TD 8175 (2/25/88) Limitations on Passive Activity Losses and Credits

AGENCY:

Internal Revenue Service, Treasury.

ACTION:

Temporary regulations.

SUMMARY:

This document contains temporary regulations relating to the limitations on passive activity losses and passive activity credits. Changes to the applicable tax law were made by the Tax Reform Act of 1986. The temporary regulations affect taxpayers subject to the limitations on passive activity losses and passive activity credits and provide them with the guidance needed to comply with the law. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register.

EFFECTIVE DATE:

Except as otherwise provided in §1.469-11T, the temporary regulations are effective for taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR Part 1) to provide temporary rules relating to the limitations on passive activity losses and passive activity credits (the “passive loss and credit limitations”). The temporary regulations reflect the amendment of the Internal Revenue Code of 1986 (the “Code”) by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2233 and 2241), which added section 469. Section 469 disallows the passive activity loss and the passive activity credit for the taxable year.

Scope of the Regulations

These regulations provide general rules for applying the the passive loss and credit limitations.

Section 1.469-1T contains rules relating to the disallowance of the passive activity loss and passive activity credit, the taxpayers to whom the passive loss and credit limitations apply, the general effect of section 469 on the treatment of items of income, gain, loss, deduction, and credit from passive activities, definitions of essential terms (including “passive activity,” “trade or business activity,” and “rental activity”), the treatment of certain losses from oil and gas working interests, the application of the passive loss and credit limitations to C corporations (including rules relating to the application of the material participation standard, the computation of net active income, and the application of section 469 to affiliated groups of corporations filing consolidated returns), and the treatment of spouses filing joint returns.

Section 1.469-2T contains rules for computing the passive activity loss, including rules for identifying passive activity gross income, passive activity deductions, and portfolio income and related deductions, and rules (including rules pursuant to section 469(l)(1), (2), and (3)) requiring that income from certain passive activities be treated as income that is not from a passive activity.

Section 1.469-3T contains rules for computing the passive activity credit, including rules relating to the identification of credits subject to section 469 and the computation of the regular tax liability allocable to passive activities.

Section 1.469-5T contains rules defining the term "material participation" for purposes of section 469 and the regulations thereunder.

Section 1.469-11T explains the effective date of section 469 and the regulations thereunder and provides guidance under the transitional rule for losses and credits from preenactment interests in passive activities.

Future regulations will provide rules identifying economic undertakings that are treated as separate activities for purposes of section 469 and the regulations thereunder (to be located in §1.469-4T), rules relating to the treatment of losses allowable under section 469(g) upon certain dispositions of interests in activities (to be located in §1.469-6T), rules relating to the treatment of certain "self-charged" expenses and related income (to be located in §1.469-7T), rules relating to the application of section 469 to trusts, estates, and their beneficiaries (to be located in §1.469-8T), rules relating to the application of the $25,000 allowance under section 469 (i) for passive activity losses and credits attributable to certain rental real estate activities (to be located in §1.469-9T), rules relating to the treatment of publicly traded partnerships under section 469(k) (to be located in §1.469-10T), and rules relating to the application of the passive loss and credit limitations in the case of former passive activities and corporations that change status from year to year, i.e., corporations that cease to be "personal service corporations," corporations that cease to be "closely held corporations," and C corporations that become S corporations (to be located in §1.469-1T (k)).

Significant Policy Issues

I. Effect of Section 469 on Other Provisions

A. Items of Income or Gain

Section §1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of any item of income or gain under any provision of the Code other than section 469. Thus, for example, an item of capital gain from a passive activity that is treated under the regulations as an item of passive activity gross income is taken into account in determining both the passive activity loss and credit for the taxable year and the allowable capital loss for the taxable year.

B. Items of Deduction

Section 1.469-1T(d)(3) provides that, except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Code. Thus, for example, if a deduction is disallowed under section 469 for purposes of computing taxable income subject to income tax, the deduction is not taken into account in computing the taxpayer's net earnings from self-employment for purposes of the tax on self-employment income imposed under chapter 2 of the Code.

II. Definition of Passive Activity

A. Trade or Business Activity

Under section 469(c)(1), an activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate is a passive activity. Section 1.469-1T(e)(2) generally defines the term "trade or business activity" to mean an activity that involves the conduct of a trade or business within the meaning of section 162.

Under section 469(c)(6), the term “trade or business” may include, to the extent provided in regulations, any activity in connection with a trade or business, and any activity with respect to which expenses are allowable as a deduction with respect to which expenses are allowable as a deduction under section 212. Although the Service is studying the possibility of treating certain activities in connection with a trade or business and certain section 212 activities as trade or business activities for purposes of section 469, these regulations do not so treat any such activities.

B. Rental Activity

Section 469(j)(8) provides that the term “rental activity” means any activity where payments are principally for the use of tangible property. Section 1.469-1T(e)(3)(i) provides that an activity generally is a rental activity for a taxable year if the gross income attributable to the conduct of the activity for the year represents amounts paid or to be paid principally for the use of tangible property. In addition, an activity may be a rental activity if tangible property in the activity is held for rent and the expected gross income from the activity will represent payments principally for the use of such property.

Section 1.469-1T(e)(3)(ii) provides six exceptions to the general rule. The first exception provides that an activity involving the use of tangible property is not a rental activity if, on the average, the period for which each customer uses the property is seven days or less. This exception will exclude from treatment as a “rental activity” most activities involving short-term use of tangible personal property such as automobiles, videocassettes, tuxedos, and tools, and short-term use of hotel and motel rooms. The rationale for the “seven-day rule” is that a customer's use of property for seven days or less generally will require the person furnishing the property to provide services significant enough to justify the conclusion that the person is engaged in a service business rather than a rental activity.

The second exception provides that an activity involving the use of tangible property is not a rental activity if (a) on the average, the period for which each customer uses the property is greater than seven days but not greater than 30 days and (b) significant personal services are provided. Thus, for example, a taxpayer operating a hotel will not be treated as engaged in a rental activity, even if guests stay for an average period that exceeds seven days, if significant personal services are provided.

Section 1.469-1T(e)(3)(iv) provides that only services performed by individuals are treated as personal services. Thus, services such as telephone and cable television service are not taken into account. Section 1.469-1T(e)(3)(iv)(B) also provides that certain specified services, referred to as “excluded services” are not taken into account. The excluded services are (a) all services necessary to permit the lawful use of the property, (b) services in connection with the construction of improvements or in connection with the performance of repairs that extend the useful life of the property, and (c) in the case of improved real property, the kinds of services commonly provided in connection with long-term rentals of high-grade commercial and residential property (e.g., janitorial services).

The third exception provides that an activity involving the use of tangible property is not a rental activity if extraordinary personal services are provided by or on behalf of the owner in connection with making property available for use by customers. This exception applies even if, on the average, the period for which each customer uses the property exceeds 30 days. Extraordinary personal services are provided only if the services are performed by individuals, and the customers' use of the property is incidental to their receipt of the services provided. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. In some cases, it may be difficult to determine whether the use of property is incidental to the services provided. The Service invites comment on the extraordinary services rule.

The fourth exception is for rentals incidental to certain nonrental activities of the taxpayer. This exception applies if (a) an insubstantial amount of rental income is derived from renting property incidental to an activity of holding such property for investment, (b) the rented property is lodging provided to the taxpayer's employees for the convenience of the taxpayer, (c) an insubstantial amount of rental income is derived from property that was recently used in a trade or business activity of the taxpayer and is temporarily rented, (d) the property is held for sale to customers in the ordinary course of a trade or business and is in fact sold during the taxable year.

The fifth exception provides that an activity of making property available for use by customers is not a rental activity if the taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers. Thus, operating a facility (such as a golf course) that is used by customers who would normally be characterized as invitees or licensees rather than lessees or tenants is not a rental activity.

The sixth exception relates to property provided for use in a nonrental activity of a partnership, S corporation, or joint venture in which the taxpayer owns an interest. The provision of such property is not a rental activity if the taxpayer does not rent the property to the partnership, S corporation or joint venture, but provides the property in the taxpayer's capacity as an owner of such an interest.

III. Special Rules Treating Certain Activities as Nonpassive

A. Exception for Certain Oil and Gas Working Interests

1. Property unit to which exception applies. Section 469(c)(3)(A) provides that the term “passive activity” does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the taxpayer's liability with respect to such interest. Section 1.469-1T(e)(4)((i) applies this rule on a well-by-well basis. Thus, if a taxpayer owns a working interest in a tract of land, assigns the working interest in part of the tract to a partnership in exchange for a limited partnership interest, and drills a well on the retained portion of the tract, the working interest exception will apply to that well. If, however, the partnership drills a well on the assigned portion of the tract, the working interest exception will not apply to the taxpayer's interest in that well.

2. Entities that limit liability. Section 1.469-1T(e)(4)(v) provides that an entity limits the liability of a holder of an interest in the entity only if, under the applicable State law, the holder's potential liability for all obligations of the entity is limited (as in the case of a limited partner or a stockholder) to a determinable fixed amount. Thus, the working interest exception may apply even if the taxpayer is protected against loss by an indemnification agreement, a stop loss arrangement, insurance, any similar arrangement, or any combination of such devices.

In addition, a partnership in which a taxpayer is a general partner is treated as an entity that does not limit the taxpayer's liability, and any working interest that the taxpayer holds through such a partnership is treated as an interest in an activity that is not a passive activity. Thus, deductions from the working interest (including deductions allocable to a limited partnership interest of the taxpayer) will not be subject to the passive loss limitation.

Taxpayers should draw no inferences from these rules concerning the application of section 465(b)(4). If deductions and losses from a working interest are subject to limitation under section 465, then the provisions of section 465(b)(4) apply without regard to the treatment of such deductions and losses under section 469. As explained below, the regulations include rules coordinating the limitations under sections 465 and 469.

3. Effect of limited liability at the time economic performance occurs. Under §1.469-1T(e)(4)(i), the working interest exception applies for a taxable year to an interest in an oil or gas well drilled or operated pursuant to a working interest that the taxpayer holds at any time during such year either directly or through an entity that does not limit the liability of the taxpayer with respect to such well. Section 1.469-1T(e)(4)(ii) provides that notwithstanding the working interest exception a portion of the taxpayer's deductions from an oil or gas well will be treated as passive activity deductions (and a corresponding portion of any gross income from the well will be treated as passive activity gross income) if the taxpayer has a net loss from the well, and economic performance occurs with respect to expenses deducted for the

taxable year in connection with the drilling or operation of the well at a time when the taxpayer holds the interest in the well through an entity that limits the taxpayer's liability with respect to such drilling or operation. For this purpose, the term "economic performance" has the same meaning as in section 461(h), without regard to the exceptions for recurring items or the spudding of oil and gas wells.

Under this rule, the working interest exception may apply for a taxable year to a well drilled by a partnership in which the taxpayer owns a general partnership interest that is convertible at the taxpayer's option into a limited partnership interest. If, however, the interest is converted before economic performance has occurred with respect to all items of deduction taken into account by the taxpayer for the taxable year in connection with the drilling or operation of the well, the working interest exception will not apply for the taxable year to that portion of the taxpayer's net loss for the year that is attributable to deductions for expenses with respect to which economic performance occurred after the conversion.

4. Income recharacterization rule. If any loss for a taxable year from an interest in an oil or gas property is treated under the working interest exception as a loss that is not from a passive activity, then any net income from the property for any subsequent taxable year is treated as income that is not from a passive activity. This rule is explained more fully below under the heading "Income from oil or gas properties with respect to which the taxpayer benefited from the working interest exception."

B. Trading Personal Property

In some circumstances, the activity of trading personal property (such as securities or commodities or other property of a type that is actively traded) for one's own account has been treated as a trade or business. Even in those circumstances, however, the income or loss from the activity resembles portfolio income or loss in that it results entirely from the holding and sale of personal property. Accordingly, §1.469-1T(e)(6) provides that an activity of trading personal property of a type that is actively traded for the account of owners of interests in the activity is not a passive activity even if the activity is treated as a trade or business.

IV. Identification of Items of Deduction and Credit That Are Disallowed Under Section 469

Section 1.469-1T(f) provides rules identifying the items of deduction and credit that are disallowed when any part of the taxpayer's passive activity loss or passive activity credit is disallowed for the taxable year. In the case of losses, the regulations generally provide that the amount of the disallowed loss is first allocated ratably among all of the taxpayer's passive activities that have net losses for the year. Any loss allocated to an activity is then generally allocated ratably among all passive activity deductions from the activity for the year. In the case of credits, the first step is omitted; the disallowed passive activity credit is allocated ratably among all of the taxpayer's credits from passive activities.

Taxpayers generally need not account separately for each item of deduction or credit disallowed under section 469. The regulations provide that separate accounting is required if and only if separate identification of an item of deduction or credit may affect the taxpayer's tax liability for any taxable year. For example, if 40 percent of the loss from a passive activity is disallowed for the taxable year, and one of the deductions from the activity is a loss from the sale of a capital asset, the taxpayer must separately identify 40 percent of that deduction as a deduction that is disallowed for the taxable year. Separate identification of the capital loss is required because the limitation on capital losses under section 1211 applies after section 469 and, thus, the disallowance of a capital loss (rather than an ordinary deduction) may affect the taxpayer's tax liability for one or more taxable years.

V. Application of Section 469 to C Corporations

A. Definition of "Personal Service Corporation"

For purposes of section 469, §1.469-1T(g)(2)(i) defines the term "personal service corporation" by cross reference to the definition of such a corporation in §1.441-4T(d). Those regulations generally provide that a corporation is not a personal service corporation unless it is a C corporation and its principal activity is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

B. Effect of Net Active Income of a Closely Held Corporation

Section 469(e)(2)(A) provides that the passive activity loss of a closely held corporation shall be allowable as a deduction against the net active income of such a corporation, and that a similar rule shall apply in the case of any passive activity credit of such a taxpayer. Section 1.469-1T(g)(4) provides that a closely held corporation's passive activity loss for the taxable year is decreased by the corporation's net active income for the year.

Section 1.469-1T(g)(5) provides that a closely held corporation's passive activity credit for the taxable year is decreased by the corporation's net active income tax liability for the year. For purposes of this rule, a closely-held corporation's net active income tax liability is the regular tax liability that is allocable to the corporation's net active income, reduced by all credits other than credits from passive activities.

Since net active income is computed by modifying taxable income, net operating loss carrybacks and carryforwards to the taxable year must be taken into account. Therefore, a net operating loss carryback which requires a closely held corporation to recompute its net active income and net active income tax liability for one or more years may also require a recomputation of the corporation's passive activity loss and passive activity credit for one or more years.

C. Treatment of Affiliated Groups of Corporations Filing Consolidated Returns

Section 1.469-1T(h) contains special rules for applying section 469 and the regulations thereunder to an affiliated group of corporations filing a consolidated return for the taxable year (a “consolidated group”). Under these rules, a consolidated group generally is treated as a single corporation for purposes of section 469 and the regulations thereunder. Thus, a single passive activity loss and passive activity credit are computed for such a group. In addition, the status of each member of an affiliated group as a personal service corporation or closely held corporation is the same as the status of the entire consolidated group, determined as though the group were a single corporation. In making this determination, and in applying the participation tests set forth in §1.469-1T(g)(3), only stockholders of the group's common parent are treated as stockholders of the hypothetical single corporation.

Section 1.469-1T(h)(5) contains rules for allocating a consolidated group's disallowed passive activity loss and credit among the group's members. Under these rules, the disallowed loss or credit is first allocated among the members of the group and is then allocated among the activities of the members under the general rules in §1.469-1T(f).

Section 1.469-1T(h)(6) contains rules relating to intercompany transactions (within the meaning of §1.1502-13(a)(1)). These rules generally are intended to attribute all items of income and deduction of all members that are attributable to an intercompany transaction to the activities of the purchasing member (within the meaning of §1.1502-13(a)).

The Service invites comment on all aspects of the rules in §1.469-1T(h).

D. Coordination With Other Provisions

The Service recognizes that further rules are needed to coordinate section 469 with certain other provisions applicable to corporations (e.g., sections 381, 382, and 1502) and invites comment on these rules.

VI. Treatment of Spouses Filing a Joint Return

Section 469(h)(5) provides that in determining whether a taxpayer materially participates in an activity, the participation of the taxpayer's spouse shall be taken into account. Section 469(i)(6)(D) provides a parallel rule for active participation. Section 469(l)(5) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of section 469, including regulations relating to changes in marital status and changes between joint returns and separate returns.

The Service believes that treating married persons filing a joint return as separate taxpayers for purposes of section 469 would present undesirable administrative difficulties, and that it is generally preferable to treat such persons as one taxpayer. In some situations, however, this treatment would frustrate the purposes of the passive loss and credit limitations. For example, the fact that one spouse holds a working interest in an oil or gas well through an entity that does not limit the spouse's liability should not be taken into account in determining whether the working interest exception applies to any portion of the working interest that is held by the other spouse. In addition, if two individuals cease filing a joint return, it is necessary for each individual to account for the deductions and credits treated under section 469(b) as allocable to his or her passive activities.

Accordingly, §1.469-1T(j) provides that spouses filing a joint return for a taxable year generally are treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder. For purposes of the working interest exception, however, married persons are treated as separate taxpayers. In addition, if any deductions or credits are disallowed under section 469, the disallowed deductions and credits attributable to each spouse's activities must be separately identified.

The Service invites comment on the treatment of married persons.

VII. Definition of Passive Activity Loss

Section 469(d)(1) defines the term "passive activity loss" as the amount (if any) by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year. In the interest of clarity, §1.469-2T(b) defines the passive activity loss for the taxable year as the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year. The rules in §1.469-2T (c) and (d) identify the items treated as passive activity gross income and passive activity deductions, respectively, for the taxable year.

VIII. Identification of Items of Gross Income and Deductions From Passive Activities

The regulations state that, except as otherwise provided, all items of gross income from a passive activity are included in passive activity gross income, and all deductions arising in connection with a passive activity are passive activity deductions. The regulations do not require that any particular method be employed in determining (a) whether items of income are derived from an activity, (b) whether deductions arise in connection with an activity, or (c) how shared costs should be allocated among activities. The regulations contemplate the use of reasonable methods in making these determinations, and the Service will disregard unreasonable determinations. The Service invites public comment regarding the desirability of detailed rules relating to these issues.

IX. Treatment of Gain From the Disposition of an Interest in an Activity or Property Used in an Activity

A. General Rule: Characterization of Gain at the Time of the Disposition

Gain from a disposition of property used in an activity or of an interest in an activity held through a partnership or S corporation generally is treated as gross income from that activity. Except in the case of gain from a disposition of substantially appreciated property formerly used in a nonpassive activity and gain attributable to such property from a disposition of an interest in a partnership or S corporation, such gain is passive activity gross income if the activity is a passive activity for the taxable year of the disposition.

For purposes of this rule, the gain recognized upon the disposition of a partnership interest or S corporation stock is treated as gain from the disposition of an interest in the activities in which the partnership or S corporation has an interest. Rules relating to the allocation of gain among the activities of a partnership or S corporation and the treatment of gain allocated to an activity that includes substantially appreciated property formerly used in a nonpassive activity are discussed under the heading "Dispostions of interests in partnerships and S corporations".

The Service recognizes that an approach that focuses on the character of the activity at the time of a disposition may in many circumstances appear arbitrary, and considered various other approaches. These approaches, including approaches taking into account the nature of the activity or the use of the property during the taxpayer's entire holding period, were rejected because they are found to be equally arbitrary and substantially more difficult to administer.

The Service invites comment on the rules relating to the treatment of gain from dispositions of interests in activities and interests in property used in activities.

B. Disposition of Property Used in More Than One Activity in the 12 Months Preceding the Disposition

To ensure that the character of gain realized on the disposition of property reflects the use of the property for a reasonable period preceding the disposition, §1.469-2T(c)(2)(ii) requires the taxpayer to allocate the amount realized on the disposition and the adjusted basis of the property among the activities in which the property was used during the 12-month period preceding the disposition. For purposes of this rule, the term "activity" includes, e.g., personal use and holding for investment.

The regulations provide only that the allocation of amount realized and adjusted basis must be reasonable. Examples illustrate that an allocation among activities is considered reasonable if it is based on the period for which the property is used in each such activity during the 12-month period. These examples are not intended to foreclose the use of other reasonable allocation methods.

In recognition of the recordkeeping burden that this allocation rule may impose, §1.469-2T(c)(2)(ii) also provides a de minimis exception under which the amount realized and adjusted basis of property that was predominantly used in one activity during the 12-month period preceding its disposition may be allocated solely to that activity if the value of the property does not exceed the lesser of (a) $10,000 and (b) 10 percent of the value of all property used in the activity at the time of the disposition.

The Service invites comment on the feasibility of the allocation requirement generally, including comment on allocation rules that may be helpful to taxpayers.

C. Disposition of Substantially Appreciated Property Formerly Used in a Nonpassive Activity

The general rule characterizing gain by reference to the character of the activity in which property is used at the time of disposition could, if not limited, encourage taxpayers to structure dispositions in a manner that generates passive activity gross income in inappropriate situations. Accordingly, §1.469-2T(c)(2)(iii) provides that any gain from a disposition of substantially appreciated property is treated as not from a passive activity unless the property was used in a passive activity for either (a) 20 percent of the taxpayer's holding period for the property or (b) the entire 24-month period ending on the date of the disposition. For purposes of this rule, property is substantially appreciated if its fair market value is more than 120 percent of its adjusted basis.

D. Pre-1987 Installment Sales

In Notice 87-8, 1987-3 I.R.B. 11, the Service announced that, under these regulations, gain recognized on the installment method would be treated as not from a passive activity if, but for the use of the installment method, the taxpayer would have taken the gain into account for a taxable year beginning before January 1, 1987. This rule is inconsistent with a proposed technical correction to section 469, and is not included in these regulations. Moreover, the Service will not enforce the rule announced in Notice 87-8 unless and until it is adopted in regulations under section 469.

X. Portfolio Income Excluded From Passive Activity Gross Income

A. General Rule

Section 1.469-2T(c)(3) provides that passive activity gross income does not include portfolio income, which is defined as gross income that is derived from specified sources (including interest, dividends, annuities, and royalties) and is not derived in the ordinary course of a trade or business. Section 1.469-2T(c)(3)(ii) provides that, for purposes of this rule, gross income is treated as derived in the ordinary course of a trade or business only to the extent specifically provided in the regulations. That provision also specifically identifies certain types of income as derived in the ordinary course of a trade or business and provides that the Commissioner may similarly treat additional types of income as similarly derived. The Service invites comment on and ruling requests relating to the treatment of interest, dividends, annuities, and royalties as derived in the ordinary course of a trade or business.

B. Characterization of Royalties From Licensing Intangible Property

Section 1.469-2T(c)(3)(iii)(B) provides that royalties from licensing intangible property may be treated as derived in the ordinary course of a trade or business only if the person receiving such royalties either created the property or performed substantial services or incurred substantial costs with respect to the development or marketing of the property. Although the determinations under this rule are generally based on all of the facts and circumstances, a person will be treated as deriving royalties in the ordinary course of a trade or business if either of two quantitative tests are satisfied. The Service invites public comment on the appropriateness of this rule and the need for additional guidance. In particular, the Service seeks comment on the quantitative tests.

C. Mineral Royalties

The regulations do not include special rules for determining whether mineral royalties are derived in the ordinary course of a trade or business because the Service is continuing to develop criteria for making this determination. The regulations include only one example illustrating the treatment of mineral royalties. This example, which follows from §1.469-2T(c)(3)(ii)(D), indicates that royalty income derived from royalty interests held in a trade or business activity of trading or dealing in such interests is treated as derived in the ordinary course of a trade or business.

Under §1.469-2T(c)(3)(ii), the only other mineral royalties treated as income derived in the ordinary course of a trade or business are those identified by the Commissioner. Therefore, unless and until these regulations are amended, taxpayers may not treat mineral royalties (other than royalties derived from a trade or business of trading or dealing in royalty interests) as derived in the ordinary course of a trade or business without obtaining a ruling.

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

XI. Personal Service Income Excluded From Passive Activity Gross Income

A. Payments to Partners for the Performance of Services

Section 469(e)(3) provides that earned income (within the meaning of section 911(d)(2)(A)) shall not be taken into account in computing the income or loss from a passive activity for any taxable year. Section

911(d)(2)(A) defines earned income in a manner that includes all payments to partners for the performance of services. Accordingly, the regulations provide, in §1.469-2T (c)(4)(i)(A) and (e)(2), that any payments to a partner that are described in section 707 (a) or (c) and represent compensation for the performance of services are excluded from passive activity gross income.

The regulations do not, however, adopt the suggestion of some commentators to treat as personal service income the portion of a partner's distributive share of partnership income that represents the value of the partner's services performed on behalf of the partnership.

B. Income From Retirement Plans

Taxable distributions from pension, profit-sharing, and other retirement plans generally are comprised of compensation for past services and investment income. Both of these components generally are excluded from passive activity gross income. Therefore, §1.469-2T(c)(4) provides that personal service income includes all income from such distributions

XII. Income From Section 481 Adjustments

If a change in accounting method results in an increase in taxable income under section 481 (a “positive section 481 adjustment”), the portion of the adjustment attributable to activities that were passive activities in the year of change is treated, under §1.469-2T(c)(5), as passive activity gross income. The portion of the adjustment attributable to an activity is determined by allocating the adjustment among the activities that would have given rise to a positive section 481 adjustment if a separate section 481 adjustment were computed with respect to each activity, in proportion to such hypothetical positive adjustments.

XIII. Income From Oil or Gas Properties With Respect to Which the Taxpayer Benefited From the Working Interest Exception

Section 469(c)(3)(B) provides that, if a taxpayer has a loss for a taxable year from a working interest in an oil or gas property that is treated as not from a passive activity, any net income from such property for any succeeding taxable year shall be treated as not from a passive activity.

A. Pre-1987 Losses and Losses From Material Participation Activities

Section 1.469-2T(c)(6)(i) provides that section 469(c)(3)(B) applies only where a loss from a working interest arises in a taxable year beginning after December 31, 1986, and is treated as not from a passive activity solely by reason of the special working interest exception in section 469(c)(3)(A). Thus, the fact that a loss for a taxable year from an oil or gas well drilled or operated pursuant to a working interest was not subject to limitation under section 469 will not cause income for any succeeding year to be treated as not from a passive activity if either (a) the loss was taken into account for a taxable year beginning prior to January 1, 1987, or (b) the loss was not subject to limitation because the taxpayer materially participated in the activity in which the loss arose.

B. Definition of “Property”

Neither section 469(c)(3)(B) nor the legislative history defines the term “oil or gas property.” Section 1.469-2T(c)(6)(iii) provides that, for purposes of applying section 469(c)(3)(B) with respect to a working interest, the term “oil or gas property” means any oil or gas property the value of which is directly enhanced by activities the costs of which are borne by the taxpayer as a result of drilling an oil or gas well with respect to the working interest. Thus, the definition of “property” in section 614(a) and the regulations thereunder is not relevant for this purpose.

The definition of the term “oil or gas property” for purposes of section 469(c)(3)(B) is illustrated by three examples. The first example indicates that if the drilling of a well on one tract reveals that a single reservoir underlies that tract and another tract in which the taxpayer owns an interest, the taxpayer's interests in both tracts are treated as part of the same oil or gas property. The second example indicates that if a well is drilled through two formations, both formations are treated as part of the same oil or gas property. The third example indicates that the mere fact that drilling activities generate information indicating the presence of oil or gas in a general geographical area is insufficient to establish that the value of oil or gas properties in such area is "directly" enhanced by the activities generating the information.

XIV. Passive Activity Deductions

A. General Rule

Section 1.469-2T(d)(1) provides that a deduction is a "passive activity deduction" for a taxable year if the deduction (a) arises in connection with the conduct of an activity that is a passive activity for the taxable year or (b) is carried over from the preceding taxable year under section 469(b). For purposes of this rule, a deduction is treated as arising in the taxable year in which the deduction would be allowable if taxable income for all taxable years were determined without regard to sections 469 and 1211. Thus, for example, if a partner's distributive share of a partnership deduction is disallowed under section 704(d) in 1987, but is not disallowed under section 704(d) (or any other provision other than section 469 or 1211) in 1988, the deduction is treated as arising in 1988.

This rule has two significant effects. First, a deduction is not taken into account in computing the passive activity loss and credit until the first taxable year in which the deduction is not disallowed by any applicable limitation other than those contained in sections 469 and 1211. Second, the determination of whether a deduction from an activity is a passive activity deduction does not depend on the character of the activity in taxable years in which the deduction is disallowed under limitations other than section 469. Thus, in the example in the preceding paragraph, the determination of whether the partner's deduction is a passive activity deduction in 1988 depends solely on whether the activity in which it arises is a passive activity of the partner in 1988.

Section 501(c)(2) of the Tax Reform Act of 1986 provides that section 469 shall not apply to any loss, deduction, or credit carried to a taxable year beginning before January 1, 1987. Consistent with the rule, §1.469-2T(d)(2)(x) provides that an item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 465, 704(d), or 1366(d), is not treated as passive activity deduction.

B. Losses From Dispositions

Section 1.469-2T(d)(5) generally treats any loss recognized upon the disposition of property used in an activity or of an interest in an activity held through a partnership or S corporation as a deduction from such activity. Rules relating to the allocation of loss among activities of a partnership or S corporation are discussed under the heading "Dispositions of interests in partnerships and S corporations." Under section 469(g)(1), the loss from a disposition may be treated in whole or in part as a loss that is not from a passive activity. Future regulations will provide rules for determining when a loss is treated under section 469(g)(1) as not from a passive activity.

C. Coordination With Sections 465, 704 (d), and 1366(d)

Since, for purposes of section 469, a deduction is not treated as arising in a taxable year in which it is disallowed under section 465, 704(d), or 1366(d), rules are needed to determine which deductions are disallowed for the taxable year under such sections. Section 1.469-2T(d)(6) provides such rules.

Under §1.469-2T(d)(6), if section 465, 704(d), or 1366(d) disallows all or any part of the taxpayer's loss attributable to an activity (within the meaning of section 465), or to an interest in a partnership or S corporation, as the case may be, a portion of each deduction taken into account in computing such loss is disallowed. To the extent the regulations under those provisions are not consistent with the rules in §1.469-2T(d)(6), the Service expects that such regulations will be amended.

The regulations do not include any other rules coordinating section 469 with other limitations on losses and deductions. The Service invites comment on the the need for additional coordination rules.

XV. Special Rules for Partners and S Corporation Shareholders

A. In General

The determination of whether an item of income or deduction from a partnership or S corporation is an item of passive activity gross income or a passive activity deduction, respectively, is made by reference to the taxpayer's participation in the activity that generated the item of income or deduction. Section 1.469-2T(e)(1) provides that, in the case of items of income, gain, loss, and deduction from an activity conducted through a fiscal year partnership or S corporation, the taxpayer's participation is determined for the entity's taxable year. The Service invites comment on the application of this rule.

B. Certain Payments to Partners

Section 1.469-2T(e)(2)(i) provides that items of gross income and deduction attributable to a transaction between a partner and a partnership shall be characterized for purposes of section 469 in a manner consistent with the treatment of such transaction under section 707(a). Section 1.469-2T(e)(2)(ii) provides that a payment to a partner for the performance of services or the use of capital, if described in section 707(c) or section 736(a)(2), is generally characterized for purposes of section 469 and the regulations thereunder as a payment of compensation for services or interest, as the case may be, and not as a distributive share of partnership income. The Service expects that a conforming amendment will be made to §1.707-1.

In addition, §1.469-2T(e)(2)(iii) provides that any gain or loss taken into account by a retiring partner or a deceased partner's successor in interest as a result or a deceased partner's successor in interest as a result of a payment under section 736(b) is treated a passive activity gross income or a passive activity deduction only to the extent that the gain or loss would have been treated as passive activity gross income or a passive activity deduction if it had been recognized at the time that the liquidation of the retiring or deceased partner's interest commenced.

C. Dispositions of Interests in Partnerships and S Corporations

In general, for Federal income tax purposes, a disposition of an interest in a partnership or S corporation (a “passthrough entity”) is treated as a disposition of such interest, rather than as a disposition of an interest in each of the entity's assets. The Service believes that the accurate measurement of passive activity gross income and deductions would be furthered by requiring such a disposition to be treated as a disposition of an interest in the passthrough entity's assets. The regulations nonetheless have not adopted this approach as the general rule because a reasonably accurate measurement of passive activity gross income and deductions generally may be accomplished by allocating the gain or loss from the disposition of an interest in a passthrough entity among the entity's activities.

Section 1.469-2T(e)(3) contains rules governing the treatment, for purposes of the passive loss and credit limitations, of a disposition of an interest in a passthrough entity by a holder of such an interest (the “holder”). A transitional rule also is provided.

The general rule, contained in §1.469-2T(e)(3)(ii), requires a holder's gain or loss from a disposition of an interest in a passthrough entity (including gain or loss recognized under section 731(a)) to be allocated among the activities of the passthrough entity in proportion to the amounts of gain or loss, respectively, that would have been allocated to the holder by the passthrough entity with respect to each of the entity's activities if the entity had sold its interests in such activities on the applicable valuation date. Generally, the passthrough entity may select either the beginning of the taxable year of the passthrough entity in which the holder's disposition occurs or the date of such disposition as the applicable valuation date. The date of the holder's disposition of an interest in the passthrough entity must be used as the applicable valuation date, however, if since the beginning of the entity's taxable year the entity has sold a significant amount of the property used in any activity or the holder has contributed a significant amount of substantially appreciated or substantially depreciated property to the passthrough entity. For purposes of this rule, property is substantially appreciated if its fair market value exceeds 120 percent of its adjusted basis, and property is substantially depreciated if its adjusted basis exceeds 120 percent of its fair market value.

Under §1.469-2T(e)(3)(iii), gain from a holder's disposition of an interest in a passthrough entity that is allocated to a passive activity under the general rule will nonetheless be treated as gain that is not from a passive activity if (a) gain that would be treated as gain that is not from a passive activity under §1.469-2T(c)(2)(iii) would have been allocated to the holder if all of the property used in the activity had been sold, and (b) the amount of that gain exceeds 10 percent of the holder's gain from the disposition that is allocated to the activity under the general rule. This rule is designed to prevent taxpayers from using passthrough entities to structure dispositions of property in a manner that generates passive income in situations where such income would otherwise be treated as not from a passive activity under §1.469-2I(c)(2)(iii).

Section 1.469-2T(c)(3)(iv) provides a transitional rule for dispositions of interests in a passthrough entity that occur during any taxable year of the entity beginning prior to February 19, 1988. Under this transitional rule, gain or loss from a qualifying disposition of an interest in the entity may be allocated among the activities of the entity under any reasonable method that the selects. This transitional rule does not apply to any sale of an interest in a passthrough entity that occurs after February 19, 1988, if the holder contributes certain substantially appreciated property (as defined above) to the entity after that date.

The Service continues to study the issues presented by dispositions of interests in passthrough entities and invites comment on the treatment accorded these dispositions under §1.469-2T(e)(3).

XVI. Recharacterization of Certain Passive Activity Gross Income

A. In General

Section 469 was intended to prevent taxpayers from using losses from rental activities and passive business activities to shelter any of three types of income: (a) Personal service income, (b) active business income, and (c) Portfolio investment income. Congress recognized the difficulty of writing statutory rules that would clearly distinguish income in these classes from income properly falling in the rental or passive business income category, and anticipated the need for additional rules to address transactions structured in order to maximize the amount of income treated as rental or passive business income. Consequently, Congress enacted section 469(l)(1), (2), and (3), granting to the Secretary the authority to prescribe regulations that eliminate certain items of gross income, or the net income from certain activities, from the computation of the passive activity loss and credit.

The Conference Report accompanying the Act states that the Secretary's regulatory authority is intended to be “exercised to protect the underlying purpose of the passive loss provision, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities.” H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess., vol. II, at 147 (1986).

In the absence of regulations, taxpayers would be encouraged to generate passive activity gross income by (a) changing their participation in, and the ownership structure of, their active businesses, and (b) replacing their portfolio investments with investments in rental or passive business activities that share many of the investment characteristics of traditional portfolio investments. Although attempts to derive capital income from rental or passive business sources are not generally abusive, they could, if undeterred, frustrate Congress' intent that the passive loss provision prevent “the sheltering of positive income sources.” Thus, §1.469-2T(f) requires that income from certain activities be treated as income that is not from a passive activity.

Since taxpayers could not clearly foresee the particular recharacterization rules that these regulations would adopt, the provisions in §1.469-2T(f) that recharacterize income from activities based on factors other than the taxpayer's participation in such activities do not apply to gross income taken into account for any taxable year beginning before January 1, 1988. In addition, the rule recharacterizing income from self-rented property does not apply to income that is attributable to the rental of property pursuant to a written binding contract entered into before February 19, 1988.

The rules contained in §1.469-2T(f) apply only to gross income that, in the absence of such rules, would be treated as passive activity gross income. Thus, if an activity is not a passive activity, the rules in §1.469-2T(f) do not apply to gross income from the activity. Moreover, except as specifically provided by regulation, the fact that an amount of gross income from an activity is recharacterized under §1.469-2T(f) does not cause that activity to be treated as other than a passive activity for purposes of section 469 or these regulations.

B. Rules Preventing Conversion of Active Business Income Into Passive Activity Gross Income

1. Passive activities in which the taxpayer's participation is significant. The Service recognizes that, in the case of an activity that is not the full-time occupation of the taxpayer, the rules regarding material participation set forth in §1.469-5T are stringent. As a result, a taxpayer spending relatively small amounts of time in unrelated activities could, in the absence of regulations, treat the gross income from such activities as passive activity gross income even though the taxpayer's participation and services are significant factors in generating the income from the activities.

In view of this concern, §1.469-2T(f)(2) provides that an amount of the taxpayer's gross income from a significant participation passive activity equal to the taxpayer's net passive income from the activity is treated as not from a passive activity. For purposes of this rule, a significant participation passive activity is an activity (other than a rental activity) in which the taxpayer participates for more than 100 hours, but does not materially participate, for the taxable year.

The Service does not believe it appropriate to treat the taxpayer's net income, but not the taxpayer's net losses, from activities as nonpassive if the taxpayer's involvement in such activities is substantial. Accordingly, §1.469-5T(a)(4) provides that a taxpayer materially participates in activities that would otherwise be significant participation passive activities for purposes of §1.469-2T(f)(2) if the taxpayer's participation in all such activities exceeds 500 hours for the taxable year.

2. Activities involving the rental of property developed by the taxpayer. In general, an activity involving the rental of property is a passive activity. Under §1.469-2T(c)(2), gain from the disposition of property used in a passive activity generally is treated as passive activity gross income. It is not appropriate, however, to treat a taxpayer's gain from the sale of a rental property as passive activity gross income if the taxpayer materially or significantly participated in the development of the property and the gain is predominantly attributable to the development of the property rather than to appreciation during the rental period.

Accordingly, §1.469-2T(f)(5) provides that, in certain situations, an amount of a taxpayer's gross income from renting and selling an item of property equal to the taxpayer's net passive income from such rental and sale is treated as not from a passive activity. This rule applies if (a) any gain from the sale, exchange, or other disposition of the property is included in the taxpayer's income for the taxable year, (b) during any taxable year the taxpayer materially or significantly participated in a trade or business activity involving the performance of services for the purpose of enhancing the value of the property, and (c) a binding contract for the sale or exchange was entered into less than 24 months after the rental of the property commenced.

In general, the effect of this rule is that property developed by the taxpayer must be rented for at least 24 months prior to selling the property or contracting for its sale or the taxpayer's gain from the sale will not be treated as passive activity gross income.

3. Self-rented property. As indicated above, section 469 is intended, in part, to prevent taxpayers from sheltering active business income with losses from rental activities and passive business activities. Income from an active business consists of both income from services and income from capital invested in the business. In the absence of regulations, a taxpayer could derive passive activity gross income from an active business in which tangible property is used by renting the property to an entity conducting the activity (or by causing an entity holding the property to rent the property to the taxpayer). It would be inconsistent with the purposes of section 469 to treat rental income as passive activity gross income in such cases, and the Conference Report accompanying the Act states that it would be appropriate for the Service to exercise its regulatory authority under section 469(l)(3) in the case of "related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income." H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess., vol. II, at 147 (1986).

Accordingly, §1.469-2T(f)(6) provides that an amount of the taxpayer's gross income from renting an item of property equal to the taxpayer's net passive income from such rental is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year. The Service recognizes that it has the authority to treat part or all of the taxpayer's rental expense in such cases as a self-charged item, and that the amount of rental income that is recharacterized under §1.469-2T(f)(6) may exceed the amount of income that it would be appropriate to recharacterize as a self-charged item. The Service invites comments on the relationship between this rule and the rules to be provided under §1.469-7T (relating to the treatment of self-charged items of income and expense).

C. Rules Preventing Conversion of Portfolio Income Into Passive Activity Gross Income

1. Activities involving the rental of nondepreciable property. The Conference Report accompanying the Act states that it may be appropriate for the Service to treat "ground rents that produce income without significant expenses" as not from a passive activity. Consistently with this suggestion, §1.469-2T(f)(3) provides that an amount of the taxpayer's gross income from an activity of renting nondepreciable property equal to the taxpayer's net passive income from the activity is treated as not from a passive activity. Since nondepreciable property may be rented together with incidental depreciable property (e.g., land with minor improvements), raising a factual issue as to whether an activity in which nondepreciable property is leased consists primarily of renting such property, §1.469-2T(f)(3) provides a bright line for distinguishing activities involving the rental of nondepreciable property from other rental activities. Under the regulations, income from a rental activity is subject to this recharacterization rule if the unadjusted basis of the depreciable property rented in the activity is less than 30 percent of the unadjusted basis of all property rented in the activity. The Service invites comment regarding the appropriateness of this objective standard.

2. Equity-financed lending activities. Under §1.469-2T(c)(3)(ii)(A), interest income from loans made in the ordinary course of a trade or business of lending money is not portfolio income. Absent a regulation expressly treating income from such an activity as nonpassive income, taxpayers could derive passive income from investments substantially similar to mutual fund investments by becoming passive investors in partnerships or S corporations that engage in a trade or business of lending equity funds contributed by the taxpayers. Permitting such income to be treated as passive income would be inconsistent with the purpose of section 469 to prevent the sheltering of portfolio income with losses from rental and passive business activities. On the other hand, income derived from borrowing money and lending the proceeds at a higher interest rate does not resemble the kind of portfolio income which Congress intended to protect from sheltering by passive losses.

Accordingly, §1.469-2T(f)(4) treats as nonpassive income an amount of the taxpayer's gross income from an equity-financed lending activity equal to the lesser of (a) the taxpayer's equity-financed interest income from the activity or (b) the taxpayer's net passive income from the activity. This rule applies to the lending activities in which the average balance of debt incurred in the activity (determined at the entity level) does not exceed 80 percent of the average balance of interest-bearing assets held in the activity. In general, the taxpayer's equity-financed interest income from the activity is equal to the taxpayer's interest income from the activity multiplied by the activity's ratio of equity to interest-bearing assets. This rule is designed to treat as nonpassive income only that portion of the taxpayer's income from the activity that approximates the product of (a) the average interest rate of the activity's interest-bearing assets and (b) the taxpayer's equity contribution to the activity.

3. Passthrough entities licensing intangible property. Section §1.469-2T(c)(3)(iii)(B) provides that royalty income received by a passthrough entity from the licensing of intangible property may be treated as income derived in the ordinary course of a trade or business if the entity (a) created the property or (b) performed substantial services or incurred substantial costs with respect to the development or marketing of the property. This treatment is appropriate in the case of a taxpayer who owns an interest in such an entity at the time that the entity creates such property, performs such services, or incurs such costs. If, however, a taxpayer acquires an interest in such an entity after the entity creates such property, performs such services, or incurs such costs, the taxpayer's royalty income resembles portfolio income rather than income derived in the ordinary course of a trade or business. Accordingly, §1.469-2T(f)(7) provides that an amount of the taxpayer's gross income from such property equal to the taxpayer's net passive income from such property is generally treated as not from a passive activity. The Service invites comment on the rules employed in §1.469-2T(f)(7) to determine when taxpayers are subject to this rule.

D. Limitation on Recharacterized Income

The rules contained in §1.469-2T(f)(2) (relating to significant participation activities), §1.469-2T(f)(3) (relating to the rental of nondepreciable property), and §1.469-2T(f)(4) (relating to equity-financed lending activities) treat as nonpassive income an amount of the taxpayer's gross income from an activity equal to the taxpayer's net passive income from the activity. Under §1.469-2T(f)(9)(i), the taxpayer's "net passive income" from an activity for a taxable year is the excess of the taxpayer's passive activity gross income from the activity for the year (determined without regard to these recharacterization rules) over the taxpayer's passive activity deductions from the activity for the year. The rules contained in §1.469-2T(f)(5) (relating to the rental of property developed by the taxpayer), §1.469-2T(f)(6) (relating to self-rented property), and §1.469-2T(f)(7) (relating to passthrough entities licensing intangible property) are similar, but apply on a property-by-property basis.

Taxpayers should note that, under §1.469-2T(d)(1)(ii), a deduction from an activity that is disallowed under section 469 for a taxable year is treated as a passive activity deduction from the activity for the succeeding taxable year and that, under §1.469-2T(f)(7)(ii)(B) and (9)(iv), a similar rule applies when deductions reasonably allocable to an item of property are disallowed. Thus, if a taxpayer's loss from an activity or an item of property is disallowed for a taxable year, the taxpayer's net passive income from the activity or property for the succeeding year is reduced by the amount of such disallowed loss. As a result, the regulations do not treat income from an activity or an item of property as nonpassive income while, at the same time, prohibiting the deduction of previously disallowed losses from such activity or property.

Although prior-year losses from an activity or an item of property subject to the rules contained in §1.469-2T(f) generally carry forward and reduce the amount of gross income that is treated as nonpassive income under those rules, this is not the case to the extent any such loss for the prior taxable year exceeds the disallowed loss allocated to such activity or property for such year under the rules of §1.469-1T(f). In that event, the excess loss has in effect absorbed passive income, thereby resulting in the disallowance of passive losses from other activities. The Service is studying the interaction between the rules for allocating disallowed losses and rules, such as those contained in §1.469-2T(f) and those to be provided with respect to former passive activities, under which a carryover loss may be allowed to the extent of income that would otherwise be treated as nonpassive income. The Service invites suggestions for the coordination of those rules.

E. Possible Recharacterization Rules to be Contained in Future Regulations

The Service recognizes that the rules in these regulations are not exhaustive and that taxpayers may structure additional investments that have economic characteristics similar to those of portfolio investments so as to derive passive activity gross income from such investments. The Service intends to monitor developments in this area closely, and anticipates prescribing additional regulations to the extent necessary to prevent portfolio-type income from being treated as passive activity gross income. In general, any such additional regulations would apply prospectively only. In appropriate circumstances, however, the regulations might apply to income, derived after the date the regulations are published, from investments made prior to such date, but in such cases the rules would be issued in proposed form (rather than as temporary regulations), with a period for public comment before the regulations become final.

During the preparation of these regulations, the Service considered an approach to recharacterizing certain passive activity gross income that is illustrative of the kinds of additional regulations the Service may prescribe in the future. Under this approach, gross income attributable to a preferred or guaranteed return from an investment (i.e., a return that through preferences or other arrangements is derived from sources other than the taxpayer's own invested capital) would be treated as portfolio income.

Some commentators have suggested that such a rule should address the following situation:

A limited partnership is formed to acquire a rental property for $10 million. The general partner contributes $5 million to the partnership and the remaining $5 million of partnership capital is raised through a private placement of limited partnership interests to five individuals. The partnership agreement allocates 99 percent of partnership taxable income to the limited partners until the income allocated to them equals a 10 percent cumulative annual return on their invested capital, with any remaining taxable income allocated 15 percent to the limited partners and 85 percent to the general partner. Thus, the income earned on the general partner's invested capital will be applied, if necessary, to satisfy the limited partners' right to a 10 percent cumulative return.

Because of the limited partners' preferential right to income, their interests, depending on circumstances such as the nature of the partnership's investment, may have the characteristics of a portfolio investment. The Service considered an approach under which a limited partner's gross income attributable to a preferred return would in certain circumstances be treated as portfolio income. The Service continues to study this approach and invites comment on the circumstances in which a “preferred” or “guaranteed” return should be treated as portfolio income.

XVII. Passive Activity Credit

A. Credits Subject to Section 469

A credit may be limited under section 469 if it is from a passive activity and is described in section 38 (b)(1) through (5) (relating to general business credits), section 27(b) (relating to section 936 corporations), section 28 (relating to clinical testing of certain drugs), or section 29 (relating to fuel from nonconventional sources).

Section 1.469-3T(b) provides that a credit is treated as from a passive activity if (a) it arises in connection with a passive activity (i.e., an activity that is passive for the taxable year in which the credit would be allowed if section 469 and other specified limitations did not apply) or (b) in the case of a credit attributable to qualified progress expenditures (within the meaning of section 46(d)), it is reasonable to believe that the progress expenditure property (within the meaning of section 46(d)(2)) will be used in a passive activity when it is placed in service. Thus, for example, a credit attributable to qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) which is allowed for the taxable year under section 46(d), is treated as a credit from a passive activity of the taxpayer if either (a) the activity in which the qualified rehabilitation expenditures are paid or incurred is a passive activity of the taxpayer for the taxable year in which such expenditures are paid or incurred, or (b) it is reasonable to believe that the rehabilitated property will be used in a passive activity of the taxpayer when it is placed in service.

B. Determination of Regular Tax Liability Allocable to Passive Activities

Under section 469(d)(2), the passive activity credit is the amount by which the sum of the taxpayer's credits that are subject to section 469 for the taxable year exceeds the taxpayer's regular tax liability allocable to all passive activities for such year. Section 469(j)(3) provides that the term "regular tax liability" has the meaning given such term by section 26(b). Section 1.469-3T(d)(1) provides that the taxpayer's regular tax liability for the taxable year that is allocable to all passive activities is the regular tax liability on the excess of the taxpayer's taxable income for the year over the amount by which the taxpayer's passive activity gross income exceeds the taxpayer's passive activity deductions for the taxable year.

C. Coordination With Other Limitations on Credits

In general, the limitation on the passive activity credit applies before all other limitations that may apply to credits from passive activities (other than the limitation in section 41(g) (relating to research credits of certain individuals)). If a credit is subject to section 469 for a taxable year but is not disallowed by section 469, the credit becomes subject to other limitations in the same manner as credits from activities that are not passive activities. In determining the years to which a general business credit may be carried, the credit is treated for purposes of section 39 as a current year business credit in the first taxable year in which the credit is subject to section 469 but is not disallowed thereby.

XVIII. Material Participation

A. In General

Under §1.469-5T(a), an individual is treated as materially participating in an activity for a taxable year if and only if the individual meets one of seven tests. The first four tests (contained in §1.469-5T(a) (1) through (4)) are quantitative in nature, and are based on the number of hours spent participating in the activity during the year. The fifth and sixth tests (contained in §1.469-5T(a) (5)) and (6)) are based on material participation by the taxpayer in prior years. The seventh test (contained in §1.469-5T (a)(7)) is a facts-and-circumstances test.

B. Quantitative tests

Under §1.469-5T(a)(1), an individual is treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 500 hours during the year.

The Service believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable year to any such investment. In addition, the Service believes that income from an activity in which an individual participates for more than 500 hours during a taxable year is not properly classified as income from a passive activity.

Under §1.469-5T(a)(2), an individual is treated as materially participating in an activity for a taxable year if the individual's participation in the activity for the year constitutes substantially all of the participation in the activity for the taxable year. Section 1.469-5T(a)(3) treats an individual as materially participating in an activity for a taxable year if the individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity for the year is not less than that of any other individual. These rules are included because the service recognizes that the operation of some activities may not require more than 500 hours of participation, or may not require more than 500 hours of participation by any one individual during a taxable year.

Under §1.469-5T(a)(4), an individual is treated as materially participating in all of the individual's significant participation activities for a taxable year if the individual's aggregate participation is significant participation activities for the year exceeds 500 hours. For purposes of this rule, a significant participation activity is a trade or business activity in which the individual participates for more than 100 hours during the taxable year but in which the individual does not materially participate for the year (without regard to this rule). This rule is included because the Service believes that an individual who devotes more than 500 hours during a taxable year to several activities, each of which is significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.

C. Tests Based on Material Participation in Prior Years

Under §1.469-5T(a)(5), an individual is treated as materially participating in an activity for a taxable year if the individual materially participated in such activity for any five of the ten taxable years that immediately precede the taxable year.

Under §1.469-5T(a)(6), an individual is treated as materially participating in a personal service activity for a taxable year if the taxpayer materially participated in the activity for any three taxable years that precede the taxable year. For purposes of this rule, an activity is a personal service activity if it principally involves the performance of personal services in (a) the fields of 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.

These rules are included because the Service believes that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood rather than a passive investment. In particular, the Service does not believe that withdrawal from a longstanding active business or from a personal service business that has been active for a substantial period should convert an individual's earnings from the business to passive income. Thus, the Service believes the income from such businesses generally is part of the earned income base that section 469 was intended to protect. In the case of a longstanding active business (other than a personal service business), however, the Service believes that a continuing interest in such an activity is more appropriately viewed as an investment in a passive activity if the individual has not materially participated in the activity for a significant period of time during the 10-year period immediately preceding the taxable year.

D. Facts-and-Circumstances Test

Section 1.469-5T(a)(7) provides that an individual may be treated as materially participating in an activity for a taxable year based on all of the facts and circumstances. The general principles to be followed in applying the facts-and-circumstances test are not addressed in these regulations, and will be included in future regulations. Section 1.469-5T(b), however, provides that certain participation is insufficient to constitute material participation, or is not taken into account, under this test. Thus, except as provided in section 469(h)(3), the fact that an individual satisfies participation standards in other provisions of the Code and the regulations (such as the “material participation” standards in sections 1402 and 2032A) is not taken into account in determining whether the individual materially participates in an activity for purposes of section 469. In addition, an individual's participation in management of an activity is not taken into account in applying the facts-and-circumstances test to the individual if a paid manager participates in the activity or if the management services performed by such individual are exceeded by those performed by any other individual. Finally, an individual who does not participate in an activity for more than 100 hours during the taxable year cannot satisfy the facts-and-circumstances test for the year.

E. Treatment of Limited Partners

Section 469(h)(2) provides that, except as provided in regulations, no interest in a limited partnership shall be treated as an interest with respect to which a taxpayer materially participates. Section 1.469-5T(d) provides two exceptions to this general rule. First, the general rule does not apply to an activity for a taxable year if (a) the taxpayer participates in the activity for more than 500 hours during the taxable year, or (b) the taxpayer is treated as materially participating in the activity for the taxable year under either the longstanding material participant test or the personal-service-activity test. Second, the general rule does not apply with respect to a limited partnership interest in a partnership in which the taxpayer is also a general partner.

F. Trusts and Estates

Material participation rules for trusts and estates will be included in future regulations providing rules for the application of section 469 to trusts, estates, and their beneficiaries.

G. Meaning of "Participation"

Section 1.469-5T(f) generally provides that all work done in an activity by an individual who owns an interest in the activity (other than an interest owned through a C corporation) is taken into account as participation by the individual in the activity, without regard to the capacity in which the individual does such work. Thus, work performed by an individual as an employee of a C corporation in connection with an activity in which the individual owns an interest (other than an interest owned through a C corporation) is taken into account as participation by the individual in the activity.

Section 1.469-5T(f) includes two exceptions to this general rule. First, under §1.469-5T(f)(2)(i), work that is not customarily done by an owner is not taken into account if a principal purpose for the performance of such work is to avoid the disallowance of a passive activity loss or credit. Second, under §1.469-5T(f)(2)(ii), work done by an individual in connection with an activity in the individual's capacity as an investor in the activity is not taken into account.

In the case of a married individual, §1.469-5T(f)(3) provides that the participation of the individual's spouse is treated as participation by such individual for purposes of the passive loss and credit limitations, without regard to whether the participation of the spouse is material participation in its own right, whether the spouse owns an interest in the activity, or whether the individual and the individual's spouse file a joint return for the taxable year.

H. No Recordkeeping Requirements

Notwithstanding the quantitative tests set forth in the regulations, §1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calenders, and narrative summaries.

I. Material Participation for Taxable Years Beginning Before January 1, 1987

A taxpayer's participation in an activity for a taxable year beginning before January 1, 1987, may be relevant under rules such as those relating to longstanding material participants and personal service activities. Section 1.469-5T(j) provides that in any case in which it is necessary to determine whether an individual materially participated in an activity for any taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), the individual is treated as materially participating in the activity for such year only if the individual participated in the activity for more than 500 hours during the year. The Service believes that the 500-hour test represents the only administrable rule for dealing with the determination of material participation for taxable years beginning before 1987.

XIX. Effective date and transition rules.

A. In General

Section 469 and the regulations thereunder generally apply for taxable years beginning after December 31, 1986. However, under §1.469-11T(a)(2), specified rules in §1.469-2T(f) treating certain income as not from a passive activity apply only for taxable years beginning after December 31, 1987. These provisions are §1.469-2T(f)(3) (relating to the rental of nondepreciable property), §1.469-2T(f)(4) (relating to equity-financed lending activities), §1.469-2T(f)(5) (relating to the rental of property developed by the taxpayer), §1.469-2T(f)(6) (relating to self-rented property), and §1.469-2T(f)(7) (relating to passthrough entities licensing intangible property). In addition, §1.469-2T(f)(6) does not apply to income attributable to the rental of property pursuant to a written binding contract entered into before February 19, 1988.

If a taxpayer is a partner, shareholder, or beneficiary of a partnership, S corporation, estate, or trust with a taxable year ending within the taxpayer's first taxable year beginning after December 31, 1986, passive items from such partnership, S corporation, estate, or trust are taken into account in computing the taxpayer's passive activity loss or credit even if such items are attributable to taxable years of such entities beginning before January 1, 1987, or are attributable to amounts paid or incurred prior to January 1, 1987. Under §1.469-2T(e)(1), the treatment of an item of gross income, deduction, or credit from a fiscal year partnership or S corporation as passive activity gross income, as a passive activity deduction, or as a credit from a passive activity, respectively, is determined by reference to the taxpayer's participation in the activity to which such item relates for the partnership's or S corporation's taxable year in which the item arose. Future regulations relating to the treatment of beneficiaries of estates and trusts will provide guidance on this issue with respect to such taxpayers.

B. Effect of Events Occurring in Years Beginning Prior to 1987

Because in certain instances the treatment under the regulations of an item of gross income, deduction, or credit for the taxable year is determined in part by reference to events in prior taxable years, §1.469-11T(a)(4) provides that events in prior taxable years generally are taken into account in making such determinations. For example, under §1.469-5T(a)(5), an individual is treated as materially participating in an activity for the taxable year if the individual materially participated in the activity for any five of the ten taxable years that immediately precede the taxable year. Under §1.469-11T(a)(4), a taxable year beginning prior to January 1, 1987, is taken into account for this purpose, but only if the individual participated in the activity for more than 500 hours during such taxable year.

C. Transitional Rule for Losses From Pre-Enactment Interest

1. In general. Section 469(m) provides a transitional rule for losses and credits attributable to pre-enactment interests in passive activities. Under that rule, which applies for taxable years beginning prior to 1991, the amount of the taxpayer's passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule is reduced by an amount equal to the product of a percentage and the lesser of (a) the amount of the passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule, or (b) the amount of the passive activity loss or passive activity credit that would be disallowed in the absence of the transitional rule (determined without taking into account previously disallowed passive items or passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities). The percentage is 65 percent for taxable years beginning in 1987, 40 percent for taxable years beginning in 1988, 20 percent for taxable years beginning in 1989, and 10 percent for taxable years beginning in 1990.

Paragraphs (b) and (c) of §1.469-11T (b) contain rules relating to the identification of pre-enactment interests in passive activities and the computation of the amount of the passive activity loss and credit that would be disallowed if passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities were not taken into account.

2. Indentification of pre-enactment interests. Under section 469(m), a taxpayer's pre-enactment interests must be identified for each taxable year during the transition period. Thus, for each such taxable year, the taxpayer must determine which of the taxpayer's interests in activities that are passive activities for the

taxable year are pre-enactment interests. Under §1.469-11T (c)(1), a pre-enactment interest is a “qualified interest” in a “pre-enactment activity.”

Section 1.469-11T(c)(3) provides that an activity is a “pre-enactment activity” if the activity was being conducted by any person on October 22, 1986, or if at least 50 percent (by value) of the property used in the activity during the taxable year was in existence or under construction on August 16, 1986, or was acquired or constructed at any time pursuant to a written binding contract in effect on August 16, 1986 (without regard to whether the taxpayer or any person related to the taxpayer was a party to such contract). Thus, for example, in the case of an activity of renting a building, the activity is a pre-enactment activity if the building was in existence or under construction on August 16, 1986.

Section 1.469-11T(c)(2) provides that an interest in an activity is a “qualified interest” if the interest was held by the taxpayer on October 22, 1986, and at all times thereafter, or was acquired by the taxpayer pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986. Section 1.469-11T(c)(7) provides rules for determining whether a taxpayer was a party to a written binding contract on October 22, 1986. Under those rules, for example, if on October 22, 1986, a taxpayer was a party to a written binding contract to acquire a partnership interest, and the partnership was a party to a written bining contract to acquire an interest in an activity, the taxpayer is treated as a party to the partnership's contract.

3. Computation of pre-enactment loss and credit. Section 1.469-11T(b)(3) and (4) contains rules relating to the computation of the amount of the passive activity loss and credit that would be disallowed if the passive items that are not attributable to the taxpayer's pre-enactment interests in passive activities were not taken into account. The amounts determined under §1.469-11T(b)(3) (relating to the pre-enactment loss) and §1.469-11T(b)(4) (relating to the pre-enactment credit) are the amounts of the passive activity loss and the passive activity credit, respectively, that would be disallowed under §1.469-1T(a)(1) taking into account all of the provisions of section 469 and the regulations thereunder, but applying such provisions as though the taxpayer had no interests in passive activities other than the taxpayer's pre-enactment interests. Under these rules, deductions and credits disallowed in a prior year and taken into account for the taxable year under section 469(b) (including deductions and credits attributable to pre-enactment interests) also are not taken into account.

Special Analyses

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Drafting Information

The principal author of these temporary regulations is Michael J. Grace of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations on matters of both substance and style.

The TD 8175 regulations were modified by later regulations that were subject to the 3-year temporary expiration rule of §7805 because issued after November 1988; thus, they were finalized while much of the TD 8175 regulations remain in temporary form. While the preamble to TD 8417 (below) notes that the IRS expected to publish in the IRB a document that integrates the final and temporary regulations, it did not do so. A better course of action though would be to finalize the temporary regulations issued in 1988!

Here is the preamble to one set of post-TD 8175 regulations that made various modifications to the §469 regulations.

TD 8417 (5/15/92) Limitation on Passive Activity Losses and Credits-Technical Amendments to Regulations

ACTION:

Final and temporary regulations.

SUMMARY:

This document contains final and temporary regulations relating to the limitation on passive activity losses and credits. This regulation adopts as final regulations amendments previously proposed that made corrective and clarifying changes to the existing regulations under section 469 of the Internal Revenue Code, as amended (the "Code"). This document also revises the temporary regulations to reflect where portions have been adopted as final. The final regulations affect taxpayers subject to the limitations on passive activity losses and passive activity credits and provide them with the guidance necessary to comply with the law.

EFFECTIVE DATES:

The final regulations under §§1.469-0, 1.469.1, 1.469-2, 1.469-3 and 1.469-5, the addition of §§1.469-6 through 1.469-10, the removal of §§1.469-0T and 1.469.6T through 1.469.11T, and the amendments to §§1.469-1T, 1.469-2T, 1.469-3T and 1.469-5T are effective for taxable years ending after May 10, 1992. The final regulations under §1.469-11 are effective for taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT:

Donna J. Welch at (202) 566-4751 (not a toll-free number).

Background

Temporary regulations (TD 8175) under §§1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T and 1.469-11T were first published in the Federal Register for February 25, 1988 (53 FR 5686). A cross-reference notice of proposed rulemaking (PS-014-88) was published in the Federal Register on the same day. These temporary regulations were amended by temporary regulations (TD 8253) published in the Federal Register for May 12, 1989 (54 FR 20527). A notice of proposed rulemaking (PS-001-89) was also published. These regulations amended the authority for part 602. Written comments were received on the amendments to the temporary regulations and a hearing was held on November 28, 1989. To avoid possible disputes about whether the amendments made to §§1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T (the "amendments") "sunset" under section 7805(e)(2) of the Code, this Treasury Decision adopts the amendments as final regulations. This document also reserves the corresponding temporary regulations and provides in the temporary regulations cross-references to the final regulations as appropriate.

Explanation of Provisions

In General

The final regulations generally adopt the amendments as originally proposed. They only make certain minor technical modifications to the amendments, including changes that conform them to the proposed regulations under §1.469-4, relating to the definition of activity.

Until the remaining regulations under §§1.469-1T, 1.469-2T, 1.469-3T, and 1.469-5T are finalized, the portions of the regulations adopted as final in this Treasury Decision will appear separately in the Code of Federal Regulations from the portions still set forth as temporary regulations. To assist taxpayers, however, the Internal Revenue Service plans to publish a separate document in the Internal Revenue Bulletin that will integrate the final regulations with the temporary regulations.

Effective Dates

The final regulations include effective date rules for both the temporary regulations and the final regulations. Under these rules, the rules contained in the final regulations and the temporary regulations, as amended by this Treasury Decision, are effective for taxable years ending after May 10, 1992. The final regulations also include a transitional rule for the taxpayer's first taxable year ending after May 10, 1992, if it begins on or before May 10, 1992. In this case, the temporary regulations as they appeared prior to their amendment by this Treasury Decision may be applied. The final regulations also contain special effective date rules for investment credit property in order to take into account changes in the investment credit rules made by the Omnibus Reconciliation Act of 1990. This document also adopts the special effective date rules previously set forth in §1.469-11T(a)(2) through (a)(5). The final regulations, however, do not adopt those provisions previously set forth in §1.469-11T (b) and (c) relating to pre-enactment losses and credits and pre-enactment activities. Those rules related to the application of the phase-in rules of section 469(m) and were applicable only for taxable years beginning 1987 through 1990.