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**

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I. OVERVIEW.

The purpose of the rules concerning passive activity losses ("PALS") is to disallow the utilization of deductions from passive activities to offset income which is not from passive activities, e.g., salaries, interest, dividends, and "active" business income. This rule applies to individuals, estates, trusts, certain closely-held 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. Passive activities generally include (A) any trade or business activity in which the taxpayer does not materially participate and (B) any rental activity. There are special rules for working interests in oil and gas properties as well as rental real estate activities in which certain moderate-income individuals 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.

This outline generally follows the steps which a taxpayer or his tax advisor must take in applying the PAL rules. This outline reflects Section 469 as enacted as well as the first set of PAL regulations issued in February 1988. The first set of regulations were temporary and proposed regulations which included the following topics:

A. Treas. Reg. §1.469-1T, General Rules;
B. Treas. Reg. §1.469-2T, Passive Activity Loss;
C. Treas. Reg. §1.469-3T, Passive Activity Credit;
D. Treas. Reg. §1.469-5T, Material Participation; and

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. §469(a)(2).
1. Widely Held 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, applications to widely-held corporations would be a logical next step for Congress.

B. Partnerships and S Corporations. The application of the PAL rules to individuals includes as a general rule trades or businesses and rental activities conducted through partnerships (both general and limited) and S corporations. Senate Finance Committee Report at page 720.

C. Closely Held Corporations. A 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. §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 §465(a)(1)(B) and §542(a)(2). 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. See §469(j)(2), Treas. Regs. §1.469-1T(g)(2)(i) and 1.441-4T(d).

1. Attribution. Attribution of ownership is applied for purposes of determining personal service corporations.

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 which is engaged in a service industry 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. §1.469-1T(g)(2)(i).
E. Corporate Change in Status. A change in status (e.g., if a personal service corporation ceases to be subject to the PAL rules) 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. Treas. Reg. §1.469-1T(h)(1).

G. Taxable v. Tax Exempt Corporation. The PAL rule does not distinguish between corporations which are taxable entities and those which are exempt from taxation.

H. Other Corporations. If a corporation satisfies the definition of either a closely held corporation or a personal service corporation (Treas. Reg. §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. §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. §1.469-2T(e) (special rules for partnerships and S corporations) which contains special computational rules that apply to partnerships and S corporations but not to grantor trusts.

III. ACTIVITY.

A. 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 partnership and S corporation that could possibly have a passive activity with respect to one shareholder or partner will have to calculate the taxable income or loss from each of the entity's activities. The activity concept is the cornerstone of Section 469. Moreover, the concept is a new one which does not rely upon legal entities.

B. Regulations. The first set of Treasury Regulations issued in February of 1988 did not include a definition of the term "activity." It is anticipated that such regulations will be issued in the near future. When issued, the definition of activity will be in Treas. Reg. §1.469-4T.
It is unfortunate that the first set of regulations did not define an activity, because many of the concepts in the regulations depend upon the definition of an activity. For example, under Treas. Reg. §1.469-5T(a)(1), a taxpayer materially participates in an activity in which he participates for more than 500 hours in the taxable year. This determination will depend upon where the activity line is drawn. See also Treas. Reg. §1.469-2T(f)(2), relating to recharacterization of income from certain "activities."

C. Definition of Activity. The statute does not define an activity. Under the Senate Finance Committee Report ("SFC") 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 SFC Report at 738-741.

2. Section 183. Analogy is made in the SFC at page 739 to the rules under Section 183 to determine whether an activity constitutes a hobby. The provision in Treas. Reg. §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. SFC Report at 739.

D. Different Products and Services. The SFC Report at page 739, provided that two or more substantially different products or services generally result in two or more activities. 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. SFC Report at 739.

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

F. Farms. Each farm will generally constitute a separate activity. SFC Report at 740.

G. Real Estate Projects. Each separate rental real estate project (a project can include an integrated group of buildings) will generally be treated as a separate activity. SFC Report 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. SFC at page 743. Management of a real estate project may also give rise to a separate activity.

1. Integrated Project. An integrated apartment project or shopping center generally will be treated as a single activity. SFC Report at 740.

2. Management Services Provided as a Partner. The treatment of management services illustrates the problems inherent in the narrow definition of an activity in Section 469. On the one hand, rental income from a rental activity is clearly passive activity income. If, however, a partner receives a management fee instead of his distributive share of rental income, the partner may not have passive activity income where the partner materially participates in the management activity. See Treas. Reg. §1.469-2T(c)(4) wherein Treasury provides that personal service income earned by a partner does not include any distributive share of gross partnership income (within the meaning of Section 704(b)), even where the services rendered by the partner to the partnership are not otherwise compensated for by adequate salary.

3. Separate Activities. Real estate entrepreneurs seeking passive income will try to avoid materially participating in income producing non-rental activities, e.g., leasing, management, land sales, condominium sales. If the regulations contain a "broad" definition of an activity, these planning opportunities may be limited.

H. Special Treatment Undertaking. Any undertaking that is accorded special treatment under the PAL rule is not treated as part of the same activity as any undertaking that does not receive such treatment. SFC 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.

1. Facts and Circumstances. The Blue Book at page 247 indicates that such personal services are not considered for determining other facts and circumstances with respect to the activity. If such other facts and circumstances include material participation, this result cannot be right. A full-time employee
would not be treated as materially participating in an activity in which he owns an interest. This language is better viewed as simply clarifying that wages and salaries are not passive income, even if the taxpayer does not materially participate in the activity. See Treas. Reg. §1.469-2T(c)(4), which excludes personal service income from the calculation of passive activity gross income.

2. Participation in Rental Activities. The rule concerning special treatment undertakings will be important in applying the material participation test of Treas. Reg. §1.469-5T. Under this rule, the hours devoted to rental activities do not count towards the quantitative test for material participation. Thus, for example, a real estate developer who devotes 300 hours to new construction and 1500 hours to managing completed rental properties would not satisfy the 500-hour requirement of Treas. Reg. §1.469-5T(a)(1) for his construction activity, even if the construction and rental activities were related.

I. Impact of Legal Entities. Legal entities are disregarded in determining what constitutes an activity. SFC at page 740. 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 tests, 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 may be required to file a separate schedule K-1 for each activity. See Tax Notes, February 8, 1988 at page 543.

J. Incidental Activities. Whether an activity is separate from a related activity depends upon whether the former is incidental to the latter. Conf. Report at page II-148. See VIII.B.2.d., below.

1. Rental Activities. The regulations provide rules for determining whether the rental of property is incidental to a non-rental activity. Treas. Reg. §1.469-1T(e)(3)(vi). Generally, the rental of property held for investment or used in a trade or business will be incidental only if gross rental income is less than 2 percent of lesser of (i) the unadjusted basis of the property or (ii) the fair market value of the property. Special rules apply to property held for sale which is rented in the year it is sold, or lodging provided for the convenience of the employer. These exceptions are very narrow and will not apply in many "normal" situations, e.g., an office sublease.
2. Incidental Farming. Under Treas. Reg. §1.469-1T(e)(3)(vi), if a landowner were to lease his land for farming purposes and the rental income exceeded the 2 percent ceiling, a separate rental activity would be created. Thus, any tax losses generated from the rental activity would be subject to the PAL rules. If such rental were incidental to the investment, tax losses would not be suspended under Section 469; instead, interest expenses would be covered under Section 163(d).

K. Legal and Accounting Impact. Facts and circumstances determinations may be required for every pass-through entity. Alternatively, taxpayers may be inclined to form separate legal entities for each activity in which they are involved, if they can accurately determine what an activity is and that they have identical owners for each undertaking that is part of the activity. In either event, legal and accounting interference in business will be dramatically increased.

1. Reporting Requirements. The reporting requirements for partnerships may become onerous when legal entities are disregarded, effectively mandating multiple legal entities.

2. Increased Administrative Burden. The formation of multiple entities will increase the administrative burden of the Internal Revenue Service ("Service").

3. Generation of Passive Income. The formation of multiple entities may aid a taxpayer who wants to generate additional income in activities in which he does not materially participate.

L. Unanswered Questions. Many of the most basic questions concerning the definition of an activity are unanswered at this time. For example, it seemed clear that different stores at different locations would be separate activities, but Treasury has indicated in recent months that it may take a much broader view of the definition of an activity. See Tax Notes, February 8, 1988, at page 541.

1. Senate Finance Report. If regulations under Section 469 follow the path indicated by the SFC Report, an activity should be defined rather narrowly as the smallest appropriate unit for the measurement of gain or loss. This approach would be consistent with limiting the use of passive losses against active income, but would facilitate taxpayers who want to generate passive activity income.
2. Elective Broad Definition of Activity. It has been suggested that a narrow definition of an activity, consistent with the Senate Report, could be coupled with an elective provision to permit taxpayers (with the consent of the Service) to treat several activities as one. This 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, Tax Notes, December 8, 1986, p. 969; Tax Notes, June 15, 1987, p. 1139.

   a. Example. If a taxpayer owned 5 stores, each 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.

3. Multiple Definitions of an Activity. The Service has indicated that it is considering applying a different definition of an activity for different passive activity loss rules. For example, for purposes of freeing suspended passive losses upon a disposition, the Service might take the narrow view of the definition of an activity, which narrow definition is apparently required by the legislative history. At the same time, for purposes of determining whether a taxpayer materially participated in an activity, the Service might take a broader view of the same activity. The use of a broad definition of activity in and of itself seems contrary to the statute and its legislative history. The use of a broad definition for one purpose under Section 469 rule and a narrow definition of the same activity for another purpose would likely be a quite controversial regulation.

M. 1987 Definition of Activity.


   a. Transitional Rule. Under Notice 88-94, a taxpayer may treat operations in which the taxpayer has an interest as one or more activities under any reasonable method. This transitional rule applies to all activities conducted during
taxable years ending prior to the date that forthcoming regulations (in Treas. Reg. §1.469-4T) concerning the definition of an activity are published in the Federal Register.

b. Reasonable Method. What constitutes a reasonable method? Notice 88-94 provides several examples. First, it generally is reasonable to treat operations that involve the provision of similar goods or services as part of the same activity. Thus, for example, all of a taxpayer's operations that involve farming (within the meaning of Section 464(e)(1)) may be treated as one activity of the taxpayer. Second, business operations that are vertically integrated (e.g., manufacturing, wholesaling and retailing substantially similar property) may be treated as part of the same activity, although it may also be reasonable to treat such operations as separate activities. Third, a taxpayer may generally treat business operations as part of the same activity if they are conducted at the same location and are owned by substantially the same persons in substantially the same proportions. Fourth, a taxpayer's treatment of rental real estate operations either as a single activity or as multiple activities generally will be considered reasonable.

On the other hand, Notice 88-94 also states that it is not reasonable to treat rental operations as part of a trade or business activity, or to treat non-rental operations as part of a rental activity, unless the operations are ancillary to the activity and are insubstantial in comparison to the activity. Thus, real estate development and construction operations may not be treated as part of a rental activity even if the taxpayer rents the property upon the completion of development and construction.

The "any reasonable method" definition of an activity set forth in Notice 88-94 is a transitional rule. Notice 88-94 explicitly states that no inference should be drawn from the transitional rule concerning the general definition of an activity which will be set forth in future regulations in Treas. Reg. §1.469-4T. Moreover, all of a taxpayer's activities (including activities that were conducted in taxable years to which the transitional rule in Notice 88-94 applies) must be determined under the general rules in the regulations for the first taxable year in which the rule set forth in Notice 88-94 does not apply. If a taxpayer's activities determined under the regulations differ from the activities determined under Notice 88-94, a special transition rule will prescribe the manner in which disallowed deductions and credits are to be allocated among the taxpayer's activities. In the meantime, Notice 88-94 is an administrative pronouncement which constitutes substantial authority for purposes of Section 6661.
Notice 88-94 does not prioritize among the various options listed. 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 where he manufactures machinery, and who also has a sales force which sells the machinery, would be justified in treating this 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 horizontally integrated operations (e.g., management, leasing, land sales, home sales, etc.) apparently could treat these operations as one activity or as separate activities in 1987.

The only limitation which Notice 88-94 places on a taxpayer is that the definition of an activity must be a "reasonable" one. The range of options available to taxpayers is highlighted by comparing the generally broad definition of an activity in Notice 88-94 (e.g., all farms can be treated as one activity) with the narrower scope of an activity in the legislative history of Section 469. A taxpayer must also be aware, however, that whatever reasonable definition of an activity the taxpayer selects for 1987 may be undone by the final regulations. This could lead to future computational problems for taxpayers who have PALs which are not fully utilized to offset other income in 1987.

The one area in which Notice 88-94 is not clear involves whether rental operations are to be treated as part of a trade or business. Under Notice 88-94, a taxpayer may treat rental operations as part of a trade or business activity if the operations are ancillary to the activity and are insubstantial in comparison to the activity. This statement appears to be contrary to the rule concerning incidental rental activities in Treas. Reg. §1.469-1T(e)(3)(vi). The definition of incidental rental activities essentially determines when the rental of property will be treated as a separate activity. Under this provision, the rental of property is treated as incidental to a non-rental activity only if certain quantitative tests are satisfied.

c. Planning. For taxpayers who have made investments which are subject to Section 469, Notice 88-94 is an extremely important planning tool. There is no universal planning prescription, however. 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.

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. See discussion of material participation below at VI.

For example, assume that Smith, the owner of ten convenience stores, works an equal number of hours at each store and works 800 hours per year in the 10 stores combined. Smith also owns rental property which generates a loss, whereas the ten convenience stores are profitable. If Smith treats all ten stores as a single activity, he will materially participate in the activity, so that the income from the stores cannot be offset by the loss from his rental activity. On the other hand, if Smith treats each store as a separate activity and he works not more than 100 hours in each store during the taxable year, the income from the stores will be income from passive activities which can be offset by the rental loss.

There will also be situations where taxpayers will want to aggregate activities. For example, assume that an individual 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 activity losses subject to the limitations of Section 469. On the other hand, if the farmer treats the farms as a single activity, his participation will exceed 500 hours. Thus, losses from the farming activity would be active losses which could offset any type of income.

Notice 88-94 may be most important, however, to persons involved in the real estate industry. The per se treatment of rental activities as passive creates a problem for real estate developers, in that losses from rental activities cannot be utilized to offset income from construction and development activities in which the developer materially participates. Thus, for example, if a developer owns a rental activity which incurs a
loss and also is 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, the developer 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.

What about taxpayers who have already filed their 1987 tax returns? Because Notice 88-94 applies to all taxable years ending prior to the issuance of regulations defining an activity, such taxpayers appear to be entitled to file amended returns which adopt any reasonable definition of an activity. Thus, if Smith had treated his 10 convenience stores as a single activity in his 1987 returns, Smith would be permitted to amend his return and adopt a different treatment. Notice 88-94 only applies to the 1987 tax year and does not state whether the definition of an activity adopted by a taxpayer for 1987 would apply to a subsequent taxable year if no regulations have been published regarding definition of activity for such subsequent tax year; presumably the Service intends to issue regulations concerning the definition of an activity before taxpayers file their returns for 1988.

Notice 88-94 should not be viewed as permanent solace, however, particularly by real estate developers and other taxpayers who may favor a narrow definition of a trade or business activity. In recent public appearances, representatives of the Service have indicated that the regulations, when issued, will likely adopt a relatively broad definition of a trade or business activity. The reason that a broad definition is being considered is that such definition will make it more difficult for taxpayers to generate passive income which can be offset by passive losses. The Service recognizes that a broad definition of an activity will also make it easier for a taxpayer to satisfy the material participation test and thereby generate active losses, but the Service has apparently decided not to place the emphasis in the regulations on the elimination of such active losses. This choice by the Service appears to be contrary to the original intent of Section 469, which was the limitation on losses generated by taxpayers' investments. It will be interesting to see whether the regulations will ultimately choose a broad or narrow definition of an activity, or whether taxpayers will be permitted to continue to use any reasonable method or some other elective alternate. See also Lipton & Evaul, Tax Notes, December 8, 1986, at 969; Lipton & Evaul, Tax Notes, June 15, 1987, at 1139.
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 use of loss rules, are publicly traded partnership activities. See §469(k).

B. Non-Passive Activities. To properly understand what a passive activity is, it is necessary to identify what a passive activity is not. Each active activity, i.e., non-rental activity in which the taxpayer materially participates, is not a passive activity. Personal service income is not income from a passive activity. Section 469(e)(3). A qualified working interest activity, see §469(c)(3), is not a passive activity, even though the taxpayer does not materially participate in the trade or business of such qualified working interest activity. See §469(c)(4).

C. Recharacterized Income from a Passive Activity. Included in the category of passive activities are certain activities, the income from which is recharacterized under Treas. Reg. §1.469-2T(f) as either (1) income from an active activity or (2) income from a portfolio activity. See the Significant Policy Issues Preamble (hereinafter "Preamble"), §XVI to Treas. Reg. §1.469, Recharacterization of Certain Passive Activity Gross Income. See Treas. Reg. §1.469-2T(f)(10). Recharacterized active income includes passive income from (1) significant participation activities, (2) self-enhanced rental properties, and (3) self-rented properties. Recharacterized portfolio income includes passive income from (1) nondepreciated rental property, (2) equity-financed lending activities, and (3) intangible property licensing by a pass-through entity. See discussion below at XIII for application of these recharacterization rules as required by Treas. Reg. §1.469-2T(f). Additionally, recharacterization outside of the provisions of Treas. Reg. §1.469-2T(f) occurs in a number of other instances in the Code and Regulations. See discussion below at Section XIII.

D. Disposition of a Passive Activity.

1. General Rule. In general, gain recognized from disposition of a passive activity or an interest in a passive activity held by a partnership or S corporation is passive income
when recognized. Treas. Reg. §1.469-2T(c)(2). Likewise, a loss that arises in connection with the conduct of a passive activity is a passive loss when recognized. Treas. Reg. §1.469-2T(d)(1). Under Section 469(g), however, a passive loss resulting from the complete disposition of an interest in a passive activity will in certain circumstances not be subject to the limitations of Section 469(a). See Section XVIII, below. In addition, in certain situations (e.g., a sale of property used in more than one activity during the preceding 12 months) any gain or loss may be recharacterized, while in other situations (e.g., a sale of substantially appreciated property) only the gain from a disposition is subject to recharacterization. Treas. Regs. §1.469-2T(c)(2)(ii) and (iii). See Section XVII, below.

2. Pre-1987 Installment Sales.

a. Revenue Notice 87-08. Revenue Notice 87-08, 1987-3 I.R.B. 11, 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.

b. Commentators. This position was criticized by certain commentators. See Lipton & Evaul, Tax Notes, April 20, 1987, page 306.

c. Technical Correction. Technical corrections are presently being considered by Congress that would specifically overrule Revenue Notice 87-08. See Section 105(a)(10) of HR 4333, S 2238.

d. Treasury Regulation. Treas. Reg. §1.469-Preamble, §IX.D. takes notice of the proposed technical correction and provides that the Service will not enforce the rule announced in Revenue Notice 87-08 unless and until such rule is adopted in regulations. At present, there is no such regulation. Therefore, until a contrary regulation is promulgated, pre-1987 installment sales of passive activities result in passive income in post-1986 recognition years. Even if Congress does not enact the proposed technical correction, a taxpayer could raise a strong argument on the basis of the statute and also Treas. Reg. §1.469-11T(a)(4) (relating to effect of events occurring in years prior to 1987) that pre-1987 installment sales should result in post-1986 passive income if the sale related to a disposition of all or a portion of a passive activity.
E. **Section 212 Activities.** Pursuant to regulations to be issued, a passive activity may include an activity conducted for profit (within the meaning of Section 212), including an activity that is not a trade or business. The initial set of Temporary and Proposed Regulations included no such rules but left open the possibility of future regulations. See Treas. Reg. Preamble §II.A.

1. **Raw Land Investment.** Such a rule would be intended to apply to activities in which losses are incurred, but which activities do not satisfy the definition of a trade or business. Congress anticipated that the exercise of this authority would be appropriate where activities other than the production of portfolio income are involved. Blue Book at p. 217. There is no indication that Treasury has any intent to apply such a rule to raw land investment property.

2. **Raw Land of a Developer.** Treasury officials have indicated that raw land held by a real estate development partnership prior to beginning a trade or business activity might be an appropriate place to exercise its regulatory authority to treat Section 212 activities as passive activities. The result of this position would be that interest incurred to carry such investment land would be subject to Section 469.

V. **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" generally includes an activity that involves the conduct of a trade or business within the meaning of Section 162. Treas. Reg. §1.469-1T(e)(2).

B. **Research and Experimental Expenditures.** 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) was adopted) are paid or incurred with respect to a trade or business activity. Section 469(c)(5) and Treas. Reg. §1.469-1T(e)(2)(A)(2).

C. **Interest Income.** As a general rule, interest income on loans and investments made in the ordinary course of the trade or business of lending money is treated as trade or business gross income. Section 1.469-2T(c)(3)(ii)(A). But see Treas. Reg.
§1.469-2T(f)(4), discussed below, wherein gross interest income from passive equity-financed lending activities may be recharacterized as portfolio income.

D. Interest on Accounts Receivable. Interest on accounts receivable arising from the ordinary course of performing business services or property sales, but only if credit is customarily offered customers, is treated as income from a trade or business activity. Treas. Reg. §1.469-2T(c)(3)(ii)(B).

E. Annuity and Life Insurance Investment. Income from the ordinary course of business investment in the trade or business of furnishing life insurance, annuities or reinsuring insurance company losses is treated as income from a trade or business activity. Treas. Reg. §1.469-2T(c)(3)(ii)(C).

F. Trading or Dealing in Property.

1. In General. Income or gain from the ordinary course of business of trading or dealing in property will be treated as trade or business income if the activity is otherwise a trade or business activity. Treas. Reg. §1.469-2T(c)(3)(ii)(C).

2. Personal Property. An activity of trading personal property (as defined by Section 1092(d) without regard to paragraph (d)(3) thereof) is not a passive activity, even if it is otherwise a trade or business in which the taxpayer does not materially participate. Treas. Reg. §1.469-1T(e)(6). The character of income or loss from such an activity appears to depend upon whether or not the taxpayer is a material participant. Such income or loss would appear to be portfolio if the taxpayer did not materially participate, and to be active if the taxpayer does materially participate.

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.
3. Property Formerly Held for Investment. Income or gain from property sold in the ordinary course of a dealer's trade or business is portfolio income if the dealer held the property for investment at any time prior to recognition of the income or gain. Treas. Reg. §1.469-2T(c)(3)(iii). Apparently, losses therefrom would be passive or active depending upon the participation level of the taxpayer.

a. Example. Assume that individual A held raw land for investment and then subdivided the property and sold residential lots. If the lots are sold at a loss, the loss is active or passive depending on A's participation level. If the lots are sold at a gain, the gain is portfolio because it is deemed not to be derived from a trade or business.

G. Royalties. 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. Regs. §1.469-2T(c)(3)(iii)(B) and 2T(c)(3)(ii)(E). The determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property is made on the basis of all of the facts and circumstances. Treas. Reg. §1.469-2T(c)(3)(iii)(B)(2). There is a "safe harbor" where a person will be deemed to have performed substantial services or incurred substantial costs if (a) the expenditures incurred in developing or marketing exceed 50% of the royalties includible in gross income in that year, or (b) the expenditures incurred in such year and all prior taxable years for developing or marketing exceed 25% of aggregate capital expenditures made with respect to the property in all taxable years. Treas. Reg. §1.469-2T(c)(3)(iii)(B)(2)(ii). In the case of a pass-through entity (S corporation, partnership, estate or trust), the determination of whether royalties are from a trade or business is a question decided at the entity level. For taxpayers purchasing interests in such entities after creation, development and marketing, the royalty income is passive income, but is subject to recharacterization as portfolio income under Treas. Reg. §1.469-2T(f)(7) discussed below at XIII.

H. Patronage Dividends. 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. §1.469-2T(c)(3)(ii)(F). 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.

VI. MATERIAL PARTICIPATION.

A. In General. If a trade or business activity is a non-rental trade or business, the next question is whether the taxpayer materially participates in this activity. An activity is a passive activity if the taxpayer does not materially participate in such activity. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous and substantial. Section 469(h).

B. Regulatory Approach. Treas. Reg. §1.469-5T provides the definition of material participation. As indicated by public statements made in December of 1987, Treasury has in general taken a quantitative view to the definition. The regulations, however, have reduced the quantitative test to a standard which is considerably lower than a careful reading of the statute and legislative history would appear to indicate.

1. Seven Ways to Materially Participate. With the exception of special rules for limited partners and certain retired farmers and surviving spouses of retired or disabled farmers, the following seven rules determine who materially participates:

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. §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. §1.469-5T.

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. §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.

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 an activity not less than any other individual (including non-owner participation). Treas. Reg. §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. §1.469-2T(f)(2), discussed in XIII below.

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. §1.469-5T(a)(4). A significant participation activity is one in which the individual participates for more than 100 hours but not more than 500 hours. Treas. Reg. §1.469-5T(c).

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. §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. §1.469-5T(b)(2)(ii) and facts and circumstances rule example VI.B.1.g.ii.(A), below.

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

e. Five out of Ten 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. §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, the prior years material participation must be determined only under the 500 hour rule. Treas. Reg. §1.469-5T(j).
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.

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. §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. §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. §1.469-5T(f)(2)(ii).

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 in a regular, continuous and substantial basis. Treas. Reg. §1.469-5T(1)(a)(7). General guidance on what constitutes appropriate facts and circumstances is not yet available. Such guidance is reserved for future regulations. Section XVIII.D. of the Preamble. Treas. Reg. §1.469-5T(b)(2), however, does set forth specific rules which leave the facts and circumstances rule quite narrow even without further guidance.

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 the regulations. See Treas. Regs. §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. §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. §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. §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. §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. §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. §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. §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.

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. §1.469-5T(b)(2)(iii).
2. Participation. In general, any work done in any capacity 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 activities. Treas. Reg. §1.469-5T(f)(1). Thus, for example, if individual A owns an interest as a limited partner in partnership ABC, and A works for the corporate general partner of ABC in an activity of ABC, such work will be treated as participation by A in such activity. Treas. Reg. §1.469-5T(k), Example (1).

a. Exception - Work Not Customarily Done By Owners. Where a taxpayer does work which has as one of its principal purposes the avoidance of §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 material participation. Treas. Reg. §1.469-5T(f)(2)(ii).

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.

b. 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 or operations of the activity. Treas. Reg. §1.469-5T(f)(2)(ii)(A). See Blue Book at page 240. Work done as 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


c. Participation of Spouse. Participation of a spouse is treated as participation of an individual. Section 469(h)(5).
i. Example. Individual A owns a weekend farm. Before A got married, he and his fiance each spent 5 hours per week working on the farm; a hired hand worked 10 hours per week. After A got married on January 1, 1990, A and his wife continued to spend 5 hours per week working on the farm. A would not materially participate under the 500-hour rule in the farm activity for pre-1990 taxable years (his participation was only 260 hours) but he would satisfy the 500-hour rule for 1990 and subsequent years, i.e., A's participation and the participation of A's wife total 520 hours per year.

d. 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. §1.469-5T(f)(4). This proof requirement is similar to the old Cohan rule for substantiating business expenses. Such a rule is the most liberal time-keeping rule the Treasury could have reasonably provided for taxpayers. Taxpayers should have substantial flexibility in proving participation.

e. 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. §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 SFC Report 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. §1.469-2T(f)(2).

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. §1.469-5T(e)(1) and (2). See §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. §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 respect 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. §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. §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. §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 the Treas. Reg. §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 as a wholly owned S corporation for liability purposes, or, apparently for PAL rules purpose, his income with respect to his limited partnership interest would be passive under Treas. Regs. §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.

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. §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.

C. Statutory Explanation. The approach in the regulations to the material participation test 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 SFC Report at pages 733-745, however, provided several examples.

1. Movies. In the case of a general partnership engaged in the business of producing movies, among the services that are necessary are (a) writing screenplays, (b) reading and selecting screenplays, (c) negotiating with agents who represent writers, actors or directors, (d) directing, editing, scoring or acting in the film, (e) actively negotiating regarding financing and distribution, and (f) actively supervising production. An individual who does not make a significant contribution concerning these or similar services does not materially participate in the partnership. For example, merely approving financing, accepting a recommendation regarding selection of the screenplay, cast, locations and director, or appointing others to perform the above functions, generally does not constitute material participation.

2. Principal Business. A taxpayer is most likely to have materially participated in an activity where involvement in the activity is the taxpayer's principal business. For example, an individual who devotes 35 hours per week (1820 hours per year) in operating a grocery store would be treated as materially participating in that business. A factor to be considered is whether, and how regularly, the individual is present at the business.

3. Horse Breeding. Regular contact 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.

4. Mississippi Barge. Another example in the SFC Report concerns an investor in a barge that transports grain. The investor 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.

5. Regular, Continuous and Substantial. The foregoing examples do not attempt to define the words "regular," "continuous," and "substantial."

a. Regular. "Regular" apparently refers to the temporal concept that participation is at a normal interval (i.e., not infrequent). For example, doing something every day would be regular.

b. Continuous. "Continuous" participation apparently refers to the fact that participation must take place throughout the taxable year. For example, a taxpayer could be involved regularly in an activity for one month, but such participation would not be continuous.

c. Substantial. "Substantial" apparently refers to the quantity of time expended, and may also be a qualitative test as well. For example, involvement in an activity for 2 minutes a day, every day, would be regular and continuous but not substantial.

i. Qualitative Test. The "substantial" test could also be qualitative. This qualitative test could imply that simply earning a salary for services is not material participation. This analysis is contrary, however, to the treatment of management in the same manner as other services for purposes of the material participation test. It is more likely that the "substantial" requirement is intended to limit material participation to situations in which involvement is real both in a temporal (regular and continuous) and level of involvement (substantial) sense. A "qualitative" test might be used to prevent abuse where a taxpayer is involved in only one activity, but only for a limited period of time or in a minimal role.

6. Regulations. The Treasury Regulations found in §1.469-5T, as explained above, make no attempt to define the terms regular, continuous and substantial.
7. **Line of Business Test and Management Participation.** One of the more difficult problems in determining the application of the material participation test relates to individuals involved in management.

a. **SFC Report.** The SFC Report 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 SFC Report 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. This proposal created significant turmoil and controversy.

i. **Line of Business Test.** The "line of business" exception is contained in the Conference Committee Report as a "clarification" to the material participation test. Rather than provide a clarification, however, the line of business exception has greatly added to the confusion. The line of business exception is explained as follows:

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.
ii. Interpreting the Line of Business Test. The meaning of this line of business rule was unclear. On the one hand, this rule could be utilized to prevent unfair treatment of taxpayers. On the other hand, this rule could be utilized to deal with taxpayers who are involved in numerous activities (particularly taxpayers in the real estate industry).

8. Potential Abuses. The problem with a broad interpretation of the line of business rule is that it could lead to abuses. For example, suppose that the line of business rule were interpreted to mean that a taxpayer would be deemed to materially participate in all activities which are in his line of business; i.e., the line of business rule were interpreted so as to "catch" persons in the real estate industry. In that event, an individual who is involved in the operations of one television station on a full-time basis could invest through an S corporation in other television stations and claim that any losses were incurred in his line of business. The same argument could be raised by taxpayers in numerous other lines of business. As a result, the effect of a broad interpretation of the line of business rule could open the floodgates for shelter by taxpayers in other industries.


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.

a. Activity-by-Activity. As a practical matter, the Blue Book indicates that an "activity-by-activity" analysis must be applied to management services.
b. **Full-Time Management.** Instead of the line of business rule, the Blue Book suggests that management services are likely to be substantial and *bona fide* 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.

c. **Application.** The rule set forth in the Blue Book prevents the abuse which could have arisen if taxpayers claimed that they materially participated in all activities in their line of business (with respect to which active losses are produced). This rule, however, does not provide relief to the individual who owns and significantly manages more than one activity. See Paragraph 8.C.iii(a) above.


10. **Line of Business Test, Role of Management and Treasury Regulations.** In general, the Treasury Regulations as described above with respect to material participation do not adopt the line of business test and therefore, to that extent, follow the Blue Book. The line of business test, however, can be applied as easily to the definition of activity as that of material participation, and the regulations which define an activity could still adopt a line of business test for determining that certain activities in the same line of business should be treated as one activity.

a. **Management as Material Participation.** In general, management is treated the same as all other types of participation for purposes of the quantitative tests in Treas. Regs. §1.469-5T(a)(1)-(6). Thus, an individual who participates in management of an activity for more than 500 hours in a year would be deemed to materially participate in the activity under Treas. Reg. §1.469-5T(a)(1). However, under Treas. Reg. §1.469-5T(b)(2)(ii), management is not taken into account for purposes of the facts and circumstances material participation rule of Treas. Reg. §1.469-5T(a)(7) unless no person receives compensation for management services and no other person performs more management services than such individual. This rule indicates that management is treated differently than other services, which does not follow the Blue Book approach.

D. **Hotel Condominiums.** With the spread of hotel condominiums, attention is being paid to the applicability of the passive loss rules to investors in hotel condominium units. As the operation of such a hotel may not be a rental activity, the
active participation exception available to middle income taxpayers is not applicable. A taxpayer, however, still has a number of hurdles to overcome for active loss treatment from a hotel condominium. First, the activity must not be a rental activity. Treas. Reg. §1.469-1T(e)(3)(viii), Example 4, however, indicates that a hotel apartment will be a rental activity unless the average period of customer use is 7 days or less. Second, even if not a rental activity, a taxpayer who owns a hotel condominium unit must show that he is a material participant with respect to the hotel unit in order to avoid the passive loss limitations.

1. Rental Activity. Treas. Reg. §1.469-1T(e)(3)(viii), Example 4 provides as follows:

The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of [Treas. Reg. §1.469-1T(e)(3)(iv)]) nor extraordinary personal services (within the meaning of [Treas. Reg. §1.469-1T(e)(3)(v)]) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

points out that a hotel condominium owner's regular and continuous onsite inspections and meetings, together with participation in other integral functions of the business away from the hotel, would be sufficient to establish material participation. Cong. Rec. S8245 (daily ed. June 24, 1986). Moreover, the hotel room rental business need not be the taxpayer's principal business.

a. Eleven Activities. A series of eleven activities are listed in the colloquy which exemplify the actions normally taken by condominium hotel unit owners who materially participate: (a) establishing the rental rate of the hotel room; (b) establishing personnel policies; (c) reviewing financial reports; (d) establishing operating and capital budgets; (e) establishing financial reserves; (f) selecting the banking depository; (g) meeting at the hotel with the onsite management and conducting onsite inspections; (h) assisting in offsite business promotion activities; (i) personally paying owner association charges; (j) personally paying real estate taxes; and (k) personally paying debt service on the hotel room. The taxpayer must be personally involved in these functions and not merely approving the decisions of others. According to the colloquy, the fact that the taxpayer might be relatively inexperienced in hotel management would not preclude a finding of material participation, nor would the use of contract management services to perform daily functions in running the hotel.

b. Precedential Value. At first, it was thought that this colloquy might facilitate the syndication of hotel condominiums. If the investor could satisfy the material participation standard described above, then tax losses thrown off by the hotel condominium unit would fall into the active basket and could absorb the investor's salary or portfolio income. Presumably, syndicators of hotel condominiums would attempt to structure the investor-owner's involvement such that the eleven factors described in the colloquy would be satisfied. The precedential value of this colloquy, however, remains to be considered. See Colloquies: What They Are and What They Do, 33 Tax Notes 128 (Oct. 13, 1986). The colloquy was undercut by a statement in the Blue Book at page 241 that hotel condominiums must satisfy the same material participation test as other activities. The Blue Book further states that no safe harbor was intended in the colloquy, and that owners of units in condominium hotels would not be treated as materially participating if the taxpayer's role were limited to pro forma ratification of the decisions of others. Blue Book at 241-242.

c. Regulations. Even to the extent that the eleven activities listed in the colloquy are considered participation for a hotel condominium owner, the material
participation quantitative tests set forth in Treas. Regs. §1.469-5T(a)(1)-(6) should make use of the colloquy to find that a hotel condominium owner materially participates an extremely rare occurrence.

VII. 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. §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 which is seven days or less is not a rental activity. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

i. Average Period of Customer Use. The average period of customer use 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. 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. §1.469-1T(e)(3)(iii).

ii. Comment. The emphasis in Treas. Reg. §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. Moreover, what if a single rental activity involves leasing cars for a year and tools for a day; the average period of customer use concept will not be easily applied. In addition, 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. §1.469-1T(e)(3)(ii)(B). Significant personal services are defined to include only services, other than excluded services, provided by an individual. The question of whether non-excluded personal services are significant is one of facts and circumstances. Relevant facts and circumstances include:

i. frequency of services;
ii. type and amount of labor required to provide services; and

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. §1.469-1T(e)(3)(viii), Example (2), personal services for photocoping 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.

Excluded services means, with respect to property made available for use by customers:
i. services needed for lawful use of the property;

ii. 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

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

(A). 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. §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. §1.469-1T(e)(3)(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. §1.469-1T(e)(3)(v).

i. Example. Use of hospital rooms by patients is incidental to the other services performed by doctors and nurses in the hospital. Treas. Reg. §1.469-1T(e)(3)(v).

ii. Example. Use of a dormitory at a boarding school is incidental to other boarding school personal services generally provided by school teachers. Treas. Reg. §1.469-1T(e)(3)(v).

iii. 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.

d. Incidental Rental. The rental of tangible property which is incidental to a non-rental activity is not a rental activity. Treas. Reg. §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. §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. §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). Subleases. This rule will be a trap for sublessors. Assume that a law firm is the lessee of six floors in a building, four for current use and two for the future; the two excess floors are subleased at a "cash loss." The loss on the sublease will be from a separate passive activity; the incidental rental activity rule will not apply because the sublessor does not own an interest in the leased property. Moreover, if the law firm eventually takes over the leased floors, there might never be a disposition which allows the partners under Section 469(g) to utilize the suspended losses.
iii. Property Held for Sale to Customers. Any rental income for the taxable year of the sale 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 (see Section 1221(1)) will, if gain or loss is recognized, be incidental to such sale. Treas. Reg. §1.469-1T(e)(3)(vi)(D).

(A). Example. A rents cars under 3, 4 and 5 year leases. Once a car has been returned, A sells the car to customers in the ordinary course of a used car business. Thus, A is involved in two activities, car rental and car sales. The fact that A rented a car for 11 months before selling it does not alter the treatment of the car rental as incidental to the car sale.

(B). Interaction with Recharacterization Rules. The treatment of rental of property as incidental to a sale leads to interesting questions under the recharacterization rules of Treas. Reg. §1.469-2T(f). For example, Treas. Reg. §1.469-2T(f)(3) recharacterizes net income from the rental activity involving the rental of nondepreciable property as portfolio income. If the property is treated as held for sale, however, the income from the rental of the property would not be income from a rental activity. Thus, it is possible that this rule could be used to limit recharacterization of income in the year property used in a rental activity is sold.

(C). Gain or Loss. The incidental rental of property held for sale to customers rule, if literally read, applies to a taxable disposition only if gain or loss is recognized. If the property is sold for its adjusted basis, Treas. Reg. §1.469-1T(e)(3)(vi)(D), as technically read, would not treat the rental of the car prior to sale as incidental. Thus, income from auto leases during the taxable year would not be rental income. Surely, this cannot be the intended result. The gain or loss recognition requirement must simply be an imprecise reference to a taxable transaction.

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


i. Example. Example 10 of Treas. Reg. §1.469-1T(e)(3)(viii) provides:
The taxpayer operates a golf course. Some customers of the golf course pay greens fees upon each use of the golf course, while other customers purchase weekly, monthly, or annual passes. The golf course is open to all customers from sunrise to sunset every day of the year except certain holidays and days on which the taxpayer determines that the course is too wet for play. The taxpayer thus makes the golf course available during prescribed hours for nonexclusive use by various customers. Accordingly, under [Treas. Reg. §1.469-1T(e)(3)(ii)(E)], the taxpayer is not engaged in a rental activity, without regard to the average period of customer use for the golf course.

f. Self-Rented Property. 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 capacity in which property is provided by the taxpayer is one of facts and circumstances. Treas. Regs. §1.469-1T(e)(3)(ii)(F) and (vii).

i. Example. Example 8 of Treas. Reg. §1.469-1T(e)(3)(viii) provides:

The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "cropshare lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of [Treas. Reg. §1.469-1T(e)(3)(vii)], the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under [Treas. Reg. §1.469-1T(e)(3)(ii)(F)], the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

C. Rental Real Estate-Scope of Activity. In the case of a rental activity, each building is generally a separate
activity. SFC Report at 740. One of the most important aspects of the definition of a rental activity is its narrow scope. Activities which immediately precede the rental activity, which are conducted by the same persons or take place in the same location, or are associated with but do not involve renting tangible property, generally are not part of a rental activity. SFC Report at 743.

1. Construction and Development. Real estate construction and development is treated as a separate activity from renting the constructed building. SFC at page 743.

2. Management Activity. Representatives of the Treasury Department have indicated that in certain situations management of rental property might be considered part of the rental activity.

D. Ground Rents. In some situations, a rental activity might be treated as giving rise to portfolio income (discussed below under recharacterization) where the income is produced by nondepreciable property. Treas. Reg. §1.469-2T(f)(3).

E. 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. This amount is reduced to $12,500 for married individuals filing separately.

   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. 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 and PALs.

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. §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.** A limited partner does not satisfy the active participation test to the extent of his limited partnership interest.

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% of all interests in the activity.

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? 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.

9. Credits. 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. 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 and low-income housing credits is entirely phased out. The exception under the passive loss limitation rule for the low-income housing credit applies only to property placed in service before 1990, and to property placed in service before 1991 if 10% or more of the project costs are incurred before 1989.

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

VIII. 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, I.R.B. 1988-27, 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, August 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. §1.163-8T, Notice 88-20, 1988-9 I.R.B. 5 or Notice 88-37, 1988-15 I.R.B. 8.
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. §1.469-2T(d)(2)(i), relating to expenses clearly and directly allocable to portfolio income.

6. **Dispositions.** The legislative history of Section 469(k) in OBRA states that suspended PALs from an activity of a PTP will be recognized only when the taxpayer disposes of his entire interest in the PTP. This statement is contrary to the statutory provision, which would permit the recognition of loss by the owner of an interest in a PTP when the PTP disposes of its entire interest in an activity (within the meaning of Section 469(g)). The proposed Technical Corrections Act contains a provision which conforms to the legislative history. Section 204(g) of HR 4333 and S 2238.

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 are (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 Loffman, 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 were 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 for smaller resale units. For purposes of determining the number of partners, each person indirectly owning an interest through a partnership, a 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 exerciseable 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 five percent safe harbor. Therefore, the total sales during the taxable year are 450/9000 X .95 = 4.75%, so that the five 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 five percent requirement discussed above were reduced to two 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 service, 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 0.95 = 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 Closed-End 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, are 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.

IX. 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. §1.469-2T(c)(4)(i). Such income is treated the same as income from an active 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. Regs. §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. Regs. §1.469-2T(c)(4)(i)(A) and -2T(e)(2). Although by incorporating Sections 707(a) and (c) by cross reference, Treas. Reg. §1.469-2T(4)(i)(A) also refers to Section 736(b), it seems unlikely that Section 736(b) payments would ever constitute compensation for services.

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 §707(c) guaranteed payment for consulting 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 83. Amounts received as compensation income under Section 83 are treated as personal service income. Treas. Reg. §1.469-2T(c)(4)(i)(B).

1. Property Received for Future Services. Treas. Reg. §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.

E. 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. Regs. §1.469-2T(c)(4)(i)(C), (D) and (E).

F. 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 a S corporation are treated as personal service income. Treas. Reg. §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 regulations, 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 he is not a material participant, the service provider will want to forego a salary and receive net income from the pass-through entity.

G. **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. §1.469-2T(d)(7)(i).

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

X. **PORTFOLIO ACTIVITY.**

A. **In General.** A portfolio activity, under Treas. Reg. §1.469-2T(c)(3)(i), is one which produces or could produce 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(a) 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. §1.469-1T(e)(6) and Treas. Reg. §1.469-2T(c)(3)(i)(7));

B. Ordinary Course of a Trade or Business. Income described above is not portfolio income if derived in the ordinary course of a trade or business. Under Treas. Reg. §1.469-2T(c)(3)(ii), gross income derived in the ordinary course of a trade or business for portfolio income purposes includes only:

1. Investment Interest Income. Interest income on loans and investments made in the ordinary course of a trade or business of lending money (but see Treas. Reg. §1.469-2T(f)(4));

2. Accounts Receivable Interest Income. Interest on accounts receivable arising from the performance of services or the sale of property, but only if credit is customarily offered to customers of the trade or business;

3. Investment Income. Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

4. Trading or Dealing Income and Gain. 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.
a. See Treas. Reg. §1.469-1T(e)(b), under which trading personal property is not a passive activity, and Treas. Reg. §1.469-2T(c)(3)(iii)(A), concerning a dealer's income or gain from an item of property held for investment at any time.

5. Royalties. Royalties derived in the ordinary course of a trade or business of licensing intangible property (within the meaning of Treas. Reg. §1.469-2T(c)(3)(iii)(B)).

6. Cooperative Patron Income. Amounts included in the gross income of a patron of a cooperative based on patronage occurring with respect to a trade or business of the patron.

7. Other Income. Other income identified by the Service as income derived by the taxpayer in the ordinary course of a trade or business.

C. Cross Reference to §163(d). The cross reference by Treas. Reg. §1.469-2T(c)(3)(i)(D) to §163(d) and the definition of "property held for investment" is a classic "catch 22" example. The §163(d)(5) definition of net investment activity is generally a cross reference back to §469(e), the incomplete statutory definition of portfolio income. The interaction between §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.

D. Investment Land. Because of the incomplete statutory portfolio income definition of Section 469(e) and the Treasury Regulations thereunder, as well as the yet undefined reference to potential passive treatment of certain §212 activities in Section 469(c)(6)(B), numerous tax practitioners have asked whether raw land investment could be a passive activity. Treasury has indicated that holding raw land for investment is a portfolio activity. Additionally, portfolio treatment of investment raw land appears to be the plain intent of Congress.

E. Recharacterization Rules. Passive income or certain passive, or even active, activities will result in portfolio income. See recharacterization discussion below at XIII.

XI. ACTIVE ACTIVITY. Section 469 itself supplies no direct definition of an active activity. By subtraction of concepts an active activity is generally a non-rental 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 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.

XII. QUALIFIED WORKING INTEREST.

A. In General. A qualified working interest is a working interest in any oil and gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest. Section 469(c)(3)(A). Under Treas. Reg. §1.469-1T(e)(4)(i), this rule is applied by reference to an oil or gas well drilled or operated pursuant to a working interest. If an interest is a qualified working interest, the interest is not an interest in a passive activity. Therefore, the Section 469 limitations would not apply to any losses incurred with respect to a qualified working interest.

1. Definition of an Oil and Gas Property. The definition of an oil or gas well as a property in Treas. Regs. §1.469-1T(e)(4)(i) is broader than the definition of an oil or gas property in Section 614.

B. Working Interest. A working interest is an operating mineral interest under section 614(d) and regulations promulgated thereunder. Treas. Reg. §1.469-1T(e)(4)(iv).

C. Entities That 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. Entities which limit liability include:

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

D. Disregarded Limitations. The following protections from loss are disregarded as a liability limitation of a working interest holder 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.

E. Deductions Attributable to a Limited Liability Period.

1. Disqualified Deductions. A taxpayer's deductions which are deductible during a year in which the taxpayer has a qualified working interest activity, but with respect to which economic performance does not occur until a time when the taxpayer holds his interest through a limited liability entity, are treated as passive deductions. Treas. Reg. §1.469-1T(e)(4)(ii)(A)(1).

2. Ratable Portion of Gross Income. If deductions are treated as passive deductions, a ratable portion of gross income from the oil or gas well is treated as passive income. The ratable portion of gross income from such qualified working interest activity equals gross income times disqualified deductions divided by total deductions attributable to the taxable year. Treas. Reg. §1.469-1T(e)(4)(ii)(C)(4).

3. Example. The following examples are provided in Treas. Reg. §1.469-1T(e)(4)(iii):

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil and gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1989, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant
to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in an passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example 2. The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(2)(ii) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A's gross income from the well for 1987 is treated as passive activity gross income.

F. Income from a Qualified Working Interest. Passive activity gross income does not include any gross income from an oil or gas property if any loss from the property was treated as eligible for the special rule concerning qualified working interests. For purposes of this rule, the term 'property' is defined broadly so as to include not only the oil or gas well which is the qualified working interest but also any property the value of which was directly enhanced by the drilling, logging, testing or other activities the costs of which were borne by the qualified working interest. Treas. Reg. §1.469-2T(c)(6)(iii). See Section XVII.C.6, below. Such income is investment income for purposes of applying Section 163(d). See Section 163(d)(5)(A)(ii).
XIII. RECHARACTERIZATION OF PASSIVE INCOME.

A. In General. 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—

... (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, ...

1. Statutory Intent. The Conference Report at page II-147 explains the regulatory authority in defining passive income provided the Secretary in Section 469(1) as follows:

The Conferees intend this authority be exercised to protect the underlying purpose of the passive loss provisions, i.e., preventing the sheltering of positive income sources [with passive losses]. [Emphasis Added].

2. Scope of Authority. It has been suggested that the scope of regulatory authority was one of insuring that substance controlled over form. Where the substance of a transaction cast in form as passive income is in economic reality portfolio, active or personal service income, Treasury was authorized to recharacterize the passive income. See Lipton and Evaul, Tax Notes Highlights and Documents, July 31, 1987, at page 933. Additionally, if substance over form was the proper limitation on such Section 469(1) regulations, recasting of loss would also be appropriate for activities in which the income would be recast.

a. Example. Assume that an activity in 1990 was recast to produce portfolio income. In 1991, the activity produces a loss. Under the substance over form approach, such a loss would also be recast as portfolio loss.

3. Regulations. 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
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 two recharacterization rules without regard to the regulations. See the qualified working interest recharacterization rule in Section 469(c)(3) and the active rental real estate recharacterization rule in Section 469(i).

Under Treas. Reg. §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, 5 & 6)) or portfolio income (2T(f)(3, 4 & 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.

There are at least an additional 18 unlabeled regulatory 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 §1.469-2T(c)(2)(iii), passive gain from a disposition of property may be recharacterized as portfolio or active income.

Furthermore, the 18 additional regulatory recharacterization rules are not limited to income or gain recharacterizations. For example, under the tax avoidance participation recharacterization rule of Treas. Reg. §1.469-5T(f)(2), active loss is recharacterized as passive loss.

The emphasis of the regulatory 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 Recharacterization Rules Under Treas. Reg. §1.469-2T(f). As set forth below there are six recharacterization rules which are formally labeled as such. The significant participation passive activity, the 24-month 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 entity acquisition 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. §1.469-2T(f)(6-11). These common rules are discussed below.
in paragraphs (B)(1-6).

1. Overlap of Recharacterization Rules. Treas. Reg. §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 a portfolio labeled recharacterization rule and an active labeled recharacterization rule both apply, the portfolio formed recharacterization rule will govern. Each of the labeled recharacterization rules states that income in certain circumstances is not passive. Treas. Reg. §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. §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. §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 exceed passive activity gross income from such activity (without regard to the recharacterization rules of 2T(f)(2-4)). Treas. Reg. §1.469-2T(f)(9)(ii).


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 the use of such items of property in the rental activity. Treas.
6. Coordination with §163(d). The interplay between Section 163(d) and the recharacterization rules is discussed above in Section X; see Treas. Reg. §1.469-2T(f)(10).

C. Passive Income Recharacterized as Active Income.

1. Significant Participation Passive Activity Recharacterization Rule (Section 1.469-2T(f)(2)). Under Treas. Reg. §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. §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 material participation 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 Passive Activity Recharacterization Rule and the 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 for 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 for 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 II, III and IV 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 materially participate in activities III, IV and V under the 500 hour rule, the substantially all participation rule, not less than any other participation rule, the 5 out of 10 material participation rule, the 3 year personal service activity rule or the facts and circumstances rule, the only material participation question left is whether A materially participates under the significant participation material participation rule.

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

A significant participation activity is defined the same as significant participation passive activity, except that the determination of material participation does not include the significant participation material participation rule. See Treas. Reg. §1.469-5T(c)(1). Thus, if the more than 100 and 500 or less hours activities add-up to more than 500 hours, they are material participation significant participation activities, but are not significant participation passive activities.

Because the sum of participation in activities III, IV and V is 500 hours or less, A does not materially participate under the significant participation material participation rule. Thus, activities III, IV and V are significant participation passive activities. If, however, A participates 200 hours instead of 101 hours in activity V, A would materially participate in activities II, IV and V under the significant participation material participation rule and therefore activities III, IV and V would not be significant participation passive activities. As a result, any losses generated would be treated as active 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 passive activity 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. §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. §1.469-5T(a)(4). 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. §1.469-5T(e)(2).

d. Application of 2T(f)(2) to Limited Partners. Although the relief provided in Treas. Reg. §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 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 activity subject to Treas. Reg. §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. Regs. §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. §1.469-1T(g)(3)(ii).

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

2. 24 Month Self-Enhanced Rental Property Recharacterization Rule (Section 1.469-2T(f)(5)). Under Treas. Reg. §1.469-2T(f)(5)(i), gross rental income equal to the net rental income (including gain from dispositions, see Treas. Reg. §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, see Treas. Reg. §1.469-2T(f)(5)(ii) less than 24 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 of commencement), and (d) development. Treas. Regs. §1.469-2T(f)(5)(iii) and (iv).

a. Purpose. The 24 month 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 24 month self-enhanced rental property recharacterization rule. The 24 month self-enhanced rental property recharacterization rule 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 24 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 24 month 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 1992. In 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 24 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 24 month rule disposition. The gain, however, is still recharacterized as active income.

d. Twenty-Four Month Period. The 24 month self-enhanced rental property recharacterization rule applies when a binding contract (oral or written) is entered into to sell the property, and not just 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.


3. Self-Rented Property Recharacterization Rule (Section 1.469-2T(f)(6)). Under Treas. Reg. §1.469-2T(f)(6),
gross rental income equal to net rental income (including income from dispositions, see Treas. Reg. §1.469-2T(f)(9)) from an item of property rented to a trade or business activity in which the taxpayer materially participates (without regard to this status as a limited partner) and which property is not property described in the 24 month self-enhanced recharacterization rule is recharacterized as active income.

a. Example. Taxpayer A rents a building to an S corporation in which he is a material participant for fair market value and has net rental income of $5,000 in 1992. If the taxpayer had rented the property from the 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 Corporations. Under §1.469-5T(f), a taxpayer cannot materially participate in a C corporation. 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 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. This rule does not apply if the lessor significantly participates in the activity.

d. Item of Property Subject to Recharacterization. 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 only to the item of property self-rented, i.e., the self-rented floor. If the term used in Treas. Reg. §1.469-2T(f)(6) was "property" and not "item of property," the whole building would be subject to recharacterization.

e. 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.

f. 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.

g. 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. §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.

D. Passive Income Recharacterized as Portfolio Income.

1. Rental of Non-Depreciable Property Recharacterization Rule (Section 1.469-2T(f)(3)). Under Treas. Reg. §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. §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 non-depreciable property recharacterization rule. The more difficult issue arises where improvements exist on leased land. Treas. Reg. §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.


2. Net Leased Property. This rule will not affect net leased real property in which a taxpayer leases an improved building to a tenant on a net lease basis, even though the landlord may not be bearing any significant expenses.

3. Equity-Financed Lending Activity Recharacterization Rule (Section 1.469-2T(f)(4)). Under Treas. Reg. §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. §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. §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 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. §1.469-2T(f)(4)(l). 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.

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4. Intangible Licensing Pass-Through Entity Acquisition Recharacterization Rule (Section 1.469-2T(f)(7)). Under Treas. Reg. §1.469-2T(f)(7), if the 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 entity acquisition 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.

a. Effective Date. The intangible licensing entity acquisition recharacterization rule is effective for twenty years beginning after December 31, 1987. Treas. Reg. §1.469-11T(a)(2)(i).

b. Interplay between the Intangible Licensing Pass-Through Entity Acquisition and the Intangible Licensing. The interplay between the intangible licensing pass-through entity acquisition and the intangible licensing recharacterization rule is crucial to understanding each rule. The licensing royalties recharacterization rule of Treas. Reg. §1.469-2T(c)(3)(iii)(C) provides 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 Treas. Reg. 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. §1.469-2T(f)(7).
5. Former Qualified Working Interest Recharacterization Rule (Section 1.469-2T(c)(6)).

a. General Rule. Under Treas. Reg. §1.469-2T(c)(6), 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 active income to the extent of the net income therefrom for such taxable year. Treas. Reg. §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 as nonpassive income. The income would constitute investment income for purposes of Section 163(d) under Section 163(d)(5)(A)(ii).

b. Example. Assume that 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 (and can be offset by investment interest deductions). 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.

c. 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 were incurred by the taxpayer as a result of holding a qualified working interest. Treas. Reg. §1.469-2T(c)(6)(iii).

d. Example. Thus, if 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), i.e., the net income is nonpassive income.

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. §1.469-11T(a)(1).
E. Passive Income Recharacterized as Active or Portfolio Income.

1. Substantially Appreciated Property Recharacterization Rule (Section 1.469-2T(c)(2)(iii)).

   a. Substantially Appreciated Former Active Property (Section 1.469-2T(c)(2)(iii)). Under Treas. Reg. §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, where such property was not 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 taxpayers held the property for investment purposes for more than 50% of his holding period, see E(1)(b) Substantially Appreciated Former Investment Property Recharacterization Rule, below.

   b. Substantially Appreciated Former Investment Property (Section 1.469-2T(c)(2)(iii)(E)). Under Treas. Reg. §1.469-2T(c)(2)(iii)(E), if substantially appreciated property was held for investment purposes more than 50% of the taxpayers' holding period, and the gain from disposition of the property is otherwise subject to recharacterization as set forth above in Treas. Reg. §1.469-2T(c)(2)(iii), the gain is recharacterized as portfolio. A more detailed discussion of this recharacterization rule is found in §XVII.C.2., below.

F. Passive or Active Income Recharacterized as Portfolio Income.

1. Trade or Business Definition Recharacterizations. For purposes of defining portfolio income as gross income not derived in the ordinary course of a trade or business, Treas. Reg. §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 Interest] 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. §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 which are not included in Treas. Reg. §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. §1.469-2T(c)(2)(i) (such as interest, dividends, royalties, etc. see Section X, above) will be portfolio even if under Section 162 principles such income would be earned in a trade or business activity.

a. Working Capital Interest. 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.

i. 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 account 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.

ii. 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.

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

b. Mineral Royalties. 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. Treas. Regs. §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. §1.469-2T(c)(3)(ii)(G). Treasury in Section X(C) of its Preamble to the Regulations 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 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.

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

   c. **Trading or Dealing in Personal Property.** Treas. Reg. §1.469-2T(c)(3)(ii)(D) provides that if any activity of trading or dealing in property is in the ordinary course of a trade or business, such activity otherwise is a trade or business. Trading in personal property, however, is trapped by another recharacterization rule, the trading personal property recharacterization rule of Treas. Reg. §1.469-1T(e)(6). Under the trading personal property recharacterization rule, if a trading of personal property trade or business activity exists and is a passive activity, it will be recharacterized as a portfolio activity. See Section X. Additionally, the income from property sold in a trade or business of dealing in property is recharacterized as portfolio income if the dealer held the property for investment at any time prior to recognition of income or gain from the property. See Treas. Reg. §1.469-2T(c)(3)(iii)(A).

   i. **Effective Date.** The effective date for the trading or dealing in personal property recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. §1.469-11T(a)(1).

   d. **Licensing Royalties.** Subject to the special licensing royalty recharacterization rule discussed below, and the intangible licensing pass-through entity acquisition 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. §1.469-2T(c)(3)(ii)(E).

   i. **Effective Date.** The effective date for the licensing royalties recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. §1.469-11T(a)(1).
2. Licensing Royalties (Section 1.469-2T(c)(3)(iii)(B)).

   a. General Rule. Under Treas. Reg. §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. §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 does not materially participate in the activity) or passive (if the taxpayer materially participates in the activity). Pursuant to Treas. Regs. §1.469-2T(d)(2),(3) and (4), expenses with respect to such royalty income will be treated as attributable to portfolio income. Thus, the end result of Treas. Reg. §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.

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


   d. Interplay with Intangible Licensing Pass-Through Entity Acquisition Recharacterization Rule. The interplay with the intangible licensing pass-through entity acquisition recharacterization rule explained above at Section XIII.D.3. is crucial to the understanding of each rule. See Preamble at Section XVI.C.3.

3. Former Investment Property Held by a Dealer Recharacterization Rule. (Section 1.469-2T(c)(3)(iii)(A)). Under Treas. Reg. §1.469-2T(c)(3)(III)(A), a dealer in property will not be treated as being in the ordinary course of a trade or business with respect to an item of property which was held for investment at any time prior to recognition of gain or income from such property. Thus, if such item of property is held by a dealer who was not a material participant, the indirect result of
not recognizing the trade or business activity is to treat a passive activity as a portfolio activity. If the taxpayer was a material participant, the activity is indirectly recharacterized from being an active activity to being a portfolio activity.

a. Example. Assume taxpayer A purchased property in 1945 for investment purposes and in 1985 decided to subdivide, develop and sell lots as a dealer in residential real estate. In 1987, A sells his first lot for a profit. The gain on that sale would have been passive or active depending on A's activity level, but for the former investment property recharacterization rule. Under the former investment property recharacterization rule, such income is portfolio. While generally this rule should be viewed as pro-government, it can work to the taxpayer's advantage. If a taxpayer has an unused investment interest deduction, he is better off transforming passive income into investment income. Investment income, and not active or passive income, can be sheltered by investment interest deductions. See Section 163(d).

b. Effective Date. The former investment property held by a dealer recharacterization rule is effective for taxable years beginning after December 31, 1986. Treas. Reg. §1.469-11T(a)(1).

4. Mineral Production Payments Recharacterization Rule. (Section 1.469-2T(c)(3)(iii)(C)). Mineral production payments are treated as interest payments to the extent such payments are interest equivalents under Section 636. Treas. Reg. §1.469-2T(c)(iii)(3)(C)(1). Since the interest payments are not in the ordinary course of a trade or business interest payments under Treas. Regs. §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. §1.469-2T(c)(3)(ii). See Treas. Reg. §1.469-2T(c)(3)(iii)(C)(2).


G. Active Loss Recharacterized as Passive Loss.


a. Tax Avoidance, Non-Owner Type Participation
Recharacterization Rule (Section 1.469-5T(f)(2)(ii)). 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. §1.469-5T(f)(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.

b. 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.

i. Effective Date. The effective date for the tax avoidance, non-owner type participation recharacterization rule is for taxable years beginning after December 31, 1986. Treas. Reg. §1.469-11T(a)(1).

H. Passive Loss Recharacterized as Active Loss.

1. Active Participation Rental Real Estate Activities. Section 469(i) recharacterizes up to $25,000 of losses from rental real estate activities in which an individual taxpayer actively participates as active loss. See VII.E.

I. Passive Activity Recharacterized as Active Activity.

1. Rental of Dwelling Unit Recharacterization Rule (Section 1.469-1T(e)(5)). Under Treas. Reg. §1.469-1T(e)(5), an activity which involved the rental of a dwelling unit under Section 280A(c)(5) is recharacterized as an active activity.


2. Material Participation Recharacterization Type Rules (5T). The following rules are extensively discussed in Section VI, above. Each of them, however, can be construed as an unlabeled recharacterization rule.


c. 5 Out of 10 Material Participation Rule. Treas. Reg. §1.469-5T(a)(5).

d. 3 Year Personal Service Activity Material Participation Rule. Treas. Reg. §1.469-5T(a)(6).

e. Limited Partners Material Participation Treatment. Treas. Reg. §1.469-5T(e).

J. Portfolio, Passive or Active Activity Prorata Recharacterized as a Different Activity.

1. 12 Month Recharacterization Rule (Section 1.469-2T(c)(2)(ii)). Under Treas. Reg. §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 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. A more thorough discussion of this rule is set forth in Section XVII.

a. Effective Date. See discussion in Section XVII.

XIV. SELF-CHARGED RULES.

A. 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.

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.

1. 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.

2. 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.

3. 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.

4. Prorata 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?

a. 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).
5. 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. §1.469-7T. The Service may take the position that self-charged rules do not exist unless and until such regulations are issued.

B. Non-Interest Self-Charged Rules.

1. 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.

2. 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. §1.469-2T(f)(6). See XIII.B.3. 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.

3. 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.

XV. CORPORATIONS.

A. In General. As discussed above in II.C. and II.D., only certain corporations are closely held corporations or personal service corporations subject to Section 469. See Treas. Regs. §1.469-1T(g)(2). If a 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 for which more than 50% of the stock 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. §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) (determined without subsection (iv)) are met with respect to the activity. Section 469(h)(4)(B); Treas. Reg. §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 467(c)(7).

   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. §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. §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, 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. §1.469-1T(g)(4)(ii). The effect of this provision is that the PALs of a closely held corporation can offset all of its income other than portfolio income and income from other publicly traded partnerships.

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 Loffman, Presant & Lipton, "The Impact of Notice 88-75 Concerning Publicly Traded Partnerships," Tax Notes, August 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. §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. §1.469-1T(g)(3)(i)(A). 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. §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. §1.469-1T(h)(4)(ii).

   a. 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. **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. §1.469-1T(h)(5).
3. 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. §1.469-1T(h)(7). This result occurs even if the corporation has an excess loss account generated by passive losses.

XVI. 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. §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. §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. §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. §1.469-1T(j)(2)(iii).

XVII. 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. §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. §1.469-2T(c)(1). 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. §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, 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 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. §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. §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. §1.469-2T(c)(3)(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 nonpassive 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.

3. Portfolio Income. All items of portfolio income (discussed above at VIII) are excluded from PAGI. Treas. Reg. §1.469-2T(c)(3).

4. Personal Service Income. All items of personal service income (discussed above at VII) are excluded from PAGI. Treas. Reg. §1.469-2T(c)(4).

5. 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. §1.469-2T(c)(5).

6. 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. §1.469-2T(c)(6).

7. Recharacterized Items. PAGI does not include items of income which are recharacterized under Treas. Reg. §1.469-2T(f). See discussion in XIII and XIV above.

8. Other Excluded Items. PAGI does not include various other items pursuant to Treas. Reg. §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;

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; and

d. **Covenant Not to Compete.** Gross income of an individual from a covenant not to compete.

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. §1.469-2T(d)(1).

1. **Exceptions.** Treas. Reg. §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. §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. **Section 172 and 1212.** An item of loss or deduction carried to the taxable year under Section 172 or 1212; and
1. 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 on his at-risk amount, as the case may be. This rule creates certain planning opportunities.

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. §1.469-8T (allocation of interest) and is not qualified residence interest (under Treas. Reg. §1.163-10T) or capitalized (under Treas. Reg. §1.163-8T(m)(7)). The allocation rules for interest expense under Treas. Reg. §1.163-8T utilize the so-called tracing concept. 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. §1.163-8T, the interest deduction has been transformed from passive into portfolio. Thus, the taxpayer will have eliminated his taxable income, unless the Service successfully applies a form over substance notion.

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 it was used according to the same general rules which apply to gains from the disposition of property used in passive activities. Treas. Reg. §1.469-2T(d)(5). There is no special rule, however, relating to losses incurred in the disposition of substantially depreciated property.

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. §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) and 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. §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 on 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.

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. §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. §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. §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. This rule also applies to Section 736(a)(2) payments (relating to liquidation of a partner's interest in a partnership) except payments relating to unrealized receivables (under Section 751) and goodwill. Any payments relating to unrealized receivables and goodwill are PAGI if the activity was a passive activity in the year in which the liquidation commenced.

i. Significant Participation. If the taxpayer significantly participated in the passive activity in the year the liquidation commenced, subsequent payments would not be recharacterized as active income, even though payments in the year the liquidation commenced would be so recharacterized.

c. 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 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? Unlike the rule for Section 736(a)(2) payments relating to unrealized receivables and goodwill, Section 736(b) payments would be subject to recharacterization. This is 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. §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
deprecated 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 substantially appreciated property formerly used in
a nonpassive activity, then the gain is not treated as PAGI if
the disposition occurs within the time periods referred to in
Treas. Reg. §1.469-2T(c)(2)(iii) (sales of substantially
appreciated property).

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.
§1.469-1T(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. §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. §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 (Loss)</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 x 9/25 = $7.56 PAL disallowed
   B: $21 x 16/25 = $13.44 PAL disallowed

   TOTAL = $21.00 PAL disallowed.

   Treas. Reg. §1.469-1T(f)(2)(i)(D), Example (1).

   b. **Significant Participation Activity Recharacterization.** For purposes of determining this allocation, if any portion of the gross income from the significant participation activities of the taxpayer is recharacterized under Treas. Reg. §1.469-2T(f)(2), all of the taxpayer's significant participation activities will be treated as a single activity that does not have a loss for the taxable year.

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. §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. §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. §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.

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. §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. §1.469-1T(d)(2).

3. 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. §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 not 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.

   b. 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.

2. 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. §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).

   a. 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. §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.

3. Regulations. The Service has reserved regulations relating to former passive activities and changes in status of corporations. Treas. Reg. §1.469-1T(k).
XVIII. DISPOSITIONS.

A. In General. Under Section 469(g)(1), 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. The regulations do not address the allowance of otherwise suspended passive losses upon the occurrence of a disposition. See Treas. Reg. §1.469-6T.

B. Statutory Mechanism. Under Section 469(g)(1) as enacted, if all gain or loss realized on the disposition is recognized, any loss from such activity (including previously suspended PALs) is not treated as a PAL and is allowable as a deduction against income in the following order:

1. To offset income or gain from the passive activity for the taxable year (including any gain recognized upon the disposition);

2. To offset net income or gain for the taxable year from any other passive activities; and

3. To offset any other income or gain.

It should be noted that only PALs, and not PACs, are allowed as a result of a disposition qualifying under Section 469(g)(1).

C. Proposed Technical Correction. Under the proposed technical corrections to Section 469, Section 469(g)(1) would be modified to provide that if all gain or loss realized on the disposition of a passive activity is recognized, the amount of loss which is treated as a loss which is not from a passive activity is (a) the loss from the activity for the taxable year (including any previously-disallowed PALs which are carried to the taxable year), plus (b) the loss realized on the disposition, minus (c) net income or gain for such taxable year from all passive activities (excluding losses from such activities). 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.

1. Anti-Gaming Provision. The proposed technical correction improves the mechanism for applying Section 469(g)(1). The proposed technical correction would also prevent taxpayers from entering into transactions which were designed to generate passive income in one year and an equal amount of active loss (upon the disposition of the interest in the activity) in the following year.
D. 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 carryover 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.

E. 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).

1. Transferor No Longer in Existence. This rule may 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?

F. Abandonment. An abandonment of an interest in an activity is treated as a fully-taxable disposition for purposes of Section 469(g)(1).

G. 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.
H. 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 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 basis.

I. 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.

J. 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. The legislative history of new Section 469(k), relating to PTPs, indicated that a complete disposition of an interest in a PTP would be required to recognize suspended PALs. This language is not mirrored, however, in the statutory provision. The proposed technical correction act contains language which reflects the legislative history of Section 469(k). Section 204(g) of HR 4333, S2238.

K. 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.
XIX. **TRUSTS AND ESTATES.** To the extent that there are problems in the application of Section 469, and there are many, such problems pale in comparison to the interaction between Section 469 and rules relating to taxation of trusts and estates. The problems run the gamut of determining whether the material participation tests should be applied at the entity or beneficiary level, to immensely complex issues involving the determination of distributable net income of a trust and the impact of the so-called "throw-back" rule. The Service wisely refrained from issuing regulations addressing the application of Section 469 to trusts and estates at this time, and there is no indication that such regulations will be issued soon. Treas. Reg. §1.469-8T. See Tax Notes, February 8, 1988, at 539. Indeed significant changes in the statute will probably be needed in order to solve some of the problems relating to applying Section 469 to trusts and estates.

XX. **FUTURE REGULATIONS.** Future Regulations will include the following:

A. Treas. Reg. §1.469-4T, Definition of Activity;
B. Treas. Reg. §1.469-5T, Dispositions;
C. Treas. Reg. §1.469-7T, Self-Charged;
D. Treas. Reg. §1.469-8T, Estate and Trust Rules;
E. Treas. Reg. §1.469-9T, Active Participation Rental Real Estate Activities;
F. Treas. Reg. §1.469-10T, Publicly Traded Partnerships; and
G. Treas. Reg. §1.469-1T(k), Former Passive Activities.

XXI. **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. §1.469-11T(a). Thus, for example, the rule concerning recharacterization of income from significant participation activities as active income would apply to income recognized in 1987.
1. Exception. An exception is provided, however, 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 incidental rental property, self-rented property or pass-through entities licensing intangible property for any taxable year beginning before January 1, 1988. Treas. Reg. §1.469-11T(a)(2)(i). 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. §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. §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. §1.469-11T(a)(4).

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>
</table>

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. §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. §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. §1.469-11T(c)(5)(ii).

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. §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. §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. §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").

September 15, 1988