Passive Activity Losses in Light of the New Section 469 Temporary Regulations

Hans-Dieter Sprohge
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by

HANS-DIETER SPROHGE*

INTRODUCTION

The Tax Reform Act of 1986 created Internal Revenue Code (I.R.C.) Section 469. The purpose of this Section is to prevent certain taxpayers from sheltering income with non-cash losses from businesses in which the taxpayers do not participate. The new Regulations are intended to provide taxpayers with guidance on compliance with the rules of Section 469. Taxpayer compliance is difficult for two reasons: First, the Regulations do not address some of the key Section 469 concepts and rules. The Section 469 concepts and rules omitted by the first set of Section 469 Regulations will be discussed in future regulations. The Treasury Department has not made known either the content or the date of future Section 469 regulations. The only currently available guidance for complying with the Section 469 rules that the Treasury Department has deferred to future regulations is Section 469 itself and its legislative history. Second, both the Section 469 rules and the new Regulations are characterized by labyrinthian complexity. This article reduces the complexity by explaining the logic and concepts underlying Section 469 and the new Regulations. The overall logic of Section 469 and the new Regulations is based on differentiating three types of income and loss and placing limitations on the ability to offset either (a) one type of income with another type of loss, or (b) the amount of income with the same type of loss. Generally, loss is the excess of deductions allowed under the I.R.C. over taxable gross income. This article explains how the three types of gross income and the three types of allowable deductions are used to determine the three types of losses and the limitations placed on the type and amount of income these losses can offset.

This article begins by explaining how the Regulations define taxpayers to which the Section 469 rules apply. Next, it is shown that the key to understanding the limitations the Section 469 rules and the new Regulations place on the ability to offset income with losses is the concept of an income-generating activity. Unfortunately, a discussion of what constitutes an activity has been deferred to future regulations. This deferral is unfortunate because Section 469 uses the concept of an income-generating activity to differentiate three types

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of gross income — active, passive, and portfolio. This article goes on to show how the Regulations explain what constitutes active activity, passive activity, and portfolio activity gross income. What distinguishes the three types of income is the degree of taxpayer participation in the income-generating activity. Gross income is active if the taxpayer materially participates in generating it. Separate regulations are provided for what constitutes "material" and "participation." Gross passive activity income is either income generated without the taxpayer's participation or rental income. Gross portfolio income is income generated by the taxpayer's investment activities. This article continues by explaining how the recharacterization rules in the Regulations are designed to prevent taxpayers from converting certain passive activity gross income into active activity income or portfolio activity income. Understanding the three types of income and the recharacterization rules is important because they determine the characterization of deductions and, hence, losses. The characterization of losses as active, passive, or portfolio is important because their character determines the amount and type of income they can offset.

The next section of this article explains that deductions are active if (1) incurred in the generation of active income, (2) passive, if incurred in the generation of passive income, and (3) portfolio, if incurred in the generation of portfolio income. Since loss is the excess of deductions allowed under the I.R.C. over taxable gross income. The three types of gross income and the three types of allowable deductions determine the character of losses. Active activity losses occur when active activity deductions exceed taxable active gross income. Passive activity losses (PALs) occur when passive activity deductions exceed taxable passive activity gross income. Losses are portfolio losses if generated by portfolio activities. Further, this article points out that (a) the character of losses received from flowthrough entities depends on the taxpayer's degree of participation in the activities that generated them and (b) that special rules apply to the characterization of a closely-held corporation's losses.

The next section of this article explains that a passive activity credit (PAC) is a tax credit arising in connection with a passive income-generating activity. The explanation of what constitutes a PAL and a PAC is followed by a discussion of the limitations imposed on their ability to offset the three types of income. Generally, a taxpayer may use active activity losses to offset any other type of income. The limitations placed on PALs and PACs are similar. A taxpayer may use PALs only to offset passive activity income and PACs only against taxes from passive activity income. If no passive activity income is available, the PALs are suspended and may be used as deductions in the same activity that generated them in the immediately succeeding taxable year. The ability to offset portfolio losses is governed by other sections of the I.R.C. Realized losses resulting from a complete taxable disposition of either an active or a passive income-generating activity may be used to offset any other type of income except portfolio income.
This article goes on to explain the three exceptions to the PAL rules. These exceptions are for a working interest in an oil- and gas-producing activity, rental real estate, and trading personal property.

Obviously, no specific tax planning suggestions can be made based on an overview of the first set of Section 469 regulations. However, some general tax planning principles that can be inferred from the Regulations are provided.

Lastly, this article concludes that considerably more guidance is needed in the form of Treasury Department regulations in order for taxpayers to comply with Section 469.

**TAXPAYERS SUBJECT TO THE PAL RULES**

Under Section 469(a)(2) individuals, trusts, estates, personal service corporations, and closely-held corporations are subject to the PAL rules. The Regulations only deal with what constitutes a personal service corporation or a closely-held corporation. A personal service corporation is a C corporation the principal activities of which are the rendering of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting by employee-owners who own, either directly or indirectly, more than 10% of the stock of the corporation.²

A closely-held corporation is a C corporation that is not a personal service corporation and in which five or fewer individuals own more than 50% of the corporations outstanding stock during the last half of the taxable year.³ A corporation having fewer than ten shareholders always meets the stock ownership requirements (100% ÷ 9 = 11%, 11% * 5 = 50%). For purposes of determining ownership, attribution is required under Section 544 for any stock owned by a corporation, partnership, estate, or trust by or for a taxpayer's family.⁴ Stock attributed to one family member can not be re-attributed to another family member.⁵ Stock attributed from a partner to the taxpayer can not be re-attributed to a member of the taxpayer's family or another partner.⁶ Stock options are treated as constructive ownership of the underlying securities.⁷ Convertible securities are treated as outstanding stock.⁸

An affiliated group of corporations filing a consolidated return is treated

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² Temp. Treas. Reg. § 1.469.1T(g)(2)(i) (1988) defines a personal service corporation as a C corporation that is a personal service corporation within the meaning of Temp. Treas. Reg. § 1.441-4T(d) and is not a personal holding company.
³ Temp. Treas. Reg. § 1.469.1T(g)(2)(ii) (1988) defines a closely-held corporation as a C corporation that meets the stock ownership requirements of § 542(a)(2) subject to the modifications of § 465(a)(3).
⁶ Id.
⁸ I.R.C. § 544(b) (1986).
as a single corporation. The status of each member of an affiliated group as a personal service corporation or a closely-held corporation is the same as the status of the entire consolidated group determined as though the group were a single corporation. Only the outstanding stock of the common parent is treated as the outstanding stock of such a corporation.

THE CONCEPT OF AN INCOME-GENERATING ACTIVITY

Section 469 differentiates three types of gross income by reference to three types of activities that produce them. Neither the I.R.C. nor the Regulations define "activity." Until future regulations are promulgated as to what constitutes an activity, the only guidance currently available is the I.R.C. and the legislative history of Section 469. Although the Senate Finance Committee Report does not define an "activity," the Report does provide indicia on what constitutes separate activities. A separate activity is an undertaking that "consists of an integrated and interrelated economic unit . . . and constituting an appropriate unit for the measurement of gain or loss." Whether undertakings possess the requisite degree of economic integration and interrelationship to constitute an aggregated activity is subject to a general facts and circumstances test in which normal business practices are highly relevant, and legal form is irrelevant.

Generally, activities can be differentiated on the basis of products or services. For example, selling clothing and selling appliances are two separate activities because two different products are involved. However, if application of the general facts and circumstances test reveals that selling clothing and appliances is economically integrated as different activities of a department store, then it would be categorized as a single income-producing activity. Economic integration is independent of legal form, management control, or financing arrangements. For example, rental real estate may not be a single income-producing activity even though operated by a single legal entity, such as an individual, a partnership, a C corporation, or an S corporation, if application of the general facts and circumstances test indicates a lack of economic integration because rental units are located in disparate geographic areas.

13 Id.
14 Id. at 739-41.
15 Id.
16 Id.
17 Id.
18 Id.
19 Id. at 740.
ACTIVE ACTIVITY GROSS INCOME

Income is active activity gross income if generated by the taxpayer in accordance with the material participation standards. Separate regulations are provided for what constitutes "material" and what constitutes "participation." The Regulations provide seven tests of materiality. The first four tests are quantitative in nature and are based on the number of hours spent in the activity during the year. The fifth and sixth test are based on material participation in the activity by the taxpayer in prior years. The seventh test is a general facts and circumstances test.

The Seven Tests of Materiality

The first three quantitative tests of material participation pertain to the taxpayer's participation in a single activity. They are, whether during the taxable year:

1. The taxpayer participates in a single activity for more than 500 hours;
2. The taxpayer's participation in a given activity constitutes essentially all the participation in a single activity; and the taxpayer participates in a single activity for more than 100 hours and the taxpayer's participation is not less than that of any other individual's.

The second and third tests permit a taxpayer's participation in a single activity to fall short of 500 hours during the taxable year.

The fourth quantitative test of material participation pertains to the taxpayer's participation in more than one activity. It is whether during the taxable year:

1. Taxpayer’s aggregate participation in all significant participation activities exceeds 500 hours.

A significant participation activity is a trade or business activity in which the taxpayer participates for more than 100 hours during the taxable year and which would be an activity in which the taxpayer does not materially participate without regard for the fourth test.

21 Id.
22 Id.
23 Id.
24 Id.
The fifth and sixth tests pertain to the taxpayer’s material participation in an activity in prior years. They are whether:

(5) the taxpayer materially participated in the same activity for any five of the preceding ten taxable years; and the

(6) taxpayer materially participated in the same personal service activity for any three preceding taxable years.\(^{27}\)

For purposes of the sixth test, an activity is a personal service activity if it involves the rendering of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.\(^ {28}\)

The seventh test is a general facts and circumstances test.\(^ {29}\) The Treasury Department delayed discussion of the nature of this test to future regulations. However, the current Regulations state that participating less than 100 hours during the taxable year will be insufficient to constitute material participation under any future general facts and circumstances test.\(^ {30}\) Specifically excluded from any future general facts and circumstances regulations in determining whether a taxpayer is materially participating in an activity are the material participation standards in other provisions of the I.R.C., such as Sections 1402 and 2032A, and managerial activities in which a paid manager participates and his participation is not exceeded by others.\(^ {31}\)

For purposes of Section 469, a taxpayer does not materially participate in any activity of a limited partnership.\(^ {32}\) There are two exceptions to this general rule.\(^ {33}\) First, the rule does not apply if the individual was not a limited partner in a particular year and (a) the taxpayer’s participation in the activity exceeds 500 hours during the taxable year, (b) the taxpayer materially participated in the same activity for any five of the preceding ten taxable years, or (c) the taxpayer materially participated in the same personal service activity for any three preceding taxable years.\(^ {34}\) Second, the general facts and circumstances test does not apply if the limited partner is also a general partner at all times during the partnership’s taxable year ending with the limited partner’s taxable year or the portion of the partnership’s taxable year during which the limited partner, directly or indirectly, owns such limited partnership interests.\(^ {35}\) For pur-

poses of this rule, a partnership interest is a limited partnership interest if either (1) it is designated as such in the limited partnership agreement, or (2) the liability of the limited partner is limited to a determinable fixed amount, such as contractual obligations to make additional capital contributions to the partnership.36

Participation

Participation in an activity means all work done in an activity by a taxpayer who owns an interest in the activity (other than an interest owned through a C corporation) without regard to the capacity in which the taxpayer performs such work.37 Work in an activity does not constitute participation if it is either (1) performed in connection with the taxpayer’s capacity as an investor or (2) not customarily performed by an owner and the purposes of doing it is to avoid the disallowance of PALs or PACs.38 For married taxpayers, the participation of the spouse is attributed to the taxpayer without regard to whether (1) the participation of the spouse is material participation, (2) the spouse owns an interest in the activity, or (3) a joint return is filed.39 Whether a taxpayer’s income-producing activity is classified as active is important, because the classification of income as passive is also dependent on the material participation standard.

The Regulations specifically include personal service income in active activity gross income. In general, personal service income is compensation received for personal services performed by an individual.40 Any payments to a partner as compensation for personal service that in accordance with Section 707(a) or (c) is considered to be a transaction occurring between the partnership and one who is not a partner is active activity gross income.41 All distributions from pension, profit sharing, or other retirement plans are active activity gross income, even though some portion thereof may represent investment income.42

Passive Activity Gross Income

Income is passive activity gross income if generated by activities that involve the conduct of a trade or business in which the taxpayer does not materially participate or by rental activities.43 An activity is a trade or business if it involves (1) the conduct of a trade or business under Section 162, (2) research or experimental expenditures deductible under Section 174, or (3) activities

43 I.R.C. § 469(c) (1986).
for which expenses are deductible under Section 212. Despite this reference to Section 212, the Regulations do not treat any activities subject to Section 212 as a trade or business. Under the Regulations, a rental activity is any activity the income from which consists of payments for the use of tangible property.

To prevent the conversion of active activity gross income into passive activity gross income, the Regulations provide six exceptions to this definition. Activities generating income from the use of tangible property are not rental activities if:

1. the average period of customer use of such property is seven days or less e.g., cars, video cassettes, tuxedos;
2. the average period of customer use for such property is less than 30 days and significant personal services are provided e.g., a hotel;
3. extraordinary services are provided by, or on behalf, of the owner in connection with making the property available for use by customers;
4. the rental are incidental to the non-rental activities of the taxpayer;
5. the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers e.g., a golf course; or,
6. the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity and the taxpayer provides property for use in the activity in the taxpayer's capacity as owner of an interest in such partnership, S corporation, or joint venture.

In the second exception, any services provided by individuals are significant services. A significant personal service is one in which there is not a large portion of non-service rental payments. Examples of services that do not constitute personal services are telephone and cable television services. Additionally, the following specifically excluded services are not taken into account: (a) all services necessary to permit the lawful use of the property, (b) services in connection with the contribution of improvements or in connection with the performance of repairs that extend the useful life of the property, and (c) in the case of improved real property, the kinds of services commonly provided in connection with long-term rentals of high grade commercial and residential property e.g., janitorial services.

48 Id.
49 Id.
In the third exception, personal services are extraordinary if provided by individuals in connection with the use of the property and its use is incidental to the receipt of such services.\(^{52}\) For example, the use by patients of a hospital’s boarding facilities is incidental to the receipt of personal services provided by the hospital’s professional staff.\(^{53}\) In the fourth exception, rental property is incidental to non-rental activity only if (a) the property is held as an investment and the gross rental income from the property is less than 2% of the lesser of its unadjusted basis or market value; (b) the taxpayer owns an interest in a trade or business in which the property was used during at least two of the preceding five taxable years and the gross rental income from the property is less than 2% of the lesser of its unadjusted basis or market value; (c) the property is held for sale to customers in the ordinary course of a trade or business; or (d) the property is lodging provided to the taxpayer’s employees for the convenience of the taxpayer.\(^{54}\)

Specifically excluded from passive activity gross income is compensation received for personal services performed or to be performed.\(^{55}\) These include (1) earned income within the meaning of Section 911(d)(2)(A), (2) amounts includible in gross income under Section 83 (property transferred in connection with performance of services), (3) amounts includible in gross income under Sections 402 and 403 (distributions from qualified plans), (4) other amounts received as deferred compensation, (5) Social Security benefits, and (6) any other items of income the Service may identify as compensation for personal services.\(^{56}\) Not included in compensation for personal services are a partner’s share of a partnership’s income or a shareholder’s pro-rata share of income from an S corporation.\(^{57}\) Also specifically excluded from passive activity gross income are gross income from (7) intangible property, such as patents, copyrights, and literary compositions, if the taxpayer’s personal efforts significantly contributed to the creation of such property; (8) certain qualified low income properties; (9) refunds of state, local or foreign income, war profits, or excess profits taxes; and (10) a covenant not to compete.\(^{58}\)

**Portfolio Activity Gross Income**

The I.R.C. defines portfolio activity gross income as (1) income from any activity that generates interest, dividends, annuities, or royalties and (2) gain or loss from the disposition of (a) investment property that is not used in a passive activity and (b) the sale of assets that produce investment income.\(^{59}\)

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\(^{53}\) Id.


The Regulations include in portfolio activity gross income the payment of interest to a partner for the use of his capital, dividends from C and S corporations, and income from a real estate investment trust, a regulated investment company, a real estate mortgage investment conduit, a common trust fund, a foreign controlled corporation, a qualified electing fund, or a cooperative.60

Interest, dividends, annuities, and so on are not portfolio activity gross income if derived in the ordinary course of a trade or business.61 For example, interest on debt securities held as an investment is, but interest on accounts receivable, is not portfolio activity gross income.62 It may be inferred that if a taxpayer holds the same type of assets for different purposes, then only the income from the assets held as an investment is portfolio activity gross income. For example, it may be inferred that if a dealer in securities holds some stocks as an investment and others for sale to customers, then the dividends from the stocks held as an investment are, and the dividends from the securities held for sale to customers are not, portfolio activity gross income.63 Royalties are derived in the ordinary course of a trade or business if the person receiving such royalties either created the property that generates them or performed substantial services or incurred substantial costs in its creation.64 Although a general facts and circumstances test is used to determine whether substantial services have been rendered or substantial costs have been incurred in generating royalties a person is treated as deriving royalties in the ordinary course of a trade or business if the expenditures incurred exceed either (a) 50% of the gross royalties or (b) 25% of the aggregate capital expenditures.65

RECHARACTERIZATION OF CERTAIN GROSS INCOME

Under authority of Section 469, the Treasury Department may promulgate regulations. These Regulations contain rules that require certain passive activity gross income to be treated as non-passive activity gross income regardless of whether such gross income is treated as Section 469 passive activity gross income.66 These rules fall into two categories. The first category consists of rules designed to prevent taxpayers from converting active business into passive activity gross income by reducing their participation in, and the ownership structure of, their businesses.67 The second category consists of rules designed to prevent taxpayers from converting their portfolio activity gross income into passive activity gross income by replacing their portfolio investments with in-

vestments in rental or passive activity businesses. Since taxpayers could not have anticipated these rules, they are not effective for any taxable year beginning before January 1, 1988.

The Recharacterization of Business Gross Income

The Regulations provide three rules to prevent the conversion of active business gross income into passive activity gross income. (1) An amount of the taxpayer's gross income from each significant participation activity equal to a ratable portion of the taxpayer's net passive income from such activity is recharacterized if the taxpayer's net income from all significant participation activities is positive. The ratable portion of net passive income from each activity to be recharacterized is determined by multiplying the net income from all significant participation activities by the ratio of all significant participation activities to income from all profitable significant participation activities. A significant participation activity is any trade or business activity in which the taxpayer participates, but not materially, more than 100 hours. For example, assume a taxpayer owns interests in three significant participation activities, X, Y, and Z, with net passive activity income or (loss) of $400, $(300), and $600 respectively. A ratable portion of the two profitable significant participation activities X and Z would be recharacterized. For X the ratable portion is $280 ($400 * $700/$1000) and for Z it is $420 ($600 * $700/$1000). (2) An amount of a taxpayer's gross income from renting and selling property equal to the taxpayer's net passive income from such rental and sale is recharacterized. This recharacterization applies if (a) any gain from the sale of the property is included in the taxpayer's income, (b) the taxpayer materially or significantly participated for any taxable year in rendering services to enhance the value of the property, (c) a binding contract for the disposition was entered into within 24 months after the rental of the property commenced. Property rental commences when substantially all of the property is first held out for rent. Services that enhance property value include construction, renovation, and leasing. (3) An amount of the taxpayer's gross income from renting property equal

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68 Id.
73 Id.
to the taxpayer’s net passive income from such rental is recharacterized if the property is rented for use in a trade or business in which the taxpayer materially participates.\textsuperscript{78}

**The Recharacterization of Portfolio Gross Income**

The Regulations also provide three rules to prevent the conversion of portfolio gross income into passive activity gross income. (1) If less than 30% of the unadjusted basis of property held for use by customers in a rental activity is subject to the allowance for depreciation under Section 167, an amount equal to the taxpayer’s net passive income from the activity is recharacterized.\textsuperscript{79}

(2) An amount of the taxpayer’s gross income from an equity-financed lending activity equal to the lesser of (a) the taxpayer’s equity financed interest income from the activity, or (b) the taxpayer’s net passive income from the activity is recharacterized.\textsuperscript{80} An equity financed activity is any lending activity in which the average balance of debt incurred in the activity (determined at the entity level) does not exceed 80% of the average balance of assets held in the activity.\textsuperscript{81} Liabilities incurred to increase the ratio are not taken into account.\textsuperscript{82} The taxpayer’s equity financed interest income from the activity is equal to the taxpayer’s interest income from the activity multiplied by the ratio of the excess of the average balance of interest bearing assets over average balance of liabilities to the average balance of interest bearing assets.\textsuperscript{83}

(3) If a taxpayer acquires an interest in a pass-through entity after it has started generating royalty income or after it has performed substantial services or incurred substantial costs in order to generate royalty income, then an amount of the taxpayer’s gross royalty income equal to the taxpayer’s net passive royalty income is recharacterized.\textsuperscript{84} The taxpayer’s gross royalty income is the taxpayer’s share of passive activity gross income.\textsuperscript{85} The taxpayer’s net passive royalty income is the excess, if any, of the taxpayer’s gross royalty income over any passive activity deductions.\textsuperscript{86} This recharacterization of royalty income does not apply if (a) the royalty income is derived in the ordinary course of a trade or business or (b) the taxpayer’s share of the expenditures incurred in generating the royalties, beginning with the year in which the taxpayer acquires an interest in the entity and ending within the taxpayer’s current taxable year, exceeds 25% of the fair market value of the taxpayer’s interest in the royalties.

\textsuperscript{80}Temp. Treas. Reg. §§ 1.469-2T(f)(4)(i)(A) and (B) (1988).
\textsuperscript{81}Temp. Treas. Reg. §§ 1.469-2T(f)(4)(ii)(A) and (B) (1988).
\textsuperscript{83}Temp. Treas. Reg. §§ 1.469-2T(f)(4)(ii)(A) and (B) (1988).
\textsuperscript{86}Temp. Treas. Reg. §§ 1.469-2T(f)(7)(ii)(A) and (B) (1988).
at the time the taxpayer acquired an interest in the entity.\textsuperscript{87}

**PASSIVE ACTIVITY DEDUCTIONS**

Passive activity deductions are all deductions arising in connection with generating passive activity gross income.\textsuperscript{88} A passive activity deduction is treated as arising in the taxable year in which the deduction would be allowable if taxable income for all years were determined without regard to Sections 469.\textsuperscript{89} It should be noted that (1) a passive activity deduction is not included in the determination of a PAL or PAC until the first taxable year in which the deduction is not disallowed by an applicable limitation other than Sections 469 and (2) the characterization of a deduction as passive does not depend on the character of the activity in taxable years in which the deduction is disallowed under limitations other than Section 469.\textsuperscript{90} For example, if a partner's distributive share is disallowed under Section 714(d) in 1987 but is allowed in 1988, the deduction is treated as arising in 1988 and the determination of its character depends on whether the activity in connection with which it arises is a passive activity in 1988.\textsuperscript{91}

The Regulations specifically exclude from classifications as a passive activity deduction (1) an expense that is allocable to portfolio income, (2) a deduction allowed under Sections 243, 244 or 245 with respect to any dividend that is not included in passive activity gross income, (3) qualified residence interest, (4) capitalized interest, (5) loss on the disposition of property that produces portfolio income, (6) a passive activity deduction that is treated as an active activity deduction because of the complete disposition of an income generating activity, (7) a state, local or foreign income, war profits, or excess profits tax, (8) a miscellaneous itemized deduction that is subject to the disallowance under Section 67(a), (9) a charitable contribution, (10) a carryover loss or deduction under Sections 172 or 1212, or (11) a loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for Sections 704(d), 1366, or 465.\textsuperscript{92}

**SPECIAL RULES FOR PARTNERS AND SHAREHOLDERS**

For purposes of Section 469, each item of revenue and deduction allocated to the taxpayer from a flowthrough entity, such as a partnership or an S corporation, is characterized as active or passive depending on the activity's characterization in the I.R.C. and in the Regulations or on the taxpayer's degree.
of participation in the activity or activities that generated them. Such participation is determined for the taxable year of the flowthrough entity, not the taxable year of the taxpayer. For example, if the flowthrough entity engages only in rental activities, then by definition the revenue and deductions allocated to the partner or shareholder are passive. Assume that a calendar year individual is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending January 31, 1988, the partnership engages in an income-generating activity. For the period from February 1, 1987, through January 31, 1988, the individual does not materially participate in this activity. In the individual's calendar year 1988 return, the individual's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions without regard to the individual's participation in the activity from February 1, 1988, through December 31, 1988.

A closely-held corporation or a personal service corporation materially participates in an activity if (1) one or more individuals who directly or indirectly hold more than 50% of the corporation's outstanding stock materially participate, or (2) if, a closely-held corporation, such corporation is a "qualifying business" within the meaning of Section 465(c)(7)(C). If a corporation is a qualifying business during the entire 12 month period ending on the last day of the taxable year the corporation had at least one full-time employee whose services were substantially in the active management of the corporation's business, and (2) during the same period, the corporation had at least three full-time non-owner employees whose services were substantially and directly related to the business, and (3) the corporation's allowable business deductions under Sections 162 and 404 exceed 15% of its gross income. For purposes of determining the participation of shareholders of the corporation, the corporation's activities are treated as activities in which the shareholder holds an interest and the shareholder's participation in all other activities is disregarded.

PASSIVE ACTIVITY CREDITS

A credit is characterized as passive if it arises in connection with a passive activity or, in the case of progress expenditures, it will be used in a passive

94 Id.
95 Id.
97 Temp. Treas. Reg. § 1.469-1T(g)(3)(ii)(B) (1988). Note that for these purposes, § 465(c)(7)(C) is taken without regard to clause iv but must be taken in conjunction with § 465(c)(7)(D).
activity when the property is placed in service. The character of a credit arising from a partnership or S corporation is determined by the participation of the taxpayer in the activity that gives rise to the credit. Such participation is determined for the taxable year of the partnership or S corporation, not the taxable year of the taxpayer. A passive activity credit is the amount by which the sum of the credits from all passive activities exceeds the taxpayer’s regular tax liability allocable to all passive activities. A taxpayer’s regular tax liability 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 example, if a taxpayer’s tax liability is $50,000 on the taxpayer’s regular income and $80,000 considering the taxpayer’s regular and passive income, then the taxpayer’s PAC is $30,000. A PAC is attributable to the taxable year in which it would be, or would have been, allowed.

Limitations on Offsetting Income With Losses and Credits

The classification of income- or loss-generating activities as one or many and as either active, passive, or portfolio determines the tax treatment that may result. An active activity loss is defined as the excess of allowable deductions over gross taxable income. An active activity loss may be used to offset income from any other source. Carrybacks and carryforwards of such losses are allowed.

A PAL is defined as the excess of passive activity deductions over passive activity gross income. The tax treatment of PALs and PACs is similar. PALs and PACs are suspended and carried forward until they are used to offset future passive activity income or taxes on future passive activity income. Carrybacks are not allowed. Suspended PALs are subjected to a two-step allocation process: First, they are allocated ratably among each of the taxpayer’s passive activities with net losses for the year. The ratable portion is computed by multiplying the total suspended PALs by the ratio of each activity’s PAL to the total suspended losses. For example, suppose an individual owns passive ac-

102 Id.
108 Id.
110 I.R.C. § 469(b) (1986).
tivities A, B and C with the following gross income and deductions for the taxable year:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$7,000</td>
<td>$4,000</td>
<td>$12,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Deductions</td>
<td>(16,000)</td>
<td>(20,000)</td>
<td>(8,000)</td>
<td>(44,000)</td>
</tr>
<tr>
<td>Net income/(loss)</td>
<td>$(9,000)</td>
<td>$(16,000)</td>
<td>$4,000</td>
<td>$(21,000)</td>
</tr>
</tbody>
</table>

The $21,000 PAL for the taxable year is suspended. Therefore, a ratable portion of the PALs from A and B are suspended. The suspended portion of each activity’s loss is computed as follows:

A \[\text{Suspended} = \frac{9,000}{25,000} \times 21,000 = 7,560\]
B \[\text{Suspended} = \frac{16,000}{25,000} \times 21,000 = 13,440\]

Total \[\text{Suspended} = 21,000\]

Second, any loss allocated to an activity from the first step is allocated ratably among all passive activity deductions for the year. The ratable portion is computed by multiplying the allocated loss by the ratio of each passive activity deduction to the total passive activity deductions for the activity.

Suspected PACs are allocated ratably among all of the taxpayer’s credits from passive activities. The ratable portion is computed by multiplying the total suspended PACs by the ratio of each activity’s PAC to the total PACs.

Suspected PALs and PACs may be recognized in one of two ways. (1) They may be used as deductions from passive activity income or reductions of taxes on passive activity income in the taxpayer’s immediately succeeding taxable year. For example, the suspended PALs from activities A and B of $7,560 and $13,440 respectively may be used to offset passive activity income from activities A and B in the immediately succeeding taxable year. Note that by treating suspended PALs as a deduction from the activity in the succeeding year, the passive activity deductions in the next year are taken into account after the suspended PALs from the preceding year are deducted from the activity’s passive gross income. (2) Suspended PALs also may be used upon the complete taxable disposition of an activity. The Regulations do not provide any guidance on dispositions. The only guidance currently available is from the I.R.C. and its legislative history. The rules provided by the I.R.C. are that upon the complete taxable disposition of an activity, suspended PALs may be used to offset income or gain first from the activity disposed of, next from any other passive activity, and finally from any other activity.

\[\text{I.R.C. § 469(g)(1) (1986).}\]
plete disposition of a passive activity involves the disposition of all entities engaged in, and all assets used or created by, the activity.\textsuperscript{119} For example, if from the previous illustration activity B is completely disposed of in a taxable transaction in the succeeding year, then the $13,440 suspended PAL from the preceding year plus any additional current losses generated by the activity may be used to offset other income in the order indicated above.

The transfer of an activity by death is a complete disposition to the extent to which the basis of the property used in the activity is increased under Section 1014.\textsuperscript{120} Suspended PALs equal to the amount of increase in basis are eliminated.\textsuperscript{121}

Installment sale of an activity is a special case of a complete disposition. Because a proposed technical correction to Section 469 is inconsistent with I.R.S. Notice 87-8, 1987-3 I.R.B. II., the Treasury Department has not issued any regulations on installment sales. In Notice 87-8, the Service announced that gain recognized on the installment method would be treated as not from a passive activity if but for the use of the installment method, the taxpayer would have taken the gain into account for the taxable year beginning before January 1, 1987.\textsuperscript{122}

Incomplete dispositions do not trigger recognition of PALs. Disposition of a passive activity to a related party or by like-kind exchange does not trigger recognition of PAL carryforwards.\textsuperscript{123} Similarly, disposition of a passive activity by gift does not trigger recognition of PAL carryforwards.\textsuperscript{124} Suspended PALs are added to the basis of the property used in the activity immediately before the gift.\textsuperscript{125} Suspended PALs equal to the amount of increase in basis are eliminated.\textsuperscript{126}

Passive activities may become active through increases in the taxpayer’s level of participation in it. The Regulation do not provide any guidance on former passive activities. The only currently available guidance is the I.R.C. and its legislative history. According to the Code, a passive activity may become active in any year after a year (or years) during which the taxpayer begins to materially participate in it.\textsuperscript{127} Suspended losses from such an activity when it was passive may be used to offset income from it after it becomes active.\textsuperscript{128}

\begin{itemize}
\item \textsuperscript{120} I.R.C. § 469(g)(2)(A) (1986).
\item \textsuperscript{121} I.R.C. § 469(g)(2)(B) (1986).
\item \textsuperscript{122} 53 Fed. Reg. 5,690 (1988).
\item \textsuperscript{123} I.R.C. § 469(g)(1)(B) (1986).
\item \textsuperscript{124} I.R.C. § 469(i)(6) (1986).
\item \textsuperscript{125} Id.
\item \textsuperscript{126} Id.
\item \textsuperscript{127} I.R.C. § 469(f)(3) (1986).
\item \textsuperscript{128} I.R.C. § 469(f)(1)(C) (1986).
\end{itemize}
Unused suspended PALs from former passive activities retain their character as such.129

The items that produce portfolio income generally do not produce losses. However, losses are possible from the sale of investment property that is not a passive activity or from assets that produce portfolio income. Section 469, its legislative history, and the Regulations are silent about the treatment of portfolio losses. However, the Regulations provide that Section 469 and the regulations thereunder do not affect the treatment of any income or gain under other sections of the I.R.C.130 Since most of the property used to generate portfolio income falls under the Section 1221 definition of a capital asset, the tax treatment of capital losses are applicable to portfolio losses.

EXCEPTIONS TO THE PAL RULES

The Oil and Gas Exception

Three exceptions to the material participation standard and, hence to the PAL rules, are (1) oil and gas interests, (2) rental real estate activities, and (3) trading personal property. A working interest in an oil- and gas-producing property held directly, or through an entity that does not limit the liability of the taxpayer with respect to such an interest, is treated as an active activity.131 Hence, any losses generated by such an activity may offset any type of income. This working interest exception is applied on a well by well basis.132 For example if a taxpayer owns a working interest in land, assigns the working interest in part of it to a partnership in exchange for a limited partnership interest and drills a well on the retained portion of the land, the working interest exception will apply to the retained land. However, if the partnership drills a well on the assigned portion of the land, the working interest exception will not apply to the taxpayer's interest in the well.133

An entity limits the liability of a holder of a working interest in an oil- and gas-producing activity if the entity is in the form of a limited partnership, corporate stock, or an interest in any other entity that under State law, limits the holder's liability to a fixed determinable amount.134 If the holder of a working interest in an oil- and gas-producing activity is a limited as well as a general partner, the holder's liability is not limited and the working interest exception applies. Any losses incurred from an oil- and gas-producing activity are not PALs if during a period in which economic performance occurs the liability of a holder of an interest in the activity is limited.135 Economic performance

has the same meaning as in Section 461(h) without regard to the exceptions for recurring items or the spudding of oil and gas wells.\textsuperscript{136} A liability is not considered to be limited by (1) an indemnification contract, (2) a stop loss arrangement, (3) insurance, or (4) any similar arrangement.\textsuperscript{137}

\textit{The Rental Real Estate Exception}

The Regulations do not provide much additional guidance with respect to the rental real estate exception beyond what is found in the I.R.C. and its legislative history. According to the Regulations, an activity involving the rental of a dwelling unit that is used as a residence by the taxpayer during the taxable year is not a passive activity.\textsuperscript{138} The I.R.C. provides that for rental real estate income to be treated as active, merely active (rather than material) participation is required.\textsuperscript{139} Active participation is either significant and \textit{bona fide} involvement in managerial decisions, or arranging for others to provide service.\textsuperscript{140} Examples of significant managerial decisions are approving new tenants, deciding on rental terms, and approving capital or repair expenditures.\textsuperscript{141} A taxpayer is not treated as meeting the standard if at any time during the taxable period the taxpayer's ownership interest in the rental real estate activity drops below 10\%.\textsuperscript{142} In determining whether the taxpayer's interest amounts to 10\%, separate buildings are treated as separate rental real estate activities.\textsuperscript{143} However, if application of the general facts and circumstances test shows that despite disparate geographic locations they are economically integrated (e.g., an integrated shopping center), then they are treated as a single rental real estate activity.\textsuperscript{144}

There is no participation requirement for low-income housing or for any rehabilitation investment credit.\textsuperscript{145}

Up to $25,000 in losses and credits may be used to offset other income by each unmarried taxpayer if generated by a rental real estate activity in which the taxpayer actively participates.\textsuperscript{146} Such losses are first used to offset other rental real estate income, then passive income, and finally any other income.\textsuperscript{147} For an unmarried taxpayer's the $25,000 amount is reduced (but not below zero) fifty cents for each dollar by which the taxpayer's adjusted gross income ex-

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{136} 53 Fed. Reg. 5,688 (1988).
\item\textsuperscript{138} Temp. Treas. Reg. § 1.469-1T(3)(e) (1988).
\item\textsuperscript{139} I.R.C. § 469(i)(1) (1986).
\item\textsuperscript{140} S. Rep. No. 313, 99th Cong., 2d Sess., 737 (1986).
\item\textsuperscript{141} Id. at 738.
\item\textsuperscript{142} I.R.C. § 469(i)(6) (1986).
\item\textsuperscript{143} S. Rep. No. 313, 99th Cong., 2d Sess., 743 (1986).
\item\textsuperscript{144} Id. at 743.
\item\textsuperscript{145} I.R.C. § 469(i)(6)(B) (1986).
\item\textsuperscript{146} I.R.C. § 469(i)(2) (1986).
\item\textsuperscript{147} I.R.C. § 469(i)(3)(D) (1986).
\end{enumerate}
\end{footnotesize}
ceeds $100,000.\textsuperscript{148} For low-income housing the 50\% phase-out begins at $200,000.\textsuperscript{149} For married taxpayers filing separate returns and living apart, the offsets are limited to $12,500, the 50\% phase-out begins at $50,000, and the 50\% phase-out for low-income housing starts at $100,000.\textsuperscript{150} Married taxpayers filing separate returns and not living apart can not use rental real estate losses to offset income.\textsuperscript{151} For purposes of applying the phase-out limitations, adjusted gross income is determined without regard to losses from passive activities other than losses allowable because of a complete disposition of the activity.\textsuperscript{152}

The Trading Personal Property Exception

The trading of personal property exception to the PAL rules is created by the Regulations.\textsuperscript{153} Neither Section 469 nor its legislative history mention such an exception. An activity of trading personal property, such as stocks, commodities, or any other actively traded property, for the account of the owners of the interests in the activity is not a passive activity, even if the activity is treated as a trade or business.\textsuperscript{154} Hence, income generated by trading personal property is not passive activity income. For example, assume a partnership is a trader of corporate securities. The capital employed by it consists of borrowed funds and amounts contributed by the partners in exchange for their partnership interest. The partnership's gross income consists of interest, dividends, and capital gains. Under these facts, the income generated by the partnership is not passive activity income.\textsuperscript{155}

TAX PLANNING STRATEGIES

Because of the time value of money, the longer the PALs have to be carried forward, the less valuable they are as a tax shield. A number of steps can be taken by taxpayers to avail themselves of this tax shield immediately. These steps include switching investments, pairing investments, changing the level of participation in income- or loss-generating activities, or paying oneself a low salary.

Switching

A taxpayer with both PALs and portfolio income can reallocate capital from activities that generate portfolio gross income to those that generate passive gross income. Doing so enables a taxpayer to offset passive activity income

\textsuperscript{148} I.R.C. § 469(i)(3)(A) (1986).
\textsuperscript{149} I.R.C. § 469(i)(3)(B) (1986).
\textsuperscript{150} I.R.C. § 469(i)(5)(A) (1986).
\textsuperscript{151} I.R.C. § 469(i)(5)(B) (1986).
\textsuperscript{152} I.R.C. § 469(i)(3)(D) (1986).
with the PALs. However, care must be exercised to make sure that the income generating activities switched into are indeed activities that generate passive activity income. The taxpayer must fail the material participation and the significant participation tests as well as make sure that the income from the activity will not be subject to recharacterization. For example, assume a taxpayer decides to sell stocks and bonds in order to place the proceeds therefrom into an activity that generates rental income. The rental income would be shielded by the PALs only if all the restrictions on recharacterization and the rendering of personal services in connection with the rental are observed.

Pairing

If a taxpayer makes additional investments, they should be made such that investments that generate passive activity income is paired with investments that generate passive activity losses.

Changing the Level of Participation

The recharacterization rules do not permit a taxpayer to convert active activity income into passive activity income by a decrease in the taxpayer’s level of participation in the activity. However, they do permit a taxpayer to convert passive activity income into active activity income by an increase in the taxpayer’s level of participation in the activity. PALs can be converted to active activity losses in the year following the year in which the taxpayer’s participation in the loss-generating activity increases to the level of materiality. Under the first set of Section 469 regulations, doing so is relatively easy. Only ten hours (500 hours/52 weeks) of participation a week is required in order for participation to be considered material. After the taxpayer increases his or her level of participation, the passive losses will become active and may be used to offset any other type of income. The suspended PALs from the time during which the taxpayer’s participation in the activity that generated them was below the level of materiality may be used to offset the income from the same activity, even though it is now active activity income.

Paying Oneself a Low Salary

Specifically included as active activity gross income are earned earnings. The definition of earned earnings provided in the Regulations enable the owner/shareholder of an S or C corporation to convert earned earnings to passive income or portfolio income. The first set of Section 469 regulations define earned income in accordance with reference to Section 911(d)(2)(A) which states that:

The term “earned income” means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a
corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered.

The net income of S corporations and C corporations is increased to the degree to which the shareholders' salaries are reduced. Hence, if the S corporation engages in rental activities, the shareholder can convert salary which is active activity income to rental income which is passive activity income by paying himself nothing or very little. If the owner/shareholder of a C corporation reduces his or her salary to increase the corporation's profitability and takes the profits out in the form of dividends, the owner/shareholder has converted salary which is active activity income to portfolio income.

CONCLUSION

The PAL rules of Section 469 are complex. The first set of Section 469 regulations help to clarify some of these rules. However, the Regulations fail to address a number of important Section 469 rules. For example, the Regulations do not explain what constitutes an “activity.” Until additional regulations are issued, planning for Section 469 will be difficult. Some general principles consistent with Section 469, its legislative history, and the currently available Regulations should be kept in mind when doing so.