income from the property was only $750,000 per year, the taxpayer had an investment interest deduction carryover of $250,000 per year for four years. If the taxpayer sold the property on December 31, 1986 for a gain of $1 million, the taxpayer could have utilized the investment interest carryovers to offset this gain.

ii. Example. What happens, however, if the taxpayer does not sell the property until January 1, 1988? In that event, the net-leased property would be treated as a passive activity in 1987. The excess interest expense of $250,000 in 1987 would generate a passive activity loss that would be limited under Section 469. When the building is sold for a gain of $1 million, only the $250,000 PAL from 1987 can be utilized to offset this gain. The suspended investment interest carryovers from pre-1987 taxable years are not passive activity deductions and, hence, cannot be utilized to offset the gain from the sale of a passive activity.


d. TAMRA Election. To address this problem in the interaction of the limitation on passive activity losses and suspended investment interest deductions, Section 1005(c)(11) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) follows the Lipton letter suggestion and provides that if (1) any interest deductions of a taxpayer were suspended prior to 1987 under Section 163(d), and (2) the suspended interest expense was paid or accrued on indebtedness incurred or continued to purchase property that was treated as property held for investment prior to 1987 and as property used in a passive activity in the taxpayer's first taxable year beginning after December 31, 1986, then the taxpayer may elect to treat the suspended investment interest deductions as passive activity deductions and not as investment interest deductions.

e. Revenue Notice 89-36. Notice 89-36 provides the requirements and conditions for making an election under Section 1005(c)(11) of TAMRA (the "Election"). The most important requirements are that the Election is an all-or-nothing choice that applies to all investment interest carryovers of the taxpayer; partial elections are not permitted. Any suspended deductions that are treated as passive activity deductions as a result of the Election are not eligible for the phase-in rule under Section 469, i.e., the suspended deductions can only be utilized to offset passive
activity gross income. Although the Election will be beneficial to many taxpayers, it could be harmful to taxpayers who lack passive activity gross income but have significant net investment income. A thorough discussion of the election is found in Lipton, “Filing Alert: To Elect or Not to Elect Under Notice 89-36,” Tax Notes (Apr. 10, 1989) at 201.

f. Method of Election. A noncorporate taxpayer that is subject to Section 469 may make the Election provided by TAMRA Section 1005(c)(11) by filing amended returns for 1987 and any subsequent taxable year for which returns were filed prior to making the Election. The amended return must be filed, however, on or before the later of (1) the due date (including extensions) for the taxpayer’s return for the first taxable year beginning after December 31, 1987 (generally, the taxpayer’s 1988 return), or (2) August 15, 1989. Thus, if a taxpayer does not file an extension for his 1988 return, the Election under TAMRA Section 1005(c)(11) must be made by filing amended returns no later than August 15, 1989; if the due date for the taxpayer’s 1988 return is extended until October 15, 1989, the taxpayer will have until that date to make the Election.

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