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Tax Symposium: Passive Activity Losses and Credits

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I. INTRODUCTION

Prior to the Tax Reform Act of 1986 ("TRA '86"), there were few limitations on the ability of a taxpayer to offset income from one activity with deductions from another activity. Similarly, a taxpayer generally could use tax credits to reduce tax liability attributable to income from any activity. There were some exceptions, notably with respect to capital losses, the alternative minimum tax, expensed intangible drilling costs, foreign tax credits, and research and development credits. These exceptions, however, proved too narrow to effectively prevent most taxpayers from reducing or avoiding tax liability attributable to salary or portfolio income by investing in tax shelters.

Section 501 of TRA '86 entitled "Passive Activity Losses and Credits Limited," codified at section 469, is designed to prevent the sheltering of active business income, salary, and portfolio income with passive losses not related to the taxpayer's trade or business. Furthermore, it is intended to limit credits from passive activities to the tax attributable to the passive activities. The underlying reason for the enactment of section 469 was to restore public confidence in the federal income tax system. Congress believed such confidence had been lost due to the tax sheltering opportunities that the system provided for taxpayers to offset income from one source with tax shelter deductions and credits from another source.

II. GENERAL SCOPE OF SECTION 469

Generally, section 469 disallows passive activity losses and passive activity credits with respect to individuals, estates, trusts, closely-held C corporations, and personal service corporations. A passive activity is any rental activity, and any activity involving the conduct of a trade or busi-
ness in which the taxpayer does not materially participate.\textsuperscript{7} Any disallowed loss or credit is treated as a deduction or credit allocable to the activity in the next taxable year.\textsuperscript{8} Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity in a fully taxable transaction to an unrelated party.\textsuperscript{9}

The "passive activity loss" is defined as the excess of the total losses from all passive activities for the taxable year over the total income from all passive activities for such year.\textsuperscript{10} Qualified residence interest, as defined in section 163(h)(3), does not enter into the computation of a taxpayer's passive activity loss.\textsuperscript{11} The "passive activity credit" is the amount of the excess of the sum of the credits from all passive activities allowable for the taxable year under sections 38 through 42 (business related credits) and sections 28 and 29 (clinical testing expenses and unconventional fuel sources), over the regular tax liability (as defined in section 26(b)) of the taxpayer for the taxable year allocable to all passive activities.\textsuperscript{12}

Thus, losses from passive activities will offset income from passive activities and credits from passive activities will offset tax liability allocable to passive activities.

There are special rules for determining the income or loss from a passive activity.\textsuperscript{13} Most notably, income from a passive activity does not include "portfolio income," i.e., interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business; or gain or loss from dispositions of property producing such income or property held for investment. For this purpose, an interest in a passive activity is not treated as property held for investment.\textsuperscript{14} A reasonable allowance received as compensation for personal services actually rendered is not treated as income from a passive activity.\textsuperscript{15}

Thus, under TRA '86 a taxpayer must first determine if he is subject to the passive activity loss rules; if he is subject to the rules, he must then identify his passive activities and compute the net income or loss or credits from each activity. In making this computation, a taxpayer should recognize that net portfolio income or loss is not treated as income or loss from a passive activity. Also, the special rules regarding active real estate rental activities, low-income housing and rehabilitation credit, closely-held C corporations, dispositions of interests in passive activities, the phase-in allowances, and transitional relief for low income housing activities should be considered in making this computation.

Special rules are applicable to closely-held C corporations, certain

\textsuperscript{7} I.R.C. § 469(c) (West Supp. 1988).
\textsuperscript{8} Id. § 469(b).
\textsuperscript{9} Id. § 469(g).
\textsuperscript{10} Id. § 469(d)(1).
\textsuperscript{11} Id. § 469(j)(7).
\textsuperscript{12} Id. § 469(d)(2).
\textsuperscript{13} See id. § 469(e).
\textsuperscript{14} Id. § 469(e)(1).
\textsuperscript{15} Id. § 469(e)(3).
real estate rental activities, certain working interests in oil and gas property, and limited partnership interests. Generally, a closely-held C corporation that is not a personal service corporation may utilize passive activity losses to offset its net active income. It may not, however, use such losses to offset its portfolio income. Also, a natural person may, subject to limitations based upon the taxpayer's adjusted gross income, deduct passive activity losses (or the deduction equivalent of the passive activity credit) up to $25,000 for any taxable year attributable to rental real estate activities in which he actively participated. Where the activity involves the low-income housing credit or the rehabilitation investment credit, active participation is not required. Generally, income or loss from any working interest in any oil or gas property, where the taxpayer's liability with respect to such interest is not limited, is treated as non-passive activity income or loss. Finally, except as provided in regulations, income or loss flowing from a limited partnership interest is treated as passive activity income or loss.

Section 469 is effective for taxable years beginning after 1986 with a four year phase-in for certain pre-enactment interests in passive activities. In addition, transitional relief is provided for losses from certain existing low income housing activities. The section does not apply to pre-1987 losses and credits that are carried over to post-1986 taxable years.

III. TAXPAYERS SUBJECT TO THE RULE

Individuals, estates, trusts, closely-held C corporations, and personal service corporations are subject to the provisions of section 469. Widely-held corporations that are not considered personal service corporations are completely excluded from section 469. Additionally, a liberalized version of section 469 applies to closely-held corporations that are not considered personal service corporations. In the case of partnerships and S corporations, section 469 is applied at the partner or share-
A closely-held C corporation that is not a personal service corporation may utilize a passive activity loss to offset its net active income. For this purpose, "'net active' income means the taxable income determined without regard to (1) any income or loss from a passive activity and (2) any item of gross income, expense, gain, or loss described in section 469(e)(1)(A)." Section 469 applies on a consolidated basis to affiliated groups of closely-held corporations filing consolidated returns. Consequently, a passive activity loss within the consolidated group may offset net active income of any member of the group. If a closely-held C corporation ceases to be a closely-held C corporation, any suspended passive losses and credits would continue to be suspended, and the losses could only be utilized against passive activity income or net active income and the credits against the tax liability with respect to such income.

A personal service corporation is a corporation whose principal activity is the performance of personal services where such services are substantially performed by employees who own more than 10% of the value of the stock of the personal service corporation on any day during the taxable year. For this purpose, all related persons, within the meaning of section 144(a)(3), are treated as one entity. If a personal service corporation ceases to be a personal service corporation for any taxable year, section 469 continues to apply to suspended losses and credits in the same manner as if the taxpayer continued to be a personal service corporation. Thus, suspended losses and credits could only be utilized against income from passive activities and tax liability allocable to passive activities.

IV. PASSIVE ACTIVITY DEFINED

A. Generally

A "passive activity" is (1) any rental activity whether or not the
taxpayer materially participates in the rental activity, and (2) any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. For purposes of determining whether an activity is a passive activity, a trade or business includes any activity involving research or experimentation, within the meaning of section 174, any activity in connection with a trade or business within the meaning of section 162, or any activity with respect to which expenses are allowable as a deduction under section 212 to the extent provided in regulations.

An exception exists for working interests in oil and gas property. A passive activity does not include any working interest in any oil or gas property held directly by the taxpayer or through an entity which does not limit his liability with respect to such interest, whether or not the taxpayer materially participates in the activity.

A working interest in any oil and gas property is generally an interest that is burdened with the cost of development and operation of the property. Rights to production payments and overriding royalties are not working interests. Where net losses from a working interest in an oil and gas property were treated as non-passive losses for a prior taxable year by a taxpayer, any net income realized from the property (or any property that has a basis determined in whole or in part by reference to the basis of such property) in a subsequent year by the taxpayer is treated as non-passive income.

B. Material Participation

As previously noted, a passive activity includes any activity involving the conduct of a trade or business where the taxpayer does not materially participate and it also includes any rental activity, whether or not the taxpayer materially participates. If the activity is a non-rental activity, and it involves the conduct of any trade or business, the key question then becomes whether or not the taxpayer materially participates in the activity. In order for a taxpayer to be treated as materially participating in an activity, the taxpayer must be involved in the opera-

35. Id. § 469(c)(2),(c)(4).
36. Id. § 469(c)(1).
37. Id. § 469(c)(5)-(6); see also Temp. Treas. Reg. § 1.469-1T(e)(2) (1988). Expenses deductible under section 212 include: expenses for the production or collection of income; for the management, conservation or maintenance of property held for the production of income; or in connection with the determination, collection or refund of any tax. I.R.C. § 212 (1982).
38. Id. § 469(c)(3)-(4) (West Supp. 1988).
39. SENATE REPORT, supra note 2, at 744.
40. Id.
42. Id. § 469(c).
43. Id. § 469(j)(8).
tions of the activity on a regular, continuous, and substantial basis. In determining whether a taxpayer materially participates in an activity, the participation of the taxpayer's spouse is taken into account.

Whether or not a taxpayer materially participates in an activity is determined on an annual basis. The existence or non-existence of material participation in an activity is generally determined with reference to all of the relevant facts and circumstances, except in the limited partnership context.

Satisfaction of the material participation standard must relate to involvement in operations. Where involvement in the activity is the taxpayer's principal business, material participation is most likely to be found; it is less likely that the material participation standard will be satisfied where an activity is not the individual's principal business. Another relevant consideration in determining material participation involves the amount of the taxpayer's time spent at the place or places where the principal operations of the activity are conducted. The performance of management functions generally is not treated differently from other services with respect to an activity. The amount of the taxpayer's knowledge or experience regarding an activity is relevant in determining whether his participation in management is likely to rise to the level of material participation.

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44. *Id.* § 469(h)(1). An individual will be treated as materially participating in an activity for the taxable year if:

1. the individual participates in the activity for more than 500 hours during the year;
2. the individual's participation in the activity for the year constitutes substantially all of the participation of all individuals for such year;
3. the individual participates in the activity for more than 100 hours and his participation is not less than the participation of any other individual;
4. the activity is a significant participation activity and the individual's aggregate participation in all significant participation activities exceeds 500 hours;
5. the individual materially participated in the activity for any five taxable years during the ten preceding taxable years;
6. the activity is a personal service activity and the individual materially participated in the activity for any three preceding taxable years; or
7. based on all facts and circumstances the individual participates in a regular, substantial, and continuous manner in the activity.

Temp. Treas. Reg. § 1.469-5T(a) (1988). A limited partner will be treated as materially participating only if he satisfies (1), (5), or (6) above. Temp. Treas. Reg. § 1.469-5T(e).


46. *Senate Report, supra* note 2, at 731.

47. *Id.* at 732.

48. In the case of a business of producing movies, the approval of financing, acceptance of a screenplay recommendation, director, cast, and locations, or appointing others to perform the operation's functions generally will not constitute involvement in operations. *Id.*

49. *Id.* at 732-33.

50. *Id.* at 734.
the daily functions of an activity are not attributed to the taxpayer for purposes of establishing material participation of the taxpayer.  

There are special rules that relate to farming. An individual who does not perform physical work with respect to a farm, but who is treated as having self-employment income from the farm under section 1402, will generally be treated as materially participating. Another special rule with respect to farming activities establishes material participation in certain situations with respect to retired or disabled individuals who were previously materially participating or that involve a surviving spouse of an individual who was materially participating.

An individual working full-time in a line of business that consists of one or more business activities is likely to be considered materially participating in all those activities (other than rental activities) even though the individual's role is in management, rather than operations. This "Line-of-Business" test seems to aggregate participation in multiple activities and ignore the concept of an activity, the unit of focus under section 469. Where a taxpayer does everything required to conduct an activity, it is likely that he will be treated as materially participating even though the amount of work is low in comparison to other activities.

Except to the extent provided by regulations, in the case of a limited partnership interest, it is conclusively presumed that the taxpayer has not materially participated in the activity conducted by the partnership. This rule applies even though the taxpayer owns the limited partnership interest indirectly through a tiered entity arrangement. The general rule does not apply to an activity for a taxable year if (i) the individual participates in the activity for more than five hundred hours during the taxable year, (ii) the individual materially participated in the activity for any five of the ten taxable years that immediately precede the taxable year, or (iii) the activity is a personal service activity and the individual materially participated in the activity for any three taxable years preceding the taxable year. Where a taxpayer owns both a limited partnership interest and a general partnership interest with respect to an activity, the

51. Id. at 735.
52. Id. at 733-34.
53. I.R.C. § 469(h)(3) (West Supp. 1988). The types of decision making that may be relevant in an agricultural activity to determine whether decision making constitutes material participation would include (1) crop selection, rotation and pricing, (2) embryo transplant or breeding expense decisions, (3) acquisition and disposition of capital items, (4) decisions regarding breeding and mating, and (5) selection of managers regarding a herd or crop who act upon the taxpayer's direction rather than as advisors who direct the conduct of the taxpayer. CONFERENCE REPORT, supra note 29, at II-148.
54. CONFERENCE REPORT, supra note 29, at II-148.
55. Id.
57. For example where the taxpayer owns a general partnership interest or stock in an S corporation and the corporation or partnership itself owns a limited partnership interest in another entity. SENATE REPORT, supra note 2, at 731.
limited interest will be treated as a general partnership interest.\textsuperscript{59}

An estate or trust is treated as materially participating in an activity if an executor or fiduciary is so participating in his capacity as such.\textsuperscript{60} In the case of a grantor trust, however, material participation is determined according to the participation of the person treated as the owner of the trust for tax purposes.\textsuperscript{61}

A closely-held C corporation or a personal service corporation will be treated as materially participating in an activity if one or more shareholders who hold stock with a value of more than 50\% of the value of the corporation's outstanding stock materially participate in the activity.\textsuperscript{62} In the case of a closely-held C corporation other than a personal service corporation, the corporation will be treated as materially participating in an activity if, with respect to such activity (i) the corporation had at least one full-time employee performing substantially all of his services in active management of the activity during the entire twelve-month period ending on the last day of the taxable year, (ii) the corporation had at least three full-time non-owner employees performing substantially all of their services in matters directly related to the activity, and (iii) the deductions attributable to the activity allowable solely by reason of sections 162 and 404 for the taxable year exceeds 15\% of the gross income from the activity for such year.\textsuperscript{63}

It is intended that the material participation test be applied on a consolidated basis in determining whether an activity conducted within a closely-held consolidated group is a passive activity.\textsuperscript{64} For example, the group will be considered to materially participate where one or more individual shareholders holding stock representing more than 50\% of a member's stock materially participate in any activity of any member of the group.\textsuperscript{65} Similarly, if the requirements as to full-time employees are satisfied for an activity by any member, or several members together, then the consolidated group is considered to participate materially in the activity.\textsuperscript{66}

Similar principles are intended to apply where a personal service corporation is a member of a consolidated group. For example, where the requisite services are rendered by owners who are employees of a subsidiary rather than of the parent corporation, the parent corporation may be treated as a personal service corporation.\textsuperscript{67}

\textsuperscript{59} See id. § 1.469-5T(e)(3)(ii). \textit{But see} Senate Report, \textit{supra} note 2, at 731.
\textsuperscript{60} Senate Report, \textit{supra} note 2, at 735.
\textsuperscript{61} See id. 735 n.21.
\textsuperscript{63} Id. § 469(h)(4)(B).
\textsuperscript{64} Conference Report, \textit{supra} note 29, at II-140.
\textsuperscript{65} Id.
\textsuperscript{66} Id.
\textsuperscript{67} Id.
C. Rental Activity

Subject to certain exceptions,68 a rental activity is, by definition, a passive activity.69 A rental activity is any activity where payments are principally for the use of tangible property.70 The activity of a dealer in real estate generally is not treated as a rental activity, while long term rentals or leases of property such as apartments, office equipment, or leased cars are generally considered to be rental activities.71 A net lease of property is a rental activity that is treated as a passive activity.72 A rental activity may include the performance of services that are incidental to the activity, for example a laundry room in a rental apartment building. If a substantial amount of services are rendered, however, they may constitute a separate activity or the entire activity might not constitute a rental activity.73 For example, the operation of a hotel or other similar transient lodging would not constitute a rental activity.74 The short-term leasing of motor vehicles where the lessor furnishes services such as engine and body repair, oil change and lubrication, tire repair and changing, maintenance of gas and oil, and cleaning and polishing, also will not be treated as a rental activity.75

Some rental activities are conducted in association with activities which do not involve renting tangible property. Assuming the other activities are part of a trade or business, they will be treated as passive activities or non-passive activities depending upon a determination as to whether or not the taxpayer materially participates in those activities.76

69. I.R.C. § 469(c)(2) (West Supp. 1988). The temporary regulations provide that an activity involving the use of tangible property will not be treated as a rental activity for a taxable year if for such taxable year: (1) the average period of use by customers for the property is seven days or less; (2) the average period of customer use for the property is 30 days or less and significant personal services are provided by or on behalf of the owner with respect to making the property available for use by customers; (3) extraordinary personal services are provided by or on behalf of the owner with respect to making the property available for use by customers; (4) the rental of the property is treated as incidental to a nonrental activity of the taxpayer; (5) the property is customarily made available by the taxpayer during defined business hours for non-exclusive use by various customers; or (6) the taxpayer provides the property for use in an activity conducted by an S corporation, a partnership, or a joint venture in which the taxpayer owns an interest. Temp. Treas. Reg. § 1.469-1T(e)(3)(iii)-(vii).
71. SENATE REPORT, supra note 2, at 720.
72. Id.; CONFERENCE REPORT, supra note 29, at II-138.
73. CONFERENCE REPORT, supra note 29, at II-148.
74. Id.
75. SENATE REPORT, supra note 2, at 742.
76. Id. at 743. For example, automobile leasing and automobile manufacturing are
V. ACTIVE PARTICIPATION IN RENTAL REAL ESTATE ACTIVITY

There is a $25,000 exemption from the general disallowance rule in the case of any natural person with respect to the passive activity loss or the deduction equivalent of the passive activity credit for any taxable year which is attributable to rental real estate activities in which the individual actively participated in the taxable year.\(^77\) The deduction equivalent of credits from a passive activity for any taxable year is the amount which, if allowed as a deduction, would reduce the regular tax liability for the taxable year by an amount equal to such credits.\(^78\) The $25,000 exemption phases out for taxpayers with adjusted gross incomes between $100,000 and $150,000. Where the taxpayer’s adjusted gross income exceeds $100,000, 50% of such excess reduces (but not below zero) the $25,000 exemption.\(^79\) For this purpose, adjusted gross income is determined without regard to (i) social security benefits and tier one railroad retirement benefits includable in gross income under section 86, (ii) any amount allowable as a deduction under section 219 (pertaining to an individual’s contributions to an individual retirement plan and certain pension plans funded only by contributions of employees), and (iii) any passive activity loss.\(^80\)

In the case of any low-income housing credit or any rehabilitation investment credit, the $25,000 exemption for the deduction equivalent of passive activity credits is allowed without regard to the active participation requirement.\(^81\) Furthermore, the exemption phase-out is between $200,000 and $250,000.\(^82\) In the case of the low-income housing credit, the increase in the phase out range to between $200,000 and $250,000, and the waiver of the requirement that the taxpayer actually participate in the activity generating the low-income housing credit, apply only to property placed in service before 1990, unless the property is placed in service before 1991 and 10% or more of the total project costs are incurred before 1989.\(^83\)

The $25,000 exemption for passive activity losses or the deduction equivalent of the passive activity credit does not apply to a married individual who files a separate return unless such individual lives apart from

\(^77\) I.R.C. § 469(i) (West Supp. 1988). The Secretary shall prescribe regulations which specify what constitutes active participation for purposes of § 469. \(Id.\) § 469(i)(1).

\(^78\) \(Id.\) § 469(j)(5).

\(^79\) Thus, for example, where a taxpayer has an adjusted gross income of $150,000 or more, the exemption is reduced to zero. Where the taxpayer’s adjusted gross income is $120,000, the exemption amount is $15,000.


\(^81\) \(Id.\) § 469(i)(6)(B).

\(^82\) \(Id.\) §§ 469(i)(3)(B), (6)(B).

\(^83\) TRA '86, supra note 1, § 501(c)(3).
his spouse at all times during the taxable year. Where a married individual files a separate return and does live apart from his spouse at all times during the taxable year, the $25,000 exemption is reduced to $12,500 and the adjusted gross income limitations of $100,000 and $200,000 are reduced to $50,000 and $100,000. Because Congress believes that separate returns give rise to unnecessary complexity and put an unwarranted burden on the administration of the tax system, this rule is intended to discourage the filing of separate returns.

In the case of a decedent who, in the taxable year in which he died, owned an interest in a rental real estate activity in which he actively participated, the $25,000 exemption will apply to the taxable years of the estate ending less than two years after the date of the death of the decedent. Consequently, the taxpayer's estate will continue to receive the same tax treatment with respect to the rental real estate activity as the taxpayer received in the tax year of his death. The purpose of this rule is to facilitate the administration of the estate without requiring the executor or fiduciary to make decisions as to the disposition of the rental real property within a short period following the taxpayer's death. In order to avoid the allowance of a double exemption, there is a reduction for the decedent's surviving spouse's exemption. The $25,000 exemption allowed to the decedent's estate is reduced by the exemption (determined without regard to the phase-out) allowable to the surviving spouse of the decedent for the taxable year ending with or within the taxable year of the estate.

In addition to the special two-year rule for estates of decedents that actively participated before their death, estates are treated as individuals and, accordingly, can qualify for the $25,000 exemption. The active participation standard is applied with respect to executors or fiduciaries acting in their capacity as such. Trusts may not qualify for the $25,000 exemption. The purpose of that rule is to prevent individuals from circumventing the $25,000 ceiling or multiplying the number of $25,000 allowances simply by transferring various rental real properties to one or more trusts.

The $25,000 exemption is applied by netting the income and loss from all rental real estate activities in which the taxpayer actively participates. If there is a net loss from such activities, then the taxpayer applies it against his net passive income from other activities to determine the

85. Id. § 469(i)(5)(A).
86. CONFERENCE REPORT, supra note 29, at II-142.
88. CONFERENCE REPORT, supra note 29, at II-142.
90. SENATE REPORT, supra note 2, at 737.
91. Id.
92. CONFERENCE REPORT, supra note 29, at II-142.
amount eligible for the $25,000 exemption.\textsuperscript{93} Where losses or credits from rental real estate activities in which the taxpayer actively participated are carried over because they exceeded $25,000 (as reduced by the applicable adjusted gross income phase-out) they are deductible or allowable under the $25,000 rule in a subsequent year only if the taxpayer is actively participating in the activity in such subsequent year.\textsuperscript{94}

An individual shall not be treated as actively participating in any rental real estate activity for any period if, at any time during the period, the individual’s interest in the activity, including any interest of his spouse in the activity, is less than 10\% in value of the total value of all the interests in the activity.\textsuperscript{95} The active participation requirement is different from the material participation requirement and does not require as much personal involvement.\textsuperscript{96} The 10\% or more requirement is designed to aid in restricting the relief provided under the $25,000 exemption to appropriate circumstances.\textsuperscript{97}

Active participation can be satisfied without regular, continuous, and substantial involvement in operations provided the taxpayer participates in a significant and bona fide manner in the activity.\textsuperscript{98} A taxpayer may be treated as actively participating even though he hires a rental agent and others who provide services such as repairs.\textsuperscript{99} Moreover, the participation of the taxpayer’s spouse is taken into account in determining whether the taxpayer actively participates.\textsuperscript{100} Services performed by the taxpayer’s spouse are considered whether or not the taxpayer and his spouse file a joint return.\textsuperscript{101}

No interest as a limited partner in a limited partnership is treated as an interest with respect to which the taxpayer actively participates.\textsuperscript{102} In addition, a lessor under a net lease is unlikely to satisfy the active participation requirement.\textsuperscript{103} A mere formal and nominal participation in management without a genuine exercise of independent discretion and judgment will not satisfy the active participation standard.\textsuperscript{104}

Only rental real estate activities are eligible for the $25,000 exemption.\textsuperscript{105} For purposes of determining whether a taxpayer’s interest in an

\begin{itemize}
\item \textsuperscript{93} \textit{Id.} at II-141.
\item \textsuperscript{94} \textit{Id.} at II-141 n.2.
\item \textsuperscript{95} I.R.C. § 469(i)(6)(A) (West Supp. 1988).
\item \textsuperscript{96} \textsc{Senate Report, supra} note 2, at 721.
\item \textsuperscript{97} \textit{Id.} at 737.
\item \textsuperscript{98} \textit{Id.} For example, in the making of management decisions or arranging for others to provide services such as repairs. \textit{Id.} Relevant management decisions involve determining rental terms, approving tenants, approving repair or capital expenditures, and other similar decisions. \textit{Id.} at 737-38.
\item \textsuperscript{99} \textit{Id.} at 738.
\item \textsuperscript{100} I.R.C. § 469(i)(6)(D) (West Supp. 1988).
\item \textsuperscript{101} \textsc{Senate Report, supra} note 2, at 736 n.23.
\item \textsuperscript{102} I.R.C. § 469(i)(6)(C) (West Supp. 1988).
\item \textsuperscript{103} \textsc{Senate Report, supra} note 2, at 738.
\item \textsuperscript{104} \textit{Id.}
\item \textsuperscript{105} \textit{See} I.R.C. § 469(i) (West Supp. 1988).
\end{itemize}
activity amounts to a minimum of 10% in value, separate buildings are
treated as separate rental real estate activities unless the degree of inte­
gration of the business and other relevant factors require treating them as
parts of a larger activity such as an integrated shopping center.

In the case of units smaller than an entire building, it is necessary to
evaluate the degree of business and functional integration among the
units to determine whether they are separate activities. A cooperative
apartment in an apartment building, owned by a taxpayer who is unre­
related to those owning the other apartments, generally will qualify as a
separate activity. Ownership of an undivided interest in the building or
of an area too small to be rented as a separate unit, however, does not
qualify as a separate activity. Where a commercial building is rented out
to various tenants and different parties own different floors, the degree of
integration with which business relating to different floors is conducted
must be examined. Where the various floors are separately sold to differ­
ent parties but rental of the building is handled in a centralized fashion,
the arrangement will generally constitute a single activity, whereas a dif­
ferent treatment might be appropriate if the owners of different floors
separately managed their own rental businesses.106

VI. PORTFOLIO INCOME

Portfolio income is not treated as income from a passive activity. As such, passive activity losses and credits may not be applied to offset portfolio income. The following items are considered portfolio income and are not taken into account in determining the income or loss from any passive activity: (1) gross income from dividends, interest, annuities, or royalties not derived in the ordinary course of a trade or business; (2) expenses (other than interest) that are clearly and directly allocable to the gross income in (1); (3) interest expense properly allocable to the gross income in (1); and (4) gain or loss attributable to the disposition of property producing income of a type described in (1), or held for investment.107 For this purpose, any interest in a passive activity is not treated as property held for investment. Income attributable to an investment of working capital to the extent it consists of interest, dividends, annuities, or royalties income, or gain or loss from dispositions of property producing such income, are treated as portfolio income.108 Real estate investment trust dividends and income received from a regulated investment company or a real estate mortgage investment conduit are also treated as portfolio income.109

Income from a general or limited partnership interest, S corporation
stock, a grantor trust, or a lease of property, generally are not treated as

106. Senate Report, supra note 2, at 744.
108. Id. § 469(e)(1)(B).
109. Senate Report, supra note 2, at 728.
portfolio income. Additionally, gains from the sale of such interests, when they are interests in passive activities, are also not treated as portfolio income except to the extent that any gain on the sale of such interests are attributable to portfolio income. For example, where a general partnership owns appreciated stock and bonds and also conducts a business activity, gain from the sale of the partnership interest would be attributable to the portfolio income and the business activity.

The temporary regulations provide that gain from a post-1986 sale of an interest in an activity that generates passive income will be treated as income from a passive activity. Initially, the Internal Revenue Service took the position in Notice 87-8 that gain from a pre-1987 sale, where the gain is reported under the installment method and recognized after 1986, would not be treated as income from a passive activity. However, the temporary regulations do not contain this rule and the Internal Revenue Service's summary of the regulations provides that the rule in Notice 87-8 would not be enforced unless and until it is adopted in regulations under section 469.

Where a taxpayer has an interest in a passive activity, any portfolio income of the activity must be taken into account separately. Such portfolio income is not taken into account in determining the passive income or loss from the activity, but is treated as non-passive income of the taxpayer. For example, where a limited partnership engaged in the publication of a magazine also holds dividend and interest bearing securities, and has operating losses that exceed the income from the securities, each limited partner must separately account for his share of the portfolio income and the operating losses and he may not offset the operating losses against the portfolio income in calculating his tax liability.

Where portfolio income is derived in the ordinary course of a trade or business, such as interest income earned by a bank, such income is not treated as portfolio income for purposes of the passive loss provision. If the taxpayer directly or through a pass-through entity owns an interest in an activity having portfolio type income that is derived in the ordinary course of a trade or business, such income is attributed to the activity and may be treated as passive, depending upon whether the taxpayer materially participates in the activity.

The Secretary is directed to provide such regulations as may be necessary or appropriate to carry out the provisions of section 469, including regulations which provide that certain items of gross income will not be taken into account in determining income or loss from a passive activity.

110. Id.
111. Id. at 728-29.
114. SENATE REPORT, supra note 2, at 729.
115. Id.
116. Id.
and the treatment of expenses allocable to such income. The temporary regulations require, in certain situations, net income or gain from a limited partnership or other passive activity to be treated as coming from a non-passive activity and provide for the determination of the allocation of interest expense for purposes of section 469. It is intended that the regulations will prevent taxpayers from structuring income producing activities, including those that do not bear significant expenses, in ways that are designed to produce passive income that could be offset by unrelated passive losses. For example, a limited partner's share of income from a limited partnership will be treated as portfolio income unless he is treated as materially participating in an activity of the partnership. In addition, such treatment might be appropriate where a corporation transfers an income producing activity to a limited partnership and then distributes the limited partnership interest to its shareholders.

As noted, portfolio income is reduced by deductible expenses that are clearly and directly allocable to such income and properly allocable interest expense. In the case of entities, a proper method of allocation might include allocating interest to portfolio income on the basis of assets. However, where the transactions are integrated, a tracing method of allocation might also be appropriate. In the case of individuals, due to the difficulty of recordkeeping required by the allocation method it is anticipated that interest expense generally will be traced to the asset or activity that is purchased or carried by the incurrence or continuance of the underlying debt.

The temporary regulations provide that interest expense (other than qualified residence interest) generally is allocated on the basis of the use of the proceeds of the underlying debt. For example, where proceeds of a debt are used solely to purchase an interest in a passive activity, the interest on the debt will be taken into account in computing the income or loss from the passive activity. Where a taxpayer borrows money to purchase an interest in a partnership or an S corporation, and all the assets of the entity are used solely in the conduct of a trade or business,

118. See Temp. Treas. Reg. § 1.469-2T(f) (1988). The regulations provide special rules for a significant participation passive activity (a concept not embodied in the statute or legislative history); the rental of nondepreciable property; net interest income from passive equity financed lending activity; net income from certain property rented incidental to development activity; property rented to a nonpassive activity; and special rules applicable to the acquisition of an interest in a pass-through entity engaged in licensing intangible property. Except for the rules regarding significant participation passive activities, which are effective for taxable years beginning after December 31, 1986, the rules are effective for taxable years beginning after December 31, 1987. Id. § 1.469-11T.
119. See id. § 1.469-2T(d)(3).
120. SENATE REPORT, supra note 2, at 730.
121. CONFERENCE REPORT, supra note 29, at II-146.
the treatment of the interest expense will depend upon whether the taxpayer is treated as materially participating in the trade or business. If he is not so treated, then his interest in the activity is an interest in a passive activity and his interest expense will be taken into account in computing his income or loss from the passive activity.

In general, interest expense on a debt is allocated in the same manner as the debt, which is allocated by tracing disbursements of the debt proceeds to specific expenditures. The Internal Revenue Service is still studying the issues such transactions raise. Therefore, the regulations reserve provisions for (1) debt allocated to distributions by pass-through entities, (2) repayment of pass-through entity debt, (3) debt allocated to expenditures for interests in pass-through entities, and (4) allocation of debt to loans between pass-through entities and interest holders.

Where an individual receives interest income on debt of a pass-through entity in which he owns an interest, the interest could be "self-charged." For example, where a taxpayer is the sole shareholder of an S corporation and he receives $100 of interest income from a loan that he made to his S corporation, the transaction could be viewed in form as giving rise to portfolio interest income and to passive interest expense. This treatment, however, is inappropriate.

Such income should be allowed to offset the interest expense passed through to the taxpayer from the activity for the same taxable year. The amount of the interest income that is appropriately offset by the interest expense, however, should not exceed the taxpayer's allocable share of the interest expense to the extent not increased by any special allocation in the case of a partner. For example, if an individual has a 40% interest in a limited partnership that conducts a business activity, and the individual makes a loan to the partnership on which the partnership pays $100 of interest expense for the year, only $40 of the partner's $100 of interest income will be permitted to offset his share of the partnership interest expense while the remaining $60 will be treated as portfolio income that cannot be offset by passive losses. It is anticipated that treasury regulations will be issued to provide for the above result. Such regulations may provide that, when appropriate, the taxpayer's allocable share of payment for this purpose will be determined without regard to special allocations. The same principles might apply where an entity loans money to the owners, such as where a limited partnership has a deferred capital contribution. The temporary regulations, consistent with the Conference Report's suggestions, treat income derived from renting non-depreciable property and income from renting property for use in a trade or business activity, in which the taxpayer materially par-

124. CONFERENCE REPORT, supra note 29, at II-147.
125. Id.
126. Id.
127. Id.
VII. DISPOSITIONS

If a taxpayer disposes of his entire interest in any passive activity (or former passive activity) to an unrelated party, in a transaction in which all gain or loss on the disposition is recognized, then any suspended loss from such activity, and any loss realized on the disposition in the case of a passive activity for the taxable year, shall not be treated as a passive activity loss but shall be allowed as a deduction against income. Such loss shall be allowable against income in the following order: (1) income or gain from the passive activity for the taxable year, including any gain recognized on the disposition; (2) net income or gain for the taxable year from all passive activities; and (3) any other income or gain. If the taxpayer and the acquiring party bear a relationship to each other as described in section 267(b) or section 707(b)(1), then any suspended loss or loss realized on the disposition shall not be allowed until the related acquiring party disposes of the interest in a fully taxable transaction to a person who is not a related party to the taxpayer. The limitation on capital losses contained in section 1211 is applied before any loss realized on the disposition of an interest in a passive activity is allowed under section 469(g)(1)(A).

Because the purpose of the disposition rule is to allow real economic losses to be deducted, credits resulting from a disposition are not allowed. Also, for purposes of determining gain or loss from a disposition to which section 469(g)(1)(A) applies, the transferor may elect to increase the basis of the disposed property immediately before the disposition by an amount equal to the portion of any unused allowable credit which reduced the basis of the property for the taxable year in which the credit arose. The portion of the passive activity credit subject to such an election shall not be allowed for any taxable year.

The reason for the disposition rule is that it is difficult to determine whether there has actually been a gain or loss with respect to an activity prior to a disposition of the taxpayer’s interest in the activity. Such gain or loss cannot be determined where there is a disposition of less than the entire interest. The disposition of an entire interest involves the disposition of the taxpayer’s interest in all entities that are engaged in the activity, and, to the extent held in proprietorship form, all assets used or

130. Id.
131. Id. § 469(g)(1)(B).
132. Id. § 469(g)(1)(C).
133. SENATE REPORT, supra note 2, at 725.
135. SENATE REPORT, supra note 2, at 725.
136. Id.
created in the activity. If a partnership or S corporation conducts two separate activities, a fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner’s or shareholder’s entire interest in the activity.

A transaction which constitutes a taxable disposition in form, but which is not treated as a taxable disposition under general tax rules, does not result in the allowance of suspended deductions. For example, wash sales, sham transactions, and transactions denied sales treatment due to the existence of a put, call, or similar repurchase right, do not give rise to the allowance of suspended losses.

A fully taxable disposition by an owner of an interest in a syndicate that insures United States risks is treated as a disposition of an interest in a passive activity. A disposition includes an abandonment that constitutes a fully taxable event where the taxpayer’s entire interest in the passive activity is abandoned. Similarly, where the worthlessness of a security is treated as a sale or exchange of the security under section 165(g), and the event otherwise represents the disposition of an entire interest in the passive activity, it is treated as a disposition.

If an interest in an activity is transferred due to the death of the taxpayer, the suspended losses with respect to the activity shall be allowed only to the extent that such losses are greater than the excess, if any, of the basis of the property in the hands of the transferee over the adjusted basis of the property immediately before the death of the taxpayer. Thus, such losses are allowed but only to the extent they exceed the amount, if any, of the step-up in basis allowed due to the death of the taxpayer.

Upon the installment sale of an entire interest in an activity, pursuant to section 453:

the suspended losses and any loss realized on the disposition of a passive activity for the taxable year, shall be allowed with respect to the portion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale realized, or to be realized, when payment is completed.

Thus, in each year of the installment obligation, the losses are allowed in the ratio that the gain recognized in each year bears to the total gain on

137. Id.
138. Id. at 725; CONFERENCE REPORT, supra note 29, at II-145.
139. CONFERENCE REPORT, supra note 29, at II-143.
140. Id.
141. Id.
142. Id. at II-144.
144. SENATE REPORT, supra note 2, at 726.
the sale.\textsuperscript{146}

A gift of any interest in a passive activity results in an increase in the basis of such interest immediately before the transfer by the amount of any passive activity losses allocable to such interest.\textsuperscript{147} Such losses are not allowable as a deduction for any taxable year.\textsuperscript{148} The treatment of subsequent deductions from the activity, to the extent of the donee's interest, depends upon whether the activity is treated as passive in the donee's hands.\textsuperscript{149} For purposes of determining the donee's loss in a subsequent disposition, the donee's basis may not exceed the fair market value of the gift at the time he received it.\textsuperscript{150}

An exchange of an interest in an activity in a transaction in which no gain or loss is recognized, such as an exchange governed by sections 351 or 721, does not trigger recognition of suspended losses because, following such an exchange, the taxpayer retains an interest in the activity and has not realized his final economic gain or loss on his investment in the activity.\textsuperscript{151} The suspended losses continue to be treated as passive activity losses of the taxpayer. They may be applied against income from the property received in the tax-free exchange where such income is attributable to the original activity. For example, if a general partnership is conducting a passive activity and then contributes that activity to an S corporation, followed by a liquidation of the partnership, the suspended losses from the activity with respect to a shareholder who was formerly a passive general partner may offset subsequent income from the activity.\textsuperscript{152} The remaining suspended losses, if any, will be allowed in full when the taxpayer disposes of his entire interest in the property received in the tax-free exchange.\textsuperscript{153} However, suspended losses may not be applied against income from the property received in the exchange where the income is attributable to an activity different from the one which the taxpayer exchanged. For example, suspended passive activity losses may not be applied against the portfolio income of a pass-through entity such as an S corporation or a partnership.\textsuperscript{154} To the extent the taxpayer recognizes gain on an otherwise tax-free exchange, the gain is treated as passive activity income which may be offset with passive activity losses.\textsuperscript{155}

Some transactions, such as a section 1031 like-kind exchange, may result in a taxpayer no longer having an interest in the original activity. In that situation, there is no special rule permitting the suspended losses

\textsuperscript{146} Senate Report, supra note 2, at 726.


\textsuperscript{148} Id. § 469(j)(6)(B).

\textsuperscript{149} Senate Report, supra note 2, at 726.

\textsuperscript{150} Id. at 726 n.12.

\textsuperscript{151} Id. at 726-27.

\textsuperscript{152} Id. at 727 n.14.

\textsuperscript{153} Id.

\textsuperscript{154} Id.

\textsuperscript{155} Id.
from the prior interest to be offset by income from the new activity, unless it is also a passive activity. Where a "pre-enactment interest" is exchanged after the effective date of section 469, the interest received will not likely be deprived of the section 469(1) phase-in rules where the exchange is a section 351 or 721 transaction since the taxpayer is treated as retaining an interest in the activity. The interest received, however, will probably be deprived of the phase-in rules where there is a section 1031 exchange and the taxpayer does not retain an interest in the original activity.

VIII. CHANGE FROM PASSIVE ACTIVITY TO NON-PASSIVE ACTIVITY

Circumstances which terminate the application of the passive activity loss rule to a taxpayer may arise without a disposition of the activity. For example, an individual who previously was passive with respect to an activity which generated net losses may begin to materially participate in the activity. In that situation, previously suspended losses and credits of the former passive activity will remain suspended and continue to be treated as passive activity losses and credits. However, such losses and credits, unlike passive activity losses and credits generally, are allowed against income (and the related tax with respect to credits) realized from the activity after it ceases to be a passive activity with respect to the taxpayer if the taxpayer is able to show that such income (and related tax with respect to credits) is from the same activity in which the taxpayer previously did not materially participate.

Similarly, when a closely-held corporation that is not a personal service corporation ceases to be subject to the passive loss rule because, for example, it becomes non-closely held, its suspended passive losses and credits continue to be deductible against all income (and related tax with respect to credits) other than its portfolio income (and related tax with respect to credits). Deductions arising after the year in which it became non-closely held are not subject to limitation under the passive activity loss rule.

IX. DEFINITION OF ACTIVITY

One of the most important determinations that must be made in applying the passive activity loss rule is the determination of the scope of a particular activity. This determination is important in establishing material participation with respect to an activity. For example, if the

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156. Id. at 727 n.13.
158. Id.
159. Id. § 469(f)(2).
160. SENATE REPORT, supra note 2, at 728.
same activity involves two undertakings, material participation with respect to the activity as a whole need only be established; if, however, they are separate activities the taxpayer must establish material participation separately for each activity.\(^{162}\) In addition, in the case of a disposition, determination of the scope of the activity is critical to determine whether the taxpayer has disposed of his entire interest in the activity or only a portion thereof.\(^{163}\) Moreover, the determination of the scope of an activity is also important with respect to determining the satisfaction of the 10% ownership requirement for active participation in a rental real estate activity.\(^{164}\) "The question to be answered is what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss."\(^{165}\) The relevant facts and circumstances for identification in determining the scope of a particular activity include the extent of the organizational and economic interrelationship of the various undertakings, the business purposes which are or could be served by carrying on such undertakings separately or together, and the similarity of the various undertakings.\(^{166}\)

Providing two or more substantially different products or services will generally involve more than one activity unless the products or services are customarily provided together, such as the clothing and appliance departments of a department store.\(^ {167}\) Generally, where the production and sale of a particular product are not carried on in an integrated fashion, the production and sale stages will not be part of the same activity.\(^ {168}\) Normal commercial practices are highly relevant in determining whether two or more undertakings are part of a single activity.\(^ {169}\)

Where two undertakings involve the same products or services they are not automatically treated, by virtue of these similarities, as part of the same activity.\(^ {170}\) For example, where separate real estate rental projects are constructed and managed in different locations by a real estate operator they will generally constitute separate activities. Conversely, an integrated department store or shopping center will generally be treated as a single activity.\(^ {171}\) The conduct of two or more undertakings by the same entity, such as a partnership or S corporation, does not establish that they are part of the same activity. Similarly, the conduct of two or more undertakings by different entities does not establish that they are different

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163. Id. at 739.
164. Id. at 739 n.27.
165. Id. at 739.
167. Senate Report, supra note 2, at 739.
168. Engaging in oil and gas drilling and operating a retail gas station will generally not be part of the same activity. Id. at 740.
169. Id.
170. Id.
171. Id.
activities.\textsuperscript{172}

Any undertaking that is accorded special treatment under the passive loss rule, such as where an activity is always treated as either active or passive, is not treated as part of the same activity as any undertaking that does not receive identical treatment under the passive loss rule.\textsuperscript{173} An oil and gas working interest, where the taxpayer's liability is not limited with respect to such interest, is treated as not passive and as being separate from any undertaking not related to oil and gas working interests.\textsuperscript{174}

**X. TREATMENT OF LOSSES AND CREDITS**

Passive activity losses are generally deductible only against income from a passive activity. Suspended passive activity losses may be carried forward indefinitely but are not carried back, and are allowed in subsequent years against passive activity income.\textsuperscript{175} Suspended losses from an activity are allowed in full upon a taxable disposition to an unrelated party of the entire activity.\textsuperscript{176}

If in any given year any passive activity losses are not deductible, the amount of the suspended losses from each passive activity must be determined on a pro-rata basis.\textsuperscript{177} The portion of the loss that is suspended and carried forward with respect to each activity is determined by the ratio of net losses from that activity to the total net loss from all passive activities for the year. Such allocation is necessary to determine the suspended losses for any particular activity.

If a taxpayer has passive losses allowed under the $25,000 allowance for rental real estate activities in which he actively participated, but insufficient non-passive income against which to apply them, the otherwise allowable rental real estate losses are treated as net operating losses arising in that year and may be carried forward and back in accordance with the rules applicable to net operating losses.\textsuperscript{178} Such net operating losses are taken into account only after reducing income from passive activities by current and suspended deductions from passive activities.\textsuperscript{179} If a taxpayer has net passive activity income for a year after applying all of his suspended past losses, the income may be offset by current year non-passive losses and by net operating loss carryovers.\textsuperscript{180}

The at-risk rules are applied first in determining whether a loss is suspended under the passive activity loss rule.\textsuperscript{181} If a loss is not allowed

\textsuperscript{172} Id.
\textsuperscript{173} Id. at 741.
\textsuperscript{174} Id.
\textsuperscript{175} Senate Report, supra note 2, at 722.
\textsuperscript{176} Id.
\textsuperscript{177} I.R.C. § 469(j)(4) (West Supp. 1988); Senate Report, supra note 2, at 722.
\textsuperscript{178} Senate Report, supra note 2, at 722.
\textsuperscript{179} Id.
\textsuperscript{180} Id. at 722-23.
\textsuperscript{181} Id. at 723.
to a taxpayer because of the at-risk rules, such loss is treated as being suspended under the at-risk provision, not the passive loss rule.\textsuperscript{182} Such amounts may become subject to the passive activity loss rule in later years when they would be allowable under the at-risk limitations.\textsuperscript{183} During the period in which the passive activity loss rule is phased in, these rules interact in the same manner.\textsuperscript{184} Interest deductions are subject to limitation under the passive activity loss rule and not under the investment interest limitation.\textsuperscript{185} Any passive activity losses allowed under the phase-in rules (other than from rental real estate activities in which the taxpayer actively participates), however, reduce net investment income.\textsuperscript{186}

Generally, credits arising with respect to passive activities are treated in the same manner as deductions.\textsuperscript{187} Credits may not be used to offset tax attributable to income other than passive activity income. The amount of tax attributable to net passive income is determined by comparing the amount that the taxpayer would pay with regard to all of his income, with the amount the taxpayer would pay with regard to all of his taxable income other than his net passive activity income.\textsuperscript{188}

Under the $25,000 benefit for certain rental real estate activities, passive activity credits may be used to offset tax on income other than passive activity income. Under that rule, credits are applied to offset tax on the portion of the $25,000 (or less as appropriate, i.e., in the phase-out range for that amount) that the taxpayer has not been able to offset by the use of deductions.\textsuperscript{189} The amount of tax on the remaining portion is determined by comparing (1) the amount that the taxpayer would owe, disregarding credits, with respect to income computed without any net passive losses other than the rental real estate deductions in the full amount allowable under the $25,000 rule, with (2) the amount the taxpayer would owe, disregarding credits, if the allowable rental real estate deductions equalled $25,000 or a lower phase-out amount.\textsuperscript{190}

Credits arising with respect to passive activities can be carried forward indefinitely, but cannot be carried back.\textsuperscript{191} The character of a passive activity credit changes, in effect, when the credit becomes allowable under the passive activity loss rule.\textsuperscript{192} At that time, the credit is aggregated with credits relating to non-passive activities of the taxpayer for purposes of determining the allowability of all such credits in light of

\textsuperscript{182} Id.
\textsuperscript{183} Id.
\textsuperscript{184} Id.
\textsuperscript{185} Id.
\textsuperscript{186} CONFERENCE REPORT, supra note 29, at II-139.
\textsuperscript{187} SENATE REPORT, supra note 2, at 723.
\textsuperscript{188} Id.
\textsuperscript{189} I.R.C. § 469(i)(3)(C) (West Supp. 1988); SENATE REPORT, supra note 2, at 724.
\textsuperscript{190} SENATE REPORT, supra note 2, at 724.
\textsuperscript{191} Id.
\textsuperscript{192} Id.
other limitations applying to the use of credits.\textsuperscript{193} In the event that other limitations are applicable and any credits are not allowed, the passive credits that are allowable under the passive activity rules are then treated as non-passive credits arising in the current taxable year.\textsuperscript{194} The treatment of such credits is then determined under the general rules applying to such credits, including carryover periods.\textsuperscript{195}

XI. EFFECTIVE DATE AND PHASE-IN RULES

The passive activity loss rule is effective for all taxable years beginning on or after January 1, 1987.\textsuperscript{196} The rule applies to all passive activity losses incurred in taxable years beginning on or after that date, and to passive activity credits for property placed in service in taxable years beginning on or after that date. However, interests in passive activities acquired by the taxpayer on or before the date of enactment of the TRA '86 are eligible for the phase-in of the passive activity loss rule. Thus, interests in activities acquired after October 22, 1986 are not eligible for the phase-in, but rather are fully subject to the passive activity loss rule.\textsuperscript{197} The amount of the passive activity loss, or the deduction equivalent of the passive activity credit, that is allowed with respect to pre-enactment interests is 65\% of the amount of such losses or deduction equivalent credits in the case of a taxable year beginning in 1987; 40\% for a taxable year beginning in 1988; 20\% for a taxable year beginning in 1989; and 10\% for a taxable year beginning in 1990.\textsuperscript{198}

Where a taxpayer owns both pre-enactment and post-enactment interests in passive activities, the amount of passive activity loss qualifying for the phase-in is determined by first determining the amount that would be disallowed without the phase-in relief. The phase-in relief then applies to the lesser of the taxpayer’s total passive activity loss, or the taxpayer’s passive activity loss determined by taking into account only his pre-enactment interest.\textsuperscript{199} For example, if a taxpayer has $100 of passive activity loss resulting from a pre-enactment interest that would be disallowed in the absence of the phase-in relief, and net passive activity income of $60 from a post-enactment interest, resulting in a net passive activity loss of $40, then the phase-in relief applies to the lesser of $100 and $40, i.e., $40. For purposes of applying this rule, the pre-enactment and post-enactment passive activity losses are calculated by including the deduction equivalent of passive activity credits.\textsuperscript{200}

Any interest acquired after the date of enactment of the TRA '86

\begin{itemize}
  \item\textsuperscript{193} Id.
  \item\textsuperscript{194} Id.
  \item\textsuperscript{195} Id.
  \item\textsuperscript{196} TRA '86, supra note 1, § 501(c)(1).
  \item\textsuperscript{197} See I.R.C. § 469(m)(3)(B)(i) (West Supp. 1988).
  \item\textsuperscript{198} See id. § 469(m)(1)-(2).
  \item\textsuperscript{199} Id. § 469(m)(3).
  \item\textsuperscript{200} Id.; CONFERENCE REPORT, supra note 29, at II-149 to -150.
\end{itemize}
pursuant to a written binding contract in effect on such date, and at all times thereafter, shall be treated as a pre-enactment interest.201 A binding contract will qualify under this rule even if the obligation to acquire an interest is subject to contingencies, provided that the contingencies are beyond the reasonable control of the taxpayer.202 If a taxpayer's ownership interest in an activity is increased after the date of enactment of TRA '86, then the portion of his interest attributable to the increase will not qualify for the phase-in relief, except to the extent the increase comes under the binding contract exception.203 In addition, if a taxpayer's interest is reduced after the date of enactment and subsequently restored to the original amount, it is only the reduced amount that qualifies for phase-in relief after the restoration.204 This result follows from the statutory definition of a "pre-enactment interest" as "any interest in a passive activity held by a taxpayer on the date of the enactment of the TRA '86 and at all times thereafter."205 Thus, in order to qualify as a pre-enactment interest the activity must have been conducted on the date of enactment unless the property used in the activity is acquired pursuant to a written binding contract in effect on August 16, 1986 and all times thereafter, or construction of the property used in the activity began on or before August 16, 1986.206

The phase-in rule applies to the passive activity net loss after such loss has been utilized against non-passive income under the $25,000 rental real estate rule.207 Furthermore, there is a transitional rule for certain low income housing which provides that if a qualified investor208 sustains any loss with respect to an interest in a qualified low-income housing project209 for any taxable year in the relief period, such loss shall

202. CONFERENCE REPORT, supra note 29, at II-148 to -149.
203. Id. at II-149.
204. See id. at II-149 n.6.
206. Id. § 469(m)(3)(B)(iii).
207. CONFERENCE REPORT, supra note 29, at II-150.
208. A "qualified investor" is any natural person who holds, directly or through one or more entities, an interest in a qualified low-income housing project, if, (1) in the case of a project placed in service before August 16, 1986, such person held an interest in the project on August 16, 1986, and the taxpayer made his initial investment after December 31, 1983, or in the case of a project placed in service on or after August 16, 1986, such investor held an interest in such project on December 31, 1986, and (2) if such investor is required to make payments after December 31, 1986, of 50% or more of the total original obligated investment for such interest. For these purposes, a person is treated as holding an interest on August 16, 1986, or December 31, 1986, if on such date the person had a binding contract to acquire the interest. TRA '86, supra note 1, § 502(d)(1). The estate of a decedent shall be treated as a qualified investor, if the decedent was a qualified investor, for the first two taxable years of the estate ending after the date of the decedent's death. Id. § 502(d)(2).
209. A "qualified low-income housing project" is any project if (1) the project meets the requirements of clauses (i), (ii), (iii) or (iv) of I.R.C. § 1250(a)(1)(B) upon the date the project is placed in service and for each taxable year thereafter which begins after 1986 and for which a passive loss may be allowable with respect to the project;
not be treated as a loss from a passive activity. 210 The "relief period" is the period beginning with the taxable year in which the investor made his initial investment in the qualified low-income housing project and ending with the earlier of the following: (1) the sixth taxable year after the taxable year in which the investor made his initial investment; (2) the first taxable year after the taxable year in which the investor is obligated to make his last investment; or (3) the taxable year preceding the first taxable year for which the project ceased to be a qualified low-income housing project. 211

If a project contains more than one building, the determination of when the project is placed in service shall be based on when the first building in the project was placed in service. 212 In determining the amount that any person invests in or is obligated to invest in any interest, only cash and other property is taken into account. 213 No low-income housing credit shall be determined under section 42 with respect to any project that has been the subject of an allowance of any benefit to any person under this transitional rule for low-income housing. 214

XII. 1987 LEGISLATION AND HINTS OF FUTURE LEGISLATION OR REGULATIONS

On December 22, 1987, the Revenue Act of 1987215 (the Revenue Act) was passed by Congress and signed into law. In general, under section 10211 216 of the Revenue Act, adding new section 7704 to the Code, "publicly traded partnerships" 217 that do not have 90% or more of their gross income consisting of "passive type" income 218 for the current tax-
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ble year and each preceding taxable year beginning after December 31, 1987 are treated as corporations for federal income tax purposes.

The Revenue Act also has provisions providing for the treatment of publicly traded partnerships under the passive activity loss rule. Under section 469 of the Code, as amended by section 10212 of the Revenue Act, net income from publicly traded partnerships is not treated as passive activity income for purposes of the passive activity loss rule, but rather is treated as portfolio income. On the other hand, net losses attributable to an interest in a publicly traded partnership are not allowed against the partner’s other income but are suspended or carried forward and may be applied against net income in succeeding years in which either the partnership has net income or any partner completely disposes of his partnership interest. If the partnership has both portfolio income and losses from business activities, a partner’s share of the loss may not be applied against the portfolio income.219

Further modifications to section 469 were proposed in section 105(a) of the Technical Corrections Bill of 1987.220 Although it was not passed by Congress, it provides a guide to possible future legislation. The bill would have clarified the definition of portfolio income, the treatment of dispositions, active participation requirements for the allowance of up to $25,000 of losses, and the application of the passive loss rules to consolidated corporate tax returns. In addition, if section 280A(c)(5) limitations applied to a residential rental unit, then income, deductions, and gain or loss from rental use would not have been taken into account for purposes of section 469. Finally, the bill would have allowed passive activity treatment for post-1986 gain arising from a pre-1987 installment sale, if it could be shown that the activity would have been considered a passive activity under post-1986 rules.

XIII. PLANNING CONSIDERATIONS

While dealing with the passive activity loss rules may seem like a totally exhausting task, the tax planner must also keep in mind other anti-tax shelter rules, such as the rules relating to the tax basis of partnership interests and S corporations in sections 704(d) and 1366(d), and the at-risk rules in section 465. For example, in 1988 a taxpayer may have $100,000 of passive activity income from activity X, and $50,000 of passive activity loss from activity Y which is not allowed because of the at-risk rules. The $100,000 of passive activity income will be taxable income in 1988 and the $50,000 of passive activity loss will be carried forward to 1989 and will not be allowed in 1989 if the taxpayer has insufficient passive activity income in 1989, even though the at-risk rules are satisfied in 1989.

and certain income and gains from commodities or futures, forwards, and options with respect to commodities. I.R.C. § 7704(d) (West Supp. 1988).

219. Id. § 469(k).
In addition, as previously noted, any passive activity loss allowed by virtue of the phase-in provisions (other than losses from rental real estate activities in which the taxpayer actively participates) will reduce net investment income for purposes of the investment interest limitation.\textsuperscript{221} For example, assume that taxpayer has a $40,000 net passive activity loss (including $10,000 interest expense) that does not fall within the active participation exemption, $36,000 of investment income, and $16,000 of investment interest expense (not part of the passive activity loss). In 1987 the taxpayer will be able to use $26,000 (65\%) of his passive activity loss against his active income. The taxpayer's investment interest subject to the investment interest limitation is $16,000 (it does not include the interest expense allocated to the passive activity). However, his investment income of $36,000 is reduced by the allowed phase-in passive activity loss of $26,000, so that his investment income available to offset his $16,000 investment interest expense is $10,000. Therefore, net investment interest expense is $6,000 and he would be allowed $3,900 (65\%) under the transitional rule,\textsuperscript{222} with the balance of $2,100 being carried over to 1988.

Moreover, there is no phase-in of the passive activity loss rules for purposes of the alternative minimum tax.\textsuperscript{223} Consequently, while a taxpayer might owe no regular tax because of the application of the phase-in rules, he could nevertheless owe alternative minimum tax.

The basic steps in planning with respect to the passive activity loss rules involve (1) identifying and separating each activity and determining its expected net income or loss; (2) categorizing, where possible, income activities as passive and loss activities as active; and (3) obtaining, if feasible, additional passive income to utilize passive activity losses or credits that otherwise would not be utilized. In attempting to categorize income activities as passive, a reduction in the taxpayer's nonrental activities to something less than material participation should be considered, as well as structuring nonrental activity interests as limited partnership interests in situations where the limited partners would not be treated as materially participating. In addition, holding a profitable working interest in an oil and gas activity in a limited partnership or S corporation should be considered. Current leases to a related C corporation should be examined to see if the rent can be increased, and proposed purchases of business property by a C corporation might be cancelled, with the shareholder purchasing the property and leasing it to the corporation.\textsuperscript{224} Similarly, the purchase of a business could be structured so that an entity,

\textsuperscript{222} Id. § 163(d)(6).
\textsuperscript{223} Id. § 58(b)(3).
\textsuperscript{224} However, net rental activity income will be treated as non-passive income if the property is rented for use in a trade or business activity in which the taxpayer materially participates (determined without regard to the rules regarding limited parties). Temp. Treas. Reg. § 1.469-2T(f)(6) (1988). Effective for taxable years of the taxpayer beginning after December 31, 1987, except that the rule does not apply to
perhaps an S corporation, acquires, all of the business assets except the real estate, which is purchased by a limited partnership and leased to the entity.225

In attempting to categorize nonrental loss activities as active, a taxpayer who is not materially participating should, where feasible, consider increasing his participation to the point where he is materially participating. In addition, the taxpayer should, where feasible, avoid holding nonrental loss activities as a limited partner in situations where he would otherwise be materially participating. An S corporation would seem to be a preferred structure in that situation. Finally, the taxpayer should consider placing his tax shelters into a C corporation.

Finally, the tax practitioner should keep abreast of any additional regulations which may be promulgated pursuant to the formidable regulatory authority granted to the Treasury under section 469(l). The tax practitioner should also be aware of potential legislative changes or modifications which Congress may make to section 469.

XIV. CONCLUSION

Section 469 appears to be the ultimate weapon in the tax shelter war. However, its complexity is such that it may create accounting and legal nightmares that breed haphazard compliance. The effectiveness of section 469 will depend, in large part, upon taxpayer compliance which in turn will depend, in large part, upon whether the public perceives the new and future regulations as being workable and equitable.