Under section 469(c)(6), the term “trade or busines

derived from property that was recently used in a trade or business activity of the taxpayer and is temporarily rented, (d) the property is held for sale to customers in the ordinary course of a trade or business and is in fact sold during the taxable year.

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

The sixth exception relates to property provided fo

the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

B Effect of Net Acti e nco e of C ose y e d Corpor tion

Section 469(e)(2)(A) provides that the passive activity loss of a closely held corporation shall be allowable as a deduction against the net active income of such a corporation, and that a similar rule shall apply in the case of any passive activity credit of

regulations as may be necessary or appropriate to carry out provisions of section 469, including regulations relating to changes in marital status and changes between joint returns and separate returns.

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

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

The Service invites comment on the treatment of married persons.

- *Definition of P ssi e Acti ity Loss*

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

- *dentific tion of te s of Gross nco e nd Ded ctions Fro P ssi e Acti ities*

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

X re t ent of G in Fro the Disposition of n nterest in n Acti ity or Property sed in n Acti ity

A Gener R e Ch r cteriz tion of G in t the i e of the Disposition

Gain from a disposition of property used in an activity or of an interest in an activity held through a

Section 1.469-2T(c)(3) provides that passive activity gross income does not include portfolio income, which is defined as gross income that is derived from specified sources (including interest, dividends,

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

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

B nco e Fro Retire ent P ns

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

X peci R es for P rtners nd Corpor tion h reho ders

A n Gener

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

B Cert in P y ents to P rtners

Section 1.469-2T(e)(2)(i) provides that items of gross income and deduction attributable to a transaction between a partner and a partnership shall be characterized for purposes of section 469 in a manner consistent with the treatment of such transaction under section 707(a). Section 1.469-2T(e)(2)(ii) provides

E Possi e Rech r cteriz tion R es to e Cont ined in F t re Reg tions

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

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

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

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

the taxable year in which such expenditures are paid or incurred, or (b) it is reasonable to believe that the rehabilitated property will be used in a passive activity of the taxpayer when it is placed in service.

B Deter in tion of Reg r Li i ity A oc e to P ssi e Acti ities

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

C Coordin tion ith Other Li it tions on Credits

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

X M teri P rticip tion

A n Gener

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

B Q ntit ti e tests

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

The Service believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable year to any such investment. In addition, the Service believes that income from an activity in which an individual participates for more

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

C ests B sed on M teri P rticip tion in Prior Ye rs

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

Under §1.469-5T(a)(6), an individual is treated as materially participating in a personal service activity for a taxable year if the taxpayer materially participated in the activity for any three taxable years that precede the taxable year. For purposes of this rule, an activity is a personal service activity if it principally involves the performance of personal services in (a) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or (b) any other trade or business in which capital is not a material income-producing factor.

These rules are included because the Service believes that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood

or (b) the taxpayer is treated as materially partic

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

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

B Effect of E ents Occ rring in Ye rs Beginning Prior to

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

C r nsition R e for Losses Fro Pre En ct ent nterest

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

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

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

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

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Final and temporary regulations.

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This document contains final and temporary regulations relating to the limitation on passive activity