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U.S. INCOME

Passive Loss Rules

by

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TAX MANAGEMENT PORTFOLIOS™

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Passive Loss Rules

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Passive Loss Rules*, No. 549-3rd, describes the passive loss rules, which typically apply to all noncorporate taxpayers, as well as closely held C corporations and personal service corporations. The passive loss rules generally limit the use of net losses and credits from certain “passive activities” against income and tax from nonpassive activities, such as wages, investment income, and active business income.

Passive activities are generally trade or business activities in which the taxpayer does not materially participate. In addition, all rental activities are treated as per se passive activities, except generally for some rental real estate owned by certain real estate professionals. Material participation requires regular, continuous, and substantial involvement by the taxpayer, such as by spending more than 500 hours in the activity during the year. Different material participation tests apply to limited partners of partnerships and certain LLC members.

Unused deductions and credits from passive activities are suspended and carried forward indefinitely, to be used against passive income in a later year. Passive loss carryovers are generally allowed against nonpassive income upon the taxable disposition of the taxpayer’s entire interest in the activity.

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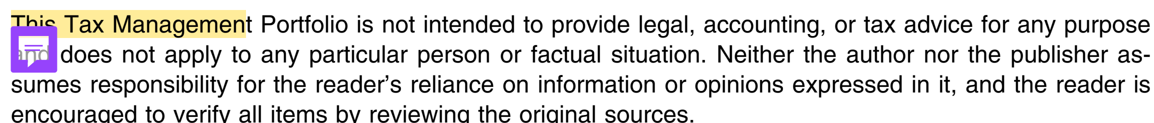

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TABLE OF CONTENTS

PAGE

DETAILED ANALYSIS

I. Overview A-1

- A. Evolution of Passive Loss Rules A-1
- B. General Application of Passive Loss Rules A-1

II. Taxpayers Subject to the Passive Loss Rules A-3

- A. General Applicability Rules A-3
- B. Trusts A-3
- C. Personal Service Corporations A-4
  - 1. Definition of Personal Service Corporation A-4
  - 2. Employee-Owner Definition and 10% Requirement A-4
  - 3. Meaning of "Personal Services" and "Substantially Performed" A-6
- D. Closely Held C Corporations A-7
  - 1. Definition of "Closely Held" A-7
  - 2. Real Estate Investment Trusts A-8
- E. Consolidated Groups A-8
- F. Publicly Traded Partnerships A-9
- G. Foreign Activities and Foreign Persons A-11

III. Activities Covered A-15

- A. Identifying Passive Activities A-15
- B. Trade or Business Activity A-15
  - 1. Meaning of "Trade or Business" A-15
  - 2. Trading Activity Per Se Nonpassive Rule A-16
  - 3. State and Local Tax (SALT) Deduction for Pass-through Entity A-18
- C. Rental Activity A-18
  - 1. Exception One: Average Customer Use Period of Seven Days or Less A-19
  - 2. Exception Two: Average Customer Use Period of 30 Days or Less A-20
  - 3. Exception Three: Providing Extraordinary Personal Services A-21
  - 4. Exception Four: Rentals Incidental to Nonrental Activities of the Taxpayer A-22
    - a. Rental Incidental to an Investment Activity A-22
    - b. Rental Incidental to a Trade or Business Activity A-23
    - c. Rental of Lodging to Employees for the Convenience of the Employer A-24
  - 5. Exception Five: Property Customarily Made Available for Nonexclusive Use by Various Customers A-24
  - 6. Exception Six: Property Provided to a Pass-through Entity in Which the Taxpayer Owns an Interest A-24
- D. Portfolio Income and Other Nonpassive Items A-25
  - 1. Items Generally Treated as Portfolio Income A-25
  - 2. Items Not Treated as Portfolio Income Because Derived in the Ordinary Course of a Trade or Business A-26
  - 3. Expenses Treated as Related to Portfolio Income A-28
    - a. Properly Allocable Interest Expense A-28
    - b. Clearly and Directly Allocable Expenses Other than Interest A-29
  - 4. Self-Charged Interest and Other Items A-30
  - 5. Compensation for Services A-33
  - 6. Cancellation of Indebtedness Income A-33
  - 7. Other Per Se Nonpassive Income and Deductions A-33
  - 8. Payments to a Retiring Partner or a Deceased Partner's Successor in Interest A-35
- E. Definition of a Separate Activity A-37
  - 1. Overview A-37
  - 2. Partnerships and Corporations A-38
  - 3. Grouping Limitations A-38
    - a. Limitation on Grouping a Rental Activity with a Trade or Business Activity A-38
    - b. Limitation on Grouping Rentals of Real Property with Rentals of Personal Property A-40
    - c. Limitation on Grouping Certain Activities of Limited Partners and Persons Not Sufficiently Involved in Management A-40
    - d. Additional Limitations on Permissible Groupings A-41
    - e. Consistency and Disclosure Requirements A-41
    - f. Grouping by the IRS to Prevent Tax Avoidance A-43
  - 4. Treatment of Partial Dispositions A-43

IV. Material Participation A-45

- A. Material Participation in Trade or Business Activity A-45
  - 1. Test One: More than 500 Hours of Participation A-46
  - 2. Test Two: Substantially All Participation Is by the Taxpayer A-48

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PAGE

3. Test Three: Participation for More than 100 Hours, if No Other Individual Participates More A-49
4. Test Four: Significant Participation Activities A-50
5. Test Five: Material Participation in Five of the Last 10 Tax Years A-51
6. Test Six: Material Participation in a Personal Service Activity for Any Three Prior Years A-52
7. Test Seven: Regular, Continuous, and Substantial Involvement Under the Facts and Circumstances A-54
8. Limited Partners A-56
   a. General Rule A-56
   b. Members of LLCs as Limited Partners A-57
9. Material Participation by Legal Entities A-59
   a. Personal Service Corporations A-59
   b. Closely Held Corporations A-60
   c. Estates and Trusts A-61
10. Special Rule for Interests Held by Retirees and Surviving Spouses in Farming Activities A-62

B. Material Participation in Rental Activity A-62
1. Qualifying as a Real Estate Professional A-63
   a. Material Participation in Real Property Trades or Businesses A-66
   b. Real Property A-67
   c. Real Property Development and Redevelopment A-68
   d. Real Property Construction and Reconstruction A-69
   e. Real Property Brokerage A-69
   f. Real Property Operation and Management A-70
   g. Spouses A-72
2. Grouping Activities vs. Real Estate Aggregation Election A-72
   a. Grouping Activities A-72
   b. Aggregation Election A-73
3. Application of Former Passive Activities Rules A-75
4. Limited Partners and Other Partnership Issues A-75

C. Net Income (But Not Net Loss) from Certain Activities Treated as Nonpassive A-76
1. Significant Participation Rule A-77
2. Nondepreciable Property Rule A-78
3. Equity-Financed Lending Rule A-79
4. Incidental-to-Development Rule A-80
5. Self-Rental Rule A-81
6. Pass-through Entity Royalty Rule A-83
7. Working Interests in Oil and Gas Property A-83
   a. Definition of an Oil and Gas Working Interest A-84
   b. Holding an Oil and Gas Working Interest Through a Liability-Limiting Entity A-84
   c. Anti-Flip-Flop Rule A-85
   d. Anti-Risk-Elimination Rule A-86

V. Effect of Passive Losses A-87

A. Passive Loss Limitation A-87
1. Application of the Passive Loss Rules to Closely Held C Corporations A-87
2. Consequences of Ceasing to Be a C Corporation Subject to the Passive Loss Rules A-89

B. Ordinary Income and Capital Gain, Capital Loss Limitation (§1211) A-89

C. Items Allocable to a Passive Activity A-90

D. Disposition of Property Used in a Passive Activity A-91
1. General Rule A-91
2. Property Used in More than One Activity During 12 Months Before Disposition A-92
3. Disposition of Substantially Appreciated Property Formerly Used in Nonpassive Activity A-92
4. Property Held for Sale to Customers After Use in a Nondealer Activity A-93
5. Disposition of an Ownership Interest in an Entity A-94
   a. Applicable Valuation Date A-95
   b. Certain Gain upon Disposition of an Ownership Interest, Otherwise Allocable to a Passive Activity, Treated as Not from a Passive Activity A-95
6. Tax Year of an Item A-96
7. Determination of Which Items Are Disallowed A-96
8. Effect of Changes in the Composition of the Taxpayer's Activities A-97

E. Passive Credits A-99

F. Rental Real Estate Activities with Active Participation A-101
1. Allowance of up to $25,000 of Losses A-101
2. Allowance of up to the Deduction Equivalent of $25,000 for Credits A-103
3. Active Participation Requirement A-103
4. Adjusted Gross Income Phase-Out A-105
5. Special Rule for Estates A-108

G. Passive Loss Carryovers and Passive Credit Carryovers A-109
1. Former Passive Activities A-110
2. Carryover of Losses and Credits to Bankruptcy Estates of Individuals (§1398) A-110

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PAGE

H. Full Unrelated Taxable Disposition of a Passive Activity A-110
1. General Rule A-110
2. Requirement that a Taxpayer Dispose of Entire Interest in Passive Activity A-112
3. Requirement of a Fully Taxable Transaction A-112
4. Related-Party Transactions A-114
5. Disposition by Death A-116
6. Gifts A-117
7. Distribution to Beneficiaries by Estate or Trust A-117
8. Treatment of Credits upon Disposition A-118
a. In General A-118
b. Elective Basis Adjustment A-118

VI. Passive Loss Rules and Other Provisions A-119

A. Alternative Minimum Tax (§55) A-119

PAGE

1. Tax Shelter Farm Activity A-119
2. Insolvent Taxpayer A-120
3. Material Participation in Research and Experimental Expenditures A-121

B. Self-Employment Tax, Base Erosion and Anti-Abuse Tax (§59A) and Other Taxes A-121
C. Investment Interest Limitation (§163(d)) A-121
D. Interest Capitalization (§263A), Business Interest Deduction Limitation (§163(j)), At-Risk Rules (§465), Excess Business Loss Rules (§461(l)) A-122
E. Use or Rental of Residence A-125
F. Transferable Tax Credits A-126

TABLE OF WORKSHEETS B-1

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DETAILED ANALYSIS

I. Overview

A. *Evolution of Passive Loss Rules*

In the 1970s and early 1980s, many taxpayers invested in tax shelters, which usually involved a small out-of-pocket equity investment combined with substantial leverage. The tax shelter acquired assets that generated a significant amount of accelerated depreciation and other tax deductions. The investor could use the deductions against its taxable income from other sources in the early years, such as wages and investment income. The investor may have eventually recognized income from the tax shelter in the later years, but that income may have been taxed at preferential capital gain rates or may be eliminated by the §1014 basis step-up at death; in any case the investor benefited from deferral of its tax liabilities until the later years. Whether the tax shelter's assets produced an economic profit or loss, most of the taxpayer's return was derived from the tax benefits.[1]

Congress became concerned about the efficiency and economic merits of the tax shelter investments, as well as the real and perceived fairness of the income tax system. The 1986 Senate Report noted that "it has become increasingly clear that taxpayers are losing faith in the Federal income tax system. This loss of confidence has resulted in large part from the interaction of two of the system's principal features: its high marginal rates (for example, in 1986, 50% for a single individual with taxable income in excess of $88,270), and the opportunities it provides for taxpayers to offset income from one source with tax shelter deductions and credits from another."[2] Even after the individual highest marginal rate was reduced from 70% to 50% in 1981, tax shelters continued to be prevalent, with studies showing that around 11% of high-income taxpayers were subject to tax rates of 5% or less.[3]

The Tax Reform Act of 1986[4] addressed these concerns in various ways, including the extension of the §465 at-risk rules to real estate, a general increase in depreciation recovery periods (especially for real estate), the expansion of the §55 alternative minimum tax, the repeal of the 10% investment tax credit, and setting the same tax rates for individuals' ordinary income and capital gains. But the most direct response to the typical tax shelter was the addition of §469, which defined a category of "passive activities," from which losses and credits generally cannot be used against income from other sources.[5] As one Senator noted, "[t]here will be no more investments made, if this bill passes, for the sake of generating paper losses; no more cattle feeding operations where you can buy a $10,000 share which is designed to lose money. No more investing in llamas, kangaroos, or syndicated shares of a greyhound."[6]

The final legislation casts a wide net and may apply to a large range of activities beyond animal husbandry. Commentators have noted that the "tax shelter wars — involving the mass marketing of debt-financed tax shelters to upper-middle (and even middle-middle) income taxpayers in the 1970s and 1980s — ended abruptly in a sweeping government victory, as a result of the enactment of the passive loss rules."[7]

B. *General Application of Passive Loss Rules*

The passive loss rules apply to individuals (including partners and S corporation shareholders), trusts, and estates. They also apply to personal service corporations, and to a lesser extent to closely held C corporations. Other C corporations are not subject to the rules and may engage in tax shelter transactions that are unimpeded by the passive loss rules, though the C corporations may be subject to other tax limitations such as under §470 for certain transactions involving tax-exempt entities.

A passive activity generally involves a trade or business in which the taxpayer does not materially participate, or a rental activity without regard to the taxpayer's level of participation. Several different tests can meet material participation, such as spending more than 500 hours in the activity during the tax year. Fewer material participation tests are allowed for limited partners of partnerships and certain LLC members. Rental activities are almost always passive, except for some rental real estate owned by certain real estate professionals. Various rules apply to identifying separate activities, which generally allow a taxpayer some discretion to "group" activities together as one activity.

"Portfolio" income, such as interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business, are treated as nonpassive income. Losses and cred-

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[1] J. Comm. on Tax'n, *Tax Reform Proposals: Tax Shelters and Minimum Tax*, JCS-34-85, at 2 (Aug. 7, 1985).

[2] S. Rep. No. 99-313, at 713 (1986) (hereinafter "1986 Senate Report"). *See also* J. Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1986*, JCS 10-87 at 209–10 (1986) (hereinafter "1986 Blue Book").

[3] 1986 Senate Report, at 714 (citing Susan Nelson, Treas. Dep't., *Taxes Paid by High-Income Taxpayers and the Growth of Partnerships*, at 55 (1983)).

[4] Pub. L. No. 99-514.

[5] The Senate rejected the alternative remedy of eliminating substantially all tax preferences in the Internal Revenue Code, because many of the preferences are "socially or economically beneficial" and "are used primarily to advance the purposes upon which Congress relied in enacting them, rather than to avoid taxation of income from sources unrelated to the preferred activity." In addition, the 1986 Senate Report noted that "it would be extremely difficult, perhaps impossible, to design a tax system that measures income perfectly," and such rules "would create serious difficulties in both compliance and administration." 1986 Senate Report at 714–15. *See also* 1986 Blue Book, at 211. The passive loss rules are applicable for tax years beginning on or after January 1, 1987. For an overview of applicable transition rules, see Worksheet 6.

[6] 132 Cong. Rec. S26481 (Sept. 26, 1986) (statement of Senator Packwood). *See also* 132 Cong. Rec. S12458 (June 4, 1986) (statement of Senator Moynihan) ("It is precisely the fact that our Tax Code has led to a near industry of passive investment enterprises designed to lose money that illustrates the near perversity of the arrangements that we come to. The object becomes to lose money — that is, to show a loss from a passive investment… The legislation we begin to consider today introduces the distinction between positive income and passive losses into the Internal Revenue Code and with this one principle drives a stake into the heart of tax sheltering activities in this country.")

[7] Marvin A. Chirelstein and Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 Colum. L. Rev. 1939 (2005).

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its from one passive activity can be used against income from another passive activity, but they generally cannot be used against portfolio income and other nonpassive income. Disallowed passive activity deductions and credits are carried forward indefinitely.

When a taxpayer disposes of its entire interest in a passive activity in a fully taxable transaction with an unrelated party, the passive loss carryovers are generally allowed in the year of the disposition. The full unrelated taxable disposition rule is based on the theory that a taxpayer's tax losses should be fully allowed once the taxpayer has fully realized its economic losses in a taxable transaction. In contrast, passive credits are not fully allowed upon the disposition.

A special allowance in §469(i) allows some individuals to deduct up to $25,000 of passive losses from certain rental real estate activities against nonpassive income. The taxpayer must actively participate in the rental real estate activity. The $25,000 amount is phased out as the taxpayer's adjusted gross income (with some modifications) increases from $100,000 to $150,000. Different versions of the $25,000 special allowance apply to passive credits.

The passive loss rules generally apply to all passive activities in the aggregate, so that income from one passive activity may be reduced by a loss from another passive activity. However, the passive loss rules apply separately to the taxpayer's interests in each publicly traded partnership. A net loss or credit allocated from a publicly traded partnership is generally usable only against income from the same publicly traded partnership.

The determination that an activity is a passive activity may have collateral tax consequences. For example, the Health Care and Education Reconciliation Act of 2010[8] enacted the 3.8% §1411 net investment income tax, which generally applies only to investments and to trades or businesses that are passive activities,[9] as determined by reference to the passive loss rules and their material participation standards.

The Inflation Reduction Act of 2022[10] enacted §6418, which allows various federal tax credits to be transferred to third parties. The passive loss rules may limit the ability of the transferee to use the transferred credits, if the transferee is an individual or other person who is subject to the passive loss rules.[11]

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[8] Pub. L. No. 111-152, §1402(a)(1).

[9] §1411(c)(2)(A); Reg. §1.1411-5(b). For discussion, see 511 T.M., *Section 1411 — Net Investment Income Tax*.

[10] Pub. L. No. 117-169, §13801(b).

[11] For further discussion, see IV.F., below.

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II. Taxpayers Subject to the Passive Loss Rules

A. General Applicability Rules

The passive loss rules apply at the taxpayer level, such as an individual or estate.[12] For a pass-through entity like an S corporation or partnership, the passive loss rules apply to the S corporation shareholder or partner, respectively, unless the partner is another pass-through entity.[13]

For a C corporation, the passive loss rules apply at the entity level. As described below, the passive loss rules apply only to a C corporation that is a personal service corporation, a closely held corporation, or both, as specifically defined in §469.[14]

Limited liability companies (LLCs) and certain other business entities are classified for federal tax purposes as disregarded entities, partnerships, or corporations.[15] The passive loss rules apply to any such entity based on its federal tax status. For a single member LLC, treated as disregarded as separate from its member for income tax purposes, the passive loss rules apply at the member level.[16] If an LLC elects to be a corporation for federal income tax purposes, and further elects to be an S corporation, the passive loss rules apply at the shareholder level. Certain qualified joint ventures, in which two spouses both materially participate in a trade or business, may elect not to be treated as partnerships for tax purposes.[17]

For a flowchart to determine applicability of the passive loss rules, *see* Worksheet 1: *Taxpayers Subject to Passive Loss Rules.*

B. Trusts

For a grantor trust, as defined in §671, the grantor is treated as the owner of the trust's assets for federal tax purposes.[18] The Chief Counsel's Office advised in FSA 200035006 that the passive loss rules apply at the individual grantor level, not at the grantor trust level. It noted that Reg. §1.469-1T(b)(2) exempts a grantor trust from being subject to the passive loss rules, which is consistent with §469 applying to the grantor instead. Similarly, the 1986 Blue Book stated that:

> In the case of a grantor trust, to the extent the grantor or beneficiary is treated as the owner for tax purposes (sec. 671), the material participation of the person treated as the owner is relevant to the determination of whether income or loss from an activity owned through the grantor trust is treated as passive in the hands of the owner. Similarly, in the case of a qualified electing Subchapter S trust (sec. 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary.[19]

The passive loss rules apply to a nongrantor trust.[20] If the trust produces income from a rental activity that is included in the trust's distributable net income, the IRS ruled in PLR 9114025 that the beneficiaries' distributions are similarly income from a rental activity under the passive loss rules.[21] The IRS has not ruled on the tax treatment of a trust's losses, but the 2005 Audit Guide has indicated that "[s]ince neither IRC §469 (passive activities) nor §641–692 (trusts and estates) contain any provision for a pass through of passive activity losses, disallowed passive losses generally remain suspended at the estate or trust level and do not flow out to beneficiaries."[22] Any passive losses suspended at the trust level may offset the trust's passive income in a subsequent year.[23]

Certain trusts may be classified as business entities, in which case the trust may be a disregarded entity, partnership, or corporation for federal tax purposes.[24] The passive loss rules apply to such a trust based on its federal income tax classification.

Although tax-exempt organizations are typically not subject to the passive loss rules because they are neither closely held corporations nor personal service corporations by definition, tax-exempt trusts may be subject to the passive loss rules

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[12] §469(a)(2)(A).

[13] §1366, §702. *See, e.g., Williams v. Commissioner*, T.C. Memo 2015-76, *aff'd*, 637 Fed. App'x 799 (5th Cir. 2016) (S corporation). For the treatment of passive loss items under the TEFRA partnership audit rules (enacted by the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. No. 97-248, §1101 and repealed by the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101 generally effective for partnership tax years beginning in 2018 and later), see *Estate of Quick v. Commissioner*, 110 T.C. 172 (1998); IRS Litigation Guideline Memo. TL-95 (Aug. 20, 1991) *obsoleted by* CC-2017-001.

For further discussion, see 624 T.M., *Audit Procedures for Pass-Through Entities*, at III.B.

For the treatment of passive loss items under the centralized partnership audit rules as enacted by the Bipartisan Budget Act (BBA) of 2015, see §6225(b)(4) (imputed underpayments are not adjusted by items that could be subject to any additional limitation if such adjustment were taken into account by any person); Reg. §301.6225-1 (same); Reg. §301.6225-2(d)(5) (imputed underpayment modification for publicly traded partnerships' passive losses). For further information on BBA audits, see 629 T.M., *The Partnership Audit Rules Under the Bipartisan Budget Act.*

[14] §469(a)(2)(B), §469(a)(2)(C).

[15] *See* Reg. §301.7701-2.

[16] *See also* Rev. Rul. 2004-77 (state law partnership may be a disregarded entity for federal tax purposes if its owners are regarded as the same taxpayer).

[17] §761(f). Material participation is determined under the passive loss rules, but without counting the participation of the other spouse under §469(h)(5). *See generally* CCA 200816030 (election of qualified joint venture status does not convert income that is otherwise excluded from §1402(a) net earnings from self-employment, such as rental real estate income excluded under §1402(a)(1), into self-employment income subject to the §1401 self-employment tax, despite §1402(a)(17) providing that notwithstanding the preceding provisions of §1402(a), each spouse's share of income or loss from a qualified joint venture shall be taken into account in determining net earnings from self-employment of each spouse); *see also* Rev. Proc. 2002-69 (an LLC or other business entity may optionally be a disregarded entity if it is wholly owned by two spouses as community property under the laws of a state, U.S. possession, or foreign country, and it is not classified as a corporation for income tax purposes).

[18] Rev. Rul. 85-13, Rev. Rul. 2004-86. *But see Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), *rev'g* 574 F. Supp. 19 (D. Conn. 1983) (holding that when the grantor is regarded as the "owner" of the trust's assets, the trust's relevant items of income, deductions, and credits will be attributed to the grantor).

[19] 1986 Blue Book at 242 n.33.

[20] Reg. §1.469-1T(b)(2). *See also* TAM 201317010 (passive loss rules apply to a nongrantor trust when a trustee materially participates in the activity of the nongrantor trust). PLR 8806065; §642(c)(5) (pooled income fund taxed as a nongrantor trust under Reg. §1.642-5 and subject to passive loss rules at the fund level).

[21] *See also* PLR 200608002, PLR 200608003.

[22] 2005 IRS Audit Guide at 6–7.

[23] *See* Instructions for Form 8582, *Passive Activity Loss Limitations.*

[24] Reg. §301.7701-4.

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for their unrelated business taxable income (UBTI) subject to the §511(b) unrelated business income tax (UBIT). Special considerations apply to the interplay between the passive loss rules and the §512(a)(6) "silo-ing" or "segmentation" rules, which generally prevent a tax-exempt trust from using its net operating losses from one unrelated trade or business against its income from another unrelated trade or business in 2018 and later.[25]

C. Personal Service Corporations

The passive loss rules are fully applicable to personal service corporations (PSCs),[26] to discourage individuals from incorporating their personal service businesses and then acquiring tax shelter investments at the corporate level.

The passive loss rules also apply to closely held corporations (CHCs), though to a more limited extent as discussed at V.A.1., below.[27] If a C corporation is both a PSC and CHC in the same tax year, it is a PSC for the tax year for passive loss purposes.[28]

Comment: The §465 at risk rules apply to CHCs but not to PSCs.[29] A CHC is defined the same for §465 at risk purposes and passive loss purposes.[30] If a corporation is both a CHC and a PSC, it is a PSC for passive loss purposes and a CHC for §465 at risk purposes.

Practice Point: The TCJA reduced the §11 corporate federal income tax rates from a top 35% marginal tax rate to a single 21% tax rate in 2018 and later.[31] Under the new rates, PSCs may be more attractive for many taxpayers in personal service businesses, particularly since many noncorporate personal service businesses are not eligible for the 20% §199A pass-through business income deduction.

Practice Point: When a PSC or CHC has disallowed passive losses that result in passive loss carryovers, the disallowed passive losses may nevertheless reduce the corporation's current earnings and profits (E&P) in the year that the loss is generated, instead of the year that the passive loss carryover is used.[32] Accordingly, the disallowed passive loss may reduce the PSC's or CHC's distributions that are taxed at the shareholder level as dividends under §301(c)(1) instead of as return of capital under §301(c)(2) or as capital gain under §301(c)(3)[33]

1. Definition of Personal Service Corporation

PSCs are defined by reference to the §269A PSC rules, with modifications.[34] The regulations defining a PSC for purposes of §441(i) should also apply for passive loss purposes, because §441(i) provides rules for the tax year of a PSC, which is also defined by reference to the §269A PSC rules with modifications identical to those in §469(j)(2).[35]

	PSC (Under §469(j)(2) and §441(i))	PSC (Under §269A)
Corporate activities	Principal activity of the corporation is the performance of personal services, and such services are substantially performed by employee-owners	Principal activity of the corporation is the performance of personal services, and such services are substantially performed by employee-owners
Definition of employee-owner	Any employee who owns, on any day during the tax year, any of the corporation's outstanding stock. Constructive ownership rules apply under §318(a), except that §318(a)(2)(C) corporation-to-shareholder attribution applies to any shareholder.	Any employee who owns, on any day during the tax year, more than 10% of the corporation's outstanding stock. Constructive ownership rules apply under §318(a), except that §318(a)(2)(C) corporation-to-shareholder attribution applies to 5% or more (by value) shareholders.
Stock ownership	More than 10% (by value) of the stock of the corporation is held by employee-owners	No requirement.

2. Employee-Owner Definition and 10% Requirement

The ownership of any stock in a corporation is sufficient for an employee of that corporation to be an employee-owner of that corporation.[36] Although the §269A statutory language refers to ownership on "any day during the taxable year," the regulations provide that a person is an employee-owner if he is an employee on any day and owns any stock on any day during the "testing period,"[37] which is generally the immediately preceding tax year.[38]

Practice Point: The employee may be an employee on a day during a testing period that is different from the day that

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[25] §512(a)(6), *added by* the TCJA, Pub. L. No. 115-97, §13702(a); Reg. §1.512(a)-6.

[26] §469(a)(2)(C).

[27] §469(a)(2)(B), §469(e)(2).

[28] Reg. §1.469-1T(g)(2)(ii).

[29] §465(a)(1)(B).

[30] §469(j)(1).

[31] Pub. L. No. 115-97, §13001(a).

[32] *See, e.g.*, Reg. §1.312-7(b)(1).

[33] *See generally* 764 T.M., *Current Distributions — Cash and Property*.

[34] §469(j)(2). Section 269A generally provides that if substantially all of the services of a §269A personal service corporation are performed for (or on behalf of) another entity, and the principal purpose of forming or using the personal service corporation is avoiding or evading certain tax matters, the Secretary of the Treasury may reallocate tax items between the §269A personal service corporation and its employee owners.

[35] *See* Reg. §1.469-1T(g)(2)(i), §1.441-3(c).

[36] §469(j)(2)(A).

[37] Reg. §1.441-3(g)(1).

[38] Reg. §1.441-3(c)(2). For a new corporation that does not have a preceding tax year, the testing period begins on the first day of its first tax year and ends on the last day of the same calendar year (or, if earlier, the last day of the first tax year). *See* Reg. §1.441-3(c)(3) *Exs.* 1, 2.

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the employee owns stock of the corporation during the testing period.

Any person who owns stock of the corporation and who performs personal services for, or on behalf of, the corporation is treated as an employee for this purpose, even if the legal form of the person's relationship to the corporation is that of an independent contractor.[39]

Modified §318 constructive ownership rules apply in determining stock ownership for PSC purposes,[40] including:

(1) Family attribution — an individual is considered to own stock owned, directly or indirectly, by his or her spouse (other than a legally separated spouse), children, grandchildren, and parents.[41]

(2) Entity-to-owner "upward" attribution (as modified by §469(j)(2)) — stock owned, directly or indirectly, by or for a partnership, estate or nongrantor trust, or corporation is considered as owned proportionately by its partners,[42] beneficiaries,[43] or shareholders,[44] respectively.

(3) Owner-to-entity "downward" attribution — stock owned, directly or indirectly, by a partner, beneficiary (except for a trust's remote contingent beneficiary), or 50%-or-more (by value) shareholder is considered as owned by the partnership,[45] estate or nongrantor trust,[46] or corporation,[47] respectively.

(4) Option attribution — if any person has an option to acquire stock, such stock is considered as owned by such person. The same rule applies to an option to acquire such an option, and each one of a series of such options.[48]

Stock constructively owned by a person by reason of family attribution is not treated as owned by him for purposes of applying family attribution again to another person.[49] Similarly, there is no "sideways" attribution;[50] that is, stock owned by an entity due to downward entity attribution is not considered to be owned by it for purposes of applying upward entity attribution to make another the constructive owner of such stock. However, if the person may constructively own stock also under option attribution, there is no prohibition on option attribution being followed by family attribution or upward entity attribution.[51] Other than the above two rules, stock constructively owned by a person is treated as actually owned by such person for purposes of applying further attribution.[52]

For §318 purposes, an S corporation is treated as a partnership, and its shareholders are treated as partners in the partnership.[53]

Practice Point: The definition of "employee-owner" is extremely broad, and can encompass employees with any amount of stock or stock options owned by themselves or their families.

> *Example:* A corporation has 100 outstanding common shares. The corporation issues one stock option each to 15 individual employees. With option attribution, the 15 employees own 13% (equal to 15 divided by 115) of the corporation, which is a PSC if the corporation's principal activity is the performance of certain personal services, and such services are substantially performed by the 15 individuals or their families.

Practice Point: Although a corporation's employee-owners are defined by reference to employees who own any amount of stock in the corporation during the testing period, a corporation is a PSC only if such employee-owners own more than 10% of the fair market value of the stock of the corporation on the last day of the testing period.[54] The 10% stock ownership is determined under the same modified §318 constructive ownership rules described above.[55]

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[39] Reg. §1.441-3(g)(2).

[40] §269A(b)(2).

[41] §318(a)(1)(A). A legally adopted child of an individual is treated as a child of the individual by blood under §318(a)(1)(B).

[42] §318(a)(2)(A).

[43] §318(a)(2)(B). There is no trust-to-beneficiary attribution for an employees trust described in §401(a) that is exempt from tax under §501(a). For how attribution applies to a §4795(f)(7) employee stock ownership plan (ESOP), *cf. Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003), *aff'g* 1998 BL 586 (D. Idaho Nov. 24, 1998) with TAM 9612001.

[44] §318(a)(2)(C), as modified by §469(j)(2)(B).

[45] §318(a)(3)(A). There is no minimum ownership required for partner-to-partnership attribution. *Cf.* Reg. §1.965-1(f)(45)(ii)(A)(1) (for certain §965 purposes, partner-to-partnership attribution applies only to 10%-or-more partners).

[46] §318(a)(3)(B). Beneficiary-to-trust attribution does not apply to an employees' trust described in §401(a) that is exempt from tax under §501(a). For any other noncontingent beneficiary, there is no minimum ownership required for beneficiary-to-trust or beneficiary-to-estate attribution. *Cf.* Reg. §1.965-1(f)(45)(ii)(A)(2) (for certain §965 purposes, beneficiary-to-trust attribution applies only to 10%-or-more beneficiaries).

[47] §318(a)(3)(C).

[48] §318(a)(4). See Rev. Rul. 69-562 (a corporation's option to purchase its own stock from a shareholder does not make the corporation the owner of the stock, for purposes of making another shareholder a constructive owner of that stock).

[49] §318(a)(5)(B).

[50] §318(a)(5)(C).

[51] *See* Reg. §1.318-4(c)(2).

[52] §318(a)(5)(A). *See generally* 554 T.M., *The Attribution Rules.*

[53] §318(a)(5)(E).

[54] Reg. §1.441-3(c)(1)(iv).

[55] Reg. §1.441-3(c)(1)(iv).

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3. *Meaning of "Personal Services" and "Substantially Performed"*

A corporation is not a PSC unless the performance of personal services was its principal activity, as determined under §269A. This condition is met if more than 50% of the corporation's compensation costs during the testing period are attributable to personal service activities.[56] Compensation costs include wages, salaries, and other payments for services (whether deducted, allocated to a long-term contract, or capitalized), such as deferred compensation and §83 income from stock options, but they do not include compensation attributable to a §401(a) or §403(a) qualified plan, or a §408(k) simplified employee pension plan.[57] The compensation costs must be allocated to personal service activities, generally using any reasonable and consistent manner, to determine whether the 50% threshold is met.[58]

Furthermore, the personal services must be "substantially" performed by employee-owners, in order for the corporation that principally provides personal services and is more than 10%-owned by employee-owners to be a PSC. This requirement is met if, during the testing period, the employee-owners are attributed more than 20% of the corporation's compensation costs attributable to personal service activities.[59] The amount attributed to employee-owners can be determined by the corporation in any reasonable and consistent manner.[60]

> *Example:* A corporation has $1,500,000 of total compensation costs, of which $1,000,000 is attributable to the corporation's personal service activity and $500,000 is attributable to another activity. The total compensation costs attributable to the corporation's employee-owners for the testing period was $250,000 ($210,000 attributable to the corporation's personal service activity and $40,000 attributable to another activity). The corporation's employee-owners substantially performed the corporation's personal services during the testing period.[61]

The regulations limit "personal services" to only the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[62] Regulations issued under §448 that define some of these fields are also controlling for passive loss purposes.[63]

Practice Point: Some of the fields are further defined in regulations issued under §199A, which incorporate the §448 regulations by analogy.[64] However, the preamble to the §199A regulations states that the §199A guidance applies only to §199A, not to §448, due to the different scope and purpose of the two provisions.[65]

	Included Under §448 regulations	Excluded Under §448 Regulations
Health	Provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals.[66]	Services not directly related to a medical field, such as operation of health clubs or health spas that provide physical exercise or conditioning to their customers.[67]
Law, Engineering, Architecture, Accounting, Actuarial Science	N/A	N/A
Performing Arts	Services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such.[68]	Services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts), services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers), and services by athletes.[69]
Consulting	Provision of advice and counsel.[70]	Services other than advice and counsel, such as sales or brokerage services, or economically similar services.[71]

Practice Point: The list of personal services for §448 and §469 purposes does not include certain services listed in

[56] Reg. §1.441-3(e)(1).
[57] Reg. §1.441-3(e)(2).
[58] *See* Reg. §1.441-3(e)(3). Time logs are not required. Reg. §1.441-3(e)(3)(ii)(A).
[59] Reg. §1.441-3(f)(1).
[60] Reg. §1.441-3(f)(2)(ii).
[61] *See* Reg. §1.441-3(f)(3) *Ex.* 2.
[62] Reg. §1.441-3(d).
[63] *See* Reg. §1.448-1T(e)(4).
[64] Reg. §1.199A-5.
[65] T.D. 9847, 84 Fed. Reg. 2959, 2969 (Feb. 8, 2019).
[66] Reg. §1.448-1T(e)(4)(ii). *See* Rev. Rul. 91-30 (field of health includes veterinarians).
[67] Reg. §1.448-1T(e)(4)(ii).
[68] Reg. §1.448-1T(e)(4)(iii).
[69] Reg. §1.448-1T(e)(4)(iii).
[70] Reg. §1.448-1T(e)(4)(iv).
[71] Reg. §1.448-1T(e)(4)(iv).

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§199A(d)(2)(A), such as athletics, financial services, and brokerage services. The incorporation of such a service business into a C corporation would not create a PSC subject to the passive loss rules.

D. *Closely Held C Corporations*

The passive loss rules apply to closely held C corporations (CHCs), though to a more limited extent as discussed at V.A.1., below.[72] If a C corporation is both a personal service corporation (PSC) and CHC in the same tax year and thereby subject to the broader passive loss rules applicable to individuals and PSCs.[73]

1. *Definition of "Closely Held"*

The passive loss rules define a CHC as any C corporation described in §465(a)(1)(B) for at-risk purposes, which in turn apply the §542(a)(2) stock ownership requirements under the personal holding company rules, with some modifications.[74] For a more detailed discussion of the personal holding company rules, *see generally* 797 T.M., *Personal Holding Companies*.

Note: The determination of whether a corporation is a personal holding company under §542(a) is based on both a stock ownership test and an income test, whereas characterization as a CHC is based on only a stock ownership test (with modifications), so a CHC might not be a personal holding company (or vice versa).

A corporation is closely held if, at any time during the last half of its tax year, more than 50% (by value) of its outstanding stock is owned, directly or indirectly, by five or fewer individuals.[75] For this purpose, "individuals" include §401(a) trusts for employee benefit plans;[76] certain trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits under §501(c)(17); private foundations under §509(a); and a portion of a trust permanently set aside or to be used exclusively for the charitable purposes described in §642(c) (or a corresponding provision of earlier income tax law).[77] In contrast, an individual for this purpose does not include a §501(c)(3) tax-exempt organization that is not a private foundation.[78]

The §544(a) constructive ownership rules, with modifications in §465(a)(3) for both the at risk and passive loss rules, apply in determining whether a corporation is a CHC. In identifying the five largest individual shareholders, the individual shareholder with the largest number of shares (directly and by attribution) is first identified, and such person's stock is not taken into account in identifying the next largest individual shareholder (directly and by attribution).[79] The constructive ownership rules generally provide for:

(1) Entity attribution — stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.[80]

(2) Family attribution — an individual shall be considered as owning the stock owned, directly or indirectly, by or for his or her family, which includes only brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.[81]

(3) Option attribution — if any person has an option to acquire stock, such stock shall be considered as owned by such person. The same rule applies to an option to acquire such an option, and each one of a series of such options.[82]

Stock constructively owned by a person by reason of entity attribution or option attribution is treated as actually owned by such person, for purposes of applying family attribution or (further) entity attribution.[83] Stock constructively owned by a person by reason of family attribution is not treated as owned by him for purposes of applying family attribution again to another person.[84] However, if a person constructively owns stock under either the family attribution or option attribution rule, the stock is considered owned by such person due to option attribution, which may be followed by further family attribution from such person to family members.[85]

Practice Point: The most notable difference between a CHC for passive loss purposes and a closely held corporation under the personal holding company rules is that the personal holding company rules provide for partner attribution, i.e., if two persons are partners in a partnership, the two persons own each other's stock in a corporation. The elimination of partner attribution greatly reduces the number of CHCs.

It is not necessary for a family member to actually own stock in a corporation in order for it to be attributed stock under family attribution.[86]

Example: Two first cousins each own 10 shares of stock in a corporation. Their stock cannot be attributed to each other under the family attribution rule, which does not apply to cousins. However, all of their stock may be attributed to a grandparent, so that a single grandparent individ-

[72] §469(a)(2)(B), §469(e)(2).

[73] Reg. §1.469-1T(g)(2)(ii).

[74] §469(j)(1).

[75] §542(a)(2).

[76] In PLR 9148019, the IRS ruled that the qualified trust (or trusts) of a qualified retirement plan, and not the plan itself, is the organization for §542(a)(2) purposes. Accordingly, when there are several trusts under a single plan, each trust is treated as a separate individual.

[77] §542(a)(2).

[78] PLR 200507004, PLR 200403027.

[79] *See* Reg. §1.544-3; Rev. Rul. 89-20.

[80] §544(a)(1). For trust-to-beneficiary attribution, *compare Steuben Securities Corp. v. Commissioner*, 1 T.C. 395 (1943) (stock owned by a trust is considered owned by the beneficiaries with a direct present interest, not future interests) *with Phinney v. Tuboscope Co.*, 268 F.2d 233 (5th Cir. 1959) (actuarial value of nonpresent interests in a trust are taken into account) and Rev. Rul. 62-155 (same). For estate-to-beneficiary attribution, see *Commercial Fin. Co. v. Commissioner*, T.C. Memo 1968-229 (stock owned by an estate is owned by the residuary beneficiaries).

[81] §544(a)(2). In contrast to §318(a), the §544(a) constructive ownership rules do not have an exception for legally separated spouses and do not have a specific provision for adopted children.

[82] §544(a)(3). In PLR 9205030, the IRS ruled that a corporation's option to purchase its own stock from a shareholder does not make the corporation the owner of the stock, and therefore the stock is still considered outstanding for determining whether the corporation is closely held.

[83] §544(a)(5).

[84] §544(a)(5).

[85] *See* Reg. §1.544-7.

[86] *Steuben Sec. Corp. v. Commissioner*, 1 T.C. 395 (1943).

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ual owns all 20 shares. The result may be different if the grandparents are all deceased.

Outstanding securities convertible into stock shall be considered as outstanding stock, if the effect is to make the corporation a CHC, whether or not the securities are convertible during the tax year.[87]

Example: A corporation is owned by 11 individuals, each of whom owns 10 shares of stock. An individual makes a convertible loan to the corporation that can be converted into 100 shares of stock in five years. The corporation is a CHC because five individuals (the individual making the convertible loan and four other individuals) own 67% of the corporation's stock (140 out of 210), after taking the potential loan conversion into account.

Practice Point: The option attribution rule and the convertible securities rule cannot be used to cause a corporation to not be a CHC.

Example: A corporation is owned by nine individuals who each own 10 shares of stock. A foreign sovereign wealth fund makes a convertible loan to the corporation that can be converted into 100 shares of stock. The corporation is a CHC because five individuals own 56% of the corporation's stock (50 out of 90). The convertible securities rule cannot be used to make the corporation not a CHC.

Practice Point: CHCs often arise in "U.S. blocker" or "leveraged blocker" structures, where foreign individuals invest in U.S. real property or other U.S. trades or businesses through a domestic C corporation or a U.S. limited liability company that is classified as a C corporation. A small number of foreign individuals may directly or constructively own all of the stock of a foreign corporation, which owns substantially all of the value of the domestic C corporation, which owns the U.S. activity.

Example: Foreign individual F owns 100% of the stock of a foreign corporation, which owns 5% of the voting stock and 90% of the value of a domestic C corporation, which owns a U.S. rental real property. An unrelated U.S. person owns 95% of the voting stock and 10% of the value of the domestic C corporation. F makes a loan in registered form at a fixed interest rate to the domestic C corporation, for which the interest payments are deductible by the corporation and are not subject to U.S. interest withholding tax under the portfolio interest exemption.[88] Although F does not own more than 10% or more of the voting stock of the domestic C corporation and therefore is not related to the domestic C corporation for purposes of the portfolio interest exemption,[89] CHC status is determined according to stock ownership by value. As the domestic C corporation's stock is more than 50% owned (by value) by one individual, the corporation is a CHC and its rental activity's losses cannot offset its interest income and other portfolio income, such as REIT dividends.

2. Real Estate Investment Trusts

A real estate investment trust (REIT) is generally a domestic C corporation that has elected to be taxed as a REIT for income tax purposes. In exchange for meeting various income tests, asset tests, and other requirements in §856 et seq., the REIT is generally allowed a dividends paid deduction for its distributions, which can reduce or eliminate the REIT's corporate-level taxable income. For a more detailed discussion of REITs, see generally 742 T.M., *Real Estate Investment Trusts.*

One of the REIT requirements requires that the REIT not be closely held as determined under §856(h),[90] which in turn applies the §542(a)(2) stock ownership requirements under the personal holding company rules, with some modifications. Most REITs that meet the closely held REIT requirement are also not CHCs, but there are some exceptions.

The REIT closely held requirement does not apply for the REIT's first tax year.[91] Accordingly, a REIT may be a CHC in its first tax year while still meeting the REIT requirements.

The REIT closely held requirement is deemed to be met if the REIT issues certain demand letters to determine the ownership of its shares, and the REIT does not know, or by exercising reasonable diligence would not have known, whether it failed to meet the REIT closely held requirement during a tax year.[92] Such a REIT may in fact have failed the closely held requirement and may be a CHC during the tax year.

Although §542(a)(2) generally provides that a §401(a) trust for employee benefit plans is a single individual, any REIT stock held by a §401(a) trust (that is tax-exempt under §501(a)) is treated as held directly by the trust's beneficiaries in proportion to their actuarial interests in the trust, instead of being treated as held by the trust.[93] A coordination rule provides that if any entity qualifies as a REIT by reason of the look-through rule, the entity is not a personal holding company for such tax year.[94] However, there is no coordination rule with the passive loss rules that prevents the REIT from being a CHC; a qualifying REIT may have a large shareholder that is a §401(a) trust and be a CHC. Furthermore, the coordination rule does not apply to the REIT's subsidiaries, which may cause a taxable REIT subsidiary (TRS) to be a personal holding company and a CHC.

E. Consolidated Groups

An affiliated group of corporations that files a consolidated return generally is treated as one taxpayer for passive loss purposes.[95] As a result, the determination of whether the members of the consolidated group are either PSCs or CHCs is made

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[87] §544(b)(1).

[88] *See* §871(h)(1).

[89] *See* §871(h)(3)(B)(i).

[90] §856(a)(6).

[91] §856(h)(2).

[92] §856(k)(1), §857(f)(1); Reg. §1.857-8.

[93] §856(h)(3)(A)(i). The look-through rule does not apply if the REIT has non-REIT accumulated earnings and profits and certain disqualified persons with respect to the trust own 5% or more of the REIT's stock. §856(h)(3)(A)(ii).

[94] §856(h)(3)(B).

[95] §469(j)(11).

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at the group level. This determination applies on an all-or-nothing basis to the group members, even if any one (or all) of them would not be a PSC or CHC if considered alone.[96] For a detailed discussion of consolidated groups, see generally 754 T.M., *Consolidated Returns — Elections and Filing.*

The principal activity standard for PSC purposes, and the material and significant participation standards, are determined at the consolidated group level.[97] An activity is treated as the principal activity if and only if it is the principal activity of the consolidated group.[98]

Moreover, an employee of any member is treated as an employee of the group, and only the outstanding stock of the common parent is treated as outstanding stock of the group.[99]

> *Example:* Corporation A and its wholly owned subsidiary B are an affiliated group that files a consolidated income tax return. During the testing period, i.e., the prior tax year, A did not perform any personal services, whereas B only performed personal services. On the last day of the testing period, employees of A did not own any stock of A, but employees of B owned 11% of the stock of A. The affiliated group may be a PSC under §469, if the affiliated group's principal activity is the performance of personal services and the personal services are substantially performed by employee owners.[100]

> *Example:* Same as above, except that the affiliated group does not file a consolidated return. A is not a PSC, whereas B may be a PSC under §469 depending on whether its personal services are substantially performed by employee owners.

The passive loss rules apply on a consolidated group basis, so that losses from any passive activity within the consolidated group can offset passive income of any member of the group (or the member's net active income if the group is a CHC).[101] Once the group's disallowed passive losses and passive credits are identified, it is necessary to apportion them among the members of the group. Apportionment is done on a pro rata basis among group members that, considered in isolation, have passive losses or credits from passive activities.[102] Apportionment may be necessary, for instance, to make various tax determinations after a member of the group is sold.

> *Example:* A consolidated group consists of three corporations: A (which has a passive loss of $5), B (which has a passive loss of $10), and C (which has net passive income of $3). The group as a whole has a passive loss of $12, of which $4 is allocated to A and $8 is allocated to B.
>
> Reg. §1.1502-13 generally applies to determine the treatment under §469 of intercompany items and corresponding items from intercompany transactions between members of a consolidated group.[103] For example, the selling member (S) and the buying member (B) are treated as divisions of a single corporation for purposes of determining whether S's intercompany items and B's corresponding items are from a passive activity.[104]

> *Example:* P, the parent corporation of a closely held consolidated group, owns all the stock of subsidiary corporations S and B. S owns and operates equipment that is used in a nonpassive activity. On January 1, Year One, S sells the equipment to B at a gain. B uses the equipment in a passive activity and does not dispose of the equipment before it has been fully depreciated. S's gain taken into account as a result of B's depreciation is treated as gain from a passive activity, even though S used the equipment in a nonpassive activity.[105]

> *Example:* Assume the same facts as above except that on December 31, Year Two, B sells the equipment to unrelated party X at a gain. If S and B were divisions of a single corporation, gain from the sale to X would be passive income attributable to a passive activity. To the extent of B's depreciation before the sale, the results are the same as in the example above. B's gain and S's remaining gain taken into account as a result of B's sale, are treated as attributable to a passive activity.[106] If B sold the equipment at a loss, B's loss and S's gain taken into account as a result of B's sale are treated as attributable to a passive activity.[107]

Any gain recognized by a member on the disposition of stock of another member, including income resulting from the recognition of an excess loss account (e.g., negative tax basis in the stock due to prior allocated losses), is treated as portfolio income.[108] In contrast, a sale of the subsidiary's assets may give rise to passive income or active income, which may include the sale of the subsidiary after it has converted into a disregarded entity for federal tax purposes and underwent a tax-free liquidation under §332.[109]

F. Publicly Traded Partnerships

In the aftermath of the Tax Reform Act of 1986, the passive loss rules incentivized the conversion of portfolio income into income from publicly traded master limited partnerships (MLPs). MLP income, such as from rental activities, would generally qualify as passive and could be sheltered by passive losses.

The Omnibus Budget Reconciliation Act of 1987[110] made two major changes to the taxation of MLPs, which are called publicly traded partnerships (PTPs) under the statute. Certain

[96] Reg. §1.469-1(h)(4)(ii).
[97] Reg. §1.469-1(h)(4)(ii).
[98] Reg. §1.469-1(h)(4)(ii)(D).
[99] Reg. §1.469-1(h)(4)(ii)(B), §1.469-1(h)(4)(ii)(C).
[100] Reg. §1.441-3(h)(2).
[101] 1986 Conference Report at II-140. *See also* 1986 Blue Book at 221.
[102] Reg. §1.469-1T(h)(5)(i).
[103] Reg. §1.469-1(h)(6)(i).
[104] Reg. §1.1502-13(c).
[105] Reg. §1.469-1(h)(6)(ii) Ex. (i) and (ii).
[106] Reg. §1.469-1(h)(6)(ii) Ex. (iii).
[107] Reg. §1.469-1(h)(6)(ii) Ex. (iv).
[108] Reg. §1.469-1T(h)(7).
[109] See *Dover Corp. v. Commissioner*, 122 TC 19 (2004) (similar transaction in the international tax context).
[110] Pub. L. No. 100-203, §10211, §10212.

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PTPs were classified as corporations for tax purposes beginning in 1988.[111] The act also changed the passive loss rules for PTPs not classified as corporations, in order to prevent them from generating passive income in tax years beginning in 1987 or later (i.e., the same effective date as the passive loss rules of the Tax Reform Act of 1986).[112]

The House Report for the Omnibus Budget Reconciliation Act of 1987 noted:

> publicly traded partnerships resemble corporations in significant respects. For example, such partnerships, like publicly traded corporations, give rise to the expectation that the entity will continue in existence for the duration of its business activities, and holders of limited partnership interests can freely transfer their interests, have limited liability, and generally do not participate in management. Further, such partnerships are marketed and access capital markets in a manner similar to that traditionally performed by corporations, and market interests in the partnership on the basis of the positive current yield that an investor can expect on his investment in the partnership.
>
> In this regard, the committee believes that the return on investment in a publicly traded partnership is essentially comparable to the return on an investment in corporate stock. Under the passive loss rule, passive losses cannot be applied to offset dividend income. Similarly, the passive loss rule treats as portfolio income from other investments such as interest-bearing obligations. The committee believes that income from all publicly traded partnerships should be treated similarly to income from investments in corporations for purposes of the passive loss rule.
>
> Thus, the bill provides that net income from an interest in any publicly traded partnership is not treated as passive income that can be offset by passive losses, but rather, like dividend income (and like other investments generating a steady stream of positive income such as interest), cannot be offset by passive losses.[113]

PTPs are generally defined as any partnership (including an LLC that is treated as a partnership for federal income tax purposes) that has interests that are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof).[114] Partnership interests are readily tradable on a secondary market, or its substantial equivalent, if the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market.[115] Specifically, partnership interests are readily tradable on a secondary market or the substantial equivalent thereof if: (i) such interests are regularly quoted by persons such as brokers or dealers making a market in the interest; (ii) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with about such interests and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others; (iii) the holder of an interest has a readily available, regular, and ongoing opportunity to sell or exchange such interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests; or (iv) prospective buyers and sellers have the opportunity to buy, sell, or exchange interests in a time frame and with the regularity and continuity that the existence of a secondary market would provide.[116]

The regulations provide various safe harbors for transfers that are not considered in determining PTP status.[117]

PTPs are treated under §7704 as corporations unless 90% or more of their gross income is qualifying income, also known as "passive-type income,"[118]

The definition of a PTP, the regulatory safe harbors for transfers and the classification of income as "qualifying income" are discussed in detail in 723 T.M., *Publicly Traded Partnerships*.

A PTP that fails the 90% gross income test and is treated as a corporation may qualify as a PSC or CHC. The PTP is treated as transferring all of its assets (subject to their liabilities) to a newly formed corporation in exchange for the stock of the corporation, and distributing the stock to the partners in liquidation of their partnership interests.[119] The tax consequences are governed generally by §351, §731, and §732. Once a PTP is taxed as a corporation due to failing the 90% gross income test, it continues to be taxed as a corporation for all subsequent tax years as long as it is publicly traded. The statute and regulations do not explicitly address the result if a PTP that is taxed as a corporation ceases to be publicly traded, but presumably the corporation becomes a partnership for federal income tax purposes and liquidates under §331 or §332 (as applicable).

For PTPs that qualify under the 90% gross income test and continue to be treated as partnerships, a separate passive loss limitation applies at the partner level.[120] The passive loss rules apply separately to each PTP in which the taxpayer owns an interest.[121] Thus, a taxpayer's net income from a PTP's passive

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[111] §7704(a).

[112] §469(k).

[113] H. Rep. No. 100-391, Part 2 at 1073 (1987).

[114] §7704(b). An established securities market includes (1) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (2) a national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions, (3) a foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in (1) or (2) (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange), (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise. Reg. §1.7704-1(b).

[115] Reg. §1.7704-1(c)(1).

[116] Reg. §1.7704-1(c)(2).

[117] Reg. §1.7704-1(e)(1).

[118] §7704(c). The term "passive-type" income, as used in §7704(d), has no relationship to any definitions under the passive loss rules.

[119] §7704(f).

[120] §469(k)(1).

[121] §469(k)(1). This special rule requiring separate treatment for each PTP also applies to a regulated investment company (as defined by §851) holding an interest in a qualified PTP (as defined by §851(h) to cover certain PTPs that would not have met the regulated investment company gross income tests if the PTP were a regulated investment company and qualifying income included only dividends, interest, gains from the sale or disposition of stocks and securities,

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activities cannot be sheltered by the taxpayer's losses from other passive activities, including passive losses from other PTPs. The nonpassive income from the PTP is portfolio income and investment income under §163(d).[122]

Similarly, a taxpayer's net loss from a PTP cannot be used to shelter net income from other passive activities, including from other PTPs, but must be suspended and carried forward until: (1) there is net income from that PTP in a future year; or (2) an appropriate disposition occurs.[123]

The definition of an appropriate disposition is different from the unrelated taxable disposition rule under the general passive loss rules,[124] as no disposition losses are allowed merely because the PTP has disposed of its entire interest in a passive activity. Instead, the taxpayer must dispose of his entire interest in the PTP to be allowed disposition losses with regard to any of the PTP's passive activities.[125] As under the full unrelated taxable disposition rule, the disposition must be a fully taxable transaction with an unrelated party.

Example: Taxpayer T purchases 100 common units of PTP. T's spouse purchases 10 preferred units of PTP. PTP generates $10 of net income per preferred unit and $5 of net loss per common unit. Spouses who file a joint return are treated as a single taxpayer for most passive loss purposes, including PTP purposes.[126] Accordingly, the $500 of losses for the common units can offset the $100 of income for the preferred units from the same PTP. Furthermore, T and T's spouse recognize the $400 PTP passive loss carryover only upon the disposition of both their common and preferred units of the PTP.

Practice Point: A taxpayer's passive activity income and deductions from the same PTP can be used to offset each other. Moreover, the passive activity deductions from a PTP include deductions for expenses incurred by the taxpayer outside the PTP if such expenses are reasonably allocable to the taxpayer's interest in passive activities held through the PTP. For example, these deductions include those incurred by the taxpayer for interest expense (*e.g.*, to acquire the PTP partnership interest), provided that such deductions are reasonably allocable to the PTP's passive activities under the rules generally applicable to allocating interest expense.[127]

Practice Point: Within a single PTP, passive losses cannot offset portfolio income or nonpassive income, and nonpassive losses are not limited by the passive loss rules.[128] Although the main example of such income (or loss) is likely to be portfolio income (or loss) of the PTP, income (or loss) from a trade or business activity conducted by a PTP also can be nonpassive if the taxpayer materially participates in the activity. General partners of a PTP may be materially participating in the PTP's activities.[129] While limited partners generally are not treated as materially participating in any activity of a limited partnership, the regulations create limited exceptions to this general rule.[130]

The $25,000 special allowance[131] for certain rental real estate activities of a lower-income taxpayer generally does not apply to PTP items.[132] However, a partner in a PTP is entitled to the $25,000 (deduction equivalent) allowance with respect to his share of the PTP's low-income housing tax credits (LIHTC) or the PTP's historic rehabilitation tax credits, to the extent that he has not fully utilized the $25,000 special allowance for passive losses and other passive credits from non-PTP sources.[133]

G. Foreign Activities and Foreign Persons

The passive loss rules apply to all taxpayers, U.S. and foreign. A U.S. taxpayer may be subject to the passive loss rules for both U.S. and foreign activities.

Example: Taxpayer T is a U.S. citizen who has a $1,000 of operating income from a U.S. restaurant business and a $1,000 net rental loss from a foreign rental real property. Due to differences in U.S. and foreign tax law, T pays $100 of foreign income tax with respect to the foreign rental real property. If T does not materially participate in the restaurant business, T's $1,000 net rental loss may offset the $1,000 of restaurant operating income. If T materially participates in the restaurant business, the $1,000 net rental loss is a passive loss that cannot offset the $1,000 of nonpassive income from the restaurant and becomes a $1,000 passive loss carryover to the next tax year. In either case, T may claim a $100 foreign tax credit for the $100 of foreign income tax paid, generally to the extent that T has sufficient U.S. income tax liability on foreign-source income in the same §904(d) category.[134]

A foreign taxpayer may be subject to the passive loss rules on its income that is effectively connected with the conduct of a U.S. trade or business and subject to U.S. income tax,[135] which may include rental income from U.S. real property that the taxpayer elects to treat as effectively connected with a U.S. trade or business,[136] and gains from the disposition of U.S. real prop-

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and other income described in §851(b)(2)(A)) with respect to items attributable to such interest in the qualified PTP. §469(k)(4). *See* 740 T.M., *Taxation of Regulated Investment Companies and Their Shareholders.*

[122] Notice 88-75. For a discussion of portfolio income, see III.C., below.

[123] *See Hasan v. Commissioner*, T.C. Memo 1997-439.

[124] *See* §469(g) (discussed at V.H., below).

[125] §469(k)(3). In PLR 9148041, the IRS ruled that the holders of a PTP disposed of their entire interests in the PTP when they exchanged all of their PTP units for a corporation's common stock in a taxable transaction, and the holders are allowed their PTP passive loss carryovers if they are not related to the corporation.

[126] Reg. §1.469-1T(j)(1).

[127] *See* Notice 88-75.

[128] *See* H. Rep. No. 100-495, at 951–52 (1987); Notice 88-75.

[129] If a PTP holds a working interest in an oil or gas activity, the activity generally qualifies as nonpassive to general partners of the PTP. *See* IV.C.7., below.

[130] *See* IV.A.8., below. An oil and gas working interest conducted by a PTP would be a passive activity to the limited partners — absent material participation — under the oil and gas working interest rule, which denies per se nonpassive treatment to oil and gas working interests held through an entity that limits the taxpayer's liability. *See* IV.C.7.b., below.

[131] §469(i), see V.F., below.

[132] §469(k)(1).

[133] §469(k)(1) *see* V.F.2., below.

[134] §469(d)(2) (passive credits do not include §27 foreign tax credits). The TCJA, Pub. L. No. 115-97, §14201, expanded the number of §904(d) foreign tax credit categories in 2018 and later years to four: general category, passive category, global intangible low-tax income (GILTI) category, and foreign branch category. See 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904* (Foreign Income Series).

[135] §871(b), §882.

[136] §871(d).

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erty that is deemed to be effectively connected with a U.S. trade or business under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[137] Income effectively connected with the conduct of a U.S. trade or business may include foreign-source income in some circumstances.[138]

Note: In addition to the U.S. income tax on a foreign corporation's income that is effectively connected with a U.S. trade or business, the foreign corporation may also be subject to an additional branch profits tax of generally up to 30% on its effectively connected earnings and profits.[139] A corporation's earnings and profits are reduced by a disallowed passive loss,[140] with the result that a foreign corporation that is subject to the passive loss rules may reduce its branch profits tax by disallowed passive losses. For more on the branch profits tax, *see generally* 6480 T.M., *The Branch-Related Taxes of Section 884* (Foreign Income Series).

Note: The TCJA enacted §864(c)(8) to provide that a foreign person's non-FIRPTA gain or loss from the disposition of a partnership interest on or after November 27, 2017, is effectively connected with the conduct of a U.S. trade or business, generally to the extent of the partner's share of the partnership's unrealized gain that is effectively connected with the conduct of a U.S. trade or business.[141] Although Congress enacted §864(c)(8) in response to the taxpayer victory in *Grecian Magnesite v. Commissioner*,[142] the case involved the entirely different issue of whether a foreign partner's non-FIRPTA gain from the redemption of an interest in a partnership (engaged in a U.S. mining activity) was U.S.-source income or foreign-source income, and not the issue of whether the income of either source was effectively connected with the conduct of a U.S. trade or business. The taxpayer in *Grecian Magnesite* successfully argued that the gain was foreign-source income, and the IRS had conceded for unclear strategic reasons that any foreign-source income would not be effectively connected with the conduct of a U.S. trade or business and therefore not subject to U.S. income tax. In contrast, §864(c)(8) generally results in the foreign partner recognizing foreign-source income that is effectively connected with the conduct of a U.S. trade or business and subject to U.S. income tax. For more on §864(c)(8) and its withholding provisions in §1446(f), *see* 6680 T.M., *Partners and Partnerships — International Tax Aspects* (Foreign Income Series), and 718 T.M., *Partnerships — Disposition of Partnership Interests or Partnership Business; Partnership Termination.*

Example: A foreign individual has a $1,000 gain from the disposition of a partnership interest engaged in a U.S. restaurant business and a $1,000 net rental loss from a U.S. rental real property. If the individual does not materially participate in the U.S. restaurant business, the $1,000 gain is passive gain that may be offset by the $1,000 passive loss from the rental real estate activity. However, if the individual materially participates in the U.S. restaurant business, the $1,000 gain is nonpassive gain that cannot be offset by the $1,000 passive loss, which becomes a $1,000 passive loss carryover to the following tax year.

Example: A foreign individual has a $1,000 loss from the disposition of a partnership interest engaged in a U.S. restaurant business and a $1,000 gain from a U.S. rental real property. Regardless of whether the $1,000 loss is passive or nonpassive due to material participation or the full unrelated taxable disposition rule,[143] the loss may offset the $1,000 passive income from the rental real estate activity.

Example: A foreign individual has a $1,000 operating loss from a U.S. restaurant business and a $1,000 capital gain dividend from a nonpublic REIT, attributable to the REIT's disposition of a U.S. real property interest. The REIT capital gain dividend is effectively connected with the conduct of a U.S. trade or business and subject to U.S. income tax.[144] Since the REIT capital gain dividend is portfolio income,[145] the $1,000 loss cannot offset the dividend income and instead becomes a $1,000 passive loss carryover to the following tax year.

A controlled foreign corporation (CFC) is generally a foreign corporation in which more than 50% of its stock (by vote or value) is owned directly, indirectly, or constructively by one or more U.S. shareholders.[146] A U.S. shareholder is any U.S. person that owns 10% or more (by vote or value) of the foreign corporation's stock.[147] A U.S. shareholder includes as gross income its pro rata shares of the CFC's subpart F income under §951 and net CFC tested income (NCTI; formerly known as global intangible low-taxed income (GILTI)) §951A income, both of which are generally calculated as if the CFC were a domestic corporation subject to the §11 corporate income tax.[148]

Subpart F income generally consists of certain types of rental income and other investment income,[149] as well as certain sales and service transactions with related parties.[150] Certain Code provisions do not apply for calculating the CFC's subpart F income or §951A income (or loss),[151] such as a disallowance of any §172 net operating loss (NOL) deduction and any §1212(a) capital loss carryback or carryover.[152] If a CFC is a personal service corporation (PSC) or closely held company (CHC) under the passive loss rules, the CFC may be subject to

[137] §897(a)(1). *See* Omnibus Reconciliation Act of 1980 (Pub. L. No. 96-499), tit. XI subt. C.

[138] *See, e.g.*, §864(c)(4).

[139] §864(c)(8).

[140] *See, e.g.*, Reg. §1.312-7(b)(1).

[141] Pub. L. No. 115-97, §13501.

[142] *Grecian Magnesite v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019).

[143] *See* V.H., below.

[144] §897(h)(1).

[145] *See* III.C.1., below.

[146] §957(a). *See* §958(b) (constructive ownership).

[147] §951(b). *See* §958(b) (constructive ownership), §957(c) (defining "U.S. person").

[148] Reg. §1.952-2(b)(1), §1.951A-2(c)(2).

[149] §954(c).

[150] *See* §954(d), §954(e).

[151] Reg. §1.952-2(c).

[152] Reg. §1.952-2(c)(5).

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passive loss limitations in computing its subpart F income and §951A income (or loss) from foreign activities.[153]

> *Example:* Taxpayer T is a U.S. citizen who owns 100% of the stock of foreign corporation CFC. CFC has $100 of net rental loss from a foreign rental real property and $100 of interest income. CFC has zero adjusted tax basis in the foreign rental real property and does not materially participate in the foreign rental activity. The net rental loss is subject to the passive loss limitations for a CHC,[154] and it cannot offset the $100 of interest income for purposes of computing either subpart F income or global intangible low-taxed income (GILTI) tested income (or loss). The CHC has a $100 passive loss carryover to the next tax year.

> *Example:* Taxpayer T is a U.S. citizen who owns 100% of the stock of foreign corporation CFC. CFC has $100 of net loss from a foreign business in Year One and $100 of net income from the same business in Year Two. CFC has zero adjusted tax basis in the assets of the foreign business, which gives rise to GILTI tested income (or loss). If CFC materially participates in the foreign business activity in Year One, the CFC's $100 net loss in Year One results in a $100 GILTI tested loss for T in Year One, which cannot be carried over to Year Two in order to offset T's $100 of GILTI tested income in Year Two. Accordingly, T has $100 of GILTI inclusions in Year Two. In contrast, if CFC does not materially participate in the foreign business activity in Year One, CFC's $100 net loss in Year One becomes a $100 passive loss carryover that can offset CFC's $100 of income in Year Two, so that T has zero GILTI tested income in Year Two.

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[153] For more on the application of the passive loss rules to CFCs, subpart F income, and net CFC tested income (NCTI f/k/a GILTI), see 6200 T.M., *CFCs — General Overview*; 6220 T.M., *CFCs — Foreign Personal Holding Company Income*; 6240 T.M., *CFCs — Foreign Base Company Income (Other than FPHCI)* (Foreign Income Series).

[154] *See* V.A.1., below.

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III. Activities Covered

A. Identifying Passive Activities

If a taxpayer is subject to the passive loss rules, the next step is to identify whether any of the taxpayer's activities are passive activities. This analysis involves several steps, including:

i. the identification of separate activities;

ii. the determination of whether an activity is a rental activity, a trade or business activity, or neither; and

iii. the application of the material participation standard, and of the various exceptions to that standard for rental activities, limited partners, and oil and gas working interests.

The statutory scheme of §469 applies on an activity-by-activity basis. Section 469(l)(1) authorizes regulations to specify what constitutes an "activity." Treasury started in 1988 with a broad rule that a taxpayer's operations could be treated as one or more activities under "any reasonable method."[155] Temporary regulations ordered on May 12, 1989,[156] attempted to impose mandatory rules for the scope of a taxpayer's separate activities, with specific rules for personal service activities and other special circumstances. The 41 pages of temporary regulations were "criticized as overly long and complex, burdensome for small taxpayers, and mechanically inflexible," and they were replaced in 1992 by five pages of "shorter and more flexible" proposed regulations. The proposed regulations were intended to "be easier to apply and ease the burden on small taxpayers," and "[i]n recognition of the difficulty in providing simple, administrable rules for such an inherently factual determination, the proposed regulations adopt a facts-and-circumstances approach to identify a taxpayer's activities."[157]

The proposed regulations were finalized with few significant changes on October 4, 1994.[158] The final regulations essentially adopt the initial flexible approach.

B. Trade or Business Activity

After a taxpayer subject to the passive loss rules has determined the scope of his separate activities, it is necessary to determine which of such activities are passive. In general, a passive activity is: (1) a trade or business activity in which the taxpayer does not materially participate (except for certain oil and gas working interests); or (2) a rental activity, for which material participation is generally irrelevant except for real estate professionals.[159] It is therefore necessary to distinguish between trade or business activities and rental activities.

The 1986 Senate Report explained the rationale for the per se passive rule for rental activities:

> [An] area in which the material participation standard is not wholly adequate is that of rental activities. Such activities predominantly involve the production of income from capital. For this reason, rental income generally is not now subject to the self-employment tax, whether or not the activity constitutes a trade or business (sec. 1402(a)(1)). Rental activities generally require less ongoing management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services. Thus, for example, an individual who is employed fulltime as a professional could more easily provide all necessary management in his spare time with respect to a rental activity than he could with respect to another type of business activity involving the same capital investment. The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.[160]

As discussed at IV.B.1., below, about real estate professionals, however, certain individuals in the real estate industry may use the material participation standards for rental activities.

1. Meaning of "Trade or Business"

An activity generally must involve the conduct of business or rental operations, and must not be a rental activity, to constitute a trade or business activity.[161]

Practice Point: A trade or business activity does not include a rental activity,[162] even if the rental activity is considered a trade or business under §162, §172, §280A, §1231, or other Code provisions.[163]

The meaning of the term trade or business was addressed by the Supreme Court in *Commissioner v. Groetzinger*,[164] which held that an individual who engaged in gambling on a full-time basis, as his source of livelihood, was engaged in a trade or business, notwithstanding the fact that gambling may not involve holding oneself out to others as providing goods and services.[165] The Court stated that generally there are two requirements for an activity to constitute a trade or business. First, the activity must be conducted for profit; that is, it must not be a hobby or recreational activity engaged in for person-

[155] Notice 88-94.

[156] T.D. 8253, 54 Fed. Reg. 20,527 (May 12, 1989).

[157] PS-01-89 (Preamble to Proposed Regulations), 57 Fed. Reg. 20,802, 20,803 (May 15, 1992). The proposed regulations were generally effective for tax years ending after May 10, 1992.

[158] T.D. 8565, 59 Fed. Reg. 50,485 (Oct. 4, 1994). ("Several comments requested guidance on when activities grouped in accordance with the rules in the temporary regulations must be regrouped under the final regulations. In accordance with the effective date provisions, taxpayers that grouped their activities under the rules in the temporary regulations must regroup their activities if their activities are not appropriate economic units under these regulations.")

[159] Reg. §1.469-1T(e)(1), §1.469-1T(e)(4).

[160] 1986 Senate Report at 718. *See also* 1986 Blue Book at 214.

[161] Reg. §1.469-4(b)(1).

[162] For a discussion of rental activities under Reg. §1.469-1T(e)(3), see III.B., below.

[163] *See, e.g., Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943); *Curphey v. Commissioner*, 73 T.C. 766 (1980); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Hazard v. Commissioner*, 7 T.C. 372 (1946).

[164] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[165] In PLR 8943055, the IRS declined to rule on whether a taxpayer's involvement in a lottery constitutes the conduct of a gambling trade or business under §162 and the passive loss rules, due to the factual nature of the issue.

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al reasons. Second, the activity must be engaged in with some regularity and continuity, even if not by the taxpayer personally.[166]

The passive loss rules expand the definition of trade or business activity in two respects, so that a taxpayer may have a trade or business activity without meeting the general Code definition for the existence of a trade or business. Accordingly, the distinction between a trade or business and a nonbusiness activity is less important in the passive loss context, compared to other situations such as the §199A pass-through business income deduction,[167] the §163(j) limitation on business interest expense,[168] or whether the taxpayer owns a capital asset or §1231 property.[169]

First, a trade or business activity includes any activity involving research and experimentation (R&E) within the meaning of §174 (and likely, §174A).[170] The regulations provide that a trade or business activity includes an activity that involves R&E expenditures that are deductible under §174 (or would be deductible if the taxpayer adopted the deduction method described in §174(a)),[171] which generally permits the expensing of R&E expenditures paid or incurred by the taxpayer "in connection with" the taxpayer's trade or business.

Practice Point: The §174 rule applies to R&E expenditures that are incurred before the trade or business has commenced.[172] For amounts paid or incurred in tax years beginning between 2022 and 2024, domestic R&E expenditures must be charged to capital account and are generally amortized over five years, or over 15 years for certain foreign research.[173] For amounts paid or incurred in tax years beginning after 2024, taxpayers are allowed an immediate deduction for any domestic R&E expenditures,[174] but still must amortize foreign R&E expenditures over a 15-year period.[175]

Presumably Reg. §1.469-4(b)(1)(iii) will be amended to treat an activity that involves such research or experimental expenditures in 2022 and later as a trade or business activity. *See generally* 556 T.M., *Research and Development Expenditures.*

Second, §469(c)(6) authorizes regulations to provide that a "trade or business" includes any activity in connection with a trade or business, and any activity with respect to which expenses are allowed as §212 deduction, e.g., an individual's deduction for expenses paid or incurred for the production or collection of income, such as investment activities. Reg. §1.469-4(b)(1) provides that "trade or business activities" includes activities that are "conducted in anticipation of the commencement of a trade or business."

Practice Point: A C corporation does not have investment activities subject to §212, which applies only to noncorporate taxpayers, and instead all of a C corporation's investment income and expenses are generally trade or business expenses.

Practice Point: For an individual, estate, or non-grantor trust, investment activities are generally not subject to the passive loss rules. Instead, the investment interest expense is subject to §163(d) limitations on investment interest, and all other investment expenses are nondeductible under §67 Miscellaneous itemized deductions are not deductible for individuals, estates, and non-grantor trusts in tax years beginning in 2018 and later.[176]

A trade or business activity does not include an activity that is incidental to an activity of holding property for investment.[177]

2. *Trading Activity Per Se Nonpassive Rule*

Active trading in securities and other property may rise to the level of a trade or business. Traders (who can be in a trade or business) differ from mere investors (who cannot) in that the former principally "endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis,"[178] while the latter rely more on the gradual appreciation of assets. In practice, the critical factor is often the amount of churning: i.e., how fast the investor turns over the investment portfolio.[179] *See generally* 561 T.M., *Capital Assets*, and 736 T.M., *Hedge Funds.*

An activity of trading certain types of personal property, for the account of owners of interests in the activity, is not a passive activity, even if the activity would otherwise be a trade or business activity.[180] As a result, the trading income and gains do not give rise to passive income (even for investors who do not materially participate in the activity) that can be offset by passive losses. Conversely, trading losses are not subject to passive loss limitations and can offset any income, though they may be subject to the §1211 capital loss limitation and other applicable limitations. The trading expenses incurred in a trade or

[166] *Commissioner v. Groetzinger*, 480 U.S. at 35. In *Deputy v. Du Pont*, 308 U.S. 488 (1940), Justice Frankfurter, concurring, had stated that the conduct of a trade or business involves holding oneself out to others as offering goods and services. After *Groetzinger v. Commissioner*, some cases had relied on this statement in determining the scope of the term "trade or business." *See, e.g., Gentile v. Commissioner*, 65 T.C. 1 (1975). *See generally* 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

[167] *See, e.g.*, Rev. Proc. 2019-38; Notice 2019-7. Note that the IRS ordinarily will not rule on whether a taxpayer or relevant pass-through entity is engaged in a specified service trade or business for purposes of §199A. Rev. Proc. 2026-3, §4.01(19).

[168] *See* Reg. §1.163(j)-9(b)(2)(ii).

[169] *See, e.g., Keefe v. Commissioner*, 126 AFTR 2d 2020-5331 (2d Cir. 2020), *aff'g* T.C. Memo 2018-28 (taxpayers have capital loss, instead of ordinary loss under §1231, on the disposition of renovated property that was never held in a rental trade or business); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953), *Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943); *Murtaugh v. Commissioner*, T.C. Memo 1997-319; *Jackson v. Commissioner*, T.C. Memo 1975-265; *Grier v. Commissioner*, 120 F.Supp. 395 (D. Ct. 1954), *aff'd per curiam*, 218 F.2d 603 (2d Cir. 1955) and cases cited therein.

[170] §469(c)(5).

[171] Reg. §1.469-4(b)(1)(iii). Note that the regulations would also likely extend to R&E expenditures that are deductible under §174A.

[172] *See Snow v. Commissioner*, 416 U.S. 500 (1974). Note that the conclusion regarding the §174 rule would also likely extend to R&E expenditures that are deductible under §174A.

[173] *See* former §174(a)(2).

[174] §174A, as added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70302(a).

[175] §174, as amended by the OBBBA, Pub. L. No. 119-21, §70302(b). For further discussion of §174 and §174A, see 556 T.M., *Research and Development Expenditures.*

[176] §67(g).

[177] Reg. §1.469-4(b)(1). See III.B.4.a., below, for the incidental rental to investment rule in Reg. §1.469-1T(e)(3)(vi)(B).

[178] *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983), *rev'g*, 553 F. Supp. 1071 (Cl. Ct. 1982). *See also King v. Commissioner*, 89 T.C. 445 (1987); *Estate of Yaeger v. Commissioner*, 889 F.2d 29 (2d Cir. 1989), *aff'g* 92 T.C. 180 (1989); *Walker v. Commissioner*, T.C. Memo 1990-609.

[179] *See, e.g., Cameron v. Commissioner*, T.C. Memo 2007-260.

[180] Reg. §1.469-1T(e)(6)(i).

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business are deductible as business expenses under §162, likewise without any limitation under the passive loss rules.

Temporary regulations explained that "[i]n some circumstances, the activity of trading personal property (such as securities or commodities or other property of a type that is actively traded) for one's own account has been treated as a trade or business. Even in those circumstances, however, the income or loss from the activity resembles portfolio income or loss in that it results entirely from the holding and sale of personal property."[181]

The trading activity per se nonpassive rule applies to personal property as defined in the §1092(d) straddle rules,[182] which is any personal property for which there is an established financial market.[183] It generally includes publicly traded stocks, bonds, options, and other securities, as well as foreign currency.[184] For further discussion, see 187 T.M., *Taxation of Non-Equity Derivatives.*

> *Example:* A partnership is a trader of stocks and bonds. The capital employed by the partnership in the trading activity consists of amounts contributed by the partners and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. The partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, the activity is not a passive activity.[185]

Practice Point: It is unclear how the trading activity per se rule applies when the taxpayer is trading in its own actively traded personal property, i.e., without the use of a pass-through entity. The taxpayer may hire a trader to do the trading for the taxpayer's personal property, in which case the trader is likely trading for the account of the owner of an interest in the activity, which is the taxpayer owner himself. Alternatively, the taxpayer can personally do the actual trading, in which case it may be challenging to avoid materially participating in the trading activity.

An established financial market includes (i) a national securities exchange that's registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); (ii) an interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934; (iii) a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission; (iv) a foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange); (v) an interbank market; (vi) an interdealer market as defined in Reg. §1.1092(d)-1(b)(2)(i); and (vii) solely about a debt instrument, a debt market as defined in Reg. §1.1092-1(b)(2)(ii).[186]

Note: Although bitcoin, ether, ripple, unobtainium classic, and other cryptocurrencies are property for income tax purposes,[187] the trading activity per se nonpassive rule applies to a trader of cryptocurrency only if the cryptocurrency has an established financial market as defined above, such as an interdealer market. The trading taxpayer may be a trader of such cryptocurrency based on the cryptocurrency's activities on another exchange, as it is not necessary for the taxpayer to use the established financial market to be subject to the trading activity per se nonpassive rule.

Even though trading activities are per se nonpassive, material participation is relevant for a partnership engaged in trading activities. In Rev. Rul. 2008-12, PRS is a parternship that is engaged solely in the trade or business of trading securities for its own account and not for customers. LP is a noncorporate taxpayer that owns an interest in PRS as a limited partner. LP does not materially participate in the activity in which PRS is engaged. PRS incurs indebtedness in its trade or business of trading securities. The ruling concluded that since LP's share of PRS's interest expense is allocable to PRS's trading activity, LP's share of PRS's interest expense is subject to the §163(d) investment limitation.

Under Reg. §1.163(j)-6(c), if a partnership has interest income or interest expense that is properly allocable to a per se non-passive trade or business activity (e.g., a trading activity), and the interest income or interest expense is allocated to direct partners that do not materially participate within the meaning of §469 in the activity, then the interest income (or expense) is not business interest income (or expense) subject to the §163(j) limitation. Instead, the interest expense is subject to the §163(d) investment interest limitation as described in Rev. Rul. 2008-12. Conversely, if the interest income or interest expense is allocated to direct partners that do materially participate in the activity, then the interest income or interest expense is subject to the §163(j) limitation. A trading partnership may have some interest expense subject to §163(j) (for its general partners that materially participate in the trading activity) and other interest expense subject to §163(j) (for its limited partners that do not materially participate in the trading activity).

Practice Point: In distinguishing between the §163(d) and §163(j) limitations, the trading partnership can only look at the material participation of its direct partners. If a direct partner is an upper-tier partnership, it does not materially participate in the activity, because the §469 material participation rules do not apply to partnerships. As a result, a trading partnership that is owned by upper-tier partnerships, which is a common master-feeder fund structure, would generate only investment interest income and expense subject to §163(d), not §163(j). Treasury and the IRS rejected a comment by the author to provide a

[181] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5688 (Feb. 25, 1988).

[182] Reg. §1.469-1T(e)(6)(i). The §1092(d)(3) offsetting position requirements for stock are not applicable.

[183] Reg. §1.1092(d)-1(a).

[184] Notice 2003-81.

[185] *See* Reg. §1.469-1T(e)(6)(iii) *Ex.*; *see also* Rev. Rul. 2008-12 (§163(d) investment interest treatment of limited partner's distributive share of interest expense allocable to partnership's trade or business of securities trading), *amplified by* Rev. Rul. 2008-38; FSA 200111001 (applying this rule, as well as the interest expense limitations rules, to a partner in a trading partnership).

[186] Reg. §1.1092(d)-1(b)(1).

[187] *See* Notice 2014-21.

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look-through rule based on material participation by the trading partnership's indirect partners.[188]

3. *State and Local Tax (SALT) Deduction for Pass-through Entity*

The deduction for state and local taxes (SALT) is governed by §164. The TCJA imposed a $10,000 annual limit for SALT deductions in 2018 through 2025, though the $10,000 limit does not apply to taxes paid or accrued in carrying on a trade or business or an activity described in §212.[189] The OBBBA increased the $10,000 annual limit to $40,000 for certain lower income taxpayers in 2025 through 2029.[190]

The TCJA's legislative history explained that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."[191] Many states and localities enacted such pass-through entity (PTE) taxes imposed on partnerships and S corporations, for which the partners and S corporation shareholders generally received a corresponding credit against their personal state and local income taxes.

Notice 2020-75 provided that such PTE taxes are deductible by the partnership or S corporation against its non-separately stated income or loss, and the PTE taxes do not have to be separately stated. The Notice explained that more detailed rules for PTE taxes will be promulgated in future proposed regulations.

If the partnership or S corporation is engaged in a trade or business or rental activity, the PTE taxes are deductible against income or loss of such activity. If the activity is a passive activity, the PTE taxes would reduce the passive income or increase the passive loss.

The proper treatment of the PTE taxes is less clear if the partnership or S corporation is engaged in an investment activity. The investment activity's income or losses would normally be separately stated by the partnership or S corporation, as dividend income, interest, capital gains, or other types of portfolio income. One tax treatment is for the PTE taxes imposed on an investment activity to create a standalone non-separately stated loss, allocated by the partnership or S corporation to the partners and shareholders. It is not obvious how the partner or shareholder would deduct such a loss and whether the loss is subject to the passive loss rules. If the loss is subject to the passive loss rules, the partner's or shareholder's material participation would presumably be measured in relation to the investment activity, which is not contemplated by the passive loss rules and implies that the passive loss rules should not apply in the first place. Another tax treatment is for the PTE taxes imposed on the investment activity to reduce the portfolio income.

C. Rental Activity

A "rental activity" is defined as "any activity where payments are principally for the use of tangible property."[192] Subject to certain exceptions described below, an activity is a rental activity during a year if:[193]

1. Tangible property, held in connection with the activity, is used by customers (or held for use by customers), and

2. The gross income (or expected gross income) attributable to the conduct of the activity represents amounts paid (or to be paid) principally for the use of such tangible property.

It does not matter whether the customers are using the property pursuant to a lease, a service contract, or other arrangement that is not denominated as a lease.[194] The 1986 Conference Report clarified that "a rental activity may include the performance of services that are incidental to the activity (e.g., a laundry room in a rental apartment building)."[195]

Rental activities are per se passive activities, regardless of material participation.[196] However, six exceptions (described below in greater detail) to rental activity treatment generally provide that the use of tangible property is not a rental activity for a tax year, if for such tax year:

(1) The average period of customer use of the property is seven days or less,[197]

(2) The average period of customer use of the property is 30 days or less, and significant personal services are provided by (or on behalf of) the property owner in connection with making the property available for customer use,[198]

(3) Extraordinary personal services are provided by (or on behalf of) the property owner in connection with making the property available for customer use,[199]

(4) The rental of the property is incidental to a nonrental activity of the taxpayer,[200]

(5) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers,[201] or

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[188] 86 Fed. Reg. 5504 (Jan. 19, 2021) ("One commenter observed that the proposed regulations do not discuss a tiered partnership structure with respect to the material participation rules. The Treasury Department and the IRS determined that such a rule is not needed. The bifurcation approach in proposed §1.163(j)-1(c)(1) and (2) applies where interest income or expense is allocable to one or more partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii). Thus, in a tiered structure where interest is not allocable to one or more partners that do not materially participate, the rules in §1.163(j)-1(c)(1) and (2) do not apply and the interest expense is subject to the rules under section 163(j)(4).").

[189] §164(b)(6); Pub. L. No. 115-97, §11042.

[190] §164(b)(6); Pub. L. No. 119-21, §70120.

[191] H. Rep. 115-466, at 260 n. 172 (2017).

[192] §469(j)(8).

[193] Reg. §1.469-1T(e)(3)(i).

[194] Reg. §1.469-1T(e)(3)(i)(A), Reg. §1.469-1T(e)(3)(i)(B).

[195] 1986 Conference Report at II-148. *See also* 1986 Blue Book at 249.

[196] *See, e.g., Kelly v. Commissioner*, T.C. Memo 2000-32 (aircraft leasing activity is a passive activity, even though the taxpayer materially participated in the activity by spending more than 500 hours a year).

[197] Reg. §1.469-1T(e)(3)(ii)(A).

[198] Reg. §1.469-1T(e)(3)(ii)(B).

[199] Reg. §1.469-1T(e)(3)(ii)(C).

[200] Reg. §1.469-1T(e)(3)(ii)(D).

[201] Reg. §1.469-1T(e)(3)(ii)(E).

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(6) The taxpayer provides the property for use in a nonrental activity conducted by a partnership, S corporation, or joint venture, in which the taxpayer owns an interest.[202]

If one of the six exceptions applies, the activity would generally be treated as a trade or business activity, instead of a rental activity. The trade or business activity is not a passive activity if the taxpayer materially participates in the activity.

Example: A taxpayer owns an apartment that is rented out to third parties on Airbnb, Vrbo, HomeAway, or a similar platform, for an average period of seven days or less. The apartment rental activity is a trade or business activity under the first exception, instead of a rental activity under the passive loss rules. The taxpayer can have nonpassive income or nonpassive loss from the Airbnb activity if the taxpayer materially participates in the activity. However, if the taxpayer is renting out a vacation home or a portion of his or her personal residence, such as a spare bedroom, certain rules under §280A(c)(5) may apply, as discussed in VI.E., below, that would disallow and carry over any loss under §280A(c)(5) and also cause any net income to be nonpassive income.

Practice Point: If an activity has net losses, a taxpayer may prefer for the activity to be a trade or business activity to materially participate in it and have nonpassive losses. Conversely, if an activity has net income, the taxpayer may prefer for the activity to be a passive activity with passive income, regardless of material participation. Status as a rental activity or a trade or business activity is also relevant for real estate professionals and their aggregation election.[203]

In TAM 9251003, the IRS National Office concluded that a "rental activity" does not include the preconstruction and development phases of an activity that eventually will become a rental activity. Accordingly, if the taxpayer materially participated in the activity during those phases, the taxpayer's allocable share of the preconstruction expenses paid by the partnership is not characterized as a passive loss, even though the final activity is a passive activity.[204]

Practice Point: In some cases, there may be a lack of clarity as to whether a customer's payments are for the use of tangible property or for services, but the six exceptions to rental activity treatment generally eliminate the uncertainty and treat the entire activity as a trade or business activity. For example, if a taxpayer holds property for sale but rents the property out in the meantime, the fourth exception may apply, as the rental activity is incidental to a nonrental activity (sales activity) of the taxpayer. This avoids the fact-intensive inquiries about rental purpose versus sales purpose that can arise in other contexts, such as in connection with §1221(a)(1) capital gain treatment, §1031 like-kind exchanges, and §857(b)(6) REIT prohibited transactions.

See Worksheet 2: Rental Activity Classification.

1. *Exception One: Average Customer Use Period of Seven Days or Less*

An activity is not a rental activity if the average period of customer use is seven days or less.[205] The regulations' preamble explained that "[t]his exception will exclude from treatment as a 'rental activity' most activities involving short-term use of tangible personal property such as automobiles, videocassettes, tuxedos, and tools, and short-term use of hotel and motel rooms. The rationale for the 'seven-day rule' is that a customer's use of property for seven days or less generally will require the person furnishing the property to provide services significant enough to justify the conclusion that the person is engaged in a service business rather than a rental activity."[206]

Practice Point: A "videocassette" is a physical token popular in the late 1900s that streamed entertainment media to a local playback device, known as a "videocassette recorder" or VCR. In contrast, the streaming of entertainment media in the form of intangible property over the Internet is generally an activity that generates royalty income, which is not a rental activity and is not covered by the exception to a rental activity.

Practice Point: The exception does not require that the lessor provide any services to the customer.

Note: The relevant customer is the taxpayer's lessee or tenant, who may not necessarily be the ultimate end user of the property. In *Kelly v. Commissioner*,[207] the taxpayer leased six aircraft on a yearly basis to a flight school, which used the aircraft for the school's customers on a short-term basis. The taxpayer's lease was a rental activity because the customer was the flight school, whose lease was on a yearly basis.[208]

The determination is made separately for each tax year, based on the average period of customer use during the tax year. The average customer use determination is a five-step process. The taxpayer must:

(1) Organize the activity's properties into different classes, using any method, as long as the daily rent does not differ significantly for the properties in the same class.[209] The regulations do not define "significantly" for this purpose.

(2) Determine each period of customer use, during which the customer has a continuous or recurring right to use the

[202] Reg. §1.469-1T(e)(3)(ii)(F).

[203] *See* IV.B.2.b., below.

[204] *See also* 1986 Senate Report at 743 ("[r]ental activities generally are treated as separate from nonrental activities involving the same persons or property. Thus, … real estate construction and development is a different activity from renting the newly constructed building."); 1986 Conference Report at II-145 ("when a real estate construction activity becomes a rental activity upon the completion of construction and the commencement of renting the constructed building, the change is not treated as a disposition."); 1986 Blue Book at 229, 249.

[205] Reg. §1.469-1T(e)(3)(ii)(A). *See* TAM 9505002 (IRS National Office advised that a beach resort condominium unit, which is rented to third parties for an average period of seven days or less, is not a rental activity).

[206] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5687 (Feb. 25, 1988).

[207] T.C. Memo 2000-32.

[208] *Compare Akers v. Commissioner*, T.C. Memo 2010-85 (cabin rental); *Hairston v. Commissioner*, T.C. Memo 2000-386 (construction equipment leased to related C corporation, which subleased the equipment to end users); *Frank v. Commissioner*, T.C. Memo 1996-177 (airplane leased to flight school); *White v. Commissioner*, T.C. Summ. Op. 2004-139 (sailboat leased to charter company); *with Eger v. United States*, 405 F. Supp. 3d 850 (N.D. Cal. 2019) (customers average stay less than seven days does not qualify as rental activity) *aff'd on other grounds in unpub. opin.*, 818 Fed. App'x. 751 (9th Cir., 2020).

[209] Reg. §1.469-1(e)(3)(iii)(E).

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property.[210] The periods include periods that began in the prior tax year and end in the current tax year. For a period that includes the last day of the current tax year, the duration may be determined on the basis of reasonable estimates.

(3) Determine the average period of customer use for each class of property, by dividing (i) the total days in all periods of customer use by (ii) the number of periods of customer use.[211]

(4) Determine the "average use factor" for each class of property, which is the average period of customer use for that class, multiplied by the class's share of the activity's total gross rental income.[212]

(5) Add the average use factors for all of the class of property.[213]

It is necessary for at least one customer to use the property during the tax year in order for the seven day test to be measured.[214]

Practice Point: The average customer use computations effectively use a mean, not a median, of customer usage. The organization of properties into classes helps ensure that properties leased for a long time and/or for low rents do not significantly skew the average.

Practice Point: The customer does not have to actually use the property for the entire period of customer use. The right to use the property may be pursuant to a single agreement or renewals of it.

Example: A parking lot offers daily and monthly parking. A customer who purchases a pass for each of the 12 months during the year has only one period of use, even if: (1) the lot is closed every evening and on weekends; (2) the customer may drive the car out of the lot several times per day, and may not use the lot during vacation periods; and (3) the parking sticker is renewed every month. On the other hand, a customer who uses the parking lot daily, but without making a long-term arrangement, may have a separate period of use for each day.

Practice Point: Some rental contracts may specify a penalty or liquidated damages for keeping the property beyond the permitted term. The distinction between such a penalty clause and a renewal period may have little practical significance, especially if the penalty is a daily or other periodic rate. While a true penalty clause does not extend the period of customer use for purposes of the regulation, since the customer has no right to use the property during that period, substance over form may need to be considered.

The regulations focus on the customer's right to use the property, which may be open-ended even though actual customer use is seven days or less. The 2005 IRS Audit Guide provides that if the taxpayer has "preferential rights" to use the property, the period of customer use is generally the entire year.[215] In *Moreno v. United States*,[216] the District Court of the Western District of Louisiana held that a customer's actual possession of an aircraft is the period of customer use, but only because the taxpayer-owner had to approve each flight-scheduling request, and there was no binding lease until approval. Because each request's approval was entirely within taxpayer's discretion, there was no continuous or recurring right that can be treated as the period of use. In *Eger v. United States*,[217] the taxpayers owned condominium units that were managed by a condo management company. The taxpayers unsuccessfully argued that the relevant customer was the condo management company, while the District Court held that the relevant customers were the end users who rented the condo units. The management company is the customer only if the taxpayers conveyed exclusive and continuous right to use the condo units to the management company, which was not the case because the taxpayers had reserved personal use rights theoretically prevented the management company from using the units for more than seven days. At one property, the taxpayers could use the property for up to 56 nights a year, which divides to once every slightly less than seven days. It was irrelevant that the taxpayers did not actually exercise their personal use options in such a manner. The Ninth Circuit Court of Appeals confirmed that the condo units' end users were the customers, noting: "When deciding who is a customer between individuals paying to stay in a property and the company responsible for marketing the property and managing payments, few people who are not creative tax lawyers would argue it is the latter."[218]

2. *Exception Two: Average Customer Use Period of 30 Days or Less*

An activity is not a rental activity if the average period of customer use is 30 days or less, and significant personal services are provided by (or on behalf of) the property owner in connection with making the property available for customer use.[219] The regulations' preamble noted that "for example, a taxpayer operating a hotel will not be treated as engaged in a rental activity, even if guests stay for an average period that exceeds seven days, if significant personal services are provided."[220]

The determination is made separately for each tax year, based on the average period of customer use and the personal services provided during the tax year. The average period of customer use is determined using the five-step computation described in Exception One, above.

It is necessary for at least one customer to use the property during the tax year in order for the 30 day test to be measured.[221]

The 1986 Senate Report noted that a rental activity does not include "an activity consisting of the short-term leasing of motor vehicles, where the lessor furnishes services including

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[210] Reg. §1.469-1T(e)(3)(iii)(D).
[211] Reg. §1.469-1T(e)(3)(iii)(C).
[212] Reg. §1.469-1T(e)(3)(iii)(B).
[213] Reg. §1.469-1T(e)(3)(iii)(A).
[214] *Rogerson v. Commissioner*, T.C. Memo 2022-49, *aff'd* 132 AFTR 2d 2023-6624 (9th Cir. 2023).
[215] 2005 IRS Audit Guide at 2-23.
[216] 2014 BL 142860 (W.D. La. May 19, 2014).
[217] 405 F. Supp. 3d 850 (N.D. Cal. 2019).
[218] *Eger v. United States*, 818 Fed. App'x. 751 (9th Cir. 2020).
[219] Reg. §1.469-1T(e)(3)(ii)(B).
[220] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5687 (Feb. 25, 1988).
[221] *Rogerson v. Commissioner*, T.C. Memo 2022-49, *aff'd* 132 AFTR 2d 2023-6624 (9th Cir. 2023).

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maintenance of gas and oil, tire repair and changing, cleaning and polishing, oil changing and lubrication and engine and body repair."[222]

Personal services considered in determining whether there are significant personal services in the aggregate include only those rendered by individuals.[223] For example, telephone and cable television service in a building are disregarded.[224]

Furthermore, certain "excluded services" are disregarded, even if rendered by individuals:

(1) services necessary to permit the lawful use of the property;

(2) services performed in connection with constructing improvements to the property, or the performance of repairs that extend the property's useful life substantially beyond the average period of customer use; and

(3) services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property such as cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters.[225]

The 1986 Senate Report refers to former §1372(e)(5) (as in effect before its repeal by the Subchapter S Revision Act of 1982 (Pub. L. No. 97-354, §2) and former Reg. §1.1372-4(b)(5)(vi), which deal with "passive rental income" for certain S corporation qualification purposes, as providing a "useful analogy."[226] That regulation provides that customarily rendered services include the furnishing of heat, light, and trash collection, while maid service is not a customarily rendered service.[227]

The distinction between customary services and non-customary services also arises in the context of REITs and tax-exempt organizations' unrelated trade or business income,[228] which may be useful analogies as well.

All relevant facts and circumstances are considered in determining whether nonexcluded personal services provided in connection with the use of the property are significant, including:

(1) the frequency of the services;

(2) the type and amount of labor required to perform them; and

(3) the value of such services relative to the amount charged for the use of the property.[229]

Example: T leases photocopying equipment and provides on-site maintenance and repair services at no additional charge. Service calls occur about three times per week, the labor required to perform the services is "substantial"; and the value of the services exceeds 50% of the amount charged for the use of the equipment. T is rendering significant personal services.[230]

Example: A residential apartment hotel provides daily maid and linen services (apart from excluded services). However, the value of these services is less than 10% of the amount of the room charges. The labor required to perform these services is insubstantial. Significant personal services are not being rendered.[231]

It is necessary for the significant personal services to be provided by (or on behalf of) the property owner. In *Hairston v. Commissioner*,[232] the taxpayers leased heavy construction equipment for a number of years to their wholly owned C corporation, which subleased the equipment to end users for less than 30 days on average. The Tax Court respected the form of the lease and rejected the taxpayers' claim that they had an agency relationship with the lessor C corporation. In addition, the services for the end users were provided by the lessee/sublessor C corporation's employees (including the taxpayers), not by the taxpayers in their capacity as lessors, who therefore did not provide significant personal services in connection with the lease that would enable them to qualify for the exception.

3. *Exception Three: Providing Extraordinary Personal Services*

An activity is not a rental activity if extraordinary personal services are provided by or on behalf of the owner of the property in connection with making the property available to customers.[233] The determination is made separately for each tax year, based on the personal services provided during the tax year. The average period of customer use is not relevant under this exception.

Services provided in connection with making property available for customer use are "extraordinary personal services" only if: (1) they are performed by individuals; and (2) the customers' use of the property is incidental to their receipt of such services.[234] Examples include the use by patients of a hospital's boarding facilities generally is incidental to their receipt of personal services provided by the hospital's medical and nursing staff.[235] Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of personal services provided by the school's teaching staff.[236] Nursing homes are another example.[237]

[222] 1986 Senate Report at 742. *See also* 1986 Blue Book at 249.

[223] Reg. §1.469-1T(e)(3)(iv)(A).

[224] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5688 (Feb. 25, 1988).

[225] Reg. §1.469-1T(e)(3)(iv)(B).

[226] 1986 Senate Report at 741–742 n.32. *See also* 1986 Blue Book at 248 n.44.

[227] *See also Crouch v. United States*, 692 F.2d 97 (10th Cir. 1982), *aff'g* 509 F. Supp. 727 (D. Kan. 1981) (maintenance of pool, laundry, and other facilities were customary services for a luxury apartment); *Stover v. Commissioner*, T.C. Memo 1984-551, *aff'd*, 781 F.2d 137 (8th Cir. 1986) (utility hookups are customary for a mobile home park); PLR 7718007 (recreational facilities are not customary for a mobile home park); PLR 7836051, PLR 7832092.

[228] *See* Reg. §1.856-4(b)(1), §1.512(b)-1(c)(5).

[229] Reg. §1.469-1T(e)(3)(iv)(A).

[230] Reg. §1.469-1T(e)(3)(viii) *Ex.* (2).

[231] Reg. §1.469-1T(e)(3)(viii) *Ex.* (4).

[232] T.C. Memo 2000-386.

[233] Reg. §1.469-1T(e)(3)(ii)(C).

[234] Reg. §1.469-1T(e)(3)(v).

[235] Reg. §1.469-1T(e)(3)(v).

[236] Reg. §1.469-1T(e)(3)(v).

[237] 2005 IRS Audit Guide at 2–3, available at https://www.irs.gov/pub/irs-mssp/pal.pdf. *Cf. Johnson v. United States*, 116 AFTR 2d 2015-5486 (D.N.C.

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The analysis of whether the use of property is incidental to providing services goes to the activity's underlying purpose. In *Al Assaf v. Commissioner*,[238] the Tax Court held that leasing office space was not considered a rental activity, where tenant's main purpose for leasing space was for taxpayer's substantial legal support services and leasing space was incidental to receipt of services. In *Welch v. Commissioner*,[239] the taxpayer was a construction coordinator for movie sets and would rent his tools to a movie production company in conjunction with providing his personal services to the company; the Tax Court held that the rental of the tools was incidental to the performance of services as construction coordinator, which was an extraordinary personal service.

A taxpayer engaged in the activity of transporting goods for customers was providing extraordinary personal services and thus was not engaged in a rental activity, despite the use, on customers' behalf, of tractor-trailers.[240] In contrast, a taxpayer who provided maintenance for trucks it leased to a trucking brokerage company was not performing extraordinary services. The maintenance was provided in connection with the trucking brokerage company's use of the leased trucks and was not incidental to personal services, since the taxpayer did not transport goods for the trucking brokerage company.[241]

In the activity of leasing photocopying equipment, the underlying purpose is to use the equipment, not to receive maintenance and repair services. Thus, the maintenance and repair services are not extraordinary services even if the value is more than half of the total amount charged.[242]

In Rev. Rul. 2005-64, the IRS contrasted two situations involving aircraft leasing. In Situation 1, the taxpayer leased an aircraft to a related corporation to satisfy the related corporation's air transportation needs, but the taxpayer did not supply the pilot or maintenance crew. The taxpayer was paid only for the lease of the aircraft. The IRS ruled that there were no extraordinary personal services. The use of the aircraft, rather than provision of services, was considered the dominant element of the relationship between the parties.[243]

By contrast, in Situation 2, the taxpayer employed a pilot and crew to operate and maintain the aircraft, and was paid a monthly fee plus an additional amount for each flying hour. The taxpayer was responsible for providing alternative aircraft if necessary. The IRS noted that the taxpayer provided air transportation services, including use of the aircraft with pilot and crew, fuel, and food. The use of the aircraft by the lessee was incidental to the passenger's receipt of personal services provided by the taxpayer's employees. As a result, the IRS ruled that the taxpayer provided extraordinary personal services, and the activities were not rental activities.[244]

Note: In *Kessler v. Commissioner*,[245] the taxpayers leased concrete-pumping equipment to their closely held C corporation; the services provided by the C corporation could not be attributed to the taxpayer's leasing activity to meet the "extraordinary personal services" exception. Similarly, in *Hairston v. Commissioner*,[246] the taxpayers leased heavy construction equipment to their wholly owned C corporation, which subleased the equipment to end users. The services for the end users were provided by the lessee/sublessor C corporation's employees (including the taxpayers), not by the taxpayers in their capacity as lessors, who therefore did not provide extraordinary personal services in connection with the lease.

4. *Exception Four: Rentals Incidental to Nonrental Activities of the Taxpayer*

An activity is not a rental activity if it is incidental to a nonrental activity of the taxpayer.[247] This exception applies only in three specific circumstances:

(a) rental incidental to an activity of holding the property for investment,[248]

(b) rental incidental to a trade or business activity,[249] or

(c) lodging for the convenience of the employer.[250]

a. *Rental Incidental to an Investment Activity*

The rental of property during a tax year is treated as incidental to an activity of holding the property for investment, and therefore is not a rental activity for the tax year, if and only if:

(1) the principal purpose for holding the property during the tax year is to realize gain from the appreciation of the property, without regard to any expectation that such gain will be realized by a sale or exchange of the property, and

(2) the gross rental income from the property for the tax year is less than 2% of the lesser of the property's unadjusted tax basis or fair market value.[251]

The determination is made separately for each tax year, based on the principal purpose and the gross rental income percentage for the tax year.

Practice Point: A rental that meets this test is neither a rental activity nor a trade or business activity, even if it is a trade or business for purposes of §162.[252] The rental is consid-

2015), *aff'd sub nom., Johnson v. Pope*, 637 Fed. App'x 106 (4th Cir. 2016) (taxpayer failed to prove that rental property with drug counseling services was extraordinary personal services, when the services were only occasional and not mentioned in the rental advertisements).

[238] T.C. Memo 2005-14.

[239] T.C. Memo 1998-310.

[240] Reg. §1.469-1T(e)(3)(viii) *Ex.* (3).

[241] TAM 9343010.

[242] Reg. §1.469-1T(e)(3)(viii) *Exs.* (1), (2).

[243] In *Frank v. Commissioner*, T.C. Memo 1996-177, the Tax Court had reached the same conclusion under facts similar to Situation 1. The court held that the fact that a taxpayer who was leasing an airplane to a flight school claimed to have helped a mechanic perform routine maintenance services fell short of establishing the provision of extraordinary personal services. The court found that these services were not "the dominant element of the [rental] relationship" between the taxpayer and the flight school. *See also* 1986 Senate Report at 742 ("furnishing a boat under a bare boat charter, or a plane under a dry lease (i.e., without pilot, fuel or oil), constitutes a rental activity under the passive loss rule, because no significant services are performed in connection with providing the property."); 1986 Blue Book at 249.

[244] *See also* TAM 199949036 (furnishing a jet for corporate travel, complete with flight crew and maintenance services, involved extraordinary personal services).

[245] T.C. Memo 2003-185.

[246] T.C. Memo 2000-386.

[247] Reg. §1.469-1T(e)(3)(ii)(D).

[248] Reg. §1.469-1T(e)(3)(vi)(B).

[249] Reg. §1.469-1T(e)(3)(vi)(C).

[250] Reg. §1.469-1T(e)(3)(vi)(D).

[251] Reg. §1.469-1T(e)(3)(vi)(B).

[252] Reg. §1.469-4(b)(1).

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ered part of the investment activity and therefore generally not subject to the passive loss rules. Any income or loss would be portfolio income or loss from an investment activity.

The regulations define "unadjusted basis" as adjusted basis determined without regard to any depreciation or other basis adjustments described in §1016 that decrease basis.[253]

Example: Taxpayer T owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000, which he holds for the principal purpose of realizing gain from appreciation. To defray the carrying costs, T leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. The gross rental income from the land of $4,000 is less than 2% of the lesser of the fair market value and the unadjusted basis of the land. Accordingly, the rental of the land is incidental to an activity of holding the property for investment, and is not a rental activity.[254]

Example: Taxpayer T tries to sell his former residence and rents it out in the interim. If the gross rental income from the property is sufficiently low, the rental of the house may be considered incidental to an activity of holding the property for investment, and is not a rental activity. It is irrelevant whether the home continues to qualify as a principal residence under §121.[255]

Practice Point: The 2% threshold is not prorated for a property that is rented out for only part of the tax year.

b. *Rental Incidental to a Trade or Business Activity*

The rental of property during a tax year is treated as incidental to a trade or business activity, and therefore is not a rental activity for the tax year, if and only if:[256]

(1) the taxpayer owns an interest in the trade or business activity during the tax year,[257] which may be through a pass-through entity,[258] a PSC,[259] or a CHC,[260]

(2) the property was (or is) predominantly used in the trade or business activity during the tax year, or was so used during at least two of the preceding five tax years,[261] and

(3) the gross rental income from the property for the tax year is less than 2% of the lesser of the property's unadjusted tax basis or fair market value.[262]

Example: Taxpayer T owns farmland in Year Six that was predominantly used — either in Year Six or in at least two of the five tax years from Years One through Five — in a farming activity in which the taxpayer had an interest in Year Six. T rents the farmland to a film production company for a few weeks in Year Six. The rental price is less than 2% of the lesser of the farmland's unadjusted basis or fair market value. The rental is treated as incidental to the farming activity, and not as a rental activity.[263]

Example: Taxpayer T is the sole owner of a law firm and leases equipment to the law firm. The gross rental income from the equipment is less than 2% of the lesser of the equipment's unadjusted basis or fair market value. T's equipment leasing activity is incidental to T's law trade or business and is not a rental activity.[264]

Example: Taxpayer T buys vacant land for the purpose of constructing a shopping center. Before beginning construction, T leases the land for less than 2% of the lesser of the land's unadjusted basis or fair market value. The incidental rule does not apply, because T has not used the land in the shopping center activity in the current year, nor in two of the previous five years.[265] The rental is also not treated as incidental to holding the land for investment, given the principal purpose of using the land for the construction of a shopping center. However, the activity may be subject to the nondepreciable property rule,[266] discussed at IV.C.2., below, which gives rise to passive loss or nonpassive income.

Practice Point: The 2% threshold is not prorated for a property that is rented out for only part of the tax year.

In examining the five tax years immediately preceding the current tax year for purposes of the incidental rule, it does not matter whether the taxpayer owned an interest either in the property or in the trade or business activity during those years. The use of separate legal entities to own the interests in the property and the activity is not relevant.

Example: Taxpayer T leases his property in Years One and Two to an unrelated S corporation, which uses the property in the S corporation's trade or business activity. T later buys a direct ownership interest in the S corporation (which is still conducting the trade or business activity) in Year Three. T's property is rented to third parties in Year Three for less than 2% of the lesser of its unadjusted basis or fair market value. The rental is incidental to the S corporation's trade or business activity in Year Three.

Accordingly, it does not matter whether, in the tax year of application, the property is rented to:

- a third party;

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[253] Reg. §1.469-1(e)(3)(vi)(E).
[254] Reg. §1.469-1T(e)(3)(viii) *Ex.* (5).
[255] *See also Seits v. Commissioner*, T.C. Memo 1994-522 (gain from the sale of cooperative apartment was nonpassive income when the taxpayer did not seriously attempt to rent it out).
[256] Reg. §1.469-1T(e)(3)(vi)(C).
[257] Reg. §1.469-1T(e)(3)(vi)(C)(1).
[258] *Tarakci v. Commissioner*, T.C. Memo 2000-358.
[259] *Misko v. Commissioner*, T.C. Memo 2005-166.
[260] *Blewett v. Commissioner*, T.C. Summ. Op. 2001-174.
[261] Reg. §1.469-1T(e)(3)(vi)(C)(2).
[262] Reg. §1.469-1T(e)(3)(vi)(C)(3).
[263] *Cf.* Reg. §1.469-1T(e)(3)(viii) *Ex.* (6).
[264] *Misko v. Commissioner*, T.C. Memo 2005-166. *See also Tarakci v. Commissioner*, T.C. Memo 2000-358; *Blewett v. Commissioner*, T.C. Summ. Op. 2001-174.
[265] *See* Reg. §1.469-1T(e)(3)(viii) *Ex.* (7).
[266] Reg. §1.469-2T(f)(3).

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• the trade or business activity in which the property was previously predominantly used (and in which the taxpayer now owns an interest); or

• any other activity in which the taxpayer owns an interest.

Practice Point: Under the third of these possibilities, the rental may also fail to qualify as a rental activity by reason of the rule concerning property provided to a pass-through entity in which the taxpayer owns an interest, discussed at III.B.6., below.[267] If the rent to the other activity is less than 2% and both provisions apply, the taxpayer may need to determine whether the rental is part of the activity in which it was previously predominantly used, or part of the activity to which it is rented during the current tax year. It probably would be the former, since Reg. §1.469-1T(e)(3)(vii) states only that the rental is not a rental activity and does not preclude the rental from being part of the pass-through entity's trade or business activity.

c. Rental of Lodging to Employees for the Convenience of the Employer

A rental of property is incidental to a nonrental activity in the case of lodging rendered to the taxpayer's employee (or to the employee's spouse or dependents) for the convenience of the employer (as defined in §119).[268]

Practice Point: The rental activity is presumably treated as part of the taxpayer's activity in which the taxpayer's employees render services. If the rental yields a loss and the taxpayer materially participates in the activity in which the employees render services, the rental loss is part of the activity and may reduce the activity's nonpassive income (or increase the activity's nonpassive loss).

5. Exception Five: Property Customarily Made Available for Nonexclusive Use by Various Customers

An activity is not a rental activity if it involves customarily making the property available during defined business hours for nonexclusive use by various customers.[269] An example might be a golf course that provides long-term passes in addition to daily greens fees[270] or a health club.[271] The determination is made separately for each tax year.

Practice Point: The idea of "nonexclusive use" is that multiple customers can use the same property over a period of time, even if each golf range or piece of health club fitness equipment can only be used by one person at a time.

However, in *Kenville v. United States*,[272] the District Court of North Dakota rejected the taxpayer's argument that its airplane leasing business could qualify under the nonexclusive use exception to rental activities. Although the airplane was made available during business hours to any customer who wanted to charter it, the court noted that "[c]hartering an airplane gives that particular customer *exclusive* use of the plane during the time the customer is using the plane, similar to renting a car. Chartering an airplane is not analogous to 'renting' use of a golf course, where many people are using the same property at the same time."

The regulations' preamble stated that this exception applies to "operating a facility (such as a golf course) that is used by customers who would normally be characterized as invitees or licensees rather than lessees or tenants."[273] The application of this exception might turn in part on state law definitions of a "licensee," and on the terms used in customer contracts.

6. Exception Six: Property Provided to a Pass-through Entity in Which the Taxpayer Owns an Interest

An activity involving the use of tangible property is not a rental activity if the property is provided for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.[274] The taxpayer must be making the property available in the taxpayer's capacity as an owner of an interest in such entity or joint venture, based on all facts and circumstances.[275] The determination is made separately for each tax year, based on the use and ownership for the tax year.

Practice Point: One relevant factor is whether the taxpayer is charging rent, which suggests that the taxpayer is acting in its capacity as a lessor and not as an owner of the entity.[276] But if the partner receives a §707(c) guaranteed payment in exchange for providing the property to the entity, the guaranteed payment is not rental income and could cause the partner to be subject to this exception.[277]

> *Example:* Taxpayer T is a 50% partner in a partnership, which is engaged in a nonrental activity that the taxpayer materially participates. T leases a building to the partnership for the fair market rent of $50,000 per year. T's depreciation and other deductible expenses with respect to the building are $60,000 per year. Based on the fair market value rent and other facts and circumstances, the exception does not apply. T has a $10,000 passive loss from his rental activity, as well as a $25,000 share of the partnership's nonpassive rent deduction.[278]

[267] Reg. §1.469-1T(e)(3)(vii).
[268] Reg. §1.469-1(e)(3)(vi)(D).
[269] Reg. §1.469-1T(e)(3)(ii)(E).
[270] Reg. §1.469-1T(e)(3)(viii) *Ex.* (10).
[271] Reg. §1.469-4T(d)(4) *Ex.* (3).
[272] 80 AFTR 2d 97-7905 (D.N.D. 1997).
[273] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5688 (Feb. 25, 1988).
[274] Reg. §1.469-1T(e)(3)(ii)(F).
[275] Reg. §1.469-1T(e)(3)(vii).
[276] *See* Rev. Rul. 72-504 (where partners rented real property from their partnership, at fair market value rentals that were negotiated at arm's length; the rents paid were deductible by the partners and includible in the partnership income that was allocated among the partners); *Sciabica v. Commissioner*, T.C. Summ. Op. 2002-146; TAM 9722007; TAM 200014010.
[277] Reg. §1.469-1T(e)(3)(vii). *See generally* Rev. Rul. 81-300, Rev. Rul. 81-301; *Pratt v. Commissioner*, 550 F.2d 1023 (5th Cir. 1977), *aff'g in part and rev'g in part* 64 T.C. 203 (1975).
[278] If T's building expenses were $40,000 and T has net income from the rental activity, the self-rental rule, described in Reg. §1.469-2(f)(6) and IV.C.5., below, may apply to cause the net income to be nonpassive income.

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Example: Taxpayer T is a 50% partner in a partnership, which is engaged in a nonrental activity that the taxpayer materially participates. Assume the same facts as the prior example except T contributes the use of the property to the partnership in exchange for a $50,000 §707(c) guaranteed payment. Based on T's receipt of the guaranteed payment and the facts and circumstances, T is subject to the exception. T has $50,000 nonpassive income from the guaranteed payment, $60,000 of nonpassive deductions with respect to the building, and a $25,000 share of the partnership's nonpassive deduction for the guaranteed payment. T effectively converts the $10,000 passive loss into a $10,000 nonpassive loss. The same nonpassive result applies if T contributes the use of the property to the partnership for no consideration.

Practice Point: This exception provides that the taxpayer's activity involving the use of the tangible property is not a rental activity, but the exception does not explicitly provide whether the activity is a different type of activity, such as a trade or business activity.

Practice Point: This exception may benefit a taxpayer who expects a net loss from the use of the property by the related pass-through entity, by converting a passive loss from a rental activity into a nonpassive loss from a nonrental activity. There is no minimum ownership interest for the taxpayer in the pass-through entity. This exception is not available if the property is used by a related C corporation.

Example: Taxpayer T owns farmland and permits a tenant to use the farmland under a crop-share lease. T agrees to bear 50% of the costs incurred in the farming activity in return for a right to 50% of the crops produced (or 50% of the proceeds from selling the crops). T is treated as furnishing the farmland pursuant to a joint venture between T and the tenant and is not engaged in a rental activity.[279]

Note: In TAM 200014010, the IRS National Office declined to find a joint venture where a company that produced petroleum products subleased property on its gas stations to convenience stores that sold the company's products. While the sublease arrangements did involve an equal split of the profits from selling the company's products at the convenience stores, there was no sharing arrangement as to the convenience stores' overall profits, or the costs of constructing or operating the stores.

D. Portfolio Income and Other Nonpassive Items

Two types of items of income, portfolio income and compensation for personal services, are, as a per se matter, treated as not derived from a passive activity.[280]

The 1986 Senate Report justified the separate treatment of salary and portfolio income as nonpassive income because they:

> generally are positive income sources that do not bear, at least to the same extent as other items, deductible expenses. Since salary and portfolio income are likely to be positive, they are susceptible to sheltering by means of investments in activities that give rise to tax benefits. The passive loss provision ensures that salary and portfolio income, along with other nonpassive income sources, cannot be offset by tax losses from passive activities until the amount of such losses is determined upon disposition.[281]

Practice Point: Portfolio income and compensation for personal services may be part of an activity and can be taken into account in determining whether the activity is a passive activity. For example, time spent performing personal services in an activity for compensation is included in determining whether the taxpayer is materially participating in the activity and may also be relevant in determining the proper grouping of an activity.[282] If the activity is passive, the portfolio items and compensation for personal services are separate from the rest of the activity's passive income or loss.

1. Items Generally Treated as Portfolio Income

In determining the income or loss from a passive activity, portfolio income — along with certain expenses related to its production — is not taken into account.[283] For an individual or other noncorporate taxpayer, some portfolio type items are generally subject to the §163(d) investment interest limitation of §67 investment expenses limitation, which disallows all noninterest investment expense deductions in 2018 and later.[284]

Portfolio income generally includes gross income, other than income derived in the ordinary course of a trade or business as described below, that is attributable to:

1. interest,[285]

2. a partnership's guaranteed payments to partners for the use of capital, which is treated as interest,[286]

3. dividends on C corporation stock,[287]

4. income (including dividends) from a §856 real estate investment trust (REIT), a §851 regulated investment company (RIC), a §860D real estate mortgage investment conduit (REMIC), a §584 common trust fund, a §957 controlled foreign corporation (such as §951 subpart F income and §951A income), or a passive foreign investment company (PFIC) that is a §1295(a) qualified electing fund, and a §1381(a) cooperative,[288]

5. annuities,[289]

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[279] Reg. §1.469-1T(e)(3)(viii) *Ex.* (8).

[280] §469(e)(1)(A), §469(e)(3).

[281] 1986 Senate Report, S. Rep. No. 313, at 719. *See* 1986 Senate Report, S. Rep. No. 313, at 728 ("To permit portfolio income to be offset by passive losses or credits would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio."). *See also* 1986 Blue Book, JCS-10-87, at 215, 231.

[282] *See* 1986 Senate Report, S. Rep. No. 313, at 731 n.17.

[283] §469(e)(1)(A).

[284] §67(g).

[285] Reg. §1.469-2T(c)(3)(i)(A).

[286] Reg. §1.469-2(e)(2).

[287] Reg. §1.469-2T(c)(3)(i)(A).

[288] Reg. §1.469-2T(c)(3)(i)(A). *See* 1986 Blue Book, JCS-10-87, at 231 n.24 ("Subpart F income that is included in the taxpayer's gross income under sec. 951 [is] treated as portfolio income.").

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6. royalties, including fees and other payments for the use of intangible property,[290]

7. the disposition of property that produces income of the above six types,[291]

8. the disposition of property held for investment within the meaning of §163(d),[292]

9. dividends on S corporation stock under §1368(c)(2),[293] which applies to distributions out of the S corporation's former C corporation earnings and profits,

10. otherwise expressly provided under the passive loss rules, e.g., under the publicly traded partnership (PTP) provisions.[294]

Portfolio income always includes income, gain, or loss that is attributable to an investment of working capital.[295] The 1986 Senate Report explained:

> No exception is provided for the treatment of portfolio income arising from working capital, i.e., amounts set aside for the reasonable needs of the business. Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part of the trade or business itself. Under this rule, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner's passive income or loss from the activity of operating the shopping mall.[296]

Example: Taxpayer T operates a rental apartment building for low-income tenants. Under local laws relating to low-income housing, T must maintain a reserve fund to pay for the maintenance and repair of the building. T invests the reserve fund in short-term interest-bearing deposits. T's interest income from the deposits is portfolio income.[297]

Comment: Reg. §1.469-2T(c)(3)(i)(D) provides that "property held for investment" for §469 purposes is defined by reference to §163(d). Section 163(d)(5)(A)(i) provides that "property held for investment" for §163(d) purposes shall include any property which provides income of a type described in §469(e)(1), thereby creating a circular reference.[298]

Practice Point: A partnership's guaranteed payments for the use of capital is portfolio income. The disposition of property that produces such guaranteed payments gives rise to gain or loss that is portfolio income. A partner who sells a partnership interest may need to bifurcate its interest between the portion that generates guaranteed payments for the use of capital (for which the gain is portfolio income) and the portion that generates other income (for which the gain may be passive income or other income).

Comment: A mineral production payment is either interest or royalty, depending on its treatment under §636.[299] Different rules, described in III.C.2., immediately below, apply in treating either interest or royalties as derived in the ordinary course of a trade or business and thus not as portfolio income.

Practice Point: When a tenant makes a payment of prepaid rent to the landlord under a lease, §467 allows both parties to treat the prepaid rent as generally a loan from the tenant to the landlord for income tax purposes, which has an interest rate equal to the 110% applicable federal rate and is amortized by imputed rent payments over the lease term.[300] The landlord has increasing taxable income over the lease term, consisting of rental income offset by decreasing interest expense.[301] Conversely, the tenant has increasing tax deductions over the lease term, consisting of rental expense offset by decreasing interest income. For some tenants, the rental expense deduction may be a passive loss that cannot offset its imputed interest income, which is portfolio income.

A different issue may arise in the case of a lease with deferred rents, which the parties may generally treat as a loan from the landlord to the tenant for income tax purposes.[302] Instead of solely rental income, the landlord's income may consist of partly rental income and partly imputed interest income, of which the latter is portfolio income.[303] If the landlord has passive losses from other sources, those losses may offset the rental income but not the imputed interest income.

2. *Items Not Treated as Portfolio Income Because Derived in the Ordinary Course of a Trade or Business*

Portfolio income does not include the above items if derived in the ordinary course of a trade or business,[304] but such items are derived in the ordinary course of a trade or business only in seven specific circumstances:

[289] Reg. §1.469-2T(c)(3)(i)(A).

[290] Reg. §1.469-2T(c)(3)(i)(A). *See* PLR 9225027 (mining income of a general partnership, engaged in mining operations, was not portfolio income when the partnership was engaged in the mining business).

[291] Reg. §1.469-2T(c)(3)(i)(C).

[292] Reg. §1.469-2T(c)(3)(i)(D).

[293] Reg. §1.469-2T(c)(3)(i)(B). *See* 1986 Blue Book, JCS-10-87, at 231 n.24:

> (dividends paid by an S corporation that was formerly a C corporation, that are treated as derived from earnings and profits from a C corporation year under Code sec. 1368, are treated as portfolio income, even though the income or loss passed through to the S corporation shareholders would otherwise be treated as passive.)

[294] §469(k). *See* II.E., above.

[295] §469(e)(1)(B).

[296] 1986 Senate Report at 729-30. *See also* 1986 Blue Book at 233.

[297] Reg. §1.469-2T(c)(3)(iv) *Ex.* 2.

[298] *See generally* Libin Zhang, *Classifying Nonbusiness Interest: Investment, Passive, or Personal*, 164 Tax Notes 353 (July 15, 2019). *See also Sandy Lake Road Limited Partnership v. Commissioner*, T.C. Memo 1997-295 (unimproved land is property held for investment).

[299] Reg. §1.469-2T(c)(3)(iii)(C).

[300] Reg. §1.467-4(a)(1).

[301] The landlord's imputed interest expense may be subject to the §163(j) business interest deduction limitation, unless the real property is part of a §163(j)(7)(B) electing real property trade or business or is otherwise not subject to the §163(j) business interest deduction limitation.

[302] Reg. §1.467-4(a)(1).

[303] Reg. §1.467-4(f) *Ex.* 1.

[304] §469(e)(1)(A)(i)(I); Reg. §1.469-2T(c)(3)(i), §1.469-2T(c)(3)(ii).

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(1) Interest income on loans and investments made in the ordinary course of a trade or business of lending money,[305] such as business income of a bank,[306]

(2) Interest on accounts receivable from the performance of services or the sale of property (e.g., under an installment sale), but only if the taxpayer furnished such services or property in the ordinary course of a trade or business, and credit is customarily offered to the business's customer,[307]

(3) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies,[308]

Note: In *More v. Commissioner*,[309] the Tax Court held that an underwriter's gain from the sale of securities pledged to a bank as collateral for a letter of credit generated portfolio income. Although the letter of credit was used as collateral for potential underwriting losses, the court concluded that the pledged stock was acquired as an investment, rather than as an ordinary and necessary part of underwriting activities, and that pledging it did not convert the stock into an asset used in the trade or business of underwriting.[310]

(4) Income or gain derived in the ordinary course of a trade or business of trading or dealing in property, provided, however, that *inventory property of a dealer does not include property that he held for investment at any time,*[311] *even for* a day,[312]

Note: The relevance of this exception is reduced by a special rule that treats the activity of trading personal property for the account of owners as nonpassive, as discussed at III.A.2., above.

(5) Royalties received with respect to a license or other transfer of any rights in intangible property, if the taxpayer either (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property;[313]

This requirement is based on all facts and circumstances, with two safe harbors.[314] Under the first safe harbor, a person has performed substantial services or incurred substantial costs where, considering only the current tax year, the expenditures reasonably incurred by him with respect to the development or marketing of property exceed 50% of includible gross royalties from licensing the property.[315] Alternatively, the second safe harbor is met where the aggregate expenditures reasonably incurred by such person in developing or marketing the property exceed 25% of the person's aggregate capital expenditures with respect to the property.[316] In the case of intangible property held by a pass-through entity, these rules are applied to the entity rather than to any holder of an interest in the entity.[317] However, where a taxpayer acquires an interest in an entity after the entity has created the intangible property (or after the entity has performed substantial services or incurred substantial costs with respect thereto), the taxpayer's share of net royalty income (but not net royalty loss) is per se nonpassive under the pass-through entity royalty rule discussed at IV.C.6., below.[318]

Note: Notwithstanding the regulations' two limited circumstances in which royalties are derived in the ordinary course of a trade or business, the regulations' preamble added:

> the Service believes that it may be appropriate to treat a portion of a mineral royalty payment as derived in the ordinary course of a trade or business in some cases not involving a trade or business of trading or dealing in royalty interests. Assume, for example, that royalty income is derived from an overriding royalty interest created on the transfer of a working interest by a partnership engaged in the trade or business of oil and gas development, and that the partnership is not taxed upon receipt of the royalty interest. In this case, it may be appropriate to treat the royalty payments, by analogy to sections 483 and 1274, as deferred payments with respect to the sale of the working interest. Under this approach, the portion of each royalty payment that represents consideration paid to the partnership for the working interest would be treated as income derived in the ordinary course of a trade or business, and only the interest element in the payments would be treated as portfolio income.[319]

(6) Amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation based

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[305] Reg. §1.469-2T(c)(3)(ii)(A).

[306] 1986 Senate Report at 729; 1986 Blue Book at 232.

[307] Reg. §1.469-2T(c)(3)(ii)(B). *See* TAM 200010004 (accounts receivable); PLR 9116029 (interest income from commercial office suites constructed and sold for installment notes; seller financing credit is customarily offered to all prospective purchasers). *But see Char-Lil Corp. v. Commissioner*, T.C. Memo 1998-457, *aff'd*, 232 F.3d 900 (10th Cir. 2000) (CHC received an installment note on the sale of real property held for rental, not held for sale to customers in the ordinary course of business; installment note interest is portfolio income); Reg.§1.469-2T(c)(3)(iv) *Ex.* 1 (portfolio income includes interest received on an installment note received from a farmer's disposition of his farmland; the farmer is in a trade or business of farming and not of selling farmland).

[308] Reg. §1.469-2T(c)(3)(ii)(C).

[309] 115 T.C. 125 (2000).

[310] *See also* FSA 200002015.

[311] Reg. §1.469-2T(c)(3)(ii)(D), §1.469-2T(c)(3)(iii)(A).

[312] Reg. §1.469-2T(c)(3)(iv) *Ex.* 3.

[313] Reg. §1.469-2T(c)(3)(ii)(E), §1.469-2T(c)(3)(iii)(B)(1).

[314] Reg. §1.469-2T(c)(3)(iii)(B)(2). *See* Reg. §1.469-2T(c)(3)(iv) *Exs.* 5, 6.

[315] Reg. §1.469-2T(c)(3)(iii)(B)(2)(ii)(a).

[316] Reg. §1.469-2T(c)(3)(iii)(B)(2)(ii)(b). The tax year in which an expenditure is made, rather than the tax year in which it is deductible, is controlling. Reg. §1.469-2T(c)(3)(ii)(B)(2)*(iii)*. The regulations do not define "development or marketing costs," but the term may include all expenditures not in the nature of acquisition costs by analogy to §616 (mine development expenditures). Capital expenditures are excluded from mine development expenditures under §616(a), but they are specifically included for passive loss purposes under Reg. §1.469-2T(c)(3)(ii)(B)(2)*(iii)*.

[317] Reg. §1.469-2T(c)(3)(iii)(B)*(3)*.

[318] Reg. §1.469-2T(f)(7).

[319] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5690–5691 (Feb. 25, 1988).

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on patronage occurring with respect to a trade or business of the patron;[320]

Example: Taxpayer T is a patron of Cooperative, which markets and distributes hummus. T is in the trade or business of selling hummus at retail, and T places orders with Cooperative to distribute T's hummus. T's patronage dividends from Cooperative, paid based on T's orders, are considered derived in the ordinary course of a trade or business. In contrast, if T owns capital stock in Cooperative and receives a regular dividend (not based on patronage), the regular dividend is portfolio income. *See generally* 744 T.M., *Taxation of Cooperatives and Their Patrons.*

and

(7) Other income identified by the IRS as income derived by the taxpayer in the ordinary course of a trade or business.[321]

Note: In PLR 199924020, PLR 199924022, and PLR 199924023, the IRS applied this residual category to certain interest income earned by partnerships that provided freight payment, auditing, and information management services to large manufacturers. These partnerships pre-audited their clients' freight bills, notified the clients which bills should be paid in what amounts, received funds to pay these bills from the clients, and then paid the bills within a period set by contracts (the float period). The IRS ruled that the interest income earned on such funds during float periods were properly viewed as a substitute for service fees, not portfolio income.

Portfolio income always includes income, gain, or loss that is attributable to an investment of working capital, which is not treated as derived in the ordinary course of a trade or business.[322] The 1986 Senate Report explained:

> No exception is provided for the treatment of portfolio income arising from working capital, i.e., amounts set aside for the reasonable needs of the business. Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part of the trade or business itself. Under this rule, for example, interest earned on funds set aside by a limited partnership operating a shopping mall, for the purpose of expanding the mall, is treated as portfolio income and is not taken into account in determining a limited partner's passive income or loss from the activity of operating the shopping mall.[323]

3. Expenses Treated as Related to Portfolio Income

After the items of gross portfolio income are identified (*i.e.*, interest, dividends, etc., not subject to the "ordinary course of trade or business" exception), the taxpayer must determine what items of expense are allocable to the portfolio income and thus are treated as not from a passive activity. Different allocation rules apply to interest expense, compared to all other expenses.

a. Properly Allocable Interest Expense

Interest expense is allocated to gross portfolio income if it is "properly allocable" to such gross income,[324] based on the regulations generally applicable to allocating interest expense: *e.g.*, for purposes of identifying investment interest and personal interest.[325]

The interest allocation regulations generally require tracing disbursements of debt proceeds to specific expenditures.[326] Interest expense allocated to a passive activity's expenditure or a former passive activity's expenditure is taken into account for passive loss purposes in determining the income or loss of the expenditure's activity.[327] Similarly, interest expense allocated to an expenditure about property that produces portfolio income is treated as interest expense about portfolio income.[328]

Debt is generally allocated to expenditures in accordance with the use of the debt proceeds, without regard to the type of property that secures repayment of the debt.[329] Where debt proceeds are commingled with other proceeds (e.g., in a bank account), the debt proceeds generally are treated as expended before unborrowed dollars.[330] A FIFO (first-in-first-out) rule applies where proceeds of more than one debt are commingled.[331] However, if expenditures are made from an account within 30 before or 30 days after the debt proceeds are deposited in the account, the taxpayer may trace the expenditure to such debt proceeds.[332]

When a debt is refinanced, the new debt proceeds are traced to the expenditures made by the old debt's proceeds.[333] If a debt is allocated to more than one type of expenditure and is repaid in part, the debt is deemed to be repaid in the following order:[334]

• Amounts allocable to personal expenditures,

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[320] Reg. §1.469-2T(c)(3)(ii)(F). A cooperative is defined under §1381(a), but without regard to §1381(a)(2)(A) (exclusion for tax-exempt cooperatives) or §1381(a)(2)(C) (exclusion for cooperatives that provide electric energy or telephone service in rural areas).

[321] Reg. §1.469-2T(c)(3)(ii)(G).

[322] §469(e)(1)(B).

[323] 1986 Senate Report at 729–730. *See also* 1986 Blue Book at 233.

[324] §469(e)(1)(A)(i)(III).

[325] *See* Reg. §1.469-2T(d)(3), §1.163-8T, Prop. Reg. §1.163-14, Reg. §1.163-15.

[326] *See* Reg. §1.469-2T(d)(3) and §1.163-8T(a)(3). *See, e.g.,* PLR 200144013 (IRS ruled that to extent debt proceeds are used to acquire property used in a passive activity, interest attributable to such debt constitutes a passive activity deduction). Different rules apply to qualified residence interest. *See* §163(h)(3); Reg. §1.163-10T.

[327] Reg. §1.163-8T(a)(4)(i)(B). A former passive activity is a former passive activity under §469(f)(3), see V.G.1. below, but only if a passive loss carryover or passive credit carryover is allocable to the activity for the tax year. Reg. §1.163-8T(b)(1).

[328] Reg. §1.163-8T(a)(4)(i)(E). *See* Reg. §1.163-8T(a)(4)(ii) *Ex.* (2). *See also* TAM 200010004..

[329] Reg. §1.163-8T(c)(1).

[330] Reg. §1.163-8T(c)(4)(ii)(A), §1.163-8T(c)(4)(ii)(A).

[331] Reg. §1.163-8T(c)(4)(ii)(B).

[332] Reg. §1.163-8T(c)(4)(iii)(B), §1.163-15(a) (formerly in section VI of Notice 89-35), finalized in T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021), applicable to tax years beginning after March 21, 2021. *See* Reg. §1.163-8T(c)(4)(iii)(B) Ex (2). Similarly, if a taxpayer receives debt proceeds in cash, the taxpayer may treat any cash expenditure within 30 days before or 30 days after the cash receipt as made from such debt proceeds and deemed to be made on the date the taxpayer receives the cash. Reg. §1.163-7T(c)(5)(i), §1.163-15(a).

[333] Reg. §1.163-8T(e)(1). *See* Reg. §1.163-8T(e)(2).

[334] Reg. §1.163-8T(d)(1). *See* Reg. §1.163-8T(d)(4) *Ex.* (1).

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- Amounts allocated to investment expenditures and passive activity expenditures (other than type (iii) below),
- Amounts allocated to passive activity expenditures in connection with a rental real estate activity for which the taxpayer actively participates under §469(i) (see V.F.1., below),
- Amounts allocated to former passive activity expenditures, and
- Amounts allocated to nonpassive trade or business expenditures.

Notice 89-35 and Notice 88-20 provide interest expense allocation rules for pass-through entities. If a partner incurs debt to purchase a partnership interest, the debt proceeds and associated interest expense are allocated among the partnership's assets using any reasonable method, such as based on fair market value, book value, or adjusted basis, in each case reduced by partnership-level debt and other partner-level debt allocated to such assets.[335] A partner's share of the partnership's interest expense with respect to the debt-financed distribution may exceed the interest on the partnership's debt proceeds distributed to that partner, in which case the partnership may allocate the partner's excess interest expense using any reasonable method.[336] However, the partnership may optionally choose to first allocate the debt proceeds to the partnership's other expenditures that are not allocated any debt.[337] In other words, the partnership may optionally choose to first allocate debt proceeds to its partnership-level expenditures such as property acquisitions and business expenses, even though the debt proceeds were actually distributed to the partners.

On September 14, 2020, Treasury and IRS issued proposed regulations that contain rules similar to Notice 89-35 and Notice 88-20 for allocating the interest expense with respect to partnerships and other pass-through entities, but with certain modifications.[338] For example, the optional method for partnerships, described above, becomes mandatory, so that a partnership must first allocate debt proceeds to the partnership's non-debt expenditures and then to any debt-financed distributions.[339] The partnership must allocate certain interest expenses based on the partnership's adjusted basis in its assets (reduced by debt), instead of any reasonable method.[340]

In *Lipnick v. Commissioner*,[341] the taxpayer's father was a partner in a real estate partnership, which made debt-financed distributions to the father. The father used the debt proceeds to purchase investment assets, which caused the partnership's interest expense allocable to the father to be investment interest expense subject to the §163(d) investment interest limitation. After the father gifted and bequeathed the partnership interest to his son (the taxpayer), the Tax Court held that the son's share of the partnership's interest expense was no longer investment interest. The son was deemed to have made a debt-financed acquisition of the partnership interest he acquired by gift and bequest, so that the interest expense was allocated to the partnership's assets, which were not investment assets.

Practice Point: If the partnership in *Lipnick* generated passive income, the father's share of the partnership's interest expense would have been investment interest but the son's share of the partnership's interest expense would have been passive interest expense. Similarly, if the father had used the debt-financed distributions for personal expenses, the father's share of the partnership's interest expense would have been nondeductible personal interest but the son's share of the partnership's interest expense would have been passive interest expense.

Note: Proposed regulations would change the outcome in *Lipnick* for transfers of interests in pass-through entities to related persons.[342]

Practice Point: Interest expense allocation for these purposes is not affected by the security for the debt. Thus, if a taxpayer buys a portfolio asset with funds from a loan secured by a building used in a passive activity, interest expense on the loan is nevertheless allocable to portfolio income. For a more detailed discussion of interest allocation, see generally 536 T.M., *Interest Expense Deductions.*

b. *Clearly and Directly Allocable Expenses Other than Interest*

Noninterest expenses are treated as not from a passive activity only if they are "clearly and directly" allocable to gross portfolio income, rather than "properly allocable" as in the case of interest.[343] To be "clearly and directly allocable" to portfolio income, an expense must be incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general overhead costs incurred by a legal entity (e.g., rent, electricity, and salaries of multipurpose employees) are not clearly and directly allocable to portfolio income.[344]

For allocable items, the regulations' preamble explained that:

> the regulations do not require that any particular method be employed in determining (a) whether items of income are derived from an activity, (b) whether deductions arise in connection with an activity, or (c) how shared costs should be allocated among activities. The regulations contemplate the use of reasonable methods in making these determi-

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[335] Notice 88-20. Reasonableness depends on the facts and circumstances, including, without limitation, whether the taxpayer consistently applies the method from year to year. Notice 89-35, §V.A.

[336] Notice 89-35.

[337] Notice 88-20, Notice 89-35, §V.B. See Notice 89-35, §V.D., for reporting rules.

[338] Prop. Reg. §1.163-14 (related to sections I–V of Notice 89-35), REG-107911-18, 85 Fed. Reg. 56,846 (Sept. 14 2020). Taxpayers and their related parties may choose to apply Prop. Reg. §1.163-14 to tax years beginning in 2018 and later, if they apply the rules of Prop. Reg. §1.163-14 to that tax year and each subsequent tax year until 60 days after publication of the final rule in the Federal Register. Prop. Reg. §1.163-14(h).

[339] Prop. Reg. §1.163-14(d)(1). *See* Prop. Reg. §1.163-14(h)(1) *Exs.* 1, 2, 3.

[340] Prop. Reg. §1.163-14(d)(2)(iii), Prop. Reg. §1.163-14(f).

[341] 153 T.C. 1 (2019).

[342] Prop. Reg. §1.163-14(d)(4). *See, e.g.*, Prop. Reg. §1.163-14(h)(5) *Ex.* 5.

[343] §469(e)(1)(A)(i)(II); Reg. §1.469-2T(d)(4).

[344] Reg. §1.469-2T(d)(4).

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nations, and the IRS will disregard unreasonable determinations.[345]

In *Sandy Lake Rd. LP v. Commissioner*,[346] the taxpayer partnership recognized gain from the sale of unimproved real property, which was portfolio income from the disposition of property held for investment. The sale caused the partnership to be liable for certain property taxes, which were allocable to the portfolio income.

Note: State and local income taxes, in contrast, are always nonpassive.[347]

4. Self-Charged Interest and Other Items

The 1986 Conference Report recognized an issue with respect to portfolio income that arises where a taxpayer receives interest income on debt of a pass-through entity in which the taxpayer owns an interest.[348] Such interest may be "self-charged interest" and therefore lack economic significance, yet it increases the taxpayer's portfolio income and decreases the taxpayer's share of the pass-through entity's passive or nonpassive income.[349] Regulations allow a percentage of "self-charged interest" to be treated as passive activity gross income and not as portfolio income.[350]

Practice Point: A taxpayer may elect out of the application of the self-charged interest rule and treat all of the interest as portfolio income.[351] This election may be useful if the taxpayer has investment interest expense under §163(d) that can be used against investment interest income but not against passive income.

The self-charged interest rule applies to lending transactions, which also includes §707(c) guaranteed payments for the use of capital.[352] Lending transactions may also give rise to interest in the form of forgone interest (under §7872(e)(2)), original issue discount (under §1273), and total unstated interest (under §483(b)).[353]

Practice Point: It may not be clear in some cases whether preferred equity in a partnership gives rise to a §707(c) guaranteed payment for the use of capital or a preferred return that is an allocation of net income from the partnership (or an allocation of gross income from the partnership in the absence of sufficient net income). A preferred return is not subject to the self-charged interest rule.[354]

The self-charged interest rule applies if:[355]

(1) a borrowing pass-through entity (either a partnership or S corporation) has deductions for its tax year for interest charged to it by persons holding either direct or indirect (i.e., through either a partnership or S corporation) interests ("self-charged interest deductions");[356]

(2) the taxpayer owning a direct or indirect interest in such pass-through entity, at any time during the entity's tax year, has gross interest income from interest charged to such pass-through entity by the taxpayer (or by a pass-through entity in which the taxpayer holds an interest);[357] and

(3) the taxpayer's share of the pass-through entity's self-charged interest deductions include passive activity deductions.[358]

If these requirements are satisfied, then the "applicable percentage" of the taxpayer's gross interest income from interest charged to the borrowing pass-through entity is passive activity gross income from the activity and likewise, the applicable percentage of each deduction (of the borrowing pass-through entity) for interest expense properly allocable to such interest income is a passive activity deduction from the activity.[359] The interest ceases to be portfolio income or investment income under §163(d).[360] If the taxpayer borrowed money from a third party or another related party to fund the loan, the taxpayer's corresponding interest expense is also recharacterized as a passive activity deduction.[361]

The "applicable percentage" is the taxpayer's share for the tax year of the borrowing pass-through entity's self-charged interest deductions treated as passive activity deductions from the activity, divided by the greater of (i) the taxpayer's share for the tax year of the borrowing pass-through entity's aggregate self-charged interest deductions for all activities (regardless of whether these deductions are treated as passive activity deductions) or (ii) the taxpayer's aggregate income for the tax year from interest charged to the borrowing pass-through entity for all activities of the borrowing entity.[362] The applicable percentage is computed separately for each of the taxpayer's activities.

Example: Taxpayer T is a 40% partner in a partnership engaged in a single rental activity. The partnership borrows $50,000 from T and uses the loan proceeds in the rental activity, and pays $5,000 of interest to T for the tax year. T incurs $2,000 of interest expense as his distributive share of the partnership's interest expense. T's applicable percentage is 40%, obtained by dividing his $2,000 share of

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[345] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5689 (Feb. 25, 1988).

[346] T.C. Memo 1997-295.

[347] *See* III.C.7., below.

[348] 1986 Conference Report at II-146. See also 1986 Bluebook at 233–34.

[349] 1986 Conference Report at II-146. *See also* 1986 Bluebook at 233.

[350] Reg. §1.469-7.

[351] Reg. §1.469-7(g). The election, once made, applies to all self-charged transactions in the tax year of the election and all subsequent tax years, and may be revoked only with the consent of the IRS. *See* Bloomberg Tax Elections & Compliance Statements, Income, *Passthrough Entity: Self-Charged Interest Rule Election to Forgo (§469).*

[352] Reg. §1.469-7(a)(1), §1.469-2(e)(2)(ii).

[353] Reg. §1.469-7(h).

[354] For valiant efforts to distinguish between §707(c) guaranteed payments for the use of capital and preferred returns, *see, e.g.*, Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 Tax Lawyer 533 (2004); New York State Bar Association Tax Section, *Report on Guaranteed Payments and Preferred Returns*, Report No. 1357 (Nov. 14, 2016); Andrew W. Needham, *GPUCs in a Post-Tax Reform World: The Proposed Taxation of (Some) Preferred Returns as Interest*, University of Chicago 2019 Federal Tax Conference (Nov. 9, 2019). *See also* TAM 8752004; REG-115452-14, 80 Fed. Reg. 43652, 43657 (July 23, 2015); Reg. §1.707-1(c) *Ex.* (2); Reg. §1.707-4(a)(2); Reg. §1.163(j)-1(b)(22)(v)(E) *Ex.* 5.

[355] Reg. §1.469-7(c)(1).

[356] Reg. §1.469-7(c)(1)(i).

[357] Reg. §1.469-7(c)(1)(ii).

[358] Reg. §1.469-7(c)(1)(iii).

[359] Reg. §1.469-7(c)(2).

[360] Reg. §1.469-7(c)(2); §163(d)(5)(A)(i).

[361] Reg. §1.469-7(c)(2)(ii), §1.469-7(d)(2)(ii).

[362] Reg. §1.469-7(c)(3).

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self-charged interest deductions that are passive activity deductions from the activity by the greater of T's $2,000 share of the partnership's self-charged interest deductions or T's $5,000 income from interest charged to the partnership. Therefore, $2,000 (40% × $5,000) of T's income from interest charged to the partnership is passive activity gross income from the passive activity that T conducts through the partnership.[363]

Practice Point: The applicable percentage is based on the self-charged interest deductions that are passive activity deductions. If the borrowing pass-through entity's borrowings are allocable to both passive and nonpassive activities, the applicable percentage computation ensures that only the passive portion gives rise to interest income treated as passive income.

The self-charged rule is applied by the lending owner and not by the borrowing pass-through entity. If a borrowing pass-through entity and its owner have different tax years, the owner's share of the entity's income and deductions is based on the entity's tax year ending with or within the owner's tax year that is subject to the self-charged rules, which may result in the self-charged interest rule not applying in some circumstances.[364]

Practice Point: The self-charged rule applies only if the interest payment is deducted by the borrowing pass-through entity, generally in the same year as the owner's interest income inclusion, but it does not apply if the interest payment is capitalized by the entity or deferred and deducted by the entity in a later year. As a result, the lending owner has only portfolio income from the interest income when the corresponding interest expense is deferred or capitalized by the borrowing pass-through entity. The regulations' preamble explained that:

> [T]he final regulations adopt the rule of the proposed regulations that the self-charged rules apply only to self-charged items recognized in the same tax year. This rule is consistent with the legislative history and avoids the complexity of the other suggested methods. For similar reasons, comments suggesting special rules for capitalized expenses are not adopted.[365]

The regulations contain similar rules for loans from pass-through entities to their direct or indirect owners.[366] When a direct or indirect owner of a lending pass-through entity borrows money from the lending pass-through entity, the self-charged interest rule provides relief for the owner's interest expense that is a passive deduction when the lending entity's interest income is not passive income. The applicable percentage of the owner's share of the entity's interest income is reclassified from portfolio income (and investment income under §163(d)) to passive income. The "applicable percentage" is the taxpayer's interest deductions charged by the lending entity and treated as passive activity deductions, divided by the greater of (i) the taxpayer's aggregate interest deduction for all activities in the tax year charged by the lending entity (regardless of whether the deductions are passive activity deductions) or (ii) the taxpayer's aggregate share for the tax year of the lending entity's self-charged interest income for all activities of the lending entity.[367] The applicable percentage is computed separately for each of the taxpayer's activities.

Example: Taxpayer T owns 40% of a partnership. The partnership lends $1,000 to T, who uses half the proceeds in a passive activity and half in a personal activity. T pays $100 of interest on the loan to the partnership, of which $50 is a passive activity deduction. The applicable percentage is 50%, equal to T's $50 of interest deductions charged by the lending entity and treated as passive activity deductions, divided by the greater of (i) all of T's $100 of interest expense or (ii) T's $50 share of the partnership's interest income received from owners. T may reclassify 50% of his $40 share of the partnership's interest income, or $20, as passive income.

When there are loans to or from more than one owner of the pass-through entity, the regulations generally allow an owner to offset its share of interest expense paid to all owners against its share of interest income received from all owners, not just the share that he is paying to himself. The proposed self-charged regulations' preamble noted that "although self-charged treatment could be limited to the owner's share of amounts that arise from the owner's own lending transaction, the regulations adopt a broader approach."[368]

Example: Taxpayers A and B are equal partners in a partnership, which pays $2,000 of interest expense to A and $1,000 of interest expense to B. Absent the self-charged rules, A recognizes $2,000 of portfolio income and $1,500 of allocated passive interest expense, and B recognizes $1,000 of portfolio income and $1,500 of allocated passive interest expense. A narrow view of the self-charged interest rules would allow A and B to recharacterized $1,000 and $500, respectively, of their interest income as passive income, based on their 50% shares of the partnership's interest passive interest expense and the conceptual view that they paid half of the interest to themselves and half to the other partner. However, A's applicable percentage is 75%, equal to his $1,500 share of the partnership's passive interest expense divided by the greater of (i) A's $1,500 share of all partnership interest expense or (ii) A's $2,000 interest income received from the partnership. A may classify $1,500 (75%) of his interest income as passive income. Similarly, B's applicable percentage is 100%, equal to his $1,500 share of the partnership's passive interest expense divided by the greater of (i) B's $1,500 share of all partnership interest expense or (ii) B's $1,000 interest income received from the partnership. A may reclassify all $1,000 of his interest expense as passive income. The effective result is that each partner may use the interest paid to the other partner to increase his applicable percentage.[369]

[363] *See* Reg. §1.469-7(h) *Ex.* 1. *See* Reg. §1.469-7(h) *Ex.* 5 for an example of loans between tiered entities.

[364] Reg. §1.469-7(b)(4). *See* Reg. §1.469-7(h) *Ex.* 4.

[365] T.D. 9013, 67 Fed. Reg. 54,087, 54,088 (Aug. 21, 2002).

[366] Reg. §1.469-7(d). *See* 1986 Blue Book at 233 n.26 ("Similar considerations apply where a partnership makes a loan to a partner (e.g., to finance such partner's purchase of all or part of his interest in the partnership, and the interest expense may be treated as part of his passive loss)").

[367] Reg. §1.469-7(d)(3).

[368] PS-39-89, 56 Fed. Reg. 14,034, 14,036 (Apr. 5, 1991).

[369] Reg. §1.469-7(h) *Ex.* 2.

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The regulations provide rules for loans between pass-through entities that have the same proportionate ownership structures.[370] To the extent that an owner shares in interest income from a loan between identically-owned pass-through entities, the owner is treated as having made the loan to the borrowing pass-through entity, and the rules governing loans from owners to entities apply to determine the applicable percentage of portfolio income or properly allocable interest expense that is recharacterized as passive.

Example: Taxpayer A and B are equal 50% partners in two partnerships, Partnership X and Partnership Y. Partnership X loans $20,000 to Partnership Y which uses the proceeds in a passive activity. Partnership Y pays $2,000 of interest to Partnership X. A's distributive share of Partnership X's interest income is $1,000, and A's distributive share of Partnership Y's interest expense is also $1,000. The loan is treated as if A had made the loan to Partnership Y. A's applicable percentage is 100%, equal to A's $1,000 share of Partnership Y's interest deductions treated as passive activity deductions, divided by the greater of (i) A's $1,000 share of Partnership Y's interest deductions or (ii) A's $1,000 share of self-charged interest income from Partnership Y. As a result, all $1,000 of A's self-charged interest income from Partnership X is treated as passive income.

Practice Point: The regulations do not provide any rules for loans among related pass-through entities that do not have identical ownership.[371] In *Hillman v. Commissioner*,[372] the Tax Court initially addressed favorably the self-charging of management fees between brother-sister entities. Although the Tax Court's decision focused more on the nature of self-charged rules for non-interest items, and the Fourth Circuit Court of Appeals later reversed the Tax Court on that point, some taxpayers may try to rely on *Hillman*'s secondary holding that the self-charged rule is available for transactions between related entities that do not have identical ownership.

Note: There is no self-charged rule for items other than interest and §707(c) guaranteed payments.[373] In *Hillman v. Commissioner*,[374] the Fourth Circuit Court of Appeals reversed the Tax Court and held that the self-charged interest rules could not be applied to other types of self-charged income and expense, such as management fees. The taxpayer's S corporation performed management services for real estate partnerships in which the taxpayer had direct and indirect interests. The taxpayer materially participated in the S corporation's management services, but not in the real estate partnerships. As a result, the real estate partnerships' payment of the management fees to the S corporation caused the taxpayer to generate nonpassive income from the S corporation and generate passive losses from the real estate partnerships, and those passive losses could not offset the nonpassive fee income. The Fourth Circuit noted "that the somewhat harsh result created by literally applying IRC section 469(a) to the wash transaction at issue here is considerably tempered by the fact that IRC section 469(b) allows the Hillmans to carry forward the passive management fee expenses" to subsequent tax years.

Note: No self-charged rule is necessary if there is no payment between the taxpayer and the related person. In *Fowler v. Commissioner*,[375] a taxpayer occupied part of his own building for a repair shop and rented the remainder of the building to others. The Tax Court held that the taxpayer did not have rental income from imputing a constructive rental payment from the sole proprietorship repair shop to the rental real estate business.

Note: The self-charged rule applies only to partnerships and S corporations, and not to non-grantor trusts, estates, or other pass-through entities. The regulations' preamble explained that:

> [c]ertain commentators requested that the regulations be extended to apply to transactions between taxpayers and their trusts, estates, REMICs and housing cooperatives. The regulations address the transactions identified by Congress involving S corporations and partnerships (including entities classified as partnerships for federal tax purposes). Application of the self-charged rules to other types of entities would require a significant expansion of the scope of these regulations to address broader issues concerning the manner in which section 469 applies to those entities.[376]

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[370] Reg. §1.469-7(e).

[371] *See* T.D. 9013, 67 Fed. Reg. 54,087, 54,088 (Aug. 21, 2002): "The proposed regulations provide self-charged treatment for items of interest income and interest expense in lending transactions between a taxpayer and a pass-through entity in which the taxpayer holds a direct or qualifying indirect interest. Several commentators suggested that the regulations should also apply to lending transactions between related pass-through entities such as brother-sister entities in which the taxpayer owns interests because such transactions also may result in mismatched income and expense for purposes of section 469. In response to the suggestions, the self-charged rules are extended to identically owned pass-through entities. This extension is limited to identically owned entities because of concerns regarding the difficulty of identifying self-charged items in transactions between less closely related or unrelated entities."

[372] 114 T.C. 103 (2000).

[373] T.D. 9013, 67 Fed. Reg. 54,087, 54,088 (Aug. 21, 2002):
> Noting that Congress authorized the Secretary to identify other situations in which self-charged treatment is appropriate, several commentators suggested that self-charged treatment be extended to other transactions involving rental real estate activities, such as the payment of management fees and salaries. After publication of the proposed regulations, Congress considered the impact of section 469 on rental real estate transactions and enacted specific relief in section 469(c)(7) for certain real estate professionals for tax years beginning after 1993. There was no indication in the legislative history of section 469(c)(7) that Congress considered additional relief for real estate transactions necessary or desirable. Moreover, there is less justification for the complexity of a self-charged rule in this area after the enactment of section 469(c)(7) because that change substantially reduced the number of real estate transactions that would benefit from a self-charged rule. Accordingly, the regulations do not extend the self-charged treatment to other transactions involving rental real estate.

But see 1986 Conference Report at II-147 ("regulations may also, to the extent appropriate, identify other situations in which netting of the kind described above [for interest] is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest."); 1986 Blue Book at 234.

[374] 250 F.3d 228 (4th Cir. 2001), *rev'g* 114 T.C. 103 (2000), *adhered to on reh'g*, 263 F.3d 338 (4th Cir. 2001), *on remand*, 118 T.C. 323 (2002) (order consistent with appellate decision).

[375] *Fowler v. Commissioner*, T.C. Memo 1993-295.

[376] T.D. 9013, 67 Fed. Reg. 54,087, 54,088 (Aug. 21, 2002).

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5. *Compensation for Services*

Compensation for services, like portfolio income, is not treated as gross income from a passive activity.[377] The principal type of compensation for services is earned income, as defined in §911(d)(2)(A) (relating to the foreign earned income exclusion) to generally include wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered.[378]

Compensation for services also includes:

(1) amounts included in gross income under §83, which generally relates to unvested stock and other property transferred in connection with performance of services,

(2) amounts includible in gross income under §402 and §403, which relate to distributions from retirement plans and retirement annuities, as well as any other amounts paid pursuant to retirement, pension, and other arrangements for deferred compensation for services,

(3) (taxable) social security benefits, includible in gross income under §86, which also includes tier 1 railroad retirement benefits, and

(4) other income from personal services as identified by the IRS.[379]

Earned income also includes §707(c) guaranteed payments made by a partnership to a partner for services,[380] but earned income does not include a partner's distributive share of partnership income under §704(b).[381] In other words, a partner's share of partnership income is not "earned income" even if some or all of the share is attributable to the partner's services performed on behalf of the partnership.[382] Similarly, earned income does not include a shareholder's pro rata share of income from an S corporation under §1377(a).[383] But earned income includes a partner's share of partnership income recharacterized under §707(a) as a payment for services by a partnership to a partner not in its capacity as a partner.[384] For further discussion, see 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

[377] §469(e)(3); Reg. §1.469-2T(c)(4).

[378] Reg. §1.469-2T(c)(4)(i). *See generally* 6080 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents* (Foreign Income Series).

[379] Reg. §1.469-2T(c)(4)(i).

[380] Reg. §1.469-2T(c)(4)(i)(A), §1.469-2(e)(2). *See* 1986 Conference Report at II-139; 1986 Blue Book at 218.

[381] Reg. §1.469-2T(c)(4)(i). Payments made in liquidation of the interest of a retiring or deceased partner, including guaranteed payments described in §736(a)(2), are discussed below. The regulation is contrary to the 1986 Conference Report at II-139, and the 1986 Blue Book at 218, which state that "in the case of a limited partner who is paid for performing services for the partnership (whether by way of salary, guaranteed payment, or allocation of partnership income), such payments cannot be sheltered by passive losses from the partnership or from any other passive activity."

[382] *See* T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5691 (Feb. 25, 1988) ("The regulations do not, however, adopt the suggestion of some commentators to treat as personal service income the portion of a partner's distributive share of partnership income that represents the value of the partner's services performed on behalf of the partnership."). *Cf.* §911(d)(2)(B).

[383] Reg. §1.469-2T(c)(4)(i).

[384] Reg. §1.469-2T(e)(2)(i).

6. *Cancellation of Indebtedness Income*

In Rev. Rul. 92-92, the IRS held that income from the discharge of indebtedness (sometimes called cancellation of debt income, or COD income) is characterized as passive activity income if that debt is allocated to a passive activity expenditure.[385] The interest tracing rules of Reg. §1.163-8T apply in allocating the debt, and therefore the COD income, to a passive activity expenditure by generally allocating debt to tracing disbursements of the debt proceeds. For a more detailed discussion of the interest tracing rules, see 536 T.M., *Interest Expense Deductions.*

Example: Taxpayer T borrows $500,000 on a recourse loan, secured by a real property used in a passive activity, and uses $300,000 of the debt proceeds on passive activity expenditures and $200,000 on other expenditures. Sometime thereafter, T transfers the real property, with basis of $100,000 and value of $200,000, to the bank in full satisfaction of the debt. T has $100,000 of gain on sale (property value minus basis) and $300,000 of COD income (liability discharged minus property value).[386] Since 60% of the debt is allocated to passive activity expenditures while 40% of the debt is allocated to other expenditures, $180,000 (60%) of the COD income is passive activity income and $120,000 (40%) of the COD income is nonpassive income.

Example: Same as the above example, except that the $500,000 loan is a nonrecourse loan. T recognizes $400,000 of gain in connection with transferring the real property with basis of $100,000 to the bank in full satisfaction of the debt.[387] The $400,000 gain is passive income because the real property is used in a passive activity.

7. *Other Per Se Nonpassive Income and Deductions*

In addition to portfolio income and personal service income, the following items of income, are treated as per se nonpassive and therefore never arising from a passive activity:

(1) an individual's gross income from intangible property (such as a patent, copyright, or literary, musical, or artistic compositions), if the taxpayer's personal efforts significantly contributed to the creation of such property;[388]

(2) gross income attributable to a refund of state, local, or foreign income tax, war profits tax, or excess profits tax;[389]

[385] *See also Shannon v. Commissioner*, T.C. Memo 1993-554 (COD income is nonpassive income when it arose from an activity in which the taxpayer materially participated).

[386] *See* Reg. §1.1001-2(a)(2), §1.1001-2(c) *Ex.* 8; Rev. Rul. 90-16.

[387] Reg. §1.1001-2(a)(1); *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[388] Reg. §1.469-2T(c)(7)(i).

[389] Reg. §1.469-2T(c)(7)(iii). For the taxation of state income tax refunds, see §111 (tax benefit rule); Reg. §1.111-1(a); Rev. Rul. 93-75, Rev. Rul. 79-15, Rev. Rul. 79-315, and Rev. Rul. 65-190 (refund of New York State corporation franchise taxes).

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which may include the refundable portion of a state income tax credit;[390]

Practice Point: In contrast, a taxable refund of real property taxes (or other nonincome taxes) may result in gross income, which is not covered by the above rule and may be passive income if attributable to a passive activity.[391] Some tax credits relate to both state property taxes and state income taxes, in which case it may be difficult to determine the type of tax refund.[392]

(3) an individual's gross income from a covenant by such individual not to compete;[393]

(4) casualty gain attributable to reimbursement of a loss claimed in a prior year as a nonpassive loss;[394]

(5) gross income or gain allocable to business or rental use of a dwelling unit, for any tax year to which §280A(c)(5) applies to such business or rental use;[395] and

(6) amounts distributed to Alaska residents by the Alaska Permanent Fund.[396]

Certain types of deductions are treated, per se, as not arising from passive activities:

(1) portfolio-income-related deductions (including losses on the disposition of portfolio assets);[397]

(2) a domestic C corporation's dividends-received deduction under §243 or §245, for any dividend that is not passive income;[398]

Observation: After the TCJA, this exception should also apply to a domestic C corporation's 100% dividends-received deduction under §245A for dividends from certain foreign corporations and its 40% or 50% deduction under §250 for certain §951A income. This exception should also apply to a taxpayer's §965(c) deduction that is based on certain §965(a) deemed repatriation income in 2017 and 2018 for undistributed 1987–2017 foreign earning of certain foreign corporations.

(3) deduction for any state, local, or foreign income tax, war profits tax, or excess profits tax;[399]

Practice Point: The tax deduction is treated as per se nonpassive even if the state, local, or foreign income tax is taxing passive income.

(4) any pre-2018 miscellaneous itemized deduction under §67(b) that was potentially subject to the 2%-of-adjusted-gross-income disallowance in §67(a), such as unreimbursed employee expenses, noninterest investment expenses, and hobby losses to the extent of hobby income;[400]

Practice Point: Because miscellaneous itemized deductions are not allowed in 2018 and later,[401] individuals and noncorporate taxpayers are subject to tax on their gross investment income without any deduction for investment expenses other than interest, and on their gross hobby income without regard to any hobby activity deductions and losses.

(5) any deduction for a contribution of property to a charitable organization under §170;[402]

Practice Point: The §170 charitable contribution deduction is a nonpassive item even if the contributed property is used in a passive activity.

Practice Point: Some estates and trusts are allowed the charitable contribution deduction under §642(c) instead of §170, but the same policy should presumably apply to treat the estate's or trust's charitable contribution deduction as nonpassive.

(6) net operating loss (NOL) carrybacks and carryovers (including any carryover of an excess business loss of a noncorporate taxpayer under §461(l)(2));[403]

Practice Point: The same policy should treat any carryover of an excess business loss of a noncorporate taxpayer under §461(l)(2) as a nonpassive loss.[404]

(7) capital loss carrybacks and carryovers under §1212(a)(1) (for corporations) and §1212(b) (for noncorporate taxpayers);[405]

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[390] *See Maines v. Commissioner*, 144 T.C. 123 (2015); *Rivera v. Commissioner*, T.C. Memo 2016-35; *Tempel v. Commissioner*, 136 T.C. 341 (2011), *aff'd sub. nom, Esgar Corp. v. Commissioner*, 744 F.3d 648 (10th Cir. 2014).

[391] *See* Rev. Rul. 78-194 (New Jersey homestead tax rebate); Rev. Rul. 75-133 (refund of Illinois personal property tax); Rev. Rul. 70-86 (California property tax rebate); CCA 200504027 (New York City property tax rebate); PLR 9853018 (Virginia property tax rebate); PLR 8020073 (Montana property tax rebate); PLR 8015099 (Utah tax rebate); PLR 7926151 (Wisconsin property tax rebate); PLR 200106021 (state intangible property tax refund); §856(c)(2)(E) (REIT gross income includes refunds and abatements of real property taxes); §856(c)(3)(E) (same). *See also* Rev. Rul. 73-385 (refund of state sales and use tax); Rev. Rul. 70-419 (same); CCA 200811017 (refund of state real property tax and state sales tax) PLR 200519002 (refund of food and beverage taxes).

[392] *See* CCA 200842002 (New York State Qualified Empire Zone Enterprise (QEZE) real property tax credit); *Maines v. Commissioner*, 144 T.C. 123 (2015) (same); CCA 201423020 (Massachusetts Senior Circuit Breaker Credit).

[393] Reg. §1.469-2(c)(7)(iv). This provision was upheld as a valid exercise of Treasury's regulatory authority in *Schaefer v. Commissioner*, 105 T.C. 227 (1995).

[394] Reg. §1.469-2(c)(7)(vi).

[395] Reg. §1.469-2(c)(7)(vii). See VI.E., below.

[396] Rev. Rul. 90-56 (also ruling that the amounts are not investment income as defined in §163(d)(4)(B)).

[397] Reg. §1.469-2T(d)(2)(i). See III.C.3., above.

[398] Reg. §1.469-2T(d)(2)(ii).

[399] Reg. §1.469-2T(d)(2)(vi).

[400] Reg. §1.469-2T(d)(2)(vii).

[401] §67(h).

[402] Reg. §1.469-2T(d)(2)(viii).

[403] Reg. §1.469-2(d)(2)(ix). Noncorporate taxpayers may not deduct business losses in excess of a threshold amount in tax years beginning after 2020. *See* §461(l), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70601, effective for tax years beginning after December 31, 2026. Any disallowed excess business loss is treated as an NOL for the tax year for purposes of determining any NOL carryover for subsequent tax years. §461(l)(2).

[404] Noncorporate taxpayers may not deduct business losses in excess of a threshold amount in tax years beginning in 2021 and later. *See* §461(l). Any disallowed excess business loss is treated as an NOL for the tax year for the purposes of determining any NOL carryover for subsequent tax years. *See* §461(l)(2).

[405] Reg. §1.469-2(d)(2)(ix).

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(8) percentage depletion for oil and gas wells under §613A(d);[406]

(9) any §165(c) casualty loss (deduction for a loss from fire, storm, shipwreck, or other casualty, or from theft), but only if "losses that are similar in cause and severity do not recur regularly in the conduct of the activity."[407] The regulations' preamble explained that "section 469 will not limit losses such as those resulting from recent natural disasters, but may disallow shoplifting losses of a retail store, accident losses typically sustained in the operation of a fleet of rental automobiles, and other similar losses that recur regularly in the conduct of an activity."[408]

Practice Point: Casualty losses (from fire, storm, shipwreck, or other casualty, or from theft) that do not occur regularly are nonpassive deductions, even with respect to property used in a passive activity and for which the casualty loss is deducted under §165(c)(1) (losses incurred in a trade or business) or §165(c)(2) (losses incurred in any transaction entered into for profit, though not connected with a trade or business). Such losses are deductible without regard to §469, though they may be limited under §165, §1231, and other Code provisions. But if a casualty results in a gain, such as if insurance reimbursement proceeds exceed the property's adjusted basis and the gain was not deferred under §1033, the gain is passive gain. However, the gain is nonpassive gain if the gain is attributable to the reimbursement of a loss claimed in a prior year as a nonpassive loss.[409] For further discussion, see 527 T.M., *Loss Deductions.*

(10) any deduction or loss allocable to business or rental use of a dwelling unit, for any tax year in which §280A(c)(5) applies to such business or rental use;[410]

(11) the deduction allowed under §164(f) generally for one-half of an individual's §1401 self-employment taxes;[411]

Practice Point: The treatment of the self-employment tax deduction as a nonpassive deduction is beneficial for the taxpayer, who may deduct the amount without any passive loss limitations. It is irrelevant that the §1401 self-employment tax was imposed on income from a passive activity or that §164(f)(2) provides that the self-employment tax deduction shall be treated as attributable to the taxpayer's trade or business.

(12) positive or negative §481(a) adjustments from changing a method of accounting, to the extent allocated to nonpassive activities.[412]

8. *Payments to a Retiring Partner or a Deceased Partner's Successor in Interest*

The tax treatment of a partnership's payments to a retiring or deceased partner, in liquidation of his entire interest in the partnership, is governed by §736.[413] The payments may consist of a series of distributions over several years, as long as the distributions culminate in the complete termination of the retired partner's economic interest in the partnership.[414] A distribution to a continuing partner is not governed by §736,[415] even if the partner is reducing its partnership interest in anticipation of ultimate retirement.

Subject to an exception below, the general rule in §736(b)(1) provides that a partnership's payments made in liquidation of the interest of a retiring or deceased partner are considered distributions by the partnership, to the extent that the payments are made in exchange for the interest of the partner in partnership property. The payments are not considered a distributive share of partnership income or a §707(c) guaranteed payment. Any gain or loss recognized by the retiring or deceased partner, which may be capital gain or loss, is passive income or loss only to the extent that it would have been so treated if recognized at the time that the liquidation of the retiring or deceased partner's interest commenced.[416]

Example: Taxpayer T retires as a limited partner in a partnership, in exchange for $200,000 of annual payments over five years. T has a zero basis in his partnership interest, and the partnership has no §751(c) unrealized receivables or §751(d) inventory items that would result in ordinary income under §751(a) upon the disposition of a partnership interest. T recognizes $200,000 of capital gain annually over the five years. Before T's retirement, T materially participated in the partnership's trade or business activity. Regardless of T's material participation in the partnership's activity after retirement, T's capital gain is passive income only up to the amount of passive income that T would have recognized if he sold his interest at the time that the liquidation of T's interest commenced, which is zero because T materially participated in the partnership's activity at the time of retirement. T therefore has $200,000 of nonpassive income annually.

An exception applies if (i) the retiring or deceased partner was a general partner in the partnership, (ii) capital is not a material income-producing factor for the partnership,[417] and (iii) the payments to the retiring or deceased partner are paid for the partnership's unrealized receivables (as defined in §751(c)) or goodwill (unless the partnership agreement provides for a payment with respect to goodwill). If all three conditions are met, the partnership's payments to the retiring or deceased partner are instead governed by §736(a), as either (i) a §736(a)(1) dis-

[406] Reg. §1.469-2(d)(2)(ix).
[407] Reg. §1.469-2(d)(2)(xi).
[408] T.D. 8290, 55 Fed. Reg. 6980 (Feb. 28, 1990).
[409] Reg. §1.469-2(c)(7)(vi) *See generally* Notice 90-21.
[410] Reg. §1.469-2(d)(2)(xii).
[411] IRS Pub. 925, *Passive Activity and At-Risk Rules*; Instructions for Form 8582, *Passive Activity Loss Limitations.*
[412] See V.C., below.

[413] *See generally* 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner.*
[414] Reg. §1.761-1(d). Reg. §1.736-1(a)(6) provides that §736 may apply to the liquidation of one partner's interest in a two-person partnership.
[415] Reg. §1.736-1(a)(1)(i).
[416] Reg. §1.469-2(e)(2)(iii)(A).
[417] For a discussion of when capital is a material income-producing factor under former §1348, see IV.A.6.

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tributive share of partnership income (if the amount is determined with regard to the partnership's income) or (ii) under §736(a)(2), a §707(c) guaranteed payment (if the amount is determined without regard to the partnership's income).[418]

If the §736(a)(1) payment is a distributive share of partnership income, the payment may be passive income based on the partner's material participation in the partnership's activities. If the payment is a guaranteed payment, under §736(a)(2), the payment is compensation to the extent paid for services and is interest and portfolio income to the extent paid for the use of capital. In either case, the §736(a)(2) payment is nonpassive income.[419] In any event, the percentage of the §736(a)(1) or §736(a)(2) payment that is passive activity gross income cannot exceed the percentage of passive activity gross income that would be included in the retiring or deceased partner's gross income that would have been recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the retiring or deceased partner's interest commenced.[420]

Practice Point: Unrealized receivables is broadly defined in §751(c) to include any rights (contractual or otherwise) to payment for services rendered (or to be rendered) or for non-capital-asset goods delivered (or to be delivered). It may therefore include a management agreement for future management services,[421] even though gain from the disposition of the agreement itself would be capital gain. However, for §736 purposes, unrealized receivables does not include certain ordinary income recharacterization items that apply under §751(c) generally, such as §1245 ordinary income depreciation recapture, §1250 ordinary income depreciation recapture, and §1248 dividend income on the disposition of certain foreign corporations' stock, accrued market discount on any §1278 market discount bond, or accrued interest on any §1283 short-term obligation.[422]

Practice Point: To the extent a partnership owns property with §1245 depreciation recapture, which is an unrealized receivable under §751(c) but not under §736, a payment to a retiring or deceased partner with respect to such property would be a payment for a partnership interest under §736(b) instead of a §736(a) payment. But the §736(b) payment may result in ordinary income under §751(a) to the extent of the depreciation recapture unrealized receivable.

> *Example:* Taxpayer T retires as a general partner from a partnership, in which capital is not a material income producing factor. T is entitled, pursuant to the partnership agreement, to $200,000 of annual payments for five years after T's retirement, in exchange for T's fair market value share of the partnership's unrealized receivables. T will provide no services to the partnership for those five years. Before T's retirement, T materially participated in the partnership's trade or business activity. When the retired T receives a cash payment of $200,000, the payment is treated by §736(a)(2) as a §707(c) guaranteed payment. T has $200,000 of nonpassive income.

> *Example:* Taxpayer T retires as a general partner from a partnership, in which capital is not a material income producing factor. T is entitled, pursuant to the partnership agreement, to receive 10% of the partnership's net income for five years after T's retirement, in exchange for T's fair market value share of the partnership's unrealized receivables. T will provide no services to the partnership for those five years. Before T's retirement, T materially participated in the partnership's trade or business activity. When the retired T receives a cash payment of $20,000 from the partnership pursuant to the partnership agreement, the $20,000 is governed by §736(a)(1) and represents T's $20,000 distributive share of partnership income in the year of payment. Regardless of T's material participation in the partnership's activities in the year of payment, the percentage of the $20,000 that is passive income is capped at the amount of passive income that would have been recognized if the partnership's unrealized receivables had been sold at the time that the liquidation of T's interest commenced, which is zero percent because T materially participated in the partnership's activity at the time of retirement. In other words, the partnership activity's status as a nonpassive activity for T is determined at the time that the liquidation of T's partnership interest commenced, and remains fixed for the duration of T's liquidation payments. As a result, T has $20,000 of nonpassive income.[423]

> *Example:* Same as above, except that partnership provides T with an additional 2% of the partnership's net income for four years after T's retirement, as an incentive for T to retire earlier than planned. The 2% share is not subject to the zero percent cap, because the payment exceeds T's share of the value of the partnership's unrealized receivables, which was established in the prior example to equal 10% of partnership's net income for five years. T must therefore determine whether he materially participated in the partnership's activity in the year of payment, in order to determine whether the 2% share is passive or nonpassive income.[424]

Practice Point: Payments made to a retired partner may be nonpassive income under any of the material participation tests, such as the 5-of-10-years test,[425] the 3-year personal services test,[426] or the facts and circumstances test (if he participates for more than 100 hours during the tax year).[427]

Practice Point: If the §736 payment to a retiring or deceased partner is nonpassive income from a trade or business in which the taxpayer materially participates or is deemed to materially participate, the income is generally not subject to the

[418] §736(a).
[419] Reg. §1.469-2(e)(2)(ii).
[420] Reg. §1.469-2(e)(2)(iii)(B).
[421] *See Ledoux v. Commissioner*, 77. T.C. 293 (1981), *aff'd per curiam*, 695 F.2d 1320 (5th Cir. 1983). *See generally* 720 T.M., *Partnership Transactions — Section 751 Property*.
[422] §751(c).
[423] Prop. Reg. §1.1411-4(g)(11)(ii)(B) *Ex.* 1.
[424] Prop. Reg. §1.1411-4(g)(11)(ii)(B) *Ex.* 2.
[425] *See* Reg. §1.469-5T(a)(5) (discussed at IV.A.5., below).
[426] *See* Reg. §1.469-5T(a)(6) (discussed at IV.A.6., below).
[427] *See* Reg. §1.469-5T(a)(7) (discussed at IV.A.7., below).

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§1411 net investment income tax.[428] The payment may also not be subject to the §1401 self-employment tax, which generally does not apply under §1402(a)(10) to amounts if:

(1) received by a partner pursuant to a written plan of the partnership, which provides for periodic payments on account of retirement to partners generally or to a class or classes of partners,

(2) the payments continue at least until the partner's death,

(3) the partner renders no services with respect to the partnership's trades or businesses during the tax year of the payment,

(4) there is no obligation from the other partners to the partner except with respect to the plan's retirement payments, and

(5) the partner's share of the partnership's capital has been paid to the partner in full.[429]

E. Definition of a Separate Activity

1. Overview

One or more trade or business activities or rental activities may be treated as a single activity, if the activity constitutes an "appropriate economic unit" for the measurement of gain or loss for §469 purposes, depending on the relevant facts and circumstances.[430] A taxpayer may use "any reasonable method" of applying the relevant facts and circumstances in grouping activities.[431]

Note: The use of the term "activity" for both the grouped activity and its component building blocks may be confusing in some instances. The building block activities are sometimes called "undertakings," such as in the 1986 legislative history and in older Treasury guidance.[432]

The factors listed below are given the greatest weight in determining whether activities constitute an appropriate economic unit, though not all of them are necessary in order for a taxpayer to treat multiple activities as a single activity:

(i) similarities and differences in types of trades or business;

(ii) the extent of common control;

(iii) the extent of common ownership;

(iv) geographical location; and

(v) interdependencies between or among the activities, such as the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records.[433]

Example: Taxpayer has four activities: a bakery in Baltimore, a bakery in Philadelphia, a movie theater in Baltimore and a movie theater in Philadelphia. Depending on the relevant facts and circumstances, the four different possible permitted groupings would be: a single activity, a bakery activity and a theater activity, a Baltimore activity and a Philadelphia activity, or four separate activities.[434]

Example: Taxpayer T is a partner in two partnerships under common control, one which sells nonfood items to grocery stores and one that owns and operates a trucking business, whose predominant activity is transporting the goods of the first business. This is the only trucking business in which T is involved. T may treat the wholesale and trucking activities as a single activity.[435]

Practice Point: Notwithstanding the somewhat circular definition that one or more "activities" are treated as a single "activity", the general concept is that any reasonable method can be used to determine whether an activity is a single activity or multiple activities, subject to the specific limitations described below. The IRS cannot change a reasonable grouping.[436]

Practice Point: A taxpayer may wish to define an activity as broadly as possible to:

(1) meet the material participation test for a loss-generating activity by spending sufficient hours in the combined activity, to generate nonpassive losses;[437] or

(2) meet the active participation test to qualify for the $25,000 special allowance for a rental real estate activity,

[428] *See* Prop. Reg. §1.1411-4(g)(11).

[429] *See* Reg. §1.1402(a)-17.

[430] Reg. §1.469-4(c)(1). *See* 1986 Senate Report at 739: ("The determination of what constitutes a separate activity is intended to be made in a realistic economic sense. The question to be answered is what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss");

see also 1986 Blue Book at 245–246.

[431] Reg. §1.469-4(c)(2).

[432] *See, e.g.*, Reg. §1.469-4T (issued on May 11, 1989 and generally applicable to tax years beginning before May 11, 1992).

[433] Reg. §1.469-4(c)(2).

[434] Reg. §1.469-4(c)(3) *Ex.* 1.

[435] Reg. §1.469-4(c)(3) *Ex.* 2. *See also Brumbaugh. v. Commissioner*, T.C. Memo 2018-40 (airplane charter activity could not be grouped with taxpayer's real estate development business, even though airplane was also chartered to taxpayer's company in order to allow employees to visit sites; application of five-factor test, particularly geography and lack of interdependencies); *Williams v. Commissioner*, T.C. Memo 2014-158, *aff'd in unpublished op.*, 771 Fed. App'x 365 (9th Cir. 2019) (airplane rental activities could not be grouped with taxpayer's telephone skills training business even though taxpayer also used the airplane to fly to meet customers; application of five-factor test, particularly differences between the two activities and minimal interdependencies); *Dunn v. Commissioner*, T.C. Memo 2010-198 (airplane rental activities could not be grouped with trade or business of retinologist where it was not apparent that retinologist used airplanes to any significant degree in his medical practice, and using airplanes to reduce employment time lost to other activities did not suffice to make activities into appropriate economic unit).

[436] *See Hardy v. Commissioner*, T.C. Memo 2017-16 (challenge to taxpayers' treatment of medical practices and outpatient surgery facilities as separate activities rejected; grouping of activities was not clearly inappropriate; application of five-factor test to taxpayers' interests indicated multiple reasonable methods for grouping interests into appropriate economic units); TAM 201634022.

[437] See IV.A., below.

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which allows up to $25,000 of rental real estate losses against nonpassive income.[438]

Practice Point: A taxpayer may wish to define an activity as narrowly as possible to:

(1) fail the material participation test for a profit-generating activity, in order to generate passive income;[439]

(2) meet the §469(g)(1) test for a full unrelated taxable disposition of an entire interest in an activity[440]; or

(3) avoid the various recharacterization rules, which sometimes apply separately to each activity.[441]

In *Lamas v. Commissioner*, the Tax Court allowed the grouping of the businesses of an S corporation and a partnership, when the two businesses had the same ownership structure, consolidated their financial statements, and operated out of the same offices using the same employees.[442]

2. Partnerships and Corporations

Specific grouping rules apply to a "section 469 entity," which is a partnership, an S corporation, or a C corporation subject to §469 (i.e., a PSC or CHC).[443] The §469 entity must first group its activities under the grouping rules. A shareholder or partner cannot treat the activities grouped together by a §469 entity as separate activities.[444] However, the shareholder or partner can group the §469 entity's separate activities together, or group any of them with other activities conducted by the shareholder or partner directly or through other §469 entities.[445]

Practice Point: The regulations do not specifically address what a shareholder or partner should do if it concludes that the §469 entity's groupings are impermissible under the grouping rules. It appears that nevertheless no ungrouping adjustment is allowed at the shareholder or partner level.

A special rule applies to a C corporation subject to the passive loss rules, i.e., either a PSC or a CHC.[446] A taxpayer may group an activity conducted through such a C corporation with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially participates or significantly participates in the other activity.[447] The C corporation's activity cannot be grouped with the taxpayer's other activity for other purposes, such as in determining whether an activity is excepted from being a "rental activity." In *Kessler v. Commissioner*,[448] the taxpayers leased concrete-pumping equipment to their CHC; the services provided by the CHC could not be attributed to the taxpayer's leasing activity to meet the "extraordinary personal services" exception to a rental activity.[449] In CCA 201411025, the Chief Counsel's Office advised that for a CHC's activities to be grouped with the taxpayer's other activities, the taxpayer must own an interest in the CHC and not be merely an employee of the CHC.

3. Grouping Limitations

a. Limitation on Grouping a Rental Activity with a Trade or Business Activity

The passive loss rules contain special treatment for rental activities, see III.B., above, and rental real estate activities in particular. A rental activity generally may not be grouped with a trade or business activity.[450]

The 1986 Senate Report explained that:

> for example, automobile leasing is treated as a different activity from automobile manufacturing, and real estate construction and development is a different activity from renting the newly constructed building. Similarly, suppose a travel agency operated in the form of a general partnership has its offices on three floors of a ten-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity.[451]

A rental apartment building, which is a rental activity, cannot be grouped with a hotel, which is a trade or business activity.[452] Three exceptions are allowed against this general prohibition, provided that the activities being grouped together constitute an appropriate economic unit. A rental activity may be grouped with a trade or business activity if:

1. the rental activity may be grouped with a trade or business activity if the rental activity is insubstantial in relation to the trade or business activity;

2. the trade or business activity is insubstantial in relation to the rental activity; or

3. each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[453]

Under the first exception, a rental activity may be grouped with a trade or business activity if the rental activity is insubstantial in relation to the trade or business activity.[454]

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[438] See V.F., below.

[439] See IV.A., below.

[440] See V.H., below.

[441] See IV.C., below.

[442] *Lamas v. Commissioner*, T.C. Memo 2015-59.

[443] Reg. §1.469-4(d)(5).

[444] Reg. §1.469-4(d)(5)(i). *See Kucera v. Commissioner*, T.C. Summ. Op. 2001-18.

[445] Reg. §1.469-4(d)(5)(i). *See Hardy v. Commissioner*, T.C. Memo 2017-16 (taxpayer is not required to group §469 entity activities with other activities, such as a doctor who does not group his individual practice with his ownership interest in a surgery center partnership).

[446] Reg. §1.469-4(d)(5)(ii).

[447] *See Blewett v. Commissioner*, T.C. Summ. Op. 2001-174 (taxpayer who leased equipment to his CHC could group the leasing activity with the CHC's trade or business activity for purposes of meeting material participation).

[448] T.C. Memo 2003-185.

[449] See III.C.3., above; *see also* Rev. Rul. 2005-64 (taxpayer's wholly owned S corporation leased an aircraft to a C corporation in which the taxpayer held an interest; the lease activity was a rental activity, which is not changed by any grouping with the C corporation); *Senra v. Commissioner*, T.C. Memo 2009-79.

[450] Reg. §1.469-4(d)(1)(i).

[451] 1986 Senate Report at 743. *See also* 1986 Blue Book at 249–250.

[452] 1986 Senate Report at 743. *See also* 1986 Blue Book at 250. See III.D.3.a., below.

[453] Reg. §1.469-4(d)(1).

[454] Reg. §1.469-4(d)(1)(i)(A).

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Example: Attorney D owns a rental real estate activity in the town in which he practices. The rental real estate activity is insubstantial in relation to his law practice. Even so, D may not treat the two activities as a single activity if, under the facts and circumstances, they do not constitute an appropriate economic unit.[455]

Conversely, under the second exception, a rental activity may be grouped with a trade or business activity if the trade or business activity is insubstantial in relation to the rental activity.[456]

For the factors in determining "insubstantiality," the regulations' preamble noted that:

> [s]ome comments suggested specifying that the term "insubstantial" refers to factors other than gross income. Other comments suggested adopting a bright-line or safe-harbor gross revenue test. Because the regulations already adopt a facts-and-circumstances test that looks at all of the pertinent factors, it is not necessary to specify that the term insubstantial refers to factors other than gross income. In addition, to avoid complex and mechanical rules, the final regulations do not adopt a bright-line or safe-harbor gross revenue test.[457]

The level of insubstantiality was considered by a federal district court in *Glick v. United States*.[458] The court held that the rental activities of 116 limited partnerships that owned apartment projects could be aggregated with an S corporation that managed the apartment projects, thus permitting the income of the S corporation (mainly from fees) to offset the passive losses from the partnerships. The court gave considerable weight to a "qualitative" examination of the inter-relationship between the S corporation and the partnerships. The S corporation and the partnerships were an integrated business unit with operational tie-ins, such as the use of a single accounting system. In addition, the S corporation had no independent role apart from servicing the partnerships, and had been formed to meet the regulatory preferences of a federal agency. Hence, the larger grouping formed an "appropriate economic unit" that ought to be grouped together in light of the passive loss rules' main purpose (combating tax shelter investments).

The court in *Glick* also based its finding of insubstantiality on a "quantitative" comparison between the S corporation and the limited partnerships. It noted that, depending on how one counted, the S corporation's gross income was only about 7 to 10%, and its fair market value only about 2 to 3%, of that of the limited partnerships during the two years it examined. However, it also noted that the S corporation's net income (counting tax depreciation and the like) was considerably higher (about 45 to 60%) in comparison to that of the limited partnerships. While the court rejected the taxpayer's argument that net income should be disregarded altogether, the court seemed to give this quantitative comparison less weight than the others.[459]

Another district court reached a similar conclusion based on both qualitative and quantitative analysis in *Candelaria v. United States*.[460] A partnership's (CEL's) leasing activity was held insubstantial in relation to the business activity of a limited partnership (DIS) that provided X-rays, MRIs, and other radiological services to a community. Qualitatively, CEL's entire business consisted of leasing image equipment solely to DIS. Quantitatively, CEL's gross income was only 3.4% or 11% of the combined gross income, or 0% or 16% of the combined net income (based on either plaintiff's or defendant's calculations), which were "insubstantial." Although CEL's assets were relatively substantial, the court rejected the IRS's argument that the relative asset values of the companies should be the determinative factor.

Both courts noted that former Reg. §1.469-4T, repealed generally for 1993 and later, contained a test for insubstantiality based on 20% of combined gross income, which was still a useful starting point. For an IRS National Office rejection of the utility of the 20% threshold and a contrary conclusion about insubstantiality, see TAM 200014010.[461]

Under the third exception, a rental activity may be grouped with a trade or business activity if each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. In such a case, the portion of the rental activity that involves the rental of property for use in the trade or business activity may be grouped with the trade or business activity.[462]

As a result, the rental activity is divided into two parts, one that is grouped with the trade or business activity and a remaining rental activity that consists of property rented to third parties and others.

Practice Point: Given the requirement that each owner must have the same proportionate ownership in the rental activity and the trade or business activity, a trivial difference in ownership may defeat the application of this rule, even if the different ownership is of someone else unrelated to the taxpayer.

Example: In Year One, Partners A, B, C, and D each own 25% both of a trade or business activity, and of a rental activity that rents property to the trade or business activity. In Year Two, Partner D transfers a 1% interest in the rental activity to a publicly traded C corporation. The transfer prevents any of the partners from grouping any portion of the rental activity with the trade or business activity in Year Two.

Two spouses who file a joint return are treated as one taxpayer for grouping purposes.[463] If Partner D transferred the 1% interest in the rental activity to his spouse in Year Two, the partners may continue to group the rental activity with the trade or business activity.

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[455] Reg. §1.469-4(d)(1)(ii) *Ex.* 2.

[456] Reg. §1.469-4(d)(1)(i)(B).

[457] T.D. 8565, 59 Fed. Reg. 50,485, 50,486 (Oct. 4, 1994).

[458] 96 F. Supp. 2d 850 (S.D. Ind. 2000).

[459] *See also* TAM 200747018 (IRS National Office conceded that truck sales and truck leasing are appropriate economic unit; rental activity determined insubstantial to sales activities).

[460] *Candelaria v. United States*, 518 F. Supp. 2d 852 (W.D. Tex. 2007).

[461] *See also Kahle v. Commissioner*, T.C. Memo 1997-20 (20% threshold does not apply when neither activity has gross income).

[462] Reg. §1.469-4(d)(1)(i)(C).

[463] Reg. §1.469-1T(j). *See* Reg. §1.469-4(d)(1)(ii) *Ex.* 1.

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b. Limitation on Grouping Rentals of Real Property with Rentals of Personal Property

An activity involving the rental of real property cannot be grouped with an activity involving the rental of personal property, except in the case where the personal property is provided in connection with the real property or vice versa (such as furniture and appliances that are included in rentals of furnished apartments).[464]

Practice Point: This limitation does not have a common ownership exception. An apparent consequence of this rule is that an activity involving the rental of real property and an activity involving the rental of personal property (other than in connection with the real property) cannot both be grouped with a trade or business activity, even if either one separately and the two of them together would have been considered insubstantial in relation to the trade or business activity or otherwise would have been allowed to be grouped with the trade or business activity.

c. Limitation on Grouping Certain Activities of Limited Partners and Persons Not Sufficiently Involved in Management

For certain activities described in the §465(c)(1) at-risk rules, a taxpayer who owns an interest as a limited partner or limited entrepreneur (as defined in former §464(e)(2), which became §461(k)(4)), may not group that activity with any other activity.[465] For a detailed discussion of the at-risk rules, see generally 550 T.M., *At-Risk Rules*.

The at-risk rules describe several types of activities that are treated as separate activities in §465(c)(1).[466] The activities are:

(i) holding, producing, or distributing motion picture films or videotapes;

(ii) farming, as defined in §464(e) as the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals, but excluding trees that do not bear fruit or nuts;

(iii) leasing §1245 property, i.e., depreciable personal property and certain other properties;

(iv) exploring for, or exploiting, oil and gas resources; and

(v) exploring for, or exploiting, geothermal deposits as defined in §613(e)(2).

Under the at-risk rules, there is generally a separate activity for each specific item of film or videotape, farm, §1245 property that is leased or held for leasing, oil and gas property, or geothermal property, as the case may be.[467] However, the limited partner or limited entrepreneur may group such an activity with another activity in the same type of business, if the grouping is appropriate under the grouping rules.[468]

The term "limited partner" may have the same meaning as found elsewhere in the passive loss rules.[469] The term "limited entrepreneur" is defined in the farming syndicate rules as any person other than a limited partner who does not actively participate in the management of the enterprise.[470] The regulations do not elaborate on the extent that the person should actively participate in the management of the enterprise. Withdrawn proposed regulations for limited entrepreneurs in farming syndicates once indicated that active participation meant either participation in the entity's operation and management decisions or participation in actual farming operations.[471] The regulation explained that:

> [f]actors which tend to indicate active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses. … lack of fee ownership of the farm land shall not be a factor indicating a lack of active participation.[472]

Similar factors can apply by analogy to limited entrepreneurs in nonfarming businesses.

Practice Point: Some other Code provisions that refer to the definition of "limited entrepreneur" contain deemed active participation rules that prevent a person from being a limited entrepreneur in specific situations, such as for farming and other syndicates.[473] These deemed active participation rules are not directly relevant to the definition of "limited entrepreneur" in the passive loss context.

> *Example:* Taxpayer T owns and operates a farm, is a member of a limited liability company that conducts a cattle-feeding business, and is a limited partner in a limited partnership engaged in oil and gas production. T is a limited entrepreneur with respect to the cattle-feeding business, which may not be grouped together with any nonfarming activity. In addition, the cattle-feeding business may only be grouped together with T's farming activity if it constitutes an appropriate economic unit. T's oil and gas production activity may not be grouped together with either T's farming or cattle-business activity, as such activities do not involve exploring for, or exploiting oil and gas resources (and in any event, the cattle-business activity cannot be grouped with the oil and gas production activity).[474]

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[464] Reg. §1.469-4(d)(2).
[465] Reg. §1.469-4(d)(3).
[466] §465(c)(1).
[467] §465(c)(2).
[468] Reg. §1.469-4(d)(3).
[469] *See* IV.A.8., below.
[470] §461(k)(4).
[471] *See* 48 Fed. Reg. 51,936 (Nov. 15, 1983) (notice of proposed rulemaking), *withdrawn by* 63 Fed. Reg. 71,047 (Dec. 23, 1998).
[472] Former Reg. §1.464-2(a)(3).
[473] §461(k)(2), §1256(e)(3)(C).
[474] Reg. §1.469-4(d)(3)(ii).

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d. Additional Limitations on Permissible Groupings

The regulations do not address grouping publicly traded partnership (PTP) activities with other activities.[475] However, such groupings would be inconsistent with the requirement that passive loss rules be applied separately to each PTP.[476]

Despite the special rule for oil and gas working interests,[477] the regulations do not address grouping them with other activities. However, the 1986 Senate Report indicates that:

> [a]n oil and gas working interest is treated as not passive without regard to material participation, and thus is treated as separate from any undertaking not relating to oil and gas working interests. This rule is necessary so that the special rules for particular undertakings will not in effect be extended to other types of undertakings (e.g., through the argument that an undertaking that is not a working interest is part of the same activity as a working interest, and hence should not be treated as passive even in the absence of material participation).[478]

Rev. Proc. 2007-65, revised by Announcement 2009-69, added an anti-grouping rule for wind energy tax credit partnerships. The revenue procedure generally provides a safe harbor for partnerships to allocate their §45 wind energy tax credits between project developers and one or more investors under §704(b), as long as certain requirements are met. One of the requirements is that each wind energy facility must be treated as a separate activity for purposes of §469 and that wind energy facitlity may not be grouped with any other activity, except other wind energy facilities.

Practice Point: A similar safe harbor applies to partnerships that allocate the §47 historic rehabilitation credit in Rev. Proc. 2014-12, but that revenue procedure does not contain any anti-grouping rule.

Regulations published in January 2021 added a new anti-grouping rule for trading activities. The rule provides that, with respect to any taxpayer that is an individual, trust, estate, closely held C corporation, or personal service corporation, a §163(d)(5)(A)(ii) activity that involves the conduct of a trade or business that is not a passive activity of the taxpayer and with respect to which the taxpayer does not materially participate, i.e., a trading activity described in III.A.2., above, could not be grouped with any other activity of the taxpayer (including any other trading activity).[479]

The rule was intended to address the interaction between the §163(j) business interest deduction limitation and the §163(d) investment interest expense limitation for a trading partnership. The trading partnership must divide its tax items between (i) partners who materially participate in the partnership's trading activity (*i.e.*, the fund managers and general partners), for whom §163(j) applies at the partnership level to their share of interest expense with respect to all of their interests in the partnership, including limited partnership interests and capital interests, and (ii) partners that do not materially participate in the partnership's trading activity (*i.e.*, the fund's investors), who are not subject to §163(j) at the partnership level and are instead subject to §163(d) at the partner level.[480] The preamble to the proposed regulation noted:[481]

> This approach, in order to be effective, adopts the presumption that a trading partnership generally will possess knowledge regarding whether its individual partners are material participants in its trading activity. No rules currently exist requiring a partner to inform the partnership whether the partner has grouped activities of the partnership with other activities of the partner outside of the partnership. Therefore, the partnership might possess little or no knowledge regarding whether an individual partner has made such a grouping. Without this information, a trading partnership may presume that an individual partner is a passive investor in the partnership's trading activity based solely on the partnership's understanding as to the lack of work performed by the partner in that activity, whereas the partner may in fact be treated as a material participant in the partnership's trading activity by grouping that activity with one or more activities of the partner in which the partner materially participates. In order to avoid this result and the potential for abuse, a new rule is proposed for the section 469 activity grouping rules to provide that any activity described in section 163(d)(5)(A)(ii) may not be grouped with any other activity of the taxpayer, including any other activity described in section 163(d)(5)(A)(ii).

The IRS has authority to issue additional grouping limitations.[482]

e. Consistency and Disclosure Requirements

Rev. Proc. 2010-13 sets forth the reporting requirements for taxpayer grouping and regrouping of activities for tax years beginning on or after January 25, 2010, and no disclosure is required for groupings made before that date until there is a change described below.[483] Rev. Proc. 2010-13 does not apply to the rental real estate activities of a taxpayer in a year in

[475] The temporary activity regulations had barred such grouping. *See* former Reg. §1.469-4T(n).

[476] §469(k)(1). *See* II.E., above.

[477] *See* §469(c)(3); IV.C.7., below.

[478] 1986 Senate Report at 741. *See also* 1986 Blue Book at 247–48.

[479] Reg. §1.469-4(d)(6), T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021), applicable to tax years beginning on or after March 22, 2021. However, taxpayers and their related parties may choose to apply the rules in Reg. §1.469-4(d)(6) to a tax year beginning after December 31, 2017, provided that those taxpayers and their related parties consistently apply all of the rules in the §163(j) regulations. Reg. §1.469-11(a)(1).

[480] Reg. §1.163(j)-6(c)(2).

[481] Preamble to REG-107911-18, 85 Fed. Reg. 56,846 (Sept. 14, 2020).

[482] Reg. §1.469-4(d)(4).

[483] Rev. Proc. 2010-13 applies to tax years beginning on or after January 25, 2010. Rev. Proc. 2010-13, §5. A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that were made prior to the effective date of the revenue procedure (referred to as "pre-existing groupings") until the taxpayer makes a change to the groupings as described in §4.03 (a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year) and §4.04 (it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate) of the revenue procedure. Rev. Proc. 2010-13, §4.06.

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which the taxpayer is a real estate professional and makes the aggregation election.[484]

The revenue procedure requires taxpayers to file a disclosure statement in the tax year that a grouping is first made; when a new activity is added to an existing grouping; and when a clearly inappropriate grouping is regrouped.[485] In addition, the revenue procedure sets forth special rules for groupings by partnerships and S corporations.[486] Failure to comply with the disclosure requirements of Rev. Proc. 2010-13 generally will result in each activity in a purported grouping being treated as separate activities, but the revenue procedure provides relief for untimely disclosure.[487]

Rev. Proc. 2010-13 requires the filing of a written statement with the original income tax return for the first tax year in which two or more trade or business activities or rental activities are originally grouped as a single activity.[488]

If a taxpayer adds a new trade or business activity or rental activity to an existing grouping for a tax year, a written statement must be filed with the taxpayer's original income tax return for that tax year, and must provide the prescribed identifying information both for the new activity that is being added and for the activity or activities within the existing group.[489]

Once a taxpayer has grouped its activities, the taxpayer may not regroup those activities in later years.[490] The taxpayer must comply with the IRS's disclosure requirements for the original groupings and the addition and disposition of specific activities within those groupings in later years. However, an exception applies if the taxpayer's original grouping either (i) was clearly inappropriate or (ii) a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, in which case the taxpayer must mandatorily regroup the activities and comply with the IRS's disclosure requirements.[491] Such written statement must be filed with the taxpayer's original income tax return for the tax year in which the trade or business activities or rental activities are regrouped.[492] In addition to identifying information for the activities being regrouped, the statement must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.[493]

Partnerships and S corporations are not subject to the disclosure requirements just described. Instead, they must comply with the disclosure instructions for grouping activities provided for on Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, respectively.[494] Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. The partner or shareholder is not required to make a separate disclosure of the groupings unless the partner or shareholder: (i) groups together any of the activities that the entity does not group together; (ii) groups the entity's activities with activities conducted directly by the partner or shareholder; or (iii) groups the entity's activities with activities conducted through other §469 entities. A shareholder or partner may not treat activities grouped together by a §469 entity as separate activities.[495]

Failure to comply with the disclosure requirements of Rev. Proc. 2010-13 generally will result in each activity being treated as separate.[496] However, the taxpayer will be deemed to have made a timely disclosure if the taxpayer files all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the tax year in which the failure to disclose is first discovered by the taxpayer.[497] If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. Although failure to comply with the disclosure requirements will generally result in unreported activities being treated as separate activities, the IRS may still regroup a taxpayer's activities to prevent tax avoidance. Relief under Reg. §301.9100-1(d)(2) is not available because the revenue procedure provides alternative relief for untimely filing.[498]

Practice Point: For purposes of the consistency and disclosure requirements, a taxpayer is not engaged in regrouping when an activity expands in size due to the acquisition of a new interest that is appropriately treated as part of it, or contracts in size due to the sale of an interest that was part of the activity.

The 3.8% §1411 net investment income tax[499] changed the calculus as to whether some prior groupings were appropriate. The §1411 net investment income tax generally applies to the taxpayer's income in tax years beginning in 2013 and later from certain investments and from trades or businesses that are passive activities.[500] The §1411 net investment income tax therefore does not apply to income from trades or businesses in which the taxpayer materially participates.[501] The regulations allow a one-time regrouping in the first tax year beginning after 2013 in which the taxpayer meets the applicable income threshold in §1411 ($250,000 of adjusted gross income for individual taxpayers who are married and filing jointly and $200,000 for all other taxpayers) and has net investment income.[502] The in-

[484] Rev. Proc. 2010-13, §3. The Reg. §1.469-9(g) aggregation election is discussed at IV.B.2.b., below.

[485] Rev. Proc. 2010-13, §4.02–§4.04. For a sample disclosure statement, see *Passive Activities: Election to Group by Economic Unit (§469)*, in the Bloomberg Tax Election & Compliance Statements Library.

[486] Rev. Proc. 2010-13, §4.05.

[487] Rev. Proc. 2010-13, §4.07.

[488] Rev. Proc. 2010-13, §4.02.

[489] Rev. Proc. 2010-13, §4.03.

[490] Reg. §1.469-4(e)(1).

[491] Reg. §1.469-4(e)(2).

[492] Rev. Proc. 2010-13, §4.04.

[493] Rev. Proc. 2010-13, §4.04.

[494] Rev. Proc. 2010-13, §4.05.

[495] Rev. Proc. 2010-13, §4.05; Reg. §1.469-4(d)(5)(i).

[496] Rev. Proc. 2010-13, §4.07.

[497] Rev. Proc. 2010-13, §4.07.

[498] Rev. Proc. 2010-13, §4.07; Reg. §301.9100-1(d)(2).

[499] Enacted by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1402(a)(1).

[500] §1411(c)(2); Reg. §1.1411-5(b).

[501] Reg. §1.1411-5(b). *See* 511 T.M., *Section 1411 — Net Investment Income Tax.*

[502] Reg. §1.469-11(b)(3)(iv)(A), §1.469-11(b)(3)(iv)(B). The regulations also provide that taxpayers may regroup their activities in reliance on the regulations for any tax year that begins during 2013 if the taxpayer meets the applicable income threshold and has net investment income for that tax year.

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come determinations are made without regard to the effect of the regrouping.[503] A taxpayer may only regroup activities pursuant to this rule once, and any regrouping will apply to the tax year for which the regrouping is done and all subsequent years.[504] The regrouping must comply with existing regulatory requirements and disclosure requirements.[505]

A taxpayer may regroup on an amended return, but only if the taxpayer was not subject to the §1411 net investment income tax on the taxpayer's original return (or previously amended return), and only if, because of a change to the original return, the taxpayer owed the §1411 net investment income tax for that tax year.[506] This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination. However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to the §1411 net investment income tax in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings.[507]

The regulations contain two exceptions to such voided elections. First, the regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to the §1411 net investment income tax in such year. Second, if the taxpayer is subject to the §1411 net investment income tax in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the prior voided regrouping.[508]

f. Grouping by the IRS to Prevent Tax Avoidance

The IRS may regroup a taxpayer's activities if (i) any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit, and (ii) a principal purpose of the taxpayer's grouping (or failure to regroup under Reg. §1.469-4(e)) is to circumvent the underlying purposes of §469.[509] The final regulations' preamble mentioned that "[i]t is expected … that the Commissioner's regrouping authority will be exercised infrequently."[510]

Practice Point: When the conjunctive test is met, not only is the taxpayer's inappropriate grouping rejected, but the taxpayer surrenders to the IRS the power to determine which of the permissible groupings will be used, including for activities that had been grouped appropriately.

> *Example:* Five doctors all either have passive losses or intend to invest in passive loss-generating activities, and they would like to convert some of their medical services income into passive income. The five doctors form a partnership to engage in the X-ray business. The partnership is managed by a general partner selected by the five doctors, none of whom materially participate in the partnership's operations. Substantially all of the partnership's services are rendered to the patients of its partner doctors, roughly in proportion to the partners' partnership interests, and the partnership charges the partners "arms-length fees", which are expected to assure the partnership a profit. The taxpayers treat the partnership as a separate activity, in order to generate passive income from the partnership's services. The IRS may regroup the taxpayers' activities.[511]

4. Treatment of Partial Dispositions

The definition of an "activity" matters principally for two reasons: (i) determining the taxpayer's material participation in an activity to classify income or loss as passive or nonpassive; and (ii) determining when losses are allowable against nonpassive income upon a full unrelated taxable disposition (discussed at V.H., below).[512]

If a taxpayer disposes of substantially all of an activity, the taxpayer may treat the part disposed as a separate activity for the tax year of disposition, but only if the taxpayer can establish with reasonable certainty (i) the amounts of passive loss and credit carryovers allocable to that part of the activity, and (ii) the income, deduction, and credits allocable to that part of the activity for the tax year.[513]

Practice Point: The regulations require the disposition of "substantially all" of an activity, in contrast to the proposed regulations that applied to the disposition of a "substantial portion" of an activity.[514]

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[503] Reg. §1.469-11(b)(3)(iv)(A).

[504] Reg. §1.469-11(b)(3)(iv)(A).

[505] *See* REG-130507-11, 77 Fed. Reg. 72,612, 72,624 (Dec. 5, 2012); T.D. 9644, 78 Fed Reg. 72,394, 72,396 (Dec. 2, 2013) (both referencing Reg. §1.469-4(e) and Rev. Proc. 2010-13).

[506] Reg. §1.469-11(b)(3)(iv)(C).

[507] Reg. §1.469-11(b)(3)(iv)(C).

[508] Reg. §1.469-11(b)(3)(iv)(C). *See* T.D. 9644, 78 Fed. Reg. 72,394, 72,397 (Dec. 2, 2013).

[509] Reg. §1.469-4(f)(1).

[510] T.D. 8565, 59 Fed. Reg. 50,485, 50,486 (Oct. 4, 1994).

[511] Reg. §1.469-4(f)(2) *Ex.*

[512] §469(g)(1).

[513] Reg. §1.469-4(g).

[514] Former Prop. Reg. §1.469-4(k).

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IV. Material Participation

A. Material Participation in Trade or Business Activity

Section 469(c) provides that a trade or business activity that is not a rental activity nor an oil and gas working interest is treated as a passive activity unless the taxpayer "materially participates" in the activity.

Section 469(h)(1) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the activity's operations on a basis that is:

(1) regular;

(2) continuous; and

(3) substantial.

The above three seeds have sprouted the mighty forest that is the material participation regulations,[515] which provide six quantitative tests and a seventh test based on both quantity and facts and circumstances, as described in great detail below:

(1) The individual participates for more than 500 hours of participation during the tax year;[516]

(2) The individual's participation in the activity constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for the tax year;[517]

(3) The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation is not less than the participation of any other individual;[518]

(4) The activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;[519]

(5) The individual materially participated in the activity for any five tax years (whether or not consecutive) during the ten tax years that immediately precede the tax year;[520]

(6) The activity is a personal service activity, and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year;[521]

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.[522]

See Worksheet 3: Material Participation.

In the case of a married taxpayer, whether filing a joint return or separate returns, participation by the taxpayer's spouse is treated as equivalent to participation by the taxpayer for all seven tests.[523] The spouse does not need to own an interest in the activity for the spouse's participation to be counted.

Practice Point: If a taxpayer materially participates in an activity, the activity is not a passive activity and may give rise to nonpassive income or nonpassive losses. A taxpayer may prefer to not materially participate in an activity to generate passive income, which can be offset by passive losses from other sources. The 2005 IRS Audit Guide noted that: "Material participation applies to *income* as well as to losses. One of the purposes of the last four material participation tests is to prevent the taxpayer from 'failing' material participation when the activity generates income instead of losses."[524]

Practice Point: Since spouses filing separate returns may still affect each other's material participation in activities, and a taxpayer may prefer to materially participate (or not materially participate) in an activity in certain circumstances, separating spouses should consider provisions in their separation agreements governing each other's material participation in various activities.

Work done by the taxpayer (or his spouse) counts for the material participation tests, without regard to the capacity in which the taxpayer (or his spouse) works in connection with the activity (e.g., as an employee), but the work must be performed when the taxpayer owns an interest in the activity.[525]

> *Example:* A taxpayer works in an activity for 200 hours per month as an employee. On December 1, the taxpayer first acquires an interest in the activity. Only the taxpayer's 200 hours spent as an employee in December count toward material participation for the year, while the 2200 hours for the preceding 11 months are not counted for the year.

Two kinds of work are not counted in determining the hours spent participating in an activity. First, work in connection with an activity is not counted if: (1) it is of a type not customarily done by an owner of such activity; and (2) one of the principal purposes for the performance of such work is to avoid the disallowance of losses or credits under §469.[526]

> *Example:* An attorney owns an interest in a football team, in which the attorney does not materially participate. The football team employs his spouse to work more than 500 hours as a receptionist, for the principal purpose of avoiding the disallowance of losses under §469.[527] The attorney's interest in the football team would normally be a nonpassive activity for the attorney due to the spouse's material participation in the football team as a receptionist. However, the spouse's hours are disregarded under this

[515] Reg. §1.469-5T.
[516] Reg. §1.469-5T(a)(1).
[517] Reg. §1.469-5T(a)(2).
[518] Reg. §1.469-5T(a)(3).
[519] Reg. §1.469-5T(a)(4).
[520] Reg. §1.469-5T(a)(5).
[521] Reg. §1.469-5T(a)(6).
[522] Reg. §1.469-5T(a)(7).

[523] §469(h)(5); Reg. §1.469-5T(f)(3). *See Wade v. Commissioner*, T.C. Memo 2014-169 (material participation by husband in an activity was sufficient to treat wife as also materially participating in the activity, even though the record did not establish that the wife actually participated in the activity).

[524] 2005 IRS Audit Guide. *See Carlstedt v. Commissioner*, T.C. Memo 1997-331 (taxpayer failed to rebut material participation through poorly corroborated self-serving testimony claiming less than 500 hours of work in a given activity).

[525] Reg. §1.469-5(f)(1). *See* Reg. §1.469-5T(k) *Ex.* (6).

[526] Reg. §1.469-5T(f)(2)(i).

[527] Reg. §1.469-5T(k) *Ex.* (7).

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test, in which case the football team activity is a passive activity for the attorney.

In *Toups v. Commissioner*,[528] the taxpayer owned a rental cottage, managed and marketed by the real estate developer. The Tax Court did not count toward the taxpayer's material participation his time spent attending annual homeowner meetings and performance of other "superficial" activities, which were recommended by the real estate developer's accounting firm after the enactment of the passive loss rules. The homeowner meetings began in 1988 and did not materially change the operation or management of the cottages.

Second, work done in a taxpayer's capacity as an investor is not counted in determining the taxpayer's hours of participation in the activity, unless the taxpayer is directly involved in the day-to-day management or operations of the activity.[529] For example, a taxpayer who is not a manager or operator of an activity cannot count his time spent: (1) studying and reviewing financial statements or reports on the activity; (2) preparing studies or analyses of the activity's finances or operations for his own use; or (3) monitoring the activity's finances or operations in a nonmanagerial capacity.[530]

In *Syed v. Commissioner*, the taxpayer spent time on research before embarking on the activity of raising livestock, but the Tax Court held "this type of work does not count as direct involvement in the day-to-day operations of a trade or business and thus does not count toward satisfying the material participation requirement."[531]

In contrast, work done as an investor is counted toward the participation tests if the taxpayer is a manager or operator of the activity. In *Mordkin v. Commissioner*,[532] the Tax Court rejected IRS arguments that this exception for work done as an investor applied to an individual who, in addition to owning two condominium apartments in a ski resort, was also the president of the condominium association (among other governance positions) and spent time analyzing the resort's operations from this standpoint. Similarly, in *Lamas v. Commissioner*,[533] the Tax Court allowed a taxpayer to count work done as an investor with respect to his children's real estate businesses when the taxpayer also assumed a management role, negotiating with contractors and tenants, dealing with code violations, and raising capital.

The 2005 IRS Audit Guide states that:

> [t]ravel time generally should not be considered in computing the hourly tests for material participation, particularly if other factors indicate the taxpayer is not participating in the activity on a regular, continuous and substantial basis. Legislative history provides that "services must be integral to operations". It is somewhat difficult to construe that travel constitutes "services" or "participation" as contemplated by Congress or the Regulations. More importantly, travel is not *integral* to operations in most cases.[534]

However, in *Truskowsky v. Commissioner*,[535] the Tax Court recognized that some travel time may count as work and add to participation, by counting travel between a cattle farm and in vitro fertilization facilities for a cattle breeding activity, but not counting commuting travel time between home and place of business.[536] In *Leyh v. Commissioner*,[537] the taxpayer was allowed to count as participation her travel time of 1.5 hours each way between her home in Dripping Springs, Texas, and her 12 rental properties in Austin, Texas. In *Shaw v. Commissioner*,[538] airplane logs contributed to the taxpayer's hours of participation in rental real estate activities.

If a taxpayer owns an interest in an activity, and the taxpayer owns stock in a C corporation that is subject to the passive loss rules (i.e., a CHC or PSC) that also owns an interest in the same activity, the taxpayer may count the hours that he spends on the activity in the C corporation's capacity toward material participation hours (or significant participation hours) in the noncorporate activity.[539] In effect, the two interests may be grouped together, despite being owned by different taxpayers (the shareholder and the C corporation), for purposes of determining the shareholder's material his participation or significant participation in the noncorporate activity.

Note: The statute uses the terms "regular, continuous, and substantial" to distinguish the material participation standard from other standards existing under prior law. Prior law standards defining material participation for purposes of Code provisions such as §1402(a) (relating to the §1401 self-employment tax), and §2032A (relating to the valuation of farm property for estate tax purposes) are not relevant.[540]

1. Test One: More than 500 Hours of Participation

An individual taxpayer materially participates in an activity for a tax year if he participates for more than 500 hours dur-

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[528] T.C. Memo 1993-359.

[529] Reg. §1.469-5T(f)(2)(ii)(A). *See Sharon-Strieby v. Commissioner*, T.C. Memo 2025-28 (no material participation where taxpayers' only activities were signing investment agreements and making contribution payments); *Antonyshyn v. Commissioner*, T.C. Memo 2018-169 (hours logged related to investment activity rather than passive activity where taxpayer contracted with three management companies to handle day-to-day operations); *Lapid v. Commissioner*, T.C. Memo 2004-222 (time taxpayer spent in nightly review of financial statements could not count toward hours of material participation); *Toups v. Commissioner*, T.C. Memo 1993-359; *Barniskis v. Commissioner*, T.C. Memo 1999-258 ("We find that several of the activities described in petitioners' personal time records constitute investor activities. In particular, petitioners' activities of organizing their personal records, preparing their taxes, paying bills, and reviewing their monthly statements of the rentals of their unit all constitute investor activities."); *Padilla v. Commissioner*, T.C. Summ. Op. 2015-38; *Harloff v. Commissioner*, T.C. Summ. Op. 2014-20.

[530] Reg. §1.469-5T(f)(2)(ii)(B).

[531] *Syed v. Commissioner*, T.C. Memo 2017-226.

[532] T.C. Memo 1996-187.

[533] T.C. Memo 2015-59.

[534] 2005 IRS Audit Guide at 4-9.

[535] T.C. Summ. Op. 2003-130.

[536] *See generally Fausner v. Commissioner*, 413 U.S. 838 (1973) (no deduction for commercial pilot's car expenses on trips to airport and return); *Lucero v. Commissioner*, T.C. Memo 2020-136 (excluding taxpayer's time driving between personal residence and rental property from 100-hour requirement); *Ellison v. Commissioner*, T.C. Memo 2017-134 (Tax Court rejected driving time as participation and noted that under general principles, taxpayers bear the expense of commuting because it is a personal expense).

[537] T.C. Summ. Op. 2015-27.

[538] T.C. Memo 2002-35.

[539] Reg. §1.469-4(d)(5).

[540] Reg. §1.469-5T(b)(2)(i). *See* 1986 Senate Report at 734, n.20.

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ing the tax year.[541] Time spent by the taxpayer's spouse counts as time spent by the taxpayer.[542]

The regulations' preamble explained that:

> [t]he Service believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a tax year to any such investment. In addition, the Service believes that income from an activity in which an individual participates for more than 500 hours during a tax year is not properly classified as income from a passive activity.[543]

The 500-hours requirement is the same for all tax years and is not prorated for a short tax year, an activity that begins late in the tax year, an activity in which the taxpayer owns an interest for part of the tax year, or a seasonal activity that is conducted for only part of the tax year. In *Gregg v. United States*,[544] the taxpayer worked approximately 100 hours in the two-month short tax year in which an LLC was organized, which was insufficient to meet the 500-hours requirement because there was no short-year adjustment or proration for hours of participation.[545]

A taxpayer who normally participates in an activity for more than 500 hours in each tax year may find his participation in one year reduced below 500 hours due to a natural disaster, such as a flood or a pandemic that closes nonessential businesses. Although Rev. Proc. 2018-58 and similar guidance may delay certain tax-related deadlines in connection with any federally declared disaster, there is no ongoing relief for a taxpayer who cannot meet a material participation test due to a federally declared disaster. The taxpayer may be able to materially participate under one of the other material participation tests described below that requires fewer hours of participation.

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax year to measure the 500 hours is the entity's tax year ending within the individual taxpayer's tax year.[546]

An individual's participation in an activity may be established by any reasonable means, which does not require contemporaneous daily time reports, logs, or similar documents if the participation may be established by other reasonable means.[547] The regulations' preamble explained that the "Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records."[548] A taxpayer may identify the services he has performed and the approximate number of hours spent performing those services based on appointment books, calendars, or narrative summaries.[549] Courts may be skeptical, however, of self-serving testimony that is not sufficiently corroborated by contemporaneous records or otherwise.[550]

The 2005 IRS Audit Guide listed the following indicators that a taxpayer did not materially participate in an activity:[551]

- The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wages or commissions.
- The taxpayer's residence is hundreds of miles from the activity.
- The taxpayer has a W-2 wage job requiring 40+ hours a week for which he or she receives significant compensation.
- The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.
- There is paid on-site management/foreman/supervisor and/or employees who provide *day-to-day* oversight and care of the operations.
- The taxpayer is elderly or has health issues.
- The majority of the hours claimed are for work that does not materially impact operations.

[541] Reg. §1.469-5T(a)(1).

[542] §469(h)(5); Reg. §1.469-5T(f)(3).

[543] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).

[544] 186 F. Supp. 2d 1123 (D. Or. 2000).

[545] *But see* 2005 IRS Audit Guide at 1-7 (describing *Gregg* as "not a precedent setting case").

[546] See Reg. §1.469-2T(e)(1).

[547] Reg. §1.469-5T(f)(4).

[548] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5697 (Feb. 25, 1988).

[549] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5697 (Feb. 25, 1988).

[550] In *Speer v. Commissioner*, T.C. Memo 1996-323, the Tax Court held that the term "narrative summaries" required more than the taxpayer's mere testimony. The taxpayer in *Speer* failed to prove his material participation because he failed to keep a diary of time devoted to activities and did not offer any records to establish or otherwise substantiate his material participation. *See Moss v. Commissioner*, 135 T.C. 365 (2010) (taxpayer who worked full-time at another job cannot count hours that taxpayer was "on call" towards an activity); *Sellers v Commissioner*, T.C. Memo 2020-84 (retailer failed to substantiate attendance at boat conferences due to lack of written records and conflicting testimony); *Tolin v. Commissioner*, T.C. Memo 2018-29, *aff'd*, 929 F.3d 548 (8th Cir. 2019) (taxpayer recovered certain attorney's fees and costs from the IRS for prevailing on the material participation issue); *Padda v. Commissioner*, T.C. Memo 2020-154 (testimony of taxpayer's involvement in his five restaurants and brewery, including employee testimony about his tight control over decor and food, in addition to evidence that he used telephone and face-to-face meetings to communicate regarding these activities rather than email is adequate evidence of his significant participation); *Tolin v. Commissioner*, T.C. Memo 2014-65 (taxpayer satisfied 500 hour requirement in thoroughbred activity where narrative summary was supported and corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials); *Bartlett v. Commissioner*, T.C. Memo 2013-182 (lack of records and documentation not cured by "guesstimates" of hours worked in bull breeding activity made years later based on purchases made near ranch reflected on credit card statement); *Fowler v. Commissioner*, T.C. Memo 2002-223; *Newhart v. Commissioner*, T.C. Memo 2001-289; *Rapp v. Commissioner*, T.C. Memo 1999-249 (monthly calendars that did little more than corroborate travel and meeting days were inadequate to show more than 100 hours of participation); *Bohannon v. Commissioner*, T.C. Memo 1997-153 (testimony that taxpayer worked 500 hours each year at U.S. car dealership was not credible when taxpayer lived in Panama and had no duties or responsibilities); *Harrison v. Commissioner*, T.C. Memo 1996-509 (court persuaded by oral testimony about material participation in a treasure-hunting expedition because it was detailed and to some extent corroborated); *Goshorn v. Commissioner*, T.C. Memo 1993-578 (1993) ("while the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow the type of post-event ballpark guesstimate that petitioner used").

[551] 2005 IRS Audit Guide at 4-6.

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• Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

In *Goshorn v. Commissioner*,[552] taxpayers residing in Connecticut unsuccessfully argued that they had participated for more than 500 hours with respect to a sailboat in Dallas, Texas, that was held for short-term rental and that they had used as a personal asset when they lived in Texas. The court, in addition to disregarding time spent on the activity in an investor capacity, seemed skeptical about the claim that travel time between Connecticut and Dallas should count, given that the taxpayers had independent business or personal reasons for making all of these trips. Moreover, the court criticized the lack of contemporaneous record-keeping, stating that "while the regulations are somewhat ambivalent concerning the records to be maintained, they by no means allow the type of post-event ballpark guesstimate that petitioner used."

In *United States v. Beckham*,[553] the Eighth Circuit Court of Appeals affirmed a tax return preparer's §7212 conviction for corruptly endeavoring to obstruct tax law administration, due to his representation of a client whom the preparer induced to participate in providing false nonpassive loss claims for a passive activity.

Note: The more than 500 hours of participation test was the only material participation test applicable to an activity for a tax year beginning in 1986 or earlier. The tests discussed below did not apply for those tax years.[554]

2. *Test Two: Substantially All Participation Is by the Taxpayer*

A taxpayer materially participates in an activity for a tax year if the taxpayer's participation (including that of his spouse, whether filing a separate return or a joint return) constitutes substantially all of the participation in the activity of all individuals (including those who are not owners of interests in the activity) during the tax year.[555] This test is sometimes known as the "substantially all participation" test. It does not matter how many (or few) hours the taxpayer and spouse spend on the activity. For example, a taxpayer who does most of the work in a rental meets this test.[556]

The regulations' preamble explained that this substantially all participation test and the comparative participation test (Test Three, described next) "are included because the Service recognizes that the operation of some activities may not require more than 500 hours of participation, or may not require more than 500 hours of participation by any one individual during a tax year."[557]

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax year to measure substantially all participation is the entity's tax year ending within the individual taxpayer's tax year.[558]

Practice Point: Work performed by non-owners (e.g., employees, independent contractors, and volunteers) is considered by this test. Thus, even if the taxpayer is the only owner of an interest in an activity and he participates in that activity, the taxpayer does not qualify as materially participating under this test if non-owners participate in any significant way.[559] For example, a friend or relative may manage or monitor a rental property for free, or a tenant may receive free or reduced rent in exchange for managing the property.[560] Work performed by other owners (but possibly unclear for non-owners) may be disregarded under the two exceptions to the general participation rules, i.e., (1) work of a type not customarily done by an owner, performed with a principal purpose of avoiding the passive loss rules; or (2) work done in an investor capacity by an owner not directly involved in day-to-day management or operations.[561]

In *Chapin v. Commissioner*,[562] the Tax Court held that the taxpayers failed to meet the substantially all participation test for a condominium unit that was leased out during the summer vacation season, due to a rental agent who did all leasing and all in-season day-to-day management of the unit. In *Akers v. Commissioner*,[563] the taxpayer also failed to meet this test for a three-bedroom cabin held for rental, due to a management company that was responsible for advertising, showing, renting, and cleaning the property; taxpayer's daughter and various other people provided management and repair services that took a substantial amount of time.

In contrast, in *Windham v. Commissioner*,[564] the Tax Court held that the taxpayer met the substantially all participation test for rental properties where she ran her rental real estate activities by herself, handling all aspects of the business from collecting rent to overseeing the work of repairmen. She also met prospective buyers and addressed problems with utility and service companies. Similarly, in *Fitch v. Commissioner*,[565] the married taxpayers met the test for various rental real properties owned by them separately. The husband, a CPA, testified that he performed all of the services for his properties including, among other services, advertising, tax payments, procur-

[552] T.C. Memo 1993-578.

[553] 917 F.3d 1059 (8th Cir. 2019), *aff'ing* 119 AFTR 2d 2017-2187 (E.D. Mo. 2017).

[554] *See* Reg. §1.469-11(c)(3), §1.469-5(j)(2); T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5697 (Feb. 25, 1988) ("The Service believes that the 500 hour test represents the only administrable rule for dealing with the determination of material participation for tax years beginning before 1987.").

[555] Reg. §1.469-5T(a)(2). *See* 1986 Conference Report at II-148 ("a taxpayer is likely to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities."). *See also* 1986 Blue Book at 240.

[556] 2005 IRS Audit Guide at 2-5.

[557] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).

[558] See Reg. §1.469-2T(e)(1).

[559] *See Wilson v. Commissioner*, T.C. Memo 2012-101 (taxpayer could not qualify under the substantially all participation test for his solar panels leased to his father-in-law, because the solar company promoter installed the panels, collected payments, maintained records regarding the income, and made the loan and excise tax payments); *Lum v. Commissioner*, T.C. Memo 2012-103 (similar failure to qualify for the substantially all participation test with solar panels); *Conner v. Commissioner*, T.C. Memo 2018-6, *aff'd per curiam*, 123 AFTR 2d 2019-2015 (11th Cir. 2019) (taxpayer could not qualify under the substantially all participation test for a real property development activity when the business hired a land surveyor and has an employee who handles accounting and bookkeeping responsibilities).

[560] *See* 2005 IRS Audit Guide at 2-22.

[561] *See* Reg. §1.469-5T(f)(2)(i), §1.469-5T(f)(2)(ii) (the two types of work not treated as participation in the activity).

[562] T.C. Memo 1996-56.

[563] T.C. Memo 2010-85.

[564] T.C. Memo 2017-68.

[565] T.C. Memo 2012-358.

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ing insurance, and bookkeeping. The wife, a real estate agent, testified that no one performed any services for her properties besides herself and her husband. Her services included advertising, screening tenants, decorating, and making repairs. The Tax Court held that the taxpayers' decision to occasionally hire contractors to perform technical tasks didn't prevent them from meeting the substantially all participation test.

Practice Point: The regulations do not state any limitation on the types of work performed by nonowners that count, whether it is done by employees, independent contractors, or family members (other than the taxpayer's spouse) who provide help as volunteers. The above case law suggests that work done by a management company counts, whereas more technical work done by repair specialists and lawyers who render legal advice may be disregarded.

> *Example:* A taxpayer owns an apartment that is rented out to third parties on Airbnb, Vrbo, HomeAway, or a similar platform. The taxpayer and the taxpayer's spouse personally manage the platform listing and clean the apartment between each use. Since nobody else participates in the activity, the taxpayer may materially participate under the substantially all participation test. In contrast, the taxpayer cannot materially participate under the substantially all participation test if a management company participates in the activity, and probably not if a cleaning company or cleaning contractor is involved in the activity.

3. *Test Three: Participation for More than 100 Hours, if No Other Individual Participates More*

A taxpayer materially participates in an activity for a tax year if the taxpayer (and his spouse, whether filing a separate return or a joint return) participates in the activity for more than 100 hours during the tax year, and his participation is not less than that of any other individual (including individuals without any ownership interest in the activity) during the same year.[566] This test is sometimes known as the "comparative participation" test.

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax year to measure comparative participation is the entity's tax year ending within the individual taxpayer's tax year.[567]

The regulations' preamble explained that this comparative participation test and the substantially all participation test (Test Two, described previously) "are included because the Service recognizes that the operation of some activities may not require more than 500 hours of participation, or may not require more than 500 hours of participation by any one individual during a tax year."[568]

> *Example:* Taxpayer B is a full-time carpenter. B also owns an interest in a partnership that converts vans, which is a trade or business activity. B and C, the other partner, are the only participants in the activity for the tax year. B and C each work for eight hours every Saturday on the van conversion activity. B meets the test because he participates in the activity for around 400 hours during the tax year, which is more than 100 hours, and his participation is not less than the participation of any other person in the activity for such year (C participates to an exactly equal degree).[569]

> *Example:* Married couple A and B participate in an activity for 60 hours apiece. The only other participants are married couple C and D who participate for 110 hours apiece. A and B, considered as one person, participate for 120 hours. Thus, they are materially participating under the comparative participation test because their participation is not less than that of any other individual. C and D also are materially participating under this test, since they can pool their hours and count A's and B's hours separately for their own comparative participation tests.

> *Example:* A taxpayer owns an apartment that is rented out to third parties on Airbnb, Vrbo, HomeAway, or a similar platform for 100 nights a year. The taxpayer and the taxpayer's spouse personally manage the platform listing, communicate with guests, and perform other services with respect to the Airbnb activity for over two hours each week. The taxpayer hires a cleaning company that cleans the apartment for an hour each week. The taxpayer can materially participate in the Airbnb activity under the comparative participation test.

Practice Point: Work performed by nonowners (e.g., employees, independent contractors, and volunteers) and other owners is considered for the comparative participation test, and work performed by other owners (but unclear for non-owners) is disregarded under the same narrow exceptions as discussed above under the substantially all participation test (Test Two), *i.e.*, work that is either: (1) of a type not customarily done by an owner, performed to avoid the disallowance of losses under the passive loss rules; or (2) work done in an investor capacity by an owner not directly involved in day-to-day management or operations.

In *Oberle v. Commissioner*,[570] the taxpayer owned a yacht available for charter but failed to establish that he spent more time in the activity than the charter broker. The taxpayer primarily performed routine inspections and maintenance. The broker actually chartered the yacht, including showing the yacht and providing orientation cruises to charterers, collecting charter fees, and cleaning and making mechanical repairs. In contrast, in *Kline v. Commissioner*,[571] the taxpayer, an airline pilot, successfully established that he materially participated in his charter boat activities. He provided invoices and testimony from the management company which showed that no individual spent more time on charter-related activities than taxpayer himself did.

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[566] Reg. §1.469-5T(a)(3).
[567] See Reg. §1.469-2T(e)(1).
[568] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).
[569] Reg. §1.469-5T(k) *Ex.* (3).
[570] T.C. Memo 1998-156.
[571] T.C. Memo 2015-144.

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In *Serenbetz v. Commissioner*,[572] the taxpayer owned one of 40 condominium units at a resort. The taxpayer was a member of the condominium board and spent at least 100 hours on board-related matters. However, the taxpayer failed to meet the comparative participation test, because the resort's on-site staff spent more time in the activity.[573] The Tax Court rejected the taxpayer's argument that the staff's hours should be divided by 40 (the number of units) to be calculated on a per-unit basis. Thus, it did not matter whether the taxpayer owned one out of 40 resort condominium units or a small interest in a partnership that owned all of the units, as all of the resort employees were counted in full either way.[574] In contrast, in *Pohoski v. Commissioner*,[575] the married taxpayers successfully met the test by showing that they spent 200 hours of participation with respect to a resort condominium unit, including 100 hours of repairs and other maintenance done during a two-week working vacation at the unit. The Tax Court concluded that the actual time spent by the condominium staff in checking tenants in and out, providing maid services, and managing rent collection and disbursements, was less than the time taxpayer participated; for this purpose, the mere availability of the front desk personnel (nine hours a day, seven days a week) did not count as participation.

Regardless of the participation of others, the taxpayer must sufficiently document that he spent at least 100 hours in the activity to use the test. In *Toups v. Commissioner*,[576] taxpayers who lived and worked in Baton Rouge, Louisiana, attempted to show that they had spent more than 100 hours participating in the activity of holding for short-term rental a cottage near Atlanta, Georgia, which they also used for their own vacations. The court rejected much of their claimed decision-making involvement under the rule, described above, that disregarded certain work one performs as an investor.[577] The court rejected the taxpayers' claim that time they ostensibly had spent discussing the cottage with neighbors and friends merited inclusion as serious marketing or promotion activity. The court expressed similar skepticism regarding the taxpayers' claims that they had worked on the cottage activity while vacationing there, and that their 16-hour round trip drive to the cottage (undertaken mainly for vacation purposes) should count as 32 hours of participation since both of them were in the car.

4. *Test Four: Significant Participation Activities*

A special material participation test applies to significant participation activities (SPAs). A SPA is a trade or business activity (*i.e.*, not a rental activity)[578] in which the taxpayer would not be treated as materially participating under any of the other six tests for the tax year, but in which he participates for more than 100 hours during the tax year (defined as "significant participation").[579] A taxpayer is materially participating in all of his SPAs for a tax year if his aggregate participation in all of the SPAs exceeds 500 hours during the tax year.[580] Time spent by the taxpayer's spouse counts as time spent by the taxpayer.[581] The SPAs do not have to be similar, and they can be a restaurant activity and a shoe store activity.[582] The regulations' preamble explained that:

> the Service recognizes that, in the case of an activity that is not the full-time occupation of the taxpayer, the rules regarding material participation set forth in §1.469-5T are stringent. As a result, a taxpayer spending relatively small amounts of time in unrelated activities could, in the absence of regulations, treat the gross income from such activities as passive activity gross income even though the taxpayer's participation and services are significant factors in generating the income from the activities … . The Service does not believe it appropriate to treat the taxpayer's net income, but not the taxpayer's net losses, from activities as nonpassive if the taxpayer's involvement in such activities is substantial. Accordingly, §1.469-5T(a)(4) provides that a taxpayer materially participates in activities that would otherwise be significant participation passive activities for purposes of §1.469-2T(f)(2) if the taxpayer's participation in all such activities exceeds 500 hours for the tax year.[583]

The regulations' preamble further added that:

> [t]his rule is included because the Service believes that an individual who devotes more than 500 hours during a tax year to several activities, each of which is significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.[584]

The regulations on grouping activities had not been promulgated at the time that the SPA test was created.[585]

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax year to measure significant

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[572] T.C. Memo 1996-510.

[573] *See also Barniskis v. Commissioner*, T.C. Memo 1999-258.

[574] *See also* TAM 9543003 (IRS National Office concluded that married taxpayers who owned one out of 53 hotel condominium units did not meet the test, because each of the management company's "front desk" clerks performed more hours of service in the activity than the taxpayers); *Scheiner v. Commissioner*, T.C. Memo 1996-554.

[575] T.C. Memo 1998-17.

[576] T.C. Memo 1993-359.

[577] Reg. §1.469-5T(f)(2)(ii)(A).

[578] *See Shaw v. Commissioner*, T.C. Memo 2002-35.

[579] Reg. §1.469-5T(c). *See Speer v. Commissioner*, T.C. Memo 1996-323 (Tax Court rejected as "ballpark guesstimate" taxpayer's testimony that he devoted 150 hours, 250 hours, and 150 hours, respectively, to three significant participation activities); *Scheiner v. Commissioner*, T.C. Memo 1996-554 (taxpayer failed to prove that she worked around 400 hours for her accounting firm as a second significant participation activity).

[580] Reg. §1.469-5T(a)(4). *See Padda v. Commissioner*, T.C. Memo 2020-154 (testimony of taxpayer's involvement in his five restaurants and brewery, including employee testimony about his tight control over decor and food, in addition to evidence that he used telephone and face-to-face meetings to communicate regarding these activities rather than email is adequate evidence of his significant participation and showed participation in each activity in excess of 100 hours, totaling more than 500 hours in all activities). *See also* TAM 202229036 (taxpayer cannot significantly participate in an activity in which the taxpayer materially participates under the 5-of-10-years test).

[581] §469(h)(5); Reg. §1.469-5T(f)(3).

[582] Reg. §1.469-5T(k) *Ex.* (4).

[583] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5693 (Feb. 25, 1988).

[584] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).

[585] Reg. §1.469-4, T.D. 8565, 59 Fed. Reg. 50,485 (Oct. 4, 1994), effective May 11, 1992. For further discussion, see III.D., above.

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participation is the entity's tax year ending within the individual taxpayer's tax year.[586]

Example: Taxpayer T spends 300 hours participating in Activity A, 150 hours participating in Activity B, and 101 hours participating in Activity C, which are all trade or business activities. T is not materially participating in the three activities under any of the six other material participation tests. All three of the activities are SPAs. T has spent 551 hours on SPAs in the aggregate, and he is treated as materially participating in all three activities.

Example: Taxpayer T spends 300 hours participating in Activity A, 150 hours participating in Activity B, and 90 hours participating in Activity C, which are all trade or business activities. T is not materially participating in the three activities under any of the six other material participation tests. Only A and B, but not C (because C involves less than 100 hours of participation) are SPAs, in which T has spent a total of 450 hours. T has spent less than 500 hours participating in SPAs and therefore does not materially participate in any of the three activities.

Example: Taxpayer T spends 510 hours participating in Activity A, 150 hours participating in Activity B, and 101 hours participating in Activity C, which are all trade or business activities. Since T is materially participating in Activity A under the 500 hours test, Activity A is no longer a SPA. Accordingly, T's time spent on SPAs (Activities B and C) is now less than 500 hours, and he is not materially participating in B or C.[587]

Practice Point: A taxpayer may materially participate in a trade or business activity under any of the six other material participation tests and cause the activity to not be an SPA. For instance, even if the taxpayer spends between 100 hours and 500 hours on the activity, the activity may fail to be an SPA under the facts-and-circumstances test, discussed at IV.A.7., below.

SPAs that fail to satisfy the aggregate 500-hour material participation test, such as Activity A and B in the second example above, are termed significant participation passive activities, or SIPPAs, and are subject to the significant participation rule (discussed at IV.C.1., below) under which aggregate gain from all of a taxpayer's SIPPAs (which are amalgamated for this purpose) is treated as nonpassive, while an aggregate loss remains a passive loss.[588]

Practice Point: In view of this rule, it often is important for the taxpayer to avoid SPA/SIPPA status by spending, on any trade or business activity, either: (1) 100 hours or less (especially if the taxpayer expects a gain), in order to not have an SPA; or (2) more than 500 hours (especially if one expects a tax loss) in order to materially participate in the activity and prevent it from being an SPA.

In TAM 202229036, the taxpayer used the SPA material participation test for five years, after which the significant participation activities became material participation activities in year 6 under the 5-of-10-years test. This reduced the taxpayer's total hours for remaining SPAs to below 500 hours in year 6, which caused those SPAs to fail the SPA material participation test in year 6. It is unclear how the taxpayer should determine the application of the 5-of-10-years test in years 11 and later; the taxpayer may have to counterfactually treat all of its SPAs as materially participating in year 6, by ignoring the application of the 5-of-10-years test in year 6.

Practice Point: A limited partner in a limited partnership cannot use the significant participation test for the limited partnership's activities.[589] A limited partnership's activity cannot be an SPA of a limited partner, even for the purposes of causing the limited partner's other SPAs to qualify under the significant participation test.[590]

5. Test Five: Material Participation in Five of the Last 10 Tax Years

If the taxpayer materially participated in an activity for any five of the 10 tax years that immediately precede the current tax year, the taxpayer is treated as so participating during the current tax year as well.[591] Material participation by the taxpayer's spouse (whether filing a separate return or a joint return) counts as material participation by the taxpayer during the period they are married.[592] This test is sometimes called the "5-of-10-years test" or the "nickel and dime test." The regulations' preamble explained that the rule was:

> included because the Service believes that an activity in which an individual has materially participated over a long period of time … is likely to represent the individual's principal livelihood rather than a passive investment. In particular, the Service does not believe that withdrawal from a longstanding active business … that has been active for a substantial period should convert an individual's earnings from the business to passive income. Thus, the Service believes the income from such businesses generally is part of the earned income base that section 469 was intended to protect. In the case of a longstanding active business (other than a personal service business), however, the Service believes that a continuing interest in such an activity is more appropriately viewed as an investment in a passive activity if the individual has not materially participated in the activity for a significant period of time during the 10-year period immediately preceding the tax year.[593]

Example: Taxpayer T spends more than 500 hours on an activity in each of Years 1, 2, 3, 5, and 6 (and took a sab-

[586] *See* Reg. §1.469-2T(e)(1).

[587] *See Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000) (taxpayer who spent more than 500 hours on one activity and 112 hours on a second activity did not meet the significant participation test for the second activity); *Brumbaugh v. Commissioner*, T.C. Memo 2018-40.

[588] Reg. §1.469-2T(f)(2).

[589] *See* IV.A.8., below.

[590] 2005 IRS Audit Guide at 4-15.

[591] Reg. §1.469-5T(a)(5).

[592] §469(h)(5); Reg. §1.469-5T(f)(3).

[593] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).

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batical in Year 4), but then spends zero hours on the activity in all subsequent years (e.g., due to retirement). For Years 7 through 11, T is treated as materially participating under this test.

In determining prior years' material participation for purposes of this test, a taxpayer disregards the application of the test itself to a prior year.[594] In the above example, T is not treated as materially participating in Year 12 since, disregarding the application of this test, he was a material participant in only four of the previous 10 years (Years 2, 3, 5, and 6).

Note: Under this test, a taxpayer is not treated as a material participant for any tax year in which he did not own an interest in the activity.

Material participation in a prior year may use any material participation test other than the 5-of-10-years test. In *Gossain v. Commissioner*, the taxpayer used the 100 hours comparative participation test (test three) for five years to use the 5-of-10-years test in subsequent years.[595]

Practice Point: Even if a taxpayer is materially participating under the 5-of-10-years test, the taxpayer should also determine whether it is materially participating under one of the other six tests. In TAM 202229036, the taxpayer used the SPA material participation activities in year 6 under the 5-of-10-years test. This reduced the taxpayer's total hours for remaining SPAs to below 500 hours in year 6, which caused the SPAs to fail the SPA material participation test in year 6. It is unclear how the taxpayer should determine the application of the 5-of-10-years test in years 11 and later; the taxpayer may have to counterfactually treat all of its SPAs as materially participating in year 6, by ignoring the application of the 5-of-10-years test in year 6.

When a partnership or S corporation owns an activity and has a different tax year than a taxpayer who owns an interest in the entity, the taxpayer is treated as materially participating in the activity for any tax year in which he treated an item of gross income or deduction from the activity, passed through from the entity, as from an activity in which he materially participated.[596]

Example: T is a full-time employee of an S corporation for six years, but does not own any stock in the corporation during this period. If T acquires stock in the corporation in Year 7, he is not treated as materially participating under this test.[597]

An issue in determining material participation for a preceding tax year is that the composition of the taxpayer's activities may have changed. A taxpayer who owns an interest in an activity during the current tax year generally is treated as having materially participated in that activity for a preceding tax year if the current year activity includes significant activities that are substantially the same as significant activities that were included in prior year activities in which the taxpayer materially participated.[598] Thus, any significant overlap between activities for different tax years causes them to be treated as the same activity for purposes of the 5-out-of-10-years test.[599]

Practice Point: The 5-out-of-10-years test is designed to prevent certain flip-flops: i.e., treatment of an activity as nonpassive in years when it generates tax losses, and then as passive when it generates net income. For example, a taxpayer who treats an activity as nonpassive during its loss generating start-up phase (of at least five years) may be foreclosed from treating it as passive, and thus as generating shelterable income, during the first few years that it shows a profit. The rule may benefit a taxpayer who retires from an activity that continues to generate tax losses.

6. *Test Six: Material Participation in a Personal Service Activity for Any Three Prior Years*

A taxpayer materially participates in a personal service activity for a tax year if the taxpayer materially participated in the personal service activity for any three prior tax years.[600] Material participation by the taxpayer's spouse (whether filing a separate return or a joint return) counts as material participation by the taxpayer during the period they are married.[601]

The regulations' preamble explained that the rule was:

> included because the Service believes that … a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood rather than a passive investment. In particular, the Service does not believe that withdrawal … from a personal service business that has been active for a substantial period should convert an individual's earnings from the business to passive income. Thus, the Service believes the income from such businesses generally is part of the earned income base that section 469 was intended to protect.[602]

Example: The taxpayer materially participated in a personal service activity in 2004, 2012, and 2020. The taxpayer will be treated as materially participating in that activity in all subsequent tax years in which he owns an interest. Rules identical to those under the 5-out-of-10-years test apply where the composition of the taxpayer's activities changes.[603]

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax years to measure material participation in prior tax years are the entity's tax years.[604]

For material participation purposes, personal service activities include services performed in: (1) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (i.e., the personal service activities for PSC purposes), and (2) any other trade or business in

[594] Reg. §1.469-5T(a)(5).

[595] *Gossain v. Commissioner*, T.C. Memo 2024-97.

[596] Reg. §1.469-5(h)(3). See also Reg. §1.469-2T(e)(1).

[597] Reg. §1.469-5T(k) *Ex.* (6).

[598] Reg. §1.469-5(j).

[599] *See Rogerson v. Commissioner*, T.C. Memo 2022-49.

[600] Reg. §1.469-5T(a)(6).

[601] §469(h)(5); Reg. §1.469-5T(f)(3).

[602] Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988).

[603] Reg. §1.469-5(j)(1), §1.469-5(j)(2).

[604] See Reg. §1.469-2T(e)(1).

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which capital is not a material income-producing factor.[605] Capital was a material income-producing factor where the taxpayer owned rental units[606] or raised livestock on a ranch.[607]

Whether capital is a material income-producing factor in a business is relevant for other Code purposes, such as in §736(b)(3) in the context of payments made by partnerships in liquidation of the interest of a retiring or deceased partner and in §761(b) in the context of capital interests in partnerships received as gifts (and formerly in §704(e)(1), in the context of family partnerships). Regulations promulgated under former §704(e)(1) state that capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership, and provide further that capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment. On the other hand, in general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.[608]

The standard of whether capital was a material income-producing factor was also used by former §1348,[609] concerning the maximum tax on earned income. In that setting, the phrase was the subject of both Treasury regulations and frequent litigation. The question of whether capital was a material income-producing factor in a business depended on all the facts and circumstances. The regulations under former §1348 set forth the same principles set forth in the §704(e)(1) regulations.[610] The cases under former §1348 typically looked at such facts as: the amount of capital investment in the business; its relation to the amount of personal services performed; how the capital was used; how critical it was to the business; and whether the business received gross income for providing services or capital.[611]

Among the businesses that were held to use capital as a material income-producing factor were:

- designing, producing, and using slot machines;[612]
- home design business;[613]
- general contracting;[614]
- maintenance contracting;[615]
- electrical contracting;[616]
- laying concrete flatwork;[617]
- operating a landfill;[618]
- real estate development;[619]
- a painting business;[620]
- a mail order business;[621]
- a jewelry store;[622]
- a pharmacy;[623]
- a retail grocery store;[624]
- a cotton merchant;[625]
- metal treating;[626]
- book publishing;[627]
- producing eggs;[628]
- selling bowling supplies;[629]
- operating motels;[630]
- a funeral home;[631]
- bars and lounges;[632]
- movie theaters;[633] and
- selling hashish.[634]

On the other hand, capital was held not a material income-producing factor for particular businesses involved in:

- taxidermy supply;[635]
- bail bonding;[636]
- promoting tax shelters;[637]
- securities brokerage;[638]

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[605] Reg. §1.469-5T(d).

[606] *Mordkin v. Commissioner*, T.C. Memo 1996-187.

[607] *Syed v. Commissioner*, T.C. Memo 2017-226.

[608] Reg. §1.704-1(e)(1)(iv). As in *Syed* regarding Reg. §1.469-5T(d), the Tax Court held in *Woodbury v. Commissioner*, 49 T.C. 180 (1967) that capital was a material income-producing factor in ranching (and farming) activities for purposes of §704(e)(1).

[609] Former §1348 *repealed by* the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §101(c)(1).

[610] Former Reg. §1.1348-3(a)(3).

[611] *See, e.g.*, *Curry v. United States*, 804 F.2d 647 (Fed. Cir. 1986).

[612] *Parker v. Commissioner*, 822 F.2d 905 (9th Cir. 1987), *aff'g* T.C. Memo 1985-545.

[613] *Bertelli v. United States*, 92-1 USTC ¶ 50,266 (N.D. Ohio 1991).

[614] *Hicks v. United States*, 787 F.2d 1018 (5th Cir. 1986), *aff'g* 85-1 USTC ¶ 9383 (N.D. Tex. 1985).

[615] *Holland v. Commissioner*, 622 F.2d 95 (4th Cir. 1980), *aff'g* 70 T.C. 1046 (1978).

[616] *United States v. Korczynski*, 78-2 USTC ¶ 9638 (S.D. Ohio 1978).

[617] *Gullion v. Commissioner*, T.C. Memo 1982-106.

[618] *McGowan v. Commissioner*, T.C. Memo 1982-65.

[619] *Hardy v. United States*, 589 F. Supp. 330 (E.D. Wis. 1984).

[620] *Nelson v. Commissioner*, T.C. Memo 1982-361, *aff'd per curiam*, 767 F.2d 667 (10th Cir. 1985).

[621] *Treatman v. Commissioner*, T.C. Memo 1981-74.

[622] *Friedlander v. United States*, 718 F.2d 294 (9th Cir. 1983), *aff'g* 82-2 USTC ¶ 9577 (W.D. Wa. 1982).

[623] *Whaley v. United States*, 84-1 USTC ¶ 9395 (W.D. Mo. 1984).

[624] *Moore v. Commissioner*, 71 T.C. 533 (1979).

[625] *Block v. United States*, 569 F. Supp. 981 (W.D. Tenn. 1983).

[626] *Weiss v. United States*, 78-2 USTC ¶ 9734 (N.D. Ohio 1978).

[627] *Thomas v. Commissioner*, 92 T.C. 206 (1989); *Harris v. Commissioner*, T.C. Memo 1984-189.

[628] *Wilson v. Commissioner*, T.C. Memo 1982-289.

[629] *Gaudern v. Commissioner*, 77 T.C. 1305 (1981).

[630] *Herman v. Commissioner*, T.C. Memo 1985-396.

[631] *Curry v. United States*, 804 F.2d 647 (Fed. Cir. 1986).

[632] *Pilkington v. Commissioner*, T.C. Memo 1983-111.

[633] *Novikoff v. Commissioner*, T.C. Memo 1980-330.

[634] *Bender v. Commissioner*, T.C. Memo 1985-375.

[635] *Van Dyke v. United States*, 696 F.2d 957 (Fed. Cir. 1982), *aff'g* 82-1 USTC ¶ 9156 (Ct. Cl. 1982) (holding that income resulted primarily from the taxpayer's artistic and technical skills).

[636] *Bruno v. Commissioner*, 71 T.C. 191 (1978).

[637] *Fried v. Commissioner*, T.C. Memo 1989-430.

[638] *Crowell v. Commissioner*, T.C. Memo 1988-305; *Barnes v. Commissioner*, T.C. Memo 1987-544. *But see Bateman v. United States*, 490 F.2d 549

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- providing management services;[639]
- fabricating and installing ornamental iron railings;[640]
- poker activities;[641] and
- drawing cartoons.[642]

Practice Point: Although each case was decided under its particular facts and was not applying the capital as material-income producing factor standard in the §469 context, the cases as a whole support two general conclusions. First, relatively few activities, outside those specifically listed in the material participation regulations (i.e., health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting) are likely to be treated as personal service activities. Second, a business's deployment of significant capital (such as buildings, inventory, or equipment) tends to establish that capital is a material income-producing factor and thus the activity is not a personal service activity.

7. Test Seven: Regular, Continuous, and Substantial Involvement Under the Facts and Circumstances

A taxpayer can establish material participation by reason of his regular, continuous, and substantial involvement in the activity, based on all of the facts and circumstances.[643] A taxpayer will be treated as materially participating under this test only if the taxpayer participates for more than 100 hours during the tax year.[644]

If the activity is conducted by a partnership or S corporation, and the entity's tax year differs from the individual taxpayer's tax year, the relevant tax year to determine the 100 hours of participation and the facts and circumstances is the entity's tax year ending within the individual taxpayer's tax year.[645]

Services performed by an individual in the activity's management are disregarded under the facts and circumstances test unless: (1) no other individual is compensated for performing management services in connection with such activity; and (2) no other individual performs management services that exceed, by hours, the amount of such services performed by the taxpayer.[646]

Note: Services performed by an individual in the operations or other nonmanagement aspect of an activity count toward the facts and circumstances test, even if other individuals are compensated for performing management services or perform more management services than the taxpayer. However, the 2005 IRS Audit Guide may have misinterpreted the rule in broadly stating that "[t]his test cannot be used if anyone besides the taxpayer is paid to manage the activity. An on-site management agency disqualifies the taxpayer from using this test."[647]

The statute requires that taxpayer's regular, continuous, and substantial involvement should be "in operations."[648] The 1986 Senate Report and the 1986 Conference Report indicated the following examples of involvement in operations:

> 1. In the case of a general partnership engaged in the business of producing movies, an individual may materially participate by making significant contributions to writing, reading, and selecting screenplays; actively negotiating with agents who represent writers, actors, or directors; directing, editing, scoring, or acting in the films, actively negotiating with third parties regarding financing and distribution; and actively supervising production, such as selecting and negotiating for the purchase or use of sets and costumes. In contrast, merely approving a financing target, accepting a recommendation regarding selection of the screenplay, cast, locations, and director, or appointing others to perform the operational functions, generally does not constitute involvement in operations.[649]
>
> 2. In the case of an employee or professional who invests in a horse breeding activity, the taxpayer is unlikely to materially participate in the activity if he lives hundreds of miles from the site of the activity and does not often visit the site.[650] An individual who raises horses on land that includes, or is close to, his primary residence, is more likely to materially participate, provided that he can demonstrate regular, continuous, and substantial involvement in the operations of the activity. Such involvement may include hiring and sometimes supervising those responsible for taking care of the horses on a daily basis, along with

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(9th Cir. 1973), *aff'g* 71-2 USTC ¶ 9546 (C.D. Calif. 1971), holding that capital was a material income-producing factor in a food brokerage, for purposes of §704(e)(1), because the food brokerage partnership's goodwill constituted "capital" for these purposes.

[639] *Roselle v. Commissioner*, T.C. Memo 1981-394.

[640] *Van Kalker v. Commissioner*, 804 F.2d 967 (7th Cir. 1984), *rev'g* 81 T.C. 91 (1983).

[641] *Baxter, Jr. v. United States*, 633 F. Supp. 912 (D. Nev. 1986).

[642] *Doty v. Commissioner*, 81 T.C. 652 (1983).

[643] Reg. §1.469-5T(a)(7).

[644] Reg. §1.469-5T(b)(2)(iii). *See Rapp v. Commissioner*, T.C. Memo 1999-249 (president of condominium association did not spend more than 100 hours a year on the condominium activity); *Machado v. Commissioner*, T.C. Memo 1995-526, *aff'd*, 119 F.3d 6 (9th Cir. 1997) (uncorroborated testimony and calendar log of 15 phone calls were insufficient to prove that the taxpayers spent over 100 hours participating in horse racing partnership).

[645] *See* Reg. §1.469-2T(e)(1).

[646] Reg. §1.469-5T(b)(2)(ii). *See, e.g., Scheiner v. Commissioner*, T.C. Memo 1996-554 (taxpayer's management activities as condominium board member did not qualify as participation for the facts-and-circumstances test because other individuals provided management services for which they were compensated; court rejected taxpayer's argument that, under the legislative history of §469, the activities of onsite management should not be considered management services for purposes of the facts-and-circumstances test); *Iversen v. Commissioner*, T.C. Memo 2012-19 (although the ranch has a full-time ranch manager, taxpayer claims he was the real day-to-day ranch manager and made essentially all of the significant decisions relating to the ranch's operation, activities, and management, but the presence of the ranch manager disqualifies much of the taxpayer's time working on ranch activities).

[647] 2005 IRS Audit Guide at 2-10. *See also* 2005 IRS Audit Guide at 4-3 ("this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the Activity"); 2005 IRS Audit Guide at 4-5 ("due to the stringent limitations, few taxpayers can meet the facts and circumstances standard. If there is paid on-site management, the facts and circumstances test cannot be used").

[648] §469(h)(1).

[649] 1986 Senate Report at 732. *See also* 1986 Blue Book at 237.

[650] 1986 Senate Report at 733. *See also* 1986 Blue Book at 238. In *Bartlett v. Commissioner*, T.C. Memo 2013-182, the taxpayer ran a full-time landscaping business in Wyoming and failed to prove that he materially participated based on the facts and circumstances in a bull ranching activity at his ranch in Idaho 220 miles away. His visits to the ranch were sporadic and totaled only 58 and 35 days in the two years at issue, and he arranged for a farmer who lived near the ranch to perform services. *See also Truskowsky v. Commissioner*, T.C. Summ. Op. 2003-130.

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making decisions (i.e., not merely ratifying decisions) regarding the purchase, sale, and breeding of horses.[651]

3. In the case of an investor in a barge that transports grain along the Mississippi River, one way of materially participating is to travel regularly with the barge, not merely as a passenger, but performing substantial services with respect to the transporting of grain. Another way to materially participate is to work on a regular basis at finding new customers for the barge service, and to negotiate service terms with new customers.[652]

4. In the case of a farming activity, an individual who does not perform physical work, but who is treated as having self-employment income with respect to the activity under §1402, generally is treated as materially participating.[653] However, the two standards remain distinguishable, and material participation is no different for farmers than for participants in any other type of activity.[654]

5. In the case of an agricultural activity, certain decision-making may be relevant to material participation if bona fide and undertaken on a regular, continuous, and substantial basis. The types of decision-making include, but are not limited to (1) crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of cropland, animals, machinery, equipment, and other capital items, (4) breeding and mating decisions, and (5) the selection of herd or crop managers who act at the taxpayer's behest, rather than as paid advisors directing the taxpayer's conduct.[655]

The 1986 Senate Report indicated that the following examples were not likely to be materially participating:

1. An individual who works full-time as an employee or in a professional service business, such as law, accounting, or medicine, and who also invests in a business involving orange groves, is unlikely to have materially participated in the orange grove business.[656]

2. In the case of a cattle-feeding activity, an investor who regularly receives and responds to "check-a-box" forms regarding when grain should be purchased, and what the cattle should be fed, may have little or no bearing on material participation. The management decisions are given little weight if they are illusory (e.g., whether to feed the cattle or let them starve), or guided by an expert in the absence of any independent exercise of judgment by the taxpayer, or unimportant to the business due to the tax benefits outweighing any risk of economic loss.[657]

Despite the statute's and the 1986 Senate Report's skepticism of material participation through management activities, the 1986 Conference Report clarified that:

> an individual who works full-time in a line of business consisting of one or more business activities generally is likely to be materially participating in those activities (except to the extent provided otherwise in the case of rental activities), even if the individual's role is in management rather than operations. This clarification is not intended to alter the description of material participation in the Senate Report in any respect. Rather, it recognizes the substantial likelihood that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and bona fide, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment.[658]

The 1986 Blue Book added that:

> if the taxpayer's involvement rises to the level of material participation in an activity on some, but not all, days during the year, but the taxpayer's involvement for the year as a whole is regular, continuous and substantial, then the taxpayer has materially participated for the year. Material participation is determined with respect to the activity for the entire period during the year that he owns an interest in the activity (not, e.g., prorated between periods of greater or lesser involvement). For example, the fact that a taxpayer takes vacations during the year can be fully consistent with a finding of material participation.[659]

In the case of a condominium hotel, as with any other type of activity, a taxpayer can possibly materially participate, under the facts and circumstances test, while not living nearby and while being inexperienced in the business. Material participation under such circumstances generally would be expected, however, to involve making frequent visits to the hotel to conduct on-site inspections, meeting with on-site management, and otherwise participating in integral functions of the business.[660]

In *Wade v. Commissioner*, the taxpayer turned over to his son the day-to-day operations of his plastics recycling and manufacturing companies and moved his home away from the companies' facilities, but he continued to be involved on a regular and continuous basis for at least 100 hours and satisfied the facts and circumstances test. Although the taxpayer lived out of state, he still spent time on nonmanagement, noninvestment activities, such as new technology research and development, securing financing, visiting facilities and meeting with employees.[661]

Practice Point: There can be some overlap between the facts and circumstances test and the other material participation tests. For example, in *Welch v. Commissioner*,[662] the Tax Court held that a construction coordinator for movie sets met the facts and circumstances test and therefore materially participated in

[651] 1986 Senate Report at 733. *See also* 1986 Blue Book at 238.
[652] 1986 Senate Report at 733. *See also* 1986 Blue Book at 238.
[653] 1986 Senate Report at 733–34. *See also* 1986 Blue Book at 238–239.
[654] *See* Reg. §1.469-5T(b)(2)(i).
[655] 1986 Conference Report at II-148. *See also* 1986 Blue Book at 241.
[656] 1986 Senate Report at 733. *See also* 1986 Blue Book at 239.
[657] 1986 Senate Report at 734. *See also* 1986 Blue Book at 239.
[658] 1986 Conference Report at II-147–148. *See also* 1986 Blue Book at 240.
[659] 1986 Blue Book at 235 n.27.
[660] 1986 Bluebook at 241. *See also* 132 Cong. Rec. S15032 (June 24, 1986) (colloquy between Senators Packwood and Hatfield), quoted in *Mordkin v. Commissioner*, T.C. Memo 1996-187.
[661] *Wade v. Commissioner*, T.C. Memo 2014-169.
[662] *Welch v. Commissioner*, T.C. Memo 1998-310.

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his activity of renting tools and equipment to the movie production companies that hired him,[663] although the taxpayer was also the only person involved in the rental activity and likely would have met the substantially all participation test. In *Montgomery v. Commissioner*,[664] the taxpayer met both the 500 hour test and the facts and circumstances test.

In *Windham v. Commissioner*,[665] the taxpayer owned a number of rental real estate properties. She spent more than 100 hours of participation on some properties, which was sufficient to meet the facts and circumstances test. She spent less than 100 hours on other properties, which meant that the facts and circumstances test could not apply, and the Tax Court instead held that she met the substantially all participation test for those other properties.

In *Barbara v. Commissioner*, the taxpayer was engaged in a money lending business in Chicago, Illinois. He handled over 40 outstanding loans during the years in question and did not have other major work-related responsibilities that would require his time and attention, after having previously sold his trucking business. The taxpayer worked at least 200 days each year and split his time 40% in Chicago and 60% in Florida. The Tax Court estimated that he spent 460 hours per year on the lending business in Chicago (200 days × 40% × 5.75 hours per day) and 240 hours per year on the lending business in Florida (200 days × 60% × 2 hours per day), or 700 total hours each year. The Tax Court held that he materially participated under the facts and circumstances test, because he exceeded the 100 hours threshold and his participation in the lending business was regular, continuous, and substantial.[666]

Practice Point: Given that the taxpayer in Barbara worked more than 500 hours per tax year in the lending activity, the Tax Court did not indicate why it did not use the 500 hours material participation test. The court used ballpark estimates for its hourly computations, which were adequate under the facts and circumstances test (as long as the taxpayer comfortably participated more than 100 hours) but might be subject to greater scrutiny under the 500 hours material participation test.

Note: The 1986 Senate Report states that, when a taxpayer who provides legal, tax, or accounting services to the general public as an independent contractor (or an employee thereof) provides these services to an activity (such as a research and development partnership in which he has invested), the taxpayer is materially participating only in the activity of providing such services to the general public, not in the activities of the partnership in which he has invested.[667] The regulations seemingly contradict this requirement, however, by requiring only that an owner of an interest in an activity perform work that is "in connection with" the activity.[668]

The facts and circumstances test may be viewed as a restatement of the statutory rule in §469(h)(1) that a taxpayer is "treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is — (A) regular, (B) continuous, and (C) substantial." In *Rogerson v. Commissioner*, the taxpayer argued that the regulations for the 5-of-10-years test are procedurally invalid for not following the Administrative Procedures Act's notice-and-comment procedures. The Tax Court held that even if all the material participation tests were invalid, the taxpayer materially participated in the activity based on the facts and circumstances because the taxpayer was a "hands-on CEO" of the business.[669]

8. Limited Partners

a. General Rule

The statute provides that a limited partner is generally treated as not materially participating in activities conducted by the partnership in which he holds an interest, except as provided in regulations.[670] The 1986 Senate Report explained why:

> additional considerations apply in the case of limited partnerships. In order to maintain limited liability status, a limited partner generally is precluded from materially participating in the business activity of the partnership; in virtually all respects, a limited partner more closely resembles a shareholder in a C corporation than an active business entrepreneur. Moreover, limited partnerships commonly are used as vehicles for marketing tax benefits to investors seeking to shelter unrelated income. In light of the widespread use of limited partnership interests in syndicating tax shelters, the committee believes that losses from limited partnership interests should not be permitted, before a taxable disposition, to offset positive income sources such as salary.[671]

The regulations allow a limited partner to materially participate in a partnership activity under only three tests:[672]

- the 500 hours test;[673]
- the 5-of-10-years test;[674] or
- the 3-years-in-personal-service-activity test.[675]

Practice Point: The regulation provides that the three tests are applied to an individual limited partner's tax year as if "the individual were not a limited partner for such taxable year."[676] It is unclear whether a limited partner may materially participate under the 5-of-10-year test or the 3-years-in-personal-service-activity test if the limited partner's material participation under the prior tax years was due to the other material participation tests, because the individual's limited partner status for the prior tax years is not explicitly disregarded under the rules. It is possible that the 5-of-10-years test or the 3-years-in-personal-service-activity test can only be achieved by the limited partner satisfying the 500 hours test in the prior three or five tax years.

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[663] *See also Tarakci v. Commissioner*, T.C. Memo 2000-358.
[664] *Montgomery v. Commissioner*, T.C. Memo 2013-151.
[665] *Windham v. Commissioner*, T.C. Memo 2017-68.
[666] *Barbara v. Commissioner*, T.C. Memo 2019-50.
[667] 1986 Senate Report at 735. *See also* 1986 Blue Book at 240.
[668] Reg. §1.469-5(f)(1).
[669] *Rogerson v. Commissioner*, T.C. Memo 2022-49, *aff'd* 132 AFTR 2d 2023-6624 (9th Cir. 2023).
[670] §469(h)(2).
[671] 1986 Senate Report at 718. *See also* 1986 Blue Book at 214.
[672] Reg. §1.469-5T(e)(2).
[673] For further discussion, see IV.A.1., above.
[674] For further discussion, see IV.A.5., above.
[675] For further discussion, see IV.A.6., above.
[676] Reg. §1.469-5T(e)(2).

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Example: A limited partner in a limited partnership spends 150 hours per tax year on the limited partnership's activity, which is not less than the participation of any other person in the activity. Test Three (participation for more than 100 hours, if no one else participates more) is not allowed for a limited partner, who therefore does not materially participate for the first five tax years. In the sixth tax year, it is unclear whether the limited partner may materially participate in the limited partnership's activity under the 5-of-10-years test.

A limited partnership interest is defined as generally (A) an interest designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership or (B) the liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount.[677] More specifically, a limited partnership interest generally includes any interest that is designated as such in the limited partnership agreement or the certificate of limited partnership — without regard to whether the holder's liability for partnership obligations in fact is limited under applicable state law.[678] For example, a taxpayer generally is treated as a limited partner for passive loss purposes even if he has lost his limited liability under applicable state law by holding himself out to creditors as a general partner.

Moreover, a limited partnership interest includes any other interest in a partnership as to which the holder's liability for partnership obligations is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount.[679] For example, a taxpayer is treated as a limited partner if his liability is limited under state law to the sum of his capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership.[680] The limited partner rule applies to an interest actually owned by the taxpayer indirectly through a tiered entity arrangement, for example, where the taxpayer is a general partner in an entity that owns a limited partnership interest in an activity.[681]

A taxpayer is not treated as a limited partner for passive loss purposes if he also is a general partner in the same partnership at all times during the relevant tax year when he holds the limited partnership interest.[682] The usual material participation tests apply with respect to his entire partnership interest, both as a limited partner and as a general partner.[683] If the partnership's tax year differs from the individual taxpayer's tax year, the relevant tax year is the partnership tax year ending within the individual taxpayer's tax year.[684] However, if for even one day during the relevant tax year, the taxpayer holds a limited partnership interest in the partnership but not a general partnership interest, the taxpayer is a limited partner with respect to his limited partnership interest for the entire tax year for material participation purposes.

Practice Point: As under the general rule for a partnership with multiple activities, a limited partner can be treated as materially participating in one activity of a limited partnership but not the other activities of the limited partnership.[685]

Special rules apply to a limited partner of an "electing large partnership" under former §771 through §777.[686] A limited partner's share of an electing large partnership's taxable income or loss from all trade or business and rental activities is generally treated as income or loss from the conduct of a single passive trade or business activity.[687]

b. Members of LLCs as Limited Partners

The IRS previously and unsuccessfully sought to extend the limited partner material participation rules in §469(h)(2) to taxpayers' interests in other types of limited liability entities, such as limited liability partnerships (LLPs) and limited liability companies (LLCs). In *Thompson v. United States*,[688] the Court of Federal Claims rejected the IRS's argument that an LLC's treatment as a partnership for federal tax purposes was sufficient to establish that the members of the LLC should be treated as limited partners for passive loss purposes. The plain language of the regulation required that the interest be in an entity that is a partnership under state law.[689] Moreover, the court found that the policy presumption of §469(h)(2), i.e., that a limited partner is passive, cannot apply to LLCs, which are designed to retain limited liability of the members while permitting their active involvement in the entity's business activities.

The District Court for the District of Oregon reached the same result for an Oregon LLC in *Gregg v. United States*,[690] which was decided over eight years before *Thompson* but was described as "not a precedent setting case" in the 2005 IRS Audit Guide.[691]

The Tax Court similarly held in *Garnett v. Commissioner*[692] that §469(h)(2) does not apply to interests in LLPs and LLCs, even though the partner or member enjoys limited liability under state law. The Tax Court noted that a limited partner is statutorily constrained from active participation in the partnership's affairs, which supports the presumption of passivity. By contrast, partners or members of LLPs and LLCs do not have any statutory restraint on participation. In *Newell v. Commissioner*,[693] the Tax Court held that the managing member of

[677] Reg. §1.469-5T(e)(3).

[678] Reg. §1.469-5T(e)(3)(i)(A).

[679] Reg. §1.469-5T(e)(3)(i)(B).

[680] Reg. §1.469-5T(e)(3)(i)(B).

[681] *See* 1986 Senate Report at 731; 1986 Blue Book at 236.

[682] Reg. §1.469-5T(e)(3)(ii). This regulation is contrary to the 1986 Senate Report, at 731, and the 1986 Blue Book at 236, which state that "[w]hen a taxpayer possesses both a limited partnership interest and another type of interest, such as a general partnership interest, with respect to an activity, lack of material participation is conclusively presumed with respect to the limited partnership interest (thus limiting the use of deductions and credits allocable thereto). The presence of material participation for purposes of any other interests in the activity owned by the taxpayer is determined with reference to the relevant facts and circumstances."

[683] *See* Reg. §1.469-5T(a).

[684] *See* Reg. §1.469-2T(e)(1).

[685] *See* Reg. §1.469-2T(e)(1).

[686] Repealed by the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101(b)(1), for partnership tax years beginning in 2018 and later.

[687] Former §772(c)(2), former §772(f).

[688] 87 Fed. Cl. 728 (2009), *acq.* in result, 2010-14 I.R.B. 515.

[689] Reg. §1.469-5T(e)(3)(i)(B).

[690] 186 F. Supp. 2d 1123 (D. Or. 2000).

[691] 2005 IRS Audit Guide at 1-7.

[692] 132 T.C. 368 (2009).

[693] T.C. Memo 2010-23.

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a California LLC was not subject to §469(h)(2) and could materially participate under the significant participation test (Test Four). In *Hegarty v. Commissioner*,[694] the Tax Court held that a member of a Maryland LLC was not subject to §469(h)(2) and could materially participate under the comparative participation test (Test Three) by spending during the tax year more than 100 hours and more than anyone else in the LLC's charter fishing business.

In March 2010, the IRS acquiesced (in result only) to the Federal Claims Court's decision in *Thompson*,[695] which meant that the IRS accepted the court's holding and will follow it in disposing of cases with the same controlling facts, yet the IRS disagreed with some or all of the reasoning by the court in reaching its conclusions. At the same time, the Chief Counsel's Office also indicated informally that it would no longer litigate the issue presented in *Thompson*, *Garnett*, and *Gregg*, and further acknowledged that the material-participation standards did not apply neatly to LLC members.[696]

In November 2011, Treasury and the IRS issued proposed regulations that would amend the definition of a "limited interest in a limited partnership" to eliminate the reliance on state law limited liability.[697] The proposed regulations are not effective until they are finalized, at which point they will apply to tax years beginning on or after they are published as final regulations in the Federal Register.[698]

Treasury and the IRS noted that the limited partner regulations were originally drafted with the constraints of the Uniform Limited Partnership Act of 1916 in mind, under which limited partners could lose their limited liability protection if they participated in the control of the partnership, but many states have adopted variants of the Revised Uniform Limited Partnership Act of 1985 (RULPA) or the Uniform Limited Liability Company Act of 1996, under which limited partners or LLC members may participate in the management and control of a limited partnership or LLC without losing their limited liability.[699] Treasury and the IRS further explained that:

> Recognizing that the original presumptions regarding the limitations on a limited partner's participation in the activities of the entity are no longer valid today, and also recognizing the emergence of LLCs, the proposed regulations eliminate the current regulations' reliance on limited liability for purposes of determining whether an interest is an interest in a limited partnership as a limited partner under section 469(h)(2) and instead adopt an approach that relies on the individual partner's right to participate in the management of the entity.[700]

The proposed regulations would restrict the definition of an "interest in a limited partnership as a limited partner" (for the purposes of the material participation rules) to only those interests in entities classified as partnerships for federal income tax purposes that are held by a taxpayer who does not have rights to manage the entity at all times during the entity's tax year.[701] Management rights are determined under the law of the jurisdiction in which the entity is organized and under the applicable provisions of the entity's governing agreement.[702] In addition, an individual is not treated as holding an interest in a limited partnership as a limited partner if the individual owns another interest in the entity, such as a state-law general partnership interest, at all times during the entity's tax year ending with or within the individual's tax year (or the portion of the entity's tax year during which the individual owns the interest in a limited partnership as a limited partner).[703]

Practice Point: If an individual owns a general partnership interest for only part of the entity's relevant tax year or relevant portion of the tax year, the individual is still treated as holding an interest in a limited partnership as a limited partner for such tax year.

Practice Point: The proposed regulations are not effective until they are finalized, and then only with respect to tax years beginning on or after the date of publication in the Federal Register.[704] In the interim, taxpayers deciding between using a limited partnership or an LLC for owning a loss-generating activity must consider the risk that LLC members who are trying to use a material participation test other than the 500 hours test, the five-of-ten-years test, or the three-years-of-personal-service-activity test may nevertheless have passive losses. As a practical matter, the IRS has lost every case on the issue and may have better use of its resources than to lose more cases. The issue is generally only relevant for LLC members who participate less than 500 hours in the tax year on the LLC's activity.

Practice Point: If the LLC's activity has net taxable income, the LLC members who participate for less than 500 hours in the tax year may consider taking the position that they can ignore the proposed regulations before they are finalized, in order to obtain passive income that can be offset by passive losses from other sources.

Note: The issue of whether a partner or member of an LLP or LLC is treated as a limited partner arises under other Code provisions, such as §1402(a)(13), which generally provides that the §1401 self-employment tax does not apply to "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments" for services. The limited partner's income is therefore not subject to the §1401 self-employment tax, while its losses cannot offset other income subject to the §1401 self-employment tax.[705] If the limited partner also materially participates in the limited partnership's trade or business, such as under the 500 hours test (whether for the limited partnership's trade or business or a larger grouped activity), under the 5-of-10-years test, or by using the spouse's material participation, the limited partner's income and gain with respect to the limited partnership is generally not subject to the

[694] T.C. Summ. Op. 2009-153.

[695] AOD 2010-02.

[696] *See IRS Turns to Practitioners for Assistance In Rewriting Rules for Partner Participation*, 46 G-8 (Mar. 11, 2010).

[697] Prop. Reg. §1.469-5(e), REG-109369-10, 76 Fed. Reg. 72,875 (Nov. 28, 2011).

[698] Prop. Reg. §1.469-5(e)(4).

[699] REG-109369-10, 76 Fed. Reg. at 72,876–77.

[700] REG-109369-10, 76 Fed. Reg. at 72,875, 72,877.

[701] Prop. Reg. §1.469-5(e)(3)(i).

[702] Prop. Reg. §1.469-5(e)(3)(i)(B).

[703] Prop. Reg. §1.469-5(e)(3)(ii).

[704] Prop. Reg. §1.469-5(e)(4).

[705] *See Hough v. Commissioner*, T.C. Memo 1997-361, *aff'd*, 162 F.3d 1151 (3d Cir. 1998).

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§1411 net investment income tax either.[706] In 1997, Treasury and the IRS issued proposed regulations that generally treat an individual as a limited partner unless (i) the individual has personal liability for the partnership's debts or claims by reason of being a partner;[707] (ii) has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[708] (iii) participates in the partnership's trade or business for more than 500 hours during the partnership's tax year;[709] or (iv) is a service partner in a service partnership, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[710] The proposed regulations are not effective until they are finalized.[711]

> *Example:* Taxpayer A owns a limited partnership interest in a limited partnership that provides investment management services. A also provides more than 500 hours of services annually to the limited partnership (or a lower-tier entity), in exchange for a guaranteed payment (or a salary). A might take the position that his or her distributive share of income from the limited partnership (i) is not subject to the self-employment tax under §1402(a)(13) and (ii) is not subject to the §1411 net investment income tax because of his material participation under the 500 hours test, but such a position has been successfully challenged by the IRS as inconsistent with A's status as a "limited partner."[712]

> *Example:* Taxpayer B owns a limited partnership interest in a limited partnership that provides investment management services. B's spouse provides more than 500 hours of services annually to the limited partnership (or a lower-tier entity), in exchange for a guaranteed payment (or a salary). B might take the position that his or her distributive share of income from the limited partnership (i) is not subject to the self-employment tax under §1402(a)(13), due to the lack of spousal attribution in the self-employment tax rules, and (ii) is not subject to the §1411 net investment income tax because of material participation by B's spouse under the 500 hours test.

[706] §1411(c)(2).

[707] Prop. Reg. §1.1402(a)-2(h)(2)(i).

[708] Prop. Reg. §1.1402(a)-2(h)(2)(ii).

[709] Prop. Reg. §1.1402(a)-2(h)(2)(iii).

[710] Prop. Reg. §1.1402(a)-2(h)(5). *See Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) (whether a partner in an LLP is a "limited partner" under the §1402(a)(13) self-employment tax exemption depended upon the individual's level of services or participation in the business).

[711] Prop. Reg. §1.1402(a)-2(j).

[712] *See, e.g., Soroban Capital Partners LP v. Commissioner* , 161 T.C. 310 (Nov. 28, 2023) (limited partner exception in §1402(a)(13) does not apply to a partner who is limited in name only; court extends functional analysis similar to that used in *Renkemeyer* to limited partners in a state law partnership by analyzing the limited partners' functions and roles in the partnership); *Denham Capital Management, LP v. Commissioner*, T.C. Memo 2024-114 (same); *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) (functional analysis for member of limited liability company); *Castigliola v. Commissioner*, T.C. Memo 2017-62; *Howell v. Commissioner*, T.C. Memo 2012-303; CCA 201640014; CCA 201436049.

The §1402(a)(13) exclusion as it applies in the context of partners and limited partners and related court cases is discussed further in 735 T.M., *Private Equity Funds*, 736 T.M., *Hedge Funds*, and 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

9. Material Participation by Legal Entities

When a legal entity (other than a pass-through entity) is subject to the passive loss rules, special rules are needed to determine material participation. For corporations, these rules generally refer to participation by owners of corporate stock, although for CHCs, participation by "nonowner employees" (employees who own up to 5% of the CHC's stock) is also relevant.

a. Personal Service Corporations

A PSC is treated as materially participating in an activity if one or more owners, representing more than 50% (by value) of the stock of the PSC, materially participate in the activity.[713] Solely for this purpose, all activities of the PSC are treated as activities in which such owners hold an interest.[714]

> *Example:* A PSC has five shareholders, each of whom owns 20% of its stock. If three or more of PSC's shareholders materially participate in an activity, so too does the corporation. If one of those three shareholders had only owned 5% of the PSC's stock, so that the three materially participating shareholders together only owned 45% of the PSC's stock, the PSC would not have materially participated in the activity.[715]

In determining the material participation of an owner for purposes of determining the PSC's material participation, that owner's participation in all activities other than the PSC's activities is disregarded.[716] For example, the material participation rule for SPAs[717] is not affected by noncorporate activities of the owner.

> *Example:* An owner spends 300 hours participating in an activity on behalf of the PSC, and also has an SPA that is not an activity conducted by the PSC but in which he participates for 300 hours. For purposes of determining the owner's material participation, the owner's involvement in the SPA is disregarded and thus the owner does not materially participate in any of the activities. Moreover, in determining the owner's material participation for his own tax purposes (i.e., with respect to the SPA), his participation in activities on behalf of the PSC is disregarded. By contrast, if both activities are conducted by the PSC, both are considered under the SPA rule and the owner is regarded as materially participating in both activities for purposes of the PSC's determining the material participation in those two activities.

[713] §469(h)(4)(A).

[714] Reg. §1.469-1T(g)(3)(iii)(A).

[715] 1986 Senate Report at 735–736. *See also* 1986 Blue Book at 242.

[716] Reg. §1.469-1T(g)(3)(iii)(B).

[717] *See* Reg. §1.469-5T(a)(4); IV.A.4., above.

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Example: A PSC has three owners (A, B, and C), each of whom own one-third of the stock. A and B participate 400 hours each in the PSC's Activity 1, and A and C participate 400 hours each in the PSC's Activity 2. A (but not B and C) is treated as materially participating in both activities under the material participation test for SPAs. However, he represents only one-third of the ownership interests, whereas PSC material participation requires material participation by more than 50% of the owners.

PSCs are also subject to the rule concerning SIPPAs. If owners representing more than 50% (by value) of the stock of the PSC significantly participate in an activity, the activity is a SIPPA unless the PSC materially participates in the activity.[718] As a result of SIPPA treatment, net losses from the activity are passive, but any aggregate net income from all of the PSC's SIPPAs is nonpassive.[719]

Significant participation is defined as participation in an activity for more than 100 hours, with no ceiling.[720]

Example: A PSC has three owners (A, B, and C), each of whom owns one-third of the stock. If A participates in an activity of the PSC for 600 hours, B for 150 hours, and C not at all, there is material participation with respect to only one-third of the PSC's ownership interests, but there is significant participation with respect to two-thirds of the PSC's ownership interests. Therefore, the activity is a SIPPA, for which net losses are passive but net income or gain is nonpassive.

Practice Point: A PSC that holds a limited partnership interest is subject to the limited partnership rules for that interest, which generally permit only the 500 hours test, the 5-of-10-years test, or the 3-years-of-personal-service-activity test to determine material participation.[721] The material participation test applies to a consolidated group by treating the group as one taxpayer.[722]

b. *Closely Held Corporations*

Similar to a PSC, a CHC materially participates in an activity if one or more owners representing more than 50% (by value) of the corporate stock materially participate in such activity.[723]

In addition, a CHC (that is not a PSC) can materially participate in an activity if the requirements of §465(c)(7)(C) (without regard to the §465(c)(7)(C)(iv) excluded business rules) are met with regard to the activity.[724] Specifically, under this test derived from the at-risk rules, the non-PSC CHC is treated as materially participating in an activity that is an "active business" if:

(1) during the entire 12-month period ending on the last day of the CHC's tax year, the corporation had at least one full-time employee whose services were all (or substantially all) in the active management of the activity;[725]

(2) during the entire 12-month period ending on the last day of the CHC's tax year, the corporation had at least three full-time, nonowner employees whose services were all (or substantially all) directly related to the activity;[726] and

(3) for the CHC's tax year, the amount of the activity's deductions, which are allowable to the taxpayer solely by reason of §162 (trade or business expenses) and §404 (generally retirement plan contributions), exceeds 15% of the activity's gross income.[727] The 15% test does not take into account any compensation deduction for personal services rendered by an employee (other than a nonowner employee) or any member of the employee's family (spouse, children, grandchildren, and parents).[728]

A "nonowner employee" is any employee who does not own more than 5% (by value) of the CHC's stock at any time during the tax year.[729] Constructive ownership is determined using modified §318 attribution rules,[730] with corporation-to-shareholder attribution for 5%-or-more (by value) shareholders.[731] Employees who own stock through an employee stock ownership plan (ESOP) are not considered owners of the stock.[732]

For purposes of this test, all component members of an affiliated group (as defined in §1504(a)), which file or are required to file consolidated returns are treated as a single taxpayer.[733]

If the CHC is a partner in a partnership, the CHC is treated as materially participating in the partnership's activity if:

i. the CHC is a general partner in the partnership;

ii. the CHC has an interest of 10% or more in the profits and losses of the partnership;

iii. the CHC has contributed property to the partnership in an amount (based on fair market value) not less than the lessor of $500,000 or 10% of the CHC's net worth;

[718] Reg. §1.469-1T(g)(3)(ii).
[719] Reg. §1.469-2T(f)(2)(i).
[720] Reg. §1.469-1T(g)(3)(iii), §1.469-5T(c)(2).
[721] For further discussion, see IV.A.8., above.
[722] II.D., above (concerning consolidated groups).
[723] §469(h)(4)(A); Reg. §1.469-1T(g)(3)(i)(A).
[724] §469(h)(4)(B); Reg. §1.469-1T(g)(3)(i)(B).
[725] §465(c)(7)(C)(i).
[726] §465(c)(7)(C)(ii).
[727] §465(c)(7)(C)(iii). Special rules apply to banks under §465(c)(7)(D)(iv) and life insurance companies under §465(c)(7)(D)(v).
[728] §465(c)(7)(D)(iii).
[729] §465(c)(7)(E)(i).
[730] §465(c)(7)(E)(i).
[731] §465(c)(7)(E)(i). For a discussion of similar, but not identical, modified §318 attribution rules in determining PSC status (§318(a)(2)(C) corporation-to-shareholder attribution applies to all shareholders), see II.B.2., above.
[732] Section 318(a)(2)(B)(i) provides that stock owned by a trust is considered owned by its beneficiaries only if the trust is not an employees' trust described in §401(a) that is exempt from tax under §501(a). In *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003), *aff'g* 1998 BL 586 (D. Idaho Nov. 24, 1998), the Ninth Circuit Court of Appeals held that §318(a)(2)(B)(i) attribution does not apply to a §4975(e)(7) employee stock ownership plan (ESOP), in the context of the §302 redemption rules, because the ESOP is a §401(a) employee's trust that is exempt from tax under §501(a). *See also Petersen v. Commissioner*, 148 T.C. 463 (2017) (contrasting ESOP constructive ownership under §318 attribution rules and §267 attribution rules). TAM 9612001 (IRS National Office concluded that ESOP beneficiaries can be attributed the stock held by the ESOP);
[733] §465(c)(7)(F).

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iv. the partnership has an "active business" that meets the requirements of (2) and (3) above; and

v. during the full 12-month period ending on the last day of the partnership's tax year, there was at least one full time employee of the partnership (or of the CHC or another corporate partner that meets the requirements of clauses (i) through (iii)) substantially all the services of whom were in the active management of such business.[734]

Practice Point: The above requirements must be met separately for each activity of the non-PSC CHC (or its affiliated group) in order for the CHC to materially participate in the activity. For example, an activity with only two full-time employees would not meet the test.

Practice Point: A newly formed CHC generally cannot meet the test during its first tax year due to the employee requirements that apply to all of the prior 12 months.

Practice Point: A CHC may not meet the test for a limited partner interest unless it holds a general partner interest and a limited partner interest at the same time. It is unclear how a CHC can be a "general partner" if the partnership is an LLC classified as a partnership for U.S. federal income tax purposes, but a functional test may apply based on the "limited partner" authorities under §469 and §1411. For discussion, see IV.A.8., below.

c. *Estates and Trusts*

In the case of a grantor trust, the determination of material participation is made at the grantor level rather than at the trust level.[735] Similarly, in the case of a qualified subchapter S trust that is treated as a grantor trust,[736] i.e., the beneficiary is treated as the trust's owner for tax purposes, the material participation of the beneficiary is relevant to determining whether the S corporation's activity is a passive activity for the beneficiary.[737] For purposes of applying the passive loss rules to the qualified subchapter S trust's beneficiary, the trust's disposition of the S corporation stock is treated as a disposition by the beneficiary,[738] with the result that the beneficiary can deduct passive loss carryovers under the full unrelated taxable disposition rule.[739]

The 1986 Senate Report provides that an estate, or a nongrantor trust, is treated as materially participating in an activity if the executor or fiduciary, in his capacity as such, is so participating.[740] But the regulations on material participation by estates, nongrantor trusts, and their beneficiaries have been reserved since 1988.[741]

In PLR 201029014, the IRS ruled that a trust may materially participate in activities of an entity that the trust holds through a partnership and another entity wholly owned by the partnership, where the trustee is involved in operations on a regular, continuous, and substantial basis.

Practice Point: If a trust satisfies the material participation standards, the IRS may seek to classify the trust as an association and therefore taxable as a corporation under the "business trust" entity classification regulations.[742] The 1986 Blue Book noted that:

> [p]rior and present law provide that, generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint venture for the conduct of business for profit (Treas. Reg. sec. 301.7701-4). A trust may be treated as an association taxable as a corporation, for tax purposes, if it is a joint enterprise for the conduct of business for profit. Thus, it is unlikely that a trust as such for Federal income tax purposes will be materially participating in a trade or business activity, within the meaning of the passive loss rule.[743]

In TAM 201317010, the IRS National Office concluded that where a special trustee's fiduciary powers are limited by the trust agreement, his work as president of a company held by the trust was an employee of the company and not as a fiduciary of the trust, and therefore the work did not count toward the trust's material participation. However, in *Frank Aragona Trust v. Commissioner*,[744] the Tax Court held that a trust may materially participate in an activity due to the activities of three of its five trustees, when the three trustees were also full-time employees of the trust.

Practice Point: The trustees in *Frank Aragona Trust* materially participated in the non-grantor trust's activities. It is not relevant whether any trustee is a real estate professional due to his or her activities outside the trust. In other words, a trust does not become a real estate professional merely because a trustee is a real estate professional.

The court in *Frank Aragona Trust* did not need to decide whether the trust may materially participate in an activity due to the activities of its employees who were not trustees. In *Mattie K. Carter Trust v. United States*,[745] the district court held that a trust may be treated as materially participating in an activity if the persons who conduct business on the trust's behalf, including its agents and employees as well as its trustees, are materially participating. The court reasoned that because a trust is a legal entity, it can participate in an activity only through the acts of its fiduciaries, employees, and agents. Accordingly, the court said that a trust was more like a C corporation than like an individual, and in determining whether the trust materially participated in the trade or business (in this case, the operation

[734] §467(c)(7)(D)(ii). Note that neither §465 nor §469 defines an "active business." For an analogous provision that requires an active trade or business, *see* §355(b) and its regulations.

[735] 1986 Senate Report at 735 n.21; 1986 Blue Book at 242 n.33.

[736] §1361(d)(1)(B).

[737] 1986 Blue Book at 242 n.33.

[738] §1361(d)(1)(C), *added by* the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §236, for dispositions in 2005 and later.

[739] H. Rep. No. 108-548, Part 1 at 131 (2004).

[740] 1986 Senate Report at 735.

[741] *See* Reg. §1.469-8; Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5697 (Feb. 25, 1988) ("Material participation rules for trusts and estates will be included in future regulations providing rules for the application of section 469 to trusts, estates, and their beneficiaries.").

[742] Reg. §301.7701-4(b).

[743] 1986 Blue Book at 242 n.33.

[744] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

[745] *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003). The court also held that even if the IRS position was correct, the taxpayer would have prevailed because the trustee's own activities were sufficiently regular, continuous, and substantial to constitute material participation.

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of a ranch), the actions performed by each of its operatives, not just the trustees, had to be taken into account. The IRS National Office rejected the holding in *Mattie K. Carter Trust* and advised that only the activities of a trustee may be accounted for in determining whether the trust materially participated in an activity.[746]

Practice Point: In all instances, participation by a nongrantor trust's beneficiary as such is not relevant in determining the trust's material participation.

10. Special Rule for Interests Held by Retirees and Surviving Spouses in Farming Activities

A taxpayer who is retired, disabled, or a surviving spouse is treated as materially participating in a farming activity for a tax year if he (or the deceased spouse of the taxpayer) materially participated to a requisite extent in prior tax years under certain §2032A special valuation rules that normally apply for estate tax purposes.[747] The specific requirement is that during the eight years preceding the retirement, disability, or death, there were periods aggregating five years or more during which the decedent or a member of the decedent's family materially participated in the farming activity.[748] Family members include the individual's ancestors and spouse, as well as the lineal descendants (and their spouses) of the individual, spouse, or parent.[749] *See generally* 833 T.M., *Special Use Valuation (Section 2032A)*

In applying the 5-out-of-8-years rule, the taxpayer may disregard periods in which the decedent was retired (i.e., receiving old-age Social Security benefits), or disabled (i.e., mentally or physically impaired such that material participation is not possible).[750]

> *Example:* Taxpayer T materially participates in a farming activity in Years One through Five, but does not work in the activity in Year 6 or any later years. T retires or becomes disabled in Year Nine. Because T has materially participated in the farming activity in five of the eight years before his retirement, T is treated as materially participating in Year Nine and later years (but not in Years Six through Eight, when he was not retired or disabled).

If the 5-out-of-8-years rule is met by a deceased taxpayer, the rule is deemed to be met with regard to the taxpayer's surviving spouse, provided that the surviving spouse actively manages the farming activity when not retired nor disabled.[751]

> *Example:* Under the facts as in the previous example, T dies in Year Ten. T's surviving spouse is treated as materially participating provided that she is actively managing the farm. Moreover, the 5-out-of-8-years rule applies to the benefit of T's surviving spouse if she retires or becomes disabled.

In TAM 200911009, the IRS National Office expanded the application of the rule to a scenario where the deceased taxpayer retired before his death, his surviving spouse was retired at the time of his death, and she did not actively manage the farm thereafter. The IRS National Office concluded that tacking of the 5-out-of-8-years rule should apply to this case as well, so that the surviving spouse is deemed to materially participate if (1) the deceased taxpayer materially participated in farming activity for five of eight years preceding deceased taxpayer's retirement; and (2) the surviving spouse was retired from farming activity at time of the deceased taxpayer's death.

> *Example:* The same facts as in the previous example, except that T's surviving spouse is retired at the time of T's death in Year Ten, and she does not actively manage the farm thereafter. The 5-out-of-8 years rule applies to the benefit of T's surviving spouse to treat her as materially participating in the farming activity.

The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.[752]

Practice Point: The 5-of-8-years rule does not apply to a limited partner in a limited partnership, which is allowed to only use the 500 hours test, the 5-of-10-years test, or the 3-years-of-personal-service-activity test for material participation.[753]

B. Material Participation in Rental Activity

Under the passive loss rules, rental activities are generally treated as per se passive — i.e., without regard to whether the taxpayer has materially participated.[754] The 1986 Senate Report justified the per se rule because:

> The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.[755]

Seven years later, a new statutory exception in §469(c)(7) provided that certain rental real estate of some real estate professionals was no longer subject to the per se passive rule. Instead, the real estate professional may materially participate in rental real estate activities and give rise to nonpassive income or nonpassive losses.

Congress enacted §469(c)(7) in the Revenue Reconciliation Act of 1993 effective for tax years beginning in 1994 or later.[756] The House Report for the legislation noted that:

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[746] TAM 200733023.

[747] §469(h)(3) (citing §2032A(b)(1)(C)(ii), §2032A(b)(4), and §2032A(b)(5)). *See also* Reg. §1.469-5T(h)(2).

[748] §2032A(b)(1)(C)(ii).

[749] §2032A(e)(2).

[750] §2032A(b)(4).

[751] §2032A(b)(5).

[752] §2032A(e)(4).

[753] For further discussion, see IV.A.8., above.

[754] §469(c)(2).

[755] 1986 Senate Report at 718. *See also* 1986 Blue Book at 214.

[756] Pub. L. No. 103-66, §13143. *See Palevada v. Commissioner*, T.C. Memo 1997-416, *aff'd*, 178 F.3d 1303 (11th Cir. 1999) (real estate professional rule does not apply to 1990 or 1991).

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> The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income. The committee bill modifies the passive loss rule to alleviate this unfairness.[757]

Comment: A taxpayer who qualifies under §469(c)(7) is called a "real estate professional" in common parlance and also by reference in Reg. §1.1411-4(g)(7)(i). The regulations under §469(c)(7) refer to such a taxpayer as a "qualifying taxpayer."[758]

Note: Real estate professional status only removes the per se passive rule for rental real estate activities. The real estate professional still needs to materially participate in a rental real estate activity in order to give rise to nonpassive income or nonpassive loss from that activity. If a real estate professional does not materially participate in the rental real estate activity, the income or loss continues to be passive income or passive loss. Several courts have rejected the taxpayer argument that a real estate professional is automatically materially participating in rental activities.[759]

Practice Point: Real estate professional status affects only the taxpayer's material participation in rental real estate activities. The taxpayer's other rental activities, such as equipment leasing, continue to be per se passive regardless of the taxpayer's material participation. Real estate professional status does not affect the exceptions to rental activities, such as property used by a customer for seven days or less, as those exceptions may generally use all material participation tests in any case.[760] Real estate professional status also does not change whether the use or rental of a residence is subject to §280A instead of the passive loss rules.[761]

Practice Point: A taxpayer may prefer not to be a real estate professional in some cases, such as if the taxpayer has passive losses from other activities that can be offset by passive income from the rental real estate activities. The taxpayer may seek to be a real estate professional in alternative tax years, and lump deductions in the real estate professional tax years in order to maximize nonpassive losses for those years and passive income in the intervening years. The 2005 IRS Audit Guide noted that: "Qualification as a real estate professional is a determination, not an election. A taxpayer may attempt to manipulate the passive activity rules by inappropriately claiming to be a real estate professional, or conversely, by not claiming to be one (for instance, if certain activities are generating net income)."[762]

See Worksheet 4: Real Estate Professional.

[757] H. Rep. No. 103-111 at 613–14 (1993). *See also* H. Rep. No. 102-631 at 40 (1992) (same provision in the H.R. 1 bill for the Revenue Act of 1992, which was vetoed by the President).

[758] *See* Reg. §1.469-9(b)(6), §1.469-9(c).

[759] *See Gragg v. United States*, 831 F.3d 1189 (9th Cir. 2016), *aff'g* 2014 BL 89974 (N.D. Cal. Mar. 31, 2014); *Perez v. Commissioner*, T.C. Memo 2010-232.

[760] *See* III.B., above.

[761] *See* VI.E., below.

[762] 2005 IRS Audit Guide at 2-6.

Note: A taxpayer may be a real estate professional for federal income tax purposes but not for certain state income tax purposes. California, for example, has never conformed to §469(c)(7) and does not recognize real estate professional status for California income tax purposes.[763] A real estate professional may have losses that are nonpassive and deductible for federal income tax purposes but passive and nondeductible for California income tax purposes, with a California-only passive loss carryover.[764] Other states like New York conform to the passive loss rules, including §469(c)(7).[765]

1. *Qualifying as a Real Estate Professional*

Qualification as a "real estate professional" in 1994 and later is available to both individuals and CHCs, but not PSCs.[766] In *Frank Aragona Trust v. Commissioner*,[767] a complex residuary trust owned several real estate rental properties and three of the six trustees worked full-time managing the properties in various capacities. The Tax Court concluded that the residuary trust qualified as a real estate professional. However, in CCA 201244017, the Chief Counsel's Office advised that trusts, estates, and PSCs cannot qualify as real estate professionals, in discussing the then-pending *Frank Aragona Trust* case.

Practice Point: There is no explicit rule that allows an estate to be a real estate professional, even if the decedent was a real estate professional before the decedent's death. For comparison, §469(i) allows an estate to claim the $25,000 special allowance generally to the extent that the decedent could have benefited from the same special allowance, as discussed at V.F.5., below.

There are two eligibility requirements for an individual to be a real estate professional. First, more than half of the taxpayer's personal services performed in trades or business during the tax year must be performed in real property trades or businesses in which the taxpayer materially participates (the 50% test).[768] Second, the taxpayer must perform more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates (the 750 hours test).[769] In other words, the taxpayer must (i) materially participate in one or more real property trades or businesses,[770] (ii) spend more than 750 hours in those trades or businesses, and (iii) have those 750 hours constitute more than half of all personal services performed in trades or businesses during the tax year.[771]

[763] Cal. Rev. & Tax Code §17561(a).

[764] *See In the Matter of Walker*, Cal. Bd. of Eq. Dec. 892858 (Sept. 26, 2017); *In the Matter of Goradia*, Cal. Bd. of Eq. Dec. 791767 (Aug. 30, 2016); *In the Matter of Hemmatt*, Cal. Bd. of Eq. Dec. 613804 (Dec. 18, 2014).

[765] *See In the Matter of Brandvold*, N.Y. Div. Tax Appeals, ALJ Determination 825578 (Mar. 19, 2015).

[766] Reg. §1.469-9(b)(6).

[767] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

[768] §469(c)(7)(B)(i).

[769] §469(c)(7)(B)(ii).

[770] *See Conner v. Commissioner*, T.C. Memo 2018-6, *aff'd per curiam*, 123 AFTR 2d 2019-2015 (11th Cir. 2019); *Schumann v. Commissioner*, T.C. Memo 2014-138 (taxpayer did not materially participate in his rental real estate activities under any of the material participation tests, and therefore could not qualify as a real estate professional regardless of the numbers of hours spent in those activities).

[771] *See, e.g., Windham v. Commissioner*, T.C. Memo 2017-68 (stockbroker qualified as real estate professional when she worked at brokerage office for

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Practice Point: Real estate professional status is a yearly determination. A taxpayer who normally qualifies as a real estate professional for each tax year may find his participation in real property trades or businesses in one year reduced below 750 hours due to a natural disaster, such as a flood or a pandemic that closes certain real property trades or businesses and other nonessential businesses. Although Rev. Proc. 2018-58 and similar guidance may delay certain tax-related deadlines in connection with any federally declared disaster, there is no ongoing relief for a taxpayer who cannot qualify for real estate professional status due to a federally declared disaster.

The types of evidence that may be used to establish the hours of real estate professional participation are the same as for the material participation tests.[772] Given the higher hours required to be a real estate professional, some taxpayers have (unsuccessfully) claimed to work more than 24 hours in a day on real property trade or business activities.[773]

In *Hairston v. Commissioner*,[774] the taxpayer failed to meet the 750 hour test because the Tax Court held that their 781 hours for the year were inflated by at least 150 hours. The court noted:

> Every task recorded on the calendars, no matter how trivial, is listed as having taken at least one hour to complete. Of the 360 recorded entries, 121 (or roughly one-third) record tasks that allegedly consumed exactly one hour. These include 36 entries for doing nothing more than receiving a rent payment, issuing a receipt for a payment, or depositing a check at the bank. There are 13 distinct one-hour entries for "paying mortgage." There are 11 distinct one-hour entries — all of which petitioners attribute to Mr. Hairston — for "hunting down" or "remind[ing]" the tenant to pay rent. Three of these entries appear in the same week, including two on the same day. There are nine distinct one-hour entries for "inspecting vacant property," i.e., walking next door to 6330 Bell to make sure it had not been broken into. This pattern of inflating recorded hours undermines the credibility of petitioners' calendars overall … . An inflationary pattern also emerges from the calendar entries recording time that Mr. Hairston allegedly spent supervising contractors. He recorded many hours during which he allegedly watched contractors work, including 33 hours while they installed and cleaned

2.5 hours each day); *Zarrinnegar & Dini v. Commissioner*, T.C. Memo 2017-34 (dentist qualified as a real estate professional because he worked fewer than 1,000 hours per year at the dental practice and more than 1,000 hours per year at real estate brokerage and rental businesses, in which he materially participated under the substantially all test); *Miller v. Commissioner*, T.C. Memo 2011-219 (commercial ship pilot with flexible schedule qualified as real estate professional based on hours spent in real estate construction and rental businesses); *Franco v. Commissioner*, T.C. Summ. Op. 2018-9 (real estate professional worked more than 750 hours managing rental properties and around 650 hours as an architect during the year); *Moon v. Commissioner*, T.C. Summ. Op. 2016-23 (real estate professional spent more than 750 hours in real estate rental businesses in which she materially participated each year, and less than 200 hours each year as ski instructor); *See also Chambers v. Commissioner*, T.C. Summ. Op. 2012-91 (taxpayer failed to be a real estate professional when he spent 1,680 hours at Navy civilian job and 832 hours on real estate activities); *Fenderson v. Commissioner*, T.C. Summ. Op. 2007-191 (taxpayer failed to be a real estate professional when she worked 780 hours at account manager job and 759 hours on real estate activities).

[772] Reg. §1.469-5T(f)(4), discussed at IV.A.1., above. *See, e.g., Hakkak v. Commissioner*, T.C. Memo 2020-46 (taxpayer calendars and self-serving testimony insufficient to establish treatment as real estate professional); *Birdsong v. Commissioner*, T.C. Memo 2018-148 (taxpayer established real estate professional status and material participation through combination of logs for the entire year, albeit only contemporaneous for the second half of the year, receipts and invoices that substantiated the logged hours, and credible testimony); *Pourmirzaie v. Commissioner*, T.C. Memo 2018-26 (noncontemporaneous logs did not establish real estate professional status when the taxpayers had credit card charges for food and lodging in foreign countries and other cities on the same days); *Windham v. Commissioner*, T.C. Memo 2017-68 (stockbroker qualified as real estate professional based on hours spent in rental real estate business); *Penley v. Commissioner*, T.C. Memo 2017-65 (court rejected as "untrustworthy" taxpayer's testimony and calendar that he spent 2,520 hours on his real estate activities, in addition to 2,194 hours in his full-time job; not credible that taxpayer worked 12.88 hours per day every day, with no holidays); *Hatcher v. Commissioner*, T.C. Memo 2016-188, *aff'd per curiam*, 726 Fed. App'x 207 (5th Cir. 2018) (taxpayer could not count any hours working for a loan origination business that had no clients in the relevant tax year and did not hire taxpayer as an employee until the next year); *Hailstock v. Commissioner*, T.C. Memo 2016-146 ("We find petitioner's narrative summary convincing because she owned numerous rental properties and conducted her business as a one-man operation [sic] without being otherwise employed. … petitioner spent well in excess of 40 hours each week doing work related to numerous rental properties (i.e., researching prospective properties, maintaining properties, supervising work orders, finding tenants, securing leases, and continuing education related to rental real estate) … . Although we caution petitioner to construct contemporaneous time logs for her future real estate endeavors, we find her detailed and credible testimony to be a "reasonable means of proof."); *Merino v. Commissioner*, T.C. Memo 2013-167 (court was skeptical that the taxpayer "on average: purchased and had delivered one appliance per month for at least one of his seven properties; received a notice of violations of homeowners association rules requiring an hour of work at least once per week; or had a property with a problem that required a contractor every week"); *Jafarpour v. Commissioner*, T.C. Memo 2012-165 (post-event ballpark guesstimate of participation time not allowed, and taxpayer's two 19-hour days spent on rental activities following a 12.5-hour driving day not found credible); *Lee v. Commissioner*, T.C. Memo 2006-193 (full-time physician and full-time IRS employee could not establish that either one worked more than half of their time in real estate partnership business, especially when noncontemporaneous time logs submitted at trial more than doubled the hours in log books submitted during audit); *Windross v. Commissioner*, T.C. Summ. Op. 2013-52 (Tax Court rejected taxpayer's argument that he only worked 50% of the time that he had a full-time job at Hewlett Packard, which paid him for 2,088 hours of work per year); *D'Avanzo v. United States*, 67 Fed. Cl. 39 (Fed. Cl. 2005), *aff'd per curiam*, 215 Fed. App'x 996 (Fed. Cir. 2007) (post-event ballpark estimate does not substantiate rental activity time spent; noncontemporaneous log book of hours and trial testimony are inadequate evidence).

[773] *See Goolsby v. Commissioner*, T.C. Memo 2010-64; *Mowafi v. Commissioner*, T.C. Memo 2001-111. *See also Rose v. Commissioner*, T.C. Memo 2019-73 ("Ms. Rose did allow time for sleep and meals in her logs, but they were not reasonable. For example, Ms. Rose routinely reports working 16-hour days on the properties and some days in excess of 18 hours, acknowledging breaks only for meals, typically half an hour each. This does not leave much time for sleeping, personal hygiene, or spending time with her young children. Ms. Rose also reported working through the holidays that petitioners spent at the Idaho property; Thanksgiving 2009 was an 18.5-hour day that included shopping for over 2 hours during the afternoon and New Years Day 2010 was a 16.25-hour day. While we believe petitioners' testimony that Ms. Rose worked very hard, these hours are not plausible, especially with young children, even though Mr. Rose was supervising them."); *Robinson v. Commissioner*, T.C. Memo 2014-120, *aff'd per curiam*, 615 Fed. App'x 147 (4th Cir. 2015) ("On some occasions, but to an extent that the credible evidence does not enable us to quantify, Mr. Robinson did, while traveling from his home in Virginia to Atlantic City, stop at the Magnolia house to make repairs. But the evidence does not support Mr. Robinson's implausible assertion that, on numerous occasions, he rose early in Atlantic City, drove an hour to Magnolia, worked a six-hour day, drove an hour back to Atlantic City, and gambled in the evening. We do not believe that he spent more than 750 hours working on the property. This would have required that he work 125 six-hour workdays — more than a third of the year — and no evidence corroborates this assertion.").

[774] *Hairston v. Commissioner*, T.C. Memo 2019-104.

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carpet. During one week in December, he recorded another 40 hours "supervising" contractors who were painting the interior of 6330 Bell. We understand that Mr. Hairston, having recently retired, had time on his hands. But we cannot believe that he spent an entire week watching paint dry.

Practice Point: A more proper time period for recordkeeping purposes, based on the quanta used in the legal profession, is to record activities in 0.1 hour (6 minute) increments.

A "trade or business" for real estate professional purposes is based on the general §469 definition of a "trade or business."[775] In addition, a trade or business includes all rental real estate activities, including rental real estate activities that do not rise to a trade or business under §162 and merely give rise to deductions for the production of income under §212.[776] A rental real estate activity is effectively the same as a rental activity under Reg. §1.469-1T(e)(3),[777] but excludes any rental real estate that is grouped with a trade or business activity.[778] Other rental activities, such as personal property rental activities, do not count in the general §469 definition of a trade or business.[779]

Practice Point: A taxpayer can spend 800 hours of personal services on managing net leased rental real properties, even if they are not in a trade or business, and qualify as a real estate professional, as long as those 800 hours exceed the taxpayer's hours of personal services spent on other trades or businesses.

Practice Point: Non-real-estate rental activities are excluded from all aspects of the two tests, regardless of the taxpayer's hours spent on those activities and regardless of whether the non-real-estate rental activities rise to the level of a trade or business under §162. For example, a taxpayer can spend 800 hours of personal services on rental real properties and 1,000 hours of personal services on rental personal properties, and be a real estate professional.

Practice Point: A rental real estate activity serves two purposes under the real estate professional rules. First, a taxpayer may become a real estate professional by spending sufficient time with the rental real estate activity to meet the 50% test and the 750 hours test. Second, once a taxpayer is a real estate professional due to any real property trade or business (not necessarily a real property rental trade or business), the taxpayer may materially participate in rental real estate activities. For both purposes, a rental real estate activity does not include any of the exceptions from rental activities, such as an activity of leasing property for an average period of seven days or less on Airbnb.[780] For the first purpose, the separate Airbnb activity may reduce the number of hours that the taxpayer spends in the rental real estate activity,[781] though the taxpayer may treat the Airbnb activity as a separate real property operation or management trade or business.[782] For the second purpose, the exceptions have no impact because the taxpayer can materially participate in the Airbnb activity, which is a trade or business activity, without being a real estate professional.

"Personal services" means any work performed by an individual in connection with a trade or business, but not any work performed in the individual's capacity as an investor.[783] Personal work apparently includes work not customarily done by owners, even though such work does not count toward material participation,[784] such as office receptionist work by an owner of a football team.[785]

In *Johnson v. United States*, the District Court of Nevada excluded 87.5 hours that the taxpayer spent studying for the California real estate exam, because studying for a license was not material participation as it did not pertain to the operation or day-to-day management of properties.[786]

Personal services performed as an employee count as services performed in real property trades or businesses only if the employee is a 5-percent owner of the employer.[787] A 5-percent owner is any person who owns, directly or indirectly, more than 5% of the stock (by vote or by value) of a corporate employer or more than 5% of the capital or profits interest in a noncorporate employer.[788] Modified constructive ownership rules under §318 apply in determining ownership of the corporate or noncorporate employer,[789] with corporation-to-shareholder attribution for 5%-or-more (by value) shareholders.[790] If the employee is a 5% owner for only part of the tax year, only the employee's personal services performed during the 5-percent owner period are counted as performed in a real property trade or business.[791]

[775] Reg. §1.469-4(b)(1). *See* III.A.1., above.

[776] Reg. §1.469-9(b)(1). *See* T.D. 9905, 85 Fed. Reg. 56,686, (Sept. 14, 2020) ("for purposes of §469(c)(7)(C), a taxpayer who owns real property and rents to tenants under a triple net lease arrangement will be treated as engaged in a real property trade or business even though the renting under the terms of a triple net lease arrangement may not rise to the level of a §162 trade or business. The triple net lease arrangement is included in the broader definition of a trade or business under Reg. §1.469-9(b)(1) because the arrangement represents an interest in rental real estate. Accordingly, renting real property under a triple net lease arrangement generally will fall within the definition of a "rental real property trade or business" in §469(c)(7)(C) and proposed Reg. §1.469-9(b)(2).").

[777] Reg. §1.469-9(b)(3). *See* III.B., above.

[778] *See* III.D.3., above.

[779] Reg. §1.469-4(b)(1).

[780] See III.B.1., above.

[781] *See Hoskins v. Commissioner*, T.C. Memo 2013-36.

[782] See IV.B.1.e., below.

[783] Reg. §1.469-9(b)(4) (reference to Reg. §1.469-5T(f)(2)(ii); discussed in IV.A., above). *See Hakkak v. Commissioner*, T.C. Memo 2020-46.

[784] Reg. §1.469-5T(f)(2)(i).

[785] Reg. §1.469-5T(k) *Ex.* (7); *see* IV.A., above.

[786] *Johnson v. United States*, No. 2:19-CV-674 JCM (DJA) (D. Nev. Aug. 3, 2020).

[787] §469(c)(7)(D)(ii) (referencing §416(i)(1)(B)). *See Flores v. Commissioner*, T.C. Memo 2015-9 (petitioner, an employee of a pavement company, did not qualify as a real estate professional for personal services done to a property because the pavement company did not engage in a real property trade or business, petitioner was not a 5-percent owner of the company, and petitioner did not spend more time working on the property than he did as an employee of the pavement company); *Almquist v. Commissioner*, T.C. Memo 2014-40 (vice president of operations for a real estate rental company, who managed 15 rental buildings and oversaw 300 employees, did not qualify as a real property trade or business because he did not own more than 5% of the company).

[788] §416(i)(1)(B)(i).

[789] §416(i)(1)(B)(i)(I), §416(i)(1)(B)(iii); Reg. §1.416-1 Q&A T-17. Although §318 attribution rules normally apply in determining only stock ownership, §416(i)(1)(B)(iii) and Reg. §1.416-1 Q&A T-18 provide that the same principles apply in determining ownership of a noncorporate employer's capital or profits interests. The aggregation rules of §414(b), §414(c), and §414(m), which generally aggregate certain service organizations and management organizations, do not apply under §416(i)(1)(C) and Reg. §1.416-1 Q&A T-17.

[790] §416(i)(1)(B)(iii)(I). For discussion of a similar, but not identical, modified §318 attribution rules in determining PSC status (§318(a)(2)(C) corporation-to-shareholder attribution applies to all shareholders), see II.B.2., above.

[791] Reg. §1.469-9(c)(5).

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In *Pungot v. Commissioner*,[792] the Tax Court upheld the constitutionality of the special rule for employees, even though the prohibition applied only to employees and not to independent contractors. The taxpayer worked as a full-time mechanical engineer for two engineering consulting firms that specialized in real estate development, but did not own more than 5% of those firms.

In *Stanley v. United States*, the District Court of Arkansas held that the 5% ownership requirement can be met by the taxpayer's ownership of restricted stock in his S corporation. The court rejected the government's argument that the restricted stock is not outstanding for tax purposes under §83 and Reg. §1.1361-1(b)(3).[793]

Practice Point: Personal services performed as an employee do count as services performed in non-real-estate trades or businesses, which can adversely affect the denominator of the 50% test.[794]

Practice Point: Under general tax rules, a partner of a partnership cannot also be an employee of the partnership.[795] The partner may qualify as a real estate professional based on his hours of personal services provided to the partnership, even if he owns 5% or less of the interests in the partnership.

Practice Point: The 50% test makes it more difficult for a person employed in a full-time job (not in a real property trade or business) to qualify as a real estate professional.[796] For a married couple, an otherwise nonworking spouse may find it easier to qualify as a real estate professional by spending around 15 hours per week on real property trades or businesses in order to meet the 750 hours test.[797] Both spouses' rental real estate activities could then be subject to the material participation tests, if they file a joint return. The 2005 IRS Audit Guide noted for IRS auditors that "If nonworking spouse claims to be the real estate professional, ask what other commitments he/she may have. Is the spouse a student? Is the spouse providing full-time care to young children?"[798]

For a CHC, the only requirement to be a real estate professional during a tax year is that more than 50% of the CHC's gross receipts for the tax year must be derived from real property trades or businesses in which the CHC materially participates.[799] Gross receipts for this purpose do not include items of portfolio income.[800]

a. Material Participation in Real Property Trades or Businesses

A real property trade or business is defined as real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[801] The statute and legislative history do not elaborate further on these definitions,[802] although some of these definitions have been developed by case law and post-TCJA regulations, as discussed below.

The regulations provide that the determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances.[803] A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services, which may consist of one or more real property trades or businesses.[804] A taxpayer's grouping of its activities has no effect on the determination of a real property trade or business.[805] Thus, although the grouping regulations provide that generally a rental activity may not be grouped with a nonrental activity,[806] such aggregation may be permitted for a real property trade or business and real estate professional status.

Practice Point: Even if a person is a real estate professional, he must still "materially participate" in an activity in order for the activity to not be a passive activity. If a person is a real estate professional for a tax year, he may use the 5-of-10-years test and count his material participation in prior tax years before he was a real estate professional, even though material participation did not have any effect during those prior tax years.[807]

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[792] *Pungot v. Commissioner*, T.C. Memo 2000-60.

[793] *Stanley v. United States*, 2015 BL 372985 (W.D. Ark. Nov. 12, 2015), *nonacq. on other grounds*, 2017-42 I.R.B. 311 (IRS nonacquiescence relating to a required 5% ownership in the employer and the taxpayer's elections).

[794] Reg. §1.469-9(c)(5).

[795] *See* Rev. Rul. 69-184.

[796] *See, e.g., Hakkak v. Commissioner*, T.C. Memo 2020-46 (lawyer's claim that he "worked as an attorney 'only from 12 to three' about 'two times a week'" was not persuasive when he earned $449,437 from the practice of law in one year); *Vandegrift v. Commissioner*, T.C. Memo 2012-14 (full-time salesman who earned $120,000 salary in 2005 was not a real estate professional); *Harnett v. Commissioner*, T.C. Memo 2011-191, *aff'd*, 496 Fed. App'x 963 (11th Cir. 2012) (bank chairman and CEO could not credibly claim that he spent only 10 hours per month on bank job, given his wide-ranging responsibilities and six-figure compensation); *Mowafi v. Commissioner*, T.C. Memo 2001-111 (research director could not credibly claim to work 1,832 hours on research job and 2,102 hours on rental properties in a year); *Harmon v. Commissioner*, T.C. Summ. Op. 2007-127 (not credible that full-time nonprofit employee worked only eight hours per week); *Nelson v. Commissioner*, T.C. Summ. Op. 2004-62 ("In light of his full work schedule at the Dial Corporation, petitioner would have to provide substantial and detailed evidence to convince us that he managed to spend more than one-half of his time on rental real estate activities or that he even spent more than 750 hours on them during the year in issue.").

[797] *See, e.g., Birdsong v. Commissioner*, T.C. Memo 2018-148 (stay-at-home mother qualified as a real estate professional based on her day-to-day management of rental properties); *Lewis v. Commissioner*, T.C. Summ. Op. 2014-112 (disabled veteran qualified as real estate professional).

[798] 2005 IRS Audit Guide at 2-21.

[799] §469(c)(7)(D)(i). For an example of a CHC that qualifies under §469(c)(7), see PLR 9551030.

[800] Reg. §1.469-9(c)(2). For the definition of portfolio income, see III.C.1., above.

[801] §469(c)(7)(C). In *Franco v. Commissioner*, T.C. Summ. Op. 2018-9, the Tax Court allowed a taxpayer to be a real estate professional due to spending more than 750 hours in connection with the management of his rental properties, which was more than the 650 hours he worked as an architect. The taxpayer did not contend that being an architect was a real property trade or business.

[802] *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995) ("Several comments requested that the regulations provide a detailed definition of real property trades or businesses beyond the cross-reference to section 469(c)(7)(C). However, to avoid complex and mechanical rules, the final regulations do not adopt a detailed definition of real property trades or businesses. Instead, the regulations provide that taxpayers may use any reasonable method for determining their real property trades or businesses.").

[803] Reg. §1.469-9(d)(1).

[804] Reg. §1.469-9(d)(1). *See also* PS-80-93, 60 Fed. Reg. 2557, 2558 (Jan. 10, 1995) ("for purposes of the qualification tests, the determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances, but the determination must generally be applied consistently from year to year.").

[805] Reg. §1.469-9(d)(1).

[806] *See* III.D.3.a., above.

[807] *See Hoskins v. Commissioner*, T.C. Memo 2013-36.

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Practice Point: A real estate professional may use any one of the material participation tests in order to prove material participation in a real property trade or business for passive loss purposes. However, material participation under the 500 hours test (or the 5-of-10-years test using the 500 hours test in prior tax years) allows the real estate professional to more easily not be subject to the §1411 net investment income tax on his rental real estate income and gains.[808] The §1411 net investment income tax applies only to the taxpayer's rental income from investments and from trades or businesses that are passive activities,[809] but not to rental income from trades or businesses that are not passive activities under the passive loss rules. The §1411 regulations provide a safe harbor that treats a real estate professional's rental activity as a trade or business for §1411 purposes if the real estate professional materially participates under the 500 hours test (or the 5-of-10-years test by using the 500 hours test in prior tax years) for the tax year, in which case rental income and gains are not subject to the §1411 net investment income tax. *See generally* 511 T.M., *Section 1411 — Net Investment Income Tax*. The real estate professional's rental income and gain may also not be subject to the §1401 self-employment tax, due to the §1402(a)(1) exception for rentals from real estate and from personal property leased with the real estate (unless the rentals are received in the course of a trade or business as a real estate dealer) and the §1402(a)(3) exception for gains from the disposition of nondealer property.

b. Real Property

The TCJA amended §163(j) to limit the deduction of business interest expense for tax years beginning in 2018 and later,[810] but an exception applies for an "electing real property trade or business."[811] An "electing real property trade or business" means a real property trade or business, as defined in §469(c)(7)(C) for real estate professional purposes,[812] that makes an election to be an electing real property trade or business.[813] The electing real property trade or business is not subject to any interest limitation under §163(j).

Final regulations published in connection with the §163(j) business interest deduction limitation,[814] broadly define real property for the purposes of determining whether a trade or business is a "real property trade or business" for purposes of §469(c)(7)(C) and §163(j)(7)(B).[815]

A "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[816] These terms are defined in c. through f., below.

The term "real property" includes any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest.[817] Real property consists of:

1. Land,[818] including water and air space superadjacent to land, and natural products and deposits that are unsevered from the land.[819]

2. Buildings,[820] which enclose a space within their walls and are generally covered by a roof or other external upper covering that protects the walls and inner space from the elements.[821] Types of buildings that are permanently affixed to land include houses, townhouses, apartments, condominiums, hotels, motels, stadiums, arenas, shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.[822]

3. Other inherently permanent structures that are permanently affixed to land,[823] such as parking facilities, bridges, tunnels, roadbeds, railroad tracks, pipelines, storage structures such as silos and storage tanks, and stationary wharves and docks.[824] Whether an asset is an inherently permanent structure is determined based on all the facts and circumstances.[825] However, an asset that serves an active function, such as an HVAC system, elevator, escalator, or other machinery or equipment, is not a building or other inherently permanent structure, even if the machinery or equipment is permanently affixed to or becomes incorporated within the building or other inherently permanent structure.[826] Accordingly, the manufacture, installation, operation, maintenance, or repair of such an asset that serves an active function is not a real property trade or business (nor a unit or component of another real property trade or business).[827]

4. Tenant improvements to land, buildings, inherently permanent structures, or other real property.[828]

Natural products and deposits, such as plants, crops, trees, water, ores, and minerals, cease to be real property when they

[808] Reg. §1.1411-4(g)(7).
[809] §1411(c)(1)(A).
[810] Pub. L. No. 115-97, §13301.
[811] §163(j)(7)(A)(ii).
[812] §163(j)(7)(B).
[813] §163(j)(7)(B).
[814] T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020), generally applicable to tax years beginning on or after November 13, 2020.
[815] Reg. §1.469-9(b)(2). Reg. §1.469-9(b)(2) applies to tax years beginning on or after November 13, 2020, but, taxpayers and their related parties may apply Reg. §1.469-9(b)(2) to a tax year beginning after December 31, 2017, if they consistently apply Reg. §1.469-9(b)(2) and the other regulations in T.D. 9905 to that tax year. Reg. §1.469-11(a)(4).
[816] §469(c)(7)(C) (incorporated by reference in §163(j)(7)(B)).
[817] Reg. §1.469-9(b)(2)(i)(A).
[818] Reg. §1.469-9(b)(2)(i)(A).
[819] Reg. §1.469-9(b)(2)(i)(B).
[820] Reg. §1.469-9(b)(2)(i)(A).
[821] Reg. §1.469-9(b)(2)(i)(D)(1).
[822] Reg. §1.469-9(b)(2)(i)(D)(2).
[823] Reg. §1.469-9(b)(2)(i)(A).
[824] Reg. §1.469-9(b)(2)(i)(C); Reg. §1.469-9(b)(2)(i)(E)(1).
[825] Reg. §1.469-9(b)(2)(i)(C). Reg. §1.469-9(b)(2)(i)(E)(2) specifies a list of factors that must be taken into account: (i) the manner in which the asset is affixed to land and whether such manner of affixation allows the asset to be easily removed from the land, (ii) whether the asset is designed to be removed or to remain in place indefinitely on the land, (iii) the damage that removal of the asset would cause to the asset itself or to the land to which it is affixed, (iv) any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the asset from the land upon the expiration of the lease), and (v) the time and expense required to move the asset from the land.
[826] Reg. §1.469-9(b)(2)(i)(C).
[827] Reg. §1.469-9(b)(2)(i)(C). *See* Reg. §1.469-9(b)(2)(iii)(D) *Ex.* 4.
[828] Reg. §1.469-9(b)(2)(i)(A).

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are harvested, severed, extracted, or removed from the land.[829] Accordingly, a real property trade or business does not include any trade or business that involves the cultivation and harvesting of plants, crops, or trees, or severing, extracting, or removing natural products or deposits from land.[830] Similarly, the storage of severed or extracted natural products and deposits in or upon real property is not a real property trade or business, even though such storage or maintenance otherwise may occur upon or within real property.[831]

Example: Taxpayer T owns farmland and uses the land in its farming business to grow and harvest crops. T uses a greenhouse that is an inherently permanent structure to grow certain crops during the winter. The trade or business of cultivation and harvesting of plants, crops, and trees is not a real property trade or business, even though the business occurs upon or within real property.[832]

Example: B is a retired farmer and owns farmland that B rents exclusively to C to operate a farm. The arrangement between B and C is a trade or business where payments by C are principally for C's use of B's real property. B also provides certain farm equipment for C's use. However, C is solely responsible for the maintenance and repair of the farm equipment along with any costs associated with operating the equipment. B also occasionally provides oral advice to C regarding various aspects of the farm operation, based on B's prior experience as a farmer. Other than the provision of this occasional advice, B does not provide any significant or extraordinary personal services to C in connection with the rental of the farmland to C. B leases farmland to C to operate a farm. C's payments to B are principally for C's use of the real property. B is engaged in a real property trade or business, but C is not. C is engaged in the business of farming.[833]

Property manufactured or produced for sale that is not real property in the hands of the manufacturer or producer, but that may be incorporated into real property through installation or any similar process or technique by any person after the manufacture or production of such property (for example, bricks, nails, paint, windowpanes), is not treated as real property in the hands of any person (including any person involved in the manufacture, production, sale, incorporation or installation of such property) before the completed incorporation or installation of such property into the real property.[834]

Note: real property for passive loss purposes does not include broadband, street lighting, telephone poles, parking meters, and rolling stock.[835]

Comment: Real property is defined in the regulations promulgated under many other Code provisions, such as former §48 (investment tax credit),[836] §263(a) (capitalization rules),[837] §263A(f) (interest capitalization),[838] §856 (REITs),[839] §897 (foreign persons subject to the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA),[840] §1031 (like-kind exchanges),[841] and §1250 (depreciation recapture).[842] To help maintain full employment for real estate tax advisers, real property is defined differently for each provision.

c. Real Property Development and Redevelopment

A real property trade or business includes real property development and real property redevelopment.[843] "Real property development" is defined as the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (that is, land covered by timber-producing forest).[844] Improvement of land may include any clearing (such as through the mechanical separation and removal of boulders, rocks, brush, brushwood, and underbrush from the land); excavation and gradation work; diversion or redirection of creeks, streams, rivers, or other sources or bodies of water; and the installation of roads (including highways, streets, roads, public sidewalks, and bridges), utility lines, sewer and drainage systems, and any other infrastructure that may be necessary for subdivision, further development, or construction of residential or commercial buildings, or for the establishment, cultivation, maintenance or improvement of timberlands.[845]

Timber businesses were initially not considered a real property trade or business, and Treasury and the IRS confirmed that timber businesses were not intended recipients for §469(c)(7)(C) relief and from the per se passive rule for rental real estate.[846] Nevertheless, timber businesses were added as a type of

[829] Reg. §1.469-9(b)(2)(i)(B).
[830] Reg. §1.469-9(b)(2)(i)(B).
[831] Reg. §1.469-9(b)(2)(i)(B).
[832] Reg. §1.469-9(b)(2)(iii)(A) *Ex.* 1.
[833] Reg. §1.469-9(b)(2)(iii)(B) *Ex.* 2.
[834] Reg. §1.469-9(b)(2)(i)(A).
[835] T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020) ("One commenter also requested that the definition of a real property trade or business be revised to include broadband, street lighting, telephone poles, parking meters, and rolling stock. The Treasury Department and the IRS decline to revise the definition of real property trade or business in section 469(c)(7)(C) in this manner because the maintenance and management of these types of assets generally do not meet the intended meaning of any of the eleven terms in section 469(c)(7)(C), and the owners of such assets were not intended recipients for relief from the per se passive rule for rental real estate when section 469(c)(7) originally was enacted.").
[836] Reg. §1.48-1(c), §1.48-1(d).
[837] Reg. §1.263(a)-3(b).
[838] Reg. §1.263A-8(c).
[839] Reg. §1.856-10.
[840] Reg. §1.897-1(b).
[841] Reg. §1.1031(a)-3.
[842] Reg. §1.1250-1(e)(3); Reg. §1.1245-3(c).
[843] §469(c)(7)(C) (incorporated by reference in §163(j)(7)(B)).
[844] Reg. §1.469-9(b)(2)(ii)(A), T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021).
[845] Reg. §1.469-9(b)(2)(ii)(A), T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021).
[846] Preamble to T.D. 9905, 85 Fed. Reg. 56,696, 56,745 (Sept. 14, 2020) ("The Treasury Department and the IRS have concluded that unharvested or unsevered timber clearly fall within the definition of "real property" as provided in the proposed regulations. The question is whether the activity of holding of timberlands falls within the definition of a "real property trade or business." The Treasury Department and the IRS have concluded that the maintenance and management of timberlands generally does not meet the intended meaning of any of the eleven terms in section 469(c)(7)(C), and that the owners of timberlands were not intended recipients for relief from the per se passive rule for rental real estate when section 469(c)(7) originally was enacted. However, as set forth in the Concurrent NPRM, such activities might constitute the development of real estate within the meaning of section 469(c)(7)(C).").

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real property development or redevelopment business in order to allow timber businesses to elect out of the §163(j) business interest deduction limitation as an electing real property trade or business.[847]

Note: An election out of §163(j) electing farm businesses and §163(j)(7)(B) electing real property trades or businesses. A §163(j)(7)(C) electing farm business is generally defined by reference to a farming business under §263A(e)(4), which specifically excludes timber businesses. For comparison, §448(d)(1) makes a cross reference to a §263A(e)(4) farm business and then adds a specific inclusion of timber businesses. Notwithstanding the clear Congressional intent to exclude timber businesses from §163(j)(7)(C) electing farm businesses, Treasury and the IRS decided to instead include timber businesses as §163(j)(7)(B) electing real property development or redevelopment trades or businesses.

Practice Point: The business of raising evergreen trees more than 6 years old at the time severed from the roots, which are known in some non-tax circles as Christmas trees or holiday trees, is also excluded from a farming business under §263A(e)(4). The same reasoning should allow such a tree farm to be a real property development or redevelopment trade or business.

d. Real Property Construction and Reconstruction

A real property trade or business includes a real property construction or reconstruction trade or business. Mere renovation of one's real property might not rise to the level of a trade or business of construction or reconstruction.[848] The preamble to the §163(j) final regulations noted that:[849]

> The Treasury Department and the IRS generally agree with the observation that real property construction, reconstruction, development, redevelopment, conversion, acquisition, or brokerage businesses should not necessarily be required to have a direct nexus or relationship to rental real estate in order to be treated as real property trades or businesses. However, the expectation nevertheless remains that the end products or final objectives of such businesses should at least have the potential to be used as rental real estate or as integral components in rental real estate activities.

In *Cantor v. Commissioner*,[850] the Tax Court discussed which glass installation activities of the taxpayer constituted a real property construction or reconstruction trade or business. The taxpayer owned a glass repair and installation business, which had both an automotive division and a residential division. Taxpayer argued that he was a real estate professional because the residential division of his business constituted a real property construction or reconstruction trade or business (and as a result, losses generated from other, separate, rental activities should not be per se passive). The Tax Court analyzed the statutory term "real property … construction, reconstruction" trade or business and reasoned that, since there is no authority defining construction and reconstruction, such words should be construed consistent with their ordinary meanings — "construction" means the "act or process of constructing," "constructing" means to "put together by assembling parts," "reconstruction" means the "act of reconstructing" and "reconstructing" means "to construct again." Because §469(c)(7) provides that the relevant activities are *real property* construction and reconstruction, the Tax Court assumed that installing original or replacement windows in newly built or existing buildings constitutes "construction" or "reconstruction" within the meaning of §469(c)(7), but cutting and installing mirrors and table tops, cutting and installing shower and bath glass enclosures, and replacing window panes do not count as construction or reconstruction. The Tax Court concluded that, although it appeared that the taxpayer spent more than 750 hours per year providing services in connection with the residential division, only a portion of those activities should be treated as real property construction or reconstruction activities. Because the taxpayer failed to keep records allocating time to such activities, he failed to show that he spent more than 750 hours per year providing services in a real property trade or business.

e. Real Property Brokerage

A real property trade or business includes real property brokerage.[851] *Agarwal v. Commissioner*[852] discussed whether a California licensed real estate agent qualified as a broker entitled to deduct losses on her rental properties. The Tax Court analyzed the common or ordinary meaning of the term "brokerage" in holding that the taxpayer qualified as a broker under §469(c)(7)(C) despite the fact that she was only a licensed real estate agent, and not a licensed real estate broker, in California during the tax years at issue and accordingly could not be engaged in a brokerage trade or business under California nontax law. The Tax Court held that the "business" of a real estate broker for §469(c)(7) purposes includes, but is not limited to: (1) selling, exchanging, purchasing, renting, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessors, or lessees. The court stated, "[c]onsistent with her real

[847] Preamble to REG-10791-18, 85 Fed. Reg. 56,846, 56,872 (Sept. 14, 2020) ("The Treasury Department and IRS have determined that real property development and redevelopment trades or businesses should be defined to include business activities that involve the preservation, maintenance, and improvement of forest-covered areas (timberland). Congress most likely intended and expected that such business activities would be excepted from section 163(j), through election, similar to other real property and farming businesses. However, because timber is specifically excluded from the definition of farming under other Code provisions (such as section 464(e)), the Treasury Department and IRS have determined that such business activities are more properly described by and should be included in the definition of real property trade or business for this purpose. These proposed regulations would clarify that "real property development" is the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (generally defined as parcels of land covered by forest). Similarly, these proposed regulations would clarify that "real property redevelopment" is the demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for the establishment and cultivation of new timberlands.").

[848] §469(c)(7)(C) (incorporated by reference in §163(j)(7)(B)); *see Estate of Lydia Ramirez v. Commissioner*, T.C. Memo 2018-196.

[849] T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020).

[850] T.C. Summ. Op. 2014-13.

[851] §469(c)(7)(C) (incorporated by reference in §163(j)(7)(B)).

[852] T.C. Summ. Op. 2009-29.

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estate salesman's license and pursuant to her contract with the brokerage firm, [the taxpayer] was engaged in 'brokerage'; i.e., she sold, exchanged, leased, or rented real property and solicited listings." Therefore, according to the Tax Court, the taxpayer was engaged in a real property brokerage trade or business within the meaning of §469(c)(7)(C).

In *Hickam v. Commissioner*,[853] the Tax Court held that the taxpayer, who brokered and originated mortgage loans for clients to buy real estate, did not qualify as a real estate professional on the basis of those activities. The Tax Court reasoned that the taxpayer was not in a real estate brokerage trade or business because he brokered loans and not real property. Additionally, he was not in the real property operation trade or business, even though the brokered mortgages were secured by real property, because his brokerage and loan origination services did not involve operating the real properties that secured those loans. The court cited CCA 201504010, in which the Chief Counsel's Office had similarly advised that a mortgage broker was a broker of financial instruments and was not in a real property brokerage trade or business.[854]

In CCA 201504010, the Chief Counsel's Office advised that Congress had initially included "finance operations" in the list of qualifying real property trades or businesses in an earlier, unenacted version of the real estate professional legislation. Since "finance operations" was removed from the final bill, it was reasonable to infer that Congress did not intend for financing activities to constitute a real property trade or business.[855]

Note: The same early legislation also had included "appraisal" in the list of qualifying real property trades or businesses,[856] which may raise the same reasonable inference that real estate appraisal activities cannot give rise to real estate professional status.

f. Real Property Operation and Management

A real property trade or business includes real property operation and real property management.[857] Real property operation and management means handling the day-to-day operations of a trade or business, relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for use, by customers, where payments received from customers are principally for the customers' use of the real property.[858] Real property operation is handled by the direct or indirect owner of the real property, whereas real property management is handled by a professional manager who is responsible, on a full-time basis, for the overall management and oversight of the real property.[859] In either case, the payments received from customers are principally for the customers' use of the real property.[860] In other words, the principal purpose of such business operations must be the provision of the use of the real property (or physical space accorded by or within the real property), to customer(s), and not the provision of other significant or extraordinary personal services (see III.B.2. and III.B.3., above) to customers in conjunction with incidental use of the real property or physical space.[861] If the real property or physical space is provided to a customer to carry on the customer's trade or business, the principal purpose of the business operations must be to provide the customers with exclusive use of the real property or physical space in furtherance of the customer's trade or business, and not to provide other significant or extraordinary personal services in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately.[862] However, incidental personal services may be provided to the customer, as long as the services are insubstantial in relation to the customer's use of the real property or physical space.[863]

> *Example:* A taxpayer owns a building in which the taxpayer operates a restaurant and bar. The taxpayer is not engaged in a trade or business where payments by customers are principally for the use of real property or physical space, so the taxpayer is not engaged in a real property trade or business. Instead, the customers are principally paying for significant or extraordinary personal services, mainly food and beverage preparation and presentation services.[864]

The TCJA legislative history indicates a congressional intent that "a real property operation or real property management trade or business includes the operation or management of a lodging facility,"[865] so that hotels, motels, and other lodging facilities are real property trades or businesses. Such a position is contrary to some pre-TCJA authorities that have held that hotels, motels, and other lodging facilities are not real property trades or businesses, at least under the real property rental trade or business category.[866] These pre-TCJA authorities should be considered superseded by the TCJA legislative history and the post-TCJA §469 regulations described in this section.[867]

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[853] T.C. Summ. Op. 2017-66.

[854] *See also Guarino v. Commissioner*, T.C. Summ. Op. 2016-12.

[855] *Cf. Hatcher v. Commissioner*, T.C. Memo 2016-188, *aff'd per curiam*, 726 Fed. App'x 207 (5th Cir. 2018) (taxpayer could not count any hours working for a real estate financing and loan origination business that had no clients in the relevant tax year and did not hire taxpayer as an employee until the next year).

[856] H.R. 3732, 101st Cong.2d Sess. (1989); S. 2384, 101st Cong. (1989–1990).

[857] §469(c)(7)(C) (incorporated by reference in §163(j)(7)(B)).

[858] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I), T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020). The regulations are generally applicable to tax years beginning on or after November 13, 2020. However, taxpayers and their related parties may choose to apply Reg. §1.469-9(b)(2) to tax years beginning after December 31, 2017, if they consistently apply the rules of Reg. §1.469-9(b)(2) and the other regulations under T.D. 9905 to those tax years. Reg. §1.469-11(a)(4).

[859] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I). A professional manager is a person responsible on a full-time basis for the overall management and oversight of the real property or properties, and who is not a direct or indirect owner of the real property or properties. Reg. §1.469-9(b)(2)(ii)(I).

[860] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I).

[861] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I).

[862] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I).

[863] Reg. §1.469-9(b)(2)(ii)(H), Reg. §1.469-9(b)(2)(ii)(I).

[864] Reg. §1.469-9(b)(2)(iii)(C) *Ex.* 3.

[865] H. Rep. 115-466, 115th Cong. 1st Sess., at 392 n.697 (2017).

[866] *See, e.g.*, *Bailey v. Commissioner*, T.C. Summ. Op. 2011-22; *Bailey v. Commissioner*, T.C. Memo 2001-296.

[867] *See* Reg. 1.469-11(a)(4) (Reg. §1.469-9(b)(2) generally applies to tax years beginning on or after November 13, 2020. However, taxpayers and their related parties may choose to apply Reg. §1.469-9(b)(2) to tax years beginning after December 31, 2017, if they consistently apply the rules of Reg. §1.469-9(b)(2) and the other regulations under T.D. 9905 to those tax years. Reg. §1.469-11(a)(4)).

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Example: A limited partnership owns and operates a luxury hotel. In addition to rooms, the hotel offers many additional amenities, such as in-room food and beverage service, maid and linen service, parking valet service, concierge service, front desk and bellhop service, dry cleaning and laundry service, and in-room barber and hairdresser service. Although the hotel provides significant personal services to its customers, the principal purpose of partnership's hotel business operations is to provide the use of hotel rooms to customers, not the provision of personal services to customers. Accordingly, the limited partnership is treated as engaged in a real property trade or business, and its partners are treated as owning an interest in a real property trade or business.[868] However, the hotel's contractor that provides maid and janitorial services to the hotel is not engaged in a real property trade or business, nor is the contractor's manager who handles the day-to-day operations of the hotel's maid and janitorial services.[869]

Practice Point: The proposed regulation had provided that both the limited partnership and its limited partner are treated as engaged in a real property trade or business in the example,[870] but the final regulations change the conclusion to provide that only the limited partnership is engaged in a real property trade or business.[871] The change primarily affects which person may elect to be a §163(j)(7)(B) electing real property trade or business.

Example: A taxpayer owns an apartment that is rented out to third parties on Airbnb, Vrbo, HomeAway, or a similar platform, which may be considered the operation or management of a lodging facility that is a real property operation or real property management trade or business. If the taxpayer spends more than 750 hours per tax year on the Airbnb activity, and less than 750 hours on personal services in other trades and businesses during the tax year, the taxpayer may qualify as a real estate professional due to the Airbnb activity. If those conditions are met, the Airbnb activity is likely a trade or business activity instead of a rental activity,[872] which would already result in nonpassive income or nonpassive loss due to the taxpayer's material participation in the Airbnb activity. But the taxpayer's real estate professional status can result in nonpassive income or nonpassive loss from the taxpayer's other rental activities (rented out for longer periods) in which the taxpayer materially participates.

In *DeGuzman v. United States*,[873] a district court held that the taxpayer was not a real estate professional because a number of hours he had counted toward meeting the 750 hours test were not in a real property operation or management trade or business. The taxpayer and his wife owned numerous rental real estate properties, and also leased office space in a property in Newark in which the wife maintained her medical practice. The taxpayer could only satisfy the 750 hours test for a real estate professional if the hours he spent cleaning the office interior, shoveling snow and investigating and testifying in court about office burglaries were taken into account. The court stated that the only types of real property trade or business activities that could be relevant to the activities described above were the "operation" and/or "management" of real property. The court noted, however, that in order to be a "trade or business," the taxpayer's primary purpose for engaging in the activity must be for income or profit. The court found that the taxpayer performed the activities described gratuitously out of a desire to aid his wife. Therefore, the court concluded that these activities were not entered into for income or profit and were not a "trade or business." As a result, the taxpayers could not be treated as being part of a real property *trade or business* of operating and/or managing real property. Therefore, the court concluded that the taxpayer fell short of the 750 hours test and was not a real estate professional.

In the landmark case of *Stanley v. United States*,[874] the District Court of Arkansas held that an in-house lawyer at a real estate management company can be engaged in a real property trade or business. His time spent on providing legal services may count toward his 750 hours test for real estate professional status.

Comment: Query whether a real estate lawyer or a real estate tax lawyer in private practice can be engaged in a real property trade or business.[875]

Note: Rev. Proc. 2021-9 provides a safe harbor allowing a trade or business that manages or operates a "qualified residential living facility" such as a nursing home or an assisted living facility to be treated as a real property trade or business, solely for purposes of qualifying as an electing real property trade or business under §163(j)(7)(B).[876] Because the safe harbor applies solely for purposes of qualifying as an electing real property trade or business under §163(j)(7)(B), satisfying the

[868] Reg. §1.469-9(b)(2)(iii)(E) *Ex.* 5.
[869] Reg. §1.469-9(b)(2)(iii)(E) *Ex.* 5.
[870] Former Prop. Reg. §1.469-9(b)(2)(iii)(E) *Ex.* 5.
[871] Reg. §1.469-9(b)(2)(iii)(E) *Ex.* 5.
[872] See III.B., above.
[873] 147 F. Supp. 2d 274 (D.N.J. 2001).

[874] 2015 BL 372985 (W.D. Ark. Nov. 12, 2015), *nonacq. on other grounds*, 2017-42 I.R.B. 311 (IRS nonacquiescence relating to a required 5% ownership in the employer and the taxpayer's elections).

[875] In *Langille v. Commissioner*, T.C. Memo 2010-49, the Tax Court denied real estate professional status to a lawyer who also owned rental real estate, stating that "The record reflects that Ms. Langille worked long hours in her law office, and there is no evidence that she worked most of those hours on real estate rental activities and not on legal matters." On appeal, in *Langille v. Commissioner*, 447 Fed. App'x 130 (11th Cir. 2011), the Eleventh Circuit stated that §469(c)(7)(C)'s "definition of 'real property trades or businesses' is explicit and does not include the practice of law." *See also Bailey v. Commissioner*, T.C. Memo 2001-296, and *Ajah v. Commissioner*, T.C. Summ. Op. 2010-90.

[876] A "qualified residential living facility" is a facility that: (1) consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semipermanent basis to individual customers or patients; (2) includes the provision of supplemental assistive, nursing, or other routine medical services; and (3) has an average period of customer or patient use of the individual rental dwelling units that is 30 days or more. The trade or business that manages or operates the qualified residential living facility would be required to retain books and records to substantiate that the safe harbor requirements have been met. The revenue procedure applies to tax years beginning after December 31, 2017. Before Rev. Proc. 2021-9 was published in the Internal Revenue Bulletin, taxpayers were permitted to rely on the proposed safe harbor provided in Notice 2020-59 in determining whether a qualified residential living facility was eligible to be an electing real property trade or business solely for purposes of §163(j).

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requirements of the safe harbor is *not* a determination that the taxpayer is engaged in a real property trade or business under §469. The stingy scope of the safe harbor in Rev. Proc. 2021-9 seems questionable when the same definitions are used in §469 and §163(j)(7)(B).

g. Spouses

Two spouses cannot combine their hours for purposes of satisfying either the 50% test or the 750 hours test.[877] In contrast, for purposes of determining in which trades or businesses the taxpayer materially participated, both spouses' efforts count together, regardless of whether the spouses file a separate return or a joint return, or whether the spouse owns an interest in the trade or business.[878] In other words, the taxpayer can use his spouse's participation in determining whether the taxpayer "materially participated" in the real property activity, but he cannot use his spouse's participation in adding up the hours spent on that activity to meet the 50% test and the 750 hours test.

> *Example:* A taxpayer's spouse spends 550 hours in a rental activity, for which the spouse and the taxpayer are both considered to materially participate. The taxpayer spends 300 hours on the rental activity. Although both spouses materially participated in the rental activity and spent a combined 850 hours, neither spouse met the 750 hours test and neither one is a real estate professional.

In the case of spouses filing a joint return, if either spouse independently satisfies both the 50% test and the 750 hours test to qualify as a real estate professional, then all rental real estate activities of both spouses can qualify as nonpassive under the material participation tests.[879]

> *Example:* A taxpayer spends 800 hours as a real estate broker and no hours on other personal services. The taxpayer materially participates in the real property brokerage trade or business under the substantially all participation test. The taxpayer's spouse owns rental real property for which she materially participates under the 5-of-10-years test. The taxpayer qualifies as a real estate professional based solely on his hours. The rental real property of the taxpayer's spouse qualifies for the real estate professional exception and is not a passive activity.

Practice Point: If the spouses file separate returns, one spouse's status as a real estate professional does not automatically allow the other spouse's rental real estate activities to qualify as nonpassive under the material participation tests.[880] However, the real estate professional spouse can still use the other spouse's hours for purposes of the material participation tests.[881]

2. Grouping Activities vs. Real Estate Aggregation Election

a. Grouping Activities

An individual will qualify as a real estate professional only if: (1) of the personal services that the taxpayer performs in trades or businesses during the tax year, more than half are performed in real property trades or businesses in which the taxpayer materially participates, and (2) during the tax year the taxpayer performs more than 750 hours of services in real property trades or businesses in which he materially participates.[882]

Therefore, in order to determine whether a taxpayer is a real estate professional, the taxpayer must first determine what are his "real property trade or businesses" in order to determine whether the two qualification tests above are satisfied with respect to such real property trades or businesses. A taxpayer's grouping of its activities has no effect on the determination of a real property trade or business.[883] Once a taxpayer has determined that he is a real estate professional, his rental activities are not treated as per se passive, and he can thus show material participation in those activities.[884] An "aggregation" election may be made to treat all interests in rental real estate as a single rental real estate activity,[885] which may allow the taxpayer to show material participation when otherwise he would be unable to do so, as discussed more fully below.

The determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances.[886] A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services.[887]

In CCA 201427016, the Chief Counsel's Office gave the example of an individual taxpayer that owned two interests in rental real estate, Property 1 and Property 2, and also owned a real property development trade or business. The taxpayer performed more than 750 total hours of personal services on Property 1, Property 2 and the real property development trade or business, and did not provide personal services in any other trade or businesses.

The Chief Counsel's Office advised in CCA 201427016 that the taxpayer must first determine, based on all the relevant facts and circumstances, whether or not his interest in Property 1, Property 2 and the real property development trade or business should be grouped together as the "real property trades or businesses" in which the taxpayer provided personal services. As the taxpayer reasonably determined that they should be so grouped, the taxpayer qualified as a real estate professional, because he materially participated in such real property trades or businesses (by spending more than 500 hours on the trade or business), and he satisfied both prongs of the real estate professional qualification test — 750 total hours of personal services performed, which was greater than the hours of personal ser-

[877] §469(c)(7)(B); Reg. §1.469-9(c)(4); *see Oderio v. Commissioner*, T.C. Memo 2014-39; *Adeyemo v. Commissioner*, T.C. Memo 2014-1.
[878] §469(h)(5); Reg. §1.469-5T(f)(3).
[879] Reg. §1.469-9(c)(4).
[880] *See Oderio v. Commissioner*, T.C. Memo 2014-39.
[881] §469(h)(5); Reg. §1.469-5T(f)(3).
[882] §469(c)(7)(B).
[883] Reg. §1.469-9(d)(1).
[884] §469(c)(7)(A).
[885] §469(c)(7)(A); Reg. §1.469-9(g).
[886] Reg. §1.469-9(d)(1).
[887] Reg. §1.469-9(d)(1).

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vices performed on non-real-property trades or businesses (or real property trades or businesses in which he did not materially participate).

Moreover, because the taxpayer was a real estate professional, taxpayer's interest in Property 1 and Property 2 was not treated as per se passive rental activities. Rather, the rental activities were treated as nonpassive if, and only if, the taxpayer materially participated in the rental activities.[888] This determination was made on an activity-by-activity basis (that is, material participation was analyzed separately with respect to Property 1 and Property 2), unless the taxpayer made the aggregation election, discussed below, to aggregate the Property 1 and Property 2 rental activities.[889]

For example, assume the taxpayer was the only person who spent any hours on Property 1 and spent no hours on Property 2, which was managed by a management company. Without an aggregation election, the taxpayer materially participated with respect to Property 1 (under the substantially all participation test) and not with respect to Property 2. Property 1 is a nonpassive activity, while Property 2 is a passive activity.

b. Aggregation Election

A real estate professional's interests in rental real estate are treated as separate activities for determining whether the taxpayer materially participates in each such activity, unless the taxpayer elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity.[890] Such an election is commonly known as an "aggregation election."

The effect of the aggregation election is to treat all of the real estate professional's rental estate activities as a single activity for all passive loss purposes, including the full unrelated taxable disposition rule.[891] In addition, passive loss carryovers from any of the rental real estate interests can offset current net income from the aggregated activity, regardless of which rental real estate interests within the aggregated activity produced the income or passive loss carryovers.[892] The passive loss carryovers may have arisen before the aggregation election is made.

> *Example:* Taxpayer T is a real estate professional who owns three buildings. In Year 1, T has $30,000 of disallowed passive losses from building X and $10,000 of disallowed passive losses from building Y. In Year 2, T has $5,000 of net income from building X, $5,000 of net losses from building Y, and $10,000 of net income from building Z. T makes the aggregation election in Year 2, when he participates in the operations of the three buildings for more than 500 hours and thus materially participates in the aggregated activity, which is a nonpassive activity. The total $40,000 of Year 1 passive loss carryovers are allocated to the aggregated activity, which can entirely offset the aggregated activity's $10,000 of net income in Year 2.[893]

The aggregation also applies to the rental real estate activities of the real estate professional's spouse who is filing a joint return, with the result that all rental real estate activities of both spouses are treated as a single activity.[894] Material participation for the single activity is determined by taking into account the participation of both spouses.[895] In contrast, if the two spouses file separate returns, the aggregation election does not apply to the spouse's rental real estate activities, even though material participation in each activity is still determined by taking into account the participation of both spouses.[896]

The aggregation election, once made, applies to all years in which the taxpayer is a real estate professional, even if there are intervening years in which the taxpayer is not a real estate professional.[897] In the years in which the taxpayer is not a real estate professional, the aggregation election has no effect, and the taxpayer's activities are determined under the general grouping rules.[898]

The aggregation election can be made in any year that a taxpayer is a real estate professional, and the failure to make the aggregation election in one year does not prevent the taxpayer from making the aggregation election in a later year when the taxpayer has real estate professional status. The aggregation election is irrevocable, unless there is a material change in the taxpayer's facts and circumstances that supports such revocation.[899] The regulations state that neither the fact that the election has become less advantageous to the taxpayer in a subsequent tax year, nor the fact that there has been a break in the taxpayer's status as a qualifying taxpayer, is "of itself" a material change in the taxpayer's facts and circumstances.[900] Such facts may help to support a claim of material change in conjunction with additional facts. Where there has been a material change permitting the revocation of the election, a statement must be filed with the taxpayer's original income tax return for the year of revocation, explaining the intent to revoke the election and the nature of the material change that makes revocation permissible.[901]

Practice Point: Although the aggregation election is generally irrevocable and needs to be made only once, a taxpayer may find it advantageous to make the aggregation election with each succeeding tax return, just in case the initial aggregation

[888] *See, e.g., Shiekh v. Commissioner*, T.C. Memo 2010-126 (real estate professional did not materially participate in the rental real estate activities).

[889] CCA 201427016 cites approvingly *Trask v. Commissioner*, T.C. Memo 2010-78, as correctly recognizing that the aggregation election does not affect whether or not the taxpayer qualifies as a real estate professional, and it cites two cases, *Jafarpour v. Commissioner*, T.C. Memo 2012-165, and *Hassanipour v. Commissioner*, T.C. Memo 2013-88, as improperly conflating the two issues and suggesting that the aggregation election applies to the determination of real estate professional status. *See also Windham v. Commissioner*, T.C. Memo 2017-68 and *Balocco v. Commissioner*, T.C. Memo 2018-108, where the courts appear to conflate the two issues. *See* Reg. §1.469-9(e)(4) *Ex.*

[890] §469(c)(7)(A).

[891] §469(g)(1), discussed at V.H., below. *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995) ("The statutory language and the legislative history do not support a rule allowing a qualifying taxpayer to treat all interests in rental real estate as a single activity for purposes of material participation and section 469(f), but as separate activities for purposes of section 469(g).").

[892] *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995).

[893] Reg. §1.469-9(e)(4) *Ex.*

[894] Reg. §1.469-1T(j)(1).

[895] Reg. §1.469-1T(j)(4).

[896] *See* Reg. §1.469-1T(j)(1), §1.469-1T(j)(4).

[897] Reg. §1.469-9(g)(1).

[898] Reg. §1.469-9(g)(1).

[899] Reg. §1.469-9(g)(1).

[900] Reg. §1.469-9(g)(2).

[901] Reg. §1.469-9(g)(3).

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election is invalid (e.g., the taxpayer failed to be a real estate professional for that year) or the taxpayer cannot find a copy of the first tax return that contained the initial aggregation election.

The regulations provide that the taxpayer may make an election to aggregate its rental real estate interests by filing a statement with the taxpayer's original income tax return for the tax year.[902] However, Rev. Proc. 2011-34 instructs taxpayers seeking to make a late election to aggregate their rental real estate interests to file an amended return for the most recent tax year.[903] Generally, the amended return must be mailed to the IRS service center where the taxpayer will file its current tax year's income tax return.[904] In addition to the declaration required by Reg. §1.469-9(g)(3), the taxpayer's statement must, among other things, represent that the taxpayer has filed all required and relevant returns (i.e., any return which would have been affected had the taxpayer timely elected aggregation) consistent with having made an aggregation election. A return is deemed to be timely filed as long as it is filed within 6 months after its unextended due date, even if the taxpayer did not obtain an extension. The taxpayer must also state that it has not filed any tax returns containing positions inconsistent with the requested aggregation for any of the relevant tax years. Finally, the statement must also set forth reasonable cause for the taxpayer's failure to file a timely election.[905] Taxpayers also cannot make the aggregation election on a Form 3115.[906]

The statement to make the aggregation election must contain a declaration that the taxpayer is a qualifying taxpayer (a real estate professional) for the tax year and is making the single-activity election pursuant to §469(c)(7)(A).[907] Merely reporting the taxpayer's items of income and deduction consistently with the aggregation election is not enough, since it fails to "clearly notify" the Commissioner of the election that is being made.[908]

Interests in rental real estate are distinguished from nonrental interests under the general rules for identifying rental activities.[909] Rental real estate interests generally cannot be grouped with the real estate professional's nonrental interests, such as development or construction activities.[910] Furthermore, a real estate professional may participate in a rental real estate activity through participation in a management activity for the taxpayer's own rental real estate interests, even if the management activity is conducted through a separate entity, but the real estate professional cannot count toward his rental real estate activity any of his management of rental real estate interests in which the real estate professional does not own an interest.[911]

Given the required segregation of interests in rental real estate and other interests in real property, real estate professional status does not afford relief to real estate professionals whose involvement in rental real estate, as distinct from real property generally, falls short of material participation.[912] For example, a full-time real estate broker might not be materially participating in his rental real estate activities.[913]

Rental real estate activities do not include any rental real estate that is appropriately grouped with a trade or business activity, either because the rental real estate is insubstantial relative to the trade or business activity (and part of the same appropriate economic unit), or the rental real estate activity involves renting property to the trade or business activity and is owned by the same interests in the same proportion. However, the aggregation election covers interests in rental real estate which the taxpayer has appropriately grouped with a trade or business activity on the ground that the trade or business activity is relatively insubstantial.[914]

Rental real estate activities also do not include the various exceptions to rental activities, as discussed at III.B.1. through

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[902] Reg. §1.469-9(g)(3). An extension of time to make this aggregation election may be granted under Reg. §301.9100-3. *See, e.g.,* PLR 199924012, PLR 200009040, PLR 200044025, PLR 200303052, PLR 200534003, PLR 200606017, PLR 200606016, PLR 200728016, PLR 201126026, PLR 201725003, and PLR 201804007. However, Rev. Proc. 2011-34 indicates that the IRS will not ordinarily issue a PLR about the aggregation election if the statute of limitations has lapsed for any tax year that would be affected by the requested late aggregation election.

[903] Rev. Proc. 2011-34, §4.02. While Rev. Proc. 2011-34 instructs taxpayers to file an amended return for the most recent tax year, there is no indication that the most recent tax year is the only tax year for which the late aggregation election could be made.

[904] Rev. Proc. 2011-34, §4.02. However, the Chief Counsel's Office advised in CCA 201321021 that if Appeals has the authority to accept amended returns from the taxpayer, the amended return may be mailed to Appeals for purposes of Rev. Proc. 2011-34.

[905] Rev. Proc. 2011-34, §4.01.

[906] IRS Info. Letter 2013-0022.

[907] Reg. §1.469-9(g)(3). *See Windham v. Commissioner*, T.C. Memo 2017-68 (taxpayer may not group rental real estate activities where she did not file aggregation election and Rev. Proc. 2010-13, which provided an exception to the requirement, did not apply to her because it was not effective for the tax year at issue). *See* Bloomberg Tax Elections & Compliance Statements, Gains and Losses, *Real Estate Professional: Election to Treat Interests in Rental Real Estate as a Single Activity (§469(c)(7)(A))*, for a sample election under §469(c)(7).

[908] *See, e.g., Shiekh v. Commissioner*, T.C. Memo 2010-126; *Kosonen v. Commissioner*, T.C. Memo 2000-107 (despite reporting real estate activities on Form 1040, *Schedule E*, as if the aggregation election had been made, in the absence of a clear statement to that effect, taxpayer did not properly elect aggregation of rental real estate interests); *McNally v. Commissioner*, T.C. Memo 2017-93; FSA 199907011 (taxpayer who did not attach an election statement to the original tax return failed to make a proper aggregation election; and, not having sought administrative relief under Reg. §301.9100-3, the taxpayer was not entitled to seek judicial relief).

[909] *See* Reg. §1.469-9(b)(3) (cross-reference to Reg. §1.469-1T(e)(3)).

[910] Reg. §1.469-9(e)(3)(i). *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995) ("Several comments suggested that the rule in the proposed regulations prohibiting the grouping of rental real estate activities with other activities be modified to allow qualifying taxpayers to group the activities of development or construction of rental real estate with rental real estate activities. The final regulations do not adopt this modification because in most cases development and construction activities are separate and distinct from rental activities. In addition, this modification would introduce significant administrative difficulties in determining which development activities or construction activities qualify.").

[911] Reg. §1.469-9(e)(3)(ii). *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995) ("The final regulations clarify that a qualifying taxpayer may participate in a rental real estate activity through participation in a management activity. In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate. The final regulations also clarify that a qualifying taxpayer who owns rental real estate through an entity, including a C corporation that is subject to section 469, may count work performed by the taxpayer in managing the rental real estate of the entity in establishing material participation in the taxpayer's rental real estate activities.").

[912] Reg. §1.469-9(e)(1).

[913] *See Gragg v. United States*, 831 F.3d 1189 (9th Cir. 2016), *aff'g* 2014 BL 89974 (N.D. Cal. Mar. 31, 2014).

[914] *See* Reg. §1.469-9(b)(3) (cross-reference to Reg. §1.469-4(d)(1)(i)(A) and §1.469-4(d)(1)(i)(C)).

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III.B.6., above. Normally a taxpayer would prefer to be subject to one of the various exceptions in order to avoid the per se passive rule for rental real estate activities, but the taxpayer position may be reversed in some cases. For instance, in *Eger v. United States*,[915] the taxpayers qualified as real estate professionals, made the aggregation election, and materially participated in their aggregated rental real estate activity. However, the IRS successfully treated some of their resort properties as not rental activities, because the average period of customer use was seven days or less.[916] The taxpayers did not materially participate separately in the resort property activities, which were therefore passive activities that generated passive losses.

Practice Point: In many cases the aggregation election would be beneficial to the taxpayer, by making it easier to materially participate in a rental real estate activity that generates net losses. If the aggregation election has no effect on material participation, such as because the taxpayer does not materially participate even in the combined rental real estate activity, the election should not be made in order to preserve optionality for future tax years. In addition, the aggregation election should not be made if the taxpayer has income from one or more rental real estate activities in which he does not materially participate and which income he would like to keep as passive income.

> *Example:* Taxpayer T is a real estate general contractor and real estate professional who owns two rental properties. T spends 300 hours on property A, which generates $50 of net loss, and 250 hours on property B, which generates $150 of net income. Assuming that the only relevant material participation test is the 500 hours test, T has $100 of net passive income if he does not make the aggregation election. If T makes the aggregation election, he materially participates in the combined activity and has $100 of net nonpassive income.

Practice Point: The aggregation election treats all rental real estate activities as a single rental real estate activity and therefore can make it more difficult to qualify for the full unrelated taxable disposition rule,[917] which requires the disposition of the taxpayer's entire interest in the activity. The aggregation election has no effect in a year in which the taxpayer is not a real estate professional, even if the taxpayer had previously been a real estate professional subject to the aggregation election.[918] If feasible, a taxpayer may deliberately fail to qualify as a real estate professional in the tax year of a property's disposition, in order to avoid the application of the aggregation election to combine multiple rental real estate activities as one rental real estate activity. Alternatively, if one spouse is a real estate professional and has made the aggregation election, but the other spouse is not a real estate professional, the two spouses may file separate tax returns in order to avoid the application of the aggregation election to the real estate activities of the spouse who is not a real estate professional.[919]

3. Application of Former Passive Activities Rules

When a passive activity with passive loss or passive credit carryovers becomes a nonpassive activity, such as if the taxpayer begins to materially participate in the activity, the passive loss or passive credit carryovers are allowed against subsequent nonpassive income from the former passive activity.[920] The 1986 Senate Report noted that the passive loss carryovers should be allowed against the same activity's nonpassive income because:

> the taxpayer could have deducted the suspended losses against income from the activity had the change in his relation to the activity not occurred… It would be inequitable to give less favorable treatment to a taxpayer whose income from an activity becomes active (i.e., not passive) than to one who continues to be merely a passive investor.[921]

The regulations confirm that a rental real estate activity that qualifies as nonpassive due to §469(c)(7) may take advantage of the former passive activity rules to the extent that the rental real estate activity has passive loss or passive credit carryover from prior tax years.[922]

> *Example:* The taxpayer T owns interests in three rental buildings. T has a $30,000 passive loss carryover from building 1 and a $10,000 passive loss carryover from building 2. In the following tax year, T is a real estate professional and makes the aggregation election to treat all three buildings as one activity. The $40,000 of disallowed passive losses are allocated to the entire activity. Because the three buildings are treated as one activity for all passive loss purposes due to the aggregation, and this activity is a former passive activity under §469(f), T may offset the net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses.[923]

4. Limited Partners and Other Partnership Issues

Under the general rule, a real estate professional's interests in rental real property held through a partnership or S corporation (a "pass-through entity") constitutes a single interest in rental real estate if the pass-through entity grouped its rental real estate as a single activity for purposes of the passive loss rules. If the entity grouped its rental real estate into separate rental activities for passive loss purposes, then each activity constitutes a separate interest in rental real estate with respect to the taxpayer.[924]

The exception to the above rule applies in the case of a real estate professional who owns "directly or indirectly, a 50%

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[915] 405 F. Supp. 3d 850 (N.D. Cal. 2019), *aff'd on other grounds in unpub. opin.*, 818 Fed. App'x. 751 (9th Cir., 2020).

[916] *See* III.B.1., above.

[917] §469(g)(1), discussed at V.H., below. *See* T.D. 8645, 60 Fed. Reg. 66,496, 66,497 (Dec. 22, 1995) ("The statutory language and the legislative history do not support a rule allowing a qualifying taxpayer to treat all interests in rental real estate as a single activity for purposes of material participation and section 469(f), but as separate activities for purposes of section 469(g).").

[918] Reg. §1.469-9(g)(1).

[919] *See* Reg. §1.469-1T(j)(1).

[920] *See* §469(f)(1), discussed at V.G.1., below.

[921] 1986 Senate Report at 727 n.15. *See also* 1986 Blue Book at 230 n.23.

[922] Reg. §1.469-9(e)(2).

[923] Reg. §1.469-9(e)(4) *Ex.*

[924] Reg. §1.469-9(h)(1).

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or greater interest in the capital, profits, or losses of a pass-through entity for a tax year."[925] In that case, each interest in rental real estate held by a pass-through entity will be treated as a separate interest in rental real estate of the real estate professional, regardless of the pass-through entity's grouping of activities.[926]

Under both the general rule and the exception, the real estate professional partner or shareholder may make the aggregation election to treat all such interests as a single real estate activity.[927]

Section 469(c)(7)(A) provides that the aggregation election provisions shall not be construed as affecting the determination of whether a real estate professional materially participates with respect to any interest in a limited partnership as a limited partner.

The regulations contain an additional special rule for a real estate professional who makes an aggregation election, and at least one of the real estate professional's interests in rental real estate is a limited partnership interest (as defined and discussed at IV.A.8., above).[928] In this case, the aggregated rental estate activity will be treated as a limited partnership interest and accordingly, the real estate professional may use only the three material participation tests applicable to limited partnerships (the 500 hours, the 5-of-10-years test, or three years of a personal service activity, of which the latter is unlikely to apply to a rental real estate activity) in determining material participation.[929] In effect, a taxpayer who has even a single limited partnership interest that owns rental real estate, and makes the aggregation election, is prohibited from using the other material participation tests. However, this harsh rule is mitigated if the real estate professional's share of gross rental income from all limited partnership interests is less than 10% of the real estate professional's share of gross rental income from all of his interests in rental real estate for the tax year, in which case the real estate professional may use any of the material participation tests for the aggregated activity.[930]

C. Net Income (But Not Net Loss) from Certain Activities Treated as Nonpassive

The regulations provide for six specific situations where the net income or gain, but not the net loss, from a passive activity (or a portion thereof) is recharacterized as nonpassive income or gain.[931] The net loss from the passive activity is still a passive loss. The regulations are promulgated under §469(l)(3), which authorizes regulations requiring net income or gain from a passive activity to be treated as not from a passive activity. The regulations' preamble noted that:

> [i]n the absence of regulations, taxpayers would be encouraged to generate passive activity gross income by (a) changing their participation in, and the ownership structure of, their active businesses, and (b) replacing their portfolio investments with investments in rental or passive business activities that share many of the investment characteristics of traditional portfolio investments. Although attempts to derive capital income from rental or passive business sources are not generally abusive, they could, if undeterred, frustrate Congress's intent that the passive loss provision prevent "the sheltering of positive income sources."[932]

> *Example:* An activity subject to a recharacterization produces gross income of $50 and deductions of $80. The net loss of $30 is a passive loss. But if the activity produces gross income of $100 and deductions of $80, the $20 net income is nonpassive income. The activity has the worst of both worlds, as a net loss is limited under the passive loss rules but a net income or gain cannot be sheltered by losses from other passive activities.

If the activity has passive loss carryovers, the carryovers may offset the (nonpassive) income of the activity.[933]

The six recharacterization rules are:

1. Significant participation rule, which applies to trade or business activities in which the taxpayer generally spends more than 100 hours during the tax year but does not materially participate,[934]

2. Nondepreciable property rule, which applies to a rental activity in which less than 30% of the unadjusted basis of the activity's property is depreciable,[935]

3. Equity-financed lending rule, which applies to a lending trade or business activity that is generally funded 20% or more by equity,[936]

4. Incidental-to-development rule, which applies when the use of property in a rental activity is incidental to a development activity,[937]

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[925] Reg. §1.469-9(h)(2). Reg. §1.469-9(h)(3) also contains a rule for interests held in tiered pass-through entities. If a pass-through entity owns a 50% or greater interest in the capital, profits or losses of another pass-through entity for a tax year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier's grouping of activities under Reg. §1.469-4(d)(5).

[926] Reg. §1.469-9(h)(2).

[927] Reg. §1.469-9(h)(1), §1.469-9(h)(2).

[928] *See* Reg. §1.469-5T(e)(2).

[929] Reg. §1.469-9(f)(1).

[930] Reg. §1.469-9(f)(2).

[931] Reg. §1.469-2T(f). The significant participation rule applies to tax years beginning in 1987 and later. Reg. §1.469-11(a)(2), §1.469-11(a)(1). The other five recharacterization rules apply to tax years beginning in 1988 and later. Reg. §1.469-11(c)(1)(i). The self-rental rule does not apply to any rental to a nonpassive activity pursuant to a written binding contract entered into before February 19, 1988. Reg. §1.469-11(c)(1)(ii).

[932] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5693 (Feb. 25, 1988).

[933] See T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5695 (Feb. 25, 1988) ("if a taxpayer's loss from an activity or an item of property is disallowed for a tax year, the taxpayer's net passive income from the activity or property for the succeeding year is reduced by the amount of such disallowed loss. As a result, the regulations do not treat income from an activity or an item of property as nonpassive income while, at the same time, prohibiting the deduction of previously disallowed losses from such activity or property.").

[934] Reg. §1.469-2T(f)(2).

[935] Reg. §1.469-2T(f)(3).

[936] Reg. §1.469-2T(f)(4).

[937] Reg. §1.469-2T(f)(5).

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5. Self-rental rule, which applies to property rented to a lessee for use in a trade or business in which the lessor materially participates,[938] and

6. Pass-through entity royalty rule, which applies to a pass-through entity, engaged in licensing intangible property, in which the taxpayer acquires an interest after the entity has incurred certain expenses.[939]

Net income or gain under the nondepreciable property rule, the equity-financed lending rule, and the pass-through entity royalty rule is further treated as portfolio income,[940] which increases the amount of investment interest deductible under §163(d). The other recharacterization rules (the significant participation rule, the incidental-to-development rule, and the self-rental rule) recharacterize net income or gain from passive to nonpassive income or gain.[941]

Practice Point: The recharacterization rules apply without regard to any credits arising from the activities. The passive credits with respect to the activity remains as passive credits, which cannot offset the income tax liability on the nonpassive income.[942]

> *Example:* The taxpayer's only passive activity is subject to a recharacterization rule that yields $10,000 of net income, along with credits in the amount of $3,000. The net income is treated as nonpassive, and the credits are suspended as passive credits. Now assume that the taxpayer owns an interest in a second passive activity that is not subject to a recharacterization rule, and that yields net income in the amount of $10,000. The credits from the first passive activity are allowed against this passive income.

Practice Point: The significant participation rule, the nondepreciable property rule, and the equity-financed lending rule apply on an activity-by-activity basis. The other recharacterization rules (the incidental-to-development rule, self-rental rule, and pass-through entity royalty rule) apply on a property-by-property basis, and they take precedence over the activity-by-activity rules.[943] Among the property-by-property rules, the incidental-to-development rule takes precedence over the self-rental rule and the pass-through entity royalty rule.[944] Among the activity-by-activity rules, only one rule can apply at a time,[945] but their priority is unclear, even though the significant participation rule generates nonpassive income while the nondepreciable property rule and the equity-financed lending rule generate portfolio income.

Practice Point: There is no recharacterization rule for a taxpayer who owns a preferred equity interest in a partnership engaged in a partnership activity. The regulations' preamble noted that:

> [d]uring the preparation of these regulations, the Service considered an approach to recharacterizing certain passive activity gross income that is illustrative of the kinds of additional regulations the Service may prescribe in the future. Under this approach, gross income attributable to a preferred or guaranteed return from an investment (i.e., a return that through preferences or other arrangements is derived from sources other than the taxpayer's own invested capital) would be treated as portfolio income. … the Service continues to study this approach and invites comment on the circumstances in which a "preferred" or "guaranteed" return should be treated as portfolio income.[946]

1. Significant Participation Rule

The first recharacterization rule is for significant participation passive activities (SIPPAs).[947] A SIPPA is a significant participation activity (SPA) in which the taxpayer is not materially participating under the 500-hour aggregate test for SPAs (Test Four).[948] A SPA is a trade or business activity, other than a rental activity, in which the taxpayer participates for more than 100 hours but does not materially participate (disregarding the aggregate 500-hour test for SPAs).[949] For many taxpayers, any activity in which the taxpayer participates between 100 and 500 hours may be a SIPPA.

Note: The effective result of the SIPPA rule is that a taxpayer has nonpassive income or passive loss from a trade or business activity in which the taxpayer spends more than 100 hours but does not materially participate. The SIPPA rule is sometimes called the "heads Treasury wins, tails taxpayer loses" rule.[950]

> *Example:* Taxpayer is an associate at a law firm from Years One through Ten and becomes a partner beginning in Year Eleven. Taxpayer leaves the law firm on Year Twelve. Since the taxpayer only worked for the partnership for two months during that partnership tax year (January and February Year Twelve), the taxpayer did not materially participate in the partnership's activity during that partnership tax year under the 500 hours test (Test One). The taxpayer did not materially participate under the three years test (Test Six) or the five-of-ten years test (Test Five), which require three years or five years of the taxpayer owning an interest in the partnership's activity, i.e., being a partner in the partnership, respectively. The taxpayer does not materially participate under the substantially all participation test (Test Two) or the comparative participation test (Test Three) if the law firm has other full-time partners. Although the taxpayer's interest in the law firm partnership may be a passive activity, the taxpayer

[938] Reg. §1.469-2(f)(6).

[939] Reg. §1.469-2T(f)(7).

[940] Reg. §1.469-2(f)(10).

[941] The three recharacterization rules have less effect on CHCs, which can use passive losses against active income, though not portfolio income.

[942] *Sidell v. Commissioner*, T.C. Memo 1999-301.

[943] Reg. §1.469-2T(f)(9).

[944] Reg. §1.469-2(f)(6)(ii).

[945] Reg. §1.469-2T(f)(8).

[946] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5695 (Feb. 25, 1988).

[947] Reg. §1.469-2T(f)(2)(i).

[948] Reg. §1.469-2T(f)(2)(ii), §1.469-5T(a)(4). See IV.A.4., above for the 500-hour aggregate test for SPAs.

[949] *See* Reg. §1.469-5T(c) and IV.A.4., above.

[950] American Bar Association Special Task Force on Passive Losses, *Preamble to the Comments on PAL Proposed Regulations*, 39 Tax Notes 1325 (June 13, 1988).

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has nonpassive income in Year Twelve from the partnership under the SIPPA rule if the taxpayer spent more than 100 hours in the partnership's trade or business activity in Year Twelve.

	Income	Loss
Taxpayer participates in the activity for less than 100 hours and does not materially participate in the trade or business activity	Passive	Passive
Taxpayer participates in the activity between 100 hours and 500 hours (SPA) but does not materially participate in the activity under any test	Nonpassive	Passive
Taxpayer participates in the activity between 100 hours and 500 hours, and materially participates in all SPAs under the aggregate test for all SPAs	Nonpassive	Nonpassive
Taxpayer materially participates in the activity under another test	Nonpassive	Nonpassive

Practice Point: Sometimes a taxpayer may not be able to plan whether it will spend more or less than 500 hours on the trade or business activity during the tax year, which may have dramatic consequences depending on whether the activity results in income or loss.

The regulations' preamble explained that:

> the Service recognizes that, in the case of an activity that is not the full-time occupation of the taxpayer, the rules regarding material participation set forth in §1.469-5T are stringent. As a result, a taxpayer spending relatively small amounts of time in unrelated activities could, in the absence of regulations, treat the gross income from such activities as passive activity gross income even though the taxpayer's participation and services are significant factors in generating the income from the activities.
>
> In view of this concern, §1.469-2T(f)(2) provides that an amount of the taxpayer's gross income from a significant participation passive activity equal to the taxpayer's net passive income from the activity is treated as not from a passive activity. For purposes of this rule, a significant participation passive activity is an activity (other than a rental activity) in which the taxpayer participates for more than 100 hours, but does not materially participate, for the tax year.[951]

The taxpayer aggregates all SIPPAs in order to determine whether they yield net income in the aggregate. Any aggregate net income is nonpassive, and is allocated among the individual SIPPAs that generated net income.[952]

> *Example:* Taxpayer T has three SIPPAs: Activity A (which has net loss of $90); Activity B (which has net income of $80); and Activity C (which has net income of $40). T's net income from SIPPAs is $30. Under the significant participation rule, gross income in the amount of $30 is treated as nonpassive, of which $20 is allocated to Activity B and $10 to Activity C.

Practice Point: A taxpayer can have a maximum of four SIPPAs. If he has five or more SPAs, then it follows arithmetically that he will have spent more than 500 hours on them in the aggregate, and therefore materially participate in the SPAs. Accordingly, they will not be passive activities.

Where an activity is subject to recharacterization not only because it is a SIPPA, but also because it involves the rental of nondepreciable property and/or an equity-financed lending activity, the gross income from the activity that is nonpassive is equal to the highest of the amounts disallowed under any one of the above three recharacterization rules, in order to avoid duplication of disallowed amounts.[953]

Practice Point: It is not clear how the nondepreciable property rule, which applies only to rental activities, can overlap with the significant participation rule or the equity-financed lending rule, both of which apply only to trades or businesses that are not rental activities.

2. *Nondepreciable Property Rule*

The nondepreciable property rule applies to a rental activity, if less than 30% of the unadjusted basis of the property used or held for use by customers is depreciable under §167.[954] The rule can apply to both personal property and real property. The net passive income from the property is portfolio income and investment income, which increases the investment interest expense allowed under the §163(d) investment interest limitation.[955]

The regulations' preamble explained that:

> [s]ince nondepreciable property may be rented together with incidental depreciable property (e.g., land with minor improvements), raising a factual issue as to whether an activity in which nondepreciable property is leased consists primarily of renting such property, §1.469-2T(f)(3) provides a bright [30%] line for distinguishing activities involving the rental of nondepreciable property from other rental activities.[956]

Unadjusted basis is defined as adjusted basis under §1016, but determined without regard to any adjustment that decreases basis.

> *Example:* Taxpayer T has a rental activity involving two assets: (1) land with an unadjusted basis of $80,000; and

[951] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5693 (Feb. 25, 1988).

[952] Reg. §1.469-2T(f)(2)(i).

[953] Reg. §1.469-2T(f)(8).

[954] Reg. §1.469-2T(f)(3).

[955] Reg. §1.469-2(f)(10).

[956] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5694 (Feb. 25, 1988).

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(2) a building located on the land with an unadjusted basis of $20,000. Since only the building is depreciable, and it accounts for 20% of total unadjusted basis, the rental activity is subject to the nondepreciable property rule. T's net income from the rental activity is nonpassive and treated as portfolio income. A similar result applies to any gain from the sale of the land and building.

The nondepreciable property rule can apply to fields leased to a farmer, mobile home parks, lots leased to sell Christmas trees, and land leased for billboards, cell towers, and campgrounds.[957] The nondepreciable property rule can apply to a rental activity that leases land to a related party, which constructs and owns building and improvements on the land.[958]

Practice Point: The term "rental activity" has the same meaning as under Reg. §1.469-1T(e)(3). Thus, an activity that satisfies one of the exceptions to the rental activity definition (*e.g.*, the average period of customer use is seven days or less) is not recharacterized under this rule, such as short-term rentals of nondepreciable musical instruments or artwork.

The nondepreciable property rule applies separately to each of the taxpayer's separate activities of renting nondepreciable property. A taxpayer may have two activities, consisting of two parcels of land rented to the same lessee, with one parcel giving rise to a passive loss and one parcel giving rise to nonpassive income under the nondepreciable property rule.[959]

If the incidental-to-development rule applies at the same time, the incidental-to-development rule takes precedence over the nondepreciable property rule because the former applies on a property-by-property basis.[960]

Practice Point: The 30% test is measured by unadjusted basis, with no adjustment for inflation.

Example: Taxpayer T purchases land with an unadjusted basis of $8,000. Twenty years later, the land is worth $100,000 and T builds a $4,000 depreciable structure on the land. The nondepreciable property rule no longer applies to the property, because 33% of the property's basis is depreciable.

Practice Point: If the taxpayer engages in a like-kind exchange of real property, it is unclear whether the replacement property's unadjusted basis is equal to the relinquished property's adjusted basis or the relinquished property's unadjusted basis.[961]

Practice Point: If the property is owned by a partnership, and the partnership's partners have positive §743(b) adjustments with respect to the partnership, each partner may be able to include its §743(b) adjustments in the 30% computation.

Practice Point: The 1986 Conference Report noted that regulations to create nonpassive income may be appropriate for "ground rents that produce income without significant expenses."[962] The final regulations, in contrast, generally apply the nondepreciable property rule to properties with insufficient depreciation, without regard to whether the property may have significant operational costs or other expenses.

Note: Repairs of property generally give rise to business deductions, while improvements to property are capitalized.[963] The repairs do not add to unadjusted basis but the capitalized improvements add to unadjusted basis, even if the capitalized amounts are immediately deducted due to 100% bonus depreciation and reduce adjusted basis.[964] Accordingly, capitalized improvements may enable a property to avoid the nondepreciable property rule.

3. *Equity-Financed Lending Rule*

Certain equity-financed lending activities generate income that is recharacterized as portfolio income and net investment income for purposes of the §163(d) investment interest limitation.[965] Such an activity is one that involves a trade or business of lending money, if the average outstanding balance of liabilities incurred in the activity for the tax year (including outstanding debt from prior tax years) does not exceed 80% of the average outstanding balance of the interest-bearing assets held in the activity for such tax year.[966] In other words, the activity is generally funded 20% or more by equity, instead of debt.

The regulations' preamble explained that:

> interest income from loans made in the ordinary course of a trade or business of lending money is not portfolio income. Absent a regulation expressly treating income from such an activity as nonpassive income, taxpayers could derive passive income from investments substantially similar to mutual fund investments by becoming passive investors in partnerships or S corporations that engage in a trade or business of lending equity funds contributed by the taxpayers.[967]

Practice Point: This rule ensures that the above method will not succeed in creating passive income (although it still can give rise to passive loss) with respect to interest on the money one invests in the activity — subject to a safe harbor with the 80% debt funding requirement.

The average outstanding balance, with respect to both liabilities and interest-bearing assets, may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.[968] The liabilities and assets taken into account generally are those that bear interest or original issue discount: *e.g.*, bonds, bank deposits, and loans to customers.[969] The test disregards liabili-

[957] 2005 IRS Audit Guide at 3-4, available at https://www.irs.gov/pub/irs-mssp/pal.pdf.

[958] *Wiseman v. Commissioner*, T.C. Memo 1995-203. See III.D.3., above, for rental activity grouping rules.

[959] The rule can apply effectively on a property-by-property basis if the properties are not grouped properly. *See Dirico v. Commissioner*, 139 T.C. 396 (2012).

[960] *See* Reg. §1.469-2(f)(5), discussed at IV.C.4., below.

[961] *Compare* Reg. §1.199A-2(c) *with* Prop. Reg. §1.199A-2(c).

[962] 1986 Conference Report at II-147. *See also* 1986 Blue Book at 235.

[963] §263.

[964] *See* §168(k), §168(n), §168(m) (50% bonus depreciation for qualified recycling and reuse property).

[965] Reg. §1.469-2T(f)(4).

[966] Reg. §1.469-2T(f)(4)(ii)(A).

[967] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5694 (Feb. 25, 1988).

[968] Reg. §1.469-2T(f)(4)(vii).

[969] Reg. §1.469-2T(f)(4)(v), §1.469-2T(f)(4)(vi).

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ties and assets that do not bear interest, *e.g.*, accounts payable and receivable, as well as contingent liabilities. The test disregards liabilities secured by tangible property used in the activity, as well as (in the case of an activity conducted by an entity in which the taxpayer owns an interest) liabilities with respect to which the entity is not the borrower.[970] The test also disregards liabilities incurred principally for the purpose of exceeding the 80% test.[971]

Practice Point: Since the 80% test is an all-or-nothing test, and the test is applied on an activity-by-activity basis, a taxpayer with two or more lending operations may seek to group some of them into a single activity in order to meet the 80% test.

Practice Point: With respect to a partnership or other entity engaged in the trade or business of lending money, only entity-level liabilities are included in the computations. Partner-level liabilities are not taken into account, even if allocable to the partner's share of the partnership's lending trade or business.

The amount of net income for the tax year from an equity-financed lending activity that is treated as nonpassive is equal to the lesser of: (1) the amount of equity-financed interest income from the activity; and (2) the overall net passive income from the activity.[972]

Equity-financed interest income is generally gross interest income from the activity, with two adjustments.[973] First, gross interest income is reduced to net interest income by reasonably allocable expenses.[974] Second, only the portion of net interest income that is equity-financed (determined by making the same calculation as under the 80% test described above) is counted.[975] As an example, if an activity is 70% liability-financed and 30% equity-financed, equity-financed interest income from that activity would equal 30% of the net interest income from the activity. The amount of net income treated as nonpassive is equal to the lesser of (1) 30% of the net interest income or (2) the overall net passive income from the activity.

Practice Point: The overall net passive income from the activity may be increased by gain from the disposition of the activity, even though the gain is not part of equity-financed interest income. Conversely, for a partnership or other entity engaged in the trade or business of lending money, partner-level interest expense is not taken into account in determining status as an equity-financed lending activity or in computing equity-financed interest income, but the partner-level interest expense may reduce the overall net passive income from the activity.

4. Incidental-to-Development Rule

The incidental-to-development rule applies to the use of an item of property in a rental activity[976] incidental to a development activity.[977] The use of an item of property in a rental activity is incidental to a development activity if all of the following three requirements are met:

1. Gain, if any, from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the tax year.[978]

2. The taxpayer either materially participated or significantly participated (i.e., participated for more than 100 hours) in an activity that involved, for any tax year, the performance of services for the purpose of enhancing the value of such item of property.[979] Services that are treated as enhancing the value of an item of property include, but are not limited to, construction, renovation, and lease-up (unless more than 50% of the property is leased on the date the taxpayer acquires an interest in the property).[980]

3. The use of the item of property in a rental activity commenced less than 12 months before the date of disposition.[981] Such rental activity is deemed to commence when the taxpayer owns an interest in the item of property, substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental), and no significant value-enhancing services (other than lease-up) remain to be performed.[982] The date of disposition is the first date on which the property is subject to an oral or written agreement that either requires the owner to transfer his interest therein for consideration that is fixed or otherwise determinable on such date, or gives the owner the option to do so.[983]

Under this recharacterization rule, any positive amount of net rental activity income for the tax year from an item of property used in a rental activity is treated as nonpassive income.[984] Net rental activity income is defined as gross income from the rental or disposition of the property during the tax year, reduced by any passive activity deductions that are reasonably allocable to such rental use.[985]

The temporary regulations' preamble explained that:

> [i]t is not appropriate … to treat a taxpayer's gain from the sale of a rental property as passive activity gross income if the taxpayer materially or significantly participated in the development of the property and the gain is predominantly attributable to the development of the property rather than to appreciation during the rental period. … In general, the effect of this rule is that property developed by the taxpayer must be rented for at least 24 months before selling the property or contracting for its sale or the taxpayer's

[970] Reg. §1.469-2T(f)(4)(vi).
[971] Reg. §1.469-2T(f)(4)(ii)(B).
[972] Reg. §1.469-2T(f)(4)(i).
[973] Reg. §1.469-2T(f)(4)(iii).
[974] Reg. §1.469-2T(f)(4)(iv). For this purpose, disregard interest on liabilities described in Reg. §1.469-2T(f)(4)(vi) (*i.e.*, those secured by certain tangible property or not incurred by the entity).
[975] Reg. §1.469-2T(f)(4)(iii).
[976] The regulations do not state whether a "rental activity" is defined for this purpose in accordance with Reg. §1.469-1T(e)(3) (providing certain exceptions to the term for general passive loss purposes). *Cf.* Reg. §1.469-2T(f)(3) (expressly providing that the general passive loss definition of "rental activity" applies with respect to the nondepreciable property rule).
[977] Reg. §1.469-2(f)(5).
[978] Reg. §1.469-2(f)(5)(i)(A).
[979] Reg. §1.469-2(f)(5)(i)(C). If the basis of the item of property is determined in whole or in part by reference to another item of property that was sold, exchanged, or otherwise disposed, the taxpayer may count the performance of services for the disposed other item of property. Reg. §1.469-2(f)(5)(i)(C).
[980] Reg. §1.469-2(f)(5)(iii).
[981] Reg. §1.469-2(f)(5)(i)(B).
[982] Reg. §1.469-2(f)(5)(ii).
[983] Reg. §1.469-2(f)(5)(i)(B), §1.469-2(c)(2)(iii)(B).
[984] Reg. §1.469-2(f)(5)(i).
[985] Reg. §1.469-2(f)(9)(iii), §1.469-2(f)(9)(iv).

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gain from the sale will not be treated as passive activity gross income.[986]

The rental period was reduced to 12 months in the final regulations.[987]

Practice Point: Net rental activity income is reduced by any passive loss carryovers for the same activity.[988] In other words, although the incidental-to-development rule gives rise to nonpassive income, the income can be offset by passive loss carryovers from the same activity.

A single rental activity can be subject to recharacterization with respect to each item of property that is used in the rental activity.

> *Example:* Two separate items of commercial realty are used in the same rental activity. One of the items gives rise to a gain, and the other to a loss, but the use of both is incidental to a development activity. The gain from the former is nonpassive income under the recharacterization rule, but the loss from the latter is a passive loss.[989]

5. Self-Rental Rule

The self-rental rule (or self-rented property rule) was anticipated by the 1986 Conference Report, which stated that regulations may be appropriate to target "related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income."[990] The regulations' preamble added that:

> [i]ncome from an active business consists of both income from services and income from capital invested in the business. In the absence of regulations, a taxpayer could derive passive activity gross income from an active business in which tangible property is used by renting the property to an entity conducting the activity (or by causing an entity holding the property to rent the property to the taxpayer).[991]

The regulations provide that an item of property is recharacterized under the self-rental rule if the property is rented to a lessee for use in a trade or business in which the lessor taxpayer materially participates.[992] The net rental activity income from the property for the tax year is nonpassive. Net rental activity income includes any gain from the sale or disposition of the property while it is subject to the self-rental rule.[993]

Practice Point: The self-rental rule does not require any minimum amount of common ownership between the lessor and the lessee. If a taxpayer leases property to a lessee partnership in which the taxpayer owns a 0.1% interest, and the taxpayer materially participates in the lessee partnership's activity, then the taxpayer's rental income and gain is subject to the self-rental rule.

The self-rental rule applies to rentals of property not only to pass-through entities in which the taxpayer owns an interest, but also to C corporations.[994]

Practice Point: When property is rented to a C corporation, the self-rental rule applies if the lessee C corporation is a PSC or a CHC, even if it is closely held by someone other than the lessor. It is possible that the self-rental rule also applies if the lessee C corporation is widely held or publicly traded. The self-rental rule applies if the lessor materially participates in the lessee's "trade or business activity" within the meaning of Reg. §1.469-4(b)(1), which is generally any activity that involves the conduct of a trade or business and is not a rental activity. Reg. §1.469-4(a) provides that a "taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships," which may imply that other C corporations' activities are excluded.[995] However, if the self-rental rule focuses on the lessee's activity and not on the lessor taxpayer's activity.

Practice Point: The nonpassive income under the self-rental rule is not investment income and therefore does not increase the interest allowed under the §163(d) investment interest limitation.

Practice Point: The self-rental rule only treats the rental income as nonpassive income, but any passive credits with respect to the activity remain as passive credits.[996] The passive credits cannot offset the income tax liability on the nonpassive income.

Practice Point: The self-rental rule applies only to net rental activity income, not losses. The self-rental losses generally continue to be passive losses, though some may be allowed by the $25,000 special allowance, discussed at V.F., below.

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[986] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5693 (Feb. 25, 1988).

[987] T.D. 8253, 54 Fed. Reg. 20,532 (May 12, 1989).

[988] Reg. §1.469-2(f)(9)(iv).

[989] *See* Reg. §1.469-2(f)(5)(i) and §1.469-2(f)(9)(iii)–(iv).

[990] 1986 Conference Report at II-147. *See also* 1986 Blue Book at 235.

[991] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5694 (Feb. 25, 1988).

[992] Reg. §1.469-2(f)(6). *See, e.g., Schumann v. Commissioner*, T.C. Memo 2014-138 (taxpayer materially participated in the lessee S corporations' businesses given that he reported $15 million of wages in one year from the S corporations, and also claimed to be actively involved in the S corporations in depositions when their minority shareholders (taxpayer's children) filed shareholder's derivative lawsuit against the taxpayer alleging that he did minimal work); *Williams v. Commissioner*, T.C. Memo 2015-76, *aff'd*, 637 Fed App'x 799 (5th Cir. 2016) (taxpayer rented property to his own S corporation's activity in which he materially participated; self-rental rule upheld as valid and caused the rental income to be nonpassive income). *See* 2005 IRS Audit Guide at 3-4, available at https://www.irs.gov/pub/irs-mssp/pal.pdf:

("Self-rented property is a frequent adjustment, as it is common practice for many professionals to own the property personally and lease it to a corporation or partnership where they conduct business.").

[993] Reg. §1.469-2(f)(9)(iv), §1.469-2(f)(9)(iii).

[994] *See Schwalbach v. Commissioner*, 111 T.C. 215 (1998) (self-rental rule upheld as valid and applied to property leased to PSC); *Samarasinghe v. Commissioner*, T.C. Memo 2012-23; *Veriha v. Commissioner*, 139 T.C. 45 (2012) (because of common ownership of S corporations leasing to C corporations, income from truck rental recharacterized as nonpassive); *Krukowski v. Commissioner*, 279 F.3d 547 (7th Cir. 2002), *aff'g* 114 T.C. 366 (2000) (rental income from taxpayer's office building to taxpayer's subchapter C law firm was nonpassive); *Sidell v. Commissioner*, 225 F.3d 103 (1st Cir. 2000), *aff'g* T.C. Memo 1999-301 (IRS properly recharacterized rental income received by a grantor trust from the taxpayer-grantor's wholly owned C corporation in which he materially participated); *Connor v. Commissioner*, 218 F.3d 733 (7th Cir. 2000), *aff'g* T.C. Memo 1999-185.

[995] *But see Robinson v. Commissioner*, 119 T.C. 44 (2002) ("If, however, the statute in question uses the word "includes" rather than "means" to define a term, then there is an indication that the definition of the term is exemplary rather than exclusive.") (citing *Colautti v. Franklin*, 439 U.S. 379, 392–393 n. 10 (1979)).

[996] *Sidell v. Commissioner*, 225 F.3d 103 (1st Cir. 2000), *aff'g* T.C. Memo 1999-301.

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The self-rental rule does not apply to any rental to a nonpassive activity pursuant to a written binding contract entered into before February 19, 1988.[997] The self-rental rule also does not apply to any item of property that is subject to the incidental-to-development rule.[998]

Practice Point: Net rental activity income includes any passive loss carryovers for the same activity.[999] In other words, although self-rental income is nonpassive income, the income can be offset by passive loss carryovers from the same activity.

In *Fransen v. United States*,[1000] the Fifth Circuit Court of Appeals held that the self-rental rule applies to all rental income from property owned by a husband and wife and rented to a C corporation in which the husband, but not the wife, held stock. Participation in an activity by one spouse is treated as participation by the other, regardless of whether the spouse files a joint or separate return or owns an interest in the activity.[1001]

The regulations recharacterize net rental activity income from an "item of property" rather than net income from the entire rental "activity."[1002] Thus, if a taxpayer leases one building at a net profit to an S corporation through which he conducts an active trade or business, and the taxpayer leases a second building at a net loss to a second S corporation through which he conducts an active trade or business, the net income can be recharacterized as nonpassive income while the net loss remains a passive loss, even if the taxpayer had otherwise validly grouped the two rental buildings as a single activity.[1003]

Recharacterization of self-rental income from an "item of property" as not from a passive activity effectively removes the income from the passive loss computation. Removal of a single item of income from such computation, however, does not affect the passive characterization of items remaining within the activity. The losses from one self-rental cannot offset income from another self-rental, despite the proper grouping of activities as a single activity.[1004]

Practice Point: If only a portion of the property is rented to a trade or business in which the taxpayer materially participates, rental income from the entire property may be subject to the self-rental rule. A taxpayer may segregate the self-rental income by establishing it as a separate activity that is an appropriate economic unit under the activity rules.[1005]

> *Example:* Taxpayer T owns a 10-story office building, of which nine floors are leased to unrelated tenants and one floor is leased to a partnership engaged in a trade or business in which T materially participates. The self-rental rule may apply to the entire building and cause all of the net rental income to be nonpassive income. Instead, T may consider contributing the use of the property to the partnership in exchange for a guaranteed payment, which would trigger the "providing property to a pass-through activity" rule.[1006] The guaranteed payment and its related deductions would still be nonpassive, but T avoids the self-rental rule for the whole building and may have passive income or loss with respect to T's rent from the unrelated tenants.

For a C corporation, material participation by a shareholder, as distinct from by the C corporation, generally does not matter in the absence of the recharacterization rule, since items of income, deduction, and credit are not passed through by C corporations to their shareholders. However, shareholder material participation does matter under the recharacterization rule. If the taxpayer, in connection with an activity conducted by a C corporation in which he owns an interest, does sufficient work to qualify as materially participating, then a rental by the taxpayer to the C corporation of property used in that activity will now be subject to recharacterization.

Practice Point: The self-rental rule does not apply to an item of property rented to a lessee for use in a trade or business in which the lessor taxpayer (and his spouse filing a joint return) does not materially participate, but in which the lessor's other family members materially participate.

Practice Point: The self-rental rule does not apply to an item of property rented to a lessee for use in a rental activity in which the lessor taxpayer materially participates.[1007] It applies only to a lessee engaged in a trade or business activity.

> *Example:* A is a real estate professional. A rents personal property to an S corporation engaged in a rental activity in which A materially participates. A does not have self-rental income from the personal property that is recharacterized as nonpassive income.

Note: In *Cox v. Commissioner*,[1008] the taxpayer owned a law practice (a sole proprietorship), which paid rent to the taxpayer and his wife for office space in a building that they owned as tenants by the entireties. The Tax Court allowed the taxpayer to deduct 50% of the rent as the law practice's business expense, and to report the wife's 50% share of the rental income as passive income from a rental activity, on their joint tax return. The taxpayer could not deduct the other 50% of the rent that his law practice was paying to himself. The self-rental rule was not mentioned, presumably because the taxpay-

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[997] Reg. §1.469-11(c)(1)(ii). *See Krukowski v. Commissioner*, 114 T.C. 366 (2000), *aff'd*, 279 F.3d 547 (7th Cir. 2002) (1991 renewal of a 1987 lease was a separate contract and therefore not grandfathered); PLR 9406010 (gain on the disposition of rental activity is passive income when the lease with the taxpayer's related S corporation was entered into before February 19, 1988). According to one commentator, Treasury has informally indicated that a renewal at the lessor's option would terminate the self-rental rule's grandfathering, while a renewal at the lessee's option would not terminate the grandfathering. *See* Amy L. Sutton and Laura Howell-Smith, *Federal Income Taxation of Passive Activities*, ¶17.01[2] (Aug. 2018).

[998] Reg. §1.469-2(f)(6)(ii), §1.469-2(f)(5). The incidental-to-development rule is discussed at IV.C.4., above.

[999] 1.469-2(f)(9)(iv).

[1000] 191 F.3d 599 (5th Cir. 1999), *aff'g* 98-2 USTC ¶ 50,776 (E.D. La. 1998).

[1001] §469(h)(5); Reg. §1.469-5T(f)(3).

[1002] Reg. §1.469-2(f)(6).

[1003] *Carlos v. Commissioner*, 123 T.C. 275 (2004). *See also Beecher v. Commissioner*, 481 F.3d 717 (9th Cir. 2007), *aff'g sub. nom. Cal Interiors Inc. v. Commissioner*, T.C. Memo 2004-99 (taxpayers leased some buildings to wholly owned C corporations for which they worked full-time, which gave rise to nonpassive income, and taxpayers leased other buildings to third parties that gave rise to passive losses).

[1004] *See Shaw v. Commissioner*, T.C. Memo 2002-35.

[1005] *See* Reg. §1.469-4(c).

[1006] *See* III.B.6., above, discussing Reg. §1.469-1T(e)(3)(ii)(F).

[1007] *Dirico v. Commissioner*, 139 T.C. 396 (2012).

[1008] T.C. Memo 1993-326. *See also Cox v. Commissioner*, 121 F.3d 390 (8th Cir. 1997), *aff'g* T.C. Memo 1996-103.

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er's sole practitioner law practice was a sole proprietorship and not a separate tax entity.

6. *Pass-through Entity Royalty Rule*

As discussed at III.C.2., above, royalties received by any person with respect to licensing intangible property are not portfolio income if that person either created the intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of that property.[1009] Such royalties generally may be passive income if the taxpayer does not materially participate during the current tax year.

However, the pass-through entity royalty rule prevents the creation of passive royalty income if royalties are received by a pass-through entity (the "development entity"), and the taxpayer acquires an interest in such entity only after the entity has created intangible property or performed substantial services or incurred substantial costs with respect to that property.[1010] When this occurs, net income (but not net loss) with respect to the royalties is nonpassive (and is net investment income for purposes of the §163(d) investment interest limitation), unless sufficient expenditures for the development or marketing of such intangible property are incurred after the taxpayer acquires his interest in the development entity. Such post-acquisition expenditures are sufficient only if: (1) expenditures reasonably incurred with respect to developing or marketing the property exceed 50% of the property's gross royalties for the tax year;[1011] or (2) the taxpayer's share of the expenditures reasonably incurred by the development entity for all tax years of the entity exceeds 25% of the fair market value of the taxpayer's interest in the property at the time he acquired the interest in the entity.[1012] A capital expenditure is taken into account for the tax year of the entity in which it is chargeable to capital account, without regard to the tax year in which it is deductible.[1013]

This rule is applied separately to each item of property with respect to which the development entity receives royalties. The amount treated as nonpassive is the taxpayer's net royalty income from the property — *i.e.*, gross royalty income from the property less any passive activity deductions that are reasonably allocable to the property.[1014]

7. *Working Interests in Oil and Gas Property*

A "passive activity" does not include a working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.[1015] Losses and credits from an oil and gas working interest which meet these requirements are not limited by the passive loss rules, without regard to material participation by the taxpayer.

The oil and gas working interest rule was created because the oil and gas industry was experiencing economic hardship in the summer of 1986, when Congress drafted the passive loss rules. As noted by the 1986 Senate Report:

> Congress's goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, can best be accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.
>
> In certain situations, however, the committee believes that financial risk or other factors, rather than material participation, should be the relevant standard. A situation in which financial risk is relevant relates to the oil and gas industry, which at present is suffering severe hardship due to the worldwide collapse of oil prices. The committee believes that relief for this industry requires that tax benefits be provided to attract outside investors.[1016]

Note: Three years later, a House bill attempted to expand the oil and gas working interest concept to also cover an interest in certain American timber property held by a natural person, directly or through an entity that does not limit the person's liability. The House noted that "economic conditions for individuals engaged in the business of cultivation and cutting of timber are such that tax relief is appropriate for them at this time."[1017] However, the timber relief was removed from the final bill that became the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239). The oil and gas working interest rule continues its special and sui generis existence, even though oil prices have generally been higher than the $9 per barrel that occurred in 1986.

In contrast to the general passive loss rules that treat spouses filing jointly as one taxpayer,[1018] the oil and gas working interest rule is applied by treating spouses as separate taxpayers, even if they file a joint return.[1019] Thus, the fact that one spouse holds an oil and gas working interest through an entity that does not limit the spouse's liability does not affect the applicability of the oil and gas working interest rule to any other portion of the working interest that is held by the other spouse.[1020]

Although the taxpayer may have nonpassive losses under the oil and gas working interest rule regardless of his level of material participation, there are two anti-taxpayer rules, de-

[1009] Reg. §1.469-2T(c)(3)(iii)(B).

[1010] Reg. §1.469-2T(f)(7)(i).

[1011] Reg. §1.469-2T(f)(7)(iii)(A), §1.469-2T(c)(3)(iii)(B)(*2*)(*ii*)(*a*). This determination is made for the tax year of the entity ending with or within the taxpayer's tax year.

[1012] Reg. §1.469-2T(f)(7)(iii)(B). This determination is made with respect to expenditures incurred in all tax years of the entity beginning with the tax year of the entity in which the taxpayer acquired the interest in the entity, and ending with the tax year of the entity ending with or within the taxpayer's current tax year.

[1013] Reg. §1.469-2T(c)(3)(iii)(B)(2)*(iii)*, §1.469-2T(f)(7)(iv).

[1014] Reg. §1.469-2T(f)(7)(ii)(B).

[1015] §469(c)(3)(A). The oil and gas working interest must be a trade or business in order to be subject to the passive loss rules. For various self-employment tax cases on whether an oil and gas working interest is a trade or business, see generally *Cokes v. Commissioner*, 91 T.C. 222 (1988); *Johnson v. Commissioner*, T.C. Memo 1990-461; *Moorhead v. Commissioner*, T.C. Memo 1993-314; *Perry v. Commissioner*, T.C. Memo 1994-215. *But see Hendrickson v. Commissioner*, T.C. Memo 1987-566.

[1016] 1986 Senate Report at 717–718. *See also* 1986 Blue Book at 214.

[1017] H. Rep. 101-247, 101st Cong. 1st Sess., at 1482 (1989).

[1018] Reg. §1.469-1T(j)(1).

[1019] Reg. §1.469-1T(j)(2)(iii).

[1020] *See* T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5689 (Feb. 25, 1988).

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scribed below as the anti-flip-flop rule[1021] and the anti-risk-elimination rule,[1022] that apply if the taxpayer does not materially participate in the oil and gas working interest's activity. Furthermore, material participation in an oil and gas working interest is relevant with respect to classifying interest expense, because §163(d)(5) provides that "investment interest" expense includes interest allocable to a trade or business activity that is not a passive activity and with respect to which the taxpayer does not materially participate.

a. *Definition of an Oil and Gas Working Interest*

A working interest is defined for passive loss purposes as a working or operating mineral interest in any tract or parcel of land under rules for intangible drilling and development costs.[1023] In general, such an interest is burdened with the cost of development (e.g., drilling and completing wells) and operation of the property. Rights that are not so burdened, such as rights to overriding royalties and production payments and contract rights to extract or share in oil and gas, or in profits from extraction, are not working interests.[1024] *See generally* 605 T.M., *Oil and Gas Transactions.*

The 1986 Senate Report noted that:

> A working interest generally has characteristics such as responsibility for signing authorizations for expenditures with respect to the activity, receiving periodic drilling and completion reports, receiving periodic reports regarding the amount of oil extracted, possession of voting rights proportionate to the percentage of the working interest possessed by the taxpayer, the right to continue activities if the present operator decides to discontinue operations, a proportionate share of tort liability with respect to the property (e.g., if a well catches fire), and some responsibility to share in further costs with respect to the property in the event that a decision is made to spend more than amounts already contributed. However, the fact that a taxpayer is entitled to decline, or does decline, to make additional contributions under a buyout, nonparticipation, or similar arrangement, does not contradict such taxpayer's possessing a working interest. In addition, the fact that tort liability may be insured against does not contradict such taxpayer's possessing a working interest.[1025]

The oil and gas working interest rule is applied on a well-by-well basis.[1026] The regulations' preamble explained that:

> if a taxpayer owns a working interest in a tract of land, assigns the working interest in part of the tract to a partnership in exchange for a limited partnership interest, and drills a well on-the retained portion of the tract, the working interest exception will apply to that well. If, however, the partnership drills a well on the assigned portion of the tract, the working interest exception will not apply to the taxpayer's interest in that well.[1027]

In CCA 200952054, the Chief Counsel's Office advised that the oil and gas working interest rule is limited to a working interest in natural deposits of oil and gas. The taxpayer had sustained losses from production of "landfill gas" from municipal waste, which the Chief Counsel's Office distinguished as producing gas from a man-made, nonconventional source, rather than from a natural deposit of oil or gas. In addition, the gas was produced from municipal solid waste, which is biomass. Since biomass is defined as any organic material other than oil and natural gas, the production of landfill gas is defined in part as being other than an activity involving an oil and gas working interest.[1028]

b. *Holding an Oil and Gas Working Interest Through a Liability-Limiting Entity*

The oil and gas working interest rule does not apply if the oil and gas working interest is held through an entity that limits the liability of the taxpayer with respect to such oil and gas working interest.[1029] Thus, an oil and gas working interest which is held through such an entity is a passive activity, unless the taxpayer materially participates in the oil and gas working interest's activity.

A taxpayer is entitled to the benefit of the oil and gas working interest rule for a tax year if, at any time during the tax year, he holds the oil and gas working interest directly or through an entity that does not limit liability.[1030] If the taxpayer is both a general and a limited partner in a partnership that owns an oil and gas working interest, his entire interest in each well drilled by the partnership qualifies for the oil and gas working interest rule.[1031]

The taxpayer's form of ownership limits the taxpayer's liability with respect to oil and gas activities if the taxpayer holds an oil and gas working interest through: (1) stock in a corporation, such as an S corporation;[1032] (2) an interest as a limited partner; and (3) an interest in any other entity that, under applicable state law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount.[1033] A fixed percentage of the entity's liability is not a determinable fixed amount.[1034]

[1021] §469(c)(3)(B).

[1022] Reg. §1.469-1T(e)(4)(ii).

[1023] Reg. §1.469-1(e)(4)(iv) (citing Reg. §1.612-4(a), which concerns the capitalization or expensing of intangible drilling and development costs under §263(c)). *See also* Rev. Rul. 68-139. While a working interest under §614(d) can relate to mineral deposits other than oil and gas, only oil and gas working interests are covered by the passive loss exception.

[1024] 1986 Senate Report at 744; 1986 Blue Book at 251. Income from such interests generally is considered to be portfolio income. 1986 Senate Report at 744; 1986 Blue Book at 251.

[1025] 1986 Senate Report at 744–745. *See* 1986 Blue Book at 251.

[1026] Reg. §1.469-1T(e)(4)(i).

[1027] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5687 (Feb. 25, 1988).

[1028] *See* Reg. §1.614-1(a)(2).

[1029] §469(c)(3)(A); Reg. §1.469-1T(e)(4)(i)(B).

[1030] Reg. §1.469-1T(e)(4)(i).

[1031] Reg. §1.469-1T(e)(4)(v)(C) *Ex.* (3). In FSA 200102018, the Chief Counsel's Office advised that when a husband and wife were both general and limited partners in the partnership, the fact that they each held a 1% general partnership interest in partnership and were jointly and severally liable for the partnership's activities under the partnership agreement and Texas law was sufficient to satisfy the oil and gas working interest rule.

[1032] *See* FSA 200102018.

[1033] Reg. §1.469-1T(e)(4)(v)(A).

[1034] Reg. §1.469-1T(e)(4)(v)(C) *Ex.* (2).

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Limiting liability is applied by looking through tiered entities.[1035] For example, the general partners in a partnership that owns a limited partnership interest in a second partnership that itself owns an oil and gas working interest do not benefit from the oil and gas working interest rule.[1036]

Practice Point: For trusts in certain states, state law may limit the liability of the grantors or the beneficiaries and may prevent the application of the oil and gas working interest rule.

The form of ownership rule is one of form, not substance. Where liability is limited by factors other than the taxpayer's form of ownership, the oil and gas working interest rule still applies.[1037] For example, indemnification agreements, stop-loss arrangements, insurance, similar arrangements, or any combination of the foregoing are disregarded.[1038]

> *Example:* Taxpayer T owns a 10% interest in a general partnership, with several liability for 10% of the partnership's expenses. The sponsor indemnifies T to the extent that his share of partnership expenses exceeds his original capital contribution. In addition, T obtains insurance against liability with respect to his partnership interest. T qualifies for the oil and gas working interest rule and has nonpassive income from the partnership, even though his risk is effectively limited with respect to the partnership.

Note: Protection against loss through guarantees, stop-loss agreements, or other similar arrangements may cause certain deductions to be disallowed under the §465 at-risk rules.[1039] The at-risk limitations are applied before and independently of the passive loss rules. *See generally* 550 T.M., *At-Risk Rules.*

c. Anti-Flip-Flop Rule

After an oil and gas working interest has generated nonpassive losses and begins to generate net income, a taxpayer may attempt to change the form of ownership to generate passive income. To prevent such flip-flops, the oil and gas working interest rule provides that if, in any tax year, the taxpayer treats net losses from an oil and gas working interest as nonpassive, any net income in subsequent tax years from such property generally is treated as nonpassive income, even if the property has become used in a passive activity.[1040] Net income from the property includes gains from the disposition of the oil and gas working interest.[1041]

Practice Point: The anti-flip-flop rule requires only one prior nonpassive loss tax year. The income recharacterization is not limited to the extent of nonpassive losses from the oil and gas working interest in prior tax years.

If the anti-flip-flop rule applies to an interest for a tax year, any passive credit attributable to the interest in that tax year is also nonpassive to the extent of any regular tax liability allocable to the net income from the activity for the tax year.[1042] Any passive credits from the activity in excess of this amount of current year tax will continue to be passive and will be treated under the rules generally applicable to the passive credit.[1043] The rule applies only to passive credits, which does not include the §27 foreign tax credit.[1044]

Practice Point: The anti-flip-flop rule applies only if the taxpayer used the oil and gas working interest rule and deducted nonpassive losses from the well in a tax year in which he did not materially participate in the oil and gas working interest's activity.[1045] Taxpayers with oil and gas working interests may find it beneficial to track material participation for all tax years, notwithstanding the per se nonpassive effect of the oil and gas working interest rule.

> *Example:* Taxpayer T has a loss of $50 in 20X1 from an oil and gas working interest, which is a nonpassive loss. T does not materially participate in the oil and gas working interest's activity. In 20X2, T contributes the oil and gas working interest to a limited partnership, and he has net income of $100 from the partnership's oil and gas working interest. All $100 of T's 20X2 net income is nonpassive because of the $50 loss in 20X1. Moreover, the anti-flip-flop rule applies only to net income, not to losses, in later tax years. In 20X3, T has a loss of $40 from the oil and gas working interest, which is a passive loss.

The anti-flip-flop rule applies to net income, not only from any well that gave rise to nonpassive net losses in a prior tax year (by reason of the oil and gas working interest rule), but from the entire property that includes such a well.[1046] Moreover, the anti-flip-flop rule applies to net income from any property the basis of which is determined in whole or in part by reference to the basis of such property.[1047]

The anti-flip-flop rule also applies to any well or other item of property if the value of such other well or other items of property was directly enhanced by drilling or other expenses

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[1035] *See* 1986 Senate Report at 745; 1986 Bluebook at 252.

[1036] *See* 1986 Senate Report at 745; 1986 Bluebook at 252. *See, e.g.,* CCA 200952054 (Chief Counsel's Office noted that:

> none of the general partners are exposed to liability with respect to the interest even though they are general partners in the general partnership. Since the general partners have used lower tier entities to limit their liability, they do not hold the interest directly or indirectly in a way that does not limit their liability.).

[1037] Reg. §1.469-1T(e)(4)(v)(B).

[1038] Reg. §1.469-1T(e)(4)(v)(B). *See* 1986 Senate Report at 745 ("the fact that a taxpayer is entitled to decline, or does decline, to make additional contributions under a buyout, nonparticipation, or similar arrangement, does not contradict such taxpayer's possessing a working interest. In addition, the fact that tort liability may be insured against does not contradict such taxpayer's possessing a working interest."); 1986 Blue Book at 251.

[1039] 1986 Senate Report at 745. *See also* 1986 Blue Book at 252.

[1040] §469(c)(3)(B); Reg. §1.469-2(c)(6)(i).

[1041] Reg. §1.469-2(c)(6)(ii) refers to passive activity gross income (as defined in Reg. §1.469-2T(c)(1)), but without regard to the Reg. §1.469-2T(f) recharacterization rules.

[1042] *See* §469(c)(3)(B).

[1043] §469(c)(3)(B). *See* H. Rep. 104-586, 104th Cong.2d Sess., at 168 (1996) ("The bill clarifies that any credit attributable to a working interest in an oil and gas property, in a tax year in which the activity is no longer treated as not being a passive activity, will not be treated as attributable to a passive activity to the extent of any tax allocable to the net income from the activity for the tax year. Any credits from the activity in excess of this amount of tax will continue to be treated as arising from a passive activity and will be treated under the rules generally applicable to the passive activity credit.").

[1044] §469(c)(3)(B). For passive credits, see V.E., below.

[1045] Reg. §1.469-2(c)(6)(i)(A). The regulation is contrary to the 1986 Blue Book at 252 n.48 ("This [anti-flip flop] rule applies whether or not the working interest would have been treated as passive in the absence of the provision treating working interests as per se passive, i.e., if material participation were relevant in this context.").

[1046] Reg. §1.469-2(c)(6)(i)(A).

[1047] §469(c)(3)(B); Reg. §1.469-2(c)(6)(i)(B).

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with respect to the oil and gas working interest.[1048] For example, if a taxpayer discovers a reservoir by drilling with respect to an oil and gas working interest, the taxpayer cannot avoid the anti-flip-flop rule by starting a second well nearby.[1049] However, the discovery that a particular county has underlying oil reserves is not treated as directly enhancing the value of all wells in that county.[1050]

d. Anti-Risk-Elimination Rule

A taxpayer may eliminate the economic risk that the oil and gas working interest rule intends to require by paying for and deducting drilling costs when his liability is not limited, but then contribute the oil and gas working interest to a liability-limiting entity before actually drilling the wells and incurring the economic risk related to the deductions. An anti-risk-elimination rule prevents the taxpayer from benefiting from the oil and gas working interest rule by structuring his unlimited liability to exist only when no economic performance has occurred.

Specifically, for a tax year when the taxpayer's oil and gas working interest yields a net loss that is treated as nonpassive solely due to the oil and gas working interest rule (i.e., the taxpayer does not materially participate in the activity that includes the oil and gas working interest), the regulations provide that "disqualified deductions" from the well are treated as passive activity deductions, and a "ratable portion" of gross income from the well is treated as passive activity gross income, despite the net loss's generally nonpassive status.[1051]

Disqualified deductions are those with respect to which economic performance[1052] occurs at a time (whether during the same tax year or a subsequent tax year) when the taxpayer's only interest in the oil and gas working interest is held through a liability-limiting entity.[1053] The ratable portion of gross income is that portion of the taxpayer's gross income from the well for the tax year that is derived by multiplying the gross income by the fraction that is obtained by dividing: (1) the disqualified deductions from the well for the tax year; by (2) the total deductions from the well for the tax year.[1054]

> *Example:* Taxpayer T holds an oil and gas working interest through a general partnership interest. T does not materially participate in the oil and gas working interest's activity; his share of gross income from the oil and gas working interest is $16,000, and his share of deductions from it is $40,000. At some point — either late in the tax year or during a subsequent tax year — T converts his general partnership interest into a limited partnership interest. Economic performance with respect to $10,000 of the deductions does not occur until after this conversion. But for the anti-risk-elimination rule, T would have a nonpassive loss from the oil and gas working interest in the amount of $24,000. However, $10,000 of his deductions are disqualified deductions that are passive activity deductions. Moreover, $4,000 — the ratable portion of his gross income[1055] — is passive activity gross income. Consequently, T has a nonpassive loss from the well of $18,000 (the excess of $30,000 nondisqualified deductions over $12,000 of non-ratable-portion gross income) and a passive loss of $6,000 (the excess of the disqualified deductions over the ratable portion of gross income).

[1048] Reg. §1.469-2(c)(6)(iii). The regulations use the term "property," but state that for this purpose, it does not have the same meaning as under §614(a) (property means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land).

[1049] *See* Reg. §1.469-2(c)(6)(iv) *Ex.* (1).

[1050] *See* Reg. §1.469-2T(c)(6)(iv) *Ex.* (2).

[1051] Reg. §1.469-1T(e)(4)(ii).

[1052] For this purpose, economic performance has the same meaning as under §461(h), without regard to the exception for recurring items in §461(h)(3) or the special rule for the spudding of oil and gas wells in §461(i)(2). Reg. §1.469-1T(e)(4)(ii)(C)(2).

[1053] Reg. §1.469-1T(e)(4)(ii)(C)(2).

[1054] Reg. §1.469-1T(e)(4)(ii)(C)(4).

[1055] This amount is derived by multiplying $16,000, the total amount of gross income, by 10,000/40,000 (one-quarter), the ratio of disqualified deductions to total deductions.

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V. Effect of Passive Losses

A. *Passive Loss Limitation*

Unused passive losses and passive credits from an activity are treated as a deduction or credit allocable to the same activity in the next tax year.[1056] The unused passive losses and credits cannot be carried back,[1057] but they can be carried forward indefinitely.[1058] See V.E., below, for the effect of passive credit carryovers.

For tax years beginning after 2017, a 20% pass-through business income deduction is allowed for certain qualified business income (QBI) of a noncorporate taxpayer.[1059] Passive loss carryovers from tax years ending in 2017 or earlier, when allowed in 2018 or later, do not reduce the taxpayer's QBI.[1060] In contrast, passive loss carryovers generated in tax years ending in 2018 or later may reduce the taxpayer's QBI and §199A deduction when the losses are taken into account for taxable income purposes, under the general rules for which items of income, gain, deduction, or loss are included in QBI.[1061] Negative QBI may give rise to a qualified business loss carryforward to subsequent tax years.[1062]

The federal income tax statute of limitations is generally three years.[1063] Even if the statute of limitations is closed for an earlier year, passive loss carryovers from an earlier year may be recomputed and used through intervening years (open or closed) in order to arrive at the correct passive loss carryover and the correct tax liability for an open year.[1064] In *Hardy v. Commissioner*,[1065] the taxpayer originally reported certain losses as nonpassive losses in closed years, and attempted to recompute those losses as passive losses in order to have a passive loss carryover to an open year. But the taxpayer was not entitled to any passive loss carryover, because it would have been fully offset by passive income in intervening years. All of the relevant records for the prior tax years should be retained in order to support the passive loss carryovers.[1066] Special rules may apply when the intervening year has unclaimed deductions or unreported income.[1067]

Note: A taxpayer who has passive loss carryovers should keep all income tax returns and other records from the tax years that generated those carryovers. In *Lowe v. Commissioner*,[1068] the taxpayer was not allowed to use passive loss carryovers from 1985 through 1990 and 1992, because the passive loss rules were not in effect in 1985 and 1986, and the taxpayer did not provide tax returns for any of those years. The taxpayer could not rely on his mere belief and conversation with tax return preparer that the passive loss carryovers were not used, especially when the 1991 and 1993 losses were (improperly) claimed as ordinary losses against nonpassive income. The taxpayer was able to use passive loss carryovers from 1994 through 2002 by presenting income tax returns for those years that showed the passive losses were not used.

1. *Application of the Passive Loss Rules to Closely Held C Corporations*

While other taxpayers subject to the passive loss rules are not permitted to use passive losses and credits against active business income or portfolio income, a CHC (that is not a PSC) is permitted to use passive losses and credits against net active income, from activities in which the CHC materially participates.[1069] In other words, a CHC cannot use passive losses and credits against portfolio income and certain other items, but it can use passive losses and credits against all other income.

The 1986 Senate Report noted that it is:

> not intended that incorporation of an individual's portfolio investments be available as a way to avoid the passive loss rule… Such [closely held] C corporations may not offset losses or credits from passive activities against portfolio income. Such corporations may, however, offset passive losses and credits against active business income (i.e., trade or business income which is not from a passive activity).[1070]

More specifically, a CHC's passive loss for the tax year is the amount, if any, by which the CHC's passive activity deductions (within the meaning of §1.469-2T(d), i.e., the deductions arising in connection with the conduct of a passive activity for the tax year and the deductions disallowed in a prior tax year and carried over) exceeds the sum of

(i) The CHC's passive activity gross income for the tax year,[1071] plus

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[1056] §469(b).

[1057] *See Adler v. United States*, 32 Fed. Cl. 736 (Cl. Ct. 1955).

[1058] §469(b).

[1059] §199A, as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70105.

[1060] Reg. §1.199A-3(b)(1)(iv).

[1061] *See* §199A(c); Reg. §1.199A-3(b).

[1062] §199A(c)(2); Reg. §1.199A-1(d)(2)(iii).

[1063] *See* §6501(a), §6511(a).

[1064] For the same concept applying to net operating loss (NOL) carryovers, see, e.g., *Phoenix Coal Co., Inc. v. Commissioner*, 231 F.2d 420 (2d Cir. 1956); *Springfield St. Ry. Co v. United States*, 312 F.2d 754 (Ct. Cl. 1963); *Lone Manor Farms, Inc. v. Commissioner*, 61 T.C. 436 (1984), *aff'd without pub. op.*, 510 F.2d 970 (3d Cir. 1975); *State Farming Co. v. Commissioner*, 40 T.C. 774 (1963); *Hill v. Commissioner*, 95 T.C. 437 (1990); *ABKCO Indus. Inc. v. Commissioner*, 56 T.C. 1083 (1971), *aff'd on other issue*, 482 F.2d 150 (3d Cir. 1973); Rev. Rul. 85-64; CCA 201151021; CCA 201509036. *See also* Rev. Rul. 82-49 (former §38 investment tax credit); Rev. Rul. 69-543 (same); *Mennuto v. Commissioner*, 56 T.C. 910 (1971) (same); *Reilly v. Commissioner*, T.C. Memo 1989-312 (NOL and former §38 investment tax credit); *Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986) (NOL and §170 charitable contribution carryover).

[1065] T.C. Memo 2017-16.

[1066] For the same concept in the NOL carryover context, see, e.g., *Owens v. Commissioner*, T.C. Memo 2001-143 (taxpayers failed to show that they are entitled to NOL carryovers based on providing their prior years' tax returns, which are "nothing more than the position of petitioners that they had the respective losses claimed in those returns"); *Richards v. Commissioner*, T.C. Memo 1999-163; *Ashbrook v. Commissioner*, T.C. Memo 1999-300; *Davis v. Commissioner*, T.C. Memo 1997-80, *aff'd on other issue in unpub. op.*, 153 F.3d 726 (10th Cir. 1998); *Hoopengarner v. Commissioner*, T.C. Memo 2003-343; *Fitch v. Commissioner*, T.C. Memo 2012-358; *Sandoval v. Commissioner*, T.C. Memo 2000-189; *Yoakum v. Commissioner*, T.C. Memo 2004-191. *See also Naylor v. Commissioner*, T.C. Memo 2013-19 (§1212 capital loss carryover and §170 charitable contribution carryover).

[1067] *See* Rev. Rul. 81-88; GCM 38292 (Feb. 22, 1980); FAA 20124101F.

[1068] *See* T.C. Memo 2008-298.

[1069] §469(e)(2).

[1070] 1986 Senate Report at 722. *See also* 1986 Blue Book at 221.

[1071] Reg. §1.469-2T(c).

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(ii) The corporation's net active income for the tax year, which is the CHC's taxable income determined without regard to:

1. Passive activity gross income,

2. Passive activity deductions,

3. Portfolio income, including gross income treated as portfolio income under the regulations, such as gain from the disposition of substantially appreciated property formerly held for investment[1072] or under certain recharacterization rules,[1073]

4. Gross income subject to the oil and gas working interest rule,[1074]

5. Gross income and deductions from a trade or business activity that involves trading personal property,[1075] if the CHC did not materially participate in the activity for the tax year, and

6. Allocable interest expense and other deductions attributable to portfolio income.[1076]

The effect of the net active income rules is that a CHC's passive losses can be generally used against all of the CHC's income, except for:

1. Portfolio income, including income treated as portfolio income under the regulations, reduced by portfolio expenses,

2. Certain income from oil and gas activities, and

3. Gain or loss from the activity of trading personal property, such as stocks or bonds, in which the CHC does not materially participate in the trading activity.

Practice Point: Portfolio income is the most important of the nonpassive items that cannot be sheltered by a CHC's passive losses and credits. The 1986 Senate Report noted that it is "not intended that incorporation of an individual's portfolio investments be available as a way to avoid the passive loss rule."[1077]

Example: Corporation X is engaged in a trade or business activity in which it materially participates and a rental activity. X has $60,000 of rental income and $100,000 of rental deductions and $100,000 gross income and $80,000 of deductions from its business activities, as well as $35,000 of portfolio income and $15,000 of expenses from investments. X has $20,000 of net active income from its business activities ($100,000 less $80,000). X's passive loss is $20,000, the amount by which passive activity deductions for the tax year ($100,000) exceed the sum of (a) passive activity gross income ($60,000) and (b) net active income ($20,000). Therefore, X's taxable income is $20,000 ($195,000 gross income less $175,000 allowable deductions, i.e., total deductions less passive loss).[1078]

Example: Assume the same facts as the previous example, except that X also has a net operating loss (NOL) carryover of $15,000. X's net active income from its business activities is $5,000 ($100,000 less $80,000 deduction and $15,000 NOL), so its passive loss is $35,000 ($100,000 passive activity deduction less $60,000 passive gross activity income and $5,000 net active income). X's taxable income would still be $20,000, as gross income and allocable deductions would both remain $195,000 and $175,000 respectively (allowable deductions would equal total deductions of $210,000, which includes the NOL, less $35,000 passive loss).[1079]

A similar rule provides that passive credits may offset a CHC's income tax liability for passive income and active income, but not portfolio income. More specifically, passive credits can offset a CHC's net active income tax liability, which is the difference in the CHC's regular tax liability (within the meaning of §26(b)) if passive activity income were excluded, over the CHC's regular tax liability if both passive activity income and net active income were excluded.[1080] Any allowed credits (other than passive credits) decrease the net active income tax liability for purposes of this computation, without regard to certain otherwise applicable credit limitations such as the tax liability limitation.[1081]

Practice Point: The CHC passive credit rule contains a taxpayer-unfavorable ordering rule for a CHC that has nonpassive credits. All nonpassive credits are deemed to first offset the taxpayer's tax liability on active income, thereby reducing the remaining net active income tax liability that may be offset by passive credits, even if the nonpassive credits are generated from portfolio sources and would more properly offset portfolio income tax liability. For example, if the CHC has an additional $100 of dividend income that is portfolio income, with $21 of foreign tax credits from foreign dividend withholding taxes, then its ability to use passive credits against tax liability on active income is reduced by $21. The $21 of foreign tax credits is not allocated to the $21 of tax liability on the $100 of portfolio income.

Practice Point: To the extent that a passive credit is otherwise allowed for AMT purposes, it appears not be allowed for a CHC against the CHC's AMT liability.

Note: If a CHC has an NOL carryback, the regulations provide that the NOL carryback is taken into account in computing the CHC's net active income first, before the CHC's passive losses are used against the CHC's remaining net active income.[1082] The effect of this ordering rule is that the CHC uses

[1072] Reg. §1.469-2(c)(2)(iii)(F), discussed at V.D.3., below.
[1073] See IV.C., above.
[1074] Reg. §1.469-2T(c)(6), discussed at IV.C.7., above.
[1075] Reg. §1.469-1T(e)(6).
[1076] Reg. §1.469-1T(g)(4).
[1077] 1986 Senate Report at 722. *See* 1986 Blue Book at 221.

[1078] §1.469-1T(g)(4)(iii) *Ex.* (1).
[1079] §1.469-1T(g)(4)(iii) *Ex.* (2).
[1080] Reg. §1.469-1T(g)(5).
[1081] Reg. §1.469-1T(g)(5)(ii)(B)(2); §38(c)(1), §38(c)(6)(E).
[1082] Reg. §1.469-1T(g)(4)(iii) *Ex.* (2). *See* T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5688–5689 (Feb. 25, 1988):

("Since net active income is computed by modifying taxable income, net operating loss carrybacks and carryforwards to the tax year must be taken into account. Therefore, a net operating loss

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up the NOL carrybacks first, and the unused passive losses become passive loss carryovers. The regulation is contrary to the 1986 legislative history, which indicated that a CHC's "NOLs are applied after the application of the passive loss rule,"[1083] in which case the passive losses are used first and the NOL carryovers are preserved for later tax years.

2. *Consequences of Ceasing to Be a C Corporation Subject to the Passive Loss Rules*

A C corporation that is subject to the passive loss rules in one tax year may not be subject to the rules in a later tax year. For example, a CHC may have a public offering of its stock and cease to meet the closely held stock ownership requirement,[1084] or a PSC may change its principal activity to one not related to the performance of personal services.

The former CHC or former PSC is not subject to limitations on the use of passive losses and passive credits arising after its change in status, but passive loss carryovers and passive credit carryovers from prior tax years continue to be limited under the CHC or PSC rules.[1085] In the case of a former CHC, such prior tax years' passive loss carryovers and passive credit carryovers still cannot offset portfolio income. In the case of a former PSC, such prior tax years' passive loss carryovers and passive credit carryovers still cannot offset portfolio income or other nonpassive income. Similarly, a former PSC that has become a CHC cannot use passive loss carryovers and passive credit carryovers from pre-change tax years against the former PSC's net active income in later tax years.

The 1986 Senate Report noted that when a CHC becomes a former CHC:

> [t]he corporation's ownership has been so broadened that the reason for limiting the corporation's ability to shelter its portfolio income becomes less compelling. A corporation which is not closely held is less susceptible to treatment as the alter ego of its shareholders, but competing considerations also apply. So as not to encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation. Deductions arising in tax years after the tax year in which the corporation's status changes are not subject to limitation under the passive loss rule.[1086]

In any event, a former CHC or former PSC can apply passive loss carryovers or passive credit carryovers against nonpassive income under the general passive loss rules, such as income from the same activity[1087] or upon a full unrelated taxable disposition of the activity.[1088] The former CHC's or former PSC's use of carryovers is subject to the "former passive activity"[1089] rules that apply when a passive activity becomes a nonpassive activity. The former CHC or former PSC should continue to track material participation and apply the same passive loss rules as before, until it no longer has any passive loss carryovers and passive credit carryovers.

For an S corporation that becomes a C corporation, or vice versa, §1371(b) generally provides that no carryforward or carryback may be carried from a C corporation tax year to an S corporation tax year, or vice versa. But in *St. Charles Inv. Co. v. Commissioner*,[1090] the Tenth Circuit Court of Appeals held that a corporation's passive loss carryovers, incurred in tax years when it was C corporation, may be carried forward and deducted in full in the tax year when it disposed of its passive activity following its election to be treated as S corporation. The general limitation on carryovers from C corporation tax years to S corporation tax years was inapplicable, because §469(b) more specifically provides that the passive loss carryovers shall be treated as an item with respect to the activity in the next tax year "except as otherwise provided in this section [469]."[1091]

If a CHC is closely held for several tax years during which it earns portfolio income, and the CHC later undergoes an ownership change such that it is no longer closely held, the former CHC's net operating loss (NOL) from a later tax year can be carried back and applied against the portfolio income earned in the earlier (closely held) tax years.[1092]

B. Ordinary Income and Capital Gain, Capital Loss Limitation (§1211)

The capital loss limitation in §1211 limits deductions for capital losses to the amount of capital gains (plus $3,000, in the case of an individual).[1093] Under the regulations, the capital loss limitation is applied after the application of the passive loss rules,[1094] which is a reverse from the order described in the 1986 Conference Report.[1095]

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carryback which requires a closely held corporation to recompute its net active income and net active income tax liability for one or more years may also require a recomputation of the corporation's passive activity loss and passive activity credit for one or more years.").

[1083] 1986 Senate Report at 723; 1986 Blue Book at 223.

[1084] *See* 1986 Senate Report at 728; 1986 Blue Book at 230.

[1085] §469(f)(2).

[1086] 1986 Senate Report at 728. *See also* 1986 Conference Report at II-139–140 (about former PSCs); 1986 Blue Book at 230–231.

[1087] §469(f)(2).

[1088] §469(g)(1). See V.H., below.

[1089] See V.G.1., below.

[1090] 232 F.3d 773 (10th Cir. 2000), *rev'g* 110 T.C. 46 (1998).

[1091] The decision reversed a contrary result at the Tax Court, in 110 T.C. 46 (1998), and the IRS National Office's conclusion in TAM 9628002.

[1092] PLR 201017007. See V.A.1., above, for a discussion of a CHC's NOL carrybacks. The TCJA and the CARES Act generally eliminated carrybacks for NOLs generated in tax years beginning in 2021 and later.

[1093] For married individuals filing separately, the amount deductible is capital gains plus $1,500. §1211(b)(1).

[1094] Reg. §1.469-1(d)(2).

[1095] *See* 1986 Conference Report at II-144:

> (The limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule. Thus, for example, if a taxpayer has a capital loss of $10,000 upon the disposition of a passive activity, and is also allowed to deduct $5,000 of previously suspended ordinary losses as a result of the disposition, the $5,000 of ordinary losses are allowed, but the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capital loss from the disposition is carried forward and allowed in accordance with the provisions determining the allowance of such capital losses.).

See also 1986 Blue Book at 227–228.

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Example: Taxpayer T has a $12,000 capital loss from a passive activity and $10,000 of ordinary income from a passive activity. T is allowed a $10,000 deduction under the passive loss rules, with a $2,000 passive loss carryover to the next tax year. Since the $10,000 deduction is a capital loss, T is allowed $3,000 of the capital loss against ordinary income under §1211, and T has a $7,000 capital loss carryover to the next tax year.[1096]

Example: In Year One, taxpayer T has a loss of $10,000 on the disposition of a portion of land used in a rental activity that is a passive activity. The land is not used in a trade or business under §1231, and accordingly the loss is a capital loss. T has $10,000 of capital gain from the sale of stock in Year One. The $10,000 deduction is disallowed under the passive loss rules. In Year Two, T sells the rest of the land used in the passive activity for a gain of $6,000. The passive loss carryover from Year One is allowed under the passive loss rules, by reason of a fully taxable disposition of his entire interest in the passive activity. The allowed passive loss carryover results in a $10,000 capital loss in Year Two, of which $9,000 is allowable in Year Two (*i.e.*, the $6,000 of Year Two capital gain plus $3,000).

Practice Point: Due to the interaction of the passive loss rules and the capital loss limitation, the recognition of an item of passive capital gain can lead to a decrease in taxable income.

Example: The taxpayer has $10,000 of capital gain from a passive activity, $12,000 of ordinary loss from another passive activity, and $10,000 of capital loss from a nonpassive activity. The taxpayer has a $2,000 passive loss, and the taxpayer can net the $10,000 nonpassive capital loss against the $10,000 passive capital gain. Thus, the taxpayer has a $10,000 ordinary loss that can be deducted currently against other income, and a $2,000 passive loss carryover to the next year.

Note: In CCA 201312041, the Chief Counsel's Office advised that, upon a disposition of a property used in a passive activity, ordinary losses generated by that property need not be used against the capital gains generated from the disposition. That is, gain from the disposition is treated as passive income for purposes of allowing that gain to offset passive losses from the same or other passive activities of the taxpayer. However, once it is determined that passive losses are not disallowed, regular rules will control the extent to which those gains and losses must offset each other for tax reporting purposes and for calculating the amount of tax due.

C. Items Allocable to a Passive Activity

The passive loss rules limit deductions from passive activities when the deductions are in excess of income from passive activities. The passive loss rules also limit credits from passive activities when the credits are in excess of the income tax liability allocable to passive activities. It is therefore necessary to determine when items of income, deduction, and credit are allocable to a passive activity.

The allocation of interest expense for passive loss purposes, as with regard to portfolio income, is governed by the regulations under §163.[1097] Thus, as discussed at III.C.3., above, with respect to the allocation of interest expense to passive income and portfolio income, the disbursements of debt proceeds are traced to specific expenditures.[1098] If debt is incurred to purchase a portfolio asset, interest expense paid on this debt is properly allocable to the portfolio asset's gross income.[1099] The same rules apply to interest expense allocable to passive income, so that interest expense is allocated to a passive activity's expenditure or a former passive activity's expenditure is taken into account for passive loss purposes in determining the income or loss of the expenditure's activity.[1100]

Debt is generally allocated to expenditures in accordance with the use of the debt proceeds, without regard to the type of property that secures repayment of the debt.[1101] Where debt proceeds are commingled with other proceeds (e.g., in a bank account), the debt proceeds generally are treated as expended before unborrowed dollars.[1102] A FIFO (first-in-first-out) rule applies where proceeds of more than one debt are commingled.[1103] However, if expenditures are made from an account within 30 days before or 30 days after the debt proceeds are deposited in the account, the taxpayer may trace the expenditure to such debt proceeds.[1104]

As discussed at III.C.3.b., above, noninterest expenses are treated as not from a passive activity only if they are "clearly and directly" allocable to gross portfolio income.[1105] The nonportfolio noninterest expenses, such as general and administrative expenses, are allocated between the taxpayer's passive and nonpassive activities. In the case of a building in which more than one activity is conducted, expenses such as rent or depreciation are allocated in proportion to the space occupied by each activity.[1106] For all other items, the regulations' preamble explained that "the regulations do not require that any particular method be employed in determining (a) whether items of income are derived from an activity, (b) whether deductions arise in connection with an activity, or (c) how shared costs should be allocated among activities. The regulations contemplate the

[1096] Reg. §1.469-1(d)(2) *Ex.*

[1097] Reg. §1.163-8T, Prop. Reg. §1.163-14 (related to sections I–V of Notice 89-35), Reg. §1.163-15 (related to section VI of Notice 89-35).

[1098] *See, e.g.*, PLR 200144013 (IRS ruled that to extent debt proceeds are used to acquire property used in a passive activity, interest attributable to such debt constitutes a passive activity deduction).

[1099] Reg. §1.163-8T(a)(3).

[1100] Reg. §1.163-8T(a)(4)(i)(B).

[1101] Reg. §1.163-8T(c)(1).

[1102] Reg. §1.163-8T(c)(4)(ii)(A).

[1103] Reg. §1.163-8T(c)(4)(ii)(B).

[1104] Reg. §1.163-8T(c)(4)(iii)(B), §1.163-15(a) (formerly in section VI of Notice 89-35), finalized in T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021), applicable to tax years beginning after March 21, 2021. *See* Reg. §1.163-8T(c)(4)(iii)(B) Ex (2). Similarly, if a taxpayer receives debt proceeds in cash, the taxpayer may treat any cash expenditure within 30 days before or 30 days after the cash receipt as made from such debt proceeds and deemed to be made on the date the taxpayer receives the cash. Reg. §1.163-7T(c)(5)(i), §1.163-15(a).

[1105] §469(e)(1)(A)(i)(II); Reg. §1.469-2T(d)(4).

[1106] 1986 Senate Report at 743. *See also* 1986 Blue Book at 249–250.

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use of reasonable methods in making these determinations, and the [IRS] will disregard unreasonable determinations."[1107]

Note: State and local income taxes are always nonpassive expenses, even if the taxes are imposed on passive income.[1108]

When a change in the taxpayer's accounting method results in either an increase or decrease in taxable income under §481, a ratable portion of the positive (or negative) adjustment that relates to a particular activity is treated as giving rise to passive income or passive deductions, if the activity is a passive activity in the tax year in which the adjustment is made.[1109]

The ratable portion that is so treated is determined by considering the extent to which positive adjustments to some activities are offset by negative adjustments to other activities, or vice versa.

> *Example:* Taxpayer T has three activities (Activities A, B, and C), of which Activities A and C are passive activities. T has positive §481 adjustments of $1,000 with respect to Activity A and $500 with respect to Activity B, and a negative §481 adjustment of $600 with respect to Activity C. Of the net positive adjustment of $900, $600 is allocated to Activity A, $300 to Activity B, and zero to Activity C.[1110] No negative adjustment is made with respect to Activity C for passive loss purposes due to the absence of an overall negative §481 adjustment for T.

Practice Point: A taxpayer may consider changing the status of an activity from passive to active, or vice versa, in the tax year of change in order to maximize its benefit or minimize its detriment from a §481 adjustment.

For a discussion of what constitutes a change in a method of accounting and the type of adjustments which are required to be made, *see* TAM 201035016 (recharacterization of taxpayers' activities from nonpassive to passive for purposes of passive loss and passive credit rules is not a change in "method of accounting" for purposes of §446(e) and §481(a)). For further discussion of changes in method of accounting and §481 adjustments, see generally 572 T.M., *Accounting Methods — Adoption and Changes.*

D. Disposition of Property Used in a Passive Activity

1. General Rule

A disposition of an interest in property that is used in an activity generally gives rise to a gain or loss with respect to that activity. The passive or nonpassive character of the disposition gain or loss generally is determined by the nature of the activity in the tax year of the disposition.[1111] The passive or nonpassive character does not depend on whether the gain is capital gain or ordinary income (such as from depreciation recapture). A special rule in §469(g)(1) applies to the full unrelated taxable disposition of an activity, as noted at V.H., below.

> *Example:* A partnership is engaged in an automobile leasing activity, which is not a rental activity because the average period of customer use is seven days or less. The activity purchases an automobile in Year One and sells it at a gain in Year Four. Taxpayer T, who owns an interest in the partnership at all relevant times, materially participates in the activity for the tax years Year One through Year Three but not in Year Four. Thus, the activity is a passive activity for T in Year Four, but in no other tax year. In that case, T's share of the gain on the disposition is passive, like his share of all other income or loss from the activity in Year Four. It is irrelevant that some of the appreciation accrued as unrealized gain in prior tax years.

> *Example:* Assume the facts in the Example above. Assume further that the disposition gain is reported under the §453 installment method, and a portion of such gain is recognized in Year Five, a tax year in which T materially participates in the activity. X's share of the disposition gain that is recognized in Year Five is passive by reason of the activity's character in the tax year of disposition (*i.e.*, Year Four), even though all other Year Five income is nonpassive.

In *Edelberg v. Commissioner*,[1112] the taxpayer sold its medical billing and collection business in 1986, in exchange for future payments based on the buyer's collections and number of billed patients. The Tax Court treated the payments received by the taxpayer in 1988 through 1990 as capital gain from the sale of the business's goodwill (or other business assets), which is nonpassive income because the taxpayer materially participated in the business in 1986.

The regulations' preamble noted that the IRS:

> recognizes that an approach that focuses on the character of the activity at the time of a disposition may in many circumstances appear arbitrary, and considered various other approaches. These approaches, including approaches taking into account the nature of the activity or the use of the property during the taxpayer's entire holding period, were rejected because they are found to be equally arbitrary and substantially more difficult to administer.[1113]

A taxpayer might change the activity of a property before its disposition, such as from a nonpassive activity to a passive activity in order to create passive gain, or from a passive activity to a nonpassive activity in order to create a nonpassive loss.[1114] Three anti-abuse rules generally require taxpayers to disregard the property's last activity in certain circumstances:

[1107] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5689 (Feb. 25, 1988).

[1108] Reg. §1.469-2T(d)(2)(vi), discussed at III.C.7., above.

[1109] Reg. §1.469-2T(c)(5)(i), §1.469-2T(d)(7)(i).

[1110] *See* Reg. §1.469-2T(c)(5)(iii), §1.469-2T(d)(7)(iii).

[1111] Reg. §1.469-2T(c)(2)(i)(A), §1.469-2T(d)(5)(i).

[1112] T.C. Memo 1995-386, *aff'd without pub. op.*, 111 F.3d 896 (11th Cir. 1997).

[1113] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5689–5690 (Feb. 25, 1988).

[1114] *See* 1986 Conference Report at II-147 (regulations may be appropriate for "activities previously generating active business losses that the taxpayer intentionally seeks to treat as passive at a time when they generate net income, with the purpose of circumventing the [passive loss] rule"). *See also* 1986 Blue Book at 234–235.

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(1) The property is used in more than one activity during the 12 months before disposition;[1115]

(2) The property disposed of is substantially appreciated;[1116] or

(3) The property was held for sale to customers after use in a nondealer activity.[1117]

In applying the disposition rule and its three anti-abuse rules, each material portion of property is treated as a separate interest in property.[1118] Reasonable allocations of adjusted basis and amounts realized must be made when necessary to determine the gain or loss upon disposition of different interests in property.[1119] For example, separate floors in a building that are used in different activities are separate interests in property, even if the taxpayer does not maintain a separate adjusted basis for each floor.[1120] The basis allocation may be based on the square footage of those portions of the building used in each activity.[1121]

In order for a disposition of property to be treated as giving rise to income or loss from a passive activity, the property must in fact be used in the activity.[1122] For example, while a building that is held for rental may constitute one or more interests in property used in a rental activity, a contract to acquire the building does not so qualify because the contract itself is not used in the activity. Accordingly, where a taxpayer enters into such a contract, but sells his rights under the contract before actual acquisition, any gain or loss on such sale is not treated as arising in a rental activity.[1123]

Similarly, a partnership interest or S corporation stock is not property used in an activity under the regulations.[1124] As described below, special rules apply to their dispositions.

2. *Property Used in More than One Activity During 12 Months Before Disposition*

If an interest in property is used in more than one activity during the 12 months before the disposition, the disposition gain or loss must be allocated among the activities on a basis that reasonably reflects the use of the interest in the property during the 12-month period.[1125]

A reasonable allocation may be based on the number of days of use in each activity or the amount of use in each activity.[1126] The regulations' preamble added that:

> [t]he regulations provide only that the allocation of amount realized and adjusted basis must be reasonable. Examples illustrate that an allocation among activities is considered reasonable if it is based on the period for which the property is used in each such activity during the 12-month period. These examples are not intended to foreclose the use of other reasonable allocation methods.[1127]

The property's use before the taxpayer acquires an interest in it through a transaction other than a nonrecognition transaction is disregarded.[1128] In other words, the taxpayer does not need to look into the prior use of property acquired in a fully taxable transaction. However, if a partnership distributes property to the taxpayer partner in a nonrecognition transaction, the partnership's use of the property is counted.

Practice Point: If during the 12-month period a partner acquired an interest in the partnership in a taxable transaction (*e.g.*, by buying it from a partner or in exchange for services contributed to the partnership), the partnership's use of the property before the acquisition should probably be disregarded, even if the taxpayer owned an interest in the partnership before the acquisition. *But see* Reg. §1.469-2T(c)(2)(ii) *Ex.* (2), which, while not on point, treats an allocation of the use of property as being made by the partnership, rather than by a partner.

Practice Point: The 12-month rule applies only if the property is used in more than one activity during the 12-month period, but not if there is only one activity that changes its nature during that period.[1129] For example, a decrease in material participation in a later tax year may cause an activity to become a passive activity, particularly if the disposition occurs early in the later tax year before the hourly tests are met, which would not trigger the 12-month rule.

Small interests in property are allowed a de minimis rule,[1130] under which the disposition gain or loss can be allocated solely to the activity in which the property was predominantly used during the 12-month period. The de minimis rule applies if the taxpayer's interest in the property does not exceed the lesser of (a) $10,000 or (b) 10% of the sum of the fair market value of the interest and all other properties used in such activity immediately before the disposition.

3. *Disposition of Substantially Appreciated Property Formerly Used in Nonpassive Activity*

To the extent that the above 12-month rule does not treat the disposition gain as nonpassive income,[1131] a further rule applies to gain from the disposition of a taxpayer's interest in substantially appreciated property that is used in a passive activity at the time of its disposition.[1132] An interest in property is considered substantially appreciated if the fair market value of such interest exceeds 120% of its adjusted basis.[1133]

Gain from such a disposition is nonpassive unless the property was used in a passive activity for either:

[1115] Reg. §1.469-2T(c)(2)(ii), §1.469-2T(d)(5)(ii).
[1116] Reg. §1.469-2(c)(2)(iii).
[1117] Reg. §1.469-2(c)(2)(v).
[1118] Reg. §1.469-2T(c)(2)(i)(C)(1).
[1119] Reg. §1.469-2T(c)(2)(i)(C)(2).
[1120] Reg. §1.469-2T(c)(2)(i)(D) *Ex.* (4).
[1121] Reg. §1.469-2T(c)(2)(i)(D) *Ex.* (4).
[1122] Reg. §1.469-2T(c)(2)(i)(A).
[1123] Reg. §1.469-2T(c)(2)(i)(D) *Ex.* (3).
[1124] Reg. §1.469-2T(c)(2)(i)(B).
[1125] Reg. §1.469-2T(c)(2)(ii), §1.469-2T(d)(5)(ii).
[1126] Reg. §1.469-2T(c)(2)(ii) *Exs.* (2), (3).
[1127] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5690 (Feb. 25, 1988).
[1128] Reg. §1.469-2(c)(2)(iv).
[1129] A change in status from a nonpassive trade or business activity to a passive rental activity is likely to trigger the 12-month rule, because a rental activity is usually a separate activity from a nonrental activity. *See* Reg. §1.469-4(d)(1) and III.D.3.a., above.
[1130] Reg. §1.469-2T(c)(2)(ii).
[1131] Reg. §1.469-2(c)(2)(iii)(E).
[1132] Reg. §1.469-2(c)(2)(iii).
[1133] Reg. §1.469-2(c)(2)(iii)(C).

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1. 20% of the period during which the taxpayer owned such interest in the property; or

2. the entire 24-month period ending on the date of the disposition.[1134]

Practice Point: In contrast to the 12-month rule, the substantially appreciated property disposition rule applies only to passive gains (not passive losses, nor nonpassive gains or losses), and treats the gain entirely as nonpassive, with no proration for the gain that accrued after the property was used in a passive activity.

For this anti-abuse rule, but apparently not for the other anti-abuse rules, the date of disposition is the date on which the taxpayer's interest in the property becomes subject to an oral or written agreement that either requires the owner or gives him an option to transfer such interest for consideration that is fixed or otherwise determinable on such date.[1135] It is unclear whether the oral agreement must be enforceable under local law, such as due to any applicable statute of frauds.

Use in tax years before 1987 is relevant to this anti-abuse rule. A taxpayer is treated as not having materially participated for such tax years before 1987 except in the case of a tax year in which he participated for more than 500 hours.[1136]

As under the 12-month rule, the ownership and use of the property before the taxpayer acquired an interest in the property in a transaction (other than in a nonrecognition transaction) is disregarded.[1137] The taxpayer can therefore disregard the prior use of a property acquired in a taxable transaction, even if the taxpayer owned an interest in the property (either directly or indirectly through a pass-through entity) before such acquisition.

Gain from a disposition of substantially appreciated property subject to the above rule is further treated as portfolio income, if the property was held for investment for more than 50% of the time during which the taxpayer held an interest therein in nonpassive activities.[1138]

Example: Taxpayer A acquires a building on January 1, Year One, and uses it in a trade or business activity in which she materially participates until March 31, Year Twelve. On April 1, Year Twelve, A leases the building to B, in what is a rental activity for A. On December 31, Year Thirteen, A sells the building. At the time of the sale, A's interest in the building is substantially appreciated. The building was not used in a passive activity for the entire 24-month period ending on the date of the sale, as its passive activity use began on April 1, Year Twelve. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the building (13 years). Therefore, the gain from the sale is not from a passive activity.[1139]

Any period during which a taxpayer holds an interest in the property through a C corporation or similar entity is treated as a period during which he holds an interest in the property for investment.[1140]

Example: A, an individual, is a stockholder of corporation X, a C corporation until its conversion into an S corporation on December 31, 20X1. X acquires a building on January 1, 20X1, which it sells on March 1, 20X2, at which time 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, in a rental activity. The building is treated as held in a nonpassive activity and as held for investment for the period that it was held by X while X was a C corp (January 1, 20X1 through December 31, 20X1) and held in a passive activity for the period that it was held by X while X was an S corp (January 1, 20X2 through February 28, 20X2). A's interest in the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the two-month period during which A's interest in the building was used in a passive activity is less than 20% of the period during which A held an interest in the building (14 months). Therefore, the gain from the sale is not from a passive activity. The gain is treated as portfolio income, because the property was held for investment for more than 50% of the period during which A held it for nonpassive activities (*i.e.*, the entire 12-month period from January 1, 20X1, to December 31, 20X1).[1141]

4. *Property Held for Sale to Customers After Use in a Nondealer Activity*

A taxpayer may have held a property in a rental activity for a long time before switching the property to being held primarily for sale to customers in the ordinary course of a trade or business, i.e., a dealer activity. Under the general disposition rules, the disposition of the property would be attributable to the dealer activity, instead of the rental activity or other prior nondealer activity.

However, a special dealer rule provides that a disposition of a taxpayer's interest in property is attributable to the prior nondealer activity, instead of the dealer activity at the time of the disposition, if all of the following circumstances are met:[1142]

(1) At the time of the disposition, the taxpayer holds the property in a dealer activity,

(2) The taxpayer has one or more other activities, i.e., nondealer activities, and the interest in the property was used in the nondealer activity (or activities) for more than 80% of the time that the taxpayer held its interest in the property, and

(3) The interest in the property was not acquired and held by the taxpayer for the principal purpose of selling the in-

[1134] Reg. §1.469-2T(c)(2)(iii)(A). The date of disposition is the date on which the taxpayer's interest in the property becomes subject to an oral or written agreement that either requires or gives an option to the owner to transfer such interest for consideration that is fixed or otherwise determinable on such date. Reg. §1.469-2(c)(2)(iii)(B).

[1135] Reg. §1.469-2(c)(2)(iii)(B).

[1136] *See* Reg. §1.469-11(c)(3) and §1.469-5(j); T.D. 8175 (Preamble to Temporary Regulations, 53 Fed. Reg. 5686 (Feb. 25, 1988)).

[1137] Reg. §1.469-2(c)(2)(iv).

[1138] Reg. §1.469-2(c)(2)(iii)(F).

[1139] Reg. §1.469-2(c)(2)(iii)(G) *Ex.* (1).

[1140] Reg. §1.469-2(c)(2)(iii)(D). An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (as defined for passive loss purposes) from it.

[1141] Reg. §1.469-2(c)(2)(iii)(G) *Ex.* (2).

[1142] Reg. §1.469-2(c)(2)(v)(A).

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terest to customers in the ordinary course of a trade or business.

Conversely, the special dealer rule does not apply if any of the following conditions are met:

(1) At the time of the disposition, the taxpayer is not engaged in any nondealer activities, whether passive or nonpassive, or

(2) The property has been used in one or more nondealer activities for only 80% or less of the time that the taxpayer held its interest in the property, disregarding any time before the taxpayer's acquisition of the interest in a fully taxable transaction.

There is rebuttable presumption[1143] that a taxpayer acquired a property for the principal purpose of selling it to customers in the ordinary course of a trade or business, if either:

(1) The taxpayer used the property in nondealer activities for the lesser of (i) 24 months or (ii) 20% of the §168 depreciation recovery period applicable to the property, or

(2) The property was simultaneously offered for sale to customers and used in the nondealer activity for more than 25% of the period during which the property was used in the taxpayer's nondealer activities. Property is not treated as offered for sale to customers solely because a lessee has an option to purchase the property.[1144]

In cases not subject to the special dealer rule, the use of the property in a nondealer activity is disregarded during any period which the property is also offered for sale to customers.[1145] Accordingly, such a property is used in the dealer activity. Generally, such a property is used in the dealer activity unless all of the following three tests are met:

(1) The property was offered for sale for 25% or less of the nondealer holding period,

(2) The nondealer holding period is more than 80% of the total holding period, and

(3) The nondealing holding period is at least 24 months (or 20% of the applicable depreciation recovery period, if less).

Example: An individual acquires a residential apartment building on January 1, Year One, and uses the building in a rental activity. In January Year Four, the apartment is converted into condominium units, which are held for sale to customers in the ordinary course of business. The condominium units are still rented out until they are sold throughout Year Four.[1146]

The special dealer rule applies in the example because:

(1) At the time of the disposition, the taxpayer holds the condominium units in a dealer activity,

(2) The taxpayer has a nondealer (rental) activity, and the building or condominium units were used in the rental activity for the entire holding period, which is more than 80% of the holding period, and

(3) The original building was not acquired and held by the taxpayer for the principal purpose of selling the building to customers in the ordinary course of a trade or business.

The rebuttable presumption of dealer property does not apply in the example because:

(1) The taxpayer used the property in the nondealer (rental activity) for more than 24 months, or

(2) The property was simultaneously offered for sale to customers and used in the nondealer activity for a year, which is 25% or less of the period during which the property was used in the taxpayer's nondealer activity (four years).

In other words, the property is not used in the dealing activity because all of the following requirements are met in the example:

(1) The condominium units were offered for sale for 25% or less of the nondealer (rental) holding period (sales period of up to 12 months compared to the rental holding period of four years).

(2) The nondealer (rental) holding period was 100% of the total holding period, which was more than 80%, because the units were rented up until their sales.

(3) The nondealer (rental) holding period was at least 24 months for the units.

Thus, the dealing activity is ignored, and the individual generates passive income under the general disposition rule because the activity was a passive rental activity in the tax year of sale. The 12-month rule does not apply because the condominium units were held in a passive rental activity for all 12 months before sale. The substantially appreciated property rule does not apply because of both the 24-month and 20% safe harbors.

Example: Assume the facts in the example above except that the individual sold some condominium units in Year Five. The rebuttable presumption of dealer property applies because the property was simultaneously offered for sale to customers and used in the nondealer activity for more than a year, which is over 25% of the period during which the property was used in the taxpayer's nondealer activity. If the presumption is not rebutted, the taxpayer's gain from the sale of the condominium units in Year Five is passive or nonpassive depending on the taxpayer's material participation in the dealer activity.

The special dealer rule applies only for purposes of the disposition rules in Reg. §1.469-2T(c) and the character of the gain or loss from the property's disposition, and not for other rules such as material participation in an activity.

5. Disposition of an Ownership Interest in an Entity

When a taxpayer recognizes gain or loss on the disposition of an interest in a pass-through entity, the gain or loss is allo-

[1143] Reg. §1.469-2(c)(2)(v)(A)(1)(ii).
[1144] Reg. §1.469-2(c)(2)(v)(A)(1)(ii).
[1145] Reg. §1.469-2(c)(2)(v)(B).
[1146] *See* Reg. §1.469-2(c)(2)(v)(C) *Exs.* (1), (3).

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cated to the activities conducted by the entity.[1147] All portfolio assets of an entity are treated as held in a single investment activity.[1148] The rules apply to all types of gain or loss transactions, such as a partnership distribution of money to a partner in excess of the partner's tax basis under §731(a) (including from a reduction of allocated liabilities under §752(b)), or an S corporation distribution to a shareholder in excess of the shareholder's tax basis under §1368(b)(2).[1149]

Different rules apply for gains and losses. If the taxpayer recognizes gain on the disposition of an interest in a pass-through entity, the gain is allocated only to the entity's appreciated trade or business, rental, or investment activities, i.e., the entity's activities that would have a net gain allocated to the taxpayer if the entity were to dispose of the entire activity.[1150] The gain is allocated to each appreciated activity based on its net gain relative to the total net gains from appreciated activities.

Conversely, if the taxpayer recognizes loss on the disposition of an interest in a pass-through entity, the loss is allocated only to the entity's depreciated trade or business, rental, or investment activities, i.e., the entity's activities that would have a net loss allocated to the taxpayer if the entity were to dispose of the entire activity.[1151] The loss is allocated to each depreciated activity based on its net loss relative to the total net losses from depreciated activities.

> *Example:* Taxpayer T sells a share of stock in an S corporation for a gain of $5,000. The corporation conducted three activities: Activity A, which would have yielded a gain to the corporation of $80,000 upon disposition; Activity B, which would have yielded a gain of $20,000; and Activity C, which would have yielded a loss of any amount (the actual loss amount does not affect the computation). Only A and B are appreciated activities, so the ratable portion of gain allocated to C is zero. Since four-fifth of the net gain from appreciated activities is related to A, four-fifth of the gain from selling the share of stock, or $4,000, is allocated to Activity A, and one-fifth, or $1,000, is allocated to Activity B. If Activities A and B are passive activities, while Activity C is a nonpassive activity that would have given rise to a nonpassive loss upon disposition, that nonpassive loss is effectively used to reduce only the passive gain from the disposition of Activities A and B, instead of other nonpassive income.

The gain or loss computations take §743(b) adjustments into account,[1152] as well as §704(c) gain or loss allocable to the selling partner.[1153]

It may be impossible to apply the above rules in some cases, in which case the gain or loss on disposition of the ownership interest is allocated among the entity's activities in proportion to their respective fair market values, rather than with regard to the amount of their appreciation or depreciation.[1154]

The rules generally are applied by looking through a tiered entity structure. For example, if an individual is a partner in Partnership UTP, which itself is a partner in Partnership LTP, and UTP disposes of an interest in LTP, then the individual is treated as having indirectly disposed of an interest in LTP.[1155]

a. Applicable Valuation Date

In all of the above cases, the pass-through entity can choose the applicable valuation date for valuing its activities and their net gains or net losses, as either (i) the date of the disposition or (i) the first day of the pass-through entity's tax year in which the disposition occurs.[1156] The method of selecting the applicable valuation date is not specified in the regulations, but it may be made separately with respect to each disposition.[1157]

However, the pass-through entity must use the date of the disposition if, during the period of its tax year before the date of the disposition, any of the following events occur:

(a) the pass-through entity disposes of more than 10% of its interest in any activity,

(b) an activity of the pass-through entity disposes of more than 10% of its property,

(c) the taxpayer contributes substantially appreciated property (fair market value exceeds 120% of adjusted basis) to the pass-through entity with a total fair market value that is more than 10% of the holder's interest in the pass-through entity, or

(d) the taxpayer contributes substantially depreciated property (adjusted basis exceeds 120% of fair market value) to the pass-through entity with a total adjusted basis that is more than 10% of the holder's interest in the pass-through entity.[1158]

In each case, the 10% valuation is made as of the beginning of the tax year.[1159]

b. Certain Gain upon Disposition of an Ownership Interest, Otherwise Allocable to a Passive Activity, Treated as Not from a Passive Activity

In certain circumstances where the above allocation rules would result in allocating gain to a passive activity, the gain may be recharacterized as from a nonpassive activity under effectively an extension of the recharacterization rules discussed at IV.C., above. The recharacterization rule applies if all of the following three conditions are met:[1160]

1. The taxpayer has gain from the disposition of an interest in a pass-through entity that is allocated to a passive activity of the pass-through entity,[1161]

2. If the passive entity had sold all of its property in the passive activity, the taxpayer would have been allocated

[1147] Reg. §1.469-2T(e)(3).
[1148] Reg. §1.469-2T(e)(3)(v).
[1149] Rev. Rul. 95-5. *See also* TAM 9501001.
[1150] Reg. §1.469-2T(e)(3)(ii)(B)(1).
[1151] Reg. §1.469-2T(e)(3)(ii)(B)(2).
[1152] Reg. §1.469-2T(e)(3)(ii)(D)(2).
[1153] Reg. §1.469-2T(e)(3)(vii) *Ex.* (2).
[1154] Reg. §1.469-2T(e)(3)(ii)(C).
[1155] Reg. §1.469-2T(e)(3)(ii)(D)(3).
[1156] Reg. §1.469-2T(e)(3)(ii)(D)(1)(i).
[1157] Reg. §1.469-2T(e)(3)(ii)(D)(1)(i).
[1158] Reg. §1.469-2T(e)(3)(ii)(D)(1)(ii).
[1159] Reg. §1.469-2T(e)(3)(ii)(D)(1)(ii).
[1160] Reg. §1.469-2T(e)(3)(iii).
[1161] Reg. §1.469-2T(e)(3)(iii)(A).

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nonpassive gain under any of the following five recharacterization rules:[1162]

a. The rule for substantially appreciated property formerly used in a nonpassive activity,[1163]

b. The oil and gas working interest rule,[1164]

c. The incidental-to-development rule,[1165]

d. The self-rental rule,[1166] or

e. The pass-through entity royalty rule,[1167] and

3. The amount of the nonpassive gain in condition #2, hypothetically allocated to the taxpayer under the above five recharacterization rules, exceeds 10% of the taxpayer's gain under condition #1.[1168]

In which case the taxpayer's gain under condition #1 is treated as nonpassive gain to the extent of the amount of nonpassive gain in condition #2.

Practice Point: The gain under condition #1 is limited to the taxpayer's interest being disposed, whereas the gain under condition #2 is the taxpayer's share of pass-through entity's entire gain from the activity, which can overstate the nonpassive gain in some cases where the taxpayer is not disposing of its entire interest in the entity.

If an upper-tier passthrough entity recognized gain from the disposition of an interest in a lower-tier pass-through entity, the above rules apply to the owners of the upper-tier pass-through entity.[1169]

6. Tax Year of an Item

The tax year of a deduction item is generally the tax year that the item would have been allowable as a deduction, under the taxpayer's method of accounting, if taxable income were determined with regard to all Code provisions other than the passive loss rules, the §613A(d) limitation of percentage depletion to generally 85% of taxable income, and the §1211 capital loss limitation.[1170] An item affects the net amount of passive income or passive loss only when it is allowable under all other Code provisions. The treatment of a deduction from an activity therefore generally depends on the activity's status for the current tax year in which the deduction is allowed.

Example: A partner materially participates in a partnership activity in 20X1, but a deduction relating to the activity (and otherwise allowable for 20X1) is limited under §704(d) due to the lack of partnership interest basis and carried over. If, in 20X2, the deduction is allowable under §704(d), but the partner is no longer materially participating in the activity, the deduction may be limited under the passive loss rules in 20X2.[1171]

Where a partnership or S corporation (pass-through entity) has a different tax year than a taxpayer who owns an interest in the entity, the pass-through entity's tax year is applied to determine participation of the taxpayer.[1172] The regulations' preamble explained that:

> the treatment of an item of gross income, deduction, or credit from a fiscal year partnership or S corporation as passive activity gross income, as a passive activity deduction, or as a credit from a passive activity, respectively, is determined by reference to the taxpayer's participation in the activity to which such item relates for the partnership's or S corporation's tax year in which the item arose.[1173]

Example: T, a calendar year taxpayer, is a partner in a partnership that has a tax year ending in February. T's tax return for 20X2 includes income and deductions from the partnership, for the period from March 1, 20X1, through February 28, 20X2. In determining how many hours T participated in an activity of the partnership, T examines his hours spent during the partnership's fiscal year, not during calendar year 20X2.[1174] If the activity is conducted partly by the partnership and partly by T in his individual capacity, T presumably would determine participation in the activity for 20X2 by adding together: (1) T's hours of participation as a partner during partnership's fiscal year; and (2) T's hours of participation as a nonpartner during the calendar year.

Any deduction that is disallowed under the passive loss rules is carried over to the next tax year, and treated as a deduction arising in that tax year.[1175] The losses may be carried over indefinitely until they are used.

7. Determination of Which Items Are Disallowed

Once the taxpayer has identified all items of passive activity gross income and deduction, it is possible to determine whether he has a passive loss that will be disallowed in the absence of the disposition rules. Passive losses and deductions are disallowed only if they exceed passive gross income, and losses or deductions from one passive activity can offset gross income from another passive activity.[1176]

In applying the passive loss rules, the taxpayer should compute separately the net gain or loss from each activity, as well as for passive activities as a whole. This is necessary to determine which deductions, from which activities, are disallowed and become part of the passive loss carryover; this may be relevant, for example, in applying the full unrelated taxable

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[1162] Reg. §1.469-2(e)(3)(iii)(B).
[1163] Reg. §1.469-2(c)(2)(iii), discussed at V.D.3., above.
[1164] Reg. §1.469-2(c)(6), discussed at IV.C.7., above.
[1165] Reg. §1.469-2(f)(5), discussed at IV.C.4., above.
[1166] Reg. §1.469-2(f)(6), discussed at IV.C.5., above.
[1167] Reg. §1.469-2T(f)(7), discussed at IV.C.6., above.
[1168] Reg. §1.469-2T(e)(3)(iii)(C).
[1169] Reg. §1.469-2T(e)(3)(iii)(A).
[1170] Reg. §1.469-2(d)(8). For more about §613A, *see* Rev. Rul. 79-347; *Lastarmco Inc. v. Commissioner*, 79 T.C. 810 (1982), *aff'd*, 737 F.2d 1140 (5th Cir. 1984).
[1171] *See* T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5691 (Feb. 25, 1988), and VI.D., below.
[1172] Reg. §1.469-2T(e)(1).
[1173] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5697 (Feb. 25, 1988).
[1174] *See* Reg. §1.469-2T(e)(1) *Ex.*
[1175] §469(b); Reg. §1.469-1(f)(4).
[1176] §469(a)(1), §469(d)(1); Reg. §1.469-1T(a)(1), §1.469-2T(b)(1).

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disposition rule or the $25,000 special allowance in a subsequent tax year.[1177]

The loss, if any, from an activity, as determined for this purpose, should reflect the allowance of any deductions against nonpassive income by reason of the $25,000 §469(i) special allowance described in V.F.1., below.[1178]

Once the gain or loss from each passive activity has been determined, the amount of any overall passive loss is allocated among the loss activities in proportion to the amount of their net losses.[1179]

> *Example:* Taxpayer T has three activities: Activities A, B, and C. Activity A has a net loss of $9,000, Activity B has a net loss of $16,000, and Activity C has net income of $4,000. T's overall passive loss is $21,000, of which $7,560 ($21,000 multiplied by $9,000 divided by $25,000) is allocated to Activity A and $13,440 is allocated to B.[1180]

In determining the loss from each activity, SIPPAs that in the aggregate generate net income are treated as a single activity that does not have a loss for the tax year.[1181]

> *Example:* Taxpayer T has four activities: Activities A, B, C, and D. Activity A has net income of $10,000, Activity B has a net loss of $5,000, Activity C has net loss of $10,000, and Activity D has net income of $2,000. Activity A and Activity B are SIPPAs that generate $5,000 of net nonpassive income in the aggregate, and they are therefore considered a single activity that does not have a loss.[1182] The taxpayer's $8,000 disallowed passive loss, from Activity C and Activity B, is allocated solely to Activity C.

If any portion of the loss from a passive activity is disallowed, a ratable portion of each deduction from the activity is disallowed.[1183] The ratable portion does not apply to certain "excluded deductions,"[1184] which generally relate to working interests in oil or gas property,[1185] property rented incidental to development,[1186] property rented to a nonpassive activity,[1187] or interest in a pass-through entity engaged in licensing intangibles.[1188]

> *Example:* T had gross income of $5,000 and deductions of $15,000 from a passive activity, which gives rise to a $10,000 loss that is disallowed in full. Since the amount of the disallowed loss is two-third of the amount of all deductions, two-third of each item of deduction is disallowed.

It is not necessary to identify each disallowed deduction separately unless it may affect the amount of tax liability for any tax year.[1189] Conversely, it is necessary to separately identify each disallowed deduction that could affect the amount of tax liability for any tax year. Specifically, it is necessary to identify disallowed deductions that are capital losses or section 1231 losses.[1190]

> *Example:* Taxpayer T disposes of a portion of a real property used in a trade or business, held for more than one year, and used in a passive activity. T recognizes $100 of loss on the disposition, which is suspended under the passive loss rules and results in a $100 passive loss carryover to subsequent tax years. In a later tax year, T has $100 of passive income that is offset by the $100 passive loss carryover. The allowed $100 passive loss carryover results in a §1231 loss in the later tax year, which may be relevant for purposes such as the §1231 hotchpot in the later tax year and any §1231(c) recapture in five subsequent tax years. *See generally* 561 T.M., *Capital Assets — Related Issues.*

Although spouses filing a joint return generally are treated as one taxpayer for passive loss purposes,[1191] they must separately keep track of the disallowed deductions and credits arising with respect to their separate interests in passive activities.[1192] This requirement has no substantive effect on which deductions or credits are disallowed (e.g., where other Code limitations, such as the at-risk rules, also apply),[1193] but it can be relevant if the spouses cease to file joint returns in subsequent tax years.[1194]

8. *Effect of Changes in the Composition of the Taxpayer's Activities*

Passive loss carryovers and passive credit carryovers are allocated with respect to each specific activity that gives rise to the carryover.[1195] Additional complications arise if the composition of the taxpayer's activities changes from year to year. Passive loss carryovers and passive credit carryovers from prior tax years generally must be allocated among the current tax year's activities in a manner that "reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity."[1196]

> *Example:* Taxpayer B operates a restaurant and a catering business, which are treated as a single passive activity in Year 1. The passive activity gives rise to a $10,000 passive loss carryover to Year 2. In Year 2, the restaurant and the catering business are treated as two separate activities. The $10,000 passive loss carryover from Year 1 must be allocated between the restaurant activity and the catering activity in Year 2, in a manner that reasonably reflects the

[1177] For the full unrelated taxable disposition rule in §469(g), see V.H., below. For the $25,000 special allowance in §469(i), see V.F., below.
[1178] Reg. §1.469-1T(f)(2)(i)(B).
[1179] Reg. §1.469-1T(f)(2)(i)(A).
[1180] Reg. §1.469-1T(f)(2)(i)(D) *Ex.* (1).
[1181] Reg. §1.469-1T(f)(2)(i)(C). See IV.C.1., above.
[1182] Reg. §1.469-1T(f)(2)(i)(D) *Ex.* (2).
[1183] Reg. §1.469-1T(f)(2)(ii)(A).
[1184] Reg. §1.469-1T(f)(2)(i)(A).
[1185] See IV.C.7., above.
[1186] See IV.C.4., above.
[1187] See IV.C.5., above.
[1188] See IV.C.6., above.
[1189] Reg. §1.469-1T(f)(2)(iii).
[1190] *See* Reg. §1.469-1T(f)(2)(iii)(C).
[1191] Reg. §1.469-1T(j)(1).
[1192] Reg. §1.469-1T(j)(2)(i).
[1193] Reg. §1.469-1T(j)(2)(ii).
[1194] *See* Reg. §1.469-1T(j)(3).
[1195] *See* Reg. §1.469-1(f)(4)(iii) *Ex. (1).*
[1196] Reg. §1.469-1(f)(4)(i)(A).

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extent to which each of the separate activities continues the prior year's combined activity.[1197]

Several different methods may be reasonable in the same situation and can ordinarily be used.

Example: Taxpayer B operates a restaurant and a catering business, which are treated as a single passive activity in Years 1 and 2. The activity generated $20,000 of passive loss carryovers in Year 1 that are carried to Year 2, which are reduced to $10,000 of passive loss carryovers carried to Year 3.

	Restaurant	Catering Business	Combined Activity
Year 1 Gross Income	$20,000	$60,000	$80,000
Year 1 Deductions	($40,000)	($60,000)	($100,000)
Year 1 Net Income (Loss)	($20,000)	$0	($20,000)
Year 2 Gross Income	$40,000	$50,000	$90,000
Year 2 Deductions	($22,000)	($58,000)	($80,000)
Passive Loss Carryover to Year 2 (allocated based on Year 1 deductions)	($8,000)	($12,000)	($20,000)
Year 2 Net Income (Loss)	$10,000	($20,000)	($10,000)

In Year 3, the restaurant and the catering business become separate activities. In allocating the $10,000 passive loss carryover from the Year 2 single activity to the Year 3= separate activities, several allocation methods can ordinarily be used:

(i) The $10,000 passive loss carryover is allocated based on the single activity's Year 2 deductions, including the passive loss carryovers from Year 1 to Year 2. The single activity's Year 2 deductions are $100,000, of which $30,000 (30%) is allocable to the restaurant and $70,000 (70%) is allocable to the catering business. Thus, the $10,000 passive loss carryover can ordinarily be allocated as $3,000 (30%) to the restaurant activity in Year 3 and $7,000 (70%) to the catering activity in Year 3.[1198]

(ii) The $10,000 passive loss carryover is allocated as if the activities were separate in Year 2. A separate restaurant activity in Year 2 would have $10,000 net income, while a separate catering activity in Year 2 would have a $20,000 net loss. Thus, the $10,000 passive loss carryover can ordinarily be allocated as all $10,000 to the catering activity in Year 3.[1199]

(iii) The $10,000 passive loss carryover is allocated as if the activities were separate in Year 1 and Year 2 (and all other tax years). The $20,000 passive loss carryover in Year 1 arose from the separate restaurant activity in Year 1 and would be entirely allocated to the separate restaurant activity in Year 2, instead of $12,000 allocated to the separate catering activity in Year 2. The separate restaurant activity would have a $2,000 net loss in Year 2, while the separate catering activity would have an $8,000 net loss in Year 2. Thus, the $10,000 passive loss carryover can ordinarily be allocated as $2,000 to the restaurant activity in Year 3 and $8,000 to the catering activity in Year 3.[1200]

(iv) Any other reasonable allocation method.

When an activity contracts or disappears due to a change in how it uses its assets, the activity's passive loss carryovers are allocable to the activity that succeeds to the use of the assets.

Example: Law partnership P owns a building, of which several floors are used for its law practice and four floors are rented out to third-party tenants in Year 1. P is engaged in separate law practice and rental activities. If P converts two of the rental floors for P's use in Year 2, any passive loss carryovers from the rental activity that are reasonably allocable to those two floors are now allocated to P's law practice trade or business and may offset P's taxable income in Year 2. The reasonable allocated methods ordinarily include (i) an allocation of the rental activity's Year 1 deductions with respect to the two floors, (ii) a calculation of the passive loss carryovers if the two floors were a separate rental activity in Year 1, (iii) a calculation of the passive loss carryovers if the two floors were a separate rental activity in Year 1 and all earlier tax years, or (iv) a 50% allocation because two of the four floors were converted for P's use.[1201]

A special rule applies when an activity with passive loss carryovers is continued partly or wholly through a C corporation or similar entity.[1202] This can happen, for example, when a taxpayer contributes the activity's assets to a C corporation, or if the activity is owned by an S corporation that becomes a C corporation.[1203] Under this special rule, the taxpayer's interest in a C corporation (or similar entity) is treated as an inter-

[1197] *See* Reg. §1.469-1(f)(4)(iii) *Ex. (2).*

[1198] Reg. §1.469-1(f)(4)(iii) *Ex.* (3)(iii).

[1199] Reg. §1.469-1(f)(4)(iii) *Ex.* (3)(iv).

[1200] Reg. §1.469-1(f)(4)(iii) *Ex.* (3)(v).

[1201] Reg. §1.469-1(f)(4)(iii) *Ex.* (4). The rental passive loss carryovers that now are allocated to the law partnership activity are covered by the rules for former passive activities, and may presumably be deducted against nonpassive income if the former rental floors are sold in an unrelated full taxable disposition. *See* V.G., below.

[1202] An activity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (as defined for passive loss purposes) from their interests. Reg. §1.469-1(f)(4)(ii).

[1203] *See* Reg. §1.469-1(f)(4)(iii) *Ex.* (6).

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est in the preexisting passive activity, but solely for purposes of determining the current tax year activity to which prior tax years' passive losses are allocable.[1204] Thus, while such treatment is relevant to the application of the disposition rules (*i.e.*, the taxpayer has not disposed of the activity until he disposes of all of his stock in the C corporation or similar entity), it does not cause portfolio income from the taxpayer's interest in the C corporation to be treated as passive income.[1205] In other words, the taxpayer's dividends, gains, and other portfolio income from the C corporation cannot be offset by the passive loss carryovers from the activity contributed to the C corporation, until the taxpayer sells the C corporation's stock in a full unrelated taxable disposition, at which point the passive loss carryovers are allowed against all of the taxpayer's income (including gain from the C corporation's stock disposition and other portfolio income).

> *Example:* Taxpayer D owns stock of an S corporation that owns a rental activity, which resulted in $5,000 of passive losses allocated to D in Year 1. D has $2,000 of passive income from other activities in Year 1, which are offset by some of the passive losses. D has a $3,000 passive loss carryover to Year 2. In Year 2, the S corporation fails to maintain S corporation status due to the existence of a second class of stock,[1206] and the S corporation becomes a C corporation. The $3,000 passive loss carryover is allocated to the C corporation's rental activity.[1207] D's dividend income and gains from the C corporation are portfolio income and cannot be offset by the $3,000 passive loss carryover. The passive loss carryover may offset D's passive income from other sources. When D sells all of his C corporation stock to an unrelated person in a fully taxable transaction for $2,000 of gain, the $3,000 passive loss carryover is allowed under the full unrelated taxable disposition rule to offset the $2,000 of gain and $1,000 of D's other income. Alternatively, the C corporation elects back to being an S corporation after around five years,[1208] at which time the $3,000 passive loss carryover may offset D's share of rental income from the S corporation (and any other passive income).

E. Passive Credits

The passive credits subject to the passive loss rules are generally divided into two categories: (i) business-related credits in §38 through §45Z; and (ii) certain miscellaneous credits in §30 through §30D.[1209] The §38 general business credit in turn makes reference to various other credits in other Code sections.

The major types of passive credits include the following general business credits under §38:

- §41 research credit;
- §42 low-income housing tax credit (LIHTC);
- §45 renewable electricity production credit;
- §45D new markets tax credit;
- §47 historic rehabilitation tax credit;
- §48 energy credit; and
- §51 work opportunity credit.[1210]

Other passive credits include the following:

- §30B alternative motor vehicle credit for a new qualified fuel cell motor vehicle;
- §30C alternative fuel vehicle refueling property credit (for property placed in service after 2005 and before July 1, 2026);
- §30D clean vehicle credit (for vehicles acquired after 2008 and before October 1, 2026);
- §40 alcohol fuels credit;
- §40A biodiesel fuel credit;
- §40B sustainable aviation fuel credit (for fuel sold after 2022 and before January 1, 2025);
- §43 enhanced oil recovery credit;
- §44 disabled access credit for an eligible small business;
- §45A Indian employment credit;
- §45B employer social security credit for certain employee cash tips;
- §45C orphan drug credit;
- §45E small employer pension plan startup cost credit;
- §45F employer-provided child care credit;
- §45G railroad track maintenance credit;
- §45H low sulfur diesel fuel production credit;
- §45I marginal well production credit;
- §45J advanced nuclear power facility production credit;
- §45K nonconventional source production credit;
- §45L new energy efficient home credit (for qualified new energy efficient homes acquired after 2005 and before June 30, 2026);
- §45N mine rescue team training credit;
- §45P differential wage payment credit for employees who are active duty members of the uniformed services;
- §45Q carbon oxide sequestration credit;
- §45R small employer health insurance credit;
- §45S employer credit for paid family and medical leave;
- §45T retirement auto-enrollment credit for retirement savings options provided by small employers;

[1204] Reg. §1.469-1(f)(4).

[1205] *See* Reg. §1.469-1(f)(4)(iii) *Ex.* (5).

[1206] §1361(b)(1)(D); §1362(d)(2).

[1207] *See* Reg. §1.469-1(f)(4)(iii) *Ex.* (6).

[1208] §1362(g).

[1209] *See* §469(d)(2)(A)(i) (reference to subpart D of part IV of subchapter A (§38–§45Z)) and §469(d)(2)(A)(ii) (reference to subpart B (other than §27 (foreign tax credit)) of Part IV of subchapter A (§27–§30D)).

[1210] The §47 historic rehabilitation tax credit and the §48 energy credit are components of the investment credit referenced in §38(b)(1). *See* §46(1), §46(2).

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- §45U zero-emission nuclear power production credit (for electricity produced in taxable years after 2023 and before January 1, 2033);
- §45V clean hydrogen production credit (for qualified clean hydrogen production facilities the construction of which begins before January 1, 2028);
- §45W qualified commercial clean vehicles credit (for vehicles acquired after 2021 and before October 1, 2025);
- §45X advanced manufacturing production credit (not applicable to any wind energy component produced and sold after 2027, nor any metallurgical coal produced after 2030);
- §45Y clean electricity production credit (for property placed in service after 2024);
- §45Z clean fuel production credit;
- §45AA military spouse retirement plan eligibility credit;
- §48A qualifying advanced coal project credit;
- §48B qualifying gasification project credit;
- §48C qualifying advanced energy project credit;
- §48D advanced manufacturing investment credit;
- §48E clean electricity investment credit (for property placed in service after 2024);
- §1396(a) empowerment zone employment credit; and
- §5011 distilled spirits credit.[1211]

Passive credits also include various §38 general business credits that have not been codified, such as:

- the qualified disaster employee retention credit;[1212]
- the California wildfire employee retention credit;[1213] and
- the Hurricanes Harvey, Irma, and Maria employee retention credits.[1214]

Some of the above credits have temporary effect and are extended periodically.

Some of the credits are transferable under §6418, in which case the transferee taxpayer may be subject to the passive credit limitations, as described in IV.F., below.

Credits that are *never* passive credits include the §27 foreign tax credit, the §53 minimum tax credit, and all personal tax credits, such as the §24 child tax credit, the §32 earned income tax credit, and the §25D residential clean energy credit. The foreign tax credit is excluded because Congress believed that foreign tax credits were not being widely used by individual tax shelter investors, and that unnecessary difficulty would result if taxpayers had to apply the complex FTC limitations (e.g., under §904) to the passive loss rules.[1215] 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904.*

In general, the credits listed above are subject to the passive loss rules if they arise in connection with the conduct of a passive activity.[1216]

Credits from passive activities are disallowed under the passive loss rules only to the extent that their sum exceeds the taxpayer's regular tax liability allocable to all passive activities for the tax year.[1217] The amount of regular tax liability allocable to all passive activities for the tax year is the excess of: (1) the taxpayer's regular tax liability for the tax year; over (2) the amount of such liability, determined by disregarding both gross income and deductions from passive activities.[1218] Net income from passive activities is effectively "stacked last" — i.e., it is deemed to arise after nonpassive income in applying the progressive marginal income tax rates. Absent net income from passive activities, no credits from passive activities are allowable under the passive loss rules.

For purposes of this calculation, "regular tax liability" has the meaning given such term under §26(b).[1219] Thus, its determination involves disregarding not only the effect of credits on the amount of tax paid, but also certain additional taxes, such as the AMT, or various penalty taxes. The effective result is that credits are determined to be passive or nonpassive solely by reference to the regular tax liability, not the AMT liability, caused by passive income.

> *Example:* Taxpayer T's first $100,000 of income is taxed at 15%, and his next $100,000 is taxed at 28%. If T has taxable income of $200,000 (exactly half of which is derived from passive activities), his regular tax liability is $43,000, and $28,000 of such liability is allocable to passive activities due to the last stacking rule. Accordingly, T can use passive credits of at least $28,000 for regular income tax purposes.[1220] T's usable passive credits may be lower for AMT purposes.

If a pass-through entity has a different tax year than a taxpayer who owns an interest in the entity, the tax year of the pass-through entity is applied to determine participation (i.e., whether material, significant, or active participation) of the taxpayer in the activity in which the credit arose.[1221]

If any passive credits are disallowed for the tax year, a ratable portion of each credit from each of the taxpayer's passive activities is disallowed.[1222] The amount of net income from any particular activity is irrelevant for this purpose. This determination is made after applying the $25,000 §469(i) special allowance and after determining the effect of any election by the

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[1211] *See* §38 (listing current year business credits), §46 (listing components of the investment credit).

[1212] Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, Title III, §303(a) (2020 credit); Taxpayer Certainty and Disaster Tax Relief Act of 2019, Pub. L. No. 116-94, Div. Q, Title II, §203(a) (2019 and 2018 credit).

[1213] Bipartisan Budget Act of 2018, Pub. L. No. 115-123, §20103.

[1214] Disaster Tax Relief and Airport and Airway Extension Act of 2017, Pub. L. No. 115-63, §503.

[1215] S. Rep. No. 99-313 (1986 Senate Report) at 723 n.10 (1986); *see* Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1986* (1986 Blue Book), JCS-10-87, at 228 n.18 (1987).

[1216] Reg. §1.469-3T(b)(1)(i)(A).

[1217] §469(d)(2); Reg. §1.469-3T(a).

[1218] Reg. §1.469-3T(d)(1).

[1219] Reg. §1.469-3T(d)(2).

[1220] Assuming rate progressivity, the taxpayer is favored by stacking passive income after nonpassive income.

[1221] Reg. §1.469-3T(b)(3).

[1222] Reg. §1.469-1T(f)(3)(i). For the $25,000 special allowance in §469(i), see V.F., below.

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taxpayer to increase the basis of property by the amount of a disallowed credit.[1223] The taxpayer need not separately identify disallowed credits if such identification would not affect tax liability for any tax year.[1224]

Once a passive credit is allowed for passive loss purposes, the credit is aggregated with credits from the taxpayer's nonpassive activities, for purposes of determining whether all such credits are allowed in light of other credit limitations, such as the tax liability limitation and certain AMT limitations.[1225] In the event that any credit is not allowed because of these other limitations, the passive credits that are allowable under the passive loss rules are treated as nonpassive credits arising in the current tax year, with one-year or three-year carryback and 20-year or 22-year carryforward.[1226]

Upon a cessation or change in use (described in §50(a)(1) or §50(a)(2)) that causes the recapture of credits, the credits allocable to a taxpayer's activities must be adjusted by reason of the recapture.[1227] If the recapture is of a passive credit suspended under §469, the passive credit carryover is adjusted accordingly. It is less clear what happens in the case of recapture of an allowed passive credit. The recaptured credit is an additional tax in the tax year of the recapture with respect to a passive activity, which conceptually should be offset by the tax-equivalent amount of any passive loss carryovers. However, there is no statutory or regulatory provision to allow such an offset.

> *Example:* Taxpayer T owns a passive activity that generated an energy tax credit of $100 in Year One, which was entirely allowed under §469 and §38 in Year One. In Year Two, the activity generates a $200 passive loss. T disposes of the activity in 2019 and triggers $80 of credit recapture. The $80 recapture tax cannot be offset by the tax-equivalent benefit of the $200 loss, though the tax may be offset by other passive credits and passive credit carryovers.

Section 47(d) allows a historic rehabilitation tax credit for an increase in qualified progress rehabilitation expenditures, before the property is placed in service. Because it may not be known, at the time that the credit is generated, whether the progress rehabilitation expenditure property will be used in a passive activity when it is placed in service, the regulations provide that the historic rehabilitation tax credit is subject to §469 if it is "reasonable to believe" that the property will be used in a passive activity.[1228] It is unclear whether the taxpayer should amend its tax returns if its reasonable belief turned out to be incorrect.

Practice Point: Certain credits allow the parties to elect to choose which taxpayer may claim the credit, which may implicate the passive credit rules. In PLR 8951072, a lessor leased a building to a related S corporation, which used the building in a trade or business in which the S corporation's shareholders materially participated. The building gave rise to a historic rehabilitation tax credit, which if claimed by the lessor would have generated passive credits as a result of the lessor's passive rental activity. Instead, the lessor may elect under former §48(d)[1229] to allow the lessee S corporation to claim the credit, which would give rise to nonpassive credits for the S corporation's shareholders because of their material participation in the S corporation's trade or business.

Unlike passive loss carryovers, passive credit carryovers are not allowed upon a disposition of the related activity.[1230] The taxpayer may elect to increase the basis of the disposed property by any unused passive credit carryovers.[1231]

Note: Certain state income tax credits may be passive credits subject to the passive loss rules for state income tax purposes. California, for example, provides that passive credits include the California research tax credit,[1232] the California targeted jobs credit,[1233] the former California orphan drug credit,[1234] and the California low income housing tax credit.[1235] Other states like New York do not apply passive credit limitations to state income tax credits.[1236]

F. *Rental Real Estate Activities with Active Participation*

1. *Allowance of up to $25,000 of Losses*

Although rental activities are per se passive, and their losses generally cannot offset nonpassive income, the passive loss rules contain a limited exception for rental real estate activities. This special rule, known as the "small landlord exception," "$25,000 rule," "$25,000 offset," or "$25,000 special allowance," permits certain taxpayers to use up to $25,000 of losses from rental real estate activities against nonpassive income.[1237] The $25,000 special allowance is subject to a phaseout as taxable income increases over $100,000.[1238]

Worksheet 5 of this Portfolio provides a link to a flowchart of the application of the §469(i) $25,000 Special Allowance.

The 1986 Senate Report explained that:

> [a] limited measure of relief [from the passive loss rules] is believed appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are

[1223] Reg. §1.469-1T(f)(3)(ii).
[1224] Reg. §1.469-1T(f)(3)(iii).
[1225] Reg. §1.469-3T(c); *see* 1986 Senate Report at 724; 1986 Blue Book at 224; *see also* §38(c)(1), §38(c)(6)(E).
[1226] §39(a)(1) (one-year carryback and 20-year carryforward), §39(a)(4) (three-year carryback and 22-year carryforward for applicable credits as defined in §6417(b)); Reg. §1.469-3(e); *see* 1986 Senate Report at 724; 1986 Blue Book at 224; *see also* Preamble to T.D. 8175, 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988) ("In determining the years to which a general business credit may be carried, the credit is treated for purposes of section 39 as a current year business credit in the first tax year in which the credit is subject to section 469 but is not disallowed thereby.").
[1227] Reg. §1.469-3(f). *See* CCA 201507020.
[1228] Reg. §1.469-3T(b)(2).
[1229] Repealed in 1990 by Pub. L. No. 101-508, §11813(a), but still applicable and incorporated by reference in §50(d)(5).
[1230] For a discussion of the full unrelated taxable disposition rule in §469(g), see V.H., below.
[1231] See V.H.8.b., below, for further discussion.
[1232] Cal. Rev. & Tax Code §17561(b)(1), §17052.12.
[1233] Cal. Rev. & Tax Code §17561(b)(2), §17053.7.
[1234] Cal. Rev. & Tax Code §17561(b)(3), former §17057.
[1235] Cal. Rev. & Tax Code §17561(b)(4), §17058.
[1236] See N.Y. Advisory Op. TSB-A-02(6)I (Sept. 18, 2002) (New York alternative fuels credit).
[1237] §469(i).
[1238] §469(i)(3).

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designed to provide financial security, rather than to shelter a substantial amount of other income.[1239]

Practice Point: The $25,000 special allowance only applies to rental real estate activities,[1240] but not to other rental activities such as airplanes or equipment leasing.[1241] As discussed at III.B., above, certain activities, such as hotels and nursing homes, are not rental activities, e.g., due to the rate of customer turnover or the level of services provided, and therefore are not eligible for the $25,000 special allowance.[1242] Such an activity is generally a passive activity unless the taxpayer materially participates in the activity.[1243]

The $25,000 special allowance applies only to: (1) rental real estate activities in which the taxpayer actively participates (active participation rental real estate activities, or APRRAs); (2) taxpayers who are "natural persons"; and (3) to the extent that the taxpayer otherwise would have a disallowed passive loss.[1244] The term "natural persons" is used instead of "individuals" to make clear that the exception does not apply to trusts, so that according to the 1986 legislative history, "individuals cannot circumvent the $25,000 ceiling, or multiply the number of $25,000 allowances, simply by transferring various rental properties to one or more trusts."[1245] It is unclear whether an individual may benefit from the $25,000 special allowance with respect to income and deductions passed through from an estate or nongrantor trust to the individual as beneficiary.

The $25,000 allowance is not available to taxpayers owning interests in publicly traded partnerships (PTPs), except in the case of certain low-income housing tax credits (LIHTC) and historic rehabilitation tax credits.[1246]

The $25,000 special allowance is applied to all of the taxpayer's APRRAs on an aggregate basis.[1247]

Example: Taxpayer T, who is a natural person and not subject to the income phase-out, has two APRRAs: Activities B and C. Even if Activities B and C each lose $25,000, only $25,000 of total losses are allowed against nonpassive income.

Example: Same facts as the previous example but Activity B yields net income of $25,000 and Activity C yields a loss of $25,000. No losses are allowed against nonpassive income because there was no net loss from rental real estate activities in which T actively participated.[1248]

Losses allowable under the $25,000 special allowance are allocated among the taxpayer's APRRAs in proportion to the total losses from the APRRAs.[1249]

Example: A taxpayer has two APRRAs: Activity B, which has losses of $100,000; and Activity C, which has losses of $50,000. Two-thirds of the losses allowable under the $25,000 special allowance will be from Activity B.

If a taxpayer has more than $25,000 (or the lower amount allowable under the income phase-out) of losses (or the deduction equivalent for credits) in a tax year from APRRAs, or if any of the losses or credits are disallowed because the taxpayer's modified adjusted gross income exceeds $100,000 as discussed at V.F.4., below, the remaining losses or credits are carried forward and may be allowable in a subsequent tax year under the $25,000 special allowance.[1250] The taxpayer must actively participate, not only in the tax year when the losses arise, but also in the tax year when the losses or credits are sought to be used under the $25,000 special allowance.[1251] Conversely, passive loss carryovers or passive credit carryovers from rental real estate activities in which the taxpayer did not actively participate, are not allowed under the $25,000 special allowance in a subsequent tax year even if the taxpayer actively participates in that subsequent tax year.[1252] All passive loss carryovers (including from APRRAs) may also be used under the general passive loss rules, such as against other passive income.

In the event a taxpayer is allowed up to $25,000 of losses due to active participation but has insufficient (or no) nonpassive income against which to apply the losses, the losses can give rise to a net operating loss (NOL).[1253] Under §172(b), NOLs generated in tax years beginning in 2018 through 2020 may generally be carried back five tax years and carried forward indefinitely, and NOLs generated in tax years beginning in 2021 and later may generally not be carried back and may be carried forward indefinitely. NOLs generated in tax years beginning in 2017 and earlier may generally be carried back two tax years and carried forward 20 years.[1254] *See* 539 T.M., *Net Operating Losses — Concepts and Computations.*

Example: In 2026, taxpayer T has $20,000 of salary income and a $60,000 loss from a rental real estate activity in which T actively participates. T is allowed $25,000 of losses under the $25,000 special allowance. The losses reduce T's 2026 taxable income to zero, and the remaining $5,000 of allowed losses cannot be carried back but can

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[1239] 1986 Senate Report at 718. *See also* 1986 Blue Book at 214.

[1240] *Harris v. Commissioner*, T.C. Memo 1998-332 (mini-storage units are rental real estate).

[1241] 1986 Senate Report at 737. *See also* 1986 Blue Book at 243; *Schetzer v. Commissioner*, T.C. Memo 1999-252 (the $25,000 special allowance for rental real estate activities, which does not apply to rental of personal property, is not an unconstitutional denial of equal protection), *appeal dismissed in unpub. op.*, 14 Fed. App'x 738 (8th Cir. 2001), *aff'd per curiam in unpub. op.*, 53 Fed. App'x 397 (8th Cir. 2002); *Frank v. Commissioner*, T.C. Memo 1996-177 ($25,000 special allowance does not apply to airplanes); *Kelly v. Commissioner*, T.C. Memo 2000-32 (same). *See also Beasley v. Commissioner*, T.C. Summ. Op. 2008-159 (boat is not real estate).

[1242] 1986 Senate Report at 737. *See also* 1986 Blue Book at 243. *See* TAM 9505002 (IRS National Office concluded that a beach resort condominium unit, rented to third parties for an average period of seven days or less, is not a rental activity and therefore does not qualify for the $25,000 special allowance; the taxpayers actively participated but did not materially participate in the condominium activity).

[1243] *See Madler v. Commissioner*, T.C. Memo 1998-112.

[1244] §469(i)(1).

[1245] 1986 Conference Report at II-142. *See also* 1986 Blue Book at 218 n.12.

[1246] §469(k)(1).

[1247] 1986 Conference Report at II-141. *See also* 1986 Blue Book at 219.

[1248] 1986 Conference Report at II-141. *See also* 1986 Blue Book at 219.

[1249] §469(j)(4).

[1250] §469(i)(1).

[1251] 1986 Conference Report at II-141; 1986 Blue Book at 220.

[1252] 1986 Conference Report at II-141 n.2; 1986 Blue Book at 220 n.13.

[1253] 1986 Senate Report at 722. *See also* 1986 Blue Book at 222.

[1254] §172(b)(1)(A)(i) before amendment by Pub. L. No. 115-97, §13302(b).

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be carried forward indefinitely. T's $35,000 of disallowed losses are carried forward to 2027.

Example: Assume the facts in the Example above. Assume further that in 2027, the above taxpayer T has $30,000 of salary income but does not actively participate in the rental real estate activity. The $35,000 of active participation passive loss carryovers are not allowed in 2027 against T's nonpassive income (salary income). If T does actively participate in the rental real estate activity in 2027, the $35,000 of active participation passive loss carryovers reduce T's 2027 taxable income to zero and generates a $5,000 NOL that can be carried forward to 2028 and later years.

2. *Allowance of up to the Deduction Equivalent of $25,000 for Credits*

The $25,000 special allowance also applies to credits, in a deduction-equivalent sense. In other words, the taxpayer is allowed the amount of credits that would give the same benefit as $25,000 (or less, if the income phase-out applies) of deductions.[1255] Additionally, the historic rehabilitation tax credit has a higher phase-out threshold and the low-income housing tax credit has no phase-out, as discussed at V.F.4., below.[1256]

Example: Assume that allowing the taxpayer to deduct $25,000 of losses would reduce his tax liability by $7,000 (due to the application of a 28% tax rate). The $25,000 special allowance allows the taxpayer to use no more than $7,000 of credits against his tax liability with respect to nonpassive income.

The $25,000 ceiling applies to losses and credits considered together, not to each separately.[1257] A taxpayer who has both passive losses and passive credits first deducts any passive losses and then uses the deduction equivalent of the passive credits for any remainder of the $25,000 limit.[1258]

Example: A taxpayer is entitled to the full $25,000 amount but has $15,000 of losses from APRRAs. He can use credits from these activities only in an amount that is the deduction equivalent of $10,000 (e.g., $2,800, assuming that the relevant tax bracket is the 28% bracket).[1259]

The active participation requirement generally does not apply to the historic rehabilitation tax credit described in §47 or to the low-income housing tax credit described in §42.[1260] While an activity giving rise to historic rehabilitation tax credits or low-income housing tax credits does not require active participation for the $25,000 special allowance to apply, the activity still must be a rental real estate activity. For example, the rule does not apply to an interest in a hotel, because hotels are generally not rental activities for passive loss purposes.[1261] *See generally* 586 T.M., *Rehabilitation Tax Credit*, and 584 T.M., *Low-Income Housing Tax Credit.*

Note: The TCJA modified the historic rehabilitation tax credit provisions to no longer allow a 10% credit for rehabilitations of pre-1936 buildings that are not certified historic structures.[1262] In addition, the 20% historic rehabilitation tax credit for a certified historic structure is allowed ratably over a five-year period, rather than all in the tax year the structure is placed in service.[1263] A grandfathering rule applies to certain buildings owned or leased by the taxpayer during the entirety of the period after December 31, 2017, if the two-year or five-year rehabilitation begins within 180 days of the enactment of the TCJA.[1264]

Former §469(i)(6)(B)(iii) also exempted the active participation requirement to the portion of a passive loss attributable to the former §1400I commercial revitalization deduction, which allowed a 50% deduction or 120-month amortization for certain revitalization expenditures for buildings in renewal communities placed in service in late 2000 through 2009.[1265] Although taxpayers cannot incur new former §1400I commercial revitalization deductions, taxpayers may have deduction carryovers from late 2000 through 2009 to the extent that those deductions resulted in carryovers, e.g., because the deductions exceeded the $25,000 limit per tax year.[1266]

A partner in a publicly traded partnership (PTP) may use the $25,000 special allowance for his share of the PTP's low-income housing tax credits or the PTP's historic rehabilitation tax credits, to the extent that he has not fully utilized the $25,000 special allowance for passive losses and other passive credits.[1267] But the partner in the PTP cannot use the $25,000 special allowance for the PTP's passive losses or other types of passive credits.[1268]

3. *Active Participation Requirement*

Active participation is generally required to use the $25,000 special allowance for a particular rental real estate activity's passive losses or passive credits (except for the §47 historic rehabilitation tax credit or the §42 low-income housing tax credit, which do not require active participation). As with material participation, participation by a taxpayer's spouse is taken into account in determining whether one actively participates,[1269] whether or not the spouses are filing separate returns or joint returns.

Note: When a taxpayer is using a passive loss carryover of the rental real estate activity under the $25,000 special al-

[1255] *See* §469(j)(5).
[1256] §469(i)(3)(B), §469(i)(3)(C).
[1257] §469(i)(2).
[1258] §469(i)(3)(D).
[1259] §469(i)(2), §469(j)(5).
[1260] §469(i)(6)(B).

[1261] *See* III.B.2., above.
[1262] Pub. L. No. 115-97, §13402.
[1263] Pub. L. No. 115-97, §13402.
[1264] Pub. L. No. 115-97, §13402(c)(2).
[1265] Former §1400I and former §469(i)(6)(B)(iii) were enacted by the Consolidated Appropriations Act of 2001 (Pub. L. No. 106-554, §1(a)(7)) and were repealed as deadwood by the Consolidated Appropriations Act of 2018 (Pub. L. No. 115-141, §401(d)(5)).
[1266] Consolidated Appropriations Act of 2018 (Pub. L. No. 115-141, §401(e)) (general savings provision with respect to repealed deadwood provisions).
[1267] §469(k)(1).
[1268] §469(k)(1).
[1269] §469(i)(6)(D).

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lowance, active participation is required for both the tax year that generated the passive loss carryover and the tax year that the carryover is being used under the $25,000 special allowance.[1270] In other words, the $25,000 special allowance does not apply to rental real estate losses originally incurred in a tax year in which the taxpayer did not actively participate and that are carried over under §469(b) to a tax year in which the taxpayer does actively participate.[1271] Conversely, if the rental estate losses are originally incurred in a tax year in which the taxpayer did actively participate, but the losses were not allowed under the $25,000 special allowance due to the losses exceeding $25,000 (or a lower limit due to the taxpayer's modified adjusted gross income), the losses are carried over under §469(b) to a subsequent tax year and can be allowed under the $25,000 special allowance in the subsequent tax year only if the taxpayer also actively participates in the subsequent tax year.[1272]

Practice Point: A taxpayer can benefit from not actively participating in rental real estate activities that have net income, so that such income will not prevent them from having a loss of at least $25,000 from other rental real estate activities in which the taxpayer actively participates.

A taxpayer otherwise eligible for the $25,000 special allowance cannot qualify as actively participating in a rental real estate activity in two situations.

First, an individual cannot actively participate in a rental real estate activity for a tax year when his interest (including the interest of his spouse) is less than 10% (by value) of all interests in the activity.[1273] A taxpayer cannot be treated as actively participating for a period if, at any time during that period, he owned less than a 10% interest.[1274] The 1986 Senate Report indicated that "[i]n such situations, the taxpayer's management activity would relate predominantly to the interests of his co-owners, rather than to the management of his own interest."[1275]

The 1986 Conference Report explains that a taxpayer cannot fall short of the 10% threshold "at any time during the year (or shorter relevant period for which the taxpayer held an interest in the activity)."[1276] Thus a taxpayer cannot own a positive percentage interest between 0% and 10% at any time during the tax year, whereas not owning any interest for a part of the tax year (e.g., after a complete disposition) is allowed for active participation during the tax year.

Second, an interest as a limited partner is not treated as an interest with respect to which the taxpayer actively participates.[1277] A limited partner does not actively participate even if he spends more than 500 hours working on the activity, and would have been treated as materially participating if the activity were a trade or business activity.[1278]

Practice Point: For a taxpayer who is both a limited partner and a general partner, only the limited partner portion is subject to the prohibition on active participation.[1279]

Practice Point: There is no guidance on whether a member of a limited liability company could actively participate in rental real estate activities. See IV.A.8., above, for a discussion of material participation of LLC members.

Practice Point: Given that the $25,000 special allowance applies to the taxpayer's passive losses, the $25,000 special allowance should apply after other provisions that convert passive income or loss into nonpassive income or loss, or vice versa.

> *Example:* Taxpayer T has losses from more than one active participation rental real estate activity, which losses in the aggregate exceed the $25,000 ceiling. The amount allowed under the $25,000 special allowance must be allocated among such activities. However, if T sold one of the activities during the tax year, losses from that activity are nonpassive under the full unrelated taxable disposition rule,[1280] which allows more losses from the other activities to be deducted under the $25,000 special allowance.

Active participation is not specifically defined in the statute.[1281] The legislative history indicates that active participation standard is designed to be less stringent than the material participation requirement, in light of the relief nature of the $25,000 special allowance and the special nature of rental activities, which generally require less in the way of personal services.[1282] The 1986 Senate Report indicated that:

> The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

[1270] §469(i)(1). See H. Rep. 100-795, 100th Cong.2d Sess., at 32 (1988); S. Rep. 100-445, 100th Cong.2d Sess. 33 (1988).

[1271] §469(i)(1). *See* 1986 Conference Report at II-141; 1986 Blue Book at 220.

[1272] §469(i)(1). *See* 1986 Conference Report at II-141 n.2; 1986 Blue Book at 220 n.13.

[1273] §469(i)(6)(A). Interests of the spouse are counted toward the 10% threshold even if the spouses do not file a joint return. 1986 Senate Report at 737.

[1274] §469(i)(6)(A).

[1275] 1986 Senate Report at 721. *See also* 1986 Senate Report at 737; 1986 Blue Book at 218, 244.

[1276] 1986 Conference Report at II-141. *See also* 1986 Blue Book at 244.

[1277] §469(i)(6)(C).

[1278] *See* Reg. §1.469-5T(e)(2), discussed at IV.A.8., above.

[1279] Section 469(i)(6)(C) states that "[e]xcept as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates."; Reg. §1.469-5T(e)(3)(ii). *See also* 1986 Senate Report at 738 and 1986 Bluebook at 244 (stating that limited partner is treated as not meeting the active participation standard "to the extent of his limited partnership interest").

[1280] See V.H., below.

[1281] Active participation standards under other Code provisions, such as §464 and §2032A, are not the same as for the $25,000 special allowance. 1986 Senate Report at 736 n.23; 1986 Blue Book at 243 n.35.

[1282] 1986 Senate Report at 737. *See also* 1986 Blue Book at 244.

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Thus, for example, a taxpayer who owns and rents out an apartment that formerly was his primary residence, or that he uses as a part-time vacation home, may be treated as actively participating even if he hires a rental agent and others provide services such as repairs. So long as the taxpayer participates in the manner described above, a lack of participation in operations does not lead to the denial of relief.

… a lessor under a net lease is unlikely to have the degree of involvement which active participation entails. Moreover, as with regard to the material participation standard, services provided by an agent are not attributed to the principal, and a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, is insufficient.

In this regard, it is useful to compare the above example of a taxpayer who owns and rents out an apartment that formerly was his primary residence with a tax shelter investor. The former taxpayer, even if he hires a rental agent and uses contract or other services to handle day-to-day problems such as routine repairs, still is likely to participate actively in light of the fact that he likely is not using it principally to generate tax losses.

By contrast, consider the case of a taxpayer who purchases an undivided interest in a shopping mall. The taxpayer purchased his interest from a promoter, based on a prospectus describing the investment opportunity and stressing the tax benefits of the $25,000 rule. Since one of the taxpayer's principal interests in the investment is to shelter income, he relies on a professional management company, which also holds an interest in the shopping mall, to make all significant management decisions. In order to create an evidentiary record purporting to show active participation, the management company sends letters to the investor detailing operating expenses, changes in tenants and new lease terms. The management company also informs the investor as to market trends, and requests approval of decisions to seek certain types of retailers as tenants. The investor ratifies such judgments without independently exercising judgment. The investor has not actively participated in the activity.[1283]

The Instructions to Form 8582 state:

Active participation is a less stringent requirement than material participation… You may be treated as actively participating if, for example, you participated in making management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that may count as active participation include: approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

[1283] 1986 Senate Report at 737–38. *See also* 1986 Blue Book at 244–45.

A taxpayer may establish participation in an activity by any "reasonable means,"[1284] but it is not sufficient to make "a postevent 'ballpark guesstimate.'"[1285] Examples of active participation include arranging repairs and purchasing supplies[1286] or meeting the material participation tests.[1287] The 2005 IRS Audit Guide explained that "there is no specific hour requirement. However, the taxpayer must be exercising independent judgment and not simply ratifying decisions made by a manager."[1288] In *Madler v. Commissioner*,[1289] a taxpayer who contracted with a management company to oversee the rental of a condominium did not actively participate in the rental, because he did not personally approve new tenants, decide rental terms, approve expenditures for repairs and capital improvements, or in any way participate in the management of the unit in a significant and bona fide sense.

4. *Adjusted Gross Income Phase-Out*

The $25,000 special allowance is phased out ratably as the taxpayer's income increases. Specifically, the $25,000 ceiling is reduced by 50% of the amount by which the taxpayer's modified adjusted gross income exceeds $100,000.[1290] Thus, for a taxpayer with modified adjusted gross income of $150,000 or greater, the $25,000 special allowance is fully phased out.

Note: The modified adjusted gross income phase-out is not adjusted for inflation and has been the same $100,000 to $150,000 range ever since the Tax Reform Act of 1986, when median household income was around $22,000. Median household income in 2024 was approximately $80,000.

Modified adjusted gross income, for this purpose, is the §62(a) adjusted gross income modified by disregarding:

(1) the taxable amount of social security and tier 1 railroad retirement benefits under §86;[1291]

(2) the excluded amounts received as unemployment compensation in a tax year beginning in 2020 under §85(c);[1292]

(3) the excluded income from U.S. savings bonds used to pay higher education tuition and fees under §135;[1293]

[1284] *See e.g., Goshorn v. Commissioner*, T.C. Memo 1993-578.

[1285] *Moss v. Commissioner*, 135 T.C. 365 (2010).

[1286] *Martin v. Commissioner*, T.C. Memo 2018-109.

[1287] *Ani v. Commissioner*, T.C. Summ. Op. 2011-119.

[1288] 2005 IRS Audit Guide at 2-2.

The 2005 IRS Audit Guide also stated that the $25,000 special allowance does not apply to "a taxpayer whose rental activity consists of a net lease. Under a net lease, the tenant pays most of the expenses."

[1289] T.C. Memo 1998-112.

[1290] §469(i)(3)(A). *See also Sharma v. Commissioner*, T.C. Memo 2020-147 (taxpayer's modified adjusted gross income includes IRA distributions and distributions from pensions and annuities); *Maguire v. Commissioner*, T.C. Memo 2012-160 (taxpayer had negative adjusted gross income due to S corporation losses and qualified for $25,000 special allowance); *Hamilton v. Commissioner*, T.C. Memo 2004-161 (California State lottery winnings caused taxpayers to have more modified adjusted gross income and lose $25,000 special allowance).

[1291] §469(i)(3)(E)(i).

[1292] §469(i)(3)(E)(ii), as amended by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9042(b)(8), effective for tax years beginning in 2020 and later.

[1293] §469(i)(3)(E)(ii).

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(4) the excluded amounts received under a qualified employer's adoption assistance program under §137;[1294]

(5) deductions under §219 for contributions to individual retirement accounts (IRAs) and §501(c)(18) pension plans;[1295]

(6) the deductions for up to $2,500 of interest paid on qualified education loans under §221;[1296]

(7) for tax years beginning in 2020 and earlier, deductions for up to $4,000 of qualified tuition and fees under former §222;[1297]

(8) deductions for §250 income (which are not allowed for an individual taxpayer) and for §951A income (presumably for an individual who makes a §962 election);[1298]

(9) any passive loss;[1299]

(10) any loss allowable by reason of real estate professional status under §469(c)(7);[1300]

(11) the value of any medal awarded in, or any prize money received from the United States Olympic Committee on account of, competition in the Olympic Games or Paralympic games (determined without regard to the $1 million adjusted gross income limitation of §74(d)(2)(A) for the exclusion of the medal or prize money from gross income).[1301]

Example: Taxpayer T has $120,000 of wage income and a $30,000 loss from a rental real estate activity in which T actively participates, but does not materially participate. T is also a real estate professional with $40,000 of losses from rental real estate activities in which T materially participates. Although the $40,000 of real estate professional losses reduce T's adjusted gross income to $80,000, T's modified adjusted gross income remains at $120,000. T's allowed special allowance is limited by the phase-out to $15,000 ($25,000 maximum reduced by 50% of the excess of $120,000 over $100,000). T's adjusted gross income is reduced by the rental real estate loss to $65,000. T has a $15,000 passive loss carryover from the actively participating rental real estate activity to the next tax year.

Example: Same as the above example, except that T's $40,000 loss from other rental real estate activities is recognized under the full unrelated taxable disposition rule,[1302] which treats the loss as a nonpassive loss. The $40,000 loss is allowed not solely due to T's real estate professional status, and therefore T's modified adjusted gross income is reduced by the loss to $80,000. T is allowed the full $25,000 special allowance, which reduces his adjusted gross income to $55,000. T has a $5,000 passive loss carryover from the actively participating rental real estate activity to the next tax year.

Note: It is unclear how passive losses are added back to modified adjusted gross income. The IRS Pub. 925 and the Instructions for Form 8582, *Passive Activity Loss Limitations*, provide that modified adjusted gross income does not take into account any passive activity income or loss included on Form 8582 or any overall loss from a publicly traded partnership (PTP). These modifications are not found in the statute. It is unclear when a taxpayer's modified adjusted gross income would ever contain net passive income, given that rental real estate losses would offset any passive income from other sources before being available for the $25,000 special allowance. It is also unclear what is an overall loss from a PTP.

Example: Taxpayer T has $120,000 of wage income and a $30,000 loss from a rental real estate activity in which T actively participates, but does not materially participate. T also has a $40,000 loss from the disposition of all of his interests in a PTP, which treats the loss as a nonpassive loss under the full unrelated taxable disposition rule. T's modified adjusted gross income is reduced by the loss to $80,000 under the statute, but may still be $120,000 under the IRS publications.[1303]

Note: IRS Pub. 925 and the Instructions for Form 8582, *Passive Activity Loss Limitations*, state that modified adjusted gross income is computed by adding back the §164(f) deduction for one-half of the §1401 self-employment tax. This modification, which is not found in the statute, creates an inconsistency between the treatment of self-employed individuals and employees, because the employees' adjusted gross income is not increased by the social security taxes paid by the employer.[1304]

[1294] §469(i)(3)(E)(ii).

[1295] §469(i)(3)(E)(iii); IRS Pub. 925, *Passive Activity and At-Risk Rules*; §219(b)(3). The §501(c)(18) plans are tax-exempt trusts created before June 25, 1959, and forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, if certain requirements are met.

[1296] §469(i)(3)(E)(iii).

[1297] Former §469(i)(3)(E)(iii), before amendment by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, Title I, Subtitle A, §104(b)(2) (citing former §222, repealed by Pub. L. No. 116-260, Div. EE, Title I, Subtitle A, §104(b)(1), effective for tax years beginning after December 31, 2020).

[1298] §469(i)(3)(E)(iii). *See* Reg. §1.962-1(b)(3) (individual who makes §962 election is allowed the §951A-related §250 deduction).

[1299] §469(i)(3)(E)(iv).

[1300] §469(i)(3)(E)(iv).

[1301] §74(d)(2)(B).

[1302] See V.H., below.

[1303] For the precedential effect (or lack thereof) of IRS publications, *see generally Johnson v. Commissioner*, T.C. Memo 1978-426, *aff'd*, 620 F.2d 153 (7th Cir. 1980); *Miller v. Commissioner*, 114 T.C. 184 (2000), *aff'd sub nom.*, *Lovejoy v. Commissioner*, 293 F.3d 1208 (10th Cir. 2002); *Boerner v. Commissioner*, T.C. Memo 1971-54; *Fisher v. Commissioner*, T.C. Memo 1997-225, *aff'd per curiam*, 141 F.3d 1158 (4th Cir. 1998); *Bobrow v. Commissioner*, Docket No. 7022-11, Order (T. C. Apr. 15, 2014) ("taxpayers rely on IRS guidance at their own peril").

[1304] The §164(f) above-the-line deduction for one-half of the taxpayer's self-employment taxes tends to equalize the treatment of self-employed individuals and employees, because the latter do not have income equal to the one-half portion of such taxes paid by their employers. *See* H.R. Rep. No. 98-47, at 126 (1983) (Conf. Rep.).

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Practice Point: The §911 foreign earned income exclusion, the §933 Puerto Rico income exclusion, and the §931 exclusion for income from certain other U.S. possessions are not added back to modified adjusted gross income for the $25,000 special allowance. In other words, a U.S. individual who is a resident of a foreign country may be able to reduce his or her modified adjusted gross income by the applicable tax year's §911 foreign earned income exclusion amount, which is adjusted annually for inflation.[1305] In contrast, the §911, §931, and §933 exclusions are added back to modified adjusted gross income for the phase-outs with respect to the §23 adoption expenses, §24 child tax credit, §25A education tax credits, §25B retirement savings credit, §36 first-time homebuyer credit (for certain periods in 2008 to 2011), §86 taxable social security and tier 1 railroad retirement benefits, §135 excluded income from U.S. savings bonds used to pay higher education tuition and fees, §221 deduction for interest on qualified education loans, and §530 contributions to Coverdell education savings accounts.

For spouses filing a joint return, the income of both spouses is counted, but the $100,000 to $150,000 modified adjusted gross income phase-out range is the same.[1306] If two spouses file separately but live apart at all times during the tax year, up to $12,500 of passive losses are allowed to each spouse, and the phase-out range for each spouse runs from $50,000 to $75,000.[1307] No passive losses or passive credits are allowed to either spouse under the $25,000 special allowance for two spouses who file separately but live together at any time during the tax year.[1308]

For the §47 historic rehabilitation tax credit,[1309] a special, higher phase-out range applies to single and married filing jointly taxpayers with modified adjusted gross income from $200,000 to $250,000. The phase-out range is halved for married taxpayers who file separate returns and who live apart at all times during the tax year, to a modified adjusted gross income range from $100,000 to $125,000.[1310] No historic rehabilitation tax credit is allowed under the $25,000 special allowance for two spouses who file separately but live together at any time during the tax year.[1311]

There is no phase-out of the $25,000 deduction-equivalent benefit for a passive credit attributable to the low-income housing tax credit,[1312] as long as the low-income housing project is placed in service in 1990 or later.[1313] Furthermore, if the taxpayer holds an indirect interest in the low-income housing project, the interest must also be acquired in 1990 or later.[1314] The $25,000 deduction-equivalent of such a low-income housing tax credit is therefore available for taxpayers in any income range who are single, married filing jointly, or married filing separate returns and who live apart at all times during the tax year. However, no low-income housing tax credit is allowed under the $25,000 special allowance for two spouses who file separately but live together at any time during the tax year,[1315] even though their reason for filing separately may have nothing to do with reducing their modified adjusted gross income to claim more low-income housing tax credit.

Former §469(i)(3)(C) also exempted from any phase-out that portion of a passive loss attributable to the former §1400I commercial revitalization deduction, which allowed a 50% deduction or 120-month amortization for certain revitalization expenditures for buildings in renewal communities placed in service in late 2000 through 2009.[1316] Although taxpayers cannot incur new former §1400I commercial revitalization deductions, taxpayers may have deduction carryovers from late 2000 through 2009 to the extent that those deductions resulted in carryovers, i.e., because the deductions exceeded the $25,000 limit per tax year.[1317]

If the taxpayer has passive credits that consist in whole or part of historic rehabilitation tax credits or low-income housing tax credits, special ordering rules apply to reflect the various exceptions and phase-outs in the application of the rental real estate active participation exception.[1318] The $25,000 allowance is applied first to the passive loss (other than the former §1400I commercial revitalization deduction),[1319] second to the former §1400I commercial revitalization deduction,[1320] third to the passive credit other than the historic rehabilitation tax credit and the low-income housing tax credit,[1321] fourth to the portion of the passive credit applicable to the historic rehabilitation tax credit (after application of the $200,000 to $250,000 adjusted gross income phase-out),[1322] and fifth to the low-income housing tax credit.[1323]

[1305] The annual inflation adjusted §911 foreign earned income exclusion amounts are provided in Tables, Charts & Lists, *Foreign Earned Income Exclusion by Year.* For a discussion of the §911 foreign earned income exclusion, see 6080 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents* (Foreign Income Series).

[1306] *See Opperwall v. Commissioner*, 105 F.3d 666 (9th Cir. 1997).

[1307] §469(i)(5)(A).

[1308] §469(i)(5)(B). *See* 1986 Conference Report at II-142

> (Absent such a rule, married taxpayers where one spouse would be eligible for a portion of the $25,000 amount if they filed separately would have an incentive so to file; the conferees believe that rules that encourage filing separate returns give rise to unnecessary complexity and place an unwarranted burden on the administration of the tax system).

See also 1986 Blue Book at 220.

[1309] §469(i)(3)(B).

[1310] §469(i)(5)(A)(iii), §469(i)(5)(B).

[1311] §469(i)(5)(B).

[1312] §469(i)(3)(C).

[1313] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, §7109(a). Low-income housing tax credits for pre-1990 low-income housing projects are subject to a modified adjusted gross income phase-out of $200,000 to $250,000 for the $25,000 special allowance.

[1314] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, §7109(b)(2).

[1315] §469(i)(5)(B).

[1316] Former §1400I and former §469(i)(3)(C) were repealed as deadwood by the Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, §401(d)(5).

[1317] Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, §401(e) (general savings provision with respect to repealed deadwood provisions).

[1318] §469(i)(3)(D).

[1319] §469(i)(3)(D)(i).

[1320] Former §469(i)(3)(D)(ii), repealed as deadwood by the Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, §401(d)(5). *See* Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, §401(e) (general savings provision with respect to repealed deadwood provisions).

[1321] §469(i)(3)(D)(ii).

[1322] §469(i)(3)(D)(iii).

[1323] §469(i)(3)(D)(iv).

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Order	Amount Limit	Active Participation Required	Modified Adjusted Gross Income Phase-Out
1. Passive loss (other than the former §1400I commercial revitalization deduction)	$25,000	Yes	$100,000 to $150,000
2. Former §1400I commercial revitalization deduction	$25,000	No	None
3. Credits other than the historic rehabilitation tax credit and the low-income housing tax credit	$25,000 deduction equivalent	Yes	$100,000 to $150,000
4. Historic rehabilitation tax credit	$25,000 deduction equivalent	No	$200,000 to $250,000
5. Low-income housing tax credit	$25,000 deduction equivalent	No	None (if property placed in service in 1990 or later and any indirect interests are acquired in 1990 or later)

Practice Point: Single and married taxpayers are generally allowed the same $25,000 deduction and are subject to the same modified adjusted gross income phase-out range of $100,000 to $150,000 (or $200,000 to $250,000 for the historic rehabilitation tax credit). Two unmarried persons with modified adjusted gross income of $80,000 each may claim a total of $50,000 of the special allowance deductions, which is reduced to zero deductions if they were married. Assuming a marginal federal income tax rate of 22%, the lost deductions correspond to $11,000 of additional federal income tax. This marriage penalty in the $25,000 special allowance has existed since the Tax Reform Act of 1986 and may discourage certain couples from getting married.

Note: Marriage may have nontax benefits.

5. *Special Rule for Estates*

For a decedent's estate, the $25,000 special allowance applies to the estate's tax years ending less than two years after the decedent's death, with respect to all rental real estate activities with respect to which the decedent actively participated before his death.[1324] The 1986 Conference Report explained the rule as "to facilitate the administration of the estate without requiring the executor or fiduciary to reach decisions with respect to the appropriate disposition of the rental real property within a short period following the taxpayer's death."[1325]

Practice Point: The estate is allowed the $25,000 special allowance only for the rental real estate activities in which the decedent actively participated before his death, even though the decedent could have claimed the deduction equivalent of the $25,000 special allowance for any historic rehabilitation tax credits and low-income housing tax credits from activities in which the decedent did not actively participate. In other words, the estate is allowed the $25,000 special allowance for historic rehabilitation tax credits and low-income housing tax credits only from an activity in which the decedent actively participated before his death.

However, the amount allowable to the estate under the $25,000 special allowance is reduced by the amount of the $25,000 special allowance allowable to the decedent's surviving spouse, in the tax year ending with or within the estate's tax year, but determined without regard to the general phase-out for the surviving spouse's modified adjusted gross income over $100,000 (or over $200,000 for the historic rehabilitation tax credit).[1326]

[1324] §469(i)(4)(A). This rule also applies to a decedent's qualified revocable trust that is treated as part of the decedent's estate under §645(a). *See* IRS Pub. 925; Bloomberg Tax Elections & Compliance Statements, Procedure and Administration, *Trust: Election to Treat Qualified Revocable Trust as Part of Estate (§645)*.

[1325] 1986 Conference Report at II-142. *See also* 1986 Blue Book at 220.

[1326] §469(i)(4)(B).

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Order for a Decedent's Estate[1327]	Amount Limit	Active Participation by Decedent Required	Modified Adjusted Gross Income Phase-Out
1. Passive loss (other than the former §1400I commercial revitalization deduction)	$25,000	Yes	$100,000 to $150,000
2. Former §1400I commercial revitalization deduction	$25,000	Yes	None
3. Credits other than the historic rehabilitation tax credit and the low-income housing tax credit	$25,000 deduction equivalent	Yes	$100,000 to $150,000
4. Historic rehabilitation tax credit	$25,000 deduction equivalent	Yes	$200,000 to $250,000
5. Low-income housing tax credit	$25,000 deduction equivalent	Yes	None (if property placed in service in 1990 or later and any indirect interests are acquired in 1990 or later)

G. *Passive Loss Carryovers and Passive Credit Carryovers*

Unused passive losses and passive credits from an activity are treated as a deduction or credit allocable to the same activity in the next tax year.[1328] The passive loss carryovers and credits can be carried forward indefinitely, though they cannot be carried back.[1329]

Once a passive credit is allowed for passive loss purposes, the credit is aggregated with credits from the taxpayer's nonpassive activities, for purposes of determining whether all such credits are allowed in light of other credit limitations, such as the tax liability limitation and certain AMT limitations.[1330] In the event that any credit is not allowed due to these other limitations, the passive credits that are allowable under the passive loss rules are treated as nonpassive credits arising in the current tax year, with one-year or three-year carryback and 20-year or 22-year carryforward.[1331]

Passive loss carryovers are applied before current tax year nonpassive losses and net operating losses (NOLs). In other words, passive loss carryovers reduce the current tax year's passive income first, before any current tax year losses and NOLs are applied against the net passive income. This permits the taxpayer to obtain the full benefit of the passive loss carryovers, before using any nonpassive losses or NOLs.[1332] However, see V.A.1., above, for regulations that provide a different ordering rule for CHCs with passive losses and NOLs.

Under §172(b), NOLs generated in tax years beginning in 2018 through 2020 may generally be carried back five tax years and carried forward indefinitely, and NOLs generated in tax years beginning in 2021 and later may generally not be carried back and may be carried forward indefinitely. NOLs generated in tax years beginning in 2017 and earlier may generally be carried back two tax years and carried forward 20 years.[1333] These carryforward and carryback periods begin after a loss is freed from any passive loss limitations. A taxpayer may prefer to suspend passive losses indefinitely instead of generating NOLs in 2017 and earlier with their limited carryover periods. Section 382(a) may apply to limit the NOL carryovers of a corporation that generally undergoes a 50% or more ownership change over a three-year period, but §382 does not apply to a CHC's or PSC's passive loss carryovers.[1334] In addition, states may differ in their treatment of passive loss carryovers compared to NOL carryovers, with greater limitations on NOL carryovers. For example, if an individual has both state NOL carryovers and passive loss carryovers when he moves to a new state, the old state NOL carryovers generally cannot be used against the new state's taxable income, but the passive loss carryovers can give rise to deductions against the new state's taxable income when the passive loss carryovers are allowed for federal and state income tax purposes. See 539 T.M., *Net Operating Losses — Concepts and Computations*.

Note: A taxpayer who has passive loss carryovers should keep all income tax returns and other records from the tax years that generated those carryovers.[1335]

Practice Point: Passive credits may be carried forward indefinitely, whereas allowed business tax credits are generally allowed a one-year or three-year carryback and a 20-year or

[1327] §469(i)(3)(D).

[1328] §469(b).

[1329] §469(b).

[1330] Reg. §1.469-3T(c). *See* 1986 Senate Report at 724; 1986 Blue Book at 224; §38(c)(1), §38(c)(6)(E).

[1331] Reg. §1.469-3(e); §39(a)(1) (one-year carryback and 20-year carryforward), §39(a)(4) (three-year carryback and 22-year carryforward for applicable credits as defined in §6417(b)), added by Pub. L. No. 117-169, §13801(d), effective for tax years beginning after 2022. *See* 1986 Senate Report at 724; 1986 Blue Book at 224; T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5696 (Feb. 25, 1988) ("In determining the years to which a general business credit may be carried, the credit is treated for purposes of section 39 as a current year business credit in the first tax year in which the credit is subject to section 469 but is not disallowed thereby.").

[1332] 1986 Senate Report at 722–23. *See also* 1986 Blue Book at 222–23.

[1333] §172(b)(1)(A)(i) before amendment by Pub. L. No. 115-97, §13302(b).

[1334] *Compare* 1986 Conference Report at II-194 ("The conference agreement also expands the scope of section 383 to include passive activity losses and credits and minimum tax credits") *with* §383 (applying limitations to §39 general business credit carryovers, §52 corporate minimum tax credit carryovers, §1212 capital loss carryovers, and §904(c) foreign tax credit carryovers, but not explicitly to passive losses or passive credits). In FSA 001682 (Sept. 7, 1995), a corporation's passive loss carryovers were mentioned in the facts, but the Chief Counsel's Office analysis focused only on §382 limitations on the corporation's NOL carryovers.

[1335] *See Lowe v. Commissioner*, T.C. Memo 2008-298.

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22-year carryforward.[1336] A taxpayer may prefer to suspend passive credits indefinitely, instead of allowing those credits and being subject to the limited carryover periods. Section 383(a)(2) may apply to limit the general business credit carryovers of a corporation that generally undergoes a 50% or more ownership change over a three-year period, but §383 does not apply to a CHC's or PSC's passive credit carryovers.[1337] *See generally* 506 T.M., *Principles of Income Tax Credits.*

1. Former Passive Activities

Passive loss carryovers are tracked with respect to each separate passive activity that generates a passive loss carryover.[1338] The fact that an activity ceases to be a passive activity with respect to the taxpayer is not treated as a disposition and does not trigger the allowance of passive losses. However, the activity's passive loss carryovers and passive credit carryovers can be used against net income (and allocable tax liability) of the activity from tax years after the activity ceases to be passive.[1339] Income from a former passive activity should be computed in the same way as income from a passive activity — e.g., by disregarding items such as gross portfolio income (net of allocable expenses) and compensation for services.

The former passive activity rule requires careful recordkeeping to show that the passive loss carryovers and passive credit carryovers are from the same activity.[1340] If the taxpayer does a §1031 like-kind exchange and the replacement property is not used in the same activity, passive losses from the old activity cannot be used against nonpassive income of the new activity.[1341]

> *Example:* Taxpayer T has $100 of passive loss carryovers from an activity that ceases to be passive. If T has at least $100 of net income from the activity in the first tax year after the change in character, the passive loss carryovers are used against this net income (whether or not T has other passive income). In the absence of net income from the nonpassive activity, the passive loss carryovers still can be used against T's other passive income.[1342]

Practice Point: In determining the amount of tax liability allocable to net income from a former passive activity, for purposes of using the former passive activity's passive credit carryovers, it is not clear how such income is "stacked" — i.e., which marginal rate is deemed to apply. One possible solution is to "stack" the income from former passive activities after any passive income, but before any other nonpassive income.

[1336] §39(a)(1) (one-year carryback and 20-year carryforward), §39(a)(4) (three-year carryback and 22-year carryforward for applicable credits as defined in §6417(b)), added by Pub. L. No. 117-169, §13801(d), effective for tax years beginning after 2022.

[1337] *Compare* 1986 Conference Report at II-194 ("The conference agreement also expands the scope of section 383 to include passive activity losses and credits and minimum tax credits") *with* §383 (applying limitations to §39 general business credit carryovers, §52 corporate minimum tax credit carryovers, §1212 capital loss carryovers, and §904(c) foreign tax credit carryovers, but not explicitly to passive losses or passive credits).

[1338] See Reg. §1.469-1(f)(4)(iii) *Ex.* 1.

[1339] §469(f)(1).

[1340] 1986 Senate Report at 727. *See also* 1986 Blue Book at 230.

[1341] 1986 Senate Report at 727, n.13. *See also* 1986 Blue Book at 229 n.21.

[1342] *See* §469(f)(1); IRS Pub. 925, *Passive Activity and At-Risk Rules.*

2. Carryover of Losses and Credits to Bankruptcy Estates of Individuals (§1398)

A bankruptcy estate succeeds to the individual debtor's passive loss carryovers and passive credit carryovers in a case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11. The passive loss carryovers and passive credit carryovers are deemed to be tax attributes that pass from the debtor to the bankruptcy estate and are determined as of the first day of the debtor's tax year in which the bankruptcy case commences. Any passive loss carryovers and passive credit carryovers are transferred back to the debtor upon termination of the bankruptcy estate.[1343]

If the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange) before the termination of the bankruptcy estate, the transfer is not treated as a taxable disposition, although the debtor succeeds to and takes into account the estate's passive loss carryovers and passive credit carryovers from the activity (determined as of the first day of the estate's tax year in which the transfer occurs). In the case of a transfer of assets that constitute part of an activity, the debtor succeeds to and takes into account the allocable portion of passive loss carryovers and passive credit carryovers as determined by the estate.[1344]

H. Full Unrelated Taxable Disposition of a Passive Activity

A taxpayer's passive activity loss is the excess of (A) the aggregate losses from all passive activities for the tax year over (B) the aggregate income from all passive activities for such year.[1345] Passive income generally includes all gain and ordinary income recapture (such as under §467, §1245, §1250, and §1254) from the disposition of a passive activity, and likewise passive activity loss generally includes any capital loss or §1231 loss from the disposition of a passive activity. However, a special rule provides that a loss from a full unrelated taxable disposition of a passive activity can be a nonpassive loss.

1. General Rule

If a taxpayer disposes of his entire interest in any passive activity in a fully taxable transaction (i.e., one in which all realized gains or losses are recognized) with an unrelated party, any excess passive losses and passive loss carryovers from the activity may offset nonpassive income.[1346]

Practice Point: The full unrelated taxable disposition rule does not apply to passive credits or net passive income, which remain passive.

The 1986 Senate Report indicated the reason for the full unrelated taxable disposition rule is that:

> When a taxpayer disposes of their entire interest in a passive activity, the actual economic gain or loss on his investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the

[1343] §1398; Reg. §1.1398-1.

[1344] Reg. §1.1398-1(d).

[1345] §469(d)(1).

[1346] §469(g)(1)(A).

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taxpayer is recognized and allowed against income (whether active or passive income). This result is accomplished by triggering suspended losses upon disposition.

The reason for this rule is that, before a disposition of the taxpayer's interest, it is difficult to determine whether there has actually been gain or loss with respect to the activity. For example, allowable deductions may exceed actual economic costs, or may be exceeded by untaxed appreciation. Upon a taxable disposition, net appreciation or depreciation with respect to the activity can be finally ascertained. Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by reason of a disposition.[1347]

A disposition is deemed to take place for this purpose in the tax year in which recognition of the gain or loss occurs.[1348]

Example: T, a calendar-year taxpayer who uses the cash method of accounting, executes a contract of sale on December 15, Year 1, of property used in a rental activity. T is not paid until January 15, Year 2. T properly includes gain or loss from the sale in his tax return for Year 2, rather than Year 1. Because such gain or loss is not recognized until Year 2, losses are not allowed for Year 1 under the full unrelated taxable disposition rule.

A special variant of the full unrelated taxable disposition rule applies where some or all of the taxpayer's realized gain is recognized in later year(s) by reason of an installment sale under §453.[1349] In the case of an installment sale of the taxpayer's entire interest in a passive activity, the passive loss carryovers allowable by reason of the disposition are reduced to reflect the fact that gain from the sale is included only ratably. The allowed percentage of the passive loss carryovers against nonpassive income is equal to the percentage of gain reported under the installment method for the tax year.[1350] *See* 565 T.M., *Installment Sales.*

Example: Taxpayer T sells his only passive activity for a gain of $100. The activity has $150 of passive loss carryovers. In Year 1, $30 of such gain is reported under the installment method. Accordingly, $45 (30% of $150) of suspended losses are triggered, and the taxpayer is treated as having a disposition loss of $15 ($45 minus $30) for the tax year. If, in Year 2, $50 of gain is reported, then $75 of losses are triggered, giving rise to a disposition loss of $25. The taxpayer may consider electing out of the installment method under §453(d), so that all $150 of suspended losses are allowed in the tax year of sale.

Practice Point: When the purchaser of property defaults on a purchase money installment note, the seller may repossess the real property. Under §1038, generally any loss on the reacquisition of the property is not recognized, and gain is recognized only to the extent that prior cash and the fair market value of other property received exceeds prior gain recognized. Although the purpose of §1038 is to nullify the first sale, there is no provision to recapture any passive losses previously allowed under the full unrelated taxable disposition rule and the installment sale rule.

Practice Point: Losses allowed for passive loss purposes by reason of a disposition may nevertheless be suspended under other Code provisions, such as the §1211 capital loss limitation or the §461(l) excess business loss. Section 461(l) applies after §469.[1351]

If all gain or loss realized on a disposition of a passive activity is recognized, the excess of: (1) any loss from the activity for the tax year (including passive loss carryovers and any gain or loss from the disposition of the passive activity);[1352] over (2) net income or gain for such tax year from all other passive activities (including use of passive loss carryovers), is not a loss from a passive activity.[1353] Thus, such excess loss may be used to offset nonpassive income.

Example: Taxpayer T has two passive activities, with $20,000 of passive loss carryovers for Activity A and $20,000 of passive loss carryovers for Activity B. T sells Activity A in a fully taxable disposition to an unrelated party for $5,000 of gain. In the same year, Activity A has $2,000 loss from operations and Activity B has $30,000 of passive income. T first determines its net loss from Activity A of $17,000, equal to the $5,000 gain reduced by $2,000 current year loss and $20,000 passive loss carryover. The $17,000 net loss is next applied against T's $10,000 net passive income from Activity B. T's remaining $7,000 net loss from Activity A may offset nonpassive income.

In TAM 9742002, the IRS National Office advised that when a taxpayer disposes of a passive activity with current passive losses and passive loss carryovers that exceed the gain on disposition, (1) the net passive income and net passive losses from all of the taxpayer's other passive activities should be netted, before any excess passive income is applied against the current passive losses and passive loss carryovers from the disposed activities and (2) any excess losses from the disposed activity are treated as nonpassive losses under the full unrelated taxable disposition rule.

Example: Taxpayer T has three passive activities. T sells Activity A in a fully taxable disposition to an unrelated party for $15,000 of loss. In the same Year, Activity B has $5,000 of passive loss and Activity C has $10,000 of passive income. The $5,000 passive loss of Activity B off-

[1347] 1986 Senate Report, S. Rep. No. 313, at 725. *See also* 1986 Blue Book at 225.

[1348] §469(g)(1)(A).

[1349] §469(g)(3).

[1350] §469(g)(3).

[1351] §461(l)(6).

[1352] *See* H. Rep. 104-586, 104th Cong.2d Sess., at 168-169 (1996) ("The bill clarifies the rule relating to the computation of the overall loss allowed upon the disposition of a passive activity. The bill provides that, in a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the activity for the tax year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) in excess of any net income or gain from other passive activities for the tax year is treated as a loss which is not from a passive activity.")

[1353] §469(g)(1)(A).

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sets the $10,000 of passive income from Activity C. T's $15,000 net loss from Activity A is applied against T's $5,000 net passive income from Activity C. T's remaining $10,000 net loss from Activity A may offset nonpassive income.

Practice Point: TAM 9742002 rejected an alternative and less taxpayer favorable approach, where T's $15,000 net loss from Activity A is first applied against the $10,000 of passive income from Activity C (and any other activities with passive income). T would end up with a $5,000 net loss from Activity A that may offset nonpassive income and a $5,000 passive loss from Activity B.

Practice Point: The full unrelated taxable disposition rule expressly applies to former passive activities that still have passive loss carryovers.[1354] It should also apply to dispositions of activities by corporations that have ceased to be PSCs or CHCs but still have passive loss carryovers.

Practice Point: A loss under the full unrelated taxable disposition rule is allowed to offset nonpassive gain, but the disposition gain or loss is technically still considered passive. When a full unrelated taxable disposition produces a gain, the gain increases passive income and thus potentially permits the usage of losses and credits from other passive activities. Similarly, a full unrelated taxable disposition loss can offset the taxpayer's passive income for the tax year and the amount of allowable passive credits. The allowance of disposition losses against nonpassive income applies on an activity-by-activity basis.

Example: Taxpayer T disposes of one passive activity (Activity A) for a $10,000 loss, and a second passive activity (Activity B) for a $10,000 gain. T also has a $10,000 loss from all other passive activities. T offsets the $10,000 passive gain from Activity B with the $10,000 passive loss from other passive activities and uses the remaining $10,000 loss from disposing of Activity A against nonpassive income.

Treasury is authorized to issue regulations to determine the extent that a disposed activity's income or gain from prior years should reduce the net loss from the disposition that may offset nonpassive income, to the extent necessary to prevent the avoidance of the passive loss rules.[1355] Congress noted that "[r]egulatory authority might appropriately be exercised, for example, in situations where passive activities produce taxable passive income in the initial years of an investment and then a loss upon disposition, such as where the investment is structured so that income is recognized in years before the allowance of related deductions."[1356] No such regulations have been issued.

2. *Requirement that a Taxpayer Dispose of Entire Interest in Passive Activity*

Only a complete disposition of the taxpayer's interest in a passive activity triggers the special allowance of disposition losses.[1357] The 1986 Senate Report reiterated that "[t]he taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of of [sic] ultimate economic gain or loss on his investment in the activity remains unresolved."[1358]

Once an "activity" is identified, it is necessary to determine whether a complete disposition of that activity has taken place. The taxpayer must dispose of all assets that are used in the activity. If a taxpayer's interest in the activity is held entirely through pass-through entities (e.g., partnerships and S corporations), all of his interests in such entities must be disposed of, though it is sufficient if the entities in which he retains an interest dispose of all assets used in the activity.[1359] Similarly, if a grantor trust conducts two activities and disposes of all the assets of one activity, the grantor is considered as disposing of his entire interest in that activity.[1360]

Example: Taxpayer T owns a limited partnership interest in Partnership P, which conducts two passive activities. T can dispose of T's interests in both activities by selling T's entire interest in Partnership P. Alternatively, if Partnership P sells all assets used in one of the activities, T is treated as having disposed of that activity.[1361] If one of the activities is conducted jointly by Partnership P and Partnership Q (in which T is also a partner), Partnership Q must dispose of all assets used in that activity as well (or T must dispose of T's interest in Partnership Q) in order for the full unrelated taxable disposition rule to apply to T.

The taxpayer can elect to have a qualifying "partial disposition" treated as a complete disposition, by electing to have a narrower definition of "activity" apply — for all passive loss purposes, including determining material participation — solely for the tax year when the taxpayer engages in the qualifying partial disposition.[1362] Eligibility for partial disposition treatment generally requires that the taxpayer dispose of "substantially all" of the larger activity.

3. *Requirement of a Fully Taxable Transaction*

The full unrelated taxable disposition rule does not apply if the disposition is not a fully taxable transaction with an unrelated party.[1363]

The 1986 Senate Report explained that:

> [a] fully taxable disposition generally includes a sale or exchange of the property to a third party at arm's length, and thus, presumably, for a price equal to its fair market value … . Where the taxpayer transfers an

[1354] §469(g)(1).

[1355] §469(g)(1)(C).

[1356] H. Rep. 100-795, 100th Cong.2d Sess., at 32 (1988); S. Rep. 100-445, 100th Cong.2d Sess., at 33 (1988).

[1357] §469(g).

[1358] 1986 Senate Report at 725. *See also* 1986 Blue Book at 226.

[1359] *See* 1986 Senate Report at 725. *See also* 1986 Blue Book at 226.

[1360] 1986 Senate Report at 725–26. *See also* 1986 Blue Book at 226.

[1361] *See* 1986 Conference Report at II-145 (reversing rule from 1986 Senate Report, at 726, that a limited partner had to dispose of his entire interest in the partnership in order to benefit from the full unrelated taxable disposition rule for an activity conducted by the partnership, because "it is not appropriate to disallow a true economic loss realized upon the disposition of the taxpayer's entire interest in an activity by reason of the taxpayer's form of ownership [through a limited partnership]").

[1362] *See* Reg. §1.469-4(g), discussed at III.D.4., above.

[1363] §469(g)(1)(B).

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interest in a passive activity in a transaction in which the form of ownership merely changes, suspended losses generally are not allowed, because the gain or loss he has realized with respect to the activity has not been finally determined. (Such suspended losses are allowed, however, to the extent that any gain recognized on such a transfer, together with other income from passive activities for the year, exceeds losses from passive activities for the year.)[1364]

Other dispositions that give rise to the recognition of taxable gain or loss (e.g., an abandonment of the activity under §165(a) or the worthlessness of a security under §165(g))[1365] similarly trigger application of the full unrelated taxable disposition rule.[1366] The 1986 Conference Report clarified, however,

> that a transaction constituting a sale (or other taxable disposition) in form, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales, and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase, do not give rise to the allowance of suspended losses.[1367]

An exchange of a taxpayer's interest in an activity (including, e.g., all assets used in the activity) in a nonrecognition transaction, such as an exchange governed by §351, §721, §1031, or §1033, does not trigger passive loss carryovers.[1368] If gain is recognized in the nonrecognition transaction (e.g., boot), such gain is a passive item like any other gain.[1369]

> *Example:* Taxpayer T purchases real property for $1,000,000 on a recourse mortgage. T is engaged in a passive rental activity under §469, and T accrues passive loss carryovers of $100,000 over the next three tax years. In the fourth tax year, T defaults on the mortgage and the lender forecloses. The FMV of the property is $825,000 and T's adjusted basis is $800,000, with a remaining balance on the mortgage of $900,000 at foreclosure. The lender cancels the remaining $75,000 on the mortgage ($900,000 mortgage less $825,000 FMV of property), which T excludes from gross income under §108 due to insolvency. Foreclosure on real property comprising T's entire interest in a passive (or former passive) activity is subject to the full unrelated taxable disposition rule. T may use the activity's $100,000 of passive loss carryovers to offset nonpassive income. Additionally, T does not reduce the $100,000 passive loss created by the excluded mortgage discharge due to insolvency because the reduction of tax attributes under §108(b)(2) is made after determining the income tax for the tax year of discharge.[1370]

If a taxpayer makes a §1031 like-kind exchange of all assets used in a passive activity, the replacement property might be used in the same passive activity or in a different activity. If the replacement property is used in the same passive activity, or in a new activity that is a passive activity, the passive loss carryovers can offset the passive income from the replacement property.[1371] If the replacement property is used in a nonpassive activity, the old activity's passive loss carryovers cannot offset income from the new activity,[1372] but a disposition of the new activity or its assets is treated as a disposition of the old activity for purposes of allowing the old activity's passive loss carryovers.[1373]

When a passive activity is contributed to a corporation under §351, a sale of the corporate stock can be a taxable disposition event that frees up passive loss carryovers.[1374] If the corporation is an S corporation, the passive loss carryovers should also be allowed upon the S corporation's taxable disposition of the contributed passive activity.

In CCA 201428008, the Chief Counsel's Office discussed the interaction of the full unrelated taxable disposition rule with the §121 exclusion for generally up to $500,000 of gain from the sale or exchange of real property that the taxpayer used as a principal residence in at least two of the five years before the sale or exchange. A principal residence eligible for the §121 exclusion may have passive loss carryovers, *e.g.*, if the property was held for rental before or after the two years of principal residence use. The Chief Counsel's Office advised that a taxpayer may benefit from the full unrelated taxable disposition rule even if some of the gain is excluded under §121, because §121 is an exclusion provision and not a nonrecognition provision.

[1364] 1986 Senate Report at 725. *See also* 1986 Blue Book at 226.

[1365] 1986 Conference Report at II-143–44. *See also* 1986 Blue Book at 227. *See Bilthouse v. United States*, 553 F.3d 513 (7th Cir. 2009), *aff'g* 2007-2 USTC ¶ 50,680 (N.D. Ill. 2007) (taxpayers failed to demonstrate S corporation stock became worthless under §165(g) in claimed tax year, thus precluding the full unrelated taxable disposition rule for that tax year).

[1366] The 1986 Conference Report at II-143 also provided clarification:

> with respect to certain transactions involving dispositions of interests in syndicates that insure U.S. risks. Generally, when an owner of an interest in such a syndicate that is treated as a passive activity enters into a transaction whereby he disposes of his interest in the syndicate in a fully taxable closing transaction, he is treated as having made a disposition of his interest in the passive activity.

See also 1986 Blue Book at 227.

[1367] 1986 Conference Report at II-143. *See also* 1986 Blue Book at 227. For a detailed discussion of the requirements that must be satisfied to establish a deductible loss, see 527 T.M., *Loss Deductions*.

[1368] *See Ramsburg v. Commissioner*, T.C. Memo 2005-252 (§731 distribution of partnership assets to partner). *See also* TAM 9739004, where the IRS National Office advised that although §469(g) does not list transactions under former §1034 as failing to trigger passive loss carryovers, the list of nonrecognition transactions was not exclusive and the full unrelated taxable disposition rule "unambiguously states" that all gain or loss realized on a disposition must be recognized to trigger passive loss carryovers.

[1369] 1986 Senate Report at 726–27; 1986 Blue Book at 216 n.8.

[1370] §108(b)(4). *See* CCA 201415002.

[1371] 1986 Senate Report at 727. *See also* 1986 Blue Book at 229.

[1372] 1986 Senate Report at 727 n.13. *See also* 1986 Blue Book at 229 n.21.

[1373] 1986 Senate Report at 727.

[1374] 1986 Senate Report at 727.

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Example: Taxpayer T buys a residence for $700,000 and uses it as a principal residence for two years, before converting the property into a rental property. After the property generates $30,000 of passive loss carryovers over less than three years, T sells the property to an unrelated third party for $800,000. All $100,000 of gain is excluded under §121, and T may use the $30,000 of passive loss carryovers against nonpassive income under the full unrelated taxable disposition rule. The excluded gain does not reduce the passive loss carryovers allowed.

Practice Point: The disposition of the principal residence (or former principal residence) must otherwise qualify for the full unrelated taxable disposition rule. For instance, the property can be sold to a related party and still result in gain excluded under §121, but the related party transaction would not allow the suspended passive loss carryovers under the full unrelated taxable disposition rule.

Practice Point: The full unrelated taxable disposition rule should also apply to other Code provisions that effectively result in gain exclusion instead of nonrecognition, such as the §1400Z-2(c) basis step-up with respect to the sale or exchange of certain investments in qualified opportunity funds held for at least 10 years.

Note: A fully taxable disposition does not include a filing for bankruptcy, the transfer of assets to a bankruptcy estate, and the transfer of the estate's losses back to the taxpayer.[1375]

4. Related-Party Transactions

The full unrelated taxable disposition rule does not apply to an otherwise fully taxable transaction to a related party (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules).[1376] The related parties are:

(1) A person and his or her family members,[1377] which includes only siblings (including half-siblings), spouse, ancestors, and lineal descendants.[1378]

(2) An individual and a corporation owned more than 50% in value by the individual.[1379] Constructive ownership rules apply to stock ownership, including attribution of ownership (i) from a corporation, partnership, trust or estate proportionately to its shareholders, partners, and beneficiaries, respectively,[1380] (ii) between family members,[1381] and (iii) an individual constructively owns any stock owned (directly or indirectly) by his partner.[1382]

Note: The scope of the §267(c)(3) partner-to-partner attribution rule is unclear and potentially very broad. For example, an individual owns 1% of a partnership, which owns 100% of the stock of a corporation. The individual may be related to the corporation, because the individual is attributed the other 99% of the partnership owned by the individual's partners. In the personal holding company context, §544(a)(2) partner-to-partner attribution has been limited in one PLR to attribution between only individual partners and not entity partners.[1383] The Revenue Act of 1937 modeled the §267(c)(3) partner-to-partner attribution rule on the §544(a)(2) partner-to-partner attribution rule and may similarly count only individual partners,[1384] especially since the partner-to-partner attribution provisions were enacted at a time when partners were mostly individuals and had a close fiduciary relationship to each other.[1385]

(3) Two corporations which are members of the same controlled group,[1386] as modified to include parent-subsidiary controlled groups with more than 50% common ownership and brother-sister controlled groups generally where the corporations are more than 50% owned by five or fewer individuals, estates, or trusts when only identical overlapping ownership is taken into account.[1387] Constructive ownership rules apply through certain entities, option attribution, and with one's spouse and sometimes children, grandchildren, parents, and grandparents.[1388] Controlled group members include foreign corporations.[1389]

Practice Point: Two C corporations wholly owned by the same partnership are not considered related for this purpose, as long as the partnership is widely held (not more

[1375] *See* §1398(f)(1) and V.G.2., above.

[1376] §469(g)(1)(B).

[1377] §267(b)(1).

[1378] §267(c)(4). In contrast to §318(a), the §267 constructive ownership rules do not have an exception for legally separated spouses or have a specific provision for adopted children. A son-in-law is not a member of the family (*Topek v. Commissioner*, 9 T.C. 763 (1947)), nor is a stepmother (Rev. Rul. 71-50). For a detailed discussion of the attribution rules, see 554 T.M., *The Attribution Rules*.

[1379] §267(b)(2).

[1380] §267(c)(1).

[1381] §267(c)(2).

[1382] §267(c)(3).

[1383] PLR 201208025. *See* H. Rep. No. 75-1546 at 7 (1937) (emphasis added) ("Corporation A owns all the stock of corporation B. In determining whether or not, and the extent to which, the stock of corporation B is considered to be held by individuals the proposed amendments look through corporation A and provide, in effect, that the stock of corporation B is owned by the shareholders of corporation A *instead of by corporation A, itself.* A similar rule is applied in a case in which the stock is held by a partnership, estate, or trust — the partners or beneficiaries are deemed to own the stock. The rule applies to the portion of the stock of B owned by A, and the rule also applies if there is a chain of corporations."); Daniel Rosen and David Madden, *Oh No! Attribution Rules!*, Journal of Corporate Taxation (May/June 2014).

[1384] H. Rep. No. 75-1546 at 27 (1937) ("[t]he amendments made [to section 267(c)] further strengthen the existing law by applying, for the purpose of determining stock ownership in a corporation, substantially the same rules as used in determining the stock ownership of a personal holding company.").

[1385] *See* H. Rep. No. 75-1546 at 7 (1937) ("[B]ecause of the close business relationship existing between members of a partnership, your committee is of the opinion that it is proper to extend the [attribution] provision so as to include in determining the ownership of stock by an individual the stock owned by or for a partner of such individual."); *Meinhard v. Salmon*, 164 NE 545 (NY 1928) ("Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

[1386] §267(b)(3).

[1387] §267(f)(1) (reference to §1563(a) with modifications). *See also* §1563(f)(5); Reg. §1.1563-1(a)(3)(ii)(C); *Complete Fin. Corp. v. Commissioner*, 766 F.2d 436 (10th Cir. 1985), *aff'g* 80 T.C. 1062 (1983).

[1388] §1563(d); §1563(e); §1563(f)(2); §1563(f)(3); Reg. §1.1563-3. The §267(c) constructive ownership rules do not apply to controlled groups. *See* J. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, at 544 n.23 (1984); TAM 9538002; PLR 200133030.

[1389] *See* CCA 200233011; Reg. §1.1563-1(a)(1)(ii).

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than 50% owned directly or indirectly by five or fewer individuals, estates, or trusts).

(4) Certain trust relationships: a grantor and his trust,[1390] two trusts if the same person is a grantor of both trusts,[1391] a trust and a beneficiary of such trust,[1392] a trust and a beneficiary of another trust if the same person is a grantor of both trusts,[1393] and a trust and a corporation owned more than 50% in value by the trust or a grantor of the trust.[1394] No constructive ownership rule applies to trusts, and thus two trusts are not related if they have different related grantors, even if they have the same beneficiaries.[1395]

(5) A person and a §501 tax-exempt educational or charitable organization that is controlled by such person or the person's family members.[1396]

(6) A corporation (either a C corporation or an S corporation) and a partnership, if the same persons own more than 50% in value of the corporation's stock and more than 50% of the capital or profits of the partnership.[1397] Constructive ownership rules apply to stock ownership, including attribution of ownership by a family member or partner.[1398] The §267(c) stock constructive ownership rules apply to ownership of the capital or profits of the partnership, except there is no partner-to-partner attribution and a corporation's ownership of partnership interests is attributed only to shareholders who own 5% or more of the corporation by value.[1399]

(7) Two S corporations, or an S corporation and a C corporation, if the same persons own more than 50% in value of both corporations.[1400] Constructive ownership rules apply to stock ownership, including attribution of ownership by a family member or partner.[1401]

(8) An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.[1402]

(9) A partnership and a person owning more than 50% of the capital or profits of the partnership.[1403] The §267(c) stock constructive ownership rules apply to ownership of the capital or profits of the partnership,[1404] except there is no partner-to-partner attribution and a corporation's ownership of partnership interests is likely attributed to only its 5%-or-more (by value) shareholders.[1405]

(10) Two partnerships in which the same persons own more than 50% of the capital or profits interests.[1406] The §267(c) stock constructive ownership rules apply to ownership of the capital or profits of a partnership,[1407] except there is no partner-to-partner attribution and a corporation's ownership of partnership interests is likely attributed to only its 5%-or-more (by value) shareholders.[1408]

Practice Point: The actual overlapping ownership between two related partnerships (or S corporations) can be minimal. For example, if a partnership is owned 1% by individual A and 99% by individual B, and a second partnership is owned 99% by A and 1% by B, the two partnerships are related under §707(b)(1)(B) even though their economic overlap of ownership interests is only 2%. In contrast, two C corporations are related only if the economic overlap of ownership is over 50%. For a more detailed discussion, see 554 T.M., *The Attribution Rules*, and 564 T.M., *Related Party Transactions*.

Note: Reg. §1.267(b)-1(b) states that §707 applies to transactions between a partner and his partnership, with a 50% ownership threshold, but that §267(b) can apply to transactions between a nonpartner and a partnership, under an aggregate theory of partnerships and without any threshold of related ownership. In other words, if a partner sells to a partnership owned 40% by the partner, the partner and the partnership are not related because §707(b)(1)(A) has a 50% ownership threshold; but if a nonpartner sells to a partnership owned 40% by the nonpartner's sibling, the nonpartner and the partnership are 40% related under §267(b), in which case the full unrelated taxable disposition rule does not apply to the sale. Reg. §1.267(b)-1(b) was issued in 1958,[1409] at a time when §707(b)(1)(A) applied only to partners in the partnership and before §707(b)(1)(A) was amended in 1986 to cover nonpartners who are more than 50% related to the partnership.[1410] One argument is that the 1986 expansion of §707(b)(1)(A) to nonpartners should further preempt Reg. §1.267(b)-1(b) and also cause all

[1390] §267(b)(4). The statute refers to the "fiduciary" of the trust, which means the trust itself and not the fiduciary acting in his personal capacity. Rev. Rul. 59-171. A corporate grantor and its employees' pension trust are related. Rev. Rul. 61-163; *Dillard Paper Co. v. Commissioner*, 42 T.C. 588 (1964), *aff'd per curiam*, 341 F.2d 897 (4th Cir. 1965).

[1391] §267(b)(5).

[1392] §267(b)(6). A trust and its remote contingent beneficiary are related. *Wyly v. United States*, 662 F.2d 397 (5th Cir. 1981), *aff'g* 80-2 USTC ¶ 9645 (N.D. Tex. 1980).

[1393] §267(b)(7).

[1394] §267(b)(8).

[1395] *Widener Tr. v. Commissioner*, 80 T.C. 304 (1983), *acq. See also Scully v. United States*, 840 F.2d 478 (7th Cir. 1988), *aff'g* 629 F. Supp. 1534 (C.D. Ill. 1986).

[1396] §267(b)(9).

[1397] §267(b)(10).

[1398] §267(c).

[1399] §267(e)(3). *See* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 543 n.20 (1984) ("The partnership constructive ownership rules of section 267(e)(3) are to apply for all purposes of section 267, such as for example, section 267(b)(10).").

[1400] §267(b)(11), §267(b)(12).

[1401] §267(c).

[1402] §267(b)(13).

[1403] §707(b)(1)(A).

[1404] §707(b)(3).

[1405] §267(e)(3). *See* PLR 200133030 (§267(e)(3) applies to related parties under §1239(c)(1)(B), which is similar to §707(b)(3)).

[1406] §707(b)(1)(B).

[1407] §707(b)(3). *See* PLR 200133030 (§267(c)(3) applies to related parties under §1239(c)(1)(B), which is similar to §707(b)(3)).

[1408] §267(e)(3). *See* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 543 n.20 (1984) ("The partnership constructive ownership rules of section 267(e)(3) are to apply for all purposes of section 267, such as for example, section 267(b)(10).").

[1409] T.D. 6312, 23 Fed. Reg. 7035 (Sept. 11, 1958).

[1410] Tax Reform Act of 1986 (Pub. L. No. 99-514, §1812(c)(3)). *See* 1986 Senate Report at 960 ("the bill provides that the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50% partnership interest was himself a partner"); Reg. §1.707-1(b)(3). Proposed rules would amend Reg. §1.707-1(b) to conform it to the 1986 statutory changes. See REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023).

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transactions between partnerships and nonpartners to be subject to only §707. In 2023, however, the IRS issued proposed rules that would remove Reg. §1.267(b)-1(b), terminate the application of Q&As 2 and 3 in Reg. §1.267(a)-2T(c), and amend Reg. §1.707-1(b) to reflect Congress's intent that partnerships should be viewed as an entity — rather than as an aggregate of its partners — when applying the loss disallowance rules of §267(a)(1) and §707(b)(1).[1411]

In contrast, Reg. §1.267(a)-2T(c) Q&A 2, issued in 1984,[1412] had a similar aggregate rule for transactions between two partnerships, but it was explicitly superseded by the Tax Reform Act of 1986's amendments to §707.[1413] As a result, sales between two partnerships are governed exclusively by §707(b)(1)(B).

	>50% related	50% or less related
Sale between a partner and his partnership	Related under §707(b)(1)(A)	Not related.
Sale between a nonpartner and a partnership	Related under §707(b)(1)(A) (after 1986)	Related (partially) under Reg. §1.267(b)-1(b), but arguable that the 1986 expansion of §707(b)(1)(A) to nonpartners preempted Reg. §1.267(b)-1(b). Furthermore, Reg. §1.267(b)-1(b) would be removed by REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023).
Sale between two partnerships	Related under §707(b)(1)(B)	Not related. (Previously related in 1985 and early 1986 under Reg. §1.267(a)-2T(c) Q&A 2, which is proposed to be removed by REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023)).

Practice Point: Proposed rules issued in November 2023 would modify the above rules regarding related-party transactions.[1414] Those proposed rules would remove Reg. §1.267(b)-1(b), terminate the application of Q&As 2 and 3 in Reg. §1.267(a)-2T(c), and amend Reg. §1.707-1(b) to reflect Congress's intent that partnerships should be viewed as an entity rather than as an aggregate of its partners when applying the loss disallowance rules of §267(a)(1) and §707(b)(1). The changes would apply to tax years ending on or after the date final rules are published in the Federal Register.

Comment: The original transferor is entitled to claim losses under the full unrelated taxable disposition rule even if the second transferee is a related party with respect to the first transferee, as long as the second transferee is not related to the original transferor.

> *Example:* Taxpayer A sells property to her brother B in a fully taxable transaction. A's passive loss carryovers are not allowed because siblings are related under §267(c)(4). B later sells the property to his daughter C in a fully taxable transaction. A's passive loss carryovers are allowed at the time of the later sale, because aunts and nieces are not related under §267(c)(4). To the extent B has any passive loss carryovers from his holding period for the property, B's own passive loss carryovers are not allowed because parent and child are related under §267(c)(4).

Practice Point: The original transferor still must dispose of his entire (pre-transfer) interest. Thus, if the transferor retains a portion of his interest in the activity, or gives different portions of his interest to two different related parties, an otherwise appropriate subsequent disposition by one transferee does not suffice to trigger the full unrelated taxable disposition rule.

5. *Disposition by Death*

If a taxpayer who owns an interest in a passive activity dies, the decedent's passive loss carryovers are allowed generally on the decedent's final income tax return against nonpassive income.[1415] However, the allowed passive loss carryovers are reduced by the amount that the basis of that interest in the hands of the transferee exceeds the adjusted basis of such property immediately before the death of the taxpayer.[1416] In other words, the decedent's passive loss carryovers allowable by reason of death are reduced by the step-up in basis to fair market value at death under §1014.

[1411] *See* REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023).

[1412] T.D. 7991, 49 Fed. Reg. 46,992 (Nov. 30, 1984). Proposed rules would remove Q&A 2 of Reg. §1.267(a)-2T(c). REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023), effective for tax years ending on or after the date final rules are published in the Federal Register.

[1413] Tax Reform Act of 1986 (Pub. L. No. 99-514, §1812(c)(3)). *See* 1986 Senate Report at 960 ("the bill provides that the deferral provisions of section 267(a)(2) will apply to two partnerships in which the same persons hold a more than 50% of the capital interests or profits interests. This rule is intended to replace the rule in the Treasury regulations [fn. 7: Temp. Reg. Sec. 1.267(a)-2T(c), Questions 2 and 3.], which was suggested by the 1984 Committee Reports, relating to transactions between related partnerships with common partners."). Proposed amendments to the regulations under §267(a) would terminate the application of Reg. §1.267(a)-2T(c) Q&A 2 and Q&A 3 for tax years ending on or after the date final rules are published in the Federal Register. REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023).

[1414] *See* REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023).

[1415] §469(g)(2). *See* Bloomberg Tax Elections & Compliance Statements, Deductions & Credits: Business, *Individual: Passive Activity Loss Deductible at Death (§469(g)(2))*.

[1416] §469(g)(2). *See, e.g.*, FSA 200106018 (decedent was the sole beneficiary of a qualified subchapter S trust (QSST) that held stock in an S corporation with passive loss carryovers, and the passive loss carryovers were allowed on the decedent's final income tax return against nonpassive income to the extent that the carryovers exceeded the basis step-up at death). Note that for decedents that died in 2010, if the executor of the estate made an election to apply the modified carryover basis rules in §1022 instead of the step-up basis rules of §1014, property owned by the decedent at death was treated under §1022 as having been transferred by gift and, therefore, §469(j)(6) (discussed in the section immediately below), rather than §469(g)(2), applied to determine the decedent's adjusted basis. Rev. Proc. 2011-41, §4.06(4).

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Example: Taxpayer T dies owning a building used in a passive activity. The building has an adjusted basis of $10, a fair market value of $30 for §1014 purposes, and passive loss carryovers of $35. T has net passive income of $50 from other activities in the tax year of death. T can use all $35 passive loss carryovers against its $50 of passive income. The passive loss carryover is not reduced by reason of the step-up in basis under §1014, since the losses are allowable without reference to the disposition at death due to T's $50 of net passive income.

Example: If T does not have net passive income from activities other than the building, the passive loss carryover allowable against nonpassive income is only $15 ($35 minus the $20 step-up in basis). The other $20 of passive loss carryovers are not allowed as a deduction for any tax year.

The reduction in passive loss carryovers allowable by reason of a disposition applies on an activity-by-activity basis.

Example: At the time of the taxpayer's death, Activity A has a passive loss carryover of $10,000 and a basis step-up of $9,000, and Activity B has a passive loss carryover of $10,000 and a basis step-up of $100,000. A disposition loss of $1,000, nonetheless, will be allowed on the decedent's tax return with respect to Activity A, since the taxpayer otherwise would have a passive loss of at least $1,000.

Note: Because of the reduction of passive loss carryovers, in some instances a taxpayer would benefit more from a disposition before death rather than a step-up in basis. For example, a taxpayer T has an activity with a fair market value of $100,000 and $10,000 in adjusted basis and $100,000 in suspended passive losses. Under either a sale before death or a step-up in basis with death, T's heirs will receive an asset with a $100,000 basis and fair market value, and T can use $10,000 of the suspended passive losses. However, if the gain on sale and suspended losses are taxed at different rates, T could benefit from using the suspended losses via disposition, rather than letting them be reduced by basis step-up at death.

Practice Point: In a community property state, the surviving spouse's one-half share of community property generally obtains a basis step-up under §1014(b)(6), which effectively allows both spouses' halves of the community property to obtain a basis step-up, as the decedent's one-half share is included in the decedent's estate. The surviving spouse's one-half share should not reduce any passive loss carryovers, as that share of the community property was not transferred by reason of death.

6. Gifts

A gift by the taxpayer of part or all of his interest in a passive activity does not trigger the allowance of passive loss carryovers. Instead, the passive loss carryovers are added to the basis of the property transferred, immediately before the gift.[1417] In the event the gifted activity is transferred at a loss, the basis of the property would be the lesser of carryover basis from the donor or the fair market value at the time of the gift.[1418] For a detailed discussion of the tax consequences related to gifts, see 845 T.M., *Gifts*.

A gift includes any transfer of property between spouses, including transfers incident to a divorce between spouses or former spouses.[1419]

A gift also generally includes any transfer of property to a charitable organization. The basis step-up from unused passive loss carryovers generally provides no benefit to the donee charitable organization,[1420] who can sell the property at any gain without being subject to tax, but the basis step-up may benefit a donor in cases where the charitable contribution deduction is limited to the basis of the property.[1421]

Practice Point: In the case of a gift of an activity consisting of more than one asset, the basis must be allocated, though the allocation method is not specified in the Code or the regulations. A donee can benefit from the step-up more quickly if the step-up is allocated to personal property and other short-lived assets instead of long-lived buildings and land. A taxpayer may presumably use any reasonable method of allocation, perhaps by analogy to §755 or §1060.

Practice Point: For a gift of a partnership interest, the step-up applies to the basis of the partnership interest, not the basis of the partnership's assets. As a gift is not a sale or exchange, a step-up of the partnership's assets is not available under §743(b) even if the partnership makes a §754 election.

7. Distribution to Beneficiaries by Estate or Trust

An estate or trust's passive loss carryovers allocable to an interest in a passive activity that is distributed by the estate or trust to beneficiaries are not allowed as such. Instead, the basis of the interest immediately before the distribution is increased by the passive loss carryovers.[1422] The legislative history indicates the basis increase would only be applied upon the distribution of an entire interest.[1423] However, the statute states that the basis increase applies to *any* interest distributed by an estate or trust,[1424] presumably including a partial interest. Gain or loss to the estate or trust, and the basis of the property in the beneficiary's hands, will be determined after the distribution under the usual applicable tax rules.[1425]

Practice Point: If a passive activity is distributed to a beneficiary in satisfaction of a pecuniary bequest, it is possible for the suspended passive losses to be deducted instead of being added to basis. For purposes of the full unrelated taxable dispo-

[1417] §469(j)(6)(A).

[1418] §1015(a).

[1419] §1041(b) (treated as acquired by the transferee by gift for purposes of subtitle A, §1 through §1563). A gift also includes transfers in connection with decedents dying in 2010, if modified carryover basis rules in §1022 were applied instead of the step-up basis rules of §1014. *See* Rev. Proc. 2011-41.

[1420] Some charitable organizations are subject to tax on their gains from sales of certain donated properties, such as a 1.4% to 8% tax on the endowment investment income of certain private universities under §4968 or a 1.39% tax on investment income of private foundations under §4940.

[1421] §170(e)(1). For a discussion of the charitable contribution rules, *see* 521 T.M., *Charitable Contributions: Income Tax Aspects*.

[1422] §469(j)(12).

[1423] *See* H. Rep. No. 100-795, at 34 (1988); S. Rep. No. 100-445, at 34 (1988).

[1424] §469(j)(12).

[1425] *See* H. Rep. No. 100-795, at 33 (1988); S. Rep. No. 100-445, at 34 (1988).

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sition rule, an estate and a beneficiary are not deemed related in the case of a sale or exchange in satisfaction of a pecuniary bequest.[1426]

8. *Treatment of Credits upon Disposition*

a. *In General*

Credits, in contrast to losses, are not specially allowable by the full unrelated taxable disposition rule.[1427] The 1986 Senate Report noted that "[s]ince the purpose of the [full unrelated taxable] disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by reason of a disposition."[1428]

Practice Point: While a passive activity's passive credits are not triggered by a disposition of the passive activity, a disposition can generate passive income and permit the taxpayer to use more passive credits. If the disposition generates passive losses, the losses reduce the taxpayer's net passive income and reduce the tax liability that can be offset by passive credits.

b. *Elective Basis Adjustment*

When a taxpayer makes a full unrelated taxable disposition of an interest in an activity, a special rule applies if: (1) the taxpayer has passive credit carryovers with respect to the activity; and (2) a basis adjustment was made, by reason of such credit carryovers, when the property to which the credits relate was placed in service.[1429] Under these circumstances, the taxpayer may elect to increase the basis of the credit property (by an amount no greater than the amount of the original basis reduction) to the extent that the passive credit has not previously been allowed by reason of the passive loss rules.[1430] As a result of making the election, the passive credits are lost and the original basis decrease is reversed.[1431]

> *Example:* In Year 1, Taxpayer T places in service rehabilitation credit property which is the only asset used in a separate passive activity and which generates a passive credit of $1,000. The basis of the property is reduced by $1,000 under §50(c). If T is allowed $600 of this passive credit against passive income in Year 1 and if T disposes of the property in Year 2, T can elect to increase the basis of the property by $400, at the cost of losing the remaining $400 passive credit.

Practice Point: The election, which is irrevocable,[1432] is made by the due date (including extensions) of the tax return for the first tax year to which the election applies.[1433] The election is not allowed for a disposition that is only partially taxable, or otherwise does not qualify for the full taxable disposition rule, in which case the basis is not increased and the taxpayer continues to have the passive credits to offset tax liability attributable to other passive income.[1434]

Practice Point: The language of §469(j)(9) allows for an election "by *an amount equal to* the portion of any unused credit." This seems to indicate that the option to make an elective basis adjustment is an "all or nothing" proposition with no option to make a partial election. In the above example T would not have the option to elect to make a $200 basis election and leave $200 of carryover credits remaining.

Practice Point: In the case of the energy credit and the clean electricity investment credit (for property placed in service after 2024), the basis of the property is reduced by only 50% of the allowed credit amount.[1435]

[1426] §267(b)(13), §469(g)(1)(B).
[1427] §469(g)(1).
[1428] 1986 Senate Report at 725. *See also* 1986 Blue Book at 225.
[1429] *See* §50(c).
[1430] §469(j)(9). For a sample election statement, see *Passive Activity Elective Credit Basis Adjustment (§469(j)(9))* in the Bloomberg Tax Election & Compliance Statements Library.
[1431] §469(j)(9).
[1432] Reg. §301.9100-7T(a)(4)(i).
[1433] Reg. §301.9100-7T(a)(2)(i).
[1434] 1986 Conference Report at II-145. *See also* 1986 Blue Book at 228.
[1435] §50(c)(3), as amended by Pub. L. No. 117-169, §13702(b)(4), effective for property placed in service after 2024.

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VI. Passive Loss Rules and Other Provisions

A. *Alternative Minimum Tax (§55)*

The passive loss rules apply in determining the noncorporate alternative minimum tax (AMT),[1436] just as in determining regular taxable income and the regular tax. For a detailed discussion of the noncorporate AMT, see 587 T.M., *Noncorporate Alternative Minimum Tax*.

For taxable years beginning after 2022, the alternative minimum tax imposed on applicable corporations is based on an applicable corporation's adjusted financial statement income;[1437] the AMT adjustments and preferences under §56 through §58 do not apply to the post-2022 corporate alternative minimum tax. For a detailed discussion of the corporate AMT, see generally 752 T.M., *Corporate Alternative Minimum Tax* at IX.

AMT adjustments and preferences under §56 (e.g., percentage of completion method for certain long-term contracts) and §57 (e.g., excess of percentage depletion over adjusted basis) must be taken into account before applying the passive loss rules for noncorporate AMT purposes.[1438]

> *Example:* Taxpayer T, an individual, actively participates in a rental real estate activity that generates a $20,000 loss. T has less than $100,000 of modified adjusted gross income, so that the entire $20,000 loss is allowed under the $25,000 special allowance for regular tax purposes. T has $5,000 less depreciation for AMT purposes under §56(a)(1) with respect to personal property not subject to bonus depreciation,[1439] and the rental real estate loss is reduced to $15,000 for AMT purposes. T must report a $5,000 adjustment on Form 6251 (Alternative Minimum Tax — Individuals), on the passive loss adjustment line instead of the depreciation adjustment line.[1440]

The passive loss rules apply the same way for noncorporate AMT purposes as for regular tax purposes in other respects. For example, the maximum amount allowable under the $25,000 special allowance in light of the §469(i)(3) income phase-out is identical for regular tax and noncorporate AMT purposes; adjusted gross income (as modified for purposes of the phase-out) is not adjusted to reflect the noncorporate AMT treatment of any item.

Three special passive loss rules apply differently for AMT purposes relative to regular income tax purposes:

1. tax shelter farm activities;[1441]
2. insolvent taxpayers;[1442] and
3. material participation in research and development expenditures.[1443]

In addition, fewer tax credits are allowed for noncorporate AMT purposes compared to regular tax purposes,[1444] such as the research and development tax credit for larger taxpayers.[1445] In light of the computational and substantive differences between the passive loss rules as applied for regular and noncorporate AMT purposes, taxpayers may often have different amounts of passive loss carryovers for regular and noncorporate AMT purposes. Even if a taxpayer does not incur AMT liability in a particular tax year, it may be necessary to make all passive loss computations for the tax year under the noncorporate AMT rules in order to determine the passive loss carryovers for noncorporate AMT purposes.

1. Tax Shelter Farm Activity

No loss from any "tax shelter farm activity" is allowed for noncorporate AMT purposes.[1446] The disallowed loss is carried forward indefinitely for noncorporate AMT purposes until the taxpayer has income or gain in a subsequent tax year from the same activity or disposes of its entire interest in the activity.[1447] Congress generally intended that the loss carryover should be allowed only "upon an appropriate disposition (i.e., a disposition that would qualify under the passive loss rules as triggering the allowance of suspended losses from the activity),"[1448] which is generally a disposition subject to the full unrelated taxable disposition rule, discussed at V.H., above.

The 1986 Senate Report explained the reason for the tax shelter farm rule:

> In the case of farming losses of individuals who do not materially participate in the farming business, the committee believes that an additional and stricter rule should apply for minimum tax purposes, preventing any loss with respect to a passive farming activity from offsetting other income of the taxpayer before disposition. The committee believes that such a rule is needed in the farming context, in addition to the rules generally applying to nonparticipatory business losses, in light of the harm to taxpayers active in the farming business that has resulted from the proliferation of tax shelter farming activities that exploit the competitive cost advantage of passive investors who can use tax losses derived from farming to offset unrelated income.[1449]

[1436] §58(b).

[1437] *See* §55(b)(2) (computation of a corporation's tentative minimum tax), §59(k)(1) (applicable corporation defined), §56A (definition of adjusted financial statement income).

[1438] §58(b)(1).

[1439] *See* §168(k)(2)(G) (in determining AMTI under §55, the depreciation deduction for bonus depreciation qualified property is determined without regard to any adjustment under §56).

[1440] Announcement 88-45.

[1441] §58(a).

[1442] §58(c).

[1443] 56(b)(2).

[1444] *See* §38(c), as amended by the Inflation Reduction Act, Pub. L. No. 117-169, §10101(d), effective for taxable years beginning after December 31, 2022 (adding §38(c)(6)(E), which modifies the application of §38(c)(1), §38(c)(2), and §38(c)(4) for corporations). For a detailed discussion, see 752 T.M., *Corporate Alternative Minimum Tax* at IX.

[1445] §41.

[1446] §58(a)(1). In determining the loss from the tax shelter activity, the alternative minimum tax adjustments of §56 and §57 apply under §58(a)(3). Farming is generally defined under §464(e) as the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Trees are not treated as an agricultural or horticultural commodity, unless they bear fruit or nuts.

[1447] §58(a)(1)(B), §58(c)(2).

[1448] 1986 Blue Book at 447.

[1449] 1986 Senate Report at 519–20. *See also* 1986 Blue Book at 434.

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The tax shelter farming activity is applied on an activity-by-activity basis, with no netting between different tax shelter farming activities.[1450]

> *Example:* Taxpayer T, an individual, has a net $40,000 loss from one tax shelter farm activity and a net $50,000 gain from another tax shelter farm activity. The $40,000 loss is allowed for regular income tax purposes but is not allowed for AMT purposes. In other words, T has a $40,000 AMT adjustment that increases alternative minimum taxable income.[1451] The $40,000 loss is carried forward for AMT purposes until T has net income from the same tax shelter farm activity or has disposed of his entire interest in that activity.

The tax shelter farm activity rule is applied, in computing noncorporate AMT income, before the passive loss rule,[1452] so that the only tax shelter farm activities that enter into the passive loss computation for noncorporate AMT purposes are those that generate net income or gain or those that the taxpayer disposed of during the tax year. The income or gain can then be offset, for noncorporate AMT purposes under the general passive loss rule, against passive losses from other activities.

A "tax shelter farm activity" is generally any one of the following broadly defined types of farming businesses:

1. Any passive activity consisting of farming.[1453]

2. Any partnership or any enterprise (other than a C corporation), engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale.[1454] Registration includes the filing of a notice of exemption from registration.[1455]

3. Any partnership or any enterprise (other than a C corporation), engaged in the trade or business of farming, if more than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs (persons who have an interest in an enterprise other than as a limited partner and do not actively participate in the management of such enterprise).[1456] Special rules treat certain persons as neither limited partners nor limited entrepreneurs,[1457] such as an individual whose principal residence is on the farm.

Practice Point: As the first definition covers all passive farming activities, the second and third definitions of "tax shelter farm activity" are relevant only to nonpassive farming activities. Similar definitions of a "tax shelter" apply to a non-farming entity under §448(a)(3), generally if interests in such business have been offered for sale in any securities offering or if more than 35% of its losses during any period are allocable to limited partners or limited entrepreneurs. This definition of "tax shelter" is relevant for the §448 cash method of accounting rules, the §163(j) business interest deduction limitation, the §263A uniform capitalization rules, and various other Code provisions. The regulations and several PLRs have clarified that an entity is a "tax shelter" under the 35% losses rule only if it in fact has actual tax losses that are allocated to limited partners or limited entrepreneurs, as determined on a year-by-year basis.[1458]

2. *Insolvent Taxpayer*

The amount of a taxpayer's noncorporate AMT passive loss, otherwise disallowed, is allowed to the extent that the taxpayer is insolvent at the close of the tax year. Similarly, the amount of a loss otherwise disallowed under the tax shelter farming activity rule is allowed to the extent that the taxpayer is insolvent at the close of the tax year.[1459]

Note: The taxpayer-favorable insolvent rule was enacted by the Tax Reform Act of 1986,[1460] and the Congressional intent for the rule is unclear.[1461]

A taxpayer is considered "insolvent" to the extent of liabilities in excess of fair market value of assets.[1462]

This special rule for insolvent taxpayers applies only for noncorporate AMT purposes but not for regular tax purposes, which may lead to a greater deduction for AMT purposes than for regular tax purposes.

> *Example:* Taxpayer T, an individual, has a net $40,000 loss from a passive activity for both AMT and regular tax purposes. However, T's liabilities exceed his assets by $30,000 at the end of the tax year. T has a $30,000 allowed loss for AMT purposes and a $10,000 AMT passive loss carryover, while he has no allowed loss for regular tax purposes and a $40,000 regular tax passive loss carryover. The loss may create an AMT net operating loss (NOL), which is generally limited to offsetting 90% of AMT taxable income in a carryover year,[1463] compared to how a regular tax NOL arising in tax years beginning in 2018 and later is generally limited to offsetting 80% of regular taxable income in a carryover tax year that begins in 2021 or later.[1464]

Practice Point: The insolvent taxpayer rule is not optional and requires the insolvent taxpayer to generally deduct all pas-

[1450] 1986 Senate Report at 528; 1986 Blue Book at 446–47; Announcement 88-45.

[1451] *See* 1986 Blue Book at 446–47.

[1452] *See* 1986 Blue Book at 447.

[1453] §58(a)(2)(B).

[1454] §461(k)(1)(A).

[1455] Reg. §1.448-2(b)(2)(ii), as amended by T.D. 9942, 86 Fed. Reg. 254, 269 (Jan. 5, 2021) (generally applicable to tax years beginning on or after January 5, 2021, but taxpayers may rely on the regulations for tax years beginning after December 31, 2017), Reg. §1.448-1T(b)(2) (applicable to tax years beginning before January 5, 2021); *see generally* FSA 200018018; GCM 39781 (Sept. 23, 1988).

[1456] §461(k)(1)(B).

[1457] §461(k)(2).

[1458] Reg. §1.448-2(b)(2)(iii)(A) (generally applicable to tax years beginning on or after January 5, 2021, but taxpayers may rely on the regulations for tax years beginning after December 31, 2017), Reg. §1.448-1T(b)(3) (applicable to tax years beginning before January 5, 2021), Reg. §1.1256(e)-2(a); PLR 9535036, PLR 9415005, PLR 9407030, PLR 9335041. *See generally* Libin Zhang, *Links to the Past: Old Exceptions to New Interest Limitations*, 162 Tax Notes 271 (Jan. 21, 2019).

[1459] §58(c)(1)(A).

[1460] Pub. L. No. 99-514, §701(a).

[1461] *See* 1986 Senate Report at 528.

[1462] §58(c)(1)(B) (similar to §108(d)(3)).

[1463] §56(d)(1)(A)(i)(II).

[1464] §172(a)(2).

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sive losses in the tax year of insolvency for noncorporate AMT purposes and thereby reduce the AMT passive loss carryovers to future tax years. The reduced AMTI in the tax year of insolvency may result in the taxpayer paying regular income tax in that tax year, but then paying more AMT in subsequent tax years due to the lack of AMT carryovers. In contrast to the §53 minimum tax credit that generally applies to a taxpayer who pays AMT first and regular tax later on the same items due to a timing mismatch, there is no tax credit mechanism for a taxpayer who pays regular tax first and AMT later on the same items due to a timing mismatch in the opposite direction.

3. Material Participation in Research and Experimental Expenditures

For amounts paid or incurred in tax years beginning after 2024, taxpayers are allowed an immediate deduction for any domestic research and experimental (R&E) expenditures,[1465] but must amortize foreign R&E expenditures over a 15-year period.[1466] For noncorporate AMT purposes, the amount allowable as deductions for foreign R&E expenditures under §174(a) and domestic R&E expenditures under §174A(a) instead must be amortized ratably over a period of 10 tax years.[1467] The taxpayer may also elect to amortize the domestic R&E expenditures ratably over 10 tax years for regular tax purposes.[1468]

However, the noncorporate AMT 10-year amortization requirement does not apply if the taxpayer materially participates in the activity in which the expenditures were incurred.[1469] The exception was enacted in order to "treat individuals actively engaged in an activity involving research and experimental expenses in the same manner as corporations,"[1470] as corporations beginning with the Tax Reform Act of 1986 did not have to amortize research or development expenditures under the pre-2018 corporate AMT for incentive reasons.[1471]

The taxpayer may elect to amortize its pre-2022 R&E expenditures ratably over a period of generally five tax years,[1472] which applies for both regular tax and noncorporate AMT purposes. A five-year amortization period is generally mandatory for R&E expenditures paid or incurred in tax years beginning in 2022 through 2024.[1473]

For further discussion of the treatment of §174 and §174A research and development expenditures under the noncorporate AMT, see 556 T.M., *Research and Development Expenditures*, and 587 T.M., *Noncorporate Alternative Minimum Tax*.

B. Self-Employment Tax, Base Erosion and Anti-Abuse Tax (§59A) and Other Taxes

The §1401 self-employment tax can apply to passive income.[1474] A suspended passive loss is not taken into account as a deduction in the computation of any tax imposed by §1 through §1563. Thus, a suspended passive loss does not reduce the §1401 self-employment tax until the passive loss carryover is used.[1475] For circumstances where an individual may have income subject to neither the §1401 self-employment tax nor the §1411 net investment income tax, see III.C.8. (payments to retired partners), IV.A.8. (limited partners), and IV.B.1.a. (real estate professionals).

C corporations are generally subject to a base erosion and anti-abuse tax (BEAT) in 2018 and later tax years under §59A. The BEAT generally applies to any corporation that: (a) is not a REIT, regulated investment company (RIC), or S corporation;[1476] (b) is a member of an aggregate group with average annual gross receipts of at least $500 million for the prior three tax years;[1477] and (c) is a member of an aggregate group that has a "base erosion percentage" of 3% or higher.[1478] A taxpayer subject to the BEAT must generally pay the greater of its 21% U.S. federal regular corporate income tax or its BEAT, which is generally imposed on the taxpayer's taxable income modified by an addback of certain "base erosion tax benefits" from transactions with foreign related parties that generally own at least 25% of the corporation's stock.[1479] The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 10.5% in 2026 and later.[1480] The BEAT cannot be reduced by foreign tax credits and most other tax credits.[1481]

A corporation that is subject to the BEAT may also be a closely held corporation (CHC) or personal service corporation (PSC), in which case the passive loss rules may apply differently to the separate computations of taxable income and modified taxable income for regular tax and BEAT purposes. For further discussion, see 6125 T.M., *Base Erosion and Anti-Abuse Tax (BEAT)* (Foreign Income Series).

Note: Base erosion tax benefits and payments do not include any amounts paid or accrued in tax years beginning before 2018, such as passive loss carryovers from before 2018 that are attributable to amounts paid or accrued to foreign related parties. Such amounts are not taken into account in determining base erosion percentage or modified taxable income.[1482]

C. Investment Interest Limitation (§163(d))

Under §163(d), a noncorporate taxpayer's deductions for investment interest are generally limited to the amount of net

[1465] §174A(a), as added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70302(a).
[1466] §174(a), as amended by the OBBBA, Pub. L. No. 119-21, §70302(b).
[1467] §56(b)(2)(A)(ii), as amended by the OBBBA, Pub. L. No. 119-21, §70302(b)(3).
[1468] §59(e)(2)(B), as amended by the OBBBA, Pub. L. No. 119-21, §70302(b)(4).
[1469] §56(b)(2)(C) (references material participation standard under §469(h)).
[1470] H. Rep. No. 101-247, at 1346 (1989).
[1471] 1986 Senate Report at 520–521. *See also* 1986 Blue Book at 433.
[1472] *See* former §174(a)(2)(B) (2014).
[1473] *See* former §174(a) (2017).
[1474] *Norwood v. Commissioner*, T.C. Memo 2000-84. For further discussion, see IV.A.8., above.
[1475] TAM 9750001.
[1476] §59A(e)(1)(A); Reg. §1.59A-2(b)(1).
[1477] §59A(e)(1)(B); Reg. §1.59A-2(c)(1), §1.59A-2(d).
[1478] §59A(e)(1)(C); Reg. §1.59A-2(c)(1), 1.59A-2(e)(1). The aggregate group's base erosion percentage threshold is reduced to 2% for certain banks and securities dealers. §59A(b)(2)(B); Reg. §1.59A-2(e)(2).
[1479] §59A(b), §59A(c).
[1480] §59A(b)(1)(A), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70331. *See* pre-OBBBA §59A(b)(1)(A).
[1481] §59A(b)(1)(B).
[1482] Reg. §1.59A-3(b)(3)(vi).

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investment income.[1483] To ensure that §163(d) and §469 do not overlap, §163(d)(4)(D) provides that investment income and expenses do not include "any income or expense taken into account under section 469 in computing income or loss from a passive activity," while §163(d)(3)(B)(ii) provides that investment interest does not include any interest taken into account in computing passive activity income or loss under §469. Nonpassive income or gain under the nondepreciable property rule,[1484] the equity-financed lending rule,[1485] and the pass-through entity royalty rule[1486] is further treated as net investment income,[1487] which increases the amount of investment interest expense deductible under §163(d). For further discussion, see 536 T.M., *Interest Expense Deductions.*

Section 163(d)(3)(A) provides that the term "investment interest" expense means any interest allowable as a deduction that is paid or accrued on indebtedness properly allocable to property held for investment. Section 163(d)(5)(A)(ii) provides that "property held for investment" includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. The two such types of trade or business activities are oil and gas working interests,[1488] and an activity of trading personal property for the account of owners of interests in the activity.[1489]

Long-term capital gain, such as gain from the sale of a stock, bond, PTP interest, or oil and gas working interest, and qualified dividend income are net investment income only to the extent that the taxpayer elects to pay income tax on the long-term capital gain or qualified dividend income at ordinary income tax rates.[1490]

In Rev. Rul. 2008-12, PRS is a partnership that is engaged solely in the trade or business of trading securities for its own account and not for customers. LP is a noncorporate taxpayer that owns an interest in PRS as a limited partner. LP does not materially participate in the activity in which PRS is engaged. PRS incurs indebtedness in its trade or business of trading securities. The ruling concluded that since LP's share of PRS's interest expense is allocable to PRS's trading activity, LP's share of PR's interest expense is subject to the §163(d) investment interest limitation. Given that the degree of participation by each noncorporate partner could limit the deductibility of the allocated interest expense, PRS must separately state this expense.[1491]

[1483] §163(d)(1).

[1484] See IV.C.2., above.

[1485] See IV.C.3., above.

[1486] See IV.C.6., above.

[1487] Reg. §1.469-2(f)(10).

[1488] See IV.C.7., above.

[1489] Reg. §1.469-1T(e)(6) (discussed at III.A.2., above).

[1490] §163(d)(4)(B)(iii), §1(h)(2). *See* Reg. §1.163(d)-1(a); PLR 200146018.

[1491] Rev. Rul. 2008-38 held that LP's share of the investment interest expense (after §163(d)(1) limitation) is an above-the-line deduction against LP's adjusted gross income, because it is attributable to a trade or business, and therefore is not a §63(d) itemized deduction. Announcement 2008-65 confirmed that the investment interest expense (after §163(d) limitation) is properly reported on Schedule E, as a separate line of "investment interest" followed by the name of the trading partnership. See also III.A.2., above.

D. Interest Capitalization (§263A), Business Interest Deduction Limitation (§163(j)), At-Risk Rules (§465), Excess Business Loss Rules (§461(l))

The TCJA enacted a revised §163(j) limitation on a taxpayer's deduction of net business interest expense in a current year, generally limited to the sum of 30% of the taxpayer's adjusted taxable income (ATI), 100% of the taxpayer's business interest income, and any floor plan financing interest.[1492] ATI is generally the taxpayer's tentative taxable income computed without regard to nonbusiness items, any §172 net operating loss deduction, any business interest expense or business interest income, any §199A pass-through business income deduction, and for tax years beginning after 2017 and before 2022, and after 2024, any deductions for depreciation, amortization, or depletion.[1493] For taxable years beginning after 2025, ATI is also calculated without regard to CFC inclusions.[1494] The §163(j) limitation generally applies at the partnership level for partnership interest expense,[1495] and at the S corporation level for S corporation interest expense.[1496]

The business interest deduction limitation applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, (but for years beginning after 2025, see the discussion of interest capitalization in the following paragraph) or other limitation[1497] such as §163(e)(5) (deferral of original issue discount for debt held by related foreign person), §163(e)(5) (deferral or disallowance of original issue discount on certain corporate high yield obligations), §163(f) (disallowance of interest deduction for certain debts not in registered form), §264(a) (debt to acquire certain types of life insurance, endowment, or annuity contracts), §163(l) (disallowance of interest deduction for certain corporate debt instruments payable in kind), §163(m) (disallowance of interest deduction for nondisclosed reportable transactions), §265 (disallowance of interest expense relating to tax-exempt income),

[1492] §163(j)(1). §163(j)(12), as redesignated by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70341, (July 4, 2025). Likewise, under former §163(j)(10) taxpayers were limited to 30% of ATI for tax years beginning in 2019 and 2020 (for partnerships only in 2020), and permitted to elect 2019 ATI for tax years beginning in 2020. A taxpayer could also elect to use its 2019 adjusted taxable income in 2020.

[1493] §163(j)(8). As enacted by the TCJA in 2017, §163(j)(8) excluded depreciation, amortization, or depletion deductions from the computation of ATI, but included a built-in provision which reversed the exclusion (thus, depreciation, amortization, and depletion deductions were included in the ATI computation) for taxable years beginning after 2022. Section §163(j)(8)(A)(v), as amended by the OBBBA, Pub. L. No. 119-21, §70303(a), permanently reinstated the exclusion of depreciation, amortization or depletion deductions, effective for taxable years beginning after 2024. *See also* Reg. §1.163(j)-1(b)(1) for an expanded definition of ATI that is adjusted for capital loss carryovers, depreciation recapture, and depreciation or amortization capitalized under §263A. *Note:* The regulations have not been amended for changes made by the OBBBA.

[1494] §163(j)(8)(A)(vi), added by the OBBBA, Pub. L. No. 119-21, §70342, (excluding from the computation of ATI: (i) amounts included in gross income under §951(a) (subpart F income), §951A(a) (net tested CFC income (NCTI; formerly known as GILTI)), and any associated gross-up under §78, and (ii) the portion of the deductions allowed by reason of those inclusions under §245A(a) (certain foreign-sourced dividends) and §250(a)(1)(B), effective for taxable years beginning after 2025).

[1495] §163(j)(4).

[1496] §163(j)(4)(D).

[1497] Reg. §1.163(j)-3(b)(2); §1.163(j)-3(b)(3).

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§267(a)(2) (matching of interest income and deduction for related parties), §267(a)(3) (matching of interest deduction and income for foreign lenders), §263A (uniform capitalization rules for interest), §267A (hybrid transactions and hybrid entities), §279 (disallowance of certain interest deductions on debt incurred by corporation to acquire stock or assets of another corporation), §1277 (deferral of interest deduction allocable to accrued market discount), and §1282 (deferral of interest deduction allocable to short-term debt obligation).[1498]

However, for taxable years beginning after 2025, calculation of the business interest deduction limitation is required *before* applying any provisions that require interest to be capitalized (other than interest capitalized under §263(g) (interest allocable to personal property that is part of a straddle) or §263A(f) (interest allocated to property produced by the taxpayer).[1499] The §163(j) limitation is first applied to the aggregate amount of capitalized interest, and second, to the aggregate amount of interest to be deducted.[1500] Thus, the §163(j) limitation offsets amounts that would otherwise be capitalized under §263A, and only the excess (if any) is deductible. No portion of any disallowed interest carried forward under §163(j)(2) (including any interest capitalization provision that previously applied to such portion) shall be treated as interest to which an interest capitalization provision applies.[1501]

The §163(j) business interest deduction limitation applies before the application of §461(l)[1502] (excess business loss limitation for a noncorporate taxpayer in tax years after 2020), §465 (at-risk rules), and the §469 passive loss rules.[1503] Section 465 applies before the §469 passive loss rules,[1504] whereas §461(l) applies after the passive loss rules.[1505] The basis adjustment rules for partners (§704(d)) or S corporation shareholders (§1366(d)) apply before §469 passive loss rules,[1506] before the §465 at-risk rules,[1507] and after the §163(j) business interest deduction limitation.[1508]

Based on the transitive property of deduction limitations, the order of their application is generally:

(1) interest disallowance, deferral, or other limitations;

(2) §163(j) business interest deduction limitation;

(3) §263A capitalization;

(4) basis limitation under §704(d) for partners or §1366(d) for S corporation shareholders;

(5) §465 at-risk limitation;

(6) §469 passive loss limitation; and

(7) §461(l) excess business loss limitation.

Example 1 — Post-OBBBA: In 2026, Taxpayer T has: (i) a §163(j) business interest deduction limitation of $100x; (ii) $70x of interest expense, and (iii) $50x of capitalized interest. The limitation under §163(j) applies to T for 2026 because total capitalized interest and interest expense exceed $100x. Applying §163(j) to both interest expense and capitalized interest, the statute's limitation first applies to disallow the taxpayer's deduction for interest expense and then applies to reduce capitalization of interest. Thus, T's deduction from interest expense is reduced from $70x to $50x, and T's capitalized interest remains at $50x.[1509]

Example 2 — Pre-OBBBA: Taxpayer T is engaged in a rental activity that is a passive activity and is a trade or business for §163(j) purposes. T receives $200 of rental income and incurs $300 of rental expenses, consisting of $150 interest expense, $60 maintenance expenses, and $90 depreciation expense. T's adjusted taxable income (ATI) is $400. T's §163(j) business interest deduction limitation is $120 (30% of $400 ATI), which disallows $30 of its $150 interest expense. The $30 disallowed interest expense is carried forward as a disallowed business interest expense carryforward. T has a $70 passive loss from the rental activity, equal to $200 rental income reduced by $120 of allowed interest expense, $60 maintenance expense, and $90 depreciation expense. The $30 disallowed business interest expense carryforward is not a deduction under the passive loss rules for the tax year, but it may reduce passive income (or increase a passive loss) in a later tax year when allowed under §163(j).[1510]

Example 3 — Pre-OBBBA: Taxpayer T has $1,000 of ATI from a passive activity and $1,000 of business interest expense, of which $900 (90%) is allocable to a passive activity and $100 (10%) is allocable to a nonpassive activity. T's §163(j) business interest deduction limitation is $300 (30% of $1,000 ATI), which disallows $700 of T's $1,000 business interest expense. The $300 of allowed interest expense is allocated proportionately as $270 (90%) to a passive activity and $30 (10%) to a nonpassive activity. The $30 disallowed business interest expense carryforward is not a deduction under the passive loss rules in the tax year.[1511]

Any §163(j) business interest expense carryforward retains its character as either passive or nonpassive in the hands

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[1498] Reg. §1.163(j)-3(b)(2); §1.163(j)-3(b)(3). *See also* Reg. §1.163(j)-3(c)(7) *Ex. 7*; H. R. Rep. No. 115-466, at 387 (2017).

[1499] §163(j)(10)(A), added by Pub. L. No. 119-21, §70341(a). *See also* §163(j)(5), as amended by Pub. L. No. 119-21, §70341(b), (excluding interest which is capitalized under §263(g) or §263A(f) from the definition of business interest), effective for taxable years beginning after 2025.

[1500] §163(j)(10)(B), added by Pub. L. No. 119-21, §70341(a).

[1501] §163(j)(10)(C), added by Pub. L. No. 119-21, §70341(a). An "interest capitalization provision" is defined as any provision under which interest is required to be charged to a capital account, or may be deducted or charged to a capital account. §163(j)(10)(D), added by Pub. L. No. 119-21, §70341(a).

[1502] §461(l)(1)(B), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70601, making the limitation permanent, effective for taxable years beginning after December 31, 2026.

[1503] Reg. §1.163(j)-3(b)(4). However, in determining tentative taxable income for purposes of computing ATI, §461(l), §465, and §469 are taken into account. *Id.*

[1504] Reg. §1.469-2T(d)(6)(i).

[1505] §461(l)(6).

[1506] Reg. §1.469-2T(d)(6)(i).

[1507] Reg. §1.469-2T(d)(6)(iv).

[1508] Reg. §1.163(j)-6(h).

[1509] *See* Samuel Pollack, *The OBBBA Changes the Capitalized Interest Rules Under §163(j)*, TMIJ (July 18, 2025).

[1510] *See* Reg. §1.163(j)-3(c)(3) *Ex. 3.* The example assumes that the rental activity is a trade or business.

[1511] *See* Reg. §1.163(j)-3(c)(4) *Ex. 4.*

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of the taxpayer when the carryforward is allowed under §163(j), such as in the hands of the partner in a partnership (or the shareholder in an S corporation) that is allocated the business interest expense.[1512]

Although the §465 at-risk limitation, the §469 passive loss limitation, and the §461(l) excess business loss limitation apply after §163(j) in computing a taxpayer's allowable business interest deductions, the calculation of ATI for §163(j) purposes is done after taking into account §465, the passive loss limitation, and §461(l).[1513]

> *Example:* Taxpayer T has $500 of passive income, $400 of business interest expense, and $600 of noninterest business expense with respect to a passive activity. In determining T's tentative taxable income for purposes of computing ATI, §469 is taken into account, and interest expense is not subject to any §163(j) limitation.[1514] Since T has only $500 of passive income, T is allowed only $500 of deductions in computing ATI with respect to the passive activity, due to the passive loss rules. The $500 of deductions is allocated pro rata between the types of expenses, as $200 of disallowed business interest expense and $300 of disallowed noninterest business expense. T's ATI is $200, equal to $500 passive income minus $200 allowed noninterest business expense. In computing T's taxable income (instead of ATI), T can deduct $60 of business interest expense under §163(j) (equal to 30% of its $200 ATI) and have a $340 business interest expense carryforward. T has a net loss of $160 (equal to $500 passive income minus $600 nonbusiness deductions and minus $60 allowed business interest expense), which becomes a $160 passive loss carryover to the next year.[1515]

In the next year, T has $500 of passive income, $100 of business interest expense, and zero other business expenses. Since T has $500 of passive income, T is allowed the $160 passive loss carryover in computing ATI under the passive loss rules, which results in $340 of ATI. In computing T's taxable income, T can deduct $102 of business interest expense (equal to 30% of its $340 ATI), which uses its $100 of business interest expense and $2 of its $340 business interest expense carryforward. T has $238 of net income, equal to $500 passive income minus $102 allowed business expense and minus $160 passive loss carryover).[1516]

Practice Point: The §163(j) regulations do not explain how to calculate a partnership's ATI in connection with the passive loss rules, especially if some partners materially participate in the partnership's activities and other partners do not. It is possible that the passive loss rules do not apply to a partnership's ATI at all, because the partnership itself is normally never subject to the passive loss rules. Another possibility is that a partnership's ATI is determined based solely on the material participation of its direct partners (to the extent that any of them are individuals or other taxpayers subject to the passive loss rules,) without regard to the material participation of indirect partners, similar to how §163(j) and §163(d) are applied to a trading partnership only by taking into account the material participation of the partnership's direct individual partners, and without regard to any material participation of the partnership's indirect partners, as described in III.A.2., above.

For further discussion about the §163(j) business interest deduction limitation, see 536 T.M., *Interest Expense Deductions*, at V.E.

Where deductions in any amount are disallowed under the at-risk rules, a ratable portion of each deduction from the activity (as defined for at-risk purposes) is disallowed.[1517] For example, assume that an at-risk activity gives rise to two depreciation deductions in the amounts of $2,000 and $3,000, respectively (for a total of $5,000). Assume further that deductions in the amount of $4,000 are disallowed under the at-risk rules from that at-risk activity. Four-fifths of the overall deductions, and thus four-fifths of each deduction, is disallowed: i.e., $1,600 with respect to the first deduction, and $2,400 with respect to the second deduction. In the tax year when a deduction (or portion thereof) is allowed under the at-risk rules, it becomes subject to the passive loss rules if derived from a passive activity. The character of the activity is determined as of that tax year.[1518]

Similarly, where deductions in any amount are disallowed under the basis limitation rules for partners under §704(d) or S corporation shareholders under §1366(d), a ratable portion of each deduction from the partnership or S corporation (as the case may be) is disallowed.[1519] For example, a partnership's activities give rise to two deductions, and the amounts of these deductions allocable to the taxpayer/partner are $4,000 and $6,000, respectively (for a total of $10,000). Deductions of $9,000 from the partnership are disallowed under §704(d). Nine-tenths of the overall deductions, and thus nine-tenths of each deduction, is disallowed: *i.e.*, $3,600 with respect to the first deduction, and $5,400 with respect to the second deduction. In the tax year when a deduction (or portion thereof) is allowed under §704(d) or §1366(d), such deduction becomes subject to the passive loss rules if derived from a passive activity. The character of the activity is determined as of that tax year.[1520]

On the interaction between the passive loss rules and §704(d) (and presumably other limitations that apply before the passive loss rules), the regulations' preamble noted that:

> [I]f a partner's distributive share of a partnership deduction is disallowed under section 704(d) in 1987, but is not disallowed under section 704(d) (or any other provision other than section 469 or 1211) in 1988, the deduction is treated as arising in 1988. This rule has two significant effects. First, a deduction is not taken into account in computing the passive activity loss and credit until the first tax year in which the deduction is not disallowed by any applicable

[1512] Reg. §1.163(j)-6(c)(4), §1.163(j)-6(l)(2).
[1513] Reg. §1.163(j)-3(b)(4).
[1514] Reg. §1.163(j)-1(b)(43).
[1515] Reg. §1.163(j)-3(c)(5) *Ex. 5.* The $160 passive loss carryover is allocated between T's two types of deductions, as $14.55 of business interest expense and $145.45 of noninterest business expense.
[1516] *See* Reg. §1.163(j)-3(c)(6) *Ex. 6.*
[1517] Reg. §1.469-2T(d)(6)(iii).
[1518] Reg. §1.469-2(d)(8).
[1519] Reg. §1.469-2T(d)(6)(ii).
[1520] Reg. §1.469-2(d)(8).

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limitation other than those contained in sections 469 and 1211. Second, the determination of whether a deduction from an activity is a passive activity deduction does not depend on the character of the activity in tax years in which the deduction is disallowed under limitations other than section 469. Thus, in the example … the determination of whether the partner's deduction is a passive activity deduction in 1988 depends solely on whether the activity in which it arises is a passive activity of the partner in 1988.[1521]

Other provisions that apply either before or after the §469 passive loss limitation include:

1. The §470 limitation on deduction for property used by tax-exempt entities applies before the §469 passive loss limitation.[1522]

2. The §461(j) limitation on excess farm losses of certain taxpayers that receive farming subsidies applies before the passive loss limitation,[1523] though §461(j) does not apply to any taxpayer after 2017 and is replaced by the broader limitation on excess business losses for non-corporate taxpayers in §461(l).[1524]

3. Under pre-2018 law, former §163(j) limited a corporation's interest expense deductions with certain related foreign persons or REITs. Section 465 and §469 applied before applying former §163(j),[1525] and there is no recomputation of deductions under §469.[1526]

4. Under §613A(c), independent producers and royalty owners generally can use percentage depletion with regard to oil and gas wells, but §613A(d) prevents the use of such percentage depletion deductions to offset more than 65% of a taxpayer's income with certain adjustments. The passive loss regulations provide that the limitation under §613A(d) applies after application of the passive loss rules.[1527] Percentage depletion carryforwards are not subject to the passive loss rules.[1528]

E. Use or Rental of Residence

Qualified residence interest, as defined in §163(h)(3) to generally include debt incurred to acquire the taxpayer's principal residence or a second residence, is excluded from the computation of passive losses.[1529]

In addition, all income, deduction, gain, or loss allocable to the use of a dwelling unit subject to §280A(c)(5) is not taken into account under the passive loss rules.[1530] In such cases, the income, gain, or loss from such use of the dwelling unit is per se nonpassive.[1531]

Section 280A(c)(5) contains its own loss disallowance and carryover rules.[1532] *See generally* 547 T.M., *Home Office, Vacation Home and Home Rental Deductions.* Although the losses of the dwelling unit are nonpassive and therefore not subject to the passive loss rules, the losses are subject to more restrictive deduction limitations under §280A(c)(5) that generally prevent some or all of the losses from being used against other income in the same tax year and subsequent tax years. The 2005 IRS Audit Guide provided for greater scrutiny of a real estate professional's rental properties that may be used as a residence.[1533]

Practice Point: Section 280A and §469 are mutually exclusive in applying to an activity's income or loss. If a taxpayer's dwelling unit is subject to §280A(c)(5), the passive loss rules do not apply to the unit's income or loss, even if the use generates net income and is not actually limited by the §280A(c)(5) deduction limitations.[1534] The entire gain from the sale of the dwelling unit is nonpassive income under §280A, including any the appreciation that occurred before §280A applied to the property.

Practice Point: Even if a dwelling unit's rental income or loss is subject to §280A(c)(5) instead of the passive loss rules, the taxpayer's participation with respect to the dwelling unit's rental activity may be relevant for purposes of the taxpayer's material participation in other activities or the taxpayer's real estate professional status.[1535]

The rental use of a dwelling unit is generally subject to §280A(c)(5) if the taxpayer uses the dwelling unit as a residence, which is defined as using the unit (or portion thereof) for personal purposes for more than 14 days (or more than10% of the number of days during the tax year that the unit is rented at fair rental, if greater).[1536] A day of fair rental does not include a day that the unit is used for personal purposes.[1537] Personal use

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[1521] T.D. 8175 (Preamble to Temporary Regulations), 53 Fed. Reg. 5686, 5691 (Feb. 25, 1988).

[1522] §470(e)(3).

[1523] §461(j)(7).

[1524] §461(l)(1)(A), as amended by the OBBBA, Pub. L. No. 119-21, §70601(b), effective for taxable years beginning after December 31, 2026. Former §461(l)(1)(A) was amended by Pub. L. No. 117-2, §9041(a) and Pub. L. No. 117-169, §13903(b)(1), to suspend §461(j) for taxable years beginning in 2018 through 2028.

[1525] Former §163(j) *repealed* by the TCJA, Pub. L. No. 115-97, §13301(a).

[1526] Former Prop. Reg. §1.163(j)-7(b). *See generally* N.Y. State Bar Ass'n, *Report on Proposed Regulations Under Section 163(j)*, Tax Report #701, at 35-7 (Oct. 23, 1991).

[1527] Reg. §1.469-1(d)(2).

[1528] Reg. §1.469-2(d)(2)(ix).

[1529] §469(j)(7); Reg. §1.163-8T(m)(3). *See* Reg. §1.163-10T(p) (defining principal residence and second residence).

[1530] §469(j)(10); Reg. §1.469-2(d)(2)(xii).

[1531] Reg. §1.469-2(c)(7)(vii), §1.469-2(d)(2)(xii).

[1532] *See* Prop. Reg. §1.280A-2(i).

[1533] *See* 2005 IRS Audit Guide at 7-5. ("Watch for Schedule E rentals with the same or similar address as on the front of the return. Unusually low gross receipts during peak rental periods may indicate rental at less than fair market value or possible personal use. Property that has little or no advertising and was unrented for many weeks during the year may indicate high personal use.").

[1534] *See* H. Rep. 100-795, 100th Cong.2d Sess., at 33 (1988) ("The bill provides that income, deductions, gain or loss from rental use of a dwelling that the taxpayer uses as a residence (or from certain other business uses of a dwelling), for any tax year in which deductions from such use are limited to the amount of income from such use under Code section §280A(c)(5), are not taken into account in determining the taxpayer's passive activity loss for the year. This provision eliminates the partial overlap of the deduction limitations imposed by section §280A(c)(5) and by the passive loss rules, principally in the circumstance of rental use of residences, and thus tends to simplify the application of these rules."); S. Rep. 100-445, 100th Cong.2d Sess. 34 (1988).

[1535] *See, e.g., Simonelli v. Commissioner*, T.C. Memo 2017-188, *aff'd*, 790 Fed. App'x 870 (9th Cir. 2020) (taxpayer could not prove real estate professional status based on activities with respect to a vacation home used for both rental and personal purposes).

[1536] §280A(d)(1); Prop. Reg. §1.280A-1(d)(1).

[1537] §280A(d)(1).

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of the unit by the taxpayer's spouse, siblings, ancestors, or lineal descendants is considered use for personal purposes,[1538] unless the unit is rented at a fair rental for use as a principal residence.[1539]

The use of a dwelling unit as an office, storage facility, or children's day care facility can also be subject to §280A(c)(5).[1540]

A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit (such as a garage appurtenant to a house),[1541] but it does not include that portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment.[1542] A portion of a unit is used exclusively as a hotel, motel, inn, or similar establishment only if (i) it is regularly available for occupancy by paying customers and (ii) no owner uses or is deemed to have used it as a residence during the tax year, such as "a portion of a home used to furnish lodging to tourists or to long-term boarders such as students."[1543]

> *Example:* A taxpayer rents out a portion of his or her personal residence, such as a spare bedroom, on Airbnb, Vrbo, HomeAway, or a similar platform. If the portion of the residence is used exclusively for such purposes, the portion may not be considered part of the dwelling unit that is subject to §280A(c)(5) because it is used exclusively as a hotel or similar establishment, in which case the portion of the residence is subject to the passive loss rules described above. The Airbnb rental may be a trade or business activity for which the taxpayer materially participates and has nonpassive income or nonpassive loss. But if the portion of the residence used in the Airbnb activity is also used by the taxpayer for personal purposes, §280A(c)(5) may apply to the Airbnb activity's income or loss so that generally any loss is disallowed and carried over under §280A(c)(5) and any net income is nonpassive income.

F. *Transferable Tax Credits*

The Inflation Reduction Act of 2022[1544] added §6418 to the Code, which allows the transfer of certain federal income tax credits in tax years beginning after December 31, 2022. In general, a taxpayer (the "transferor taxpayer") may elect to transfer some or all of its "eligible credit" to another taxpayer (the "transferee taxpayer") that is not related to the transferor taxpayer. If the transfer occurs, the transferee taxpayer "shall be treated as the taxpayer for purposes of this title with respect to such credit (or such portion thereof)."[1545]

If the transferee taxpayer is an individual or other taxpayer subject to §469, then the transferee taxpayer's use of the transferred credit is subject to §469 under §6418 regulations.[1546] The regulations apply to tax years ending on or after April 30, 2024, but taxpayers may elect to apply all of the §6418 regulations to earlier tax years in their entirety and in a consistent manner.[1547] Under the regulations, the transferee taxpayer is treated as if it generated the transferred credit in connection with the conduct of a trade or business,[1548] which may result in the transferred credit being a passive credit if the transferee taxpayer does not materially participate in the trade or business. The transferee taxpayer is not treated as owning an interest in the trade or business (which is required for material participation) by virtue of having the transferred credit, unless the transferee taxpayer actually owns an interest in the transferor taxpayer's trade or business that generated the credit at the time it was generated.[1549]

The transferor taxpayer is not subject to any limitations under §469 for the transferred credit.[1550] In contrast, the transferor taxpayer is subject to the §49 at risk rules for the transferred credit.[1551]

> *Example:* An individual generates $100 of credits from an activity in which the individual does not materially participate. The transferor individual sells the credits to a transferee individual for $90 cash. The transferor individual has $90 of tax-free income. If the transferee individual does not materially participate in the activity, then the purchased credits may offset up to $100 of the transferee individual's tax liability imposed on other passive income. Any unused credits are carried forward under the passive credit carryover rules. If the transferee individual materially participates in the activity in the year that the credit was generated by the transferor individual, such as if the transferee is an employee and also an owner of the activity, then the transferee individual may use the purchased credits against any $100 of tax liability.

Practice Point: Employees of a credit-generating activity may be interested in purchasing credits to offset their own tax liabilities. If they spend enough hours to otherwise materially participate in the credit-generating activity, they may acquire a small interest in the activity in order to materially participate in the activity and cause the credits to be nonpassive credits. Alternatively, they may invest in the activity through a tax credit partnership, which automatically provides them with an interest in the activity.

Note: The original proposed regulations under §6418 provided that (i) the transferee taxpayer is not considered to own an interest in the transferor taxpayer's trade or business at the time the work is done, as required for material participation and (ii) the transferee taxpayer cannot change its participation in the transferor taxpayer's trade or business by using any of the grouping rules in Reg. §1.469-4(c).[1552] In response to com-

[1538] §280A(d)(2)(A); Prop. Reg. §1.280A-1(e)(1).

[1539] §280A(d)(3)(A).

[1540] *See* §280A(c)(5) (cross reference to §280A(c)(1), §280A(c)(2), and §280A(c)(4)); Prop. Reg. §1.280A-2(b), §1.280A-2(c), §1.280A-2(d), §1.280A-2(e), §1.280A-2(f).

[1541] §280A(f)(1)(A); Prop. Reg. §1.280A-1(c)(1).

[1542] §280A(f)(1)(B).

[1543] Prop. Reg. §1.280A-1(c)(2).

[1544] Pub. L. No. 117-169.

[1545] §6418(a).

[1546] Reg. §1.6418-2(f)(3)(i).

[1547] Reg. §1.6418-2(g).

[1548] Reg. §1.6418-2(f)(3)(ii).

[1549] Reg. §1.6418-2(f)(3)(ii).

[1550] Reg. §1.6418-2(d)(1).

[1551] Reg. §1.6418-2(d)(2).

[1552] Prop. Reg. §1.6418-2(f)(3)(ii). REG-10610-23, 88 Fed. Reg. 40,496 (June 21, 2023).

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ments,[1553] the final regulations removed the anti-grouping rule and acknowledged that some transferee taxpayers may already own an interest in the trade or business that generated the credits.

Note: The full gamut of §469 rules apply to the transferee taxpayer's transferred credit. For example, a transferee taxpayer that is a CHC may use the transferred credit against corporate tax liability from active income.

The transferor taxpayer's payment received from the transferee taxpayer is not included in the transferor taxpayer's gross income and is not deductible by the transferee taxpayer.[1554] If the transferor taxpayer is a partnership or an S corporation, the payment is treated as tax-exempt income for purposes of §705 and §1366.[1555] Furthermore, for a transferor taxpayer that is a partnership or an S corporation, the payment is treated as arising from an investment activity and not from a trade or business for purposes of §469(c)(1)(A).[1556] The payment therefore does not increase the passive income of the transferor partnership's partners or transferor S corporation's shareholders.

The transferee taxpayer does not have gross income from buying the transferred credits at a discount.[1557]

A transferee taxpayer may be a partnership or an S corporation, in which case it allocates the transferred credit to its partners or shareholders.[1558] Any passive loss limitation on the transferred credit would apply at the partner or shareholder level.

Transferable credits include the §30C alternative fuel refueling property credit (for depreciable property, i.e., not a personal home electric vehicle charger), the §45 renewable electricity production credit, the §48 energy credit, the §45Q carbon oxide sequestration credit, the §45U nuclear power production credit, the §45V clean hydrogen production credit, the §45X advanced manufacturing production credit, the §45Y technology-neutral clean electricity production credit, the §45Z clean fuel production credit, the §48C qualifying advanced energy project credit, the §48E technology-neutral clean electricity investment credit, and the §40A(b)(4) small agri-biodiesel producer biodiesel fuels credit (for fuel sold or used after June 30, 2025).[1559]

A taxpayer may also elect direct pay under §6417 for the §45V clean hydrogen production credit, the §45Q carbon oxide sequestration credit, §45X advanced manufacturing production credit for tax years beginning in 2032 or earlier.[1560] Direct pay effectively causes the credit to be fully refundable to the electing taxpayer. The electing taxpayer may be a taxable entity, partnership, or S corporation.[1561] If the electing taxpayer is a partnership or an S corporation, the direct credit payment is treated as tax-exempt income for purposes of §705 and §1366,[1562] and the payment is treated as arising from an investment activity and not from a trade or business for purposes of §469(c)(1)(A).[1563] The payment therefore does not increase the passive income of the transferor partnership's partners or transferor S corporation's shareholders.

Practice Point: The §469 passive loss rules apply to a transferee taxpayer that acquires the §45V clean hydrogen production credit, the §45Q carbon oxide sequestration credit, or §45X advanced manufacturing production credit, but the passive loss rules do not apply if the transferor taxpayer instead elects direct pay under §6417 for the three credits. Depending on the transferable credits market, it may be preferable to elect direct pay for the three credits instead of transferring them, even if a transfer would result in more immediate cash payment and not require waiting until the filing of the year's tax return. Direct pay may also have certain other limitations.

[1553] *See e.g.*, N.Y. State Bar Ass'n Tax Section, Report No. 1475 — Report on the Transferability of Energy Tax Credits Under Section 6418 (March 28, 2023).

[1554] §6418(b)(2).

[1555] Reg. §1.6418-3(a)(2).

[1556] Reg. §1.6418-3(a)(5).

[1557] Reg. §1.6418-2(f)(2) ("For example, a transferee taxpayer who paid $9X for $10X of a specified credit portion that the transferee taxpayer then claims on its return does not result in the $1X difference being included in the gross income of the transferee taxpayer.").

[1558] Reg. §1.6418-3(b)(4), §1.6418-3(c)(2).

[1559] §6418(f)(1)(A).

[1560] §6417(d)(1)(E)(ii).

[1561] Reg. §1.6417-3. §1.6417-4.

[1562] Reg. §1.6417-4(c)(1).

[1563] Reg. §1.6417-4(c)(3).

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TABLE OF WORKSHEETS

Worksheet 1	Taxpayers Subject to Passive Loss Rules.
Worksheet 2	Rental Activity Classification.
Worksheet 3	Material Participation.
Worksheet 4	Real Estate Professional.
Worksheet 5	Section 469(i) $25,000 Allowance.
Worksheet 6	Transition Rules [Archived Discussion].

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IRS GUIDANCE

- Publication 925, *Passive Activity and At-Risk Rules.*
- Passive Activity Loss Audit Technique Guide.

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