Treasury Decision 8253, 26 CFR, IRC Sec(s). 42

ACTION:

Temporary regulations.

SUMMARY:

This document contains temporary regulations relating to the definition of "activity" for purposes of applying the limitations on passive activity losses and passive activity credits and amends previously issued temporary regulations relating to the limitations. Changes to the applicable tax law were made by the Tax Reform Act of 1986, the Revenue Act of 1987, and the Technical and Miscellaneous Revenue Act of 1988. 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:

These regulations are effective for taxable years beginning after December 31, 1986, except for §§1.469-2T(f) (3) through (7), which are effective for taxable years beginning after December 31, 1987.

FOR FURTHER INFORMATION CONTACT:

Robert Stoddart or Michael J. Grace at 202-566-4751 (not a toll-free number), or at Internal Revenue Service, 1111 Constitution Avenue NW., Room 4429, Washington, DC 20224 (Attn: CC:CORP:T:R (PS-001-89)).

Supplementary information:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the requirements for collecting information contained in this regulation have been reviewed and, pending receipt and evaluation of public comments, approved for use through January 31, 1991, by the Office of Management and Budget (OMB) under control number 1545-1037. The estimated annual burden per respondent for making a written election varies from 5 minutes to 15 minutes, depending on individual circumstances, with an estimated average of 6 minutes.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require more or less time, depending on their circumstances.

For further information concerning this collection of information, and where to submit comments on this collection of information, the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section of this issue of the Federal Register.

Issuance of Proposed Regulation and Submission to Small Business Administration

The rules contained in this document are also being issued as proposed regulations by the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of the rules will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Background

Temporary regulations under section 469 were published in the Federal Register for February 25, 1988 (53 FR 5686, T.D. 8175). Those regulations added §§1.469-0T, 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T to Title 26 of the Code of Federal Regulations, and indicated that the definition of activity would be contained in §1.469-4T. This document adds rules for identifying activities in §1.469-4T and amends §§1.469-0T, 1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T, and 1.469-11T in certain respects.

The temporary regulations reflect the amendment of the Internal Revenue Code by sections 501 and 502 of the Tax Reform Act of 1986 (Pub. L. 99-514), which added section 469, and the amendment of section 469 by section 10212 of the Revenue Act of 1987 (Pub. L. 100-203) and sections 1005(a) and 2004(g) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647). Section 469 disallows the passive activity loss and the passive activity credit for the taxable year. Section 469(l)(1) provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary or appropriate to carry out provisions of section 469, including regulations which specify what constitutes an activity.

Definition of Activity

I. Description of Provisions

A. Scope and Structure of §1.469-4T

Section 1.469-4T provides rules under which endeavors to which the passive loss and credit limitations apply (business and rental operations) are treated as one or more activities for purposes of those limitations. In general, these rules are divided into three groups: (i) rules that identify the business and rental operations that constitute an undertaking (the undertaking rules); (ii) rules that identify the undertaking or undertakings that constitute an activity (the activity rules); and (iii) rules that apply only under certain special circumstances (the special rules).

B. Undertaking Rules

The undertaking is generally the smallest unit that can constitute an activity, and an undertaking may include diverse business and rental operations. The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person.

In some circumstances the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated. In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support.

The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings. This rule does not apply, however, if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (i.e., rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in §1.469-1T(e)(3)(ii). For purposes of this rule, short-term rentals of real property (e.g., hotel-room rentals) are generally treated as nonrental operations. The regulations also treat oil and gas wells that are subject to the working-interest exception in §1.469-1T(e)(4) as separate undertakings.

C. Activity Rules

The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer. In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

Trade or business undertakings include all nonrental undertakings other than oil and gas undertakings described above and professional service undertakings decribed below. An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure that the Service is issuing in conjunction with these regulations) or if the undertakings are vertically integrated. All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests. If, however, each member of a group of five or fewer persons owns a

substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests.

Trade or business undertakings (including undertakings that are aggregated under the rules described above) are also subject to a second aggregation rule. Under this rule, undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity.

Broader aggregation rules apply to professional service undertakings (i.e., undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity. The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking.

The rules for aggregating rental real estate undertakings are generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. The fragmentation of rental real estate into separate activities is limited by two consistency requirements. Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held. There are no comparable limitations on the aggregation of rental real estate into a single activity. A coordination rule provides, however, that a rental real estate undertaking must be treated as a separate activity if income or gain from the undertaking is subject to recharacterization under §1.469-2T(f)(3) (relating to the rental of nondepreciable property).

Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking. This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations. Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (i.e., material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.

D. Special Rules

Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members, and business and rental operations owned through a publicly traded

partnership cannot be aggregated with operations that are not owned through the partnership.

There is also a special rule for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method. A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of §1.469-4T.

II. Significant Policy Issues

A. Definition of Undertaking

Under the regulations, an activity of a taxpayer generally consists of either a single undertaking or a combination of two or more undertakings. Thus, the definition of undertaking should be broad enough to provide a useful intermediate step in determining a taxpayer's activities, but not so broad that unrelated business and rental operations are inappropriately combined in the same activity. Moreover, an undertaking should be defined with such precision that the business and rental operations that constitute an activity can be determined with reasonable certainty. The Service recognizes that no single definition of undertaking can reconcile these objectives in all cases. It believes, however, that a definition that strikes a reasonable balance among these competing objectives is essential to carry out the purposes of section 469 and to comply with section 469(l)(1), which directs the service to prescribe regulations that specify what constitutes an activity.

Location and ownership are the primary factors used to identify the business and rental operations that constitute an undertaking. Thus, the number of a taxpayer's undertakings is generally limited to the number of locations at which the taxpayer conducts business directly plus the number of locations at which business is conducted by passthrough entities in which the taxpayer owns an interest. In most cases, the number of undertakings should be small enough to avoid the need for extensive application of the aggregation rules contained in the regulations. In fact, for the large number of taxpayers who conduct all their business operations at a single location, either directly or through a single passthrough entity, the determination that such operations constitute a single undertaking is generally the only analysis that the regulations require.

The use of location and ownership as the primary factors in determining undertakings also contributes to certainty in the determination of activities. While some uncertainty is likely in the case of operations that are included in an undertaking without regard to the location at which the operations are conducted (i.e., operations that are not conducted at a fixed place of business, operations that are conducted at the customer's place of business, and support operations), the Service contemplates that reasonable methods will be used in determining the undertaking with which such operations are associated and that any reasonable method will be respected. The Service invites public comment regarding the desirability of detailed rules for determining the undertakings with which such operations are associated.

The Service recognizes that unrelated business operations may be treated as part of a single undertaking under these rules. In the typical case, however, operations that are conducted at the same location and are owned by the same person constitute an integrated and interrelated economic unit. Moreover, identification of the exceptional case in which such operations do not constitute an integrated and interrelated economic unit and might appropriately be treated as multiple undertakings would require additional analysis that would greatly undermine the certainty that these regulations are intended to provide. In addition, the accurate measurement of gain or loss from, and participation in, such multiple undertakings would generally require unduly burdensome allocations of income, expenses, and participation among the undertakings. For these reasons, the regulations do not provide an exception to the basic undertaking rule for those few cases in which, based on all the facts and circumstances, the operations conducted at a single location might appropriately be treated as multiple undertakings.

B. Rental Undertaking

All rental activities are passive, but other activities are passive only if the taxpayer does not materially participate. Because of this difference in treatment, it is inappropriate in most cases to combine rental operations and nonrental operations in a single activity. In the absence of a special rule, however, the basic undertaking rule would often treat rental operations and nonrental operations that are conducted at the same location as part of the same undertaking. To prevent this, the regulations provide in such cases that the rental operations and the nonrental operations are generally treated as two separate undertakings.

In some cases, however, it is appropriate to treat rental operations and nonrental operations as part of the same activity. For example, operations that are incidental to other operations should be treated as part of the same activity even if they are not in the same class (i.e., rental or nonrental) as such other operations. Although all the facts and circumstances should be taken into account in determining whether operations in one class are incidental to operations in the other class, one of the most significant factors is the substantiality of the operations in each class relative to those in the other class. Moreover, even though it is generally more appropriate to separate rental and nonrental operations, the separation of those operations increases accounting burdens because of the need to allocate income, expenses, and participation between the rental and nonrental undertakings. As a result, it is difficult to justify treating rental and nonrental operations that are conducted at the same location as separate undertakings unless substantial operations are included in each undertaking. For these reasons, the rule separating rental and nonrental operations conducted at the same location does not apply if more than 80 percent of the aggregate income from the operations is attributable to one class of operations.

C. Aggregation of Nonrental Undertakings

The purpose of the aggregation rules applicable to nonrental undertakings is to identify undertakings that constitute an integrated and interrelated economic unit. This purpose suggests that all the facts and circumstances should be taken into account in determining whether undertakings are aggregated into a single activity. On the other hand, a rule requiring consideration of all relevant facts and circumstances would necessitate difficult and time-consuming analyses of the relationships between undertakings and would also introduce substantial uncertainty

into the identification of activities. Accordingly, the regulations generally limit the relevant factors to the two that the Service believes are most significant (similarity and control) and provide specific rules for taking those factors into account.

The first of these factors, similarity, involves either common lines of business or different stages in the production or distribution of the same product or group of products. The function of this factor is to ascertain whether the nature of the businesses in which the undertakings are engaged is such that there can be meaningful interactions among undertakings, whether in the form of economies of scale, transactions between undertakings, or otherwise. Such interactions are an essential characteristic of an integrated and interrelated economic unit and do not typically occur between businesses that are conducted at different locations unless the businesses are similar within the meaning of the regulations.

Businesses that, by their nature, could constitute an integrated and interrelated economic unit may, nevertheless, be competitors (if they involve a common line of business) or adversarial in their dealings (if they involve different stages in production or distribution) unless they serve and are coordinated by common interests. Conversely, businesses that are commonly controlled are typically integrated if the nature of the businesses is such that integration would result in economies of scale or other efficiencies. Accordingly, the second factor that must be taken into account under the regulations is control of the undertakings.

The rules for determining whether undertakings are similar and are controlled by the same interests further limit the need to consider all relevant facts and circumstances. The regulations provide bright-line tests for determining whether undertakings are similar. Under these tests, the only relevant factors are the line of business (if any) from which more than 50 percent of an undertaking's gross income is derived and whether the undertaking provides more than 50 percent (by value) of its property and services to related undertakings or obtains more than 50 percent (by value) of its property and services from a related undertaking. Moreover, the lines of business used to determine similarity are generally adapted from the Standard Industrial Classification (SIC) of the United States, and thus are consistent with an established method of distinguishing and categorizing business operations. Similarly, the regulations simplify and minimize the uncertainty in determinations of common control by providing a rebuttable presumption under which undertakings are generally presumed to be controlled by the same interests if more than 50 percent of the interests in the undertakings are owned by the members of a group of five or fewer persons.

The Service recognizes that unrelated business operations may be treated as part of the same activity under these rules. This raises essentially the same issue as treating unrelated business operations as part of the same undertaking, and the considerations taken into account in that context are equally applicable here. Accordingly, the regulations do not provide an exception to the aggregation rules for those few cases in which, based on all the facts and circumstances, similar and commonly-controlled undertakings might appropriately be treated as multiple activities.

The aggregation rules are generally inapplicable to small interests held by passive investors in the undertakings, except to the extent such interests are held through the same passthrough entity. The purpose of this exception is not to ascertain more

accurately whether undertakings constitute an integrated and interrelated business activity, but rather to simplify the determination of activities for the taxpayers to whom it applies. In general, such taxpayers may accept a passthrough entity's identification and aggregation of undertakings and need not engage in further analysis to determine whether undertakings held through the entity should be aggregated with undertakings held directly or through other passthrough entities.

In some cases, businesses that are not similar within the meaning of the regulations nonetheless constitute an integrated business if all the facts and circumstances are taken into account. The Service believes that a rule requiring such businesses to be treated as a single activity, if applied after the rule aggregating similar and commonly controlled undertakings, would not affect a large number of taxpayers. Moreover, even though such a rule requires consideration of all relevant facts and circumstances, this should not be a substantial burden if the only analysis required is of the relationships among a few large groups of operations. Accordingly, the regulations provide that one or more undertakings (or groups of undertakings that have been aggregated because of their similarity) are treated as a single activity if the undertakings (or groups of undertakings) are controlled by the same interests and, based on all the facts and circumstances, their operations constitute a single integrated business.

Special aggregation rules are provided for professional service undertakings. These rules are necessary, in part, because of the material participation rule applicable to personal service activities. Thus, the rules do not permit the aggregation of professional service activities and other activities. In addition, the rules are significantly broader than those applicable to other nonrental undertakings. The Service believes that broader aggregation rules are appropriate in this context because all professional services share certain similarities and it is increasingly common for professional-service firms to provide services in more than one field. Morever, a professional-service firm's success in one field is more likely to be attributable to expertise and goodwill developed in another field than is the case with other nonrental businesses.

D. Rental Real Estate Undertakings

The treatment of a taxpayer's nonrental operations as one or more activities significantly affects the computation of the taxpayer's passive activity loss and credit, primarily because material and significant participation are measured on an activity-by-activity basis and because certain rules that recharacterize income associated with nonrental operations also apply on an activity-by-activity basis. Thus, to prevent avoidance of the passive loss rules by inappropriately grouping operations into activities that do not constitute integrated and interrelated economic units, taxpayers are required to conform to precise rules for identifying the operations that are included in a nonrental activity.

The organization of rental operations into activities does not provide comparable opportunities for avoidance of the passive loss rules because the character of the income or loss from rental operations is generally not affected by the taxpayer's participation in the activity in which the operations are included and the rules recharacterizing income from rental operations generally apply on a property-by-property basis. A taxpayer's participation is relevant in computing the $25,000 offset for rental real estate activities. The purpose of the offset, however, it to provide

targeted relief to moderate income taxpayers, and its amount and the taxpayers to which it applies are limited accordingly. Thus, the Service does not believe it is necessary to provide rules in these regulations that further restrict the availability of the offset.

Because specific rules similar to those applicable to nonrental operations are not necessary in the case of rental operations, the regulations generally permit taxpayers to organize their rental real estate operations into activities in any manner they find convenient or advantageous. Taxpayers are not permitted, however, to fragment their rental real estate operations into separate activities to a greater extent than in preceding taxable years or to a greater extent than such operations are fragmented by the passthrough entity through which they are held. The first limitation prevents taxpayers from treating operations as an activity in cases in which their records are not likely to contain sufficient detail to permit them to compute the suspended loss from the activity. Similarly, the second limitation prevents taxpayers from treating operations as an activity in cases in which the accounting information provided to them by the passthrough entity is unlikely to be detailed enough to permit them to compute the net income or loss from the activity. A third limitation provides that a rental real estate undertaking must be treated as a separate activity if income from the undertaking is subject to recharacterization under §1.469-2T(f)(3). This limitation is necessary to maintain the integrity of the recharacterization rule.

The rules described above apply only to rental operations involving real property. The Service invites public comment regarding the desirability of providing similar flexibility with respect to rental operations involving personal property.

E. Election to Treat Nonrental Undertakings as Separate Activities

Although a nonrental undertaking may, with other nonrental undertakings, constitute an integrated and interrelated economic unit, the synergistic effects resulting from the conduct of the undertaking as part of an integrated business generally cease when there is a disposition of the undertaking. Thus, the activity that remains after such a disposition is fundamentally different from the activity conducted before the disposition. As a result, the disposition of an undertaking will often be an appropriate time to measure economic income or loss. Moreover, an undertaking generally consists of identifiable operations that are conducted at a single location, and a disposition of such operations should, in most cases, permit the accurate measurement of the economic income or loss from the portion of a business that is conducted at the location.

For the reasons described above, the Service believes that an undertaking may constitute an appropriate unit for measuring gain or loss even in cases in which it is part of a larger integrated business. Accordingly, the regulations permit taxpayers to elect to treat a nonrental undertaking as a separate activity (other than for purposes of measuring participation) even though under the aggregation rules the undertaking would be treated as part of a larger activity. This election is not available, however, if the taxpayer treated the undertaking as part of a larger activity in a preceding taxable year or if the passthrough entity through which the undertaking is held treats it as part of a larger activity. The purpose of these exceptions is the same as the purpose of the similar limitations that apply to the election to treat rental real estate operations as separate activities.

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

Amendments Made to Existing Regulations

This document also amends portions of the existing regulations under section 469 to coordinate those regulations with the definition of activity contained in §1.469-4T and to make certain clarifying and corrective changes to the existing regulations. The significant changes made to the existing regulations by these amendments are described below.

I. Section 1.469-1T

The determination of whether an activity is a rental activity under §1.469-1T(e)(3) generally requires the computation of an average period of customer use for the activity. The average period of customer use, as defined in §1.469-1T(e)(3)(iii), is not weighted to reflect differences in the rental value of the activity's property. Thus, property that produces an insignificant amount of an activity's rental income might significantly affect the activity's average period of customer use. Therefore, this document amends the definition of average period of customer use to take into account the amount of income generated by an item of property.

This document also amends the rule contained in §1.4469-1T(f)(4) (relating to the allocation of disallowed deductions and credits among activities) to reflect the possibility that the composition of an activity may change from year to year.

II. Section 1.469-2T

This document amends §1.469-2T (c) and (d) to provide rules for characterizing the gain and loss from the sale of property held in a dealing activity at the time of the sale. For purposes of characterizing the gain or loss from the sale of any such property that was used predominantly in one or more nondealing activities and was not acquired for the principal purpose of dealing in such property, the rules provide that holding the property in the dealing activity is treated as the use of the property in the last nondealing activity in which such property was used before its sale. In all other cases, the rules provide that the property is treated as used in the dealing activity, and treat such property as used in a dealing activity for any period during which it is simultaneously offered for sale to customers and used in a nondealing activity. These rules replace the provision contained in §1.469-1T(e)(3)(vi)(D) of the existing regulations. Under that provision, certain rentals of property were treated as incidental to an activity of dealing in such property rather than as part of a rental activity.

The Service has received numerous comments regarding the income-recharacterization rule contained in §1.469-2T(f)(5), relating to the treatment of net

income from certain property rented incidental to a developent activity. Some commentators have argued that there are a substantial number of cases in which the gain on the dispositon of property that is used in a rental activity for less than 24 months after its development is predominantly attributable to its use in a rental activity rather than to the development of the property. Other commentators have argued that there should be no special recharacterization rule with respect to development activities. After careful consideration, it has been determined that §1.469-2T(f)(5) should apply only if the use of an item of property in an activity involving the rental of such property commenced less than 12 months prior to its sale (or contracting for its sale). Accordingly, this document amends the existing regulations to provide for this result.

III. Section 1.469-5T

Under §1.469-4T, the business and rental operations that constitute an activity may change from year to year. The existing regulations do not address how the material participation tests that are based on participation in prior years will apply in cases in which such changes occur. Accordingly, this document amends §1.469-5T to provide that, for purposes of the material participation tests that are based on participation in prior years, a taxpayer is treated as materially participating in an activity for a prior taxable year if the activity includes an undertaking involving substantially the same operations as an undertaking that was included in an activity in which the taxpayer materially participated during such prior taxable year.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required.

Drafting Information

The principal author of these regulations is Michael J. Grace, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), 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

26 CFR 1.441-1 through 1.483-2

Accounting, Deferred compensation plans, Income taxes.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, Title 26, Chapter 1, Parts 1 and 602 of the Code of Federal Regulations are amended as follows:

PART 1- INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

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

Authority:

26 U.S.C. 7805. Section 1.469-4T also issued under 26 U.S.C. 469(l)(1).

Par. 2. Section 1.469-OT is revised to read as follows:

§1.469-OT Table of contents (temporary).

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

Section 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 data 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 sections 613A (d) and 1211.

(3) Treatment of passive activity losses.

(e) Definition of "passive activity."

(1) In general.

(2) Trade or business activity.

(3) Rental activity.

(i) In general.

(ii) Exceptions.

(iii) Average period of customer use.

(A) In general.

(B) Average use factor.

(C) Average period of customer use for class of property.

(D) Period of customer use.

(E) Class of property.

(F) Gross rental income and daily rent.

(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) Lodging rented for convenience of employer.

(E) 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) Definition of "working interest."

(v) Entitles 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 activities.

(A) General rule.

(B) Loss from an activity.

(C) Significant participation passive activities.

(D) Examples.

(ii) Allocation with loss activities.

(A) In general.

(B) Excluded deductions.

(iii) Separately identified deductions.

(3) Identification of disallowed credits from passive activities.

(i) General rule.

(ii) Coordination rule.

(iii) Separately identified credits.

(4) Carryover of disallowed deductions and credits.

(i) In general.

(ii) Operations continued through C corporations or similar entities.

(iii) Examples.

(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 participation of members.

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

(ii) Determination of status and 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 of dispositions.

(D) Certain recharacterized items treated as portfolio items.

(E) Property involved in deferred intercompany transaction.

(iv) Definitions.

(A) Deferred intercompany transactions.

(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 of 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]

Section 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 group 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 or 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) Disposition of substantially appreciated property formerly used in nonpassive activity.

(A) In general.

(B) Date of disposition.

(C) Substantially appreciated property.

(D) Investment property.

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

(F) Coordination with section 163(d).

(G) Examples.

(iv) Taxable acquisitions.

(v) Property held for sale to customers.

(A) Sale incidental to another activity.

(1) Applicability.

(i) In general.

(ii) Principal purpose.

(2) Dealing activity not taken into account.

(B) Use in a nondealing activity incidental to sale.

(C) Examples.

(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) Gross and net passive 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) Applicability of rules in paragraph (c)(2).

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

(6) Coordination with other limitations on deductions 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 adjustments.

(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 sections 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(iii) Payments in liquidation of a partner's interest in partnership property.

(A) In general.

(B) Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).

(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) Exception.

(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 enhancing 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.

(1) Purpose and effect of overview.

(2) Scope and structure of §1.469-4T.

(3) Undertaking rules.

(i) In general.

(ii) Basic undertaking rule.

(iii) Circumstances in which location is disregarded.

(iv) Rental undertakings.

(v) Oil and gas wells.

(4) Activity rules.

(i) In general.

(ii) Aggregation of trade or business undertakings.

(A) Trade or business undertakings.

(B) Similar, commonly-controlled undertakings treated as a single activity.

(C) Integrated businesses treated as a single activity.

(iii) Aggregation of professional service undertakings.

(iv) Rules for rental real estate.

(A) Taxpayers permitted to determine rental real estate activities.

(B) Limitations on fragmentation and aggregation of rental real estate.

(v) Election to treat nonrental undertakings as separate activities.

(5) Special rules.

(i) Consolidated groups and publicly traded partnerships.

(ii) Transitional rule.

(b) General rule and definitions of general application.

(1) General rule.

(2) Definitions of general application.

(i) Passthrough entity.

(ii) Business and rental operations.

(A) In general.

(B) Operations conducted through nonpassthrough entities.

(c) Undertaking.

(1) In general.

(2) Operations treated as a separate source of income production.

(i) In general.

(ii) Treatment of support operations.

(A) In general.

(B) Support operations.

(iii) Location.

(iv) Income-producing operations.

(v) Ownership by the same person.

(3) Facts and circumstances determinations.

(4) Examples.

(d) Rental undertaking.

(1) In general.

(2) Exceptions.

(3) Rental operations.

(i) General rule.

(ii) Real property provided for short-term use.

(iii) Property made available to licensees.

(4) Examples.

(e) Special rules for certain oil and gas operations.

(1) Wells treated as nonpassive under §1.469-1T(e)(4)(i).

(2) Business and rental operations that constitute an undertaking.

(3) Examples.

(f) Certain trade or business undertakings treated as part of the same activity.

(1) Applicability.

(i) In general.

(ii) Trade or business undertaking.

(2) Treatment as part of the same activity.

(3) Substantial indirect interest.

(i) In general.

(ii) Coordination rule.

(4) Similar undertakings.

(i) In general.

(ii) Predominant operations.

(iii) Vertically-integrated undertakings.

(A) Supplier undertaking similar to recipient undertaking.

(B) Recipient undertaking similar to supplier undertaking.

(C) Coordination rules.

(iv) Lines of business.

(5) Examples.

(g) Integrated businesses.

(1) Applicability.

(i) In general.

(ii) Trade or business activity.

(2) Treatment as a single activity.

(3) Facts and circumstances tests.

(4) Examples.

(h) Certain professional service undertakings treated as a single activity.

(1) Applicability.

(i) In general.

(ii) Professional service undertaking.

(2) Treatment as a single activity.

(i) Undertakings controlled by the same interests.

(ii) Undertakings involving significant similar or significant related services.

(iii) Coordination rule.

(3) Significant similar or significant related services.

(4) Examples.

(i) [Reserved]

(j) Control by the same interests and ownership percentage.

(1) In general.

(2) Presumption.

(i) In general.

(ii) Common-ownership group.

(iii) Special aggregation rule.

(3) Ownership percentage.

(i) In general.

(ii) Passthrough entities.

(iii) Attribution rules.

(A) In general.

(B) Determination of common-ownership percentage.

(C) Related person.

(4) Special rule for trade or business activities.

(5) Examples.

(k) Identification of rental real estate activities.

(1) Applicability.

(i) In general.

(ii) Rental real estate undertaking.

(2) Identification of activities.

(i) Multiple undertakings treated as a single activity or multiple activities by taxpayer.

(ii) Multiple undertakings treated as a single activity by passthrough entity.

(iii) Single undertaking treated as multiple undertakings.

(3) Treatment in succeeding taxable years.

(4) Applicable return of passthrough entity.

(5) Evidence of treatment required.

(6) Coordination rule for rental of nondepreciable property.

(7) Coordination rule for rental of dwelling unit.

(8) Examples.

(l) [Reserved]

(m) Consolidated groups.

(1) In general.

(2) Examples.

(n) Publicly traded partnerships.

(o) Elective treatment of undertakings as separate activities.

(1) Applicability.

(2) Undertakings treated as separate activities.

(3) Multiple undertakings treated as a single activity by passthrough entity.

(4) Multiple undertakings treated as a single activity for a preceding taxable year.

(5) Applicable return of passthrough entity.

(6) Participation.

(7) Election.

(i) In general.

(ii) Written statement.

(8) Examples.

(p) Special rule for taxable years ending before August 10, 1989.

(1) In general.

(2) Unreasonable methods.

(3) Allocation of disallowed deductions in succeeding taxable year.

Section 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 partnership 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.

(3) Coordination with rules governing the treatment of passthrough entities.

(i) [Reserved]

(j) Material participation for preceding taxable years.

(1) In general.

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

(k) Examples.

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

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

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

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

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

Section 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) Definition 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 [Amended]

Par. 3. Section 1.469-1T is amended as follows:

1. Paragraph (d)(2) is amended by revising the heading and first sentence to read as follows:

(d)

(2) Coordination with sections 613A(d) and 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 613A(d) or 1211.

2. Paragraph (e)(2) is revised to read as follows:

(e)

(2) Trade or business activity. An activity (within the meaning of §1.469-4T) is a trade or business activity for a taxable year if and only if such activity-

(i) Is not a rental activity for such taxable year; and

(ii) Involves the conduct during such taxable year of business or rental operations (within the meaning of §1.469-4T(b)(2)(ii)) that are not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding property for investment.

3. Paragraph (e)(3)(iii) is revised to read as follows:

(e)

(3)

(iii) Average period of customer use-(A) In general. For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity (the "activity's average period of customer use") is the sum of the average use factors for each class of property held in connection with the activity.

(B) Average use factor. The average use factor for a class of property held in connection with an activity is the average period of customer use for such class of property multiplied by the fraction obtained by dividing-

(1) The activity's gross rental income attributable to such class of property; by

(2) The activity's gross rental income.

(C) Average period of customer use for class of property. In determining an activity's average period of customer use for a taxable year, the average period of customer use for a class of property held in connection with an activity is determined by dividing-

(1) The aggregate number of days in all periods of customer use for property in such class (taking into account only periods that end during such taxable year or that include the last day of such taxable year); by

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

(D) Period of customer use. 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 for purposes of this paragraph (e)(3)(iii) as a separate period of customer use. The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.

(E) Class of property. Taxpayers may organize property into classes for purposes of this paragraph (e)(3)(iii) using any method under which items of property for which the daily rent differs significantly are not included in the same class.

(F) Gross rental income and daily rent. In determining an activity's average period of customer use for a taxable year-

(1) The activity's gross rental income is the gross income from the activity for such taxable year taking into account only income that is attributable to amounts paid for the use of property;

(2) The activity's gross rental income attributable to a class of property is the gross income from the activity for such taxable year taking into account only income that is attributable to amounts paid for the use of property in such class; and

(3) The daily rent for items of property may be determined on any basis that reasonably reflects differences during the taxable year in the amounts ordinarily paid for one day's use of such items of property.

4. Paragraph (e)(3)(vi) is amended by removing paragraph (e)(3)(vi)(D) and by redesignating paragraph (e)(3)(vi)(E) and (F) as paragraph (e)(3)(vi)(D) and (E).

5. Paragraph (e)(4)(iv) is revised to read as follows:

(e)

(4)

(iv) Definition of "working interest." For purposes of section 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of §1.612-4(a)).

6. Paragraph (e)(5) is revised to read as follows:

(e)

(5) Rental of dwelling unit. An activity involving the rental of a dwelling unit is not a passive activity of a taxpayer for any taxable year in which section 280A (c)(5) applies to the taxpayer's use of such dwelling unit.

7. Paragraph (f)(4) is revised to read as follows:

(f)

(4) Carryover of disallowed deductions and credits-(i) In general. If any deductions or credits from an activity of a taxpayer (the loss activity) are disallowed for a taxable year under paragraph (f)(2) or (f)(3) of this section-

(A) The disallowed deductions or credits shall be allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity; and

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from such activity for the succeeding taxable year.

(ii) Operations continued through C corporations or similar entities. (A) If a taxpayer continues part or all of the business and rental operations that constitute a loss activity through a C corporation or similar entity, the taxpayer's interest in such entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues such operations. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of §1.469-2T(c)(3)(i)) from such interests.

(B) If, after the application of this paragraph (f)(4)(ii), an interest in a C corporation or similar entity is a loss activity for a taxable year, such interest shall be treated for purposes of applying this paragraph (f)(4) in the succeeding taxable year as an interest in a passive activity that continues the business and rental operations of such loss activity.

(iii) Examples. The following examples illustrate the application of this paragraph (f)(4). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). (i) The taxpayer owns interests in a convenience store and an apartment building. In each taxable year, the taxpayer's interests in the convenience store and the apartment building are treated under § 1.469-4T as interests in two separate passive activities of the taxpayer. A $5,000 loss from the convenience-store activity and a $3,000 loss from the apartment-building activity are disallowed under paragraph (f)(2) of this section for 1989.

(ii) Under paragraph (f)(2) of this section, the $5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1989, and the $3,000 loss from the apartment-building activity is treated similarly. In 1990, the business and rental operations that constituted the convenience-store activity are continued in a single activity, and the business and rental operations that constituted the apartment-building activity are similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1989 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1990. Similarly, the disallowed deductions from the apartment-building activity for 1989 must be allocated to the taxpayer's apartment-building activity in 1990. Under paragraph (f)(4)(i)(b) of this section, the disallowed deductions allocated to the convenience-store activity in 1990 are treated as deductions from that activity for 1990, and the disallowed deductions allocated to the

apartment-building activity for 1990 are treated as deductions from the apartment-building activity for 1990.

Example (2). (i) In 1991, the taxpayer acquires a restaurant and a catering service. In 1991 and 1992, the restaurant and the catering service are conducted at the same location, and the taxpayer's interests in the restaurant and catering service are treated under §1.469-4T as an interest in a single passive activity of the taxpayer. A $10,000 loss from the activity is disallowed under paragraph (f)(2) of this section for 1992. In 1993, the restaurant and the catering service are conducted at different locations, and the taxpayer's interests in the restaurant and the catering service are treated under §1.469-4T as interests in two separate passive activities of the taxpayer.

(ii) Under paragraph (f)(2) of this section, the $10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1992. In 1993, the business and rental operations that constituted the restaurant and catering activity are continued, but are treated as two separate activities under §1.469-4T. Thus, the disallowed deductions from the restaurant and catering activity for 1992 must be allocated under paragraph (f)(4)(i)(A) of this section between the restaurant activity and the catering activity in 1993 in a manner reasonably reflects the extent to which each of the activities continues the operations of the restaurant and catering activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the restaurant activity in 1993 are treated as deductions from the restaurant activity for 1993, and the disallowed deductions allocated to the catering activity in 1993 are treated as deductions from the catering activity for 1993.

Example (3). (i) The facts are the same as in example (2). In addition, a $20,000 loss from the activity was disallowed under paragraph (f)(2) of this section for 1991, and the gross income and deductions (including deductions that were disallowed for 1991 under paragraph (f)(2) of this section) from the restaurant and catering service for 1991 and 1992 are as follows: ---------- ---------- Restaurant Catering service ---------- ---------- 1991: Gross income ..... $20,000 $60,000 Deductions ..... 40,000 60,000 ---------- ---------- Net income (loss) ..... (20,000) ---------- ---------- 1992: Gross income ..... 40,000 50,000 Deductions ..... [] 30,000 [] 70,000 ---------- ---------- Net income (loss) ..... 10,000 (20,000) ---------- ---------- 1 Includes $8,000 of deductions that were disallowed for 1991 ($20,000x$40,000/$100,000). 2 Includes $12,000 of deductions that were disallowed for 1991 ($20,000x$60,000/$100,000).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering operations must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which such activities continue the restaurant and catering operations. The remainder of this example describes a number of allocation methods that will ordinarily satisfy the requirement of paragraph (f)(4)(i)(A) of this section. One or more of the allocation methods described in this example may, however, be unreasonable in certain cases. In addition, the description of specific allocation methods in this example does not

preclude the use of other reasonable allocation methods for purposes of paragraph (f)(4)(i)(A) of this section.

(iii) Ordinarily, an allocation of disallowed deductions from the restaurant operations to the restaurant activity and disallowed deductions from the catering operations to the catering activity would satisfy the requirement of paragraph (f)(4)(i)(A) of this section. Under paragraph (f)(2)(ii) of this section, a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1992. Thus, $3,000 of the 1992 deductions from the restaurant operations are disallowed ($10,000×$30,000/$100,000), and $7,000 of the 1992 deductions from the catering operations are disallowed ($10,000×$70,000/$100,000). Thus, the taxpayer can ordinarily treat $3,000 of the disallowed deductions as deductions from the restaurant activity for 1993, and $7,000 of the disallowed deductions as deductions from the catering activity for 1993.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant and catering activities in proportion to the losses from the restaurant operations and the catering operations for 1992 would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant operations and the catering operations had been treated as separate activities in 1992, the restaurant activity would have had net income of $10,000 and the catering activity would have had a $20,000 loss. Thus, the taxpayer can ordinarily treat all $10,000 of disallowed deductions as deductions from the catering activity for 1993.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant and catering activities in proportion to the losses from the restaurant operations and catering operations for 1992 (determined as if the restaurant operations and the catering operations had been separate activities for all taxable years) would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant operations and the catering operations had been treated as separate activities for all taxable years, the entire $20,000 loss from the restaurant operations in 1991 would have been allocated to the restaurant activity in 1992, and the gross income and deductions from such separate activities for 1992 would be as follows: ---------- ---------- Restaurant Catering service ---------- ---------- Gross income ..... $40,000 $50,000 Deductions ..... 42,000 58,000 ---------- Net income (loss) ..... (2,000) (8,000) ---------- ----------

Thus, the taxpayer can ordinarily treat $2,000 of the disallowed deductions as deductions from the restaurant activity for 1993, and $8,000 of the disallowed deductions as deductions from the catering activity for 1993.

Example (4). (i) The taxpayer is a partner in a law partnership that acquires a building in December 1988 for use in the partnership's law practice. In taxable year 1989, four floors that are not needed in the law practice are leased to tenants; in taxable year 1990, two floors are leased to tenants; in taxable years after 1990, only one floor is leased to tenants. Under §1.469-4T(d), the law practice and the rental operations with respect to the leased property are treated as a trade or business activity and a separate rental activity for taxable years 1989 and 1990 and as a single trade or business activity for taxable years after 1990. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a

passive activity. Under paragraph (f)(2) of this section, a $12,000 loss from the rental activity is disallowed for 1989, and a $9,000 loss from rental activity is disallowed for 1990.

(ii) Under paragraph (f)(2) of this section, the $12,000 loss from the rental activity for 1989 is allocated among the passive activity deductions from that activity for 1989. In 1990, the business and rental operations that constituted the rental activity are continued in two separate activities. Only the business and rental operations with respect to two floors of the building are continued in the rental activity, and the other two floors (i.e., the floors that were leased to tenants in 1989, but not in 1990) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1989 must be allocated under paragraph (f)(4)(i)(A) of this section between the rental activity and the law-practice activity in a manner that reasonably reflects the exent to which each of the activities continues the operations with respect to the four floors that were leased to tenants in 1989. In these circumstances, the requirement of paragraph (f)(4)(i)(A) of this section would ordinarily be satisfied by any of the allocation methods illustrated in example (3) or by an allocation of 50 percent of the disallowed deductions ($6,000) to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1990 are treated as deductions from the rental activity for 1990, and the disallowed deductions allocated to the law-practice activity in 1990 are treated as deductions from the law-practice activity for 1990.

(iii) Under paragraph (f)(2) of this section, the $9,000 loss from the rental activity for 1990 is allocated among the passive activity deductions from that activity for 1990. In 1991, the business and rental operations that constituted the rental activity are continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1990 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's law-practice activity in 1991. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the law-practice activity are treated as deductions from the law-practice activity for 1991.

(iv) Rules relating to former passive activities will be contained in paragraph (k) of this section. Under those rules, any disallowed deductions from the rental activity that are treated as deductions from the law-practice activity will be treated as unused deductions that are allocable to a former passive activity.

Example (5). (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1991 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1991, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under paragraph (f)(2) of this section.

(ii) Under paragraph (f)(2) of this section, the taxpayer's $5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1991. In 1992, the business and rental operations that constituted the rental activity are continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii)(A) of this section as a passive activity that continues such operations (the C corporation activity). Thus, the disallowed deductions from the rental activity for 1991 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1992, and are

treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1992.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the operations of the rental activity does not change the character of the taxpayer's dividend income from the C corporation. Thus, the taxpayer's dividend income is portfolio income (within the meaning of §1.469-2T(c)(3)(i)) and is not included in passive activity gross income. Accordingly, the taxpayer's loss from the C corporation activity for 1992 is $5,000.

Example (6). (i) The facts are the same as in example (5), except that the taxpayer has income from other passive activities for 1992, and only 60 percent of the taxpayer's loss from the C corporation activity ($3,000) is disallowed for 1992 under paragraph (f)(2) of this section.

(ii) Under paragraph (f)(2) of this section, the $3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1992. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1991 is again disallowed for 1992.

(iii) Under paragraph (f)(4)(ii)(B) of this section, the taxpayer's interest in the C corporation is treated for years after 1992 as an interest in a passive activity that continues the business and rental operations of the C corporation activity. Thus, the disallowed deductions from the C corporation activity for 1992 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1993, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1993.

8. Paragraph (g)(4)(ii)(C) is amended by removing "§1.469-2T(c)(2)(iii)(E)" and adding in its place "§1.469-2T(c)(2)(iii)(F)".

9. Paragraph (h)(4) is amended by removing the word "material" from the captions of paragraphs (h)(4) and (h)(4)(ii) and by adding the words "or significantly" immediately after the word "materially" in paragraph (h)(4)(ii).

§1.469-2T [Amended]

Par. 4. Section 1.469-2T is amended as follows:

1. Paragraphs (c)(2)(iii)(D) through (c)(2)(iii)(F) are redesignated as paragraphs (c)(2)(iii)(E) through (c)(2)(iii)(G) and the following new paragraph (c)(2)(iii)(D) is added:

(c)

(2)

(iii)

(D) Investment property. For purposes of this paragraph (c)(2)(iii), an interest in property shall be treated as an interest in property used in an activity other than a

passive activity and as an interest in property held for investment for any period during which such interest is held through a C corporation or similar entity. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of paragraph (c)(3)(i) of this section) from such interests.

2. Paragraph (c)(2)(iii)(G) (as redesignated by this Treasury decision) is revised to read as follows:

(c)

(2)

(iii)

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

Example (1). 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, 1998. On April 1, 1998, A leases the building to B. On December 31, 1999, A sells the building. At the time of the sale, A's interest in the building is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). 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 building (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

Example (2). (i) A, an individual, is a stockholder of corporation X. X is a C corporation until December 31, 1990, and is an S corporation thereafter. X acquires a building on January 1, 1990, and sells the building on March 1, 1991. At the time of the sale, A's interest in the building held through X is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). The building is leased to various tenants at all times during the period in which it is held by X. Assume that the lease of the building would constitute a rental activity (within the meaning of §1.469-1T(e)(3)) with respect to a person that holds the building directly or through an S corporation.

(ii) Paragraph (c)(2)(iii)(D) of this section provides that an interest in property is treated for purposes of this paragraph (c)(2)(iii) as used in an activity other than a passive activity and as held for investment for any period during which such interest is held through a C corporation. Thus, for purposes of determining the character of A's gain from the sale of the building, A's interest in the building is treated as an interest in property held for investment for the period from January 1, 1990 to December 31, 1990, and as an interest in property used in a passive activity for the period from January 1, 1991 to February 28, 1991.

(iii) A's interest in 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 2-month period during which A's interest in the building was used in a passive activity is less than 20 percent of the period during which A held an interest in the building (14 months). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

(iv) Under paragraph (c)(2)(iii)(F) of this section, gain that is treated as nonpassive under this paragraph (c)(2)(iii) is treated as portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if the 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 activities other than passive activities. In this case, A's interest in the building was treated as held for investment for the entire period during which it was used in activities other than passive activities (i.e., the 12-month period from January 1, 1990 to December 31, 1990). Accordingly, A's gain from the sale is treated under this paragraph (c)(2)(iii) as portfolio income.

3. New paragraphs (c)(2)(iv) and (c)(2)(v) are added to read as follows:

(c)

(2)

(iv) Taxable acquisitions. If a taxpayer acquires an interest in property in a transaction other than a nonrecognition transaction (within the meaning of section 7701(a)(45)), the ownership and use of such interest in property before such transaction shall not be taken into account for purposes of applying this paragraph (c)(2) to any subsequent disposition of such interest in property by the taxpayer. For example, if a taxpayer is a partner in a partnership that owns an interest in property and the taxpayer acquires such interest in property from the partnership in a fully taxable sale or exchange, such interest shall be treated, in applying this paragraph (c)(2) to any subsequent disposition of such interest, as an interest in property that was not held by the taxpayer until the date on which such interest was acquired from the partnership and that was not used before such date in any activity of the taxpayer.

(v) Property held for sale to customers-(A) Sale incidental to another activity-(1)-Applicability-(i) In general. This paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property if and only if-

(A) At the time of the disposition, the taxpayer holds the interest in property in an activity that involves holding similar property that is treated for purposes of section 1221(1) as property held primarily for sale to customers in the ordinary course of a trade or business (a "dealing activity");

(B) One or more other activities of the taxpayer do not involve holding similar property for sale to customers in the ordinary course of a trade or business ("nondealing activities") and the interest in property was used in such activity or activities for more than 80 percent of the period during which the taxpayer held such interest in property; and

(C) The interest in property was not acquired and held by the taxpayer for the principal purpose of selling such interest to customers in the ordinary course of a trade or business.

(ii) Principal purpose. For purposes of this paragraph (c)(2)(v)(A), a taxpayer is rebuttably presumed to have acquired and held an interest in property for the principal purpose of selling such interest to customers in the ordinary course of a trade or business if-

(A) The period during which the interest in property was used in nondealing activities of the taxpayer does not exceed the lesser of 24 months or 20 percent of the recovery period (within the meaning of section 168) applicable to such property; or

(B) The interest in property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which such interest in property was used in nondealing activities of the taxpayer.

For purposes of the preceding sentence, an interest in property shall not be considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property.

(2) Dealing activity not taken into account. If this paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property, holding such interest in the dealing activity shall, for purposes of this paragraph (c)(2), be treated as the use of such interest in the last nondealing activity of the taxpayer in which such interest in property was used prior to its disposition.

(B) Use in a nondealing activity incidental to sale. If paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of disposition, the use of such interest in property in a nondealing activity of the taxpayer for any period during which such interest in property is also offered for sale to customers shall, for purposes of this paragraph (c)(2), be treated as the use of such interest in property in the dealing activity of the taxpayer.

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

Examples (1). (i) The taxpayer acquires a residential apartment building on January 1, 1987, and uses the building in a rental activity. In January 1990, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in such property. (Assume that these dealing operations are treated as a separate activity under §1.469-4T, and that the taxpayer materially participates in this activity.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1990, and the last unit is sold on December 31, 1990.

(ii) This paragraph (c)(2)(v) provides that holding an interest in property in a dealing activity (the marketing of the property) is treated for purposes of this paragraph

(c)(2) as the use of such interest in a nondealing activity if the marketing of the property is incidental to such use. Under paragraph (c)(2)(v)(A)(2) of this section, such interests in property are treated as used in the last nondealing activity in which they were used prior to their disposition. In addition, paragraph (c)(2)(v)(A)(1) of this section provides rules for determining whether the marketing of the property is incidental to the use of an interest in property in a nondealing activity. Under these rules, the marketing of the property is treated as incidental to such use if (a) the interest in property was used in nondealing activities for more than 80 percent of the taxpayer's holding period in the property (the holding period requirement) and (b) the taxpayer did not acquire and hold the interest in property for the principal purpose of selling it to customers in the ordinary course of a trade or business (a dealing purpose).

(iii) In this case, the apartments were used in a rental activity for the entire period during which they were held by the taxpayer. Thus, the apartments were used in a nondealing activity for more than 80 percent of the taxpayer's holding period in the property, and the marketing of the property satisfies the holding period requirement.

(iv) Paragraph (c)(2)(v)(A)(1)(ii) of this section provides that a taxpayer is rebuttably presumed to have a dealing purpose unless the interest in property was used in nondealing activities for more than 24 months or 20 percent of the property's recovery period (whichever is less). The same presumption applies if the interest in property was offered for sale to customers during more than 25 percent of the period in which the interest was held in nondealing activities. In this case, the taxpayer used each apartment in a nondealing activity (the rental activity) for a period of 36 to 48 months (i.e., from January 1, 1987, to the date of sale in the period from January through December 1990). Thus, the apartments were used in nondealing activities for more than 24 months, and the first of the rebuttable presumptions described above does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) during the period in which the apartments were used in a nondealing activity. The percentage obtained by dividing the period during which an apartment was held for sale to customers by the period during which the apartment was used in nondealing activities ranges from zero in the case of apartments sold on January 1, 1990, to 25 percent (i.e., 12 months/48 months) in the case of apartments sold on December 31, 1990. Thus, no apartment was offered for sale to customers during more than 25 percent of the period in which it was used in nonrental activities, and the second rebuttable presumption does not apply.

(v) Because neither of the rebuttable presumptions in paragraph (c)(2)(v)(A)(1)(ii) of this section applies in this case, the taxpayer will not be treated as having a dealing purpose unless other facts and circumstances establish that the taxpayer acquired and held the apartments for the principal purpose of selling the apartments to customers in the ordinary course of a trade or business. Assume that none of the facts and circumstances suggest that the taxpayer had such a purpose. If that is the case, the taxpayer does not have a dealing purpose.

(vi) The marketing of the property satisfies the holding period requirement, and the taxpayer does not have a dealing purpose. Thus, holding the apartments in the taxpayer's dealing activity is treated for purposes of this paragraph (c)(2) as the use of the apartments in a nondealing activity. In this case, the rental activity is the only nondealing activity in which the apartments were used prior to their disposition.

Thus, the apartments are treated under paragraph (c)(2)(v)(A)(2) of this section as interests in property that were used only in the rental activity for the entire period during which the taxpayer held such interests. Accordingly, the rules in paragraph (c)(2) (ii) and (iii) of this section do not apply, and all gain from the sale of the apartments is treated as passive activity gross income.

Example (2). (i) The facts are the same as in example (1), except that the taxpayer converts the apartments into condominum units on July 1, 1987, and the first unit is sold on January 1, 1988.

(ii) In this case, all of the apartments were simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the apartments were used in nondealing activities. Thus, the taxpayer is rebuttably presumed to have acquired the apartments (including apartments that are used in the rental activity for at least 24 months) for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. If that is the case, the taxpayer has a dealing purpose, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of the apartments.

(iii) Paragraph (c)(2)(v)(B) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of the disposition, the use of the interest in property in any nondealing activity of the taxpayer for any period during which the interest is also offered for sale to customers is treated as incidental to the use of the interest in the dealing activity. Accordingly, for purposes of applying the rules of this paragraph (c)(2) to the disposition of the apartments, the rental of the apartments after July 1, 1987, is treated as the use of the apartments in the taxpayer's dealing activity.

Example (3). (i) The facts are the same as in example (1), except that the last unit is sold in 1991.

(ii) The treatment of apartments sold in 1990 is the same as in example (1). The apartments sold in 1991, however, were simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which such apartments were used in nondealing activities. (For example, an apartment that is sold on January 31, 1991, has been offered for sale for 13 months or 26.1 percent of the 49-month period during which it was used in nondealing activities.) Thus, the taxpayer is rebuttably presumed to have acquired the apartments sold in 1991 for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. In that case, the marketing of the apartments sold in 1991 does not satisfy the principal purpose requirements, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of those apartments. Accordingly, for purposes of applying the rules of this paragraph (c)(2) to the disposition of the apartments sold in 1991, the rental of the apartments after January 1, 1990, is treated, under paragraph (c)(2)(v)(B) of this section, as the use of the apartments in the taxpayer's dealing activity.

4. Paragraph (c)(6) (i), (ii), and (iii) is revised to read as follows:

(c)

(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 passive income for such year from-

(A) An oil or gas property that includes an oil or gas well if, for any prior taxpayer year beginning after December 31, 1986, any of the taxpayer's loss from the well was treated, 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 passive income from such property for the taxable year.

(ii) Gross and net passive income from the property. For purposes of this paragraph (c)(6)-

(A) The taxpayers's gross passive income for any taxable year from any property described in paragraph (a)(6)(i) of this section is any passive activity gross income for such year (determined without regard to this paragraph (c)(6) and paragraph (f) of this section) from such property;

(B) The taxpayer's net passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is the excess, if any, of-

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

(2) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for such year under §1.469-1T(f)(4)) that are reasonably allocable to such income; and

(C) If any oil or gas well or other item of property (the item) is included in two or more properties described in paragraph (c)(6)(i) of this section (the properties), the taxpayer shall allocate the passive activity gross income (determined without regard to this paragraph (c)(6) and paragraph (f) of this section) from such item and the passive activity deductions reasonably allocable to such item among such properties.

(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, and an oil or gas property that includes an oil or gas well is-

(A) The well; and

(B) Any other item of property (including any oil or gas well) the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities the costs of which were taken into account in determining the amount of the taxpayer's income or loss from the well.

5. Paragraph (c)(6)(iv) is amended by removing the phrase "net income" in the last sentences of examples (1) and (2), and adding the phrase "net passive income" in its place.

6. Paragraph (d)(1), Example, is amended by removing "sections 469 and 1211" and adding "sections 469, 613A(d), and 1211" each place the former occurs.

7. Paragraph (d)(2)(ix) is amended by adding "section 613A(d)," immediately before "section 1212(a)(1)(B)".

8. Paragraph (d)(5)(iii)(A) is revised to read as follows:

(d)

(5)

(iii)

(A) Applicability of rules in paragraph (c)(2). 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. In addition, the rules contained in paragraph (c)(2) (iv) and (v) of this section shall apply in determining for purposes of this paragraph (d)(5) the activity (or activities) in which an interest in property is used at the time of its disposition and during the 12- month period ending on the date of its disposition.

(9) Paragraph (d)(6)(v)(E) is revised to read as follows:

(d)

(6)

(v)

(E) Are taken into account under section 613A(d) (relating to limitations on certain depletion deductions), 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

10. Paragraph (d)(8) is amended by removing the phrase "sections 469 and 1211" and adding the following in its place: "sections 469, 613A(d), and 1211".

11. Paragraphs (e)(2) (ii) and (iii) are revised to read as follows:

(e)

(2)

(ii) Section 707(c). Except as provided in paragraph (e)(2)(iii)(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 a payment for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(iii) Payments in liquidation of a partner's interest in partnership property-(A) In general. 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 retired 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.

(B) Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a). (1) If a payment is made in liquidation of a retiring or deceased partner's interest, such payment is described in section 736(a), and any income-

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

(ii) Is attributable to the portion (if any of the payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership;

the percentage of such income that is treated as passive activity gross income shall not exceed the percentage of passive activity gross income that would be included in the gross income that such retiring or deceased partner (or such other person) would have recognized if such unrealized receivables and goodwill had been sold at the time that the liquidation of such partner's interest commenced.

(2) For purposes of this paragraph (e)(2)(iii)(B), the portion (if any) of a payment under section 736(a) that is allocable to unrealized receivables and goodwill of a partnership shall be determined in accordance with the principles employed under §1.736-1(b) for determining the portion of a payment made under section 736 that is treated as a distribution under section 736(b).

12. Paragraph (e)(3)(iii)(B) is revised to read as follows:

(e)

(3)

(iii)

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) (relating to substantially appreciated property formerly used in a nonpassive activity), (c)(6) (relating to certain oil or gas properties), (f)(5) (relating to certain property rented incidental to development), (f)(6) (relating to property rented to a nonpassive activity), or (f)(7) (relating to certain interests in a passthrough entity engaged in the trade or business of licensing intangible property) of this section 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

13. Paragraph (f)(5)(i) is amended by removing the phrase "used in a rental activity for such year", by removing "24" and adding "12" in its place, and by removing the phrase ", but without regard to paragraph (e) thereof" from the parenthetical immediately following the words "materially participated".

14. Paragraph (f)(5)(ii) is amended by adding the following phrase immediately after the word "when": "the performance of the services described in paragraph (f)(5)(i)(C) of this section is complete, and".

15. Paragraph (f)(5)(iii)(C) is amended by removing the parenthetical phrase and adding the following in its place: "(but only if, as of the time the taxpayer acquires an interest in the property, a substantial portion of the property is not leased)".

16. Paragraph (f)(5)(iv), Example, is revised to read as follows:

(f)

(5)

(iv)

Example. (i) A, a calendar year individual, is a partner in calendar year partnership P, which develops 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. Construction is completed in February 1990, and substantially all of the building is held out for rent and is in a state of readiness for rental beginning on March 1, 1990.

(ii) P holds the building for rent for the remainder of 1990 and all of 1991, and sells the building on January 15, 1992, pursuant to a contract entered into on January 15, 1991. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1990 and $30,000 for 1991. 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) of this section, in 1988, 1989, and 1990, the real estate development activity that A holds through P involves the performance of services for the purpose of enhancing the value of the building. In 1992, the building is sold, and the date on which the use of the building in the rental activity commenced (March 1, 1990) was less than 12 months before the date on which a binding contract for such sale was entered into (January 15, 1991). Accordingly, if A materially participated in the 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 1992 from the building equal to A's net rental activity income for 1992 from such building ($150,000-$80,000 of previously disallowed deductions = $70,000) is treated under this paragraph (f)(5) as gross income that is not from a passive activity.

17. Paragraph (f)(6) is amended by removing the phrase "used in a rental activity for such year" and by removing the phrase ", but without regard to paragraph (e) thereof" from the parenthetical immediately following the words "materially participates".

18. Paragraph (f)(9)(iii) is revised to read as follows:

(f)

(9)

(iii) The gross rental activity income for a taxable year from an item of property is any passive activity gross income (determined without regard to paragraph (f) (2) through (6) of this section) that-

(A) Is income for such year from the rental or disposition of such item of property; and

(B) In the case of income from the disposition of such item of property, is income from an activity that involved the rental of such item of property during the 12-month period ending on the date of the disposition (see paragraph (c)(2)(ii) of this section); and

19. Paragraph (f)(9)(iv)(B) is amended by removing the phrase "the use of such item of property in the rental activity" and adding in its place the words "such income".

20. Paragraph (f)(10) is revised to read as follows:

(f)

(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) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and paragraph (c)(3)(i)(D) of this section as property held for investment;

(iii) 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

(iv) 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)).

Par. 5. Section 1.469-3T is amended as follows:

1. Paragraph (e) is revised.

2. Paragraph (f) is redesignated as paragraph (g), and a new paragraph (f) is added.

3. The revised provisions read as follows:

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

(e) Coordination with section 38(b). Any credit described in section 38(b) (1) through (5) is taken into account in computing the 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) Coordination with section 47. In the case of any cessation described in section 47(a) (1), (3), or (5) or any change in use described in section 47(a) (2) or (4), the credits allocable to the taxpayer's activities under §1.469-1T(f)(4) shall be adjusted by reason of such cessation (or change in use).

Par. 6. The text of §1.469-4T is added to read as follows:

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

(a) Overview-(1) Purpose and effect of overview. This paragraph (a) contains a general description of the rules contained in this section and is intended solely as an aid to readers. The provisions of this paragraph (a) are not a substitute for the more detailed rules contained in the remainder of this section and cannot be relied upon in cases in which those rules qualify the general description contained in this paragraph (a).

(2) Scope and structure of §1.469-4T. This section provides rules under which a taxpayer's business and rental operations are treated as one or more activities for purposes of section 469 and the regulations thereunder. (See paragraph (b)(2)(ii) of

this section for the definition of business and rental operations.) In general, these rules are divided into three groups:

(i) Rules that identify the business and rental operations that constitute an undertaking (the undertaking rules).

(ii) Rules that identify the undertaking or undertakings that constitute an activity (the activity rules).

(iii) Rules that apply only under certain special circumstances (the special rules).

(3) Undertaking rules-(i) In general. The undertaking is generally the smallest unit that can constitute an activity. (See paragraph (b)(1) of this section for the general rule and paragraph (k)(2)(iii) of this section for a special rule that permits taxpayers to treat a single rental real estate undertaking as multiple activities.) An undertaking may include diverse business and rental operations.

(ii) Basic undertaking rule. The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person. (See paragraph (c)(2)(i) of this section.)

(iii) Circumstances in which location is disregarded. In some circumstances, the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated (see paragraph (c)(2)(iii)(C) of this section). In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support (see paragraph (c)(2)(ii) of this section).

(iv) Rental undertakings. The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings (see paragraph (d)(1) of this section). This rule does not apply if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (i.e., rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in §1.469-1T(e)(3)(ii) (see paragraph (d)(2) of this section). In applying the rental undertaking rules, short-term rentals of real property (e.g., hotel-room rentals) are generally treated as nonrental operations (see paragraph (d)(3)(ii) of this section).

(v) Oil and gas wells. Another exception to the basic undertaking rule treats oil and gas wells that are subject to the working-interest exception in §1.469-1T(e)(4) as separate undertakings (see paragraph (e) of this section).

(4) Activity rules-(i) In general. The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer (see paragraph (b)(1) of this section). In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

(ii) Aggregation of trade or business undertakings-(A) Trade or business undertakings. Trade or business undertakings include all nonrental undertakings other than oil and gas undertakings described in paragraph (a)(3)(v) of this section and professional service undertakings described in paragraph (a)(4)(iii) of this section (see paragraph (f)(1)(ii) of this section).

(B) Similar, commonly-controlled undertakings treated as a single activity. An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. (See paragraph (f)(2) of this section.) Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure issued pursuant to paragraph (f)(4)(iv) of this section) or if the undertakings are vertically integrated (see paragraph (f)(4)(iii) of this section). All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule (see paragraph (j)(1) of this section). If, however, each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests (see paragraph (j) (2) and (3) of this section).

(C) Integrated businesses treated as a single activity. Trade or business undertakings (including undertakings that have been aggregated because of their similarity and common control) are subject to a second aggregation rule. Under this rule undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity. (See paragraph (g) of this section.)

(iii) Aggregation of professional service undertakings. Professional service undertakings are nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (see paragraph (h)(1)(ii) of this section). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity (see paragraph (h)(2) of this section). The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking (see paragraph (h)(3) of this section).

(iv) Rules for rental real estate-(A) Taxpayers permitted to determine rental real estate activities. The rules for aggregating rental real estate undertakings are

generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. (See paragraph (k)(2) (i) and (iii) of this section.)

(B) Limitations on fragmentation and aggregation of rental real estate. Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held (see paragraph (k) (2)(ii) and (3) of this section). There are no comparable limitations on the aggregation of rental real estate into a single activity. If however, the income or gain from a rental real estate undertaking is subject to recharacterization under §1.469-2T(f)(3) (relating to the rental of nondepreciable property), a coordination rule provides that the undertaking must be treated as a separate activity (see paragraph (k)(6) of this section.)

(v) Election to treat nonrental undertakings as separate activities. Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking (see paragraph (o)(2) of this section). This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations (see paragraph (o) (3) and (4) of this section). Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (i.e., material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election (see paragraph (o)(6) of this section).

(5) Special rules-(i) Consolidated groups and publicly traded partnerships. Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members (see paragraph (m) of this section), and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership (see paragraph (n) of this section).

(ii) Transitional rule. A special rule applies for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method (see paragraph (p)(1) of this section). A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of §1.469-4T (see paragraph (p)(3) of this section).

(b) General rule and definitions of general application-(1) General rule. Except as otherwise provided in this section, each undertaking in which a taxpayer owns an interest shall be treated as a separate activity of the taxpayer. See paragraphs (f), (g), and (h) of this section for rules requiring certain nonrental undertakings to be treated as part of the same activity and paragraph (k) of this section for rules identifying the rental real estate undertakings (or portions thereof) that are included in an activity.

(2) Definitions of general application. The following definitions set forth the meaning of certain terms for purposes of this section:

(i) Passthrough entity. The term "passthrough entity" means a partnership, S corporation, estate, or trust.

(ii) Business and rental operations-(A) In general. Except as provided in paragraph (b)(2)(ii)(B) of this section, the term "business and rental operations" means all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

(1) Such endeavors involve the conduct of a trade or business (within the meaning of section 162) or are conducted in anticipation of such endeavors becoming a trade or business;

(2) Such endeavors involve making tangible property available for use by customers; or

(3) Research or experimental expenditures paid or incurred with respect to such endeavors are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(B) Operations conducted through nonpassthrough entities. For purposes of applying section 469 and the regulations thereunder, a taxpayer's activities do not include operations that a taxpayer conducts through one or more entities (other than passthrough entities). The following example illustrates the operation of this paragraph (b)(2)(ii)(B):

Example. (i) A, an individual, owns stock of X, a closely held corporation (within the meaning of §1.469-1T(g)(2)(ii) that is directly engaged in the conduct of a real estate development business. A participates in X's real estate development business, but does not own any interest in the business other than through ownership of the stock of X.

(ii) X is subject to section 469 (see §1.469-1T(b)(5)) and does not hold the real estate development business through another entity. Accordingly, for purposes of section 469 and the regulations thereunder, the operations of X's real estate development business are treated as part of X's activities.

(iii) A is also subject to section 469 (see §1.469-1T(b)(1)), but A's only interest in the real estate development business is held through X. X is a C corporation and therefore is not a passthrough entity. Thus, for purposes of section 469 and the regulations thereunder, A's activities do not include the operations of X's real estate development business. Accordingly, A's participation in X's busines is not participation in an activity of A, and is not taken into account in determining whether A materially participates (within the meaning of §1.469-5T) or significantly participates (within the meaning of §1.469-1T(c)(2)) in any activity. (See, however, §1.469-1T(g)(3) for rules under which a shareholder's participation is taken into account for purposes of determining whether a corporation materially or significantly participates in an activity.

(c) Undertaking-(1) In general. Except as otherwise provided in paragraphs (d), (e), and (k)(2)(iii) of this section, business and rental operations that constitute a separate source of income production shall be treated as a single undertaking that is separate from other undertakings.

(2) Operations treated as a separate source of income production-(i) In general. Except as otherwise provided in this paragraph (c)(2), business and rental operations shall be treated for purposes of this paragraph (c) as a separate source of income production if and only if-

(A) Such operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section); and

(B) Income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) owned by such person are conducted at such location.

(ii) Treatment of support operations-(A) In general. For purposes of section 469 and the regulations thereunder-

(1) The support operations conducted at a location shall not be treated as part of an undertaking under paragraph (c)(2)(i) of this section; and

(2) The income and expenses that are attributable to such operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking.

(B) Support operations. For purposes of this paragraph (c)(2), the business and rental operations conducted at a location are treated as support operations to the extent that-

(1) Such operations and an undertaking that is conducted at a different location are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(2) Such operations involve the provision of property or services to such undertaking; and

(3) Such operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) Location. For purposes of this paragraph (c)(2)-

(A) The term "location" means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

(iv) Income-producing operations. For purposes of this paragraph (c)(2), the term "income-producing operations" means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of)-

(A) The production of property at such location;

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

(C) The performance of services for customers at such location;

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

(E) Any other transactions that involve the presence of customers at such location.

(v) Ownership by the same person. For purposes of this paragraph (c)(2), business and rental operations are owned by the same person if and only if one person (within the meaning of section 7701(a)(1)) is the direct owner of such operations.

(3) Facts and circumstances determinations. In determining whether a location is the location with which business and rental operations are most closely associated for purposes of paragraph (c)(2)(iii)(D) of this section, the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

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

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

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

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

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

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

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

(x) Whether such operations are conducted under the same trade name.

(4) Examples. The following examples illustrate the application of this paragraph (c). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusion relate to a single taxable year.

Example (1). The taxpayer is the sole owner of a department store and a restaurant and conducts both businesses in the same building. Thus, the department store and restaurant operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., property is sold to customers and services are performed for customers on the premises of the department store). Accordingly, the department store and restaurant operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (2). (i) The facts are the same as in example (1), except that the taxpayer is also the sole owner of an automotive center that services automobiles and sells tires, batteries, motor oil, and accessories. The taxpayer operates the automotive center in a separate structure in the shopping mall in which the department store is located. Although the automotive center operations and the department store and restaurant operations are not conducted in the same physical structure, they are conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of one another. Thus, the department store, restaurant, and automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) As in example (1), the operations conducted at the same location are owned by the same person, and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location. Accordingly, the department store, restaurant, and automotive center operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example (3). (i) The facts are the same as in example (2), except that the automotive center is located several blocks from the shopping mall. As in example

(1), the department store and restaurant operations are treating as a single undertaking that is separate from other undertakings. Because, however, the automotive center operations are not conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of the department store and restaurant operations, all of the taxpayer's operations are not conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) All of the automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., property is sold to customers and services are performed for customers on the premises of the automotive center). Accordingly, the automotive center operations are also treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (4). The taxpayer is the sole owner of a building and rents residential, office, and retail space in the building to various tenants. The taxpayer manages these rental operations from an office located in the building. The rental operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., customers take physical possession in the building of property made available for their use). Accordingly, the rental operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (d) of this section for rules for determining whether this undertaking is a rental undertaking and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (5). (i) The facts are the same as in example (4), except that the taxpayer also uses the rental office in the building ("Building 1") to manage rental operations in another building ("Building 2") that the taxpayer owns. The rental operations conducted in Building 2 are treated as a separate source of income production under paragraph (c)(2) of this section and as a single undertaking that is separate from other undertakings (the "Building 2 undertaking") under paragraph (c)(1) of this section.

(ii) The operations conducted at the rental office in Building 1 and the Building 2 undertaking are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the operations conducted at the rental office with respect to the Building 2 undertaking relate to transactions in which customers take physical possession at another location of property that is made available for their use (i.e., the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the rental office involve the management of the Building 2 undertaking, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the Building 2 undertaking.

(iii) Paragraph (c)(2)(ii)(A)(1) of this section provides that support operations are not treated as part of an undertaking under paragraph (c)(2)(i) of this section. Therefore, the support operations conducted at the rental office are not treated as part of the undertaking that consists of the rental operations conducted in Building 1 (the "Building 1 undertaking"). Paragraph (c)(2)(ii)(A)(2) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the rental office that are reasonably allocable to the Building 2 undertaking are taken into account in determining the income or loss from the activity or activities that include the Building 2 undertaking. See paragraph (k) of this section for rules for identifying rental real estate activities.

(iv) Rental office operations that involve the management of rental operations conducted in Building 1 are not support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) because they relate to an undertaking that is conducted at the same location (the "Building 1 undertaking"). Thus, the rules for support operations in paragraph (c)(2)(ii)(A) of this section do not apply to such operations, and they are treated as part of the Building 1 undertaking.

Example (6). (i) The taxpayer conducts business and rental operations at eleven different locations (within the meaning of paragraph (c)(2)(iii) of this section). At ten of the locations the taxpayer owns grocery stores, and at the eleventh location the taxpayer owns a warehouse that receives goods and supplies them to the taxpayer's stores. The operations of each store are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at each location (i.e., property is sold to customers on the store premises, and customers take physical possession on the store premises of property made available for their use). Accordingly, the operations of each of the ten grocery stores are treated as a separate source of income production (see paragraph (c)(2) of this section), and each store is treated as a single undertaking (a "grocery store undertaking") that is separate from other undertakings (see paragraph (c)(1) of this section). The operations conducted at the warehouse, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Accordingly, the warehouse operations do not satisfy the requirements of paragraph (c)(2)(i) of this section and are not treated as a separate undertaking under paragraph (c)(1) of this section.

(ii) The warehouse operations and the grocery store undertakings are owned by the same person (i.e., the taxpayer is the direct owner of the operations), the operations conducted at the warehouse involve the provision of property to the grocery store undertakings, and the warehouse operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Thus, the warehouse operations are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the grocery store undertakings. Paragraph (c)(2)(ii)(A)(2) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking.

Accordingly, the income and expenses of the warehouse operations that are reasonably allocable to a grocery store undertaking are taken into account in determining the income or loss from the activity or activities that include such undertaking. See paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (7). (i) The facts are the same as in example (6), except that the warehouse operations also include the sale of goods to grocery stores that the taxpayer does not own ("other grocery stores"). Because of these sales, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the warehouse. The warehouse operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). Accordingly, prior to the application of the rules for support operations in paragraph (c)(2)(ii) of this section, the warehouse operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking (the "separate warehouse undertaking") that is separate from other undertakings (see paragraph (c)(1) of this section).

(ii) As in example (6), the warehouse operations that involve supplying goods to the taxpayer's grocery store undertakings are support operations with respect to those undertakings. Therefore, those operations are not treated as part of the separate warehouse undertaking (see paragraph (c)(2)(ii)(A)(1) of this section), and the income and expenses of such operations are taken into account, as in example (6), in determining the income or loss from the activity or activities that include the taxpayer's grocery store undertakings.

Example (8). (i) A partnership is formed to acquire real property and construct a building on the property. The partnership hires brokers to locate a suitable parcel of land, lawyers to negotiate zoning variances, easements, and building permits, and architects and engineers to design the improvements. After the architects and engineers have designed the improvements and other preliminaries have been completed, the partnership hires a general contractor who hires subcontractors and oversees construction. During the construction process and after construction has been completed, the partnership leases out space in the building. The partnership then operates the building as a rental property. The operations of acquiring the real property, negotiating contracts, overseeing the designing and construction of the improvements, leasing up the building, and operating the building are conducted at an office (the "management office") that is not at the same location (within the meaning of paragraph (c)(2)(iii) of this section) as the building.

(ii) The operations conducted at the building site (e.g., excavating the land, pouring the concrete for the foundation, erecting the frame of the building, completing the exterior of the building, and building out the interior of the building) are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the partnership is the direct owner of the operations). In addition, the partnership conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., during the construction period property (the building) is produced at the building site, and during the rental period customers take physical possession in the building of property made available for their use). Accordingly, the operations conducted at the building site are treated as a separate source of income production (see

paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the management office and the undertaking conducted at the building site are owned by the same person (i.e., the partnership is the direct owner of the operations). In addition, the operations conducted at the management office relate to transactions in which customers take physical possession at another location of property that is made available for their use (i.e., the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the management office involve the provision of services to the undertaking conducted at the building site, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to such undertaking.

(iv) Paragraph (c)(2)(ii)(A)(2) of this section provides that the income and expenses of support operations that are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the management office that are reasonably allocable to the undertaking conducted at the building site are taken into account in determining the income or loss from the activity or activities that include such undertaking.

(v) Until the building is first held out for rent and is in a state of readiness for rental, the undertaking conducted at the building site is a trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section). See paragraph (d) of this section for rules for determining whether the undertaking is a rental undertaking for periods after the building is first held out for rent and is in a state or readiness for rental and paragraph (k) of this section for rules for identifying rental real estate activities.

Example (9). The taxpayer owns 15 oil wells pursuant to a single working interest (within the meaning of §1.469-1T (e)(4)(iv). All of the wells are drilled and operated for the development of a common reservoir. Thus, all of the wells are at the same location (see paragraph (c)(2)(iii)(E) of this section). All of the wells are owned by the same person (i.e., the taxpayer is the direct owner of the operations), and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., oil wells are drilled in reasonable anticipation of producing oil at the location). Accordingly, the operations of the wells are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (e) of this section for rules under which certain oil and gas operations are treated as multiple undertakings even if they would be part of the same undertaking under the rules of this paragraph (c).

Example (10). (i) Partnership X owns an automobile dealership and partnership Y owns an automobile repair shop. The dealership and repair shop operations are conducted in the same physical structure. Individuals A, B, and C are the only partners in partnerships X and Y, and each of the partners owns a one-third interest in both partnerships.

(ii) The dealership operations and the repair-shop operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section), but are

owned by different persons (i.e., X is the direct owner of the dealership operations, and Y is the direct owner of the repair-shop operations). Moreover, indirect ownership of the operations is not taken into account under paragraph (c)(2)(v) of this section. Thus, it is irrelevant that the two partnerships are owned by the same persons in identical proportions. Accordingly, the dealership and repair-shop operations are not treated as part of the same source of income production (see paragraph (c)(2) of this section) or as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example (11). (i) The taxpayer owns and operates a delivery service. The business consists of a central office, retail establishments, and messengers who transport packages from one place to another. Customers may bring their packages to a retail establishment for delivery elsewhere or, by calling the central office, may have packages picked up at their homes or offices. The central office dispatches messengers and coordinates all pickups and deliveries. Customers may pay for deliveries when they drop off or pick up packages at a retail establishment, or the central office will bill the customer for services rendered. In addition, many packages are routed through the central office.

(ii) The operations conducted at the central office are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). The operations actually conducted at the central office, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) Under paragraph (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the facts that the central office dispatches messengers, coordinates all pickups and deliveries, and is the transshipment point for many packages) establish that the operations of delivering packages from one location to another are most closely associated with the central office. Thus, the delivery operations are treated as operations that are conducted at the central office, and the deliveries are treated as income-producing operations (i.e., the performance of services for customers) that the taxpayer conducts at the central office. Accordingly, the operations conducted at the central office are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iv) The operations conducted at each retail establishment are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). At each retail establishment, the taxpayer's operations include transactions that involve the presence of customers at the establishment. Thus, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv)(E) of this

section) at the retail establishments. Accordingly, the operations of each retail establishment are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example (12). (i) The taxpayer is the sole owner of a saw mill and a lumber yard. The taxpayer's business operations consist of converting timber into lumber and other wood products and selling the resulting products. The timber is processed at the saw mill, and the resulting products are transported to the lumber yard where they are sold. The saw mill and the lumber yard are at different locations (within the meaning of paragraph (c)(2)(iii) of this section). The transportation operations are managed at the saw mill.

(ii) The operations conducted at the saw mill are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., lumber is produced at the mill). Similarly, the selling operations at the lumber yard are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (i.e., the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (i.e., lumber is sold to customers at the lumber yard). Thus, the milling operations and the selling operations are treated as separate sources of income production (see paragraph (c)(2) of this section) and as separate undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the mill involve the provision of property to the lumber-yard undertaking. Nonetheless, the milling operations are income-producing operations because they relate to the production of property at the mill, and an undertaking's income-producing operations are not treated as support operations (see paragraph (c)(2)(ii)(B)(3) of this section). Accordingly, the milling operations are not support operations with respect to the lumber-yard undertaking. See, however, paragraph (f) of this section for rules under which certain vertically-integrated undertakings are treated as part of the same activity.

(iv) The operations of transporting finished products from the saw mill to the lumber yard are not conducted at a fixed location. Under paragraphs (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the fact that the transportation operations are managed at the saw mill) establish that the transportation operations are most closely associated with the saw mill. Thus, the transportation operations are treated as operations that are conducted at the mill and as part of the undertaking that consists of the milling operations.

(d) Rental undertaking-(1) In general. This paragraph (d) applies to operations that are treated, under paragraph (c) of this section and before the application of paragraph (d)(1)(i) of this section, as a single undertaking that is separate from other undertakings (a "paragraph (c) undertaking"). For purposes of this section-

(i) A paragraph (c) undertaking's rental operations and its operations other than rental operations shall be treated, except as otherwise provided in paragraph (d)(2) of this section, as two separate undertakings;

(ii) The income and expenses that are reasonably allocable to an undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be taken into account in determining the income or loss from the activity or activities that include such undertaking; and

(iii) An undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T(e)(3)).

(2) Exceptions. Paragraph (d)(1)(i) of this section shall not apply to a paragraph (c) undertaking for any taxable year in which-

(i) The rental operations of the paragraph (c) undertaking, considered as a separate activity, would not constitute a rental activity (within the meaning of §1.469-1T(e)(3));

(ii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to rental operations; or

(iii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to operations other than rental operations.

(3) Rental operations. For purposes of this paragraph (d), a paragraph (c) undertaking's rental operations are determined under the following rules:

(i) General rule. Except as otherwise provided in paragraph (d)(3) (ii) or (iii) of this section, a paragraph (c) undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith.

(ii) Real property provided for short-term use. A paragraph (c) undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith shall not be treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. An item of property is treated as short-term real property for this purpose if and only if such item is real property that the paragraph (c) undertaking makes available for use by customers and the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for all of the paragraph (c) undertaking's real property of the same type as such item is 30 days or less.

(iii) Property made available to licensees. A paragraph (c) undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers shall not be treated as rental operations. (See §1.469-1T(e)(3)(ii)(E).)

(4) Examples. The following examples illustrate the application of this paragraph (d). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). The taxpayer owns a building in which the taxpayer rents office space to tenants and operates a parking garage that is used by tenants and other persons. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an office for at least one year, and the services provided to tenants are those customarily provided in office buildings. Some persons (including tenants) rent spaces in the parking garage on a monthly or annual basis. In general, however, spaces are rented on an hourly or daily basis, and the average period for which all customers (including tenants) use the parking garage is less than 24 hours. The paragraph (c) undertaking derives 75 percent of its gross income from office-space rentals and 25 percent of its gross income from the parking garage. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The parking spaces are real property and the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the parking spaces is 30 days or less. Thus, the parking spaces are short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section). (For this purpose, individual parking spaces that are rented on a monthly or annual basis are, nevertheless, short-term real properties because all the parking spaces are property of the same type, and the average rental period taking all parking spaces into account is 30 days or less.) In addition, the parking-garage operations involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T(e)(3)). In this case, the parking-garage operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for the parking spaces is seven days or less (see §1.469-1T(e)(3)(ii)(A)). Accordingly, the parking-garage operations are not treated as rental operations.

(iv) The paragraph (c) undertaking's remaining operations involve the provision of tangible property (the office spaces) for use by customers and the provision of property and services in connection therewith. The average period of customer use for the office spaces exceeds 30 days. Thus, the office spaces are not short-term real properties, and the undertaking's operations involving the rental of office spaces are rental operations.

(v) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations) and at least 20 percent is attributable to operations other than rental operations (the parking-garage operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the office spaces exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the office spaces is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the rental operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the parking-garage operations are treated as two separate undertakings (the "office-space undertaking" and the "parking-garage undertaking").

(vi) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity (see (v) above), and the parking-garage undertaking, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Accordingly, the office-space undertaking is treated as a rental undertaking, and the parking-garage undertaking is not.

Example (2). (i) The taxpayer owns a building in which the taxpayer rents apartments to tenants and operates a restaurant. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an apartment for at least one year, and the services provided to tenants are those customarily provided in residential apartment buildings. The paragraph (c) undertaking derives 85 percent of its gross income from apartment rentals and 15 percent of its gross income from the restaurant. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The operations with respect to apartments (the "apartment operations") involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the apartment operations are rental operations (within the meaning of paragraph (d)(3) of this section). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the restaurant operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(iii) of this section applies because less than 20 percent

of the paragraph (c) undertaking's gross income is attributable to operations other than rental operations (the restaurant operations). Accordingly, the rental operations and the restaurant operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the apartment operations and the restaurant operations, and the gross income of this undertaking represents amounts paid principally for the use of tangible property (the apartments). Moreover, the average period of customer use for the apartments exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the apartments is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the undertaking, if considered as a separate activity, would constitute a rental activity. Accordingly, the undertaking is treated as a rental undertaking.

Example (3). (i) The taxpayer owns a building in which the taxpayer rents hotel rooms, meeting rooms, and parking spaces to customers, rents space to various retailers, and operates a restaurant and health club. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Although some customers occupy hotel rooms for extended periods (including some customers who reside in the hotel), customers use hotel rooms for an average period of two days and meeting rooms for an average period of one day. The services provided to persons using the hotel rooms and meeting rooms are those customarily provided in hotels (including wake-up calls, valet services, and delivery of food and beverages to rooms). Some customers rent spaces in the parking garage on a monthly or annual basis. In general, however, parking spaces are rented on an hourly or daily basis, and the average period for which customers use the parking garage is less than 24 hours. Retail tenants typically occupy their space for at least one year, and the services provided to retail tenants are those customarily provided in commercial buildings. The paragraph (c) undertaking derives 45 percent of its gross income from renting hotel rooms, meeting rooms, and parking spaces, 35 percent of its gross income from renting retail space, and 20 percent of its gross income from the restaurant and health club. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The parking spaces, hotel rooms, and meeting rooms are real property of three different types, but the average period of customer use (within the meaning of §1.469-1T (e)(3)(iii)) for property of each type is 30 days or less. Thus, the parking spaces, hotel rooms, and meeting rooms are short-term real properties. (For this purpose, individual parking spaces or hotel rooms that are rented for extended periods are, nevertheless, short-term real properties if the average rental period for all parking spaces is 30 days or less and the average rental period for all hotel rooms is 30 days or less.) In addition, the parking garage operations, the operations with respect to hotel rooms (the "hotel-room operations"), and the operations with respect to meeting rooms (the "meeting-room operations") involve making short-

term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469-1T (e)(3)). In this case the parking-garage, hotel-room and meeting-room operations, if considered as separate activities, would not constitute rental activities because the average period of customer use for parking spaces, hotel rooms, and meeting rooms does not exceed seven days (see §1.469-1T (e)(3)(ii)(A)). Accordingly, the parking-garage, hotel-room, and meeting-room operations are not treated as rental operations.

(iv) The operations with respect to retail space in the building (the "retail-space operations") involve the provision of tangible property (the retail spaces) for use by customers and the provision of property and services in connection therewith. In addition, the retail spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T (e)(3)(iii)) for the retail spaces exceeds 30 days. Accordingly, the retail-space operations are rental operations.

(v) The health-club operations involve making tangible property available for use by customers, but the property is customarily made available during defined business hours for nonexclusive use by various customers. Accordingly, the health-club operations are not rental operations (see paragraph (d)(3)(iii) of this seciton). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the restaurant operations also are not rental operations.

(vi) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (35 percent of the paragraph (c) undertaking's gross income is from the retail-space operations) and at least 20 percent is attributable to operations other than rental operations (45 percent from the hotel-room, meeting-room and parking-garage operations and 20 percent from the restaurant and health-club operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the retail space exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T (e)(3)(v)) are not provided, and the rental of the retail space is not treated as incidental to a nonrental activity under §1.469-1T (e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the retail-space operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the retail-space operations are treated as an undertaking (the "retail-space undertaking") and all the other operations conducted in the building (i.e., renting hotel and meeting rooms and parking spaces and operating the restaurant and health club) are treated as a separate undertaking (the "hotel undertaking").

(vii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the retail-space undertaking, if considered as a separate activity, would constitute a rental activity (see (iv) above). Accordingly, the retail-space undertaking is treated as a rental undertaking. The hotel undertaking, if considered as a separate activity, would not constitute a rental activity because all tangible property provided for the use of customers in the hotel undertaking is either property for which the average period of customer use is seven days or less (see §1.469-1T (e)(3)(ii)(A)) or property customarily made available during defined business hours for nonexclusive use by various customers (see §1.469-1T (e)(3)(ii)(E)). Accordingly, the hotel undertaking is not treated as a rental undertaking.

Example (4). (i) A law partnership owns a ten-story building. The partnership uses eight floors of the building in its law practice and leases two floors to one or more tenants. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Tenants typically occupy space on the two rented floors for at least one year, and the services provided to tenants are those customarily provided in office buildings. The paragraph (c) undertaking derives 90 percent of its gross income from rendering legal services and 10 percent of its gross income from renting space. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T (e)(3)(vi)).

(ii) The operations with respect to the office space leased to tenants (the "office-space operations") involve the provision of tangible property (the office space) for use by customers and the provision of property and services in connection therewith. In addition, the office spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the office space exceeds 30 days. Accordingly, the office-space operations are rental operations (within the meaning of paragraph (d)(3) of this section).

(iii) The operations that involve the performance of legal services (the "law-practice operations") do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the law-practice operations are not rental operations.

(iv) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations). Accordingly, the law-practice operations and the office-space operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(v) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the

application of paragraph (d)(1)(i) of this section) includes both the law-practice operations and the office-space operations, and the gross income of this undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (5). (i) The facts are the same as in example (4), except that the building is owned by a separate partnership (the "real estate partnership"), which leases eight floors of the building to the law partnership for use in its law practice and two floors to one or more other tenants. The law partnership and real estate partnership are owned by the same individuals in identical proportions.

(ii) The operations conducted in the building are owned by two different persons (i.e., the law partnership and the real estate partnership). (See paragraph (c)(2)(v) of this section.) Thus, the operations conducted in the building are not treated as a single undertaking under paragraph (c)(1) of this section. Instead, each partnership's share of such operations is treated as a separate paragraph (c) undertaking (the "law-practice undertaking" and the "office-space undertaking").

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity because all of the undertaking's gross income (including rents paid by the law partnership) represents amounts paid principally for the use of tangible property (the office space), the average period of customer use for the office space exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the rental of the office space is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Accordingly, the office-space undertaking is treated as a rental undertaking. See, however, §1.469-2T(f)(6) (relating to certain rentals of property to a trade or business activity in which the taxpayer materially participates).

(iv) The law-practice undertaking, if considered as a separate activity, would not constitute a rental activity because none of the undertaking's gross income represents amounts paid principally for the use of tangible property. Accordingly, the law-practice undertaking is not treated as a rental undertaking.

Example (6). (i) The taxpayer owns a building in which the taxpayer operates a nursing home and a medical clinic. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The nursing-home operations consist of renting apartments in the nursing home to elderly and handicapped persons and providing medical care, meals, and social activities. (Assume that these services are extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)). The medical clinic provides medical care to nursing-home residents and other individuals. Nursing-home residents typically occupy an apartment for at least one year. The paragraph (c) undertaking derives 55 percent of its gross income from nursing-home operations (including the provision of medical services to nursing-home residents) and 45 percent of its gross income from medical-clinic operations. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's nursing-home operations involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the nursing-home operations are rental operations (within the meaning of paragraph (d)(3) of this section). The medical-clinic operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the medical-clinic operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity because extraordinary personal services are provided in connection with making nursing-home apartments available for use by customers (see §1.469-T(e)(3)(ii)(C)). Thus, the exception in paragraph (d)(2)(i) of this section applies, and the nursing-home operations and the medical-clinic operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the nursing-home operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (7). (i) The taxpayer rents and sells videocassettes. (Assumes that, under paragraph (c)(1) of this section, the videocassette operations are treated as a single paragraph (c) undertaking.) Renters of videocassettes typically keep the videocassettes for one or two days, and do not receive any other property or services in connection with videocassette rentals. The paragraph (c) undertaking derives 70 percent of its gross income from renting videocassettes and 30 percent of its gross income from selling videocassettes. The videocassette operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The rental of videocassettes involves the provision of tangible property (the videocassettes) for use by customers. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the videocassettes are not real property. Thus, the operations that involve videocassette rentals are rental operations (within the meaning of paragraph (d)(3) of this section). The sale of videocassettes does not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the operations that involve videocassette sales are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental

operations are treated as two separate undertakings. In this case, however, the rental operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for rented videocassettes does not exceed seven days (see §1.469-1T(e)(3)(ii)(A)). Accordingly, the exception in paragraph (d)(2)(i) of this section applies, and the videocassette-rental operations and videocassette-sales operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the videocassette-rental operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the videocassette-rental operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (8). (i) The taxpayer owns a building in which the taxpayer sells, leases, and services automobiles. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The minimum lease term for any leased automobile is 31 days, and the services provided to lessees (including periodic oil changes, lubrication, and routine services and repairs) are those customarily provided in long-term automobile leases. The paragraph (c) undertaking derives 75 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 10 percent of its gross income from leasing automobiles. The taxpayer's automobile operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469-1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's automobile-leasing operations involve the provision of tangible property (the automobiles) for use by customers and the provision of services in connection therewith. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the automobiles are not real property. Accordingly, the automobile-leasing operations are rental operations (within the meaning of paragraph (d)(3) of this section). The paragraph (c) undertaking's automobile-sales operations and servicing operations for automobiles other than leased automobiles (the "selling-and-servicing operations") do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the selling-and-servicing operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the "automobile-leasing operations"). Accordingly, the rental operations and the selling-and-servicing operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the selling-and-servicing operations and the automobile-leasing operations, and the gross income of the undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example (9). (i) The facts are the same as in example (8), except that the paragraph (c) undertaking derives 60 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 25 percent of its gross income from leasing automobiles.

(ii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, more than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the automobile-leasing operations), and more than 20 percent is attributable to operations other than rental operations (the selling-and-servicing operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for leased automobiles exceeds 30 days, extraordinary personal services (within the meaning of §1.469-1T(e)(3)(v)) are not provided, and the leasing of the automobiles is not treated as incidental to a nonrental activity under §1.469-1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the leasing operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the selling-and-servicing operations are treated as two separate undertakings (the "automobile-leasing undertaking" and the "automobile selling-and-servicing undertaking").

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the automobile-leasing undertaking would, if considered as a separate activity, constitute a rental activity, and the automobile selling-and-servicing undertaking would not, if considered as a separate activity, constitute a rental activity (see example (8) and (ii) above). Accordingly, the automobile-leasing undertaking is treated as a rental undertaking, and the automobile selling-and-servicing undertaking is not.

(e) Special rules for certain oil and gas operations-(1) Wells treated as nonpassive under §1.469-1T(e)(4)(i). An oil or gas well shall be treated as an undertaking that is separate from other undertakings in determining the activities of a taxpayer for a taxable year if the following conditions are satisfied:

(i) The well is drilled or operated pursuant to a working interest (within the meaning of §1.469-1T(e)(4)(iv)) and 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; and

(ii) The taxpayer would not be treated as materially participating (within the meaning of §1.469-5T) for the taxable year in the activity in which such well would be included if the taxpayer's activities were determined without regard to this paragraph (e).

(2) Business and rental operations that constitute an undertaking. In any case in which an oil or gas well is treated under this paragraph (e) as an undertaking that is separate from other undertakings, the business and rental operations that constitute such undertaking are the business and rental operations that are attributable to such well.

(3) Examples. The following examples illustrate the application of this paragraph (e). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). During 1989, A directly owns an undivided interest in a working interest (within the meaning of §1.469-1T(e)(4)(iv)) in two oil wells. A does not participate in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). Under paragraph (e)(1) of this section, each well is treated as a separate undertaking in determining A's activities for 1989 because A holds the working interest directly and would not be treated as materially participating for 1989 in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). The aggregation rules in paragraph (f) of this section do not apply to these undertakings (see paragraph (f)(1)(ii)(B) of this section). Thus, each of the undertakings is treated as a separate activity under paragraph (b)(1) of this section. The result is the same even if A has net income from one or both wells for 1989 and even if the wells would otherwise be treated as part of the same undertaking under paragraph (c) of this section. The result would also be the same if A held the working interest through an entity, such as a general partnership, that does not limit A's liability with respect to the drilling or operation of the wells pursuant to the working interest.

Example (2). (i) During 1989, B is a general partner in a partnership that owns a working interest (within the meaning of §1.469-1T(e)(4)(iv)) in an oil well. B does not own any interest in the well other than through the partnership. At the end of 1989, however, B's partnership interest is converted into a limited partnership interest, and during 1990 B holds the working interest only as a limited partner. B does not participate in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e).

(ii) Under paragraph (e)(1) of this section, the well is treated as a separate undertaking in determining B's activities for 1989 because B holds the working interest during 1989 through an entity that does not limit B's liability with respect to the drilling or operation of the well pursuant to the working interest, and B would not be treated as materially participating for 1989 in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e). Throughout 1990, however, B's liability with respect to the drilling and operation of

the well is limited by the entity through which B holds the working interest (i.e., the limited partnership). Accordingly, paragraph (e)(1) of this section does not apply to the well in 1990, and the well may be included under paragraph (c) of this section in an undertaking that includes other operations.

Example (3). The facts are the same as in example (2), except that B's partnership interest is converted into a limited partnership interest at the end of November 1989. An oil or gas well may be treated as a separate undertaking under paragraph (e)(1) of this section if at any time during the taxable year the taxpayer holds a working interest in the well directly or through an entity that does not limit the taxpayer's liability with respect to the drilling or operation of the well pursuant to the working interest (see §1.469-1T(e)(4)(i)). Thus, although B's liability with respect to the drilling and operation of the well is limited during December 1989, the result in both 1989 and 1990 is the same as in example (2). In 1989, however, disqualified deductions and a ratable portion of the gross income from the well may be treated under §1.469-1T(e)(4)(ii) as passive activity deductions and passive activity gross income, respectively.

(f) Certain trade or business undertakings treated as part of the same activity-(1) Applicability-(i) In general. This paragraph (f) applies to a taxpayer's interests in trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(ii) Trade or business undertaking. For purposes of this paragraph (f), the term "trade or business undertaking" means any undertaking in which a taxpayer has an interest, other than-

(A) A rental undertaking (within the meaning of paragraph (d) of this section);

(B) An oil or gas well treated as an undertaking that is separate from other undertakings under paragraph (e) of this section; or

(C) A professional service undertaking (within the meaning of paragraph (h) of this section).

(2) Treatment as part of the same activity. A taxpayer's interests in two or more trade or business undertakings that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer for any taxable year in which the taxpayer-

(i) Owns interests in each such undertaking through the same passthrough entity;

(ii) Owns a direct or substantial indirect interest (within the meaning of paragraph (f)(3) of this section) in each such undertaking; or

(iii) Materially or significantly participates (within the meaning of §1.469-5T) in the activity that would result if such undertakings were treated as part of the same activity.

(3) Substantial indirect interest-(i) In general. For purposes of this paragraph (f), a taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership percentage (determined in accordance with paragraph (j)(3) of this section) in a passthrough entity that directly owns such undertaking exceeds ten percent.

(ii) Coordination rule. A taxpayer shall be treated for purposes of this paragraph (f) as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which-

(A) Such undertakings are treated as part of the same activity of the taxpayer under paragraph (f)(2)(i) of this section; and

(B) The taxpayer owns a substantial indirect interest (within the meaning of paragraph (f)(3)(i) of this section) in any such undertaking.

(4) Similar undertakings-(i) In general. Except as provided in paragraph (f)(4)(iii) of this section, two undertakings are similar for purposes of this paragraph (f) if and only if-

(A) There are predominant operations in each such undertaking; and

(B) The predominant operations of both undertakings are in the same line of business.

(ii) Predominant operations. For purposes of paragraph (f)(4)(i)(A) of this section, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.

(iii) Vertically-integrated undertakings. If an undertaking (the "supplier undertaking") provides property or services to other undertakings (the "recipient undertakings"), the following rules apply for purposes of this paragraph (f):

(A) Supplier undertaking similar to recipient undertaking. If the supplier undertaking predominantly involves the provision of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the supplier undertaking shall be treated as similar to the recipient undertaking. For purposes of applying the preceding sentence-

(1) If a supplier undertaking and two or more recipient undertakings that are similar (within the meaning of paragraph (f)(4)(i) of this section) are controlled by the same interests, such recipient undertakings shall be treated as a single undertaking; and

(2) A supplier undertaking predominantly involves the provision of property and services to a recipient undertaking for any taxable year in which such recipient undertaking obtains more than 50 percent (by value) of all property and services provided by the supplier undertaking.

(B) Recipient undertaking similar to supplier undertaking. If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this

section), the recipient undertaking shall be treated, except as otherwise provided in paragraph (f)(4)(iii)(C) of this section, as similar to the supplier undertaking. For purposes of the preceding sentence, a supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50 percent (by value) of all property and services obtained by the recipient undertaking.

(C) Coordination rules. (1) Paragraph (f)(4)(iii)(B) of this section does not apply if, under paragraph (f)(4)(iii)(A) of this section-

(i) The supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(ii) The recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(iii) Another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(2) If paragraph (f)(4)(iii)(A) of this section applies to a supplier undertaking, the supplier undertaking shall be treated as similar to undertakings that are similar to the recipient undertaking and shall not otherwise be treated as similar to undertakings to which the supplier undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(3) If paragraph (f)(4)(iii)(B) of this section applies to a recipient undertaking, the recipient undertaking shall be treated as similar to undertakings that are similar to the supplier undertaking and shall not otherwise be treated as similar to undertakings to which the recipient undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(iv) Lines of business. The Commissioner shall establish, by revenue procedure, lines of business for purposes of this paragraph (f)(4). Business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a line of business for purposes of this paragraph (f)(4). Such operations shall be included in a single line of business or in multiple lines of business on a basis that reasonably reflects-

(A) Similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered; and

(B) The treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(5) Examples. The following examples illustrate the application of this paragraph (f). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in partnerships A, B, C, and D and owns a five-percent interest in each partnership. Each partnership owns a single undertaking (undertakings A, B, C, and D), and the undertakings are trade or business

undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are controlled by the same interests (within the meaning of paragraph (j) of this section). In addition, undertakings A, B, and D are similar (within the meaning of paragraph (f)(4) of this section). The taxpayer is not related to any of the other partners, and does not participate in any of the undertakings.

(ii) In general, each undertaking in which a taxpayer owns an interest is treated as a single activity that is separate from other activities of the taxpayer (see paragraph (b)(1) of this section). This paragraph (f) provides aggregation rules for trade or business undertakings that are similar and controlled by the same interests. These aggregation rules do not apply, however, unless the taxpayer owns interests in the undertakings through the same passthrough entity, owns direct or substantial indirect interests in the undertakings, or materially or significantly participates in the undertakings. In this case, the taxpayer does not satisfy any of these conditions, and the aggregation rules in this paragraph (f) do not apply. Accordingly, except as otherwise provided in paragraph (g) of this section (relating to an aggregation rule for integrated businesses), undertakings A, B, C, and D are treated as separate activities of the taxpayer under paragraph (b)(1) of this section.

Example (2). (i) The facts are the same as in example (1), except that the taxpayer owns a 25-percent interest in partnership A, a 15-percent interest in partnership B, and a 40-percent interest in partnership C.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships A, B, and C, and these partnerships directly own undertakings A, B, and C. Thus, the taxpayer owns a substantial indirect interest in undertakings A, B, and C (see paragraph (f)(3)(i) of this section). Of these undertakings, only undertakings A and B are both similar and controlled by the same interests. Accordingly, the taxpayer's interests in undertakings A and B are treated as part of the same activity. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertakings C and D, and except as otherwise provided in paragraph (g) of this section, undertakings C and D are treated as separate activities.

Example (3). (i) The facts are the same as in example (1), except that the taxpayer participates (within the meaning of §1.469-5T(f)) for 60 hours in undertaking A and for 60 hours in undertaking B.

(ii) Paragraph (f)(2)(iii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer materially or significantly participates (within the meaning of §1.469-5T) in the activity that would result from the treatment of similar, commonly-controlled undertakings as part of the same activity. In this case, the activity that would result from treating the similar, commonly-controlled undertakings as part of the same activity consists of undertakings A, B, and D, and the taxpayer participates for 120 hours in the activity that results from this treatment. Accordingly, undertakings A, B, and D are treated as part of the same activity because the taxpayer significantly participates (within the meaning of §1.469-5T(c)(2)) in the activity that results from this treatment. The result is the same whether the taxpayer participates in one, two, or all three of the similar,

commonly-controlled undertakings, so long as the taxpayer's aggregate participation in undertakings A, B, and D exceeds 100 hours. As in example (1), the aggregation rules in this paragraph (f) do not apply to undertaking C, and except as otherwise provided in paragraph (g) of this section, undertaking C is treated as a separate activity.

Example (4). (i) The taxpayer owns a 5-percent interest in partnership A. Partnership A owns interests in partnerships B and C, each of which owns a single undertaking (undertakings B and C). In addition, the taxpayer is a partner in partnerships C and D and directly owns a 15-percent interest in each partnership. Partnership D also owns a single undertaking (undertaking D). Undertakings B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section). The taxpayer does not participate in undertaking B, C, or D.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the taxpayer owns interests in undertakings B and C through partnership A. Thus, the taxpayer's interests in undertakings B and C are treated as part of the same activity.

(iii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships C and D, and these partnerships directly own undertakings C and D. Thus, the taxpayer owns a substantial indirect interest in undertakings C and D (see paragraph (f)(3)(i) of this section).

(iv) The coordination rule in paragraph (f)(3)(ii) of this section applies to undertakings B and C because they are treated as part of the same activity under paragraph (f)(2)(i) of this section, and the taxpayer owns a substantial indirect interest in undertaking C. Under the coordination rule, the taxpayer is treated as owning a substantial indirect interest in undertaking B as well as undertaking C. Accordingly, the taxpayer's interests in undertakings B, C, and D are treated as part of the same activity.

Example (5). (i) Undertakings A, B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), each of which involves the operation of a department store, restaurants, and movie theaters. The following table shows, for each undertaking, the percentages of gross income attributable to the various operations of the undertaking. ---------- ---------- Department store Restaurants Movie Theaters ---------- ---------- Undertaking A ..... 70% 20% 10% Undertaking B ..... 60% 20% 20% Undertaking C ..... 35% 35% 30% Undertaking D ..... 35% 10% 55% ----------

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each

undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that "general merchandise stores," "eating and drinking places," and "motion picture services" are three separate lines of business.)

(iii) Undertaking A and undertaking B each derives more than 50 percent of its gross income from department-store operations, which are in the general-merchandise-store line of business. Thus, there are predominant operations in undertaking A and undertaking B, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

(iv) Undertaking C does not derive more than 50 percent of its gross income from operations in any single line of business. Thus, there are no predominant operations in undertaking C, and undertaking C is not similar to any of the other undertakings.

(v) Undertaking D derives more than 50 percent of its gross income from movie-theater operations, which are in the motion-picture-services line of business. Thus, there are predominant operations in undertaking D. The predominant operations of undertaking D, however, are not in the same line of business as those of undertakings A and B. Accordingly, undertaking D is not similar to undertakings A and B.

Example (6). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that derive all of their gross income from the sale of automobiles. Undertakings C and D derive all of their gross income from the rental of automobiles. Undertaking C is not a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section) because the average period of customer use (within the meaning of §1.469-1T(e)(3)(iii)) for its automobiles does not exceed seven days (see §1.469-1T(e)(3)(ii)(A)). Undertaking D, on the other hand, leases automobiles for periods of one year or more and is a rental undertaking.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) "automotive dealers and service stations" (automotive retail) and (b) "auto repair, services (including rentals), and parking" (automotive services) are two separate lines of business.)

(iii) Undertakings A and B both derive more than 50 percent of their gross income from operations in the automotive-retail line of business (the automobile-sales operations). Similarly, undertakings C and D both derive more than 50 percent of their gross income from operations in the automotive-services line of business (the automobile-rental operations). Thus, there are predominant operations in each undertaking, the predominant operations of undertakings A and B are in the same line of business, and the predominant operations of undertakings C and D are in the same line of business. Accordingly, undertakings A and B are similar, undertakings C and D are similar, and undertakings A and B are not similar to undertakings C and D.

(iv) Paragraph (f)(1) of this section provides that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or

business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertakings C and D, although similar, are not treated, under this paragraph (f), as part of the same activity.

Example (7). (i) Undertakings A, B, and C are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that involve real estate operations. Undertaking A derives all of its gross income from the development of real property, undertaking B derives all of its gross income from the management of real property and the performance of services as a leasing agent with respect to real property, and undertaking C derives all of its gross income from buying, selling, or arranging purchases and sales of real property. Undertaking D derives all of its gross income from the rental of residential apartments and is a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section).

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that real estate development and services (including the development and management of real property, dealing in real property, and the performance of services as a leasing agent with respect to real property) is a single line of business (the "real-estate" line of business).)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertaking D also derives more than 50 percent of its gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertaking D, and the predominant operations of undertaking D are in the same line of business as those of undertakings A, B, and C. Paragraph (f)(1) of this section provides, however, that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertaking D, although similar to undertakings A, B, and C, is not treated, under this paragraph (f), as part an activity that includes undertaking A, B, or C.

Example (8). (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), both of which involve the provision of moving services. Undertaking A derives its gross income principally from local moves, and undertaking B derives its gross income principally from long-distance moves.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. Under paragraph (f)(4)(iv) of this section, operations that are not in the lines of business established by the applicable revenue procedure are nonetheless included in a line of business. In addition, such operations are included in a single line of business or in multiple lines of business on a basis that reasonably

reflects (a) similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered, and (b) the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences. (Assume that the provision of moving services is not in any line of business established by the Commissioner and that within the lines of business established by the Commissioner services that differ only in the distance over which they are performed (e.g., local and long-distance telephone services) are generally treated as part of the same line of business.)

(iii) Undertakings A and B provide the same types of services to similar customers, and the only significant difference in the services provided is the distance over which they are performed. Thus, treating local and long-distance moving services as a single line of business (the "moving-services" line of business) reasonably reflects the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(iv) Each undertaking derives more than 50 percent of its gross income from operations in the moving-services line of business. Thus, there are predominant operations in each undertaking, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

Example (9). (i) Undertakings A, B, C, D, and E are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertakings A, B, and C derive all of their gross income from retail sales of dairy products, and undertakings D and E derive all of their gross income from the processing of dairy products. Undertakings D and E sell less than ten percent of their dairy products to undertakings A, B, and C, and sell the remainder to unrelated undertakings. Undertakings A, B, and C purchase less than ten percent of their inventory from undertakings D and E and purchase the remainder from unrelated undertakings.

(ii) Paragraph (f)(4)(i) of this section provides that, except as provided in paragraph (f)(4)(iii) of this section, undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) "food stores" and (b) "manufacturing-food and kindred products" are two separate lines of business.)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the food-store line of business (the dairy-sales operations). Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertakings D and E both derive more than 50 percent of their gross income from operations in the food-manufacturing line of business (the dairy-processing operations). Thus, there are predominant operations in undertakings D and E, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings D and E are similar. The predominant operations of undertakings D and E are not in the same line of business as those of undertakings

A, B, and C. Accordingly, undertakings D and E are not similar to undertakings A, B, and C.

(v) Paragraph (f)(4)(iii) of this section provides rules under which certain undertakings whose operations are not in the same line of business nevertheless are similar to one another if one of the undertakings (the "supplier undertaking") provides property or services to the other undertaking (the "recipient undertaking"), and the undertakings are controlled by the same interests. These rules apply, however, only if the supplier undertaking predominantly involves the provision of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(A) of this section), or the supplier undertaking is the predominant provider of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(B) of this section). In this case, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. Undertakings D and E, however, sell less than ten percent of their dairy products to undertakings A, B, and C and thus do not predominantly involve the provision of property and services to recipient undertakings. Similarly, undertakings D and E are not the predominant providers of property and services to undertakings A, B, and C. Thus, the rules for vertically-integrated undertakings in paragraph (f)(4)(iii) of this section do not apply in this case.

Example (10). (i) The facts are the same as in example (9), except that undertaking D sells 75 percent of its dairy products to undertakings A, B, and C.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. Paragraph (f)(4)(iii)(A)(2) of this section provides that a supplier undertaking predominantly involves the provision of property to a recipient undertaking if the supplier undertaking provides more than 50 percent of its property to such recipient undertaking. In addition, paragraph (f)(4)(iii)(A)(1) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertakings are treated as a single undertaking for purposes of applying paragraph (f)(4)(iii)(A) of this section. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings and undertakings A, B, and C are recipient undertakings. Undertaking D predominantly involves the provision of property to undertakings A, B, and C. Moreover, undertakings A, B, and C are treated as a single undertaking under paragraph (f)(4)(iii)(A)(1) of this section because undertakings A, B, and C are similar to one another under paragraph (f)(4)(i) of this section, and undertakings A, B, C, and D are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A, B, C, and D.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii) (A) and (C)(2) of this section as an undertaking that is similar to the recipient undertakings and to undertakings to which the recipient undertakings are similar. Accordingly, undertaking D is similar, for purposes of this paragraph (f), to undertakings A, B, and C.

(iv) Undertaking E does not predominantly involve the provision of property to undertakings A, B, and C, or to any other related undertakings. Thus, paragraph

(f)(4)(iii)(A) of this section does not apply to undertaking E, and undertaking E is not similar to undertakings A, B, and C. Moreover, undertakings D and E are not similar because, under paragraph (f)(4)(iii)(C)(2) of this section, undertaking D is not similar to any undertaking that is not similar to undertakings A, B, and C.

Example (11). (i) The facts are the same as in example (10), except that 75 percent of undertaking D's dairy products are sold to undertakings A and B, and none are sold to undertaking C.

(ii) In this case, undertaking D is a supplier undertaking only with respect to undertakings A and B. Accordingly, paragraph (f)(4)(iii)(A) applies only to undertakings A, B, and D. As in example (10), undertaking D is similar to undertakings A and B, and is not similar to undertaking E. In addition, if paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(2) of this section as an undertaking that is similar to the recipient undertakings and undertakings to which the recipient undertakings are similar. Accordingly, even though undertaking D does not provide any property or services to undertaking C, undertaking D is similar to undertaking C because undertaking C is similar to undertakings A and B.

Example (12). (i) The facts are the same as in example (9), except that undertakings A and B purchase 80 percent of their inventory from undertaking D.

(ii) Paragraph (f)(4)(iii)(B) of this section applies, except as provided in paragraph (f)(4)(iii)(C) of this section, if a supplier undertaking is the predominant provider of property to a recipient undertaking that is controlled by the same interests. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. In addition, undertaking D is the predominant provider of property and services to undertakings A and B, and undertakings A, B and D are controlled by the same interests. Thus, except as provided in paragraph (f)(4)(iii)(C) of this section, paragraph (f)(4)(iii)(B) of this section applies to undertakings A, B, and D.

(iii) The coordination rules in paragraph (f)(4)(iii)(C)(1) of this section provide that paragraph (f)(4)(iii)(B) of this section does not apply in certain cases to which paragraph (f)(4)(iii)(A) of this section applies. These coordination rules would apply if undertaking D or E (or any other undertaking that is controlled by the interests that control undertakings A, B, and C) predominantly involved the provision of property and services to undertakings A, B, and C. The coordination rules in paragraph (f)(4)(iii)(C)(1) of this section would also apply if undertaking A, B, or D predominantly involved the provision of property or services to a recipient undertaking that is controlled by the same interests. Assume that these coordination rules do not apply in this case.

(iv) If paragraph (f)(4)(iii)(B) of this section applies to supplier and recipient undertakings, the recipient undertakings are treated under paragraph (f)(4)(iii) (B) and (C)(3) of this section as undertakings that are similar to the supplier undertaking and to undertakings to which the supplier undertaking is similar. Accordingly, undertakings A and B are similar, for purposes of this paragraph (f), to undertaking D and, because undertakings D and E are similar, to undertaking E.

(v) The principal providers of property and services to undertaking C are unrelated undertakings. Thus, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking C, and undertaking C is not similar to undertakings D and E. Moreover, undertaking C is not similar to undertakings A and B because, under paragraph (f)(4)(iii)(C)(3) of this section, undertakings A and B are not similar to any undertaking that is not similar to undertaking D.

Example (13). (i) Undertakings A through Z are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertaking A derives all of its gross income from the manufacture and sale of men's and women's clothing, undertaking B derives all of its gross income from sales of men's and women's clothing to retail stores, and undertakings C through Z derive all of their gross income from retail sales of men's and women's clothing. Undertaking A sells clothing exclusively to undertaking B. Undertaking B sells 75 percent of its clothing to undertakings C through Z, and sells the remainder to unrelated retail stores. Undertaking B purchases 80 percent of its inventory from undertaking A, and undertakings C through Z purchase 60 to 90 percent of their inventory from undertaking B.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. In addition, paragraph (f)(4)(iii)(A)(1) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertaking are treated as a single undertaking for this purpose. Undertaking B provides men's and women's clothing to undertaking C through Z. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking B is a supplier undertaking and undertakings C through Z are recipient undertakings. In addition, undertaking B predominantly involves the provision of property to undertakings C through Z, and undertakings C through Z are treated as a single undertaking for purposes of paragraph (f)(4)(iii)(A) of this section. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings B and C through Z.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to the recipient undertakings. Accordingly, undertaking B is similar, for purposes of this paragraph (f), to undertakings C through Z.

(iv) Undertaking A provides men's and women's clothing to undertaking B. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking A is a supplier undertaking and undertaking B is a recipient undertaking. In addition, undertaking A predominantly involves the provision of property to undertaking B, and undertakings A and B are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A and B, and undertaking A is similar to undertaking B.

(v) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(2) of this section as an undertaking that is similar to undertakings to which the recipient

undertakings are similar. Accordingly, undertaking A is also similar, for purposes of this paragraph (f), to undertakings C through Z.

(vi) The coordination rule in paragraph (f)(4)(iii)(C)(1)(i) of this section provides that paragraph (f)(4)(iii)(B) of this section does not apply if, as described above, the supplier undertaking predominantly involves the provision of property to recipient undertakings and is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to such recipient undertakings. Accordingly, paragraph (f)(4)(iii)(B) of this section does not apply to undertakings B through Z, even though undertaking B is the predominant provider of property and services to undertakings C through Z, and undertakings B through Z are controlled by the same interests. For the same reason, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking A and B. (Paragraph (f)(4)(iii)(B) of this section is also inapplicable to undertakings A and B because the coordination rule in paragraph (f)(4)(iii)(C)(1)(ii) of this section applies if the recipient undertaking (undertaking B) is itself a supplier undertaking that is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to its recipient undertakings (undertakings C through Z).)

(g) Integrated businesses-(1) Applicability-(i) In general. This paragraph (g) applies to a taxpayer's interests in trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section).

(ii) Trade or business activity. For purposes of this paragraph (g), the term "trade or business activity" means any activity (determined without regard to this paragraph (g)) that consists of interests in one or more trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(2) Treatment as a single activity. A taxpayer's interests in two or more trade or business activities shall be treated as a single activity if and only if-

(i) The operations of such trade or business activities constitute a single integrated business, activities constitute a single integrated business; and

(ii) Such activities are controlled by the same interests (within the meaning of paragraph (j) of this section).

(3) Facts and circumstances test. In determining whether the operations of two or more trade or business activities constitute a single integrated business for purposes of this paragraph (g), all the facts and circumstances are taken into account, and the following factors are generally the most significant:

(i) Whether such operations are conducted at the same location;

(ii) The extent to which other persons conduct similar operations at one location;

(iii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

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

(v) Whether such operations are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

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

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

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

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

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

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

(xii) Whether such operations are conducted under the same trade name.

(4) Examples. The following examples illustrate the application of this paragraph (g). The facts, analysis, and conclusion in each example relate to a single taxable year, and the trade or business activities described in each example are controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (1). (i) The taxpayer owns a number of department stores and auto-supply stores. Some of the taxpayer's department stores include auto-supply departments. In other cases, the taxpayer operates a department store and an auto-supply store at the same location (within the meaning of paragraph (c)(2)(iii) of this section), or at different locations from which the same group of customers can be served. In cases in which a department store and an auto-supply store are operated at the same location, the department-store operations are the predominant operations (within the meaning of paragraph (f)(4)(ii) of this section), and the undertaking that includes the stores is treated as a department-store undertaking for purposes of paragraph (f) of this section. Under paragraph (f) of this section, the department-store undertakings are all treated as part of the same activity of the taxpayer (the "department-store activity"). Similarly, the auto-supply undertakings (i.e., the auto-supply stores that are not operated at a department-store location) are all treated as part of the same activity (the "auto-supply activity"). (Assume that department-store undertakings and auto-supply undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The department stores and auto-supply stores use a common trade name and coordinate their marketing activities (e.g., the stores advertise in the same catalog and the same newspaper supplements, honor the same credit cards (including credit cards issued by the department stores), and jointly conduct sales and other promotional activities). Although sales personnel generally work only in a particular store or in a particular department within a store, other employees (e.g., cashiers, janitorial and maintenance workers, and clerical staff) may work in or perform

services for various stores, including both department and auto-supply stores. In addition, the management of store operations is organized on a geographical basis, and managers above the level of the individual store generally supervise operations in both types of store. A central office provides payroll, financial, and other support services to all stores and establishes pricing and other business policies. Most inventory for both types of stores is acquired through a central purchasing department and inventory for all stores in an area is stored in a common warehouse.

(iii) Based on the foregoing facts and circumstances, the operations of the department-store activity and the auto-supply activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the conduct of department-store and auto-supply operations at the same location, the location of department and auto-supply stores at sites where the same group of customers can be served, the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel, facilities, and equipment to conduct and support the operations, the use of a common trade name, and the coordination (as evidenced by the coordinated marketing activities) of department-store and auto-supply operations.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The department-store activity and the auto-supply activity consist of trade or business undertakings and, thus, are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the department-store activity and the auto-supply activity are treated as a single activity of the taxpayer.

Example (2). (i) The taxpayer owns a number of stores that sell stereo equipment and a repair shop that services stereo equipment. Under paragraph (f) of this section, the stores are all treated as part of the same activity of the taxpayer (the "store activity"). The repair shop does not sell stereo equipment, does not predominantly involve the provision of services to the taxpayer's stores, and is treated as a separate activity (the "repair-shop activity"). (Assume that stereo-sales undertakings and stereo-repair undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

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

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

(iv) Based on the foregoing facts and circumstances, the operations of the store activity and the repair-shop activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel and facilities to support the operations, the use of a common trade name, the extent to which the same customers patronize both the stores and the repair shop, the similarity of the products (i.e., stereo equipment) involved in both store and repair-shop operations, and the extent to which the provision of repair services contributes to the taxpayer's ability to obtain the stereo equipment sold in store operations.

(v) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The store activity and repair-shop activity consist of trade or business undertakings and thus are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the store activity and the repair-shop activity are treated as a single activity of the taxpayer.

Example (3). (i) The taxpayer owns interests in three partnerships. One partnership owns a television station, the second owns a professional sports franchise, and the third owns a motion-picture production company. The operations of the partnerships are treated as three separate undertakings. Although other persons own interests in the partnerships, all three undertakings are controlled (within the meaning of paragraph (j) of this section) by the taxpayer. The operations of the partnerships are treated as three separate activities (the "television activity," the "sports activity," and the "motion-picture activity"). (Assume that the undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) Each partnership prepares financial statements that reflect only the results of that partnership's operations, and each of the activities is conducted under its own trade name. The taxpayer participates extensively in the management of each partnership and makes the major business decisions for all three partnerships. Each partnership, however, employs separate management and other personnel who conduct its operations on a day-to-day basis. The taxpayer generally arranges the partnerships' financing and often obtains loans for two, or all three, partnerships from the same source. Although the assets of one partnership are not used as security for loans to another partnership, the taxpayer's interest in a partnership may secure loans to the other partnerships. The television station broadcasts the sports franchise's games, and the motion-picture production company occasionally

prepares programming for the television station. In addition, support staff of one partnership may, during periods of peak activity or in the case of emergency, be made available to another partnership on a temporary basis. There are no other significant transactions between the partnerships. Moreover, all transactions between the partnerships involve essentially the same terms as would be provided in transactions between unrelated persons.

(iii) Based on the foregoing facts and circumstances, the television activity, the sports activity, and the motion-picture activity constitute three separate businesses. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of the activities as separate units in the partnerships' financial statements, the use of a different trade name for each activity, the separate day-to-day management of the activities, and the limited extent to which the activities contribute to or depend on each other (as evidenced by the small number of significant transactions between the partnerships and the arm's length nature of those transactions). The taxpayer's participation in management and financing are taken into account in this determination, as are the transactions between the partnerships, but these factors do not of themselves support a determination that the activities constitute an integrated business.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer only if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. In this case, the taxpayer's activities do not constitute an integrated business, and the aggregation rule in paragraph (g)(2) of this section does not apply. Accordingly, the television activity, the sports activity, and the motion-picture activity are treated as three separate activities of the taxpayer.

(h) Certain professional service undertakings treated as a single activity-(1) Applicability-(i) In general. This paragraph (h) applies to a taxpayer's interests in professional service undertakings (within the meaning of paragraph (h)(1)(ii) of this section).

(ii) Professional service undertaking. For purposes of this paragraph (h), an undertaking is treated as a professional service undertaking for any taxable year in which the undertaking derives more than 50 percent of its gross income from the provision of services that are treated, for purposes of section 448 (d)(2)(A) and the regulations thereunder, as services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(2) Treatment as a single activity-(i) Undertakings controlled by the same interest. A taxpayer's interests in two or more professional service undertakings that are controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer.

(ii) Undertakings involving significant similar or significant related services. A taxpayer's interests in two or more professional service undertakings that involve the provision of significant similar services or significant related services shall be treated as part of the same activity of the taxpayer.

(iii) Coordination rule. (A) Except as provided in paragraph (h)(2)(iii)(B) of this section, a taxpayer's interests in two or more undertakings (the "original undertakings") that are treated as part of the same activity of the taxpayer under the provisions of paragraph (h)(2) (i) or (ii) of this section shall be treated as interests in a single professional service undertaking (the "aggregated undertaking") for purposes of reapplying such provisions.

(B) If any original undertaking included in an aggregated undertaking and any other undertaking that is not included in such aggregated undertaking involve the provision of significant similar or related services, the aggregated undertaking and such other undertaking shall be treated as undertakings that involve the provision of significant similar or related services for purposes of reapplying the provisions of paragraph (h)(2)(ii) of this section.

(3) Significant similar or significant related services. For purposes of this paragraph (h)-

(i) Services (other than consulting services) in any field described in paragraph (h)(1)(ii) of this section are similar to all other services in the same field;

(ii) All the facts and circumstances are taken into account in determining whether consulting services are similar;

(iii) Two professional service undertakings involve the provision of significant similar services if and only if-

(A) Each such undertaking provides significant professional services; and

(B) Significant professional services provided by one such undertaking are similar to significant professional services provided by the other such undertaking;

(iv) Services are significant professional services if and only if such services are in a field described in paragraph (h)(1)(ii) of this section and more than 20 percent of the undertaking's gross income is attributable to services in such field (or, in the case of consulting services, to similar services in such field); and

(v) Two professional service undertakings involve the provision of significant related services if and only if more than 20 percent of the gross income of one such undertaking is derived from customers that are also customers of the other such undertaking.

(4) Examples. The following examples illustrate the application of this paragraph (h). In each example that does not state otherwise, the taxpayer is an individual, and the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) The taxpayer is a partner in a law partnership that has offices in various cities. Some of the partnership's offices provide a full range of legal services. Other offices, however, specialize in a particular area or areas of the law (e.g., litigation, tax law, corporate law, etc.). In either case, substantially all of the office's gross income is derived from the provision of legal services. Under paragraph (c)(1)

of this section, each of the law partnership's offices is treated as a single undertaking that is separate from other undertakings (a "law-office undertaking").

(ii) Each law-office undertaking derives more than 50 percent of its gross income from the provision of services in the field law. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each law-office undertaking derives more than 20 percent of its gross income from services in the field of law. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of law. In addition, all services in the field of law are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the law-office undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interest in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the law-office undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even if the undertakings are not controlled by the same interests (within the meaning of paragraph (j) of this section).

Example (2). (i) The taxpayer is a partner in medical partnerships A and B. Both partnerships derive all of their gross income from the provision of medical services, but partnership A specializes in internal medicine and partnership B operates a radiology laboratory. Under paragraph (c)(1) of this section, the medical-service business of each partnership is treated as a single undertaking that is separate from other undertakings (a "medical-service undertaking"). Partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's medical-service undertaking derives more than 50 percent of its gross income from the provision of services in the field of health. Thus, each partnership's medical-service undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each partnership's medical-service undertaking derives more than 20 percent of its gross income from services in the field of health. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of health. In addition, all services in the field of health are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the medical-services undertakings of partnerships A and B involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the medical-service undertakings of partnerships A and B are

treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even though the undertakings are not controlled by the same interests.

Example (3). (i) The facts are the same as in example (2), except that the taxpayer withdraws from partnership A in 1989 and becomes a partner in partnership B in 1990. In addition, the taxpayer was a full-time participant in the operations of partnership A from 1970 through 1989, but does not participate in the operations of partnership B.

(ii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. This rule is not limited to cases in which the taxpayer holds such interests simultaneously. Thus, as in example (2), the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer.

(iii) The activity that includes the taxpayer's interests in the medical-service undertakings of partnerships A and B is a personal service activity (within the meaning of §1.469-5T(d)) because it involves the performance of personal services in the field of health. In addition, the taxpayer materially participated in the activity for three or more taxable years preceding 1990 (see §1.469-5T(j)(1)). Thus, even if the taxpayer does not work in the activity after 1989, the taxpayer is treated, under §1.469-5T(a)(6), as materially participating in the activity for 1990 and subsequent taxable years.

Example (4). (i) The taxpayer is a partner in an accounting partnership that has offices in various cities (partnership A) and in a management-consulting partnership that has a single office (partnership B). Each of partnership A's offices derives substantially all of its gross income from services in the field of accounting, and partnership B derives substantially all of its gross income from services in the field of consulting. Under paragraph (c)(1) of this section, partnership B's consulting business is treated as a single undertaking that is separate from other undertakings (the "consulting undertaking") and each of partnership A's offices is similarly treated (the "accounting undertakings"). The accounting undertakings are controlled by the same interests, but partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership B's consulting business derives 50 percent of its gross income from customers of partnership A's accounting undertakings, but does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking.

(ii) Each accounting undertaking derives more than 50 percent of its gross income from the provision of services in the field of accounting, and the consulting undertaking derives more than 50 percent of its gross income from the provision of services in the field of consulting. Thus, each accounting undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section), and the consulting undertaking is also treated as a professional service undertaking.

(iii) Each accounting undertaking derives more than 20 percent of its gross income from services in the field of accounting. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of accounting. In addition, all services in the field of accounting

are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the accounting undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2) (i) and (ii) of this section provides that a taxpayer's interests in professional service undertakings that are controlled by the same interests or that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. The accounting undertakings are controlled by the same interests (see (i) above) and involve the provision of significant similar services (see (iii) above). Accordingly, the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2) (i) and (ii) of this section.

(v) The consulting undertaking derives more than 20 percent of its gross income from services in the field of consulting. If, based on all the facts and circumstances, these services are determined to be similar consulting services under paragraph (h)(3)(ii) of this section, the consulting undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section). In this case, however, the consulting undertaking and the accounting undertakings do not involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section) because consulting services and accounting services are not treated as similar services under paragraph (h)(3)(i) of this section.

(vi) The consulting undertaking does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking of partnership A. If, however, partnership A's accounting undertakings are aggregated, the consulting undertaking derives more than 20 percent of its gross income from customers of the aggregated undertakings. Paragraph (h)(3)(v) of this section provides that two professional service undertakings involve the provision of significant related services if more than 20 percent of the gross income of one undertaking is derived from customers of the other undertaking. For purposes of applying this rule, partnership A's accounting undertakings are treated as a single undertaking under paragraph (h)(2)(iii) of this section because the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section. Thus, the consulting undertaking and the accounting undertakings involve the provision of significant related services.

(vii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant related services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the consulting undertaking and the accounting undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

Example (5). (i) The facts are the same as in example (4), except that partnership B's consulting business derives only 15 percent of its gross income from customers of partnership A's accounting undertakings.

(ii) As in example (4), the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section and are treated under paragraph (h)(2)(iii) of this section as a single undertaking for purposes of reapplying those provisions. In this case, however, the consulting

undertaking does not derive more than 20 percent of its gross income from the customers of partnership A's accounting undertakings. Thus, the consulting undertaking and the accounting undertakings do not involve the provision of significant related services. Accordingly, the accounting undertakings and the consulting undertaking are not treated as part of the same activity under paragraph (h)(2)(i) or (ii) of this section because they are not controlled by the same interests and do not involve the provision of significant similar or related services.

Example (6). (i) The taxpayer is a partner in partnerships A, B, and C. Partnership A derives substantially all of its gross income from the provision of engineering services, partnership B derives substantially all of its gross income from the provision of architectural services, and partnership C derives 40 percent of its gross income from the provision of engineering services and the remainder from the provision of architectural services. Under paragraph (c)(1) of this section, each partnership's service business is treated as a single undertaking that is separate from other undertakings. Partnerships A, B, and C are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's undertaking derives more than 50 percent of its gross income from the provision of services in the fields of architecture and engineering. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Partnership A's undertaking ("undertaking A") derives more than 20 percent of its gross income from services in the field of engineering, partnership B's undertaking ("undertaking B") derives more than 20 percent of its gross income from services in the field of architecture, and partnership C's undertaking ("undertaking C") derives more than 20 percent of its gross income from services in the field of engineering and more than 20 percent of its gross income from services in the field of architecture. Thus, undertaking A involves significant services in the field of engineering, undertaking B involves significant services in the field of architecture, and undertaking C involves significant services in both fields. Under paragraph (h)(3)(i) of this section, all services within each field are treated as similar services, but engineering services and architectural services are not treated as similar services. Thus, undertakings A and C, and undertakings B and C, involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in undertakings A and C are treated as part of the same activity of the taxpayer.

(v) Under paragraph (h)(2)(iii)(A) of this section, undertakings A and C are also treated as a single undertaking for purposes of determining whether undertaking B involves the provision of significant similar services. Paragraph (h)(2)(iii)(B) of this section in effect provides that treating undertakings A and C as a single undertaking does not affect the conclusion that the architectural services provided by undertakings B and C are significant similar services. Thus, undertaking B and the single undertaking in which undertakings A and C are included under paragraph (h)(3)(iii) of this section involve the provision of significant similar services, and the

taxpayer's interests in undertakings A, B, and C are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

(i) [Reserved]

(j) Control by the same interests and ownership percentage-(1) In general. Except as otherwise provided in paragraph (j)(2) of this section, all the facts and circumstances are taken into account in determining, for purposes of this section, whether undertakings are controlled by the same interests. For this purpose, control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control that is determinative, and not its form or mode of exercise.

(2) Presumption-(i) In general. Undertakings are rebuttably presumed to be controlled by the same interests if such undertakings are part of the same common-ownership group.

(ii) Common-ownership group. Except as provided in paragraph (j)(2)(iii) of this section, two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this paragraph (j)(2) if and only if the sum of the common-ownership percentages of any five or fewer persons (within the meaning of section 7701(a)(1), but not including passthrough entities) with respect to such undertakings exceeds 50 percent. For this purpose, the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage (determined in accordance with paragraph (j)(3) of this section) in any such undertaking.

(iii) Special aggregation rule. If, without regard to this paragraph (j)(2)(iii), an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this paragraph (j)(2) as part of a single common-ownership group in determining the activities of such taxpayer.

(3) Ownership percentage-(i) In general. For purposes of this section, a person's ownership percentage in an undertaking or in a passthrough entity shall include any interest in such undertaking or passthrough entity that the person holds directly and the person's share of any interest in such undertaking or passthrough entity that is held through one or more passthrough entities.

(ii) Passthrough entities. The following rules apply for purposes of applying paragraph (j)(3)(i) of this section:

(A) A partner's interest in a partnership and share of any interest in a passthrough entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding guaranteed payments under section 707(c)) of such partnership.

(B) A shareholder's interest in an S corporation and share of any interest in a passthrough entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.

(C) A beneficiary's interest in a trust or estate and share of any interest in a passthrough entity or undertaking held through a trust or estate shall not be taken into account.

(iii) Attribution rules-(A) In general. Except as otherwise provided in paragraph (j)(3)(iii)(B) of this section, a person's ownership percentage in a passthrough entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related to such person owns (determined without regard to this paragraph (j)(3)(iii)) in such passthrough entity or in such undertaking.

(B) Determination of common-ownership percentage. The common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of paragraph (j)(3)(iii)(A) of this section, two or more such persons own the same interest in any such undertaking (the "related-party owners") by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.

(C) Related person. A person is related to another person for purposes of this paragraph (j)(3)(iii) if the relationship of such persons is described in section 267(b) or 707(b)(1).

(4) Special rule for trade or business activities. In determining whether two or more trade or business activities are controlled by the same interests for purposes of paragraph (g) of this section, each such activity shall be treated as a separate undertaking in applying this paragraph (j).

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

Example (1). (i) Partnership X is the sole owner of an undertaking (undertaking X), and partnership Y is the sole owner of another undertaking (undertaking Y). Individuals A, B, C, D, and E are the only partners in partnerships X and Y, and the partnership agreements of both X and Y provide that no action may be taken or decision made on behalf of the partnership without the unanimous consent of the partners. Moreover, each partner actually participates in, and agrees to, all major decisions that affect the operations of either partnership. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, C, D, and E in each partnership (and in the undertaking owned by the partnership) are as follows: ---------- Partner Partnership/Undertaking ---------- X (percent) Y (percent) ---------- A ..... 15 5 B ..... 10 60 C ..... 10 20 D ..... 77 12 E ..... 8 20 ---------- 120 117 ----------

The sum of the ownership percentages exceeds 100 percent for both X and Y because, under paragraph (j)(3)(ii)(A) of this section, each partner's ownership percentage is determined on the basis of the greater of the partner's percentage interest in the capital of the partnership or the partner's largest distributive share of any item of income or gain of the partnership.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, C, D, and E with respect to undertakings X and Y are as follows: ---------- Partner Common-ownership percentage ---------- A ..... 5 B ..... 10 C ..... 10 D ..... 12 E ..... 8 ---------- 45 ----------

(iii) Paragraph (j)(2)(i) of this section provides that undertakings are rebuttably presumed to be controlled by the same interests if the undertakings are part of the same common-ownership group. In general, undertakings are part of a common-ownership group only if the sum of the common-ownership percentages of any five or fewer persons with respect to such undertakings exceeds 50 percent. In this case, the sum of the partners' common-ownership percentages with respect to undertakings X and Y is only 45 percent. Thus, undertakings X and Y are not part of the same common-ownership group.

(iv) If the presumption in paragraph (j)(2)(i) of this section does not apply, all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests (see paragraph (j)(1) of this section). In this case, all actions and decisions in both undertakings require the unanimous consent of the same persons and each of those persons actually participates in, and agrees to, all major decisions. Accordingly, undertakings X and Y are controlled by the same interests (i.e., A, B, C, D, and E).

Example (2). (i) Partnerships W, X, Y, and Z are each the sole owner of an undertaking (undertakings W, X, Y, and Z). Individuals A, B, and C are partners in each of the four partnerships, and the remaining interests in each partnership are owned by a number of unrelated individuals, none of whom owns more than a one-percent interest in any of the partnerships. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, and C in each partnership (and in the undertaking owned by the partnership) are as follows: ---------- Partnership/Undertaking Partner ---------- A B C ---------- W ..... 23% 21% 40%% X ..... 19% 30% 22%% Y ..... 25% 25% 20%% Z ..... 8% 4% 2% ----------

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, and C in undertakings W, X, Y, and Z are as follows: ---------- Partner Common-ownership percentage ---------- A ..... 8 B ..... 4 C ..... 2 ---------- 14 ----------

(iii) The sum of the common-ownership percentages of A, B, and C with respect to undertakings W, X, Y, and Z is 14 percent, and no other person owns more than a one-percent interest in any of the undertakings. Thus, the sum of the common-

ownership percentages of any five or fewer persons with respect to all four undertakings cannot exceed 50 percent. Accordingly, undertakings W, X, Y, and Z are not part of the same common-ownership group (see paragraph (j)(2)(ii) of this section) and are not rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

(iv) The common-ownership percentages of A, B, and C in undertakings W, X, and Y are as follows: ---------- Partner Common ownership percentage ---------- A ..... 19 B ..... 21 C ..... 20 ---------- 60 ----------

(v) The sum of the common-ownership percentages of A, B, and C, taking into account only undertakings W, X, and Y, is 60 percent. Because the sum of the common-ownership percentages exceeds 50 percent, undertakings W, X, and Y are part of the same common-ownership group (see paragraph (j)(2)(ii) of this section and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

Example (3). (i) Corporation X, an S corporation, is the sole owner of an undertaking (undertaking X), and corporation Y, another S corporation, is the sole owner of another undertaking (undertaking Y). Individuals A, B, and C are shareholders in corporations X and Y. Both A and B are related (within the meaning of paragraph (j)(3)(iii)(C) of this section) to C, but not to each other. A, B, and C are not related to any other person that owns an interest in either corporation X or corporation Y. The ownership percentages (determined without regard to the attribution rules of paragraph (j)(3)(iii) of this section) of A, B, and C in each corporation (and in the undertaking owned by the corporation) are as follows: Corporation/Undertaking ---------- Shareholder X (percent) Y (percent) ---------- A ..... 20 ---------- B ..... ---------- 20 C ..... 5 5 ----------

(ii) In general, a person's ownership percentage is determined by treating the person as the owner of interests that are actually owned by related persons (see paragraph (j)(3)(iii)(A) of this section). If A, B, and C are treated as owning interests that are actually owned by related persons, their ownership percentages are as follows: Corporation/Undertaking ---------- Shareholder X (percent) Y (percent) ---------- A ..... 25 5 B ..... 5 25 C ..... 25 25 ----------

(iii) Paragraph (j)(3)(iii)(B) of this section provides that, in determining the sum of the common-ownership percentages of any five or fewer persons with respect to any undertakings, each interest in such undertakings is counted only once. If two or more persons are treated as owners of the same interest under paragraph (j)(3)(iii)(A) of this section, the person whose ownership would result in the highest sum is treated as the only owner of the interest. In this case, C's common-ownership percentage with respect to undertakings X and Y, determined by treating C as the owner of the interests actually owned by A and B, is 25 percent. If, however, A and B are treated as the owners of the interests actually owned by C, each has a common-ownership percentage of only five percent. Thus, in determining the sum of common-ownership percentages with respect to undertakings X and Y, C is treated as the

owner of the interests actually owned by A and B because this treatment results in the highest sum of common-ownership percentages with respect to such undertakings.

Example (4). (i) The ownership percentages of individuals A, B, and C in undertakings X, Y, and Z are as follows: Undertaking ---------- ---- Individual X Y Z ---------- A ..... 30% 30% 30% B ..... 30% 30% 30% C ..... -------- 30% 30% ----------

No other person owns an interest in more than one of the undertakings.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, A's common-ownership percentage with respect to undertakings X, Y, and Z is 30 percent, and the common-ownership percentages of B and C (and all other persons owning interests in such undertakings) with respect to such undertakings is zero. Accordingly, the sum of the common ownership percentages with respect to undertakings X, Y, and Z is only 30 percent, and undertakings X, Y, and Z are not treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iii) B's common-ownership percentage with respect to undertakings X and Y is 30 percent, and the sum of A's and B's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings X and Y are treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section. Similarly, C's common-ownership percentage with respect to undertakings Y and Z is 30 percent, and the sum of A's and C's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings Y and Z are also treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iv) Paragraph (j)(2)(iii) of this section requires the aggregation of common-ownership groups that include the same undertaking. In this case, undertaking Y is treated as part of the common-ownership group XY and as part of the common-ownership group YZ. Accordingly, undertakings X, Y, and Z are treated as part of a single common-ownership group and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section) even though B does not own an interest in undertaking Z and C does not own an interest in undertaking X. The fact that B and C are not common owners with respect to undertakings X and Z is taken into account, however, in determining whether this presumption is rebutted.

(k) Identification of rental real estate activities-(1) Applicability-(i) In general. Except as otherwise provided in paragraph (k)(6) of this section, this paragraph (k) applies to a taxpayer's interests in rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section).

(ii) Rental real estate undertaking. For purposes of this paragraph (k), a rental real estate undertaking is a rental undertaking (within the meaning of paragraph (d) of this section) in which at least 85 percent of the unadjusted basis (within the meaning of §1.469-2T(f)(3)) of the property made available for use by customers is real property. For this purpose the term "real property" means any tangible property other than tangible personal property (within the meaning of §1.48-1(c)).

(2) Identification of activities-(i) Multiple undertakings treated as a single activity or multiple activities by taxpayer. Except as otherwise provided in this paragraph (k), a taxpayer may treat two or more rental real estate undertakings (determined after the application of paragraph (k)(2) (ii) and (iii) of this section) as a single activity or may treat such undertakings as separate activities.

(ii) Multiple undertakings treated as a single activity by passthrough entity. A taxpayer must treat two or more rental real estate undertakings as a single rental real estate undertaking for a taxable year if any passthrough entity through which the taxpayer holds such undertakings treats such undertakings as a single activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(iii) Single undertaking treated as multiple undertakings. Notwithstanding that a taxpayer's interest in leased property would, but for the application of this paragraph (k)(2)(iii), be treated as used in a single rental real estate undertaking, the taxpayer may, except as otherwise provided in paragraph (k)(3) of this section, treat a portion of the leased property (including a ratable portion of any common areas or facilities) as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. This paragraph (k)(2)(iii) shall apply for a taxable year if and only if-

(A) Such portion of the leased property can be separately conveyed under applicable State and local law (taking into account the limitations, if any, imposed by any special rules or procedures, such as condominium conversion laws, restricting the separate conveyance of parts of the same structure); and

(B) The taxpayer holds such leased property directly or through one or more passthrough entities, each of which treats such portion of the leased property as a separate activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(3) Treatment in succeeding taxable years. All rental real estate undertakings or portions of such undertakings that are treated, under this paragraph (k), as part of the same activity for a taxable year ending after August 9, 1989 must be treated as part of the same activity in each succeeding taxable year.

(4) Applicable return of passthrough entity. For purposes of this paragraph (k), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(5) Evidence of treatment required. For purposes of this paragraph (k), a person (including a passthrough entity) does not treat a rental real estate undertaking as multiple undertakings for a taxable year or, except as otherwise provided in paragraph (k) (2)(ii) or (3) of this section, treat multiple rental real estate undertakings as a single undertaking for a taxable year unless such treatment is reflected on a schedule attached to the person's return for the taxable year.

(6) Coordination rule for rental of nondepreciable property. This paragraph (k) shall not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis (within the meaning of §1.469-2T(f)(3)) of property used or held

for use by customers in such undertaking during the taxable year is subject to the allowance for depreciation under section 167.

(7) Coordination rule for rental of dwelling unit. For any taxable year in which section 280A(c)(5) applies to a taxpayer's use of a dwelling unit-

(i) Paragraph (k) (2) and (3) of this section shall not apply to the taxpayer's interest in such dwelling unit; and

(ii) The taxpayer's interest in such dwelling unit shall be treated as a separate activity of the taxpayer.

(8) Examples. The following examples illustrate the application of this paragraph (k). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example (1). (i) In 1989, the taxpayer directly owns five condominium units (units A, B, C, D, and E) in three different buildings. Units A, B, and C are in one of the buildings and constitute a single rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Units D and E are in the other two buildings, and each of these units constitutes a separate rental real estate undertaking. Each of the units can be separately conveyed under applicable State and local law.

(ii) Paragraph (k)(2)(iii) of this section permits a taxpayer to treat a portion of the property included in a rental real estate undertaking as a separate rental real estate undertaking if the property can be separately conveyed under applicable State and local law and the taxpayer owns the property directly. Thus, the taxpayer can treat units A, B, and C as three separate undertakings. Alternatively, the taxpayer could treat two of those units (e.g., units A and C) as an undertaking and the remaining unit as a separate undertaking, or could treat units A, B, and C as a single undertaking.

(iii) Paragraph (k)(2)(i) of this section permits a taxpayer to treat two or more rental real estate undertakings as a single activity, or to treat such undertakings as separate activities. Thus, the taxpayer, by combining undertakings, can treat all five units as a single activity. Alternatively, the taxpayer could treat each undertaking as a separate activity, or could combine some, but not all, undertakings. Thus, for example, the taxpayer could treat units A, B, C, and D as an activity and unit E as a separate activity.

(iv) For purposes of paragraph (k)(2)(i) of this section, a taxpayer's rental real estate undertakings are determined after the application of paragraph (k)(2)(iii) of this section. Thus, the taxpayer, by treating units as separate undertakings under paragraph (k)(2)(iii) of this section and combining them with other units under paragraph (k)(2)(i) of this section, can treat any combination of units as a single activity. For example, the taxpayer could treat units A and B as a separate rental real estate undertaking, and then treat units A, B, and D as a single activity. In that case, the taxpayer could treat units C and E either as a single activity or as two separate activities.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer treats all five units as a single activity for 1989 and sells unit E in 1990. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the taxpayer's return.)

(ii) Under paragraph (k)(3) of this section, rental real estate undertakings that are treated as part of the same activity for a taxable year must be treated as part of the same activity in each succeeding year. In this case, all five units were treated as part of the same activity for 1989 and must therefore be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g) and the rules to be contained in §1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (3). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that is the direct owner of the five condominium units. In its return for its taxable year ending on November 30, 1989, the partnership treats the five units as a single activity. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the partnership's return.) The partnership sells unit E on November 1, 1990.

(ii) Paragraph (k)(2)(ii) of this section provides that a taxpayer who holds rental real estate undertakings through a passthrough entity must treat those undertakings as a single rental real estate undertaking if they are treated as a single activity on the applicable return of the passthrough entity. Under paragraph (k)(4) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the five condominium units as a single rental real estate undertaking (and thus as part of the same activity) for 1989 because they are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (k)(3) of this section, the taxpayer must continue treating the condominium units as part of the same activity for taxable years after 1989. Accordingly, as in example (2), the five condominium units are treated as part of the same activity for 1990, and the sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's interest in an activity for purposes of section 469(g) and the rules to be contained in §1.469-6T.

Example (4). (i) The taxpayer owns a shopping center and a vacant lot that are separate rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section). The taxpayer rents space in the shopping center to various tenants and rents the vacant lot to a parking lot operator. Most of the unadjusted basis of the property used in the shopping-center undertaking (taking into account the land on which the shopping center is built) is subject to the allowance for depreciation, but no depreciable property is used in the parking-lot undertaking.

(ii) This paragraph (k) provides rules for identifying rental real estate activities (including the rule in paragraph (k)(2)(i) of this section that permits a taxpayer to treat two or more rental real estate undertakings as a single activity). Paragraph

(k)(6) of this section provides, however, that these rules do not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Thus, the taxpayer may not combine the parking-lot undertaking, which includes no depreciable property, with the shopping-center undertaking or any other rental real estate undertaking under paragraph (k)(2)(i) of this section. Accordingly, the parking lot undertaking is treated as a separate activity under paragraph (b)(1) of this section.

Example (5). (i) The facts are the same as in example (4), except that the shopping center and the vacant lot are at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are part of the same rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Taking into account the property used in the shopping center operations (including the land on which the shopping center is built) and the vacant lot, 50 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation.

(ii) In this case, the vacant lot is used in a rental real estate undertaking in which depreciable property is also used. Moreover, the exception in paragraph (k)(6) of this section does not apply to the undertaking consisting of the shopping center and the parking lot because at least 30 percent of unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Accordingly, the taxpayer may combine the undertaking with other rental real estate undertakings and treat the combined undertakings as a single activity under paragraph (k)(2)(i) of this section.

(l) [Reserved.]

(m) Consolidated groups-(1) In general. The activities of a consolidated group (within the meaning of §1.469-1T(h)(2)(ii)) and of each member of such group shall be determined under this section as if the consolidated group were one taxpayer.

(2) Examples. The following examples illustrate the application of this paragraph (m). In each example, the facts, analysis, and conclusions relate to a single taxable year.

Example (1). (i) Corporations M, N, and O are the members of a consolidated group (within the meaning of §1.469-1T(h)(2)(ii)). Under §1.469-1T(h)(4)(i)(A) and (ii), the consolidated group and its members are treated as closely held corporations (within the meaning of §1.469-1T(g)(2)(ii)). Each member of the consolidated group owns a two-percent interest in partnership X and a two-percent interest in partnership Y, and owns interests in a number of trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) through the partnerships. Each of these undertakings is directly owned by partnership X or Y, and all the undertakings of partnerships X and Y are controlled by the same interests (within the meaning of paragraph (j) of this section) and are similar (within the meaning of paragraph (f)(4) of this section). The employees of the consolidated group and the shareholders of its common parent do not participate in the undertakings that the member corporations own through the partnerships.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same

activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the member corporations own interests in similar, commonly-controlled undertakings through both partnerships, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Accordingly, the member corporations' interests in the undertakings owned through partnership X are treated as part of the same activity of the consolidated group, and their interests in the undertakings owned through partnership Y are treated similarly.

Example (2). (i) The facts are the same as in example (1), except that each member of the consolidated group owns a five-percent interest in partnership X and a five-percent interest in partnership Y.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the member corporations own, in the aggregate, a 15-percent interest in partnership X and a 15-percent interest in partnership Y, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Thus, the consolidated group owns a substantial indirect interest in the similar, commonly-controlled undertakings owned by partnerships X and Y (see paragraph (f)(3)(i) of this section). Accordingly, the member corporations' interests in the undertakings owned through partnerships X and Y are treated as part of the same activity of the consolidated group.

(n) Publicly traded partnerships. The rules of this section shall apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership (within the meaning of section 469(k)(2)) as if the taxpayer had no interest in any other business and rental operations. The following example illustrates the application of this paragraph (n):

Example. (i) The taxpayer, an individual, owns a 20-percent interest in partnership X and a 15-percent interest in partnership Y. Partnership X directly owns a hotel ("hotel 1") and a commercial office building ("building 1"). Partnership Y directly owns two hotels ("hotels 2 and 3") and two commercial office buildings ("buildings 2 and 3"). Each of the three hotels is a separate trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section), and each of the three office buildings is a separate rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). The three hotel undertakings are similar (within the meaning of paragraph (f)(4) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership X is not a publicly traded partnership (within the meaning of section 469(k)(2)). Partnership Y, however, is a publicly traded partnership and is not treated as a corporation under section 7704.

(ii) This paragraph (n) provides that the rules of this section apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership as if the taxpayer had no interest in any other business and rental operations. Thus, undertakings owned through partnership Y may be treated as part of the same activity under the rules of this section, but an undertaking owned through partnership Y and an undertaking that is not owned through partnership Y may not be treated as part of the same activity.

(iii) Paragraph (f)(2)(i) of this section provides that a taxpayer's interests in two or more trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity if the taxpayer owns interests in each undertaking through the same passthrough entity. Partnership Y's hotel undertakings (i.e., hotels 2 and 3) are similar and are controlled by the same interests. In addition, the taxpayer owns interests in both undertakings through the same partnership. Accordingly, the taxpayer's interests in partnership Y's hotel undertakings are treated as part of the same activity.

(iv) The hotel undertaking owned through partnership X (i.e., hotel 1) and the hotel undertakings owned through partnership Y are similar and controlled by the same interests, and the taxpayer owns a substantial indirect interest in each of the undertakings (see paragraph (f)(3)(i) of this section). Thus, the three undertakings would ordinarily be treated as part of the same activity under paragraph (f)(2)(ii) of this section. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the hotel undertaking that the taxpayer owns through partnership X and the hotel undertakings that the taxpayer owns through partnership Y are treated as two separate activities.

(v) Paragraph (k)(2)(i) of this section provides that, with certain exceptions, a taxpayer may treat two or more rental real estate undertakings as a single activity or as separate activities. Thus, the taxpayer's interests in the rental real estate undertakings owned through partnership Y (i.e., buildings 2 and 3) may be treated as a single activity or as separate activities. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the taxpayer's interest in the rental real estate undertaking owned through partnership X (building 1) cannot be treated as part of an activity that includes any rental real estate undertaking owned through partnership Y.

(o) Elective treatment of undertakings as separate activities-(1) Applicability. This paragraph applies to a taxpayer's interest in any undertaking (other than a rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section)) that would otherwise be treated under this section as part of an activity that includes the taxpayer's interest in any other undertaking.

(2) Undertakings treated as separate activities. Except as otherwise provided in this paragraph (o), a person (including a passthrough entity) shall treat an undertaking to which this paragraph (o) applies as an activity separate from the remainder of the activity in which such undertaking would otherwise be included for a taxable year if and only if, for such taxable year or any preceding taxable year, such person made an election with respect to such undertaking under this paragraph (o).

(3) Multiple undertakings treated as a single activity by passthrough entity. A person (including a passthrough entity) must treat interests in two or more undertakings as part of the same activity for a taxable year if any passthrough entity through which the person holds such undertakings treats such undertakings as part of the same activity on the applicable return of the passthrough entity for the taxable year of such person.

(4) Multiple undertakings treated as a single activity for a preceding taxable year. If a person (including a passthrough entity) treats undertakings as part of the same activity on such person's return for a taxable year ending after August 9, 1989, such person may not treat such undertakings as part of different activities under this paragraph (o) for any subsequent taxable year.

(5) Applicable return of passthrough entity. For purposes of this paragraph (o), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(6) Participation. The following rules apply to multiple activities (the "separate activities") that would be treated as a single activity (the "briginal activity") if the taxpayer's activities were determined without regard to this paragraph (o):

(i) The taxpayer shall be treated as materially participating (within the meaning of §1.469-5T) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as materially participating for the taxable year in the original activity.

(ii) The taxpayer shall be treated as significantly participating (within the meaning of §1.469-5T(c)(2)) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as significantly participating for the taxable year in the original activity.

(7) Election-(i) In general. A person makes an election with respect to an undertaking under this paragraph (o) by attaching the written statement described in paragraph (o)(7)(ii) of this section to such person's return for the taxable year for which the election is made (see paragraph (o)(2) of this section).

(ii) Written statement. The written statement required by paragraph (o)(7)(i) of this section must-

(A) State the name, address, and taxpayer identification number of the person making the election;

(B) Contain a declaration that an election is being made under §1.469-4T(o);

(C) Identify the undertaking with respect to which such election is being made; and

(D) Identify the remainder of the activity in which such undertaking would otherwise be included.

(8) Examples. The following examples illustrate the application of this paragraph (o):

Example (1). (i) During 1989, the taxpayer, an individual whose taxable year is the calendar year, acquires and is the direct owner of ten grocery stores. The operations of each grocery store are treated under paragraph (c)(1) of this section as a single undertaking that is separate from other undertakings (a "grocery-store undertaking"), and the taxpayer's interests in the grocery-store undertakings would

be treated as part of the same activity of the taxpayer under paragraph (f)(2) of this section.

(ii) Paragraph (o)(2) of this section provides that, with certain exceptions, undertakings that would be treated as part of the same activity under other rules in this section may, at the election of the taxpayer, be treated as separate activities. Thus, the taxpayer may elect to treat each grocery-store undertaking as a separate activity for 1989. Alternatively, the taxpayer may combine grocery-store undertakings in any manner and treat each combination of undertakings (and each uncombined undertaking) as a separate activity for 1989. In either case, the election must be made by attaching the written statement described in paragraph (o)(7)(ii) of this section to the taxpayer's 1989 return.

Example (2). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity and participates for 15 hours in each of the grocery-store undertakings.

(ii) The taxpayer's interest in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989 (a "grocery-store activity"). In 1989, however, the taxpayer participates for more than 100 hours in the activity in which the undertakings would be included (but for the election to treat the grocery-store undertakings as separate activities) and would be treated under §1.469-5T(c)(2) as significantly participating in such activity. Accordingly, the taxpayer is treated under paragraph (o)(6)(ii) of this section as significantly participating in each of the grocery-store activities for 1989.

Example (3). (i) The facts are the same as in example (1). In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity. The taxpayer does not participate in any of the grocery-store undertakings in 1989 or 1990, and sells one of the grocery stores in 1990.

(ii) As in example (2), the taxpayer's interests in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989. Because the taxpayer elected to treat the undertakings as separate activities for a preceding taxable year (1989), each grocery-store undertaking is also treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1990. In addition, each of the taxpayer's grocery-store activities is a passive activity for 1989 and 1990 because the taxpayer does not participate in any of the grocery store undertakings for 1989 and 1990. Accordingly, the taxpayer's sale of the grocery store will generally be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469-6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example (4). (i) The facts are the same as in example (3), except that the taxpayer elects to treat the grocery-store undertakings as two separate activities. One of the activities includes three grocery-store undertakings, and the store sold in 1990 is part of this activity. The other activity includes the seven remaining grocery-store undertakings.

(ii) Paragraph (o)(4) of this section provides that a person who treats undertakings as part of the same activity for a taxable year ending after August 9, 1989, may not

elect to treat those undertakings as separate activities for a subsequent taxable year. The grocery store sold in 1990 was treated for 1989 as part of an activity that includes two other grocery stores. Thus, those three stores must be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of the grocery store cannot be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469-6T.

Example (5). (i) The facts are the same as in example (1), except that the taxpayer is a partner in a partnership that acquires and is the direct owner of the ten grocery stores. The taxable year of the partnership ends on November 30, and the partnership acquires the grocery stores in its taxable year ending on November 30, 1989. In its return for that taxable year, the partnership treats the grocery-store undertakings as a single activity.

(ii) Paragraph (o)(3) of this section provides that a person who holds undertakings through a passthrough entity may not elect to treat those undertakings as separate activities if they are treated as part of the same activity on the applicable return of the passthrough entity. Under paragraph (o)(5) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the grocery-store undertakings as a single activity for 1989 because those undertakings are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (o)(4) of this section, the taxpayer must continue treating the grocery-store undertakings as part of the same activity for taxable years after 1989. This rule applies even if the partnership subsequently distributes its interest in the grocery stores to the taxpayer, and the taxpayer becomes the direct owner of the grocery-store undertakings.

(p) Special rule for taxable years ending before August 10, 1989-(1) In general. For purposes of applying section 469 and the regulations thereunder for a taxable year ending before August 10, 1989, a taxpayer's business and rental operations may be organized into activities under the rules or paragraphs (b) through (n) of this section or under any other reasonable method. For example, for such taxable years a taxpayer may treat each of the taxpayer's undertakings as a separate activity, or a taxpayer may treat undertakings that involve the provision of similar goods or services as a single activity.

(2) Unreasonable methods. A method of organizing business and rental operations into activities is not reasonable if such method-

(i) Treats rental operations (within the meaning of paragraph (d)(3) of this section) that are not ancillary to a trade or business activity (within the meaning of §1.469-1T(e)(2)) as part of a trade or business activity;

(ii) Treats operations that are not rental operations and are not ancillary to a rental activity (within the meaning of §1.469-1T(e)(3)) as part of a rental activity;

(iii) Includes in a passive activity of a taxpayer any oil or gas well that would be treated, under paragraph (e)(1) of this section, as a separate undertaking in determining the taxpayer's activities;

(iv) Includes in a passive activity of a taxpayer any interest in a dwelling unit that would be treated, under paragraph (K)(7) of this section, as a separate activity of the taxpayer; or

(v) Is inconsistent with the taxpayer's method of organizing business and rental operations into activities for the taxpayer's first taxable year beginning after December 31, 1986.

(3) Allocation of dissallowed deductions in succeeding taxable year. If any of the taxpayer's passive activity deductions or the taxpayer's credits from passive activities are disallowed under §1.469-1T for the last taxable year of the taxpayer ending before August 10, 1989, such disallowed deductions or credits shall be allocated among the taxpayer's activities for the first taxable year of the taxpayer ending after August 9, 1989, using any reasonable method. See §1.469-1T(f)(4).

§1.469-5T [Amended]

Par. 7. Section 1.469-5T is amended as follows:

1. Paragraph (f)(1) is amended by removing the parenthetical phrase "(directly or indirectly, other than through a C corporation)".

2. Paragraph (h) is amended by adding the following new paragraph (h)(3):

(h)

(3) Coordination with rules governing the treatment of passthrough entities. If a taxpayer takes into account for a taxable year of such taxpayer any item of gross income or deduction from a partnership or S corporation that is characterized as an item of gross income or deduction from an activity in which the taxpayer materially participated under §1.469-2T(e)(1), such taxpayer shall be treated as materially participating in such activity for such taxable year for purposes of applying paragraph (a)(5) and (6) of this section to any succeeding taxable year of such taxpayer.

3. Paragraph (j) is amended by redesignating paragraph (j) (including its heading) as paragraph (j)(2) and adding the following new heading and paragraph (j)(1):

(j) Material participation for preceding taxable years-(1) In general. For purposes of paragraph (a)(5) and (6) of this section, a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated (determined without regard to paragraph (a)(5) of this section) for such preceding taxable year

4. Paragraph (k), Example (5), is amended by removing "1999" and adding in its place "2000" wherever the former occurs.

Par. 8. Section 1.469-11T is amended as follows:

1. Paragraph (c)(2)(i) is revised.

2. Paragraph (c)(3)(i)(A) is revised.

3. Paragraph (c)(3)(ii) is revised.

4. The examples in paragraph (c)(4) are revised.

5. In paragraph (c)(5)(i), the introductory text is revised.

6. The first four examples in paragraph (c)(5)(iii) are revised.

7. The revised provisions read as follows:

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

(c)

(2) Qualified interest-(1) In general. For purposes of this paragraph (c), a taxpayer's interest in an undertaking (the "current-year undertaking") shall be treated as a qualified interest in the activity in which such undertaking is included for the taxable year if and only if the current-year undertaking continues business and rental operations of an undertaking that was-

(A) Held by the taxpayer on October 22, 1986, and at all times thereafter; 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 (see paragraph (c)(7) of this section) on October 22, 1986, and held by the taxpayer at all times after such acquisition.

(3)

(1)

(A) Any of the business and rental operations that are part of such activity continue business and rental operations that were being conducted by any person on October 22, 1986; or

(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 continues business and rental operations that would have been part of a passive activity of the taxpayer for any taxable year beginning before January 1, 1987, had section 469 and the regulations been in effect for such year.

(4)

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 (within the

meaning of §1.469-1T(e)(3)). 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 rental activity does not continue business and rental operations of any undertaking in which the taxpayer held an interest on October 22, 1986, because the taxpayer did not hold the property in an activity on that date. In addition, the taxpayer did not acquire an interest in an undertaking involving such operations pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. 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 preenactment interest in the rental activity.

Example (2). The taxpayer owns an interest in a partnership, which owns property used in a rental activity (within the meaning of §1.469-1T(e)(3)). The taxpayer acquired the partnership interest pursuant to a written bidding 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 rental activity is a qualified interest (within the meaning of paragraph (c)(2) of this section) because the taxpayer's interest in the rental property (i.e., in undertakings involving business and rental operations that are continued in the rental activity) was acquired after October 22, 1986, pursuant to written binding contracts to which the taxpayer was a party on that date. Because the property used in the rental activity was under construction on August 16, 1986, the rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Accordingly, the taxpayer's interest in the 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 rental activity is not a pre-enactment interest because the taxpayer's interest in the rental property 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 that continues business and rental operations that were conducted by the taxpayer on October 22, 1986. After that date, the taxpayer died, and the decedent's interest in the activity passed to the decedent's estate. Because 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 decedent 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). Because, however, the activity does not continue the business and rental operations of an undertaking that the estate held on October 22, 1986, or acquired pursuant to a written binding contract, the estate does not have a qualified interest in the activity (within the meaning of paragraph (c)(2) of this section).

(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 an interest in 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 a pre-enactment interest in such activity shall be determined by taking into account-

(iii)

Example (1). A taxpayer owns interests in a pre-enactment activity through an S corporation. On October 22, 1986, the taxpayer owned a 10-percent interest in the S corporation. After October 22, 1986, the taxpayer acquires an additional 5-percent interest in the S corporation pursuant to a contract entered into after October 22, 1986. Under this paragraph (c)(5), only items from the 10-percent interest that the taxpayer owned on October 22, 1986, are attributable to the taxpayer's pre-enactment interest in the activity.

Example (2). On October 22, 1986, individuals A and B each owned a rental property. After October 22, 1986, A and B contribute their rental properties 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 share of each partnership item attributable to the rental property contributed by A is attributable to a pre-enactment interest. None of A's share of the partnership items attributable to the rental property 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 property 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 share of each partnership item attributable to the rental property 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 property contributed by A to the partnership. Under paragraph (c)(5)(i) of this section, only 80 percent of A's income, gain, loss, deductions, and credits from the property for 1988 and subsequent years is attributable to a pre-enactment interest.

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority for Part 602 continues to read as follows:

Authority:

26 U.S.C. 7805.

§602.101 [Amended]

Par. 10. Section 602.101(c) is amended by inserting in the appropriate places in the table "§1.469-4T(k) 1545-1037" and "§1.469-4T(o) 1545-1037".

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable 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.

March 20, 1989.

Dennis Earl Ross,

Acting Assistant Secretary of the Treasury.