Treasury Decision 8175, 26 CFR, IRC Sec(s). 42

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 (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(1)(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 (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(1)(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.

List of Subjects in 26 CFR 1.441-1-1.483-2

Income taxes, Accounting, Deferred compensation plans.

Adoption of Amendments to the Regulations

For the reasons set forth in the preamble, Title 26, Chapter I, Subchapter A, Part 1 of the Code of Federal Regulations is amended as set forth below:

PART 1-[AMENDED]

Income Tax Regulations

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority:

26 U.S.C. 7805. Sections 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T also issued under 26 U.S.C. 469(1).

Par. 2. The following new sections are added to Part 1 in the appropriate place:

§1.469-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 469.

§1.469-1T General rules (temporary).

(a) Passive activity loss and credit disallowed.

(1) In general.

(2) Exceptions.

(b) Taxpayers to whom these rules apply.

(c) Cross references.

(1) Definition of passive activity.

(2) Passive activity loss.

(3) Passive activity credit.

(4) Effect of rules for other purposes.

(5) Special rule for oil and gas working interests.

(6) Treatment of disallowed losses and credits.

(7) Corporations subject to section 469.

(8) Consolidated groups.

(9) Joint returns.

(10) Material participation.

(11) Effective date and transition rules.

(12) Future regulations.

(d) Effect of section 469 and the regulations thereunder for other purposes.

(1) Treatment of items of passive activity income and gain.

(2) Coordination with section 1211.

(3) Treatment of passive activity losses.

(e) Definition of "passive activity."

(1) In general.

(2) Trade or business activity.

(i) In general.

(ii) Certain activities not involving the conduct of a trade or business treated as trade or business activities. [Reserved]

(3) Rental activity.

(i) In general.

(ii) Exceptions.

(iii) Average period of customer use.

(iv) Significant personal services.

(A) In general.

(B) Excluded services.

(v) Extraordinary personal services.

(vi) Rental of property incidental to a nonrental activity of the taxpayer.

(A) In general.

(B) Property held for investment.

(C) Property used in a trade or business.

(D) Property held for sale to customers.

(E) Lodging rented for convenience of employer.

(F) Unadjusted basis.

(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

(viii) Examples.

(4) Special rule for oil and gas working interests.

(i) In general.

(ii) Exception for deductions attributable to a period during which liability is limited.

(A) In general.

(B) Coordination with rules governing the identification of disallowed passive activity deductions.

(C) Meaning of certain terms.

(1) Allocable deductions.

(2) Disqualified deductions.

(3) Net loss.

(4) Ratable portion.

(iii) Examples.

(iv) Definitions of "working interest."

(v) Entities that limit liability.

(A) General rule.

(B) Other limitations disregarded.

(C) Examples.

(vi) Cross reference to special rule for income from certain oil or gas properties.

(5) Rental of dwelling unit.

(6) Activity of trading personal property.

(i) In general.

(ii) Personal property.

(iii) Example.

(f) Treatment of disallowed passive activity losses and credits.

(1) Scope of this paragraph.

(2) Identification of disallowed passive activity deductions.

(i) Allocation of disallowed passive activity loss among activites.

(A) General rule.

(B) Loss from an activity.

(C) Significant participation passive activities.

(D) Examples.

(ii) Allocation within loss activities.

(A) In general.

(B) Excluded deductions.

(iii) Separately identified deductions.

(3) Identification of disallowed credits from passive activites.

(i) General rule.

(ii) Coordination rule.

(iii) Separately identified credits.

(4) Carryover of disallowed deductions and credits.

(g) Application of these rules to C corporations.

(1) In general.

(2) Definitions.

(3) Participation of corporations.

(i) Material participation.

(ii) Significant participation.

(iii) Participation of individual.

(4) Modified computation of passive activity loss in the case of closely held corporations.

(i) In general.

(ii) Net active income.

(iii) Examples.

(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.

(i) In general.

(ii) Net active income tax liability.

(h) Special rules for affiliated group filing consolidated return.

(1) In general.

(2) Definitions.

(3) Disallowance of consolidated group's passive activity loss or credit.

(4) Status and material participation of members.

(i) Determination by reference to status and participation of group.

(ii) Determination of status and material participation of consolidated group.

(5) Modification of rules for identifying disallowed passive activity deductions and credits.

(i) Identification of disallowed deductions.

(ii) Ratable portion of disallowed passive activity loss.

(iii) Identification of disallowed credits.

(6) Transactions between members of a consolidated group.

(i) Scope.

(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions.

(A) In general.

(B) Recharacterization of gain or loss as portfolio items.

(iii) Deferred intercompany transactions.

(A) In general.

(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion.

(C) Restoration of deferred gain or loss or dispositions.

(D) Certain recharacterized items treated as portfolio items.

(E) Property involved in deferred intercompany transaction.

(iv) Definitions.

(A) Deferred intercompany transaction.

(B) Directly related.

(C) Intercompany transaction.

(D) Purchasing member.

(E) Selling member.

(7) Disposition of stock of a member of an affiliated group.

(8) Dispositions of property used in multiple activities.

(i) [Reserved]

(j) Spouses filing joint return.

(1) In general.

(2) Exceptions to treatment as one taxpayer.

(i) Identification of disallowed deductions and credits.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d) and 465.

(iii) Treatment of losses from working interests.

(3) Joint return no longer filed.

(4) Participation of spouses.

(k) Former passive activities and changes in status of corporations. [Reserved]

§1.469-2T Passive activity loss (temporary).

(a) Scope of this section.

(b) Definition of passive activity loss.

(1) In general.

(2) Cross references.

(c) Passive activity gross income.

(1) In general.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.

(i) In general.

(A) Treatment of gain.

(B) Dispositions of partnership interests and S corporation stock.

(C) Interest in property.

(D) Examples.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Dispostion of substantially appreciated property formerly used in nonpassive activity.

(A) In general.

(B) Date of disposition.

(C) Substantially appreciated property.

(D) Coordination with paragraph (c)(2)(ii) of this section.

(E) Coordination with section 163(d).

(F) Example.

(3) Items of portfolio income specifically excluded.

(i) In general.

(ii) Gross income derived in the ordinary course of a trade or business.

(iii) Special rules.

(A) Income from property held for investment by dealer.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.

(1) In general.

(2) Substantial services or costs.

(i) In general.

(ii) Exception.

(iii) Expenditures taken into account.

(3) Passthrough entities.

(4) Cross reference.

(C) Mineral production payments.

(iv) Examples.

(4) Items of personal service income specifically excluded.

(i) In general.

(ii) Example.

(5) Income from section 481 adjustment.

(i) In general.

(ii) Positive section 481 adjustments.

(iii) Ratable portion.

(6) Gross income from certain oil or gas properties.

(i) In general.

(ii) Net income from the property.

(iii) Property.

(iv) Examples.

(7) Other items specifically excluded.

(d) Passive activity deductions.

(1) In general.

(2) Exceptions.

(3) Interest expense.

(4) Clearly and directly allocable expenses.

(5) Treatment of loss from disposition.

(i) In general.

(ii) Disposition of Property used in more than one activity in 12-month period preceding disposition.

(iii) Other applicable rules.

(A) Interest in property.

(B) Dispositions of partnership interests and S Corporation stock.

(6) Coordination with other limitations on deduction that apply before section 469.

(i) In general.

(ii) Proration of deductions disallowed under basis limitations.

(A) Deductions disallowed under section 704(d).

(B) Deductions disallowed under section 1366(d).

(iii) Proration of deductions disallowed under at-risk limitation.

(iv) Coordination of basis and at-risk limitations.

(v) Separately identified items of deduction and loss.

(7) Deductions from section 481 adjustment.

(i) In general.

(ii) Negative section 481 adjustment.

(iii) Ratable portion.

(8) Taxable year in which item arises.

(e) Special rules for partners and S corporation shareholders.

(1) In general.

(2) Payments under section 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(A) In general.

(B) Exception.

(iii) Section 736 (b).

(3) Sale or exchange of interest in passthrough entity.

(i) Application of this paragraph (e) (3).

(ii) General rule.

(A) Allocation among activities.

(B) Ratable portion.

(1) Dispositions on which gain is recognized.

(2) Dispositions on which loss is recognized.

(C) Default rule.

(D) Special rules.

(1) Applicable valuation date.

(i) In general.

(ii) 2Exception.

(2) Basis adjustments.

(3) Tiered passthrough entities.

(E) Meaning of certain terms.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity.

(iv) Dispositions occurring in taxable years beginning before February 19, 1988.

(A) In general.

(B) Exceptions.

(v) Treatment of portfolio assets.

(vi) Definitions.

(vii) Examples.

(f) Recharacterization of passive income in certain situations.

(1) In general.

(2) Special rule for significant participation.

(i) In general.

(ii) Significant participation passive activity.

(iii) Example.

(3) Rental of nondepreciable property.

(4) Net interest income from passive equity-financed lending activity.

(i) In general.

(ii) Equity-financed lending activity.

(A) In general.

(B) Certain liabilities not taken into account.

(iii) Equity-financed interest income.

(iv) Net interest income.

(v) Interest-bearing assets.

(vi) Liabilities incurred in the activity.

(vii) Average outstanding balance.

(viii) Example.

(5) Net income from certain property rented incidental to development activity.

(i) In general.

(ii) Commencement of use.

(iii) Services performed for the purpose of endhancing the value of property.

(iv) Example.

(6) Property rented to a nonpassive activity.

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property.

(iv) In general.

(ii) Royalty income from property.

(iii) Exceptions.

(iv) Capital expenditures.

(v) Example.

(8) Limitation on recharacterized income.

(9) Meaning of certain terms.

(10) Coordination with section 163 (d).

(11) Effective date.

§1.469-3T Passive activity credit (temporary).

(a) Computation of passive activity credit.

(b) Credits subject to section 469.

(1) In general.

(2) Treatment of credits attributable to qualified progress expenditures.

(3) Special rule for partners and S corporation shareholders.

(4) Exception for pre-1987 credits.

(c) Taxable year to which credit is attributable.

(d) Regular tax liability allocable to passive activities.

(1) In general.

(2) Regular tax liability.

(e) Coordination with section 39.

(f) Examples.

§1.469-4T Definition of activity (temporary). [Reserved]

§1.469-5T Material participation (temporary).

(a) In general.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

(i) Participation satisfying standards not contained in section 469.

(ii) Certain management activities.

(iii) Participation less than 100 hours.

(c) Significant participation activity.

(1) In general.

(2) Significant participation.

(d) Personal service activity.

(e) Treatment of limited partners.

(1) General rule.

(2) Exceptions.

(3) Limited Parntership interest.

(i) In general.

(ii) Limited Partner holding general partner interest.

(f) Participation.

(1) In general.

(2) Exceptions.

(i) Certain work not customarily done by owners.

(ii) Participation as an investor.

(A) In general.

(B) Work done in individual's capacity as an investor.

(3) Participation of spouse.

(4) Methods of proof.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules.

(1) Participation of corporations.

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.

(i) [Reserved]

(j) Material participation for taxable years beginning before January 1, 1987.

(k) Examples.

§1.469-6T Treatment of losses upon certain dispositions (temporary). [Reserved]

§1.469-7T Treatment of self-charged items of income and expense (temporary). [Reserved]

§1.469-8T Application of section 469 to trusts, estates, and their beneficiaries (temporary). [Reserved]

§1.469-9T Treatment of income, deductions, and credits from certain rental real estate activities (temporary). [Reserved]

§1.469-10T Application of section 469 to publicly traded partnerships (temporary). [Reserved]

§1.469-11T Effective date and transition rules (temporary).

(a) Effective date.

(1) In general.

(2) Application of certain income recharacterization rules.

(i) In general.

(ii) Property rented to a nonpassive activity.

(3) Qualified low-income housing projects.

(4) Effect of events occurring in years prior to 1987.

(5) Examples.

(b) Transitional rule for pre-enactment loss and pre-enactment credit.

(1) In general.

(2) Applicable percentage.

(3) Pre-enactment loss.

(4) Pre-enactment credit.

(5) Examples.

(c) Definitions of pre-enactment interest.

(1) General rule.

(2) Qualified interest.

(i) In general.

(ii) Stock in a C corporation.

(3) Pre-enactment activity.

(i) In general.

(ii) Character before 1987 irrelevant.

(4) Examples.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity.

(i) In general.

(ii) Partnership terminations under section 708(b)(1)(B).

(iii) Examples.

(6) Special rule for beneficiaries of trusts or estates.

(i) In general.

(ii) Interests distributed to beneficiaries.

(7) Written binding contract.

(i) In general.

(ii) Special rule for contract of partnership or S corporation.

(iii) Application of rule to partnership agreements.

§1.469-1T General rules (temporary).

(a) Passive activity loss and credit disallowed-(1) In general. Except as otherwise provided in paragraph (a)(2) of this section-

(i) The passive activity loss for the taxable year shall not be allowed as a deduction; and

(ii) The passive activity credit for the taxable year shall not be allowed.

(2) Exceptions. Paragraph (a)(1) of this section shall not apply to the passive activity loss or the passive activity credit for the taxable year to the extent provided in-

(i) Section 469(i) and the rules to be contained in §1.469-9T (relating to losses and credits attributable to certain rental real estate activities); and

(ii) Section 1.469-11T (relating to losses and credits attributable to certain pre-enactment interests in activities).

(b) Taxpayers to whom these rules apply. The rules of section 469 and the regulations thereunder generally apply to-

(1) Individuals;

(2) Trusts (other than trusts (or portions of trusts) described in section 671);

(3) Estates;

(4) Personal service corporations (within the meaning of paragraph (g)(2)(i) of this section); and

(5) Closely held corporations (within the meaning of paragraph (g)(2)(ii) of this section).

(c) Cross references-(1) Definition of "passive activity." Rules relating to the definition of the term "passive activity" are contained in paragraph (e) of this section.

(2) Passive activity loss. Rules relating to the computation of the passive activity loss for the taxable year are contained in §1.469-2T.

(3) Passive activity credit. Rules relating to the computation of the passive activity credit for the taxable year are contained in §1.469-3T.

(4) Effect of rules for other purposes. Rules relating to the effect of section 469 and the regulations thereunder for other purposes under the Code are contained in paragraph (d) of this section.

(5) Special rule for oil and gas working interests. Rules relating to the treatment of losses and credits from certain interests in oil and gas wells are contained in paragraph (e)(4) of this section

(6) Treatment of disallowed losses and credits. Paragraph (f) of this section contains rules relating to-

(i) The treatment of deductions from passive activities in taxable years in which the passive activity loss is disallowed in whole or in part under paragraph (a)(1)(i) of this section; and

(ii) The treatment of credits from passive activities in taxable years in which the passive activity credit is disallowed in whole or in part under paragraph (a)(1)(ii) of this section.

(7) Corporation subject to section 469. Rules relating to the application of section 469 and regulations thereunder to C corporations are contained in paragraph (g) of this section.

(8) Consolidated groups. Rules relating to the application of section 469 and the regulations thereunder to affiliated groups of corporations filing a consolidated return for the taxable year are contained in paragraph (h) of this section.

(9) Joint returns. Rules relating to the application of section 469 and the regulations thereunder to spouses filing a joint return for the taxable year are contained in paragraph (j) of this section.

(10) Material participation. Rules defining the term "material participation" are contained in §1.469-5T.

(11) Effective date and transition rules. Rules relating to the effective date of section 469 and the regulations thereunder and transition rules applicable to pre-enactment interests in activities are contained in §1.469-11T.

(12) Future regulations. (i) Rules relating to former passive activities and changes in corporate status will be contained in paragraph (k) of this section.

(ii) Rules relating to the definition of "activity" will be contained in §1.469-4T.

(iii) Rules relating to the treatment of deductions from activities that are disposed of in certain transactions will be contained in §1.469-6T.

(iv) Rules relating to the treatment of self-charged items of income and expense will be contained in §1.469-7T.

(v) Rules relating to the application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries will be contained in §1.469-8T.

(vi) Rules relating to the treatment of income, deductions, and credits from certain rental real estate activities of individuals and certain estates will be contained in §1.469-9T.

(vii) Rules relating to the application of section 469 to publicly traded partnerships will be contained in §1.469-10T.

(d) Effect of section 469 and the regulations thereunder for other purposes-(1) Treatment of items of passive activity income and gain. Neither the provisions of section 469 (a) (1) and paragraph (a)(1) of this section nor the characterization of items of income or deduction as passive activity gross income (within the meaning of §1.469-2T (c)) or passive activity deductions (within the meaning of §1.469-2T (d)) affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469. The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1991, an individual's only income and loss from passive activities are a $10,000 capital gain from passive activity × and a $12,000 ordinary loss from

passive activity Y. The taxpayer also has a $10,000 capital loss that is not derived from a passive activity.

(ii) Under §1.469-2T (b), the taxpayer has a $2,000 passive activity loss for the taxable year. The only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's $2,000 passive activity loss for the taxable year. Thus, the taxpayer's capital loss for the taxable year is allowed because the $10,000 capital gain from passive activity × is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.

(2) Coordination with section 1211. A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 1211. The following example illustrates the application of this paragraph (d)(2):

Example. In 1987, an individual derives $10,000 of ordinary income from passive activity X, no gains from the sale or exchange of captial assets or assets used in a trade or business, $12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of §1.469-2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed $10,000 of the $12,000 passive activity deduction and has a $2,000 passive activity loss for the taxable year. Since the $10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed $3,000 of the $10,000 capital loss under section 1211 and has a $7,000 capital loss carryover (within the meaning of section 1212 (b)) to the succeeding taxable year.

(3) Treatment of passive activity losses. Except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder 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 Internal Revenue Code. The following example illustrates the application of this paragraph (d)(3):

Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under paragraph (a)(1) of this section. All of the disallowed loss is allocated under paragraph (f) of this section to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, under this paragraph (d)(3), such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.

(e) Definition of "passive activity"-(1) In general. Except as otherwise provided in this paragraph (e), an activity is a passive activity of the taxpayer for a taxable year if and only if the activity-

(i) Is a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer does not materially participate for such taxable year; or

(ii) Is a rental activity (within the meaning of paragraph (e) (3) of this section), without regard to whether or to what extent the taxpayer participates in such activity.

(2) Trade or business activity-(i) In general. An activity is a trade or business activity for a taxable year if for such year-

(A) (1) The activity involves the conduct of a trade or business (within the meaning of section 162);

(2) Research or experimental expenditures paid or incurred with respect to the activity are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)); or

(3) The activity is described in paragraph (e)(2)(ii) of this section; and

(B) The activity is not a rental activity or an activity involving the rental of property described in paragraph (e)(3) (vi)(B) of this section.

(ii) Certain activities not involving the conduct of a trade or business treated as trade or business activities. [Reserved]

(3) Rental activity-(1) In general. Except as otherwise provided in this paragraph (e)(3), an activity is a rental activity for a taxable year if-

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(ii) Exceptions. For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year-

(A) The average period of customer use for such property is seven days or less;

(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

(iii) Average period of customer use. For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity is determined for a taxable year by dividing-

(A) The aggregate number of days in all periods of customer use for such property ending during the taxable year; by

(B) The number of such periods of customer use.

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

(iv) Significant personal services-(A) In general. For purposes of paragraph (e)(3)(ii)(B) of this section, personal services include only services performed by individuals, and do not include excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section). In determining whether personal services provided in connection with making property available for use by customers are significant, all of the relevant facts and circumstances shall be taken into account. Relevant facts and circumstances include the frequency with which such services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property.

(B) Excluded services. For purposes of paragraph (e)(3)(iv)(A) of this section, the term "excluded services" means, with respect to any property made available for use by customers-

(1) Services necessary to permit the lawful use of the property;

(2) Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers; and

(3) Services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of

common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

(v) Extraordinary personal services. For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. 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. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

(vi) Rental of property incidental to a nonrental activity of the taxpayer-(A) In general. For purposes of paragraph (e)(3)(ii)(D) of this section, the rental of property shall be treated as incidental to a nonrental activity of the taxpayer only to the extent provided in this paragraph (e)(3)(vi).

(B) Property held for investment. The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if-

(1) The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(2) The gross rental income from the property for such taxable year is less than two percent of the lesser of-

(i) The unadjusted basis of such property; and

(ii) The fair market value of such property.

(C) Property used in a trade or business. The rental of property during a taxable year shall be treated as incidental to a trade or business activity (within the meaning of paragraph (e)(2) of this section) if and only if-

(1) The taxpayer owns an interest in such trade or business activity during the taxable year;

(2) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

(3) The gross rental income from such property for the taxable year is less than two percent of the lesser of-

(i) The unadjusted basis of such property; and

(ii) The fair market value of such property.

(D) Property held for sale to customers. The rental of property during the taxable year in which the property is sold or exchanged (in a transaction in which gain or loss is recognized) shall be treated as incidental to an activity of dealing in such property if at the time of the sale or exchange the property is held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business of the taxpayer (within the meaning of section 1221(1)).

(E) Lodging rented for convenience of employer. The provision of lodging to an employee or to an employee's spouse or dependents shall be treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if such lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

(F) Unadjusted basis. For purposes of this paragraph (e)(3)(vi), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest. If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in section 707(c) is not income from a rental activity under any circumstances (see §1.469-2T(e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

(viii) Examples. The following examples illustrate the application of this paragraph (e)(3):

Example (1). The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

Example (2). The facts are the same as in example (1), except that the average period of customer use for the photocopying equipment exceeds seven days but does not exceed 30 days. Under these facts, significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided in connection with making the photocopying equipment available for use by customers and, under paragraph (e)(3)(ii)(B) of this section, the activity is not a rental activity.

Example (3). The taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) and, under paragraph (e)(3)(ii)(C) of this section, the activity is not a rental activity.

Example (4). The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

Example (5). The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02×$210,000=$4,200). Accordingly, under paragraph (e)(3)(ii)(D) of this section, the rental of the land is not a rental activity because the rental is treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

Example (6). (i) A calendar year taxpayer owns an interest in a farming activity which is a trade or business activity (within the meaning of paragraph (e)(2) of this section) and owns farmland which was used in the farming activity in 1985 and 1986. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1987, 1988, and 1989, the taxpayer continues to own an interest in

the farming activity but does not use the land in the activity. In 1987, the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1988, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1989, the taxpayer again leases the land for $4,000 to the rancher.

(ii) For 1987 and 1989, the taxpayer owns an interest in a trade or business activity, and the farmland which the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02x$210,000=$4,200). Accordingly, the taxpayer's rental of the land is treated under paragraph (e)(3)(vi)(C) of this section as incidental to the taxpayer's farming activity, and is not a rental activity.

(iii) Because the taxpayer's gross rental income from the land for 1988 ($10,000) is not less than two percent of the lesser of the fair market value and the unadjusted basis of the land, the requirement of paragraph (e)(3)(vi)(C)(3) of this section is not met. Therefore, the taxpayer's rental of the land in 1988 is not treated as incidental to the taxpayer's farming activity and is a rental activity.

Example (7). (i) In 1988, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1989.

(ii) The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose or realizing gain from the appreciation of the property. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

(iii) The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(C) of this section as incidental to a trade or business activity.

(iv) Since the rental of the land in 1988 is not treated under paragraph (e)(3)(vi) of this section as incidental to a nonrental activity of the taxpayer, the rental of the land in 1988 is a rental activity. See §1.469-2T(f)(3) for a special rule relating to the treatment of gross income from the rental of nondepreciable property.

Example (8). The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop-share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this

section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

Example (9). The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules to be contained in §1.469-4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

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

(4) Special rule for oil and gas working interests-(i) In general. Except as otherwise provided in paragraph (e)(4)(ii) of this section, an interest in an oil or gas well drilled or operated pursuant to a working interest (within the meaning of paragraph (e)(4)(iv) of this section) of a taxpayer is not an interest in a passive activity for the taxpayer's taxable year (without regard to whether the taxpayer materially participates in such activity) if at any time during such taxable year the taxpayer holds such working interest either-

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest.

(ii) Exception for deductions attributable to a period during which liability is limited-(A) In general. If paragraph (e)(4)(i) of this section applies for a taxable year to the taxpayer's interest in an oil or gas well that would, but for the application of paragraph (e)(4)(i) of this section, by an interest in a passive activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(3) of this section) from the well for the taxable year-

(1) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(2) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for such year (within the meaning of §1.469-2T(d)); and

(2) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(4) of this section) of the taxpayer's gross income from such oil or gas well for such year shall

be treated as passive activity gross income for such year (within the meaning of §1.469-2T(c)).

(B) Coordination with rules governing the identification of disallowed passive activity deductions. If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) Meaning of certain terms. For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(1) Allocable deductions. The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of §1.469-2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(2) Disqualified deductions. The taxpayer's "disqualified deductions" from an oil or gas well for a taxable year are the taxpayer's deductions-

(i) That are attributable to such well and allocable to the taxable year; and

(ii) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(3) Net loss. The "net loss" of a taxpayer from an oil or gas well for a taxable year equals the amount by which the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(4) Ratable portion. The "ratable portion" of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing-

(i) The disqualified deductions from such oil or gas well for the taxable year; by

(ii) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) Examples. The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working

interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

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

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

(iv) Definition of "working interest." For purposes of section 469 and the regulations thereunder, the term "working interest" means an operating mineral interest (within the meaning of section 614(d) and the regulations thereunder).

(v) Entities that limit liability-(A) General rule. For purposes of paragraph (e)(4)(i)(B) of this section, an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of-

(1) A limited partnership interest in a partnership in which the taxpayer is not a general partner;

(2) Stock in a corporation; or

(3) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

(B) Other limitations disregarded. For purposes of this paragraph (e)(4), protection against loss through any of the following is not taken into account in determining whether a taxpayer holds a working interest through an entity that limits the taxpayer's liability:

(1) An indemnification agreement;

(2) A stop loss arrangement;

(3) Insurance;

(4) Any similar arrangement; or

(5) Any combination of the foregoing.

(C) Examples. The following examples illustrate the application of this paragraph (e)(4)(v):

Example (1). A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(1) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (2). B owns a 10 percent interest in X, an entity (other than a limited partnership or corporation) created under applicable State law to hold working interests in oil or gas properties. Under applicable State law, B is liable without limitation for 10 percent of X's costs and expenses with respect to X's working interests but is not liable for the remaining 90 percent of such costs and expenses. Since B's liability for the obligations of X is not limited to a determinable fixed amount (within the meaning of paragraph (e)(4)(v)(A)(3) of this section), the entity does not limit B's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (3). C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph(e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

(vi) Cross reference to special rule for income from certain oil or gas properties. A special rule relating to the treatment of income from certain interests in oil or gas properties is contained in §1.469-2T(c)(6).

(5) Rental of dwelling unit. An activity involving the rental of a dwelling unit that is used as a residence by the taxpayer during the taxable year (within the meaning of section 280A(c)(5)) is not a passive activity of the taxpayer for such year.

(6) Activity of trading personal property-(i) In general. An activity of trading personal property for the account of owners of interests in the activity is not a passive activity

(without regard to whether such activity is a trade or business activity (within the meaning of paragraph (e)(2) of this section)).

(ii) Personal property. For purposes of this paragraph (e)(6), the term "personal property" means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof).

(iii) Example. The following example illustrates the application of this paragraph (e)(6):

Example. A partnership is a trader of stocks, bonds, and other securities (within the meaning of section 1236(c)). The capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests, and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. Under these facts, the partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, under this paragraph (e)(6), the activity is not a passive activity.

(f) Treatment of disallowed passive activity losses and credits-(1) Scope of this paragraph. The rules in this paragraph (f)-

(i) Identify the passive activity deductions that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity loss is disallowed under paragraph (a)(1)(i) of this section;

(ii) Identify the credits from passive activities that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity credit is disallowed under paragraph (a)(1)(i) of this section; and

(iii) Provide for the carryover of disallowed deductions and credits.

(2) Identification of disallowed passive activity deductions-(i) Allocation of disallowed passive activity loss among activities-(A) General rule. If all or any portion of the taxpayer's passive activity loss is disallowed for the taxable year under paragraph (a)(1)(i) of this section, a ratable portion of the loss (if any) from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the taxable year by the fraction obtained by dividing-

(1) The loss from the activity for the taxable year; by

(2) The sum of the losses for the taxable year from all activities having losses for such year.

(B) Loss from an activity. For purposes of this paragraph (f)(2)(i), the term "loss from an activity" means-

(1) The amount by which the passive activity deductions from the activity for the taxable year (within the meaning of §1.469-2T(d)) exceed the passive activity gross

income from the activity for the taxable year (within the meaning of §1.469-2T(c)); reduced by

(2) Any part of such amount that is allowed under section 469(i) and the rules to be contained in §1.469-9T (relating to the $25,000 allowance for certain rental real estate activities).

(C) Significant participation passive activities. If the taxpayer's passive activity gross income from significant participation passive activities (within the meaning of §1.469-2T(f) (2)(ii)) for the taxable year (determined without regard to §1.469-2T(f)(2) through (4)) exceeds the taxpayer's passive activity deductions from such activities for the taxable year, such activities shall be treated, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, as a single activity that does not have a loss for such taxable year.

(D) Examples. The following examples illustrate the application of this paragraph (f)(2)(i):

Example (1). An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows: ---------- A B C Total ---------- Gross income ..... $7,000 $4,000 $12,000 $23,000 Deductions ..... (16,000) (20,000) (8,000) (44,000) ---------- Net income (loss) ..... ($9,000) ($16,000) $4,000 ($21,000) ----------

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows: A: $21,000 x $9,000/$25,000 ..... $7,560 B: $21,000 x $16,000/$25,000 ..... $13,440 ---------- Total $21,000

Example (2). An individual holds interests in four passive activities, A, B, C, and D. The results of operations of these activities for the taxable year are as follows: ---------- A B C D Total ---------- Gross income ..... 15,000 5,000 10,000 10,000 40,000 Deductions ..... (5,000) (10,000) (20,000) (8,000) (43,000) Net income (loss) .... 10,000 (5,000) (10,000) 2,000 (3,000) ----------

Activities A and B are significant participation passive activities (within the meaning of §1.469-2T(f)(2)(ii)). The gross income from these activities for the taxable year ($20,000) exceeds the passive activity deductions from those activities for the taxable year ($15,000) by $5,000 and, under §1.469-2T(f)(2), $5,000 of gross income from those activities is treated as not from a passive activity. Therefore, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, activities A and B are treated as a single activity that does not have a loss for the taxable year. Under §1.469-2T(b), the taxpayer's passive activity loss for the taxable year is $8,000 ($43,000 of passive activity deductions minus $35,000 of passive activity gross income). The results of treating activities A and B as a single activity that does not have a loss for the taxable year is that none of the $8,000 passive activity loss is

allocated under this paragraph (f)(2)(i) to activity B for the taxable year, even though the taxpayer incurred a loss in that activity for the taxable year.

(ii) Allocation within loss activities-(A) In general. If all or any portion of a taxpayer's loss from an activity is disallowed under paragraph (f)(2)(i) of this section for the taxable year, a ratable portion of each passive activity deduction (other than an excluded deduction (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity is disallowed. For purposes of the preceding sentence, the ratable portion of a passive activity deduction of a taxpayer is the amount of the disallowed portion of the taxpayer's loss from the activity (within the meaning of paragraph (f)(2)(i)(B) of this section) for the taxable year multiplied by the fraction obtained by dividing-

(1) The amount of such deduction; by

(2) The sum of all passive activity deductions (other than excluded deductions (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity from the taxable year.

(B) Excluded deductions. The term "excluded deduction" means any passive activity deduction of a taxpayer that is taken into account in computing the taxpayer's net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity under §1.469-2T(c)(6) or §1.469-2T(f) (5), (6), or (7).

(iii) Separately identified deductions. In identifying the deductions from an activity that are disallowed under this paragraph (f)(2), the taxpayer need not account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such deduction not taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Deductions that must be accounted for separately include (but are not limited to) deductions that-

(A) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in taxable years in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity;

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity; or

(C) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions).

(3) Identification of disallowed credits from passive activities-(i) General rule. If all or any portion of the taxpayer's passive activity credit is disallowed for the taxable year under paragraph (a)(1)(ii) of this section, a ratable portion of each credit from each

passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a credit of a taxpayer is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed for the taxable year by the fraction obtained by dividing-

(A) The amount of the credit; by

(B) The sum of all of the taxpayer's credits from passive activities for the taxable year.

(ii) Coordination rule. For purposes of paragraph (f)(3)(i) of this section, the credits from a passive activity do not include any credit or portion of a credit that-

(A) Is allowed for the taxable year under section 469(i) and the rules to be contained in §1.469-9T (relating to the $25,000 allowance for certain rental real estate activities); or

(B) Increases the basis of property during the taxable year under section 469(j)(9) and the rules to be contained in §1.469-6T (relating to the election to increase the basis of certain property by disallowed credits).

(iii) Separately identified credits. In identifying the credits from an activity that are disallowed under this paragraph (f)(3), the taxpayer need not account separately for any credit unless such credit may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such credit not taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Credits that must be accounted for separately include (but are not limited to)-

(A) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) that arise in a taxable year in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity;

(B) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) that arise in a taxable year in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity;

(C) Low-income housing and rehabilitation investment credits from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T); and

(D) Any credit that is subject to the limitations of sections 26(a), 28(d)(2), 29(b)(5), or 38(c) in a manner that differs from the manner in which any other credit is subject to such limitations.

(4) Carryover of disallowed deductions and credits. Any deduction or credit from an activity of the taxpayer that is disallowed for a taxable year under paragraph (f)(2) or (3) of this section, respectively, shall be treated for purposes of section 469 and the regulations thereunder as a deduction or credit, as the case may be, from such activity for the taxpayer's immediately succeeding taxable year. The following example illustrates the application of this pragraph (f)(4):

Example. The facts are the same as in example (1) in paragraph (f)(2)(i)(D) of this section. The $7,560 of loss from activity A and the $13,440 of loss from activity B that are disallowed for the taxable year under paragraph (f)(2) of this section are allocated among the passive activity deductions from those activities for such year under paragraph (f)(2)(ii) of this section and are treated under this paragraph (f)(4) as deductions from activities A and B, respectively, for the succeeding taxable year.

(g) Application of these rules to C corporations-(1) In general. Except as otherwise provided in the rules to be contained in paragraph (k) of this section, section 469 and the regulations thereunder do not apply to any corporation that is not a personal service corporation or a closely held corporation for the taxable year. See paragraphs (g) (4) and (5) of this section for special rules for computing the passive activity loss and passive activity credit, respectively, of a closely held corporation.

(2) Definitions. For purposes of section 469 and the regulations thereunder-

(i) The term "personal service corporation" means a C corporation that is a personal service corporation for the taxable year (within the meaning of §1.441-4T(d)); and

(ii) The term "closely held corporation" means a C corporation that meets the stock ownership requirements of section 542(a)(2) (taking into account the modifications in section 465(a)(3)) for the taxable year and is not a personal service corporation for such year.

(3) Participation of corporations-(i) Material participation. For purposes of section 469 and the regulations thereunder, a corporation described in paragraph (g)(2) of this section shall be treated as materially participating in an activity for a taxable year if and only if-

(A) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as materially participating in such activity for the taxable year, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation; or

(B) In the case of a closely held corporation (within the meaning of paragraph (g)(2)(ii) of this section), the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof and taking into account section 465(c)(7)(D)) are met with respect to such activity.

(ii) Significant participation. For purposes of §1.469-2T(f)(2), an activity of a corporation described in paragraph (g)(2) of this section shall be treated as a significant participation passive activity for a taxable year if and only if-

(A) The corporation is not treated as materially participating in such activity for the taxable year; and

(B) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as significantly participating in such activity, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation.

(iii) Participation of individual. Whether an individual is treated for purposes of this paragraph (g)(3) as materially participating or significantly participating in an activity of a corporation shall be determined under the rules of §1.469-5T, except that in applying such rules-

(A) All activities of the corporation shall be treated as activities in which the individual holds an interest in determining whether the individual participates (within the meaning of §1.469-5T(f)) in an activity of the corporation; and

(B) The individual's participation in all activities other than activities of the corporation shall be disregarded in determining whether the individual's participation in an activity of the corporation is treated as material participation under §1.469-5T(a)(4) (relating to material participation in significant participation activities).

(4) Modified computation of passive activity loss in the case of closely held corporations.-(i) In general. A closely held corporation's passive activity loss for the taxable year is the amount, if any, by which the corporation's passive activity deductions for the taxable year (within the meaning of §1.469-2T(d)) exceed the sum of-

(A) The corporation's passive activity gross income for the taxable year (within the meaning of §1.469-2T(c)); and

(B) The corporation's net active income for the taxable year.

(ii) Net active income. For purposes of this paragraph (g)(4), a corporation's net active income for the taxable year is such corporation's taxable income for the taxable year, determined without regard to the following items for the year:

(A) Passive activity gross income;

(B) Passive activity deductions;

(C) Portfolio income (within the meaning of §1.469-2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (see, e.g., §1.469-2T(c)(2)(iii)(E) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and §1.469-2T(f)(10) (relating to certain recharacterized passive activity gross income);

(D) Gross income that is treated under §1.469-2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity;

(E) Gross income and deductions from any trade or business activity (within the meaning of paragraph (e)(2) of this section) that is described in paragraph (e)(6) of this section (relating to certain activities of trading personal property) but only if the corporation did not materially participate in such activity for the taxable year;

(F) Deductions described in §1.469-2T(d)(2)(i), (ii), and (iv) (relating to certain deductions attributable to portfolio income); and

(G) Interest expense allocated under §1.163-8T to a portfolio expenditure (within the meaning of §1.163-8T(b)(6)).

(iii) Examples. The following examples illustrate the application of this paragraph (g)(4):

Example (1). (i) For 1987, X, a closely held corporation, is engaged in two activities, a trade or business activity in which X materially participates for 1987 and a rental activity. X also holds portfolio investments. For 1987, X has the following gross income and deductions: Gross income: Rents ..... $60,000 Gross income from business ..... 100,000 Portfolio income ..... 35,000 ---------- Total ..... $195,000 ---------- Deductions: Rental deductions ..... ($100,000) Business deductions (80,000) Interest expense allocable to portfolio expenditures under sec. 1.163-8T ..... (10,000) Deductions (other than interest expense) clearly and directly allocable to portfolio income ..... (5,000) ---------- Total ..... ($195,000) ----------

(ii) The corporation's net active income for 1987 is $20,000, computed as follows: Gross income ..... $195,000 Amounts not taken into account in computing net active income: Rents (see paragraph (g)(4)(ii)(A) of this section) ..... $60,000 Portfolio income (see paragraph (g)(4)(ii)(C) of this section) ..... $35,000 ---------- $95,000 ($95,000) ---------- Gross income taken into account in computing net active income ..... $100,000 $100,000 ---------- Deductions ..... ($195,000) Amounts not taken into account in computing net active income: Rental deductions (see paragraph (g)(4)(ii)(B) of this section) ..... ($100,000) Interest expense allocated to portfolio expenditures (see paragraph (g)(4)(ii)(G) of this section) ..... ($10,000) Other deductions clearly and directly allocable to portfolio income (see paragraph (g)(4)(ii)(F) of this section) ..... ($5,000) ($115,000) $115,000 ---------- Deductions taken into account in computing net active income ..... ($80,000) ($80,000) ---------- Net active income ..... $20,000 ----------

(iii) Under paragraph(g)(4)(i) of this section, X's passive activity loss for 1987 is $20,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($20,000). Under paragraph (f)(4) of this section, the $20,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. If computed without regard to the net active income for the taxable year, X's

passive activity loss would be $40,000 ($100,000 of rental deductions minus $60,000 of rental income). Thus, the effect of the rule in paragraph (g)(4)(i) of this section is to reduce the corporation's passive activity loss for the taxable year by the amount of the corporation's net active income for such year.

(iv) Under these facts, X's taxable income for 1987 is $20,000, computed as follows: Gross income ..... $195,000 Deductions: Total deductions ..... ($195,000) Passive activity loss ..... $20,000 ---------- Allowable deductions ..... ($175,000) ($175,000) ---------- Taxable income ..... $20,000 ----------

Example (2). (i) The facts are the same as in example (1), except that, in 1988, X has a loss from the trade or business activity, and a net operating loss ("NOL") of $15,000 that is carried back under section 172(b) to 1987. Since NOL carrybacks are taken into account in computing net active income, X's net active income for 1987 must be recomputed as follows: Net active income before NOL carryback ..... $20,000 NOL carryback ..... ($15,000) ---------- Net active income ..... $5,000 ----------

(ii) Under these facts, X's disallowed passive activity loss for 1987 is $35,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($5,000).

(iii) Under paragraph (f)(4) of this section, the $35,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. X's taxable income for 1987 is $20,000, computed as follows: Gross income ..... $195,000 Deductions: Total deductions ..... ($210,000 Passive activity loss ..... $35,000 Allowable deductions ..... ($175,000) ($175,000) ---------- Taxable income ..... ---------- $20,000 ----------

Thus, taking the NOL carryback into account in computing net active income for 1987 does not affect X's taxable income for 1987, but increases the deductions treated under paragraph (f)(4) as deductions from X's rental activity for 1988 and decreases X's NOL carryover to years other than 1987.

(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability-(i) In general. Solely for purposes of determining the amount disallowed under paragraph (a)(1)(ii) of this section, a closely held corporation's passive activity credit for the taxable year shall be reduced by such corporation's net active income tax liability for such year.

(ii) Net active income tax liability. For purposes of paragraph (g)(5)(i) of this section, a corporation's net active income tax liability for a taxable year is the amount (if any) by which-

(A) The corporation's regular tax liability (within the meaning of section 26(b)) for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the corporation's passive activity gross income for such year over the corporation's passive activity deductions for such year; exceeds

(B) The sum of-

(1) The corporation's regular tax liability for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the sum of the corporation's net active income (within the meaning of paragraph (g)(4)(ii) of this section) and passive activity gross income for such year over the corporation's passive activity deductions for such year; and

(2) The corporation's credits (other than credits from passive activities) that are allowable for the taxable year (without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469).

(h) Special rules for affiliated group filing consolidated return-(1) In general. For purposes of computing the consolidated taxable income and tax liability of an affiliated group of corporations filing a consolidated return for the taxable year, and the separate taxable income (within the meaning of §1.1502-12) of each member of such group, section 469 and the regulations thereunder shall be applied in the manner provided in this paragraph (h).

(2) Definitions. For purposes of this paragraph (h)-

(i) The terms "group," "member," "subsidiary," and "consolidated return year" shall have the meanings set forth in §1.1502-1;

(ii) The term "consolidated group" means a group filing a consolidated return for the taxable year; and

(iii) The term "consolidated taxable income" shall have the meaning set forth in §1.1502-11.

(3) Disallowance of consolidated group's passive activity loss or credit. A consolidated group's passive activity loss or passive activity credit for the taxable year shall be disallowed to the extent provided in paragraph (a) of this section. For purposes of the preceding sentence, a consolidated group's passive activity loss and passive activity credit shall be determined by taking into account the following items of each member of such group:

(i) Passive activity gross income;

(ii) Passive activity deductions;

(iii) Net active income (in the case of a consolidated group treated as a closely held corporation under paragraph (h)(4)(ii) of this section); and

(iv) Credits from passive activities.

(4) Status and material participation of members-(i) Determination by reference to status and participation of group. For purposes of section 469 and the regulations thereunder-

(A) Each member of a consolidated group shall be treated as a closely held corporation or personal service corporation, respectively, for the taxable year, if and only if the consolidated group is treated (under the rules of paragraph (h)(4)(ii) of this section) as a closely held corporation or personal service corporation for such year; and

(B) The determination of whether a trade or business activity (within the meaning of paragraph (e)(2) of this section) conducted by one or more members of a consolidated group is a passive activity of such members shall be made by reference to the consolidated group's participation in such activity.

(ii) Determination of status and material participation of consolidated group. For purposes of determining under paragraph (g)(2) of this section whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under paragraph (g)(3) of this section whether the consolidated group materially participates in any activity conducted by one or more members of such group-

(A) The members of such consolidated group shall be treated as one corporation;

(B) Only the outstanding stock of the common parent shall be treated as outstanding stock of such corporation;

(C) An employee of any member of such group shall be treated as an employee of such corporation; and

(D) An activity is treated as the principal activity of such corporation if and only if it is the principal activity (within the meaning of §1.44-4T(f)) of the consolidated group.

(5) Modification of rules for identifying disallowed passive activity deductions and credits-(i) Identification of disallowed deductions. In applying paragraphs (f) (2) and (4) of this section to a consolidated group for purposes of identifying the passive activity deductions of such consolidated group and of each member of such consolidated group that are disallowed for the taxable year and treated as deductions from activities for the succeeding taxable year, the following rules shall apply:

(A) A ratable portion (within the meaning of paragraph (h)(5)(ii) of this section) of the passive activity loss of the consolidated group that is disallowed for the taxable year shall be allocated to each member of the group;

(B) Pararaph (f)(2) of this section shall then be applied to each member of the group as if-

(1) Such member were a separate taxpayer; and

(2) The amount allocated to such member under paragraph (h)(5)(i)(A) of this section were the amount of such member's passive activity loss that is disallowed for the taxable year; and

(C) Paragraph (f)(4) of this section shall be applied to each member of the group as if it were a separate taxpayer.

(ii) Ratable portion of disallowed passive activity loss. For purposes of paragraph (h)(5)(i)(A) of this section, a member's ratable portion of the disallowed passive activity loss of the consolidated group is the amount of such disallowed loss multiplied by the fraction obtained by dividing-

(A) The amount of the passive activity loss of such member of the consolidated group that would be disallowed for the taxable year if the items of gross income and deduction of such member were the only items of the group for such year; by

(B) The sum of the amounts described in paragraph (h)(5)(ii)(A) of this section for all members of the group.

(iii) Identification of disallowed credits. In applying paragraph (f)(3) of this section to a consolidated group for purposes of identifying the credits from passive activities of members of such consolidated group that are disallowed for the taxable year, the consolidated group shall be treated as one taxpayer. Thus, a ratable portion of each of the group's credits from passive activities is disallowed.

(6) Transactions between members of a consolidated group-(i) Scope. This paragraph (h)(6) provides rules regarding the treatment, for purposes of section 469 and the regulations thereunder, of items of income and deduction attributable to intercompany transactions. See paragraph (h)(6)(iv) of this section for the definition of "intercompany transaction" and certain other terms used in this paragraph (h)(6).

(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions-(A) In general. If the selling member in an intercompany transaction (other than a deferred intercompany transaction) recognizes an item of gain or loss described in §1.1502-13(b) that is directly related to an item of deduction of the purchasing member, and both the gain or loss and the directly related item of deduction are taken into account in computing consolidated taxable income for the same taxable year, the items of income or deduction that are taken into account by the selling member in computing such gain or loss shall be taken into account in computing consolidated taxable income for such taxable year as items of income or deduction of the selling member from the activity to which the directly related deduction of the purchasing member is attributable.

(B) Recharacterization of gain or loss as portfolio items. Any item of income or deduction of a selling member that is recharacterized under this paragraph (h)(6)(ii) shall be treated as an item of income or deduction described in §1.469-2T(c)(3)(i) (relating to portfolio income) or §1.469-2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the directly related item of deduction is a deduction described in §1.469-2T (d)(2)(i) or a deduction for interest expense that is allocated under §1.163-8T to a portfolio expenditure (within the meaning of §1.163-8T (b)(6)).

(iii) Deferred intercompany transactions-(A) In general. For purposes of section 469 and the regulations thereunder, the treatment of deferred gain or loss on a deferred intercompany transaction between members of a group shall be determined in accordance with this paragraph (h)(6)(iii).

(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion. If, for any consolidated return year, the selling member in a deferred intercompany transaction is required to take into account deferred gain or loss under §1.1502-13(d) as a result of depreciation, amortization, or depletion of a member of the group, then for purposes of section 469 and the regulations thereunder such deferred gain or loss shall be taken into account for such year as gain or loss of the selling member from the activity (or activities) to which such depreciation, amortization, or depletion deductions are attributable.

(C) Restoration of deferred gain or loss on dispositions. If, for any consolidated return year, the selling member in a deferred intercompany transaction (other than a deferred intercomapny transaction described in §1.1502-13(e)(1)) is required to take deferred gain or loss into account under §1.1502-13(e)(2) or (f), then for purposes of section 469 and the regulations thereunder-

(1) Such deferred gain or loss shall be treated as gain or loss of the selling member from a disposition of the property involved in such deferred intercompany transaction at the time of (i) the event that requires such gain or loss to be taken into account or (ii) in the case of a transaction described in §1.1502-13(e)(2), the disposition of such property outside the consolidated group; and

(2) Such deferred gain or loss shall, except as otherwise provided in §1.1502-2T (c)(2) or (d)(5), be taken into account for such year as gain or loss of the selling member from the activity (or activities) of the affiliated group in which the property involved in such deferred intercompany transaction is used immediately preceding the time specified in paragraph (h)(6)(iii)(C)(1) of this section.

See paragraph (h)(8) of this section, relating to dispositions by a member of substantially appreciated property formerly used in a nonpassive activity.

(D) Certain recharacterized items treated as portfolio items. Any deferred gain or loss or a selling member that is recharacterized under this paragraph (h)(6)(iii) shall be treated as an item of income or deduction described in §1.469-2T(c)(3)(i) (relating to portfolio income) or §1.469-2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the property involved in the transaction is property that produces portfolio income (within the meaning of §1.469-2T(c)(3)((i)).

(E) Property involved in deferred intercompany transaction. For purposes of this paragraph (h)(6)(iii), the property involved in a deferred intercompany transaction is the property sold or exchanged in such transaction or the property with respect to which expenditures incurred in such transaction are capitalized.

(iv) Definitions. For purposes of this paragraph (h)(6), the terms set forth below shall have the following meanings:

(A) Deferred intercompany transaction. The term "deferred intercompany transaction" shall have the meaning set forth in §1.1502-13(a)(2).

(B) Directly related. An item of gross income and an item of deduction are "directly related" if and to the extent that the same amount paid or accrued generates both

the income and the deduction, without regard to whether the income and the deduction are taken into account by the taxpayer in the same taxable year.

(C) Intercompany transaction. The term "intercompany transaction" shall have the meaning set forth in §1.1502-13(a)(1).

(D) Purchasing member. The term "purchasing member" shall have the meaning set forth in §1.1502-13(a).

(E) Selling member. The term "selling member" shall have the meaning set forth in §1.502-13(a).

(7) Disposition of stock of a member of an affiliated group. Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under §1.1502-19 (a)) shall be treated as portfolio income (within the meaning of §1.469-2T (c)(3)(i)).

(8) Dispositions of property used in multiple activities. The determination of whether §1.469-2T(c)(2)(ii) or (iii) or (d)(5)(ii) applies to a disposition (including a deemed disposition described in paragraph (h)(6)(iii)(C)(1) of this section) of property by a member of a consolidated group shall be made by treating such member as having held the property for the entire period that the group has owned such property and as having used the property in all of the activities in which the group has used such property

(i) [Reserved]

(j) Spouses filing joint return-(1) In general. Except as otherwise provided in the regulations under section 469, spouses filing a joint return for a taxable year shall be treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder Thus, for example, spouses filing a joint return are treated as one taxpayer for purposes of-

(i) Section 1.469-2T (relating generally to the computation of such taxpayer's passive activity loss); and

(ii) Paragraph (f) of this section (relating to the allocation of such taxpayer's disallowed passive activity loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities).

(2) Exceptions to treatment as one taxpayer-(i) Identification of disallowed deductions and credits. For purposes of paragraphs (f)(2)(iii) and (3) (iii) of this section, spouses filing a joint return for the taxable year must account separately for the deductions and credits attributable to the interests of each spouse in any activity.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d), and 465. Notwithstanding any other provision of this section or §1.469-2T, this paragraph (j) shall not affect the application of section 704(d), section 1366(d), or section 465 to taxpayers filing a joint return for the taxable year.

(iii) Treatment of losses from working interests. Paragraph (e)(4) of this section (relating to losses and credits from certain interests in oil and gas wells) shall be applied by treating a husband and wife (whether or not filing a joint return) as separate taxpayers.

(3) Joint return no longer filed. If an individual-

(A) Does not file a joint return for the taxable years; and

(B) Filed a joint return for the immediately preceding taxable year;

then the passive activity deductions and credits allocable to such individual's activities for the taxable year under paragraph (f)(4) of this section shall be determined by taking into account the items of deduction and credit attributable to such individual's interests in passive activities for the immediately preceding taxable year. See paragraph (j)(2)(i) of this section.

(4) Participation of spouses. Rules treating an individual's participation in an activity as participation of such individual's spouse in such activity (without regard to whether the spouses file a joint return) are contained in §1.469-5T(f)(3).

(k) Former passive activities and changes in status of corporations. [Reserved]

§1.469-2T Passive activity loss (temporary).

(a) Scope of this section. This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section-

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) Definition of passive activity loss-(1) In general. In the case of a taxpayer other than a closely held corporation (within the meaning of §1.469-1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) Cross references. See paragraph (c) of this section for the definition of "passive activity gross income," paragraph (d) of this section for the definition of "passive

activity deduction," and §1.469-1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) Passive activity gross income-(1) In general. Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity-(i) In general-(A) Treatment of gain. Except as otherwise provided in the regulations under section 469, any gain recognized upon the sale, exchange or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(1) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(2) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(3) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) Dispositions of partnership interests and S corporation stock. A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) Interest in property. For purposes of applying this paragraph (c)(2) to a disposition of property-

(1) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(2) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) Examples. The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially partcipated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(2) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment

sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(3) of this section, none of B's gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C's rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(1) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(2) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(1) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition. In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an iterest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of-

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(2) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for $8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominatly used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) Disposition of substantially appreciated property formerly used in nonpassive activity-(A) In general. If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless such interest in property was used in a passive activity for either-

(1) 20 percent of the period during which the taxpayer held such interest in property; or

(2) The entire 24-month period ending on the date of the disposition.

(B) Date of disposition. For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property shall be deemed to occur on the date that such interest in property becomes subject to an oral or written agreement that either requires the

owner or gives the owner an option to transfer such interest in property for consideration that is fixed or otherwise determinable on such date.

(C) Substantially appreciated property. For purposes of this paragraph (c)(2)(iii), an interest in property is substantially appreciated if the fair market value of such interest in property exceeds 120 percent of the adjusted basis of such interest.

(D) Coordination with paragraph (c)(2)(ii) of this section. If paragraph (c)(2)(ii) of this section applies to the disposition of an interest in property, this paragraph (c)(2)(iii) shall apply only to that portion of the gain from the disposition of such interest in property that is characterized as gain from a passive activity after the application of paragraph (c)(2)(ii) of this section.

(E) Coordination with section 163(d). Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) shall be treated as income described in section 469(e)(1)(A) and paragraph (c)(3)(i) of this section if and only if such gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held such interest in property in activities other than passive activities.

(F) Example. The following example illustrates the application of this paragraph (c)(2)(iii):

Example. A acquires a building on January 1, 1987, and uses the building in a trade or business activity in which A materially participates until March 31, 1997. On April 1, 1998, A leases the building to B. On December 31, 1999, A sells the building. Assuming A's lease of the building to B constitutes a rental activity (within the meaning of §1.469-1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 1998, through December 31, 1999). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the property (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a pasive activity.

(3) Items of portfolio income specifically excluded-(i) In general. Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to-

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2);

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163 (d)).

(ii) Gross income derived in the ordinary course of a trade or business. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only-

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) Special rules-(A) Income from property held for investment by dealer. For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not dervied by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property-(1) In general. Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person-

(i) Created such property; or

(ii) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(2) Substantial services or costs-(i) In general. Except as provided in paragraph (c)(3)(iii)(B)(2)(ii) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(ii) Exception. A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if-

(a) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(b) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(iii) Expenditures taken into account. For purposes of paragraph (c)(3)(iii)(B)(2)(ii) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(3) Passthrough entities. For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(4) Cross reference. For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) Mineral production payments. For purposes of section 469 and the regulations thereunder-

(1) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(2) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) Examples. The following examples illustrate the application of this paragraph (c)(3):

Example (1). A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example (2). P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordinary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example (3). (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example (4). C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example (5). (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for $100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988

are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years. ---------- ---------- Year Gross royalties Expenditures Cumulative capital expenditures ---------- ---------- 1987 ..... $20,000 $8,000 $100,000 1988 ..... 20,000 12,000 100,000 1989 ..... 60,000 15,000 115,000 1990 ..... 120,000 0 115,000 ---------- ----------

(ii) Under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design ($8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years ($8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design ($100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(2)(ii) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design ($20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design ($100,000). However, the amount of such expenditures incurred by the partnership in 1988 ($12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design ($15,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years ($35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design ($115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(2)(ii)(b) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for

purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example (6). The facts are the same as in example (5), except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design ($1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design ($2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. This is because, under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) Items of personal service income specifically excluded-(i) In general. Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only-

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services;

provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) Example. The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in connection with the management of X's rental properties. Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) Income from section 481 adjustment-(i) In general. If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) Positive section 481 adjustments. For purposes of applying this paragraph (c)(5)-

(A) The term "net positive section 481 adjustment" means the increase (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "positive section 481 adjustment with respect to an activity" means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) Ratable portion. The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing-

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) Gross income from certain oil or gas properties-(i) In general. Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross income for such year from-

(A) An oil or gas property, if any loss from a working interest in such property for any prior taxable year beginning after December 31, 1986, was treated by the taxpayer, solely by reason of §1.469-1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph(c)(6)(i)(A) of this section;

equal to the taxpayer's net income from such property for the taxable year. The preceding sentence applies without regard to whether the taxpayer's interest in the property is held through an entity that limits the taxpayer's liability (within the meaning of §1.469-1T(e)(4)(v)).

(ii) Net income from the property. For purposes of this paragraph (c)(6), the taxpayer's net income for the taxable year from any property described in paragraph (c)(6)(i) of this section is the amount, if any, by which the taxpayer's gross income from such property exceeds the taxpayer's deductions for such taxable year (including any deduction treated as a deduction for such year under §1.469-1T(f)(4)) that are reasonable allocable to such property.

(iii) Property. For purposes of paragraph (c)(6)(i)(A) of this section, the term "property" does not have the meaning given such term by section 614(a) or the regulations thereunder, but means any property the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities any part of the costs of which were borne by the taxpayer as a result of holding the working interest described in such paragraph (c)(6)(i)(A).

(iv) Examples. The following examples illustrate the application of this (c)(6):

Example (1). A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1987, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under §1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservoir in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1988 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net income from the property for purposes of this paragraph (c)(6).

Example (2). B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In 1987, S drills a well, and B's distributive share of S's losses from drilling the well is treated under §1.469-1T(e)(4) as not from a passive activity. In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1987, S completes the well in the underlying formation. On January 1, 1988, B converts B's entire general partnership interest in S into a limited partnership interest. In 1988, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section, 614 (a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net income from the property for purposes of this paragraph (c)(6).

Example (3). C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under §1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph (c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) Other items specifically excluded. Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

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

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) Gross income of an individual from a covenant by such individual not to compete; and

(v) Gross income that is treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to §1.469-1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and paragraph (f) of this section (relating to recharacterized passive income).

(d) Passive activity deductions-(1) In general. Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction-

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of a activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under §1.469-1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive

share of R's 1987 loss is $1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is $600; accordingly, section 704(d) disallows any deduction in 1987 for $400 of A's distributive share of R's loss. The remainder of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again $1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is $2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's $1,000 distributive share of R's 1988 loss or the $400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only $400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of §1.469-1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the $400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) Exceptions. Passive activity deductions do not include-

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and §1.469-6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 1212(a)(1)(B) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations); and

(x) An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 704(d), 1366, or 465.

(3) Interest expense. Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense-

(i) Is allocated under §1.163-8T to a passive activity expenditure (within the meaning of §1.163-8T(b)(4)); and

(ii) Is not-

(A) Qualified residence interest (within the meaning of §1.163-10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of §1.163-8T(m)(7)(i)).

(4) Clearly and directly allocable expenses. For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) Treatment of loss from disposition-(i) In general. Except as otherwise provided in the regulations under section 469-

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation

and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition. In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) Other applicable rules-(A) Interest in property. For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to such interests shall be determined under paragraph (c)(2)(i)(C) of this section.

(B) Dispositions of partnership interests and S corporation stock. A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(6) Coordination with other limitations on deductions that apply before section 469-(i) In general. An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) Proration of deductions disallowed under basis limitations-(A) Deductions disallowed under section 704(d). If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing-

(1) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(2) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) Deductions disallowed under section 1366(d). If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable

year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing-

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

(2) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) Proration of deductions disallowed under at-risk limitation. If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing-

(1) The amount of the loss from the activity that is disallowed for the taxable year; by

(2) The sum of all deductions from the activity for the taxable year.

(iv) Coordination of basis and at-risk limitations. The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) Separately identified items of deduction and loss. In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that-

(A) Are attributable to separate activities (within the meaning of the rules to be contained in §1.469-4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions); or

(F) Are attributable to pre-enactment interests in activities (within the meaning of §1.469-11T(c)).

(7) Deductions from section 481 adjustment-(i) In general. If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in §1.469-1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) Negative section 481 adjustments. For purposes of applying this paragraph (d)(7)-

(A) The term "net negative section 481 adjustment" means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "negative section 481 adjustment with respect to an activity" means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) Ratable portion. The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing-

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) Taxable year in which item arises. For purposes of this paragraph (d), an item of deduction arises in the taxable year in which such item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469 and 1211.

(e) Special rules for partners and S corporation shareholders-(1) In general. For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross

income and deduction allocated to a taxpayer from a partnership or S corporation (a "passthrough entity") shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A's calendar year 1988 return, A's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A's participation in the activity from February 1, 1988, through December 31, 1988. See also §1.469-11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) Payments under sections 707(a), 707(c), and 736(b). Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) Section 707(a). Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) Section 707(c)-(A) In general. Except as provided in paragraph(e)(2)(ii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c) (including any payment described in section 736(a)(2) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner)) shall be characterized as the payment of compensation for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(B) Exception. (1) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, any income that-

(i) Is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of such payment; and

(ii) Is attributable to the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership; shall be treated as passive activity gross income if and only if the activity was a passive activity of such retiring or deceased partner (or such other person) for the taxable year of such retiring or deceased partner (or such other person) in which the liquidation of such partner's interest commenced.

(2) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership is determined, for purposes of this paragraph (e)(2)(ii)(B), by multiplying the amount of such payment by the fraction obtained by dividing-

(i) The amount to be paid under section 736(a)(2) in liquidation of such partner's interest in the unrealized receivables and goodwill of such activity of the partnership; by

(ii) The sum of all payments to be made under section 736(a)(2) in liquidation of such partner's interest.

(iii) Section 736(b). If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retiring or deceased partner's interest in partnership property) applies, such gain or loss shall be treated as passive activity gross income or a passive activity deduction only to the extent that such gain or loss would have been passive activity gross income or a passive activity deduction of such retiring or deceased partner (or such other person) if it had been recognized at the time the liquidation of such partner's interest commenced.

(3) Sale or exchange of interest in passthrough entity-(i) Application of this paragraph (e)(3). In the case of the sale, exchange, or other disposition (a "disposition") of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) General rule-(A) Allocation among activities. Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3) (iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) Ratable portion-(1) Dispositions on which gain is recognized. The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing-

(i) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(3) of this section) that would have been allocated to the holder of such interest with respect

thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(1) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(2) Dispositions on which loss is recognized. The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing-

(i) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(4) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(2) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) Default rule. If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) Special rules. For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(1) Applicable valuation date-(i) In general. Except as otherwise provided in paragraph (e)(3)(ii)(D)(1)(ii) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(a) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(b) The date on which such disposition occurs.

(ii) Exception. If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition-

(a) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(b) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(c) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(2) Basis adjustments. Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(3) Tiered passthrough entities. In the case of a disposition of an interest in a passthrough entity (the "subsidiary passthrough entity") by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) Meaning of certain terms. For purposes of this paragraph (e)(3)(ii)-

(1) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(2) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(3) The term "net gain" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(4) The term "net loss" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of

the property used by (or representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity. If, in the case of a disposition of an interest in a passthrough entity-

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section (relating to substantially appreciated property formerly used in a nonpassive activity) would have been allocated to such holder (or such other person) with respect to such interest if all of the property used in such passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(1) of this section; and

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) Dispositions occurring in taxable years beginning before February 19, 1988-(A) In general. Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) Exceptions. This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of §1.469-1T(e)) of the holder (or such other person) during-

(1) The taxable year of such person in which such contribution occurs; or

(2) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of §1.469-5T) in the activity for such year.

(v) Treatment of portfolio assets. For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) Definitions. For purposes of this paragraph (e)(3)-

(A) The term "portfolio asset" means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term "substantially appreciated property" means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term "substantially depreciated property" means property with an adjusted basis that exceeds 120 percent of its fair market value.

(vii) Examples. The following examples illustrate the application of this paragraph (e)(3):

Example (1). (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for $50,000. A's adjusted basis for the interest sold is $30,000. Thus, A recognizes $20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's $20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(1) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(1)(i) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(1)(ii) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows: ---------- Adjusted basis Fair market value ---------- -- X ..... $68,000 $48,000 Y ..... 30,000 62,000 Z ..... 20,000 80,000 Marketable securities ..... 2,000 10,000 ---------- Total ..... 120,000 200,000 ----------

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's $20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993: ---------- ---------- Activity Net gain ---------- Y ..... $8,000 Z ..... 15,000 Marketable securities ..... 2,000 ---------- Total ..... 25,000 ----------

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, $6,400 of A's $20,000 gain ($20,000 × $8,000/$25,000) is allocated to activity Y, $12,000 of A's $20,000 gain ($20,000 × $15,000/$25,000) is allocated to activity Z, and $1,600 of A's $20,000 gain ($20,000 × $2,000/$25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example (2). (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of $40,000 and a fair market value of $66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for $37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual

method of accounting, is as follows: ---------- ---------- Adjusted basis per books Fair market value ---------- ---------- Assets Cash ..... $30,000 $30,000 Accounts receivable: Dealership ..... 20,000 18,000 Inventory: Dealership ..... 52,000 66,000 Building ..... 40,000 66,000 ---------- - Total ..... 142,000 180,000 ---------- ---------- Liabilities and Capital Liabilities ..... $30,000 $30,000 Capital: B ..... 47,000 75,000 C ..... 65,000 75,000 ---------- ---------- Total ..... 142,000 180,000 ----------

Thus, B's gain from the sale is $14,000 ($45,000 amount realized from the sale (consisting of $37,500 of cash and $7,500 of liabilities assumed by the purchaser) minus B's $31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of $62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all $14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of $66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated $13,000 of gain under section 704(c) with respect to the interest in R that B sold to D. This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale ($14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale ($13,000). Thus, $13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) Recharacterization of passive income in certain situations-(1) In general. This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) Special rule for significant participation-(i) In general. An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable

portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing-

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) Significant participation passive activity. For purposes of this paragraph (f)(2), the term "significant participation passive activity" means any trade or business activity (within the meaning of §1.469-1T(e)(2)) in which the taxpayer significantly participates (within the meaning of §1.469-5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of §1.469-5T) for such year.

(iii) Example. The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows: ---------- ---------- X Y Z ---------- ---------- Passive activity gross income ..... $600 $700 $900 Passive activity deductions ..... (200) (1,000) (300) ---------- Net passive income ..... 400 (300) 600 ---------- ----------

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities ($2,200) exceeds A's passive activity deductions from significant participation passive activities ($1,500) by $700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year ($700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year ($1,000). Accordingly, $280 of gross income from activity X ($400 x 700/1000) and $420 of gross income from activity Z ($600 x 700/1000) is treated as gross income that is not from a passive activity.

(3) Rental of nondepreciable property. If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of §1.469-1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from

the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) Net interest income from passive equity-financed lending activity-(i) In general. An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of-

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year

shall be treated as not from a passive activity.

(ii) Equity-financed lending activity-(A) In general. For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if-

(1) The activity involves a trade or business of lending money; and

(2) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) Certain liabilities not taken into account. For purposes of paragraph (f)(4)(ii)(A)(2) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(2) of this section shall not be taken into account in computing such percentage.

(iii) Equity-financed interest income. For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing-

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) Net interest income. For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is-

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) Interest-bearing assets. For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) Liabilities incurred in the activity. For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns a interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) Average outstanding balance. For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) Example. The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for $90,000, using $50,000 of unborrowed funds and $40,000 of proceeds of a loan bearing interest at an annual rate of 10 percent. A pays $4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is $20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is $11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(2) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is $2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is $990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total $250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is $50,000. All of the interest expense paid or incurred by P for 1988 is allocated under §1.63-8T to expeditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(ii) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity ($11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity ($20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing $9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by $20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is $19,000 (A's distributive share of $2.2 million of gross interest income less A's distributive share of $300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense ($990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is $8,550 ($19,000 x $9 million/$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under §1.163-8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all $4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under §1.163-8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is $5,100, computed as set forth in the following table: Gross income: Interest income ..... $22,000 Deductions: Distributive share of P's expenses from the activity ..... (12,900) Interest expense on A's acquisition debt ..... (4,000) ---------- Net passive income 5,100

(vii) A's net passive income from the activity for 1988 ($5,100) is less than A's equity-financed income form the activity for 1988 ($8,550). Accordingly, under this paragraph (f)(4), $5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) Net income from certain property rented incidental to development activity-(i) In general. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if-

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The use of the item of property in an activity involving the rental of such property commenced less than 24 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of §1.469-5T, but without regard to paragraph (e) thereof) or significantly participated (within the meaning of §1.469-5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) Commencement of use. For purposes of paragraph (f)(5)(i)(B) of this section, the use of an item of property in an activity involving the rental of such property commences when substantially all of the property is first held out for rent and is in a state of readiness for rental.

(iii) Services performed for the purpose of enhancing the value of property. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to-

(A) Construction;

(B) Renovation; and

(C) Lease-up (but only if, as of the time the taxpayer commences using the property in the activity described in paragraph (f)(5)(i)(B), a substantial portion of the property is not leased).

(iv) Example. The following example illustrates the application of this paragraph (f)(5):

Example. (i) A, a calendar year individual, is a partner in calendar year partnership P, which is engaged in an activity of developing commercial real estate. In 1988, P acquires an interest in undeveloped land, and arranges for the financing and construction of an office building on the land. Beginning on March 1, 1990, substantially all of the building is held out for rent and is in a state of readiness for rental.

(ii) P holds the building for rent for the remainder of 1990 and all of 1991 and 1992, and sells the building on January 15, 1993, pursuant to a contract entered into on

January 15, 1992. P did not hold the building for sale to customers in the ordinary course of P's trade or business (see §1.469-1T (e)(3)(vi)(D)). A's distributive share of P's taxable losses from the rental of the building is $50,000, $30,000, and $30,000, respectively, for 1990, 1991, and 1992. All of A's losses from the rental of the building are disallowed under §1.469-1T (a)(1)(i). A's distributive share of the gain recognized by P on the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) For purposes of paragraph (f)(5)(i)(C), in 1988, 1989, and 1990, P's real estate development activity involves the performance of services for the purpose of enhancing the value of the building. In 1993, the building is sold, and the date on which the use of the building in the rental activity commenced (March 1, 1990) was less then 24 months before the date on which a binding contract for such sale was entered into (January 15, 1992). Accordingly, if A materially participated in P's real estate development activity in 1988, 1989, or 1990 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income for 1993 from the building equal to A's net rental activity income for 1993 from such building ($150,000-$110,000 of previously disallowed deductions = $40,000) is treated under this paragraph (f)(5) as gross income that is not from a passive activity.

(6) Property rented to a nonpassive activity. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if such property-

(i) Is rented for use in a trade or business activity (within the meaning of §1.469-1T (e)(2)) in which the taxpayer materially participates (within the meaning of §1.469-5T, but without regard to paragraph (e) thereof) for the taxable year; and

(ii) Is not described in paragraph (f)(5) of this section.

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property-(i) In general. If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(3) of this section (the "development entity") after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) Royalty income from property. For purposes of this paragraph (f)(7)-

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of-

(1) The taxpayer's gross royalty income for the taxable year from such item of property; over

(2) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under §1.469-1T (f)(4)) that are reasonably allocable to such item of property.

(iii) Exceptions. Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if-

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

(iv) Capital expenditures. For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) Example. The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in example (5) in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for $13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($27,000 x .10 = $2,700) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest ($13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty

income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) Limitation on recharacterized income. The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) Meaning of certain terms. For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) The gross rental activity income for a taxable year from an item of property used in a rental activity for such year is any passive activity gross income for such year (determined without regard to paragraphs (f) (2) through (6) of this section) from the rental or disposition of such item of property; and

(iv) The net rental activity income from an item of property for a taxable year is the excess, if any, of-

(A) The gross rental activity income from such item of property for the taxable year; over

(B) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under §1.469-1T(f)(4)) that are reasonably allocable to the use of such item of property in the rental activity.

(10) Coordination with section 163(d). Gross income that is treated as not from a passive activity under paragraph (f) (3), (4), or (7) of this section shall be treated as income described in section 469 (e)(1)(A) and paragraph (c)(3)(i) of this section except in determining whether-

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and paragraph (c)(3)(i)(C) of this section as property that produces income of a type described in paragraph (c)(3)(i)(A) of this section;

(ii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and paragraph (d)(4) of this section as clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section); and

(iii) Interest expense is allocated under §1.163-8T to an investment expenditure (within the meaning of §1.163-8T(b)(3)) or to a passive activity expenditure (within the meaning of §1.163-8T(b)(4)).

(11) Effective date. For the effective date of the rules in this paragraph (f), see §1.469-11T (relating to effective date and transition rules).

§1.469-3T Passive activity credit (temporary).

(a) Computation of passive activity credit. The taxpayer's passive activity credit for the taxable year is the amount (if any) by which-

(1) The sum of all of the taxpayer's credits that are subject to section 469 for such year; exceeds

(2) The taxpayer's regular tax liability allocable to all passive activities for such year.

(b) Credits subject to section 469-(1) In general. Except as otherwise provided in this paragraph (b), a credit is subject to section 469 for a taxable year if and only if-

(i) Such credit-

(A) Is attributable to such taxable year and arises in connection with the conduct of an activity that is a passive activity for such taxable year; and

(B) Is decribed in-

(1) Section 38(b) (1) through (5) (relating to general business credits);

(2) Section 27(b) (relating to corporations described in section 936);

(3) Section 28 (relating to clinical testing of certain drugs); or

(4) Section 29 (relating to fuel from nonconventional sources); or

(ii) Such credit is allocable to an activity for such taxable year under §1.469-1T(f)(4).

(2) Treatment of credits attributable to qualified progress expenditures. Any credit attributable to an increase in qualified investment under section 46(d)(1)(A) (relating to qualified progress expenditures) with respect to progress expenditure property (as defined in section 46(d)(2)) is subject to section 469 for a taxable year if-

(i) Such credit is attributable to such taxable year;

(ii) Such credit is described in paragraph (b)(1)(i)(B) of this section; and

(iii) It is reasonable to believe that such progress expenditure property will be used in a passive activity of the taxpayer when it is placed in service.

(3) Special rule for partners and S corporation shareholders. The character of a credit of a taxpayer arising in connection with an activity conducted by a partnership or S corporation (as a credit subject to section 469) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in such activity. Such participation is determined for the taxable year of the partnership or S corporation (and not the taxable year of the taxpayer). See §1.469-2T(e)(1).

(4) Exception for pre-1987 credits. A credit is not subject to section 469 if it is attributable to a taxable year of the taxpayer beginning prior to January 1, 1987.

(c) Taxable year to which credit is attributable. A credit is attributable to the taxable year in which such credit would be (or would have been) allowed if the credits regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

(d) Regular tax liability allocable to passive activities-(1) In general. For purposes of paragraph (a)(2) of this section, the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of-

(i) The taxpayer's regular tax liability for such taxable year; over

(ii) The amount of such regular tax liability determined by reducing the taxpayer's income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

(2) Regular tax liability. For purposes of this section, the term "regulary tax liability" has the meaning given such term in section 26(b).

(e) Coordination with section 39. For purposes of section 39 (relating to the carryback and carryforward of unused business credits), any credit described in section 38(b) (1) through (5) is treated as a current year business credit for the first taxable year in which such credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) Examples. The following examples illustrate the application of this section:

Example (1). (i) A, a calendar year individual, is a general partner in calendar year partnership P. P purchases a building in 1987 and, in 1987, 1988, and 1989, incurs rehabilitation costs with respect to the building. The building is placed in service in the rental activity in 1989. P's rehabilitation costs are qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) and are taken into account in determining the amount of the investment credit for rehabilitation expenditures. P's qualified rehabilitation expenditures are not qualified progress expenditures (within the meaning of section 46(d)).

(ii) Because, under section 46(c)(1), the credit is allowable for the taxable year in which the rehabilitated property is placed in service, the credit allowable for P's qualified rehabilitation expenditures arises in connection with the activity in which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for such year if A's credits allowed for all taxable years were determined without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

Accordingly, under paragraph (b)(1) of this section, A's distributive share of the credit is subject to section 469 for 1989 because the credit arises in connection with a rental activity for such year.

Example (2). The facts are the same as in example (1), except that the rehabilitation costs are incurred in anticipation of placing the building in service in a rental activity, the qualified rehabilitation expenditures in 1987 and 1988 are qualified progress expenditures ("QPEs") (within the meaning of section 46(d)(3)), the improvements resulting from the expenditures are progress expenditure property (within the meaning of paragraph (d)(2) of this section), and it is reasonable to expect that such property will be transition property (within the meaning of section 49(e)) when the property is placed in service. Therefore, under section 46(d)(1)(A), the qualified investment for 1987 and 1988 is increased by an amount equal to the aggregate of the applicable percentage of the qualified rehabilitation expenditures incurred in such years. The credits that are based on these expenditures are attributable (under paragraph (c) of this section) to 1987 and 1988, respectively. It is reasonable to believe in 1987 and 1988 that the progress expenditure property will be used in a rental activity when it is placed in service. Accordingly, under paragraph (b)(2) of this section, A's distributive share of the credit for 1987 and 1988 is subject to section 469. Under paragraph (b)(1) of this section (as in example (1)), A's distributive share of the credit for 1989 is also subject to section 469.

Example (3). (i) B, a single individual, acquires an interest in a partnership that, in 1988, rehabilitates a building and places it in service in a trade or business activity in which B does not materially participate. For 1988, B has the following items of gross income, deduction, and credit: Gross income: Income other than passive activity gross income ..... $110,000 Passive activity gross income ..... 20,000 $130,000 ---------- Deductions: Deductions other than passive activity deductions ..... 23,950 Passive activity deductions ..... 18,000 (41,950) ---------- Taxable income ..... 88,050 ---------- Credits: Rehabilitation credit from the passive activity 8,000

(ii) For 1988, the amount by which B's passive activity gross income exceeds B's passive activity deductions (B's net passive income) is $2,000. Under paragraph (d) of this section, B's regular tax liability allocable to passive activities for 1988 is determined as follows: (A) Taxable income ..... $88,050 (B) Regular tax liability ..... ---------- $24,578.50 (C) Taxable income minus net passive income ..... 86,050 (D) Regular tax liability for taxable income of $86,050.00 ..... ---------- 23,918.50 ---------- (E) Regular tax liability allocable to passive activities ((B) minus (D)) ..... ---------- $660.00

(iii) Under paragraph (a) of this section, B's passive activity credit for 1988 is the amount by which B's credits that are subject to section 469 for 1988 ($8,000) exceed B's regular tax liability allocable to passive activities for 1988 ($660.00). Accordingly, B's passive activity credit for 1988 is $7,340.

Example (4). (i) The facts are the same as in example (3) except that, in 1988, B also has additional deductions of $100,000 from a trade or business activity in which B materially participates for 1988. Thus, B has a taxable loss for 1988 of $11,950, determined as follows: Gross income: Income other than passive activity gross

income ..... $110,000 Passive activity gross income ..... 20,000 $130,000 ---------- Deductions: Deductions other than passive activity deductions ..... 123,950 Passive activity deductions ..... 18,000 (141,950) ---------- Taxable income ..... ---------- (11,950)

(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

§1.469-4T Definition of activity (temporary). [Reserved]

§1.469-5T Material participation (temporary).

(a) In general. Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if-

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) Facts and circumstances-(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b) -(i) Participation satisfying standards not contained in section 469. Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) Certain management activities. An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year-

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) Participation less than 100 hours. If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) Significant participation activity -(1) In general. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity-

(i) Is a trade or business activity (within the meaning of §1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) Significant participation. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity 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.

(e) Treatment of limited partners-(1) General rule. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to-

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) Exceptions. Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) Limited partnership interest-(i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if-

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractural obligations to make additional capital contributions to the partnership).

(ii) Limited partner holding general partner interest. A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) Participation-(1) In general. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does such work) in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest at the time the work is done shall be treated for purposes of this section as participation of such individual in the activity.

(2) Exceptions-(i) Certain work not customarily done by owners. Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if-

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) Participation as an investor-(A) In general. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) Work done in individual's capacity as an investor. For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes-

(1) Studying and reviewing financial statements or reports on operations of the activity;

(2) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(3) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) Participation of spouse. In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) Methods of proof. The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules-(1) Participation of corporations. For rules relating to the participation in an activity of a personal service corporation (within the meaning of

§1.468-1T(g)(2)(i)) or a closely held corporation (within the meaning of §1.469-1T(g)(2)(ii)), see §1.469-1T(g)(3).

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers. An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming it paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity had the individual died during such taxable year.

(i) [Reserved]

(j) Material participation for taxable years beginning before January 1, 1987. In any case in which it is necessary to determine whether an individual materially participated in any activity for a 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), such determination shall be made without regard to paragraphs (a) (2) through (7) of this section.

(k) Examples. The following examples illustrate the application of this section:

Example (1). A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of §1.469-1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under §1.469-1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example (2). The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example (3). B, an individual, is employed fulltime as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of §1.469-1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable

year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example (4). C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of §1.469-1T(e)(2)) that are treated as separate activities under the rules to be contained in §1.469-4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example (5). In 1990, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of §1.469-1T(e)(2)). For every taxable year from 1990 through 1994, D is treated as materially participating (without regard to paragraph (a)(5) of this section) in the activity. D retires from the activity at the beginning of 1995, and would not be treated as materially participating in the activity for 1995 and subsequent taxable years if material participation for such years were determined without regard to paragraph (a)(5) of this section. Under paragraph (a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1995 through 1999 because D materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under paragraph (a)(5) of this section as materially participating in the activity for taxable years after 1999 because of such years D has not materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five of the ten immediately preceding taxable years.

Example (6). The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own as interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (7). (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of §1.469-1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under §1.469-1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph

(f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under §1.469-1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example (8). (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911 (d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

§1.469-6T Treatment of losses upon certain dispositions (temporary). [Reserved]

§1.469-7T Treatment of self-charged items of income and expense (temporary). [Reserved]

§1.469-8T Application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries (temporary). [Reserved]

§1.469-10T Application of section 469 to publicly traded partnerships (temporary). [Reserved]

§1.469-11T Effective date and transition rules (temporary).

(a) Effective date-(1) In general. Except as provided in paragraph (a)(2) of this section, section 469 and the regulations thereunder apply for taxable years beginning after December 31, 1986.

(2) Application of certain income recharacterization rules-(i) In general. No amount of gross income shall be treated under §1.469-2T(f)(3) through (7) as income that is not from a passive activity for any taxable year of the taxpayer beginning before January 1, 1988.

(ii) Property rented to a nonpassive activity. In applying §1.469-2T(f)(6) to a taxpayer's rental of an item of property, the taxpayer's net rental activity income (within the meaning of §1.469-2T(f)(9)(iv)) from such property for any taxable year beginning after December 31, 1987, shall not include the portion of such income (if any) that is attributable to the rental of such item of property pursuant to a written binding contract entered into before February 19, 1988.

(3) Qualified low-income housing projects. For a transitional rule concerning the application of section 469 to losses from qualified low-income housing projects, see section 502 of the Tax Reform Act of 1986.

(4) Effect of events occurring in years prior to 1987. The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss, deduction, or credit as an item of passive activity gross income, passive activity deduction, or credit from a passive activity, shall be determined as if section 469 and the regulations thereunder had been in effect for taxable years beginning before January 1, 1987, but without regard to any passive activity loss or passive activity credit that would have been disallowed for any taxable year beginning before January 1, 1987, if section 469 and the regulations thereunder had been in effect for such year. For example, in determining whether a taxpayer materially participates in an activity under §1.469-5T(a)(5) (relating to taxpayers who have materially participated in an activity for five of the ten immediately preceding taxable years) for any taxable year beginning after December 31, 1986, the taxpayer's participation in the activity for all prior taxable years (including taxable years beginning before 1987) is taken into account. See §1.469-5T(j) (relating to the determination of material participation for taxable years beginning before January 1, 1987).

(5) Examples. The following examples illustrate the application of this paragraph (a):

Example (1). A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under §1.469-2T(e)(1) and paragraph (a)(4) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

Example (2). B, a calendar year individual, is a beneficiary of a trust described in section 651 that has a taxable year ending January 31. The trust conducts a rental activity (within the meaning of §1.469-1T(e)(3)). Because the trust's taxable year ending January 31, 1987, began before January 1, 1987, section 469 and the regulations thereunder do not apply to the trust for such year. Section 469 and the regulations thereunder do apply, however, to B for B's calendar year 1987. Therefore, income of the trust from the rental activity for the trust's taxable year ending January 31, 1987, that is included in B's gross income for 1987 is taken into account in applying section 469 to B for 1987.

(b) Transitional rule for pre-enactment loss and pre-enactment credit-(1) In general. For taxable years beginning after December 31, 1986, and before January 1, 1991, §1.469-1T(a)(1) shall not apply to-

(i) An amount of the passive activity loss equal to the applicable percentage of the pre-enactment loss; and

(ii) An amount of the passive activity credit equal to the applicable percentage of the pre-enactment credit.

(2) Applicable percentage. For purposes of this paragraph (b), the applicable percentage of the pre-enactment loss or the pre-enactment credit for a taxable year shall be determined in accordance with the following table:

In the case of a taxable year beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10

(3) Pre-enactment loss. The pre-enactment loss for any taxable year is the lesser of-

(i) The amount of the passive activity loss that would be disallowed for the taxable year under §1.469-1T(a)(1)(i) if this section were disregarded; and

(ii) The amount of the passive activity loss that would be disallowed for the taxable year under §1.469-1T(a)(1)(i) if this section were disregarded and the following items were not taken into account:

(A) Any deduction treated as a deduction from an activity for the taxable year under §1.469-1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in any passive activity.

(4) Pre-enactment credit. The pre-enactment credit for any taxable year is the lesser of-

(i) The amount of the passive activity credit that would be disallowed for the taxable year under §1.469-1T(a)(1)(ii) if this section were disregarded; and

(ii) The amount of the passive activity credit that would be disallowed for the taxable year under §1.469-1T(a)(1)(ii) if this section were disregarded and the following items were not taken into account:

(A) Any deduction or credit treated as a deduction or credit from an activity for the taxable year under §1.469-1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in a passive activity.

(5) Examples. The following examples illustrate the application of this paragraph (b):

Example (1). A, an individual, owns interest in two passive activities, X and Y. A's interest in activity X is a pre-enactment interest (within the meaning of paragraph (c) of this section), while A's interest in activity Y is not a pre-enactment interest. For 1987 A has a $10,000 loss from activity X and $9,000 of income from activity Y. The amount determined under paragraph (b)(3)(i) of this section is $1,000. The amount determined under paragraph (b)(3)(ii) of this section is $10,000. Therefore, A's pre-enactment loss for 1987 is $1,000. Accordingly, §1.469-1T(a)(1)(i) does not apply to $650 ($1,000 × .65) of A's $1,000 passive activity loss for 1987.

Example (2). (i) B, an individual, owns an interest in one passive activity, and B's interest in the activity is a pre-enactment interest (within the meaning of paragraph (c) of this section). For 1987 and 1988, B has the following passive activity gross income and passive activity deductions from the activity: ---------- 1987 1988 ---------- Gross income ..... $20,000 $20,000 Deductions ..... ($50,000) ($40,000) ----------

(ii) Under §1.469-2T(b), B's passive activity loss for 1987 is $30,000 ($50,000 of passive activity deductions minus $20,000 of passive activity gross income). Under paragraph (b)(3) of this section, B's pre-enactment loss for 1987 is $30,000. Accordingly, under paragraphs (b) (1) and (2) of this section, §1.469-1T(a)(1)(i) does not apply to $19,500 ($30,000 × .65) of B's $30,000 passive activity loss for 1987. Under §1.469-1T(a)(1)(i), $10,500 of B's loss for 1987 ($30,000 × .35) is disallowed. Under §1.469-1T(f) (2) and (4), the disallowed loss is allocated among deductions from the activity, and the disallowed deductions are treated as deductions from the activity for 1988.

(iii) For 1988, B's pre-enactment loss is computed as shown in the following table: ---------- (b)(3)(i) (b)(3)(ii) ---------- Gross income ..... $20,000 $20,000 Current deductions ..... (40,000) (40,000) sec. 1.469-1T(f)(4) ..... (10,500) -0- ---------- Net loss ..... ($30,500) ($20,000) ----------

Therefore, B's pre-enactment loss for 1988 is $20,000.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section §1.469-1T(a)(1)(i) does not apply to $8,000 ($20,000 × .40) of B's $30,500 passive activity loss for 1988.

Example (3). (i) C, an individual, owns interests in three passive activities, R, S, and T. C's interest in each activity is a pre-enactment interest. For 1987 and 1988, C's gross income, deductions, and net income (loss) from each of the three activities are as follows: ---------- R S T ---------- 1987: Gross income ..... $8,000 $5,000 $2,000 Deductions ..... (9,000) (7,000) (1,400) ---------- Net income (loss) ..... ($1,000) ($2,000) $600 ----------

1988: Gross income ..... $7,000 $6,000 $2,000 Deductions ..... (8,000) (4,500) (3,000) ---------- Net income (loss) ..... ($1,000) $1,500 ($1,000) ----------

(ii) Under §1.469-2T(b), C's passive activity loss for 1987 is $2,400 ($17,400 of passive activity deductions less $15,000 of passive activity gross income). Under paragraph (b)(3) of this section, C's pre-enactment loss for 1987 is $2,400. Accordingly, under paragraph (b)(1) and (2) of this section, §1.469-1T (a)(1)(i) does not apply to $1,560 ($2,400 × .65) of C's passive activity loss for 1987. Under §1.469-1T (a)(1)(i), $840 of C's passive activity loss for 1987 ($2,400 x .35) is disallowed.

(iii) Under §1.469-1T (f)(2)(i), since a portion of C's passive activity loss for 1987 is disallowed, a ratable portion of the loss from each of C's activities that has a loss for 1987 (activity R and activity S) is disallowed for 1987. Accordingly, $280 of the 1987 loss from activity R ($840 × $1,000/$3,000) and $560 of the 1987 loss from activity S ($840 × $2,000/$3,000) is disallowed for 1987. Under §1.469-1T (f)(2) and (4), corresponding portions of the deductions from each activity are disallowed for 1987 and treated as deductions from activities R and S, respectively, for 1988. The deductions that are disallowed for 1987 and treated as deductions for 1988 are taken into account under paragraph (b)(3)(i) but not paragraph (b)(3)(ii) of this section. Thus, the amounts determined under paragraphs (b)(3)(i) and (b)(3)(ii) of this section for 1988 are as follows: ---------- Activity (b)(3)(i) (b)(3)(ii) ---------- R ..... ($1,280) ($1,000) S ..... 940 1,500 T ..... (1,000) (1,000) Total ..... ($1,340) ($500) ----------

Therefore, C's pre-enactment loss for 1988 is $500.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section, §1.469-1T (a)(1)(i) does not apply to $200 ($500 × .40) of C's $1,340 passive activity loss for 1988.

Example (4). (i) D, an individual, has interests in there passive activities, X, Y, and Z. Activities X and Y are rental real estate activities (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) in which D actively participates (within the meaning of section 469(i) and the rules to be contained in §1.469-9T) for the taxable year. D's interest in activity X is a pre-enactment interest, and D's interest in activity Y is not a pre-enactment interest. Activity Z is not a rental real estate activity, and D's interest in activity Z is not a pre-enactment interest. The amount of income (loss) from each activity for the taxable year is as follows: ---------- Activity Income (loss) ---------- X (pre-enactment rental) ..... ($40,000) Y (other rental) ..... $30,000 Z (other non-rental) ..... ($20,000) ----------

(ii) The amount determined under paragraph (b)(3)(ii) of this section is computed by applying section 469 to D as if D's only interests in passive activities were D's pre-enactment interests in such activities. If D's only interests in passive activities were D's pre-enactment interests in such activities, the amount to which §1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in §1.469-9T, would be $25,000. Taking into account all of D's interests in passive

activities, the amount to which §1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in §1.469-9T, is $10,000. Accordingly, the amounts determined under paragraph (b)(3)(i) and (b)(3)(ii) of this section for the taxable year are as follows: ---------- Activity (b)(3)(i) (b)(3)(ii) ---------- X ..... ($40,000) ($40,000) Y ..... $30,000 Z ..... ($20,000) ---------- ---------- Subtotal ..... ($30,000) ($40,000) sec. 469(i) allowance ..... $10,000 $25,000 ---------- Total ..... ($20,000) ($15,000) ----------

Therefore, D's pre-enactment loss for the taxable year is $15,000.

Example (5). E, an individual, has for the taxable year the following items of income, deduction, and credit from passive activities: ---------- Pre-enactment Other interests Total interests ---------- Income (deductions) ..... $100 ($1,00) -0- Credits ..... 28 28 $56 ----------

For the taxable year, E is subject to tax at a marginal rate of 28 percent. Under §1.469-3T (d), E's regular tax liability allocable to passive activities for the taxable year is zero. If, however, the only interests in passive activities taken into account were the pre-enactment interests (i.e., if the $100 loss were disregarded), E's regular tax liability allocable to passive activities for the taxable year would be $28. Thus, the amounts determined under paragraphs (b)(4)(i) and (b)(4)(ii) of this section are as follows: ---------- (b)(4)(i) (b)(4)(ii) ---------- $56 ..... -0- ----------

Therefore, E's pre-enactment credit for the taxable year is zero, and §1.469-1T (a)(1)(ii) applies to E's $56 passive activity credit for the taxable year.

(c) Definition of pre-enactment interest-(1)

Geneal rule. Except as otherwise provided in this paragraph (c), the term "pre-enactment interest" means a qualified interest in a pre-enactment activity.

(2) Qualified interest-(i) In general. For purposes of this paragraph (c), a qualified interest in an activity is any interest in an activity that was-

(A) Held by the taxpayer on October 22, 1986, and at all times thereafter (but only if the activity existed on October 22, 1986); or

(B) Acquired by the taxpayer after October 22, 1986, directly or indirectly, pursuant to one or more written binding contracts to which the taxpayer was a party on October 22, 1986, and held by the taxpayer at all times after such acquisistion.

See paragraph (c)(7) of this section for rules for determining whether a taxpayer was a party on October 22, 1986, to a written binding contract.

(ii) Stock in a C corporation. For purposes of this paragraph (c)(2), stock in a C corporation is not treated as an interest in any activity of the corporation. The following example illustrates the application of this paragraph (c)(2)(ii):

Example. On October 22, 1986, the taxpayer owned all of the stock of a C corporation that conducted a single activity. On December 31, 1986, the corporation liquidated and distributed to the taxpayer the assets used in the activity. Under this paragraph (c)(2)(ii), the taxpayer does not have a qualified interest in the corporation's activity as a result of the liquidation. The result would be the same if, on December 31, 1986, instead of liquidating, the corporation elected under section 1362(a) to be an S corporation.

(3) Pre-enactment activity-(i) In general. For purposes of this paragraph (c), an activity is a pre-enactment activity if-

(A) The activity was being conducted by any person on October 22, 1986; or

(B) At least 50 percent (by value) of the property used in the activity during the taxable year was-

(1) In existence or under construction on August 16, 1986; or

(2) Acquired or constructed by any person pursuant to a written binding contract (without regard to whether the taxpayer or any person related to the taxpayer was a party to such contract) in effect on August 16, 1986.

(ii) Character before 1987 irrelevant. For purposes of this paragraph (c), an activity may be treated as a pre-enactment activity without regard to whether such activity would have been a passive activity of the taxpayer for any taxable year beginning before January 1, 1987, had section 469 and the regulations thereunder been in effect for such year.

(4) Examples. The following examples illustrate the application of paragraphs (c) (1), (2), and (3) of this section:

Example (1). On October 22, 1986, the taxpayer owned an interest in property used as a personal residence. After October 22, 1986, the taxpayer ceased to use the property as a personal residence and began to use it in a rental activity. The rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section) because the property used in the rental activity was in existence on August 16, 1986. The taxpayer did not hold any interest in the rental activity on October 22, 1986, however, because the activity did not exist on that date. In addition, the taxpayer did not acquire an interest in the activity after October 22, 1986, pursuant to a written binding contract to which the taxpayer was a party on such date. Accordingly, the taxpayer's interest in the rental activity is not a qualified interest (within the meaning of paragraph (c)(2) of this section), and the taxpayer does not have a pre-enactment interest in the rental activity.

Example (2). The taxpayer owns an interest in a partnership, which owns property used in a rental activity. The taxpayer acquired the partnership interest pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986.

The partnership acquired its interest in the rental property pursuant to written binding contracts to which the partnership was a party on October 22, 1986. Construction of the property used in the rental activity commenced prior to August 16, 1986. Under paragraph (c)(7)(ii) of this section, the taxpayer is treated as a party to the contracts to which the partnership was a party on October 22, 1986. Therefore, the taxpayer's interest in the partnership's rental activity is a qualified interest (within the meaning of paragraph (c)(2) of this section) because the taxpayer is treated as acquiring an interest in the partnership's rental activity pursuant to written binding contracts to which the taxpayer was party on October 22, 1986. Since the property used in the rental activity was under construction on August 16, 1986, the partnership's rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Accordingly, the taxpayer's interest in the partnership's rental activity is a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that the partnership acquired the property after October 22, 1986, pursuant to a contract entered into after October 22, 1986. The taxpayer's interest in the partnership's rental activity is not a pre-enactment interest because such interest was not acquired pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986.

Example (4). The taxpayer owned a pre-enactment interest in an activity on October 22, 1986. After that date, the taxpayer died, and the decedent's interest in the activity passed to the decendent's estate. Since a decedent and the decedent's estate are not the same taxpayer, the estate must independently satisfy the requirements for a pre-enactment interest regardless of the fact that the decendent had a pre-enactment interest in the activity. Since the activity was being conducted by the decedent on October 22, 1986, the activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Since, however, the estate did not hold any interest in the activity on October 22, 1986, the estate does not have a qualified interest in the activity (within the meaning of paragraph (c)(2) of this section). Accordingly, the estate does not have a pre-enactment interest in the activity.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity-(i) In general. If the taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity was increased or decreased at any time after October 22, 1986, and prior to the end of such taxable year (other than pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986), the share of such item that is attributable to the taxpayer's pre-enactment interest in such activity shall be determined by taking into account-

(A) The taxpayer's share for such taxable year of such item as of October 22, 1986; reduced by

(B) The greatest amount at any time subsequent to October 22, 1986, by which the sum of all the decreases in the taxpayer's share for such year of such item (other than decreases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986) exceeds the sum of all the increases in the taxpayer's share for such year of such item (other than increases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986).

For purposes of this paragraph (c)(5)(i), the taxpayer's share of an item as of October 22, 1986, is determined by taking into account any written binding contract to which the taxpayer was a party on October 22, 1986.

(ii) Partnership terminations under section 708(b)(1)(B). A taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity conducted by a partnership shall not be treated as having increased or decreased at any time after October 22, 1986, solely because the partnership is treated as terminating at any time after such date under section 708(b)(1)(B).

(iii) Examples. The following examples illustrate the application of this paragraph (c)(5):

Example (1). On October 22, 1986, an individual owned a 10 percent interest in a pre-enactment activity. After October 22, 1986, the taxpayer acquires an additional five percent interest in the activity pursuant to a contract entered into after October 22, 1986. Under this paragraph (c)(5), only the 10 percent interest in the activity the taxpayer owned on October 22, 1986, is a pre-enactment interest.

Example (2). On October 22, 1986, individuals A and B each owned a rental activity. After October 22, 1986, A and B contribute their rental activities to a partnership in exchange for which each receives a 50 percent interest in all items of income, gain, loss, deduction, and credit of the partnership. Under paragraph (c)(5)(i) of this section, A's 50 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest. None of A's interest in the partnership items attributable to the rental activity contributed by B is attributable to a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that under the partnership agreement the items of income, gain, loss, deduction, and credit attributable to the rental activity A contributed to the partnership are allocated 80 percent to A and 20 percent to B. Under paragraph (c)(5)(i) of this section, A's 80 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest.

Example (4). The facts are the same as in example (3) except that on January 1, 1988, the partnership liquidates, distributing to A the rental activity contributed by A to the partnership. Under paragraph (c)(5)(i) of this section, only 80 percent of A's interest in the rental activity distributed to A is a pre-enactment interest.

Example (5). On October 22, 1986, an individual is the general partner in a limited partnership. Under the partnership agreement in effect on that date, the taxpayer is allocated one percent of each item of partnership income, gain, loss, deduction, and credit for 1987 and 10 percent of each such item for 1988. Since the increase was provided for in a written binding contract to which the taxpayer was a party on October 22, 1986, the increase in the taxpayer's share of each item of partnership income, gain, loss, deduction, and credit is taken into account, under paragraph (c)(5)(i) of this section, as income, gain, loss, deduction, and credit from a pre-enactment interest.

Example (6). The facts are the same as in example (5) except that the partnership agreement is amended on November 30, 1986. The amendment decreases the taxpayer's share of partnership depreciation for 1987 from 10 percent to five percent, but does not affect the partner's share of partnership depreciation for any other year. Since the taxpayer's share of partnership depreciation for 1988 is not decreased by the amendment, the result, for 1988, is the same as in example (5). For 1987, however, only five percent of the partnership depreciation is attributable to the taxpayer's pre-enactment interest even if, after November 30, 1986, another amendment to the partnership agreement restores the taxpayer's 10 percent share of partnership depreciation for 1987.

Example (7). (i) A and B, calendar year individuals, own all the stock of X, a calendar year S corporation. On October 22, 1986, A and B each own 50 shares of X stock. On July 1, 1987, X issues an additional 100 shares of stock to B (but does not issue any additional stock to A). On December 1, 1987, A purchases 70 shares of X stock from B. Thus, A and B have the following shares of items of income, gain, loss, deduction, and credit from activities of X: ---------- Period A's share B's share ---------- 10/22/86-6/30/87 ..... 50% 50% 7/1/87-11/30/87 ..... 25% 75% 12/1/87- ..... 60% 40% ----------

(ii) Under paragraph (c)(5)(i) of this section, A and B each have a 50 percent share of each item of X as of October 22, 1986. Since there are no increases or decreases in their shares before June 30, 1987, their 50 percent shares of items of X assigned to the period from January 1, 1987, through June 30, 1987, are attributable to their pre-enactment interests.

(iii) As a result of the decrease in A's share on June 30, 1987, only a 25 percent share of the items of X assigned to the period from July 1, 1987, through November 30, 1987, is attributable to A's pre-enactment interest. In addition, notwithstanding the increase in B's share, only a 50 percent share of such items (B's share as of October 22, 1986) is attributable to B's pre-enactment interest.

(iv) As a result of the decrease in B's share on November 30, 1987, only a 40 percent share of the items of X assigned to the period from December 1, 1987, through December 31, 1987, is attributable to B's pre-enactment interest. In addition, notwithstanding the increase in A's share, only a 25 percent share of such items (A's share as of October 22, 1986, reduced by the amount of the decrease in A's share on June 30, 1987) is attributable to A's pre-enactment interest.

(6) Special rule for beneficiaries of trusts or estates-(i) In general. If a beneficial interest in a trust or estate was held by a taxpayer on October 22, 1986, and at all times thereafter, any income, directly allocable deductions, and credits taken into account by the taxpayer with respect to such interest shall be treated as income, deductions, and credits, respectively, from a pre-enactment interest of the beneficiary if and only if such income, deductions, and credits are from a pre-enactment interest of the trust or estate. For purposes of the preceding sentence, "directly allocable deductions" means-

(A) Depreciation allowable to the beneficiary under section 167(h);

(B) Depletion allowable to the beneficiary under section 611(b)(3); and

(C) Amortization apportioned to the beneficiary under section 642(f).

The following example illustrates the application of this paragraph (c)(6)(i):

Example. The taxpayer is a beneficiary of a trust that conducts a rental activity. The trust's interest in the activity is a pre-enactment interest of the trust. On October 22, 1986, under the trust agreement the trustee had discretion to allocate any amount of the depreciation deductions from the rental activity to the beneficiary. Under this paragraph (c)(6)(i), any depreciation deductions from the rental activity that are allocated to the beneficiary will be treated as deductions attributable to a pre-enactment interest of the beneficiary.

(ii) Interests distributed to beneficiaries. A beneficiary of a trust or estate to whom the trust or estate distributes an interest in an activity shall be treated as having a pre-enactment interest in the activity by reason of such distribution if and only if such interest was a pre-enactment interest of the trust or estate, and the beneficiary held a beneficial interest in the trust or estate on October 22, 1986, and at all times thereafter.

(7) Written binding contract-(i) In general. A contract shall be treated as a written binding contract of a person for purposes of this section if and only if the contract is enforceable against such person under the applicable State law and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). For purposes of the preceding sentence, a contractual provision that limits damages to an amount equal to five percent or more of the total contract price is not treated as limiting damages. In general, a contract is binding upon a person even if it is subject to a condition, as long as the condition is not within the control of such person. A contract is not binding on any date with respect to a person if the contract became enforceable against such person only by reason of an assignment occurring after such date. The following example illustrates the application of this paragraph (c)(7)(i):

Example. As of October 22, 1986, the taxpayer had signed a subscription agreement to acquire an interest in a partnership. The taxpayer's obligation to purchase an interest in the partnership was contingent on other persons signing subscription agreements by a particular date after October 22, 1986, to acquire a minimum number of the total interests offered for sale. If the taxpayer acquires an interest in the partnership, such interest will be treated as acquired pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. Although the taxpayer's obligation to acquire an interest in the partnership was subject to a contingency, the contingency was not within the taxpayer's control.

(ii) Special rule for contract of partnership or S corporation. For purposes of this section, a person shall be treated as a party to a contract on October 22, 1986, if on such date such person is a partner in a partnership or a shareholder in an S corporation (or is bound by a written contract to acquire an interest in such partnership or stock in such corporation) which itself is a party to such contract (or is treated under this paragraph (c)(7)(ii) as a party to such contract) on such date.

(iii) Application of rule to partnership agreements. A provision of a partnership agreement shall be treated as a binding contract with respect to a partner if the requirements of this paragraph (c)(7) are otherwise satisfied and such partner does

not have the power to amend any provision of the partnership agreement without the consent of other partners.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: February 12, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.