

Treasury Decision 8417, 26 CFR, IRC Sec(s). 42

May 15, 1992

AGENCY:

Internal Revenue Service, Treasury.

ACTION:

Final and temporary regulations.

SUMMARY:

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

EFFECTIVE DATES:

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

FOR FURTHER INFORMATION CONTACT:

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

Background

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

reserves the corresponding temporary regulations and provides in the temporary regulations cross-references to the final regulations as appropriate.

Explanation of Provisions

In General

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

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

Effective Dates

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

Special Analyses

These final regulations are not major rules as defined in Executive Order 12291. Therefore, a regulatory Impact Analysis is not required. It is hereby certified that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that these rules do not have a significant impact on a substantial number of small entities. Therefore, a final Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comments on their impact on small businesses.

Drafting Information

The principal author of these regulations is Donna J. Welch, 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 their development.

Adoption of Amendments to the Regulations.

Accordingly, title 26, chapter 1, part 1 is amended as follows:

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

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "§§1.469-1T, 1.469-2T, 1.469-3T, 1.469-5T and 1.469-11T" and adding the following citations:

Authority:

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

§1.469-0T (Removed)

Par. 2. Section 1.469-0T is removed.

Par. 2a. Section 1.469-0 is added to read as follows:

§1.469-0 Table of contents.

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

Section 1.469-1 General rules.

(a) through (d)(1) (Reserved).

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

(d)(3) through (e)(1) (Reserved).

(2) Trade or business activity.

(e)(3)(i) through (e)(3)(ii) (Reserved).

(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.

(e)(3)(iv) through (e)(3)(vi)(C) (Reserved).

(D) Lodging rented for convenience of employer.

(E) Unadjusted basis.

(e)(3)(vii) through (e)(4)(iii) (Reserved).

(iv) Definition of "working interest."

(e)(4)(v) through (vi) (Reserved).

(5) Rental of dwelling unit.

(e)(6) through (f)(3)(iii) (Reserved).

(4) Carryover of disallowed deductions and credits.

(i) In general.

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

(iii) Examples

(g)(1) through (g)(4)(ii)(B) (Reserved).

(g)(4)(ii)(C) (no paragraph heading).

(g)(5) through (h)(3) (Reserved).

(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.

(h)(5) through (k) (Reserved).

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 date and transition rules.
 - (12) Future regulations.
- (d) Effect of section 469 and the regulations thereunder for other purposes.
 - (1) Treatment of items of passive activity income and gain.
 - (2) Coordination with sections 613A(d) and 1211 (Reserved).
 - (3) Treatment of passive activity losses.
- (e) Definition of "passive activity".
 - (1) In general.
 - (2) Trade or business activity (Reserved).
 - (3) Rental Activity.
- (i) In general.

- (ii) Exceptions.
 - (iii) Average period of customer use (Reserved).
 - (A) In general (Reserved).
 - (B) Average use factor (Reserved).
 - (C) Average period of customer use for class of property (Reserved).
 - (D) Period of Customer use (Reserved).
 - (E) Class of property (Reserved).
 - (F) Gross rental income and daily rent (Reserved).
 - (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 (Reserved).
 - (E) Unadjusted basis (Reserved).
 - (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 rules 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" (Reserved).

(v) Entities that limit liability.

(A) General rule.

(B) Other limitations disregarded.

(C) Examples.

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

(5) Rental of dwelling unit (Reserved).

(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 deductions.

(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 (Reserved).
 - (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 (Reserved).

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

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

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

(i) Identification of disallowed deductions.

(ii) Ratable portion of disallowed passive activity losses.

(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 recharacterization items treated as portfolio items.
- (E) Property involved in deferred intercompany transactions.
- (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 returns.
 - (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 1.469-2 Passive activity loss.

- (a) through (c)(2)(ii) (Reserved).
- (iii) Disposition of substantially appreciated property formerly used in a nonpassive activity.

(d)(2)(x) through (d)(2)(xi) (Reserved).

(d)(2)(xii) (no paragraph heading).

(d)(3) through (d)(5)(ii) (Reserved).

(d)(5)(iii)(A) Applicability of rules in §1.469-2T(c)(2).

(d)(5)(iii)(B) through (d)(6)(v)(D) (Reserved).

(d)(6)(v)(E) (no paragraph heading).

(d)(6)(v)(F) through (d)(7) (Reserved).

(8) Taxable year in which item arises.

(e)(1) through (e)(2)(i) (Reserved).

(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).

(e)(3)(i) through (iii)(A) (Reserved).

(e)(3)(iii)(B) (no paragraph heading).

(e)(3)(iii)(C) through (f)(4) (Reserved).

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

(i) In general.

(f)(5)(ii)(B) through (f)(5)(iv) (Reserved).

(6) Property rented to a nonpassive activity.

(f)(7) through (f)(9)(ii) (Reserved).

(f)(9)(iii) through (f)(9)(iv) (no paragraph heading).

(10) Coordination with section 163(d).

(f)(11) (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 reference.

(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 of gain.

(B) Dispositions of partnership interest 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 used in nonpassive activity (Reserved).

(A) In general (Reserved).

(B) Date of disposition (Reserved).

(C) Substantially appreciated property (Reserved).

(D) Investment property (Reserved).

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

(F) Coordination with section 163(d) (Reserved).

(G) Examples (Reserved).

(iv) Taxable acquisitions (Reserved).

- (v) Property held for sale to customers (Reserved).
- (A) Sale incidental to another activity (Reserved).
- (1) Applicability (Reserved).
 - (i) In general (Reserved).
 - (ii) Principal purpose (Reserved).
- (2) Dealing activity not taken into account (Reserved).
- (B) Use in a nondealing activity incidental to sale (Reserved).
- (C) Examples (Reserved).
- (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 adjustments.
- (i) In general.
 - (ii) Positive section 481 adjustments.
 - (iii) Ratable portion.
- (6) Gross income from certain oil or gas properties (Reserved).
- (i) In general (Reserved).
 - (ii) Gross and net passive income from the properties (Reserved).
 - (iii) Property (Reserved).
 - (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 or rules in paragraph (c)(2).
 - (B) Dispositions of partnership interest 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 limitations.
- (iv) Coordination of basis and at-risk limitations.
- (v) Separately identified items of deduction and loss.
- (7) Deductions from section 481 adjustment.

- (i) In general.
- (ii) Negative section 481 adjustment.
- (iii) Ratable portion.
- (8) Taxable year in which item arises.
- (e) Special rules for partners and S corporation shareholders.

- (1) In general.
- (2) Payments under 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 of a partnership property.
- (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 portions.

- (1) Disposition on which gain is recognized.
- (2) Disposition on which loss is recognized.
- (C) Default rule.
- (D) Special rules.
 - (1) Applicable valuation date.
 - (i) In general.
 - (ii) Exception.
 - (2) Basis adjustment.
 - (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 (Reserved).

(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 of a passthrough entity engaged in the trade or business of licensing intangible property.

(i) In general.

(ii) Royalty income from property.

(iii) Exceptions.

(iv) Capital expenditures.

(v) Example.

(8) Limitation on recharacterized income.

(9) Meaning of certain terms.

(10) Coordination with section 163(d).

(11) Effective date.

Section 1.469-3 Passive activity credit.

(a) through (d) (Reserved).

(e) Coordination with section 38(b).

(f) Coordination with section 50.

(g) (Reserved).

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

(a) Computation of passive activity credit.

(b) Credits subject to section 469.

(1) In general.

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

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

(4) Exception for pre-1987 credits.

(c) Taxable year to which credit is attributable.

(d) Regular tax liability allocable to passive activities.

(1) In general.

(2) Regular tax liability.

(e) Coordination with section 38(b) (Reserved).

(f) Coordination with section 47 (Reserved).

(g) Examples.

Section 1.469-4 Definition of activity. (Reserved)

Section 1.469-5 Material participation.

(a) through (e) (Reserved).

(f) Participation.

(1) In general.

(f)(2) through (h)(2) (Reserved).

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

(i) (Reserved).

(j) Material participation for preceding taxable years.

(1) In general.

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

(k) Examples (1) through (4) (Reserved).

(k) Example (5).

(k) Examples (6) through (8) (Reserved).

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 (Reserved).
 - (1) In general (Reserved).
 - (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 spouses.
 - (4) Methods of proof.
 - (g) Material participation of trust 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 passthroughs entities (Reserved).
 - (i) (Reserved).
 - (j) Material participation for preceding taxable years (Reserved).
 - (1) In general (Reserved).
 - (2) Material participation for taxable years beginning before January 1, 1987 (Reserved).

(k) Examples.

Section 1.469-6 Treatment of losses upon certain dispositions. (Reserved)

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

Section 1.469-8 Application of section 469 to trust, estates, and their beneficiaries. (Reserved)

Section 1.469-9 Treatment of income, deductions and credits from certain rental real estate activities.

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

Section 1.469-11 Effective date and transition rules.

(a) Generally applicable effective dates.

(b) Additional effective dates.

(1) Transition rule for 1992 amendments.

(2) Certain investment credit property.

(c) Special rules.

(1) Applicability of certain income recharacterization rules.

(i) in general.

(ii) Property rented to a nonpassive activity.

(2) Qualified low-income housing projects.

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

(d) Examples.

Par. 3. Section 1.469-1 is added to read as follows:

§1.469-1 General rules.

(a) through (d)(1). (Reserved)

(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. The following example illustrates the application of this paragraph (d)(2):

Example. In 1993, an individual derives \$10,000 of ordinary income from passive activity X, no gains from the sale or exchange of capital assets or assets used in a trade or business, \$12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of §1.469-2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed \$10,000 of the \$12,000 passive activity deduction and has a \$2,000 passive activity loss for the taxable year. Since the \$10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed \$3,000 of the \$10,000 capital loss under section 1211 and has a \$7,000 capital loss carryover (within the meaning of section 1212(b)) to the succeeding taxable year.

(d)(3) through (e)(1). (Reserved).

(e)(2) Trade or business activities. Trade or business activities are activities that constitute trade or business activities within the meaning of §1.469-4(b)(1).

(e)(3)(i) through (e)(3)(ii) (Reserved)

(e)(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 that class of property multiplied by the fraction obtained by dividing-

(1) The activity's gross rental income attributable to that 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 the class (taking into account only periods that end during the taxable year or that include the last day of the taxable year); by

(2) The number of those 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 the 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 amount of 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 the 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 the taxable year taking into account only income that is attributable to amounts paid for the use of property in that 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 those items of property.

(e)(3)(iv) through (e)(3)(vi)(C) (Reserved)

(e)(3)(vi)(D) Lodging rented for convenience of employer. The provision of lodging to an employee or to an employee's spouse or dependents is treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if the lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

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

(e)(3)(vii) through (e)(4)(iii) (Reserved)

(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)).

(e)(4)(v) through (f)(3) (Reserved)

(f)(4) Carryover of disallowed deductions and credits-

(i) In general. In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under §1.469-1T (f)(2) or (f)(3) (the loss activity)-

(A) The disallowed deductions or credits is allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues 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 the activity for the succeeding taxable year.

(ii) Business continued through C corporations or similar entities. If a taxpayer continues part or all of a loss activity through a C corporation or similar entity (C corporation entity), the taxpayer's interest in the C corporation entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues that loss activity in whole or part. 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 the interests.

(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 §1.469-4 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 §1.469-1T(f)(2) for 1993. Under §1.469-1T(f)(2), the \$5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1993, and the \$3,000 loss from the apartment-building activity is treated similarly.

(ii) In 1994, the convenience store is continued in a single activity, and the section 469 activities that constituted the apartment building is similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1994. Similarly, the disallowed deductions from the apartment-building activity for 1993 must be allocated to the taxpayer's apartment-building activity in 1994. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the convenience-store activity in 1994 are treated as deductions from that activity for 1994, and the disallowed deductions allocated to the apartment-building activity for 1994 are treated as deductions from the apartment-building activity for 1994.

Example 2. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under §1.469-4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A \$10,000 loss from the activity is disallowed under §1.469-1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under §1.469-4 as interests in two separate passive activities of the taxpayer.

(ii) Under §1.469-1T(f)(2), the \$10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1994. In 1995, the businesses that constituted the restaurant and catering activity are continued, but are treated as two separate activities under §1.469-4. Thus, the disallowed deductions from the restaurant and catering activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section between the restaurant activity and the catering activity in 1995 in a manner that reasonably reflects the

extent to which each of the activities continues the single restaurant and catering activity. Under paragraph (f) (4) (i) (B) of this section, the disallowed deductions allocated to the restaurant activity in 1995 are treated as deductions from the restaurant activity for 1995, and the disallowed deductions allocated to the catering activity in 1995 are treated as deductions from the catering activity for 1995.

Example 3. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under §1.469-4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A \$10,000 loss from the activity is disallowed under §1.469-1T(f) (2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under §1.469-4 as interests in two separate passive activities of the taxpayer. In addition, a \$20,000 loss from the activity was disallowed under §1.469-1T(f) (2) for 1993, and the gross income and deductions (including deductions that were disallowed for 1993 under §1.469-1T(f) (2)) from the restaurant and catering business for 1993 and 1994 are as follows: ----

		Restaurant	
Catering business -----			
---- 1993: Gross income	\$20,000	\$60,000	
Deductions	40,000	60,000	Net income (loss)
..... (20,000) -----			
..... 40,000	50,000		1994: Gross income
30,000	[FN2] 70,000		Deductions
..... (20,000) -----			[FN1]
			Net income (loss)
			10,000

----- 1 Includes \$8,000 of deductions that were disallowed for 1993 (\$20,000 x \$40,000/\$100,000). 2 Includes \$12,000 of deductions that were disallowed for 1993 (\$20,000 x \$60,000/\$100,000).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering activity must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which those activities continue the restaurant and catering activity. 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. 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 to the restaurant activity and disallowed deductions from the catering business to the catering activity would satisfy the requirement of paragraph (f) (4) (i) (A) of this section. Under §1.469-1T (f) (2) (ii), a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1994. Thus, \$3,000 of the 1994 deductions from the restaurant are disallowed ($\$10,000 \times \$30,000/\$100,000$), and \$7,000 of the 1994 deductions from the catering business are disallowed ($\$10,000 \times \$70,000/\$100,000$). Thus, the taxpayer can ordinarily treat \$3,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and \$7,000 of the disallowed deductions and deductions from the catering activity for 1995.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 would also satisfy the requirement of paragraph (f) (4) (i) (A) of this section. If the restaurant and the catering business had been treated as

separate activities in 1994, 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 1995.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 (determined as if the restaurant and the catering business 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 and the catering business had been treated as separate activities for all taxable years, the entire \$20,000 loss from the restaurant in 1993 would have been allocated to the restaurant activity in 1994, and the gross income and deductions from the separate activities for 1994 would be as follows:

					Restaurant
Catering business					Catering business
.....	\$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 1995, and \$8,000 of the disallowed deductions as deductions from the catering activity for 1995.

Example 4. (i) The taxpayer is a partner in a law partnership that acquires a building in December 1993 for use in the partnership's law practice. In taxable year 1993, four floors that are not needed in the law practice are leased to tenants; in taxable year 1994, two floors are leased to tenants; in taxable years after 1994, only one floor is leased to tenants and the rental operations are insubstantial. Assume that under §1.469-4, the law practice and the rental property are treated as a trade or business activity and a separate rental activity for taxable years 1993 and 1994. Assume further that the law practice and the rental operations are a single trade or business activity for taxable years after 1994 under §1.469-4. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a passive activity. Under §1.469-T(f)(2), a \$12,000 loss from the rental activity is disallowed for 1993 and a \$9,000 loss from the rental activity is disallowed for 1994.

(ii) Under §1.469-1T(f)(2), the \$12,000 loss from the rental activity for 1993 is allocated among the passive activity deductions from that activity for 1993. In 1994, the business of the rental activity is continued in two separate activities. Only two floors of the building remain in the rental activity, and the other two floors (i.e., the floors that were leased to tenants in 1993, but not in 1994) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1993 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 extent to which each of the activities continues business on the four floors that were leased to tenants in 1993. 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 to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1994 are treated as deductions from the rental activity for 1994, and the disallowed deductions (\$6,000)

allocated to the law-practice activity in 1994 are treated as deductions from the law-practice activity for 1994.

(iii) Under §1.469-1T(f)(2), the \$9,000 loss from the rental activity for 1994 is allocated among the passive activity deductions from that activity for 1994. In 1995, the rental activity is continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1994 must be allocated under paragraph (f)(4)(ii) of this section to the taxpayer's law-practice activity in 1995. 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 1995.

(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 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, 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 §1.469-1T(f)(2) of this section.

(ii) Under §1.469-1T(f)(2), the taxpayer's \$5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1993. In 1994, the rental activity is continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii) of this section as a passive activity that continues the rental activity (the C corporation activity) for purposes of allocating the previously disallowed loss. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1994, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1994.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the business 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 1994 is \$5,000.

Example 6. (i)(i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, 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 §1.469-1T(f)(2). The taxpayer has \$2,000 in income from other passive activities for 1994, and as a result, only 60% of the taxpayer's loss from the C corporation activity (\$3,000) is disallowed for 1994 under §1.469-1T(f)(2).

(ii) Under §1.469-1T(f)(2), the \$3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1994. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1993 is again disallowed for 1994.

(iii) Under paragraph (f)(4) of this section, the taxpayer's interest in the C corporation is treated as a loss activity and as an interest in a passive activity that continues the business of that loss activity for 1995. Thus, the disallowed deductions from the C corporation activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1995, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1995.

(g)(1) through (g)(4)(ii)(B) (Reserved)

(g)(4)(ii)(C) Portfolio income (within the meaning of §1.469-2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (See, e.g., §1.469-2(c)(2)(iii)(F) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and §1.469-2(f)(10) (relating to certain recharacterized passive activity gross income))

(g)(5) through (h)(3) (Reserved)

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

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

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

(ii) Determination of status and participation of consolidated group. For purposes of determining under §1.469-1T(g)(2) whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under §1.469-1T(g)(3) whether the consolidated group materially or significantly participates in any activity conducted by one or more members of the group-

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

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

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

(D) An activity is treated as the principal activity of the corporation if and only if it is the principal activity (within the meaning of §1.441-4T(f)) of the consolidated group.

(h)(5) through (k) (Reserved)

Par. 4. Section 1.469-1T is amended by revising paragraphs (d)(2), (e)(2), (e)(3)(iii), (e)(3)(vi)(D) and (E), (e)(4)(iv), (e)(5), (f)(4), (g)(4)(ii)(C), and (h)(4) to read as follows:

§1.469-1T General rules.

(d)

(2) Coordination with sections 613A(d) and 1211. (Reserved) See §1.469-1(d)(2) for rules relating to this paragraph.

(e)

(2) Trade or business activity. (Reserved) See §1.469-1(e)(2) for rules relating to this paragraph.

(3)

(iii) Average period of customer use. (Reserved) See §1.469-1(e)(3)(iii) for rules relating to this paragraph.

(vi)

(D) Lodging for convenience of employer. (Reserved) See §1.469-1(e)(3)(vi)(D) for rules relating to this paragraph.

(E) Unadjusted basis. (Reserved) See §1.469-1(e)(3)(vi)(E) for rules relating to this paragraph.

(4)

(iv) Definition of "working interest." (Reserved) See §1.469-1(e)(4)(iv) for rules relating to this paragraph.

(5) Rental of dwelling unit. (Reserved) See §1.469-1(e)(5) for rules relating to this paragraph.

(f)

(4) Carryover of disallowed deductions and credits. (Reserved) See §1.469-1(f)(4) for rules relating to this paragraph.

(g)

(4)

(ii)

(C) (Reserved) See §1.469-1(g)(4)(ii)(C) for rules relating to this paragraph.

(h)

(4) (Reserved) See §1.469-1(h)(4) for rules relating to this paragraph.

Par. 5. Section 1.469-2 is added to read as follows:

§1.469-2 Passive activity loss.

(a) through (c)(2)(ii) (Reserved)

(c)(2)(iii) Disposition of substantially appreciated property formerly used in nonpassive activity-(A) In general. If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either-

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

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

(B) Date of disposition. For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property is deemed to occur on the date that the interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the interest in property for consideration that is fixed or otherwise determinable on that date.

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

(D) Investment property. For purposes of this paragraph (c)(2)(iii), an interest in property is 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 the 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 §1.469-2T) from the interests.

(E) Coordination with §1.469-2T(c)(2)(ii). If §1.469-2T(c)(2)(ii) applies to the disposition of an interest in property, this paragraph (c)(2)(iii) applies only to that portion of the gain from the disposition of the interest in property that is characterized as gain from a passive activity after the application of §1.469-2T(c)(2)(ii).

(F) Coordination with section 163(d). Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) is treated as income described in section 469(e)(1)(A) and §1.469-2T(c)(3)(i) if and only 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 that interest in property in activities other than passive activities.

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

Example 1. A acquires a building on January 1, 1993, and uses the building in a trade or business activity in which A materially participates until March 31, 2004. On April 1, 2004, A leases the building to B. On December 31, 2005, 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, 2004, through December 31, 2005). 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, 1993, and is an S corporation thereafter. X acquires a building on January 1, 1993, and sells the building on March 1, 1994. 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 the 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, 1993, to December 31, 1993, and as an interest in property used in a passive activity for the period from January 1, 1994, to February 28, 1994.

(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 §1.469-2T(c)(3)(i)) 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 the 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, 1993, to December 31, 1993). Accordingly, A's gain from the sale is treated under this paragraph (c)(2)(iii) as portfolio income.

(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 the interest in property before the transaction is not taken into account for purposes of applying this paragraph (c)(2) to any subsequent disposition of the interest in property by 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, for purposes of section 1221(1), involves holding the property or similar property 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 the nondealing activity or activities for more than 80 percent of the period during which the taxpayer held the interest in property; and

(C) The interest in property was not acquired and held by the taxpayer for the principal purpose of selling the 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 the 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 the 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 the interest in property was used in nondealing activities of the taxpayer.

For purposes of the preceding sentence, an interest in property is not 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 paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property, holding the interest in the dealing activity is treated, for purposes of §1.469-2T(c)(2), as the use of the interest in the last nondealing activity of the taxpayer in which the 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 the interest in property in a nondealing activity of the taxpayer for any period during which the interest in property is also offered for sale to customers is treated, for purposes of §1.469-2T(c)(2), as the use of the interest in property in the dealing activity of the taxpayer.

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

Example 1. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, 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 condominium units. (Assume that these are dealing operations treated as separate activities under §1.469-4, and that the taxpayer materially participates in the 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, 1996, and the last unit is sold on December 31, 1996.

(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 §1.469-2T(c)(2) as the use of the interest in a nondealing activity if the marketing of the property is incidental to the nondealing use. Under paragraph (c)(2)(v)(A)(2) of this section, the 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 the use in a nondealing activity if 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 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, 1993, to the date of sale in the period from January through December 1996). 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, 1996, to 25 percent (i.e., 12 months/48 months) in the case of apartments sold on December 31, 1996. Thus, no apartment was offered for sale to customers during more than 25 percent of the period in which it was used in nondealing 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 the interests. Accordingly, the rules in §1.469-2T(c)(2)(ii) and paragraph (c)(2)(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 taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. The taxpayer converts the apartments into condominium units on July 1, 1993. 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 condominium units. (Assume that these are dealing operations treated as separate activities under §1.469-4, and that the taxpayer materially participates in the activities.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The first unit is sold on January 1, 1994, and the last unit is sold on December 31, 1996.

(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 provides that 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 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 §1.469-2T(c)(2) to the disposition of the apartments, the rental of the apartments after July 1, 1993, is treated as the use of the apartments in the taxpayer's dealing activity.

Example 3. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, 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 condominium units. (Assume that these are dealing operations treated as separate activities under §1.469-4, and that the taxpayer materially participates in the activities.) 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, 1996, and the last unit is sold in 1997.

(ii) The treatment of apartments sold in 1996 is the same as in Example 1. The apartments sold in 1997, however, were simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which the apartments were used in nondealing activities. (For example, an apartment that is sold on January 31, 1997, 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 1997 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 1997 does not satisfy the principal purpose requirement, 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 §1.469-2T(c)(2) to the disposition of the apartments sold in 1997, the rental of the apartments after January 1, 1996, is treated, under paragraph (c)(2)(v)(B) of this section, as the use of the apartments in the taxpayer's dealing activity.

(c)(3) through (c)(5) (Reserved)

(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 the year from a property described in this paragraph (c)(6)(i) equal to the taxpayer's net passive income from the property for the year. Property is described in this paragraph (c)(6)(i) if the property is-

(A) An oil or gas property that includes an oil or gas well if, for any prior taxable year beginning after December 31, 1996, 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.

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

(A) The taxpayer's gross passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is any passive activity gross income for the year (determined without regard to this paragraph (c)(6) and §1.469-2T(f)) from the 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 the property; over

(2) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under §1.469-1T(f)(4)) that are reasonably allocable to the 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 must allocate the passive activity gross income (determined without regard to this paragraph (c)(6) and §1.469-2T(f)) from the item and the passive activity deductions reasonably allocable to the item among the properties.

(iii) Property. For purposes of paragraph (c)(6)(i)(A) of this section, the term "property" does not have the meaning given the 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.

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

Example 1. A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1993, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under §1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservoir in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1994 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net passive income from the property for purposes of this paragraph (c)(6).

Example 2. B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In 1993, S drills a well, and B's distributive share of S's losses from drilling the well is treated under §1.469-1T(e)(4) as not from a

passive activity. In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1993, S completes the well in the underlying formation. On January 1, 1994, B converts B's entire general partnership interest in S into a limited partnership interest. In 1994, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section 614(a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net passive income from the property for purposes of this paragraph (c)(6).

(c)(6)(iv) Example 3 through (c)(7)(vi) (Reserved).

(c)(7)(vii) Gross income or gain allocable to business or rental use of a dwelling unit for any taxable year in which section 280A(c)(5) applies to such business or rental use.

(d)(1) through (d)(2)(viii) (Reserved).

(d)(2)(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 613A(d), section 1212(a)(1) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations); and

(d)(2)(x) through (d)(2)(xi) (Reserved)

(d)(2)(xii) A deduction or loss allocable to business or rental use of a dwelling unit for any taxable year in which section 280(c)(5) applies to such business or rental use.

(d)(3) through (d)(5)(ii) (Reserved)

(d)(5)(iii) Other applicable rules-(A) Applicability of rules in §1.469-2T(c)(2). For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to the interests shall be determined under §1.469-2T(2)(i)(C). In addition, the rules contained in paragraph (c)(2) (iv) and (v) of this section 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.

(d)(5)(iii)(B) through (d)(6)(v)(D) (Reserved)

(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

(d)(6)(v)(F) through (d)(7) (Reserved)

(d)(8) Taxable year in which item arises. For purposes of §1.469-2T(d), an item of deduction arises in the taxable year in which the item would be allowable as a

deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211.

(e)(1) through (e)(2)(i) (Reserved)

(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), is 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 the partner if the 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, the gain or loss is treated as passive activity gross income or a passive activity deduction only to the extent that the gain or loss would have been passive activity gross income or a passive activity deduction of the retiring or deceased partner (or the other person) if it had been recognized at the time the liquidation of the 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, the 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 the partner if the partner is a passthrough entity) or the deceased partner's successor in interest as a result of the 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 the 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 the retiring or deceased partner (or the other person) would have recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the 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).

(e)(3)(i) through (iii)(A) (Reserved)

(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) of this section (relating to substantially appreciated property formerly used in a nonpassive activity), paragraph (c)(6) of this section (relating to certain oil or gas properties), §1.469-2T(f)(5) (relating to certain property rented incidental to development), paragraph (f)(6) of this section (relating to property rented to a nonpassive activity), or §1.469-2T(f)(7) (relating to certain interests in a passthrough entity engaged in the trade or business of licensing intangible property) would have been allocated to the holder (or such other person) with respect to the interest if all of the property used in passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of §1.469-2T(e)(3)(ii)(D)(1)); and

(e)(3)(iii)(C) through (f)(4) (Reserved)

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

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

(B) The taxpayer's use of the item of property in an activity involving the rental of the property commenced less than 12 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of §1.469-5T) or significantly participated (within the meaning of §1.469-5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(f)(5)(ii) through (f)(5)(iv) (Reserved)

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

(i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of §1.469-5T) for the taxable year; and

(ii) Is not described in §1.469-2T(f)(5).

(f)(7) through (f)(9)(ii) (Reserved)

(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 §1.469-2T(f)(2) through (f)(6)) that-

(A) Is income for the 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 §1.469-2T(c)(2)(ii)); and

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

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

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

(10) Coordination with section 163(d). Gross income that is treated as not from a passive activity under §1.469-2T(f)(3), (4), or (7) is treated as income described in section 469(e)(1)(A) and §1.469-2T(c)(3)(i) except in determining whether-

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and §1.469-2T(c)(3)(i)(C) as property that produces income of a type described in §1.469-2T(c)(3)(i)(A);

(ii) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and §1.469-2T(c)(3)(i)(D) 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 §1.469-2T(d)(4) as clearly and directly allocable to portfolio income (within the meaning of §1.469-2T(c)(3)(i)); 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)).

(11) (Reserved)

Par. 6. Section 1.469-2T is amended by revising paragraphs (c)(2)(iii), (c)(2)(iv), (c)(2)(v), (c)(6)(i), (c)(6)(ii), (c)(6)(iii), (c)(6)(iv) Examples (1) and (2), (d)(2)(ix), (d)(5)(iii)(A), (d)(6)(v)(E), (d)(8), (e)(2)(ii) and (iii), (e)(3)(iii)(B), (f)(5)(i), (f)(6), (f)(9)(iii), (f)(9)(iv) and (f)(10) to read as follows:

§1.469-2T Passive activity loss.

(c)

(2)

(iii) Disposition of substantially appreciated property formerly used in nonpassive activity. (Reserved) See §1.469-4(c)(2)(iii) for rules relating to this paragraph.

(iv) Taxable acquisitions. (Reserved) See §1.469-2(c)(iv) for rules relating to this paragraph.

(v) Property held for sale to customers. (Reserved) See §1.469-2(c)(v) for rules relating to this paragraph.

(6) Gross income from certain oil or gas properties-(i) In general. (Reserved) See §1.469-2(c)(6)(i) for rules relating to this paragraph.

(ii) Gross and net passive income from the property. (Reserved) See §1.469-2(c)(6)(ii) for rules relating to this paragraph.

(iii) Property. (Reserved) See §1.469-2(c)(6)(iii) for rules relating to this paragraph.

(iv) Examples.

Example 1. (Reserved) See §1.469-2(c)(6)(iv) Example 1.

Example 2. (Reserved) See §1.469-2(c)(6)(iv) Example 2.

(d)

(2)

(ix) (Reserved) See §1.469-2(d)(2)(ix) for rules relating to this paragraph.

(5)

(iii)

(A) Applicability of rules in paragraph (c)(2). (Reserved) See §1.469-2(d)(5)(iii)(A) for rules relating to this paragraph.

(6)

(v)

(E) (Reserved) See §1.469-2(d)(6)(v)(E) for rules relating to this paragraph.

(8) Taxable year in which item arises. (Reserved) See §1.469-2(d)(8) for rules relating to this paragraph.

(e)

(2)

(ii) Section 707(c). (Reserved) See §1.469-2(e)(ii) for rules relating to this paragraph.

(iii) Payments in liquidation of a partner's interest in partnership property. (Reserved) See §1.469-2(e)(iii) for rules relating to this paragraph.

(3)

(iii)

(B) (Reserved) See §1.469-2(e)(3)(iii)(B) for rules relating to this paragraph.

(f)

(5)

(i) In general. (Reserved) See §1.469-2(f)(5)(i) for rules relating to this paragraph.

(6) Property rented to a nonpassive activity. (Reserved) See §1.469-2(f)(6) for rules relating to this paragraph.

(9)

(iii) (Reserved) See §1.469-2(f)(9)(iii) for rules relating to this paragraph.

(iv) (Reserved) See §1.469-2(f)(9)(iv) for rules relating to this paragraph.

(10) Coordination with section 163(d). (Reserved) See paragraph 1.469-2(f)(10) for rules relating to this paragraph.

Par. 7. Section 1.469-3 is added to read as follows:

§1.469-3 Passive activity credit.

(a) through (d) (Reserved)

(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 the credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) Coordination with section 50. In the case of any cessation described in section 50(a) (1) or (2), the credits allocable to the taxpayer's activities under §1.469-1(f)(4) shall be adjusted by reason of the cessation.

(g) (Reserved)

Par. 8. Section 1.469-3T is amended by revising paragraphs (e) and (f) to read as follows:

§1.469-3T Passive activity credit.

(e) Coordination with section 38(b). (Reserved) See §1.469-3(e) for rules relating to this paragraph.

(f) Coordination with section 50. (Reserved) See §1.469-3(f) for rules relating to this paragraph.

Par. 9. Section 1.469-5 is added to read as follows:

§1.469-5 Material participation.

(a) through (e) (Reserved)

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

(f)(2) through (h)(2) (Reserved)

(h)(3) Coordination with rules governing the treatment of passthrough entities. If a taxpayer takes into account for a taxable year of the 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), the taxpayer is treated as materially participating in the activity for the taxable year for purposes of applying §1.469-5T(a)(5) and (6) to any succeeding taxable year of the taxpayer.

(i) (Reserved)

(j) Material participation for preceding taxable years-(1) In general. For purposes of §1.469-5T(a)(5) and (6), a taxpayer has materially participated in an activity for a preceding taxable year if the activity includes significant section 469 activities that are substantially the same as significant section 469 activities that were included in an activity in which the taxpayer materially participated (determined without regard to §1.469-5T(a)(5)) for the preceding taxable year.

(2) Material participation for taxable years beginning before January 1, 1987. In any case in which it is necessary to determine whether an individual materially participated in any activity for a taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), the determination shall be made without regard to paragraphs (a)(2) through (7) of this section.

(k) Examples. Example (1) through Example (4) (Reserved)

Example (5). In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of §1.469-1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating

(without regard to §1.469-5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation of those years were determined without regard to §1.469-5T(a)(5). Under §1.469-5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to §1.469-5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under §1.469-5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to §1.469-5T(a)(5) for five of the last ten immediately preceding taxable years.

Par. 10. Section 1.469-5T is amended by revising paragraphs (f)(1), (h)(3), (j) and (k) Example 5 to read as follows:

§1.469-5T Material participation.

(f)(1) (Reserved) See §1.469-5(f)(1) for rules relating to this paragraph.

(h)

(3) Coordination with rules governing the treatment of passthrough entities. (Reserved) See §1.469-5(h)(3) for rules relating to this paragraph.

(j) Material participation for preceding taxable years. (Reserved) See §1.469-5(j) for rules relating to this paragraph.

(k)

Example 5. (Reserved) See §1.469-5(k) Example 5 for this example.

§§1.469-6T-1.468-11T (Removed)

Par. 11. Sections 1.469-6T through 1.468-11T are removed.

Par. 12. Sections 1.469-6 through 1.469-10 are added and reserved and §1.469-11 is added to read as follows:

§1.469-6 Treatment of losses upon certain dispositions. (Reserved)

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

§1.469-8 Application of section 469 to trust, estates, and their beneficiaries. (Reserved)

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

**§1.469-10 Application of section 469 to publicly traded partnerships.
(Reserved)**

§1.469-11 Effective date and transition rules.

(a) Generally applicable effective dates. Except as otherwise provided in this section-

(1) The rules contained in §§1.469-1, 1.469-1T, 1.469-2, 1.469-2T, 1.469-3, 1.469-3T, 1.469-5, and 1.469-5T apply for taxable years ending after May 10, 1992.

(2) The rules contained in 26 CFR 1.469-1T, 1.469-2T, 1.469-3T, 1.469-4T, 1.469-5T, 1.469-11T (b) and (c) (as contained in the CFR edition revised as of April 1, 1992) apply for taxable years beginning after December 31, 1986, and ending on or before May 10, 1992; and

(3) This section applies for taxable years beginning after December 31, 1986.

(b) Additional effective dates.- (1) Transition rule for 1992 amendments. If a taxpayer's first taxable year ending after May 10, 1992, begins on or before that date, the taxpayer may treat the taxable year, for purposes of paragraph (a) of this section, as a taxable year ending on or before May 10, 1992.

(2) Certain investment credit property. (i) The rules contained in §1.469-3(f) apply with respect to property placed in service after December 31, 1990 (other than property described in section 11813 (c)(2) of the Omnibus Reconciliation Act of 1990 (P.L. 101-508)).

(ii) The rules contained in 26 CFR 1.469-3T(f) (as contained in the CFR edition revised as of April 1, 1992) apply with respect to property placed in service on or before December 31, 1990, and property described in section 11813(c)(2) of the Omnibus Reconciliation Act of 1990.

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

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

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

(3) Effect of events occurring in years prior to 1987. The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss,

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

(d) Examples. The following examples illustrate the application of paragraph (c) of this section:

Example 1. A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under §1.469-2T(e)(1) and paragraph (c)(3) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

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

Shirley D. Peterson,

Commissioner of Internal Revenue.

Approved: May 7, 1992.

Fred T. Goldberg, Jr.,

Assistant Secretary of the Treasury.