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SOME PLANNING CONSIDERATIONS
IN LIGHT OF THE SECOND SET OF PAL REGULATIONS

by
HANS-DIETER SPROHGE*

INTRODUCTION

The second set of passive activity loss (PAL) Regulations define "activity" and amend the first set of Regulations. For taxpayers subject to Internal Revenue Code (I.R.C.) Section 469, the definition of an activity is important for a number of reasons. Taxpayers must know what constitutes an activity to determine: (1) its income or loss, (2) whether it is a rental activity or trade or business activity, (3) whether it has been completely disposed of, (4) whether the level of their participation in it is material, significant, or otherwise, and (5) the applicability of a phase-in rule to losses and credits from certain activities acquired before Congress enacted section 469.

This article consists of three parts: (1) an overview of the definition of an activity, (2) planning considerations, and (3) a summary of amendments to the first set of PAL Regulations. First, the overview section explains that a separate activity is an undertaking that consists of income-producing operations at a single location that are either predominantly rental operations or predominantly trade or business operations. Second, the overview discusses the aggregation and fragmentation rules for rental activities and trade or business activities. The Regulations provide detailed rules only for aggregating separate rental real estate activities into a single activity or for fragmenting a separate or an aggregated rental real estate activity and treating it as a separate activity. Separate trade or business activities controlled by the same interests must be aggregated into a single trade or business activity if they are similar or economically integrated. However, taxpayers may elect to fragment a trade or business activity from an aggregated activity and treat it as a separate activity. Third, the overview discusses special rules for professional service undertakings, oil and gas undertakings, the activities of a consolidated group, and publicly traded partnerships.

The planning section discusses two general strategies for enhancing taxpayer wealth in light of the second set of PAL Regulations. One strategy is to create passive activity income so that non-cash PALs can be utilized. Another strategy is to create active activity losses so that they can be used to offset cash income. The planning section also points out a potential planning pitfall that may arise from equating the

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1 The second set of temporary PAL Regulations were issued on May 12, 1989. 54 Fed. Reg. 20,533-566 (1989).
minimization of tax liability with the enhancement of taxpayer wealth.

Generally, the amendments section focuses on rules that were problematic under the first set of PAL Regulations. Technical corrections are ignored.

**AN OVERVIEW OF THE DEFINITION OF AN ACTIVITY**

An activity is defined by reference to the concept of an undertaking. An undertaking consists of all the income-producing operations a person owns and conducts at the same location, regardless of their similarity or diversity. Income-producing operations are all endeavors conducted and relating to (or conducted in reasonable anticipation of): (1) the production of property, (2) the sale of property to customers, (3) the performance of services for customers, (4) transactions in which customers take physical possession of property that is made available for their uses, or (5) any other transactions that involve the presence of customers. Income-producing operations do not include investment endeavors.

Income-producing operations must be distinguished from support operations. Support operations are business and rental operations that: (1) provide goods or services to an undertaking at another location, (2) do not produce income, and (3) are owned by the same person that owns the undertaking. Support operations are treated as part of an undertaking. Using any reasonable method, the revenue and expenses of support operations are allocable to the undertaking(s) they support. For example, suppose that an individual owns Building #1, Building #2, and Building #3 and manages all three buildings from an office in Building #1. To the extent that the management operations relate to Building #2 and Building #3, they are support operations. Hence, a portion of the total management expenses are allocable to Building #2 and Building #3. The management operations relating to Building #1 are not support operations because they are part of an income-producing operation at that location.

A person owns income-producing operations only if the person is the direct owner of such operations. The term ‘‘person’’ means an individual, trust, estate, partnership, association, company, or corporations.

The term ‘‘location’’ means a fixed place of business. Income-producing operations are conducted at the same location if they are conducted in the same

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physical structure or within close proximity of one another. Income-producing operations not conducted at a fixed place of business or conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated. In determining the location with which income-producing operations are most closely associated, all facts and circumstances are taken into account. Generally, the most significant relationships between operations that are conducted at such location and operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are listed in Exhibit I.

The income-producing operations a person owns and conducts at the same location may include business and rental operations. The term "business and rental operations" means all endeavors engaged in for profit that involve either (1) the conduct of a trade or business (or are conducted in anticipation of becoming a trade or business), (2) making tangible property available for use by customers, or (3) paying or incurring research or experimental expenditures that are deductible under section 174 or would be deductible if the taxpayer so elected. Hence, by definition, an undertaking may include business and rental operations.

If an undertaking consists of both business and rental operations (termed a "paragraph c undertaking" in the Regulations and hereinafter a "mixed undertaking"), the undertaking must be split into its business and rental undertakings before the aggregation or fragmentation rules can be applied. Rental operations must be split off from a mixed undertaking and treated as a separate rental undertaking if such undertaking considered as a separate activity would constitute a rental activity. For the definition of a rental activity, the second set of PAL Regulations specifically refer to the first set of PAL Regulations. Subject to six exceptions, the first set of PAL Regulations define a rental activity as any activity the income from which consists of payments for the use of tangible property.

Rental operations do not need to be split off from a mixed undertaking if the rental operations are insignificant relative to such undertaking's business operations or vice versa. The rental operations of a mixed undertaking are insignificant relative to its business operations if less than 20 percent of the gross income of the mixed undertaking is attributable to rental operations; the business operations of a mixed undertaking are insignificant relative to its business operations if less than 20 percent

For example, assume that a mixed undertaking consists of a building with office space and parking space operations. Tenants typically rent office space for at least one year. Hence, the office space operations are treated as a separate rental undertaking because, considered as a separate activity, it would constitute a rental activity. The average period for which all customers use a parking space is less than 24 hours. Hence, the parking space operations are not treated as a separate rental undertaking because, considered as a separate activity, it would fall under one of the six exceptions to a rental activity. Specifically, the parking space operations are not a rental undertaking because the average period of customer use of the parking space is seven days or less. Whether this mixed undertaking constitutes a single activity or must be split into two activities depends on the relative contribution of each operation to total gross income. On the one hand, if less than 20 percent of total gross income is attributable to the parking space operations, the mixed undertaking is treated as a single rental activity. On the other hand, if more than 20 percent of the total gross income is attributable to the parking space operations, the mixed undertaking is split into a rental activity and a business activity.

**Rental Real Estate Activities**

A rental real estate undertaking is a rental undertaking in which at least 85 percent of the unadjusted basis of the property made available for use by customers is real property. Real property is any tangible property other than tangible personal property. Generally, two or more rental real estate undertakings may be treated as separate activities or aggregated into a single activity. However, two or more rental real estate undertakings must be aggregated into a single activity if any pass-through entity through which they are held treats them as a single activity.

A single rental real estate undertaking may be fragmented (including a ratable portion of any common areas or facilities) into two or more smaller undertakings that may be treated as (1) separate activities or (2) aggregated into activities that include fragments of other undertakings. Fragmentation of a rental real estate undertaking is permitted only if (1) the fragment can be separately conveyed under applicable state and local law taking into account the limitations, if any, imposed by any special rules or procedures (such as condominium conversion laws) restricting the separate conveyance of parts of the same structure and (2) the same treatment is adopted by each pass-through entity through which they are held.
For example, assume an individual owns condominium units A and B in Building #1; C and D in Building #2; and E and F in Building #3.\textsuperscript{28} Each building is a separate rental real estate undertaking. On the one hand, the three rental real estate undertakings consisting of Buildings #1, #2, and #3 may be treated as three separate activities or aggregated into a single activity. On the other hand, Building #1 and Building #2 may be fragmented into undertakings consisting of units A, B, C, and D. Each of the five resulting rental real estate undertakings (units A, B, C, D, and Building #3) may be treated as separate activities or aggregated in any combination. If units A and D are combined, four rental real estate activities result consisting of the combined activity, unit B, unit C, and Building #3.

The aggregation and/or fragmentation of rental real estate undertakings into activities must be consistent for each succeeding taxable year ending after August 8, 1989.\textsuperscript{29} A person (including a pass-through entity) cannot aggregate and/or fragment rental real estate undertakings for a taxable year unless evidence of such treatment is reflected in a schedule attached to the person’s return for the taxable year.\textsuperscript{30}

A rental real estate undertaking may not be aggregated or fragmented if either (1) income or gain from the undertaking is subject to recharacterization under §1.469-2T(f)(3) because less than 30 percent of the unadjusted basis of property made available to customers in such undertaking is subject to the allowance for depreciation\textsuperscript{31} or (2) the undertaking is an interest in a dwelling unit to which I.R.C. §280A(c)(5) applies.\textsuperscript{32}

\textit{Trade or Business Activities}

A trade or business undertaking is any undertaking that is not a rental undertaking, an oil or gas well treated as an undertaking that is separate from other undertakings, or a professional service undertaking.\textsuperscript{33} Generally, each separate trade or business undertaking is an “activity.”\textsuperscript{34} Separate trade or business activities controlled by the same interests must be aggregated into a single activity if they are similar. Dissimilar trade or business activities controlled by the same interests must in turn be aggregated into a activity if they are economically integrated.

1. Common-Control

The determination of whether multiple undertakings are controlled by the

\textsuperscript{32} Temp. Treas. Reg. §§ 1.469-4T(k)(7)(i) and (ii) (1989).
same interests is subject to a facts and circumstances test. Control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. The reality of control, not its form or mode of exercise, is determinative. 35 Multiple undertakings are rebuttably presumed to be controlled by the same interests if such undertakings are part of the same common-ownership group. 36 Two or more undertakings are part of the same common-ownership group if the sum of the common-ownership percentages of any five or fewer persons (other than pass-through entities) with respect to such undertakings exceeds 50 percent.

2. Similar Undertakings

Two or more commonly-controlled similar trade or business undertakings must be aggregated into a single activity if the taxpayer: (1) owns interests in each such undertaking through the same pass-through entity, (2) owns a direct or substantial indirect interest in each such undertaking, and (3) materially or significantly participates in the activity that would result if such undertakings were treated as part of the same activity. 37 Two or more undertakings are similar if they are either in the same line of business or vertically integrated.

Two or more undertakings are in the same line of business if more than 50 percent of each undertaking’s gross income is attributable to operations in a single line of business. 38 Lines of business are promulgated in Revenue Procedure 89-38. 39 These lines of business are based on the Standard Industrial Classification (SIC) codes set forth in the Standard Industrial Classification Manual (1987). Operations not covered by Revenue Procedure 89-38 are included in a single line of business on a basis that reasonably reflects similarities and differences in the property or services provided and the treatment of comparable operations. 40

Two or more undertakings are vertically integrated if one undertaking (the “supplier undertaking”) provides property or services to other undertakings (the “recipient undertakings”). 41 The supplier undertaking is similar to a recipient undertaking if (1) both are controlled by the same interest and (2) the supplier undertaking provides more than 50 percent (by value) of its property and/or services to the recipient undertaking. 42 All supplier undertakings similar to a recipient undertaking are treated as similar to the recipient undertaking. 43 If a supplier undertaking and two or more similar recipient undertakings are controlled by the

same interests, the recipient undertakings are aggregated into a single undertaking.\textsuperscript{44}

The recipient undertaking is similar to a supplier undertaking if (1) both are controlled by the same interests and (2) the recipient undertaking obtains more than 50 percent (by value) of its property and services from the supplier undertaking.\textsuperscript{45} All recipient undertakings similar to a supplier undertaking are treated as similar to the supplier undertaking.\textsuperscript{46} A recipient undertaking is not similar to a supplier undertaking if (1) the supplier undertaking is treated as an undertaking that is similar to any recipient undertaking, (2) the recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking, or (3) another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.\textsuperscript{47}

For example, assume that undertakings A through Z are trade or business undertakings controlled by the same interests.\textsuperscript{48} Undertaking A derives all of its gross income from the manufacture and exclusive sale of clothing to undertaking B. Undertaking B derives all of its gross income by selling 75 percent of its clothing to undertakings C through Z and the remainder to unrelated retail stores. Undertakings C through Z derive all of their gross income from retail sales of clothing. Undertaking B purchases 80 percent of its inventory from undertaking A. Undertakings C through Z purchase 60 to 90 percent of their inventory from undertaking B.

Undertaking A is a supplier undertaking to recipient undertaking B and undertaking B is a recipient undertaking and a supplier undertaking to recipient undertakings C through Z. Supplier undertaking A is treated as similar to recipient undertaking B and supplier undertaking B is treated as similar to recipient undertakings C through Z. Undertaking A also is similar to undertakings C through Z because undertaking A is an undertaking that is similar to undertaking B and undertaking B is similar to undertakings C through Z. Undertakings C through Z are treated as a single undertaking.

Recipient undertakings B through Z cannot be treated as similar to supplier undertaking A because supplier undertaking A is already treated as similar to undertakings C through Z. Similarly, recipient undertakings B through Z cannot be treated as similar to supplier undertakings A and B because recipient undertaking B is itself a supplier undertaking that is treated as an undertaking that is similar to the recipient undertakings C through Z.

A taxpayer \textit{owns a direct interest} in an undertaking if the undertaking is a sole proprietorship. A taxpayer \textit{owns a substantial indirect interest} in a single undertak-

ing if at any time during the taxable year the taxpayer’s ownership percentage in a pass-through entity that directly owns such undertaking exceeds ten percent.\textsuperscript{49} A taxpayer owns a substantial indirect interest in each of two or more undertakings if (1) such undertakings are treated as part of the same activity of the taxpayer and (2) the taxpayer owns a substantial indirect interest in any such undertaking.\textsuperscript{50} For example, assume a taxpayer owns a 5 percent interest in partnership A and a 15 percent interest in partnership C.\textsuperscript{51} Partnership A owns interests in Partnerships B and C each of which owns a single undertaking (undertakings B and C). Undertakings B and C are treated as part of the same activity of the taxpayer. Thus, the taxpayer owns a substantial indirect interests in undertakings B and C.

To illustrate how two or more similar and commonly-controlled trade or business undertakings are treated as part of a single activity because the taxpayer significantly participates in the activity that would result from aggregating such undertakings into a single activity assume the following: The taxpayer owns a five percent interest in partnerships A, B, C, and D.\textsuperscript{52} Each partnership owns a single undertaking (undertakings A, B, C, and D). The undertakings are trade or business undertakings that are controlled by the same person. In addition, undertakings A, B, and D are similar. The taxpayer is not related to any of the other partners and the taxpayer participates for 60 hours in undertaking A and for 60 hours in undertaking B. The activity that would result from treating the similar and commonly-controlled undertakings as a single activity consists of undertakings A, B, and D. The taxpayer participates for 120 hours in the activity that results from this treatment. Accordingly, undertakings A, B, and D are treated as part of a single activity because the taxpayer significantly participates in the activity that results from this treatment. The result is the same whether the taxpayer participates in one, two, or all three of the similar commonly-controlled undertakings, so long as the taxpayer’s aggregate participation in undertakings A, B, and D exceeds 100 hours. The aggregation rules do not apply to undertaking C. Undertaking C is treated as a separate activity.

\textit{Economically Integrated Activities}

Two or more commonly-controlled dissimilar trade or business undertakings must be aggregated into a single activity if the activities are economically integrated. Trade or business declivities are economically integrated if their operations constitute a single integrated business.\textsuperscript{53} Whether the operations of two or more trade or business activities constitute a single integrated business is subject to a facts and circumstances test.\textsuperscript{54} Generally, the most significant factors in determining whether the operations of two or more trade or business activities constitute an integrated

\textsuperscript{50} Temp. Treas. Reg. §§ 1.469-4T(f)(3)(ii)(A) and (B) (1989).
\textsuperscript{53} Temp. Treas. Reg. § 1.469-4T(g)(2)(i) and (ii) (1989).
business are listed in Exhibit I.55

1. Elections

Taxpayers may elect to fragment an undertaking (other than a rental real estate undertaking) from an aggregated activity and treat it as a separate activity.56 This election is limited by two consistency requirements: (1) the fragmented undertaking must be treated as a separate activity in the year of election and in each succeeding taxable year thereafter,57 and (2) the fragmented undertaking cannot be treated as a separate activity if any pass-through entity through which it is held treats the fragmented undertaking as part of a larger activity on the return reporting the income, gain, loss, deductions, and credits taken into account by the taxpayer.58 The taxpayer’s level of participation (i.e., material, significant, or otherwise) in the separate activity resulting from the election is the same as the taxpayer’s level of participation in the original aggregated activity.59

The fragmentation election may not be made if an undertaking is treated as part of a larger activity on a return for a taxable year ending after August 8, 1989.60 The election with respect to an undertaking is made by attaching a written statement to the return for the taxable year for which such election is made.61 This written statement must: (1) state the name, address, and taxpayer identification number of the person making the election, (2) contain a declaration that an election is being made, (3) identify the undertaking with respect to which such election is being made, and (4) identify the remainder of the activity in which such undertaking would otherwise be included.62

In effect, the fragmentation election allows a taxpayer to treat an undertaking as a separate activity for purposes of determining whether the taxpayer has sold an activity in a transaction that frees up otherwise disallowed passive activity deductions.

Special Rules

1. Professional Service Undertakings

A professional service undertaking is a nonrental undertaking that derives more than 50 percent of its gross income from the provision of services in the fields

55 Temp. Treas. Reg. §§ 1.469-4T(g)(3)(ii) - (iv) and (vi) - (xii) (1989).
Two or more professional service undertakings must be aggregated into a single activity if (1) they are controlled by the same interests or (2) provide significantly similar services or significantly related services. The same rules for determining whether trade or business undertakings are controlled by the same interests also apply to professional service undertakings.

Two professional service undertakings provide significantly similar services if (1) more than 20 percent of each undertaking’s gross income is attributable to services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts (but not consulting), and (2) the services provided by one such undertaking is in the same field as the services provided by the other such undertaking. In the case of consulting service, all facts and circumstances are taken into account in determining similarity. Two professional service undertakings provide significantly related services if more than 20 percent of the gross income of one such undertaking is derived from customers that are also customers of the other such undertaking.

A single professional service activity that results from the aggregation of two or more commonly-controlled, similar, or related undertakings (the “original undertakings”) is treated as a single professional service undertaking that may be aggregated with other commonly-controlled, similar, or related undertakings. If any original undertaking included in an aggregated undertaking and any other undertaking that is not included in such aggregated undertaking involve the provision of significant similar or related services, the aggregated undertaking and such other undertaking are treated as undertakings that involve the provision of significant similar or related services.

For example, assume the taxpayer is a partner in partnerships A, B, and C. Partnership A derives substantially all of its gross income from the provision of engineering services, partnership B derives substantially all of its gross income from the provision of architectural services, and partnership C derives 40 percent of its gross income from the provision of engineering services and the remainder from the provision of architectural services. Each partnership’s service business is a single undertaking that is separate from other undertakings. Partnerships A, B, and C are not controlled by the same interests.

Each partnership's undertaking is a professional service undertaking. Partnership A's undertaking ("undertaking A") derives more than 20 percent of its gross income from services in the field of engineering, partnership B's undertaking ("undertaking B") derives more than 20 percent of its gross income from services in the fields of architecture, and partnership C's undertaking ("undertaking C") derives more than 20 percent of its gross income from services in the fields of engineering and architecture.

Undertaking A involves significant services in the field of engineering, undertaking B involves significant services in the field of architecture, and undertaking C involves significant services in both fields. Thus, undertakings A and C and undertakings B and C involve the provision of significant similar services. Accordingly, the taxpayer's interests in undertaking A and C are treated as part of a single activity.

The activity consisting of undertakings A and B is also treated as single professional service undertaking that may be aggregated with other commonly-controlled, similar, or related undertakings. Since undertakings B and the single undertaking in which undertakings A and C are included involve the provision of significant similar services, the taxpayer's interests in undertakings A, B and C are treated as part of a single activity.

2. Oil and Gas

An oil or gas well is treated as a separate undertaking if the following conditions are satisfied: (1) the well is drilled or operated pursuant to a working interest that is held at any time during the taxable year either directly or through an entity that does not limit liability,72 and (2) the taxpayer would not be treated as materially participating in the activity in which such well would be included if the taxpayer's activities were determined without regard to this rule.73

For example, assume that during 1989, B is a general partner in a partnership that owns a working interest in an oil well.74 B does not own any interest in the well other than through the partnership. At the end of 1989, however, B's partnership interest is converted into a limited partnership interest. During 1990, B holds the working interest only as a limited partner. B does not participate in the activity in which the well would be included if B's activities were determined without regard to the rule that treats oil wells subject to the working interest exception as separate undertakings.

The well is treated as a separate undertaking in determining B's activities for 1989 because B holds the working interest during 1989 through an entity that does

72 Temp. Treas. Reg. §§ 1.469-4T(e)(1)(i)(A) and (B) (1989).
not limit B’s liability with respect of the drilling or operations of the well and B would not be treated as materially participating for 1989 in the activity in which the well would be included if B’s activities were determined without regard to the rule that treats oil wells subject to the working interest exception as separate undertakings. Throughout 1990, however, B’s liability with respect to the drilling and operation of the well is limited by the entity through which B holds the working interest (i.e., the limited partnership). Accordingly, the rule that treats oil wells subject to the working interest exception as separate undertakings does not apply to the well in 1990 and the well may be included in an undertaking that includes other operations.

3. Consolidated Groups

The activities of a consolidated group and of each of its members are determined as if the consolidated group were one taxpayer. For example, assume corporations, M, N, and O are the members of a consolidated group that is treated as a closely held corporation. Each member of the consolidated group owns a five percent interest in partnership X, a five percent interest in partnership Y, and interests in a number of trade or business undertakings through the partnerships. Each of these undertakings is directly owned by partnership X or Y. All the undertakings of partnerships X and Y are similar and controlled by the same interests. The employees of the consolidated group and the shareholders of its common parent do not participate in the undertakings that the member corporations own through the partnership.

The member corporations own, in the aggregate, a fifteen (15) percent interest in partnership X and a fifteen (15) percent interest in partnership Y. These interests are treated as interests owned by one taxpayer (the consolidated group). Thus, the consolidated group owns a substantial indirect interest in the similar and commonly-controlled undertakings owned by partnerships X and Y. Accordingly, the member corporations’ interests in the undertakings owned through partnerships X and Y are treated as part of the same activity of the consolidated group.

4. Publicly Traded Partnerships

Undertakings owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. For example, assume that an individual taxpayer owns a twenty (20) percent interest in partnership X and a fifteen (15) percent interest in partnership Y. Partnership X directly owns a hotel (“hotel 1”). Partnership Y directly owns two hotels (“hotels 2 and 3”). Each of the three hotels is a separate trade or business undertaking. The

three hotel undertakings are similar and are controlled by the same interests. Partnership X is, and partnership Y is not, a publicly traded partnership. Partnership Y’s hotel undertakings are treated as part of the same activity. However, the hotel undertaking the taxpayer owns through partnership X and the hotel undertakings the taxpayer owns through partnership Y are treated as two separate activities.

PLANNING CONSIDERATIONS

The objective of tax planning is to increase the taxpayer’s wealth by reducing, or eliminating, the taxpayer’s current tax liability. Until the enactment of the Tax Reform Act of 1986, tax shelters attempted to achieve this objective by netting currently taxable income from one source with losses from other sources that do not involve (1) cash and (2) the personal activities of the taxpayer. The PAL rules place restrictions on the ability to net income with losses on the basis of the taxpayer’s involvement in the income- and loss-generating activities. The PAL rules place no restrictions on the ability to net income with non-cash losses provided the restrictions based on the taxpayer’s participation in the income- and loss-generating activities are met.

To recapitulate, the restrictions of the PAL rules are as follows: Active activity losses (AALs) may be netted against either active or passive income. Any unused AALs may be carried back or forward. PALs may be netted only against passive activity income. Any unused PALs are suspended and carried forward until they are used as deductions from passive activity income in the immediately succeeding tax year. Carrybacks are not allowed. Upon the complete taxable disposition of a passive activity, suspended PALs may be netted against income or gain first from the activity disposed of, next from any other passive activity, and finally from any other activity. Within these parameters, the taxpayer’s wealth may be enhanced through two general planning strategies. The first strategy is to net non-cash PALs against passive activity income. The second strategy is to net non-cash AALs against either passive or active activity income.

The First Strategy

Generally, the problem of netting non-cash PALs against passive activity income lies in producing passive activity income. Passive activity income is difficult to generate because the thresholds of the first set of PAL Regulations for producing active activity income are low. Within the limitations of the aggregation rules of the second set of PAL Regulations, taxpayers may isolate undertakings that stay within these low thresholds and thereby produce passive activity income. The isolation of passive income-producing activities depends on whether the taxpayer’s income-producing operations are conducted at one or more than one location.
1. One Location

If all income-producing operations are conducted at one location, the passive income-producing operations may be isolated by (1) moving them to another location or (2) placing them under the ownership of a separate legal entity. For example, assume an individual conducts dry-cleaning and coin-operated laundry undertakings in one building as a sole proprietor. The individual participates more than 500 hours in the dry-cleaning operations; the individual does not participate at all in the laundry operations. The individual has PALs from other activities. In this case, the dry-cleaning and the laundry operations must be aggregated into a single activity that produces active activity income. Consequently, the individual may not net the PALs from the other activities against the income from the laundry undertaking.

The individual may isolate the income from the laundry undertaking in one of two ways. One way is to move the laundry undertaking to another location. If doing so is not feasible, then another way is to hold the laundry undertaking through a different legal entity such as an S corporation. The S corporation is a different person from the individual. In this case, the dry-cleaning undertaking and the laundry undertaking must be treated as two separate activities of the taxpayer, even though they are both conducted at the same location. Now the individual may net the PALs from the other activities against the income from the laundry activity.

2. More Than One Location

If income-producing operations conducted at more than one location are treated as separate undertakings, then the problem of isolating undertakings that produce passive income arises only with respect to similar or economically integrated trade or business undertakings. Passive income-producing undertakings may be isolated from similar or economically integrated undertakings by failing to exercise control. For example, assume an individual owns pizzeria operations in 15 different locations (pizzerias #1 through #15). Pizzerias #1 through #14 are in 14 different locations within a single metropolitan area. The individual participates more than 500 hours in the operations of pizzerias #1 through #14. Because pizzeria #15 is located in another city, the individual does not participate in any of its operations. The taxpayer has PALs from other activities. In this case, pizzerias #1 through #15 must be aggregated into a single activity that produces active activity income. Consequently, the individual may not net the PALs against the income from pizzeria #15.

The individual may isolate the income from pizzeria #15 by using Pizzeria #15 as the individual’s share of capital contributed in a partnership with other persons. There is no presumption of control over pizzeria #15 if either the partnership is formed with at least five other persons or the sum of the common-ownership
percentages is less than 50 percent. If each of the other partners also contributed a pizzeria to the partnership, then the income from the pizzerias would be passive activity income for each partner.

The Second Strategy

The aggregation of similar trade or business rules of the second set of PAL Regulations may be used to convert a PAL into an AAL. Under these rules, a taxpayer who meets the material participation standard of just one trade or business undertaking is treated as meeting the standard for all other similar or integrated trade or business undertakings. Trade or business undertakings are similar if they fall within the same line of business as set forth in Revenue Proceedings 89-38. Each of these lines is very broad. For example, Revenue Proceeding 89-38 line of business 01 (agriculture) includes SIC major groups 01 (agricultural production - crops), 02 (agricultural production livestock and animal specialities), 07 (agricultural services), and 08 (forestry). Each of the SIC major groups are subdivided even further.

A taxpayer with active activity income from one undertaking within any one of these major groups may shelter that income with non-cash losses from any other undertaking classified as agriculture. For example, veterinarian and cattle feeding undertakings both fall within the agriculture line of business established by Revenue Proceeding 89-38. Thus, a veterinarian’s income may be sheltered by the cattle feeding operation as long as the control requirement is met. The veterinarian may meet the control requirement by establishing an S corporation that purchases the cattle feeding operation. A similar arrangement could be used by taxpayers with active activity income from farms, nurseries, poultry hatcheries, and so on. Similar opportunities for sheltering income exist for other lines of business.

Trade or business undertakings are integrated if they meet the criteria listed in Exhibit I. A taxpayer with active activity income from one undertaking within any one of a group of integrated trade of business undertakings may shelter that income with non-cash losses from any other undertaking within the same group. For example, assume that a taxpayer owns a number of liquor store undertakings and food store undertakings. Revenue Proceeding 89-38 classifies liquor stores as one line of business (47) and food stores as another line of business (41). Each liquor and food store is in a different location. The taxpayer participates more than 500 hours in the operations of the liquor stores. The taxpayer does not participate at all in the operations of the food stores.

The liquor store undertakings are profitable. The food store undertakings generate losses. The liquor store and food store operations are not economically integrated. Hence, the liquor store undertakings constitute one activity and the food

\[79\] The *Standard Industrial Classification Manual* (1987) classifies veterinary services under agricultural, not health, services. Hence, the professional service rules do not apply to veterinarians.
store undertakings constitute another activity. The income from the liquor store activity is active activity income. The losses from the food store are PALs. Consequently, the taxpayer may not net the PALs from the food store activity against the active activity income from the liquor store activity.

The taxpayer could integrate the liquor store and food store operations by serving the same group of customers, treating the operations as a unit in the financial statements, using the same personnel, facilities, and equipment, using a common trade name, and coordinating their marketing activities. In this case, the liquor store activities and the food store activities constitute an integrated business that must be aggregated into a single activity. Consequently, the taxpayer may net the losses from the food store activity against the income from the liquor store activity. Obviously the implementation of this strategy depends on the tax benefits exceeding the costs of integration.

A Caveat

Two potential pitfalls in implementing the above outlined strategies are the netting of cash losses against income or the incurrence of suspended cash PALs. For example, assume a physician in Chicago has a high income because of a lucrative medical practice. A theatrical production in New York is experiencing cash losses. Purchase of a controlling interest in the theatrical production would enable the physician to net the losses from the theatrical production against the income from the medical practice. Under the aggregation rules for professional service undertakings, the physician must treat the medical practice and the theatrical production as a single professional activity even if the production is located in New York.80 From the standpoint of tax liability, the physician is better off. However, from an economic standpoint, the physician is no better off because the reduction in taxes does not result in an increase in wealth. The purchase would merely divert resources (the physician’s taxes) from the U.S. Treasury to the theatrical production. Doing so may be a desirable goal, but should not be confused with tax planning.

The taxpayer’s wealth is diminished by suspended cash PALs. Suspended cash PALs are tax shelters in reverse because the deductibility of cash losses is deferred. Suspended cash PALs may be avoided either through additional investments that produce passive cash income or through a complete taxable disposition of the activity that generates them. For example, if the physician in Chicago does not meet any of the tests for aggregating the theatrical production with the medical practice resulting in the suspension of the theatrical production losses, then the physician would be worse off from an economic point of view. In this case, the physician could either invest in activities that generate passive activity income or dispose of the interest in the theatrical production.

Rental Activities Exceptions

Three of the six exceptions to the definition of a rental activity are based on the average period of customer use.\(^{81}\) The average period of customer use as defined in the first set of PAL Regulations is not weighted to reflect differences in the rental value of the activity’s property.\(^{82}\) Thus, property that produces an insignificant amount of an activity’s rental income might significantly affect the activity’s average period of customer use. Therefore, the second set of PAL Regulations amend the definition of average period of customer use to take into account the amount of income generated by an item of property.

The average period of customer use for all classes of property held in connection with an activity is the sum of the average use factors for each class of property held in connection with the activity.\(^{83}\) The average use factor for a class of property held in connection with an activity is the average period of customer use for such class of property multiplied by the ratio of the activity’s gross rental income attributable to such class of property to the activity’s gross rental income.\(^{84}\) The average period of customer use for a class of property held in connection with an activity is determined by dividing (1) the aggregate number of days in all periods of customer use for property in such class (taking into account only periods that end during such taxable year or that include the last day of such taxable year by (2) the number of periods of such customer use.\(^{85}\)

A separate period of customer use is each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewal thereof). The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.\(^{86}\)

Properties may be organized into classes using any method under which items of property for which the daily rent differs significantly are not included in the same class.\(^{87}\) The daily rent for items of property may be determined on any basis that reasonably reflects differences during the taxable year in the amounts ordinarily paid for one day’s use of such items of property.\(^{88}\)

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\(^{82}\) Temp. Treas. Reg. §§ 1.469-1T(e)(3)(iii)(A) and (B) (1986).
An activity’s gross rental income is the gross income from the activity taking into account only income that is attributable to amounts paid for the use of property. 89 An activity’s gross rental income attributable to a class of property is the gross income from the activity taking into account only income that is attributable to amounts paid for the use of property in such class. 90

Disallowed Deductions or Credits

The first set of PAL Regulations explain that any disallowed deductions or credits from a loss activity are to be treated as deductions or credits from such activity for the taxpayer’s immediately succeeding taxable year. 91 The first set of PAL Regulations do not take into account the possibility that the composition of an activity may change from year to year. The second set of PAL Regulations address this problem by stating that disallowed deductions or credits are to be (1) allocated among the taxpayer’s activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity and (2) treated as deductions or credits from such activity for the succeeding taxable year. 92

To illustrate the application of this Regulation to the fragmentation of a loss activity from one year to the next assume the following: In 1992, the taxpayer’s loss activity consists of a restaurant undertaking and a catering undertaking. 93 A $10,000 loss from the activity is disallowed for 1992. In 1993, the loss activity is split into a restaurant activity and a catering activity because the taxpayer moves the catering undertaking to another location.

In 1993, the $10,000 disallowed loss from the restaurant and catering activity for 1992 must be allocated between the restaurant activity and the catering activity in a manner that reasonably reflects the extent to which each of the activities continues the operations of the restaurant and catering service activity. Allocations are reasonable if based upon the ratio of the (1) deduction for each activity to the deductions for both activities, (2) loss of each activity to the loss of both activities, and (3) loss of each activity to the loss of both activities determined as if the restaurant and catering undertakings had been separate activities in 1992. The disallowed deductions allocated to the restaurant activity in 1993 are treated as deductions from the restaurant activity in 1993 and the disallowed deductions allocated to the catering activity in 1993 are treated as deductions from the catering activity for 1993.

92 Temp. Treas. Reg. §§ 1.469-1T(f)(4)(i)(A) and (B) (as amended in 1989).
To illustrate the application of this Regulation to the aggregation of a loss activity with another activity from one year to the next assume the following: In 1989, the taxpayer owns a law-practice undertaking and a rental undertaking from the same building. The rental undertaking consists of leasing four floors not needed in the law-practice to tenants. The law-practice undertaking and the rental undertaking are treated as two separate activities. The taxpayer materially participated in the law-practice activity. In 1989, a $12,000 loss from the rental activity is disallowed. In 1990, the law-practice activity and the rental activity are aggregated into a single activity because the four floors that were leased to the tenants in 1989 are used in the taxpayer’s law-practice activity.

In 1990, the disallowed deductions from the rental activity for 1989 are allocated to the combined law-practice and rental activity because the combined activity continues the operations with respect to the four floors that were leased to tenants in 1989.

The amendments also explain that if a taxpayer continues a loss activity through a C corporation or similar entity, the taxpayer’s interest in such entity is to be treated as an interest in a passive activity that continues such activities. An entity is similar to a C corporation if the owners of interests in the entity derive only portfolio income from such interests. If an interest in a C corporation or similar entity is a loss activity, such interest is to be treated in the succeeding taxable year as an interest in a passive activity that continues the business and rental operations of such loss activity.

For example, assume the taxpayer owns stock in a corporation that is an S corporation for the taxpayer’s 1991 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1991, the taxpayer’s pro-rata share of the corporation’s loss from the rental activity is $5,000 and the entire loss is disallowed.

In 1991, the taxpayer’s $5,000 loss from the rental activity is allocated among the taxpayer’s deductions from that activity. In 1992, the disallowed deductions from the rental activity for 1991 must be allocated to the taxpayer’s C corporation activity and treated as deductions from the C corporation activity. Treating the taxpayer’s interest in the C corporation as an interest in a passive activity that continues the operations of the rental activity does not change the character of the taxpayer’s dividend income from the C corporation. Thus, the taxpayer’s dividend income is portfolio income that is not included in passive activity gross income.
Gain from Sale of Property

The second set of PAL Regulations provide rules for characterizing the gain or loss from the sale of property held in a C corporation, acquired in a nonrecognition transaction, or in a dealing activity. Under the first set of PAL Regulations, if an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain form the disposition is treated as not from a passive activity unless such interest in property was used in a passive activity either (1) twenty (20) percent of the period during which the taxpayer held such interest in property or (2) the entire twenty-four (24) month period ending on the date of the disposition.98 The amendments make rule applicable to an interest in property held through a C corporation. An interest in property is treated as an interest in property used in an activity other than a passive activity and as an interest in property held for investment for any period during which such interest is held through a C corporation or similar entity. An entity is similar to a C corporation for this purpose if the owners of interests in the activity derive only portfolio income from such interests.99

For example, assume A, an individual, is a stockholder in Corporation X.100 X is a C corporation until December 31, 1990 and is an S corporation thereafter. X acquires a building on January 1, 1990 and sells the building on March 1, 1991. At the time of the sale, A’s interest in the building held through X is substantially appreciated. The building is leased to various tenants at all times during the period in which it is held by X. Assume that the lease of the building would constitute a rental activity with respect to a person that holds the building directly or through an S corporation.

A’s interest in the building is treated as an interest in property held for investment for the period from January 1, 1990 to December 31, 1990 and as an interest in property used in a passive activity for the period from January 1, 1991 to February 28, 1991. The gain from the sale of the building is treated as not from a passive activity because (1) A’s interest in the building was not used in a passive activity for the entire twenty-four (24) month period ending on the date of sale and (2) the two (2) month period during which A’s interest in the building was used in a passive activity is less than twenty (20) percent of the period during which A held an interest in the building (fourteen (14) months).

If a taxpayer acquires an interest in property in a transaction other than a nonrecognition transaction, the ownership and use of such interest in property before such transaction is not taken into account in determining the character of the gain or loss upon subsequent disposition of such interest in property by the taxpayer. For example, if a taxpayer is a partner in a partnership that owns an interest in property

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and the taxpayer acquires such interest in property from the partnership in a fully taxable sale or exchange, such interest is treated upon subsequent disposition of such interest, as an interest in property that was not held by the taxpayer until the date on which such interest was acquired from the partnership and that was not used before such date in any activity of the taxpayer.\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(iv) (as amended in 1989).}

The rules for characterizing the gain or loss from the sale of property held in a dealing activity at the time of sale are as follows: If the sale of such property is incidental to its use in one or more nondealing activities, holding the property in the dealing activity is treated as the use of the property in the last nondealing activity in which the property was used before its sale.\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(A)(2) (as amended in 1989).} The sale of a taxpayer’s interest in property is incidental to a nondealing activity if (1) at the time of disposition, the taxpayer holds the interest in property in an activity that involves holding similar property as inventory for sale to customers in the ordinary course of a trade or business (a “dealing activity”), (2) the interest in property was used in nondealing activities for more than eighty (80) percent of the taxpayer’s holding period (the holding period requirement), and (3) the taxpayer did not acquire and hold the interest in property for the principal purpose of selling it to customers in the ordinary course of a trade or business (a dealing purpose).\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(A)(1)(i)(A) - (C) (as amended in 1989).} A taxpayer is rebuttably presumed to have a dealing purpose unless the interest in property was used in nondealing activities for more than twenty-four (24) months or twenty (20) percent of the property’s recovery period (whichever is less).\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(A)(1)(ii)(A) (as amended in 1989).} The same presumption applies if interests in property were offered for sale to customers during more than twenty-five (25) percent of the period in which the interest was held in nondealing activities. An interest in property is not considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property.\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(A)(1)(ii)(B) (as amended in 1989).}

If the sale of property held in a dealing activity at the time of sale is not incidental, its use in one or more nondealing activities, the property is treated as used in the dealing activity of the taxpayer for any period during which it is simultaneously offered for sale to customers and used in a nondealing activity.\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(B) (as amended in 1989).}

For example, assume the taxpayer acquires a residential apartment building on January 1, 1987 and uses the building in a rental activity.\footnote{Temp. Treas. Reg. § 1.469-2T(c)(2)(v)(C) (Example 1) (as amended in 1989).} In 1990, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominiums for sale to customers in the ordinary course of a trade or business of dealing in such property. (Assume that these dealing operations are...
treated as a separate activity and that the taxpayer materially participates in this activity). In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1990 and the last unit is sold on December 31, 1991.

At the time of sale, the condominiums were held in a dealing activity. The sale of the property satisfies the holding period requirement because the property was used in a nondealing activity (the rental activity) for more than eighty (80) percent of the taxpayer's holding period - i.e., the apartments were used in a rental activity for the entire period during which they were held by the taxpayer. The rebuttable presumption that the condominiums were held for sale does not apply because (1) the property was used in nondealing activities for more than twenty-four (24) months and (2) no apartment was offered for sale during more than twenty-five (25) percent of the period in which it was held in nondealing activities. Because neither of the rebuttable presumptions applies in this case, the taxpayer will not be treated as having a dealing purpose.

The sale of the property satisfies the holding period requirement and the taxpayer does not have a dealing purpose. Thus, holding the apartments in the taxpayer's dealing activity is treated as the use of the apartments in a nondealing activity. In this case, the rental activity is the only nondealing activity in which the apartments were used prior to their disposition. Thus, the apartments are treated as interests in property that were used in the rental activity for the entire period during which the taxpayer held such interests. Accordingly, all gain from the sale of the apartment is treated as passive activity gross income.

Partnerships

Under the first set of PAL Regulations, payments to retiring or deceased partners attributable to unrealized receivables or goodwill were treated as passive activity income if the activity was a passive activity to the taxpayer in the year of liquidation. Under the second set of PAL Regulations, payments in liquidation of a retiring or deceased partner's interest and any income that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership are characterized in the same manner as if such unrealized receivables and goodwill had been sold at the time the liquidation of such partner's interest commenced.

Under the first set of PAL Regulations, if more than ten (10) percent of the gain from the disposition of an interest in a pass-through entity would have been treated as gain not from a passive activity if all of the property used in such passive activity had been sold immediately prior to the disposition for its fair market value, then the

gain is treated as not from a passive activity. The first set of PAL Regulations limit
the application of this rule to substantially appreciated property formerly used in a
nonpassive activity. The second set of PAL Regulations, expand the application
of this rule to certain oil and gas properties, certain property rented incidental to
development, property rented to a nonpassive activity, or certain interests in a pass-
through entity engaged in the trade or business of licensing tangible property.

Recharacterization

Under the first set of PAL Regulations, income from the disposition of an
interest in self-developed property was subject to recharacterization from passive to
nonpassive if the use of the item of property in the rental activity commenced less
than twenty-four (24) months before the date of disposition. The second set of
PAL Regulations reduce the holding period to twelve (12) months. A potential
pitfall may arise if the interest in self-developed property is substantially appreciated
at the time of disposition. An interest in property is substantially appreciated if its
fair market value exceeds 120 percent of its adjusted basis. If an interest in
property used in an activity is substantially appreciated at the time of disposition, any
gain from the disposition is treated as not from a passive activity unless such interest
in property was used in a passive activity for either (1) twenty (20) percent of the
period during which the taxpayer held such interest in property or (2) the entire total
twenty-four (24) month period ending on the date of disposition. Hence, gain from
the disposition of an interest in substantially appreciated self-developed property
may be recharacterized as nonpassive even if used in a rental activity for more than
twelve (12) months before disposition if such use if less than either (1) twenty (20)
percent of the total period during which the taxpayer held such interest in property
or (2) the entire twenty-four (24) month period ending on the date of the disposition.

CONCLUSION

The ability to net losses against income is partially a function of the taxpayer’s
level of participation in the activities that generate them. The first set of PAL
Regulations provided criteria for determining the taxpayer’s level of participation in
income- or loss-generating activities. However, the first set of PAL Regulations
omitted a definition of an activity. This omission created uncertainty for taxpayers
about compliance and planning. The second set of PAL Regulations remove a great
deal of this uncertainty by explaining what constitutes an activity. They define an
activity by reference to the concept of an undertaking. The smallest unit that may
constitute an activity is an undertaking. An undertaking consists of all income-

producing operations conducted at one location unless they are mixed. Mixed income-producing operations consists of both rental and nonrental operations. Under the Regulations a mixed undertaking must be split into a separate rental activity and a separate nonrental activity. Similar commonly-controlled undertakings at different locations must be aggregated into a single activity. Additionally, dissimilar commonly-controlled activities must be aggregated into an activity if they are economically integrated.
### EXHIBIT I

**FACTORS IN DETERMINING LOCATION AND/OR INTEGRATION**

- whether such operations are
  - (1) conducted under the same trade name or
  - (2) treated as a unit in the primary accounting records reflecting the results of such operations;
- the extent to which other persons
  - (3) conduct similar operations at one location or
  - (4) treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;
- the extent to which such operations
  - (5) involve products or services that are commonly provided together,
  - (6) serve the same customers,
  - (7) are conducted in coordination with or reliance upon each other, or
  - (8) depend on each other for their economic success;
- the extent to which
  - (9) the same personnel, facilities, or equipment are used to conduct such operations or
  - (10) the conduct of any such operations is incidental to the conduct of the remainder of such operations.