

gross income (determined without regard to § 1.469-2T(f)(2) through (f)(6)) that—

(A) Is income for the year from the rental or disposition of such item of property; and

(B) In the case of income from the disposition of such item of property, is income from an activity that involved the rental of such item of property during the 12-month period ending on the date of the disposition (see § 1.469-2T(c)(2)(ii)); and

(iv) The net rental activity income from an item of property for the taxable year is the excess, if any, of—

(A) The gross rental activity income from the item of property for the taxable year; over

(B) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under § 1.469-1(f)(4)) that are reasonably allocable to the income.

(10) *Coordination with section 163(d)*. Gross income that is treated as not from a passive activity under § 1.469-2T(f)(3), (4), or (7) is treated as income described in section 469(e)(1)(A) and § 1.469-2T(c)(3)(i) except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and § 1.469-2T(c)(3)(i)(C) as property that produces income of a type described in § 1.469-2T(c)(3)(i)(A);

(ii) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and § 1.469-2T(c)(3)(i)(D) as property held for investment;

(iii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and § 1.469-2T(d)(4) as clearly and directly allocable to portfolio income (within the meaning of § 1.469-2T(c)(3)(i)); and

(iv) Interest expense is allocated under § 1.163-8T to an investment expenditure (within the meaning of § 1.163-8T(b)(3)) or to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)).

(11) [Reserved]

[T.D. 8417, 57 FR 20754, May 15, 1992, as amended by T.D. 8477, 58 FR 11538, Feb. 26, 1993; 58 FR 13706, Mar. 15, 1993; 58 FR 29536, May 21, 1993; T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 8417, 59 FR 45623, Sept. 2, 1994]

§ 1.469-2T Passive activity loss (temporary).

(a) *Scope of this section*. This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section—

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) *Definition of passive activity loss—*

(1) *In general*. In the case of a taxpayer other than a closely held corporation (within the meaning of § 1.469-1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) *Cross references*. See paragraph (c) of this section for the definition of "passive activity gross income," paragraph (d) of this section for the definition of "passive activity deduction," and § 1.469-1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) *Passive activity gross income—*(1) *In general*. Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) *Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity—*(i) *In general—*(A) *Treatment of gain*. Except as otherwise provided in the regulations under section 469, any gain recognized

upon the sale, exchange or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(1) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(2) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(3) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) *Interest in property.* For purposes of applying this paragraph (c)(2) to a disposition of property—

(1) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(2) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially participated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(2) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially

participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(3) of this section, none of B's gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C's rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(1) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(2) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(1) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the

date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an interest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) \$10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(2) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for \$8,000. During the 12-month period ending on

the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was \$200,000. Under these facts, the computer was predominately used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price (\$8,000), does not exceed the lesser of (a) \$10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale (\$20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity.* [Reserved]. See § 1.469-4(c)(2)(iii) for rules relating to this paragraph.

(iv) *Taxable acquisitions.* [Reserved]. See § 1.469-2(c)(iv) for rules relating to this paragraph.

(v) *Property held for sale to customers.* [Reserved]. See § 1.469-2(c)(v) for rules relating to this paragraph.

(3) *Items of portfolio income specifically excluded—(i) In general.* Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)),

or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163(d)).

(ii) *Gross income derived in the ordinary course of a trade or business.* Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) 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;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) *Special rules—(A) Income from property held for investment by dealer.* For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not derived by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) *Royalties derived in the ordinary course of the trade or business of licensing intangible property—(1) In general.* Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person—

(i) Created such property; or

(ii) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(2) *Substantial services or costs—(i) In general.* Except as provided in paragraph (c)(3)(iii)(B)(2)(ii) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(ii) *Exception.* A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if—

(a) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(b) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(iii) *Expenditures taken into account.* For purposes of paragraph (c)(3)(iii)(B)(2)(ii) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(3) *Passthrough entities.* For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(4) *Cross reference.* For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) *Mineral production payments.* For purposes of section 469 and the regulations thereunder—

(1) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(2) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example (1). A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example (2). P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordi-

nary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example (3). (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example (4). C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example (5). (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for \$100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988 are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years.

Year	Gross royalties	Expenditures	Cumulative capital expenditures
1987	\$20,000	\$8,000	\$100,000
1988	20,000	12,000	100,000
1989	60,000	15,000	115,000
1990	120,000	0	115,000

(ii) Under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design (\$8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design (\$20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years (\$8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design (\$100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(2)(ii) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design (\$20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design (\$100,000). However, the amount of such expenditures incurred by the partnership in 1988 (\$12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design (\$20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design (\$15,000) do not exceed 50 percent of the part-

nership's gross royalties for such year from licensing the design (\$60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years (\$35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design (\$115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(2)(ii)(b) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example (6). The facts are the same as in example (5), except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design (\$1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design (\$2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. This is because, under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) *Items of personal service income specifically excluded—(i) In general.* Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only—

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services;

provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in connection with the management of X's rental properties. Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) *Income from section 481 adjustment—(i) In general.* If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) *Positive section 481 adjustments.* For purposes of applying this paragraph (c)(5)—

(A) The term “net positive section 481 adjustment” means the increase (if any) in taxable income taken into ac-

count under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term “positive section 481 adjustment with respect to an activity” means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) *Gross income from certain oil or gas properties—(i) In general.* [Reserved]. See § 1.469-2(c)(6)(i) for rules relating to this paragraph.

(ii) *Gross and net passive income from the property.* [Reserved]. See § 1.469-2(c)(6)(ii) for rules relating to this paragraph.

(iii) *Property.* [Reserved]. See § 1.469-2(c)(6)(iii) for rules relating to this paragraph.

(iv) *Examples.* The following examples illustrate the application of this (c)(6):

Example 1. [Reserved]. See § 1.469-2(c)(6)(iv) *Example 1.*

Example 2. [Reserved]. See § 1.469-2(c)(6)(iv) *Example 2.*

Example (3). C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph

(c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) *Other items specifically excluded.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

(i) Gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property;

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) [Reserved]. See § 1.469-2(c)(7)(iv) for rules relating to this paragraph (c)(7)(iv).

(v) [Reserved]. See § 1.469-2(c)(7)(v) for rules relating to this paragraph (c)(7)(v).

(vi) [Reserved]. See § 1.469-2(c)(7)(vi) for rules relating to this paragraph (c)(7)(vi).

(d) *Passive activity deductions*—(1) *In general.* Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction—

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of a activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under § 1.469-1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive share of R's 1987 loss is \$1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is \$600; accordingly, section 704(d) disallows any deduction in 1987 for \$400 of A's distributive share of R's loss. The remainder

of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469, 613A(d), and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again \$1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is \$2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's \$1,000 distributive share of R's 1988 loss or the \$400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only \$400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of § 1.469-1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the \$400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) *Exceptions.* Passive activity deductions do not include—

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that

produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and § 1.469-6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) [Reserved]. See § 1.469-2(d)(2)(ix) for rules relating to this paragraph.

(x) [Reserved]. See § 1.469-2(d)(2)(x) for rules relating to this paragraph (d)(2)(x).

(xi) [Reserved]. See § 1.469-2(d)(2)(xi) for rules relating to this paragraph (d)(2)(xi).

(xii) [Reserved]. See § 1.469-2(d)(2)(xii) for rules relating to this paragraph (d)(2)(xii).

(3) *Interest expense.* Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense—

(i) Is allocated under § 1.163-8T to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)); and

(ii) Is not—

(A) Qualified residence interest (within the meaning of § 1.163-10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of § 1.163-8T(m)(7)(i)).

(4) *Clearly and directly allocable expenses.* For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is 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 and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) *Treatment of loss from disposition—*
(i) *In general.* Except as otherwise provided in the regulations under section 469—

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a “disposition”) of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) *Other applicable rules—*

(A) *Applicability of rules in paragraph (c)(2).* [Reserved]. See § 1.469-2(d)(5)(iii)(A) for rules relating to this paragraph.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities

in which the partnership or S corporation has an interest.

(6) *Coordination with other limitations on deductions that apply before section 469*—(i) *In general.* An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) *Proration of deductions disallowed under basis limitations*—(A) *Deductions disallowed under section 704(d).* If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(2) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) *Deductions disallowed under section 1366(d).* If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

(2) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) *Proration of deductions disallowed under at-risk limitation.* If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the loss from the activity that is disallowed for the taxable year; by

(2) The sum of all deductions from the activity for the taxable year.

(iv) *Coordination of basis and at-risk limitations.* The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) *Separately identified items of deduction and loss.* In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in § 1.469-4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) [Reserved]. See § 1.469-2(d)(6)(v)(E) for rules relating to this paragraph.

(F) Are attributable to pre-enactment interests in activities (within the meaning of § 1.469-11T(c)).

(7) *Deductions from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in § 1.469-11T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) *Negative section 481 adjustments.* For purposes of applying this paragraph (d)(7)—

(A) The term “net negative section 481 adjustment” means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term “negative section 481 adjustment with respect to an activity” means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net negative section 481 adjust-

ments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) *Taxable year in which item arises.* [Reserved]. See § 1.469-2(d)(8) for rules relating to this paragraph.

(e) *Special rules for partners and S corporation shareholders*—(1) *In general.* For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a “pass-through entity”) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A’s calendar year 1988 return, A’s distributive share of the partnership’s gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A’s participation in the activity from February 1, 1988, through December 31, 1988. See also § 1.469-11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) *Payments under sections 707(a), 707(c), and 736(b).* Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) *Section 707(a)*. Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) *Section 707(c)*. [Reserved]. See § 1.469-2(e)(ii) for rules relating to this paragraph.

(iii) *Payments in liquidation of a partner's interest in partnership property*. [Reserved]. See § 1.469-2(e)(iii) for rules relating to this paragraph.

(3) *Sale or exchange of interest in passthrough entity*—(i) *Application of this paragraph (e)(3)*. In the case of the sale, exchange, or other disposition (a “disposition”) of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) *General rule*—(A) *Allocation among activities*. Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3)(iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) *Ratable portion*—(1) *Dispositions on which gain is recognized*. The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity de-

scribed in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(i) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(3) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(1) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(2) *Dispositions on which loss is recognized*. The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(i) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(4) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(2) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) *Default rule*. If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph

(e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) *Special rules.* For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(1) *Applicable valuation date—(i) In general.* Except as otherwise provided in paragraph (e)(3)(ii)(D)(1)(ii) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(a) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(b) The date on which such disposition occurs.

(ii) *Exception.* If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(a) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(b) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(c) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(2) *Basis adjustments.* Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in

computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(3) *Tiered passthrough entities.* In the case of a disposition of an interest in a passthrough entity (the "subsidiary passthrough entity") by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) *Meaning of certain terms.* For purposes of this paragraph (e)(3)(ii)—

(1) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(2) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(3) The term "net gain" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(4) The term "net loss" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or

representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) *Treatment of gain allocated to certain passive activities as not from a passive activity.* If, in the case of a disposition of an interest in a passthrough entity—

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) [Reserved]. See § 1.469-2(e)(3)(iii)(B) for rules relating to this paragraph.

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) *Dispositions occurring in taxable years beginning before February 19, 1988—(A) In general.* Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the

passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) *Exceptions.* This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of § 1.469-1T(e)) of the holder (or such other person) during—

(1) The taxable year of such person in which such contribution occurs; or

(2) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of § 1.469-5T) in the activity for such year.

(v) *Treatment of portfolio assets.* For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) *Definitions.* For purposes of this paragraph (e)(3)—

(A) The term “portfolio asset” means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term “substantially appreciated property” means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term “substantially depreciated property” means property with

an adjusted basis that exceeds 120 percent of its fair market value.

(vii) *Examples.* The following examples illustrate the application of this paragraph (e)(3):

Example (1). (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for \$50,000. A's adjusted basis for the interest sold is \$30,000. Thus, A recognizes \$20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's \$20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(1) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(1)(i) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(1)(ii) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows:

	Adjusted basis	Fair market value
X	\$68,000	\$48,000
Y	30,000	62,000
Z	20,000	80,000
Marketable securities	2,000	10,000
Total	120,000	200,000

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's \$20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been al-

located to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993:

Activity	Net gain
Y	\$8,000
Z	15,000
Marketable securities	2,000
Total	25,000

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, \$6,400 of A's \$20,000 gain (\$20,000 × \$8,000/\$25,000) is allocated to activity Y, \$12,000 of A's \$20,000 gain (\$20,000 × \$15,000/\$25,000) is allocated to activity Z, and \$1,600 of A's \$20,000 gain (\$20,000 × \$2,000/\$25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example (2). (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of \$40,000 and a fair market value of \$66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for \$37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual method of accounting, is as follows:

	Adjusted basis per books	Fair market value
ASSETS		
Cash	\$30,000	\$30,000
Accounts receivable:		
Dealership	20,000	18,000
Inventory:		
Dealership	52,000	66,000
Building	40,000	66,000

	Adjusted basis per books	Fair market value
Total	142,000	180,000
LIABILITIES AND CAPITAL		
Liabilities	\$30,000	\$30,000
Capital:		
B	47,000	75,000
C	65,000	75,000
Total	142,000	180,000

Thus, B's gain from the sale is \$14,000 (\$45,000 amount realized from the sale (consisting of \$37,500 of cash and \$7,500 of liabilities assumed by the purchaser) minus B's \$31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of \$62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all \$14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of \$66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated \$13,000 of gain under section 704(c) with respect to the interest in R that B sold to D. This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale (\$14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale (\$13,000). Thus, \$13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) *Recharacterization of passive income in certain situations*—(1) *In general.* This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) *Special rule for significant participation*—(i) *In general.* An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing—

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) *Significant participation passive activity.* For purposes of this paragraph (f)(2), the term "significant participation passive activity" means any trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the taxpayer significantly participates (within the meaning of § 1.469-5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of § 1.469-5T) for such year.

(iii) *Example.* The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

	X	Y	Z
Passive activity gross income	\$600	\$700	\$900

Internal Revenue Service, Treasury

§ 1.469-2T

	X	Y	Z
Passive activity deductions	(200)	(1,000)	(300)
Net passive income	400	(300)	600

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities (\$2,200) exceeds A's passive activity deductions from significant participation passive activities (\$1,500) by \$700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year (\$700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year (\$1,000). Accordingly, \$280 of gross income from activity X ($\$400 \times 700/1000$) and \$420 of gross income from activity Z ($\$600 \times 700/1000$) is treated as gross income that is not from a passive activity.

(3) *Rental of nondepreciable property.* If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of § 1.469-1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for \$300,000, constructs improvements on the land at a cost of \$100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for \$600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements (\$100,000) equals 25 percent of the unadjusted basis of all property

(\$400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) *Net interest income from passive equity-financed lending activity—(i) In general.* An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of—

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year shall be treated as not from a passive activity.

(ii) *Equity-financed lending activity—*

(A) *In general.* For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if—

(1) The activity involves a trade or business of lending money; and

(2) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) *Certain liabilities not taken into account.* For purposes of paragraph (f)(4)(ii)(A)(2) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(2) of this section shall not be taken into account in computing such percentage.

(iii) *Equity-financed interest income.* For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing—

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) *Net interest income.* For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is—

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) *Interest-bearing assets.* For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) *Liabilities incurred in the activity.* For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns a interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) *Average outstanding balance.* For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) *Example.* The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for \$90,000, using \$50,000 of unborrowed funds and \$40,000 of proceeds of a loan bearing interest at an annual rate of 10 percent. A pays \$4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is \$20 million. P incurs numerous interest-bearing liabilities in connec-

tion with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is \$11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(2) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is \$2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is \$990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total \$250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is \$50,000. All of the interest expense paid or incurred by P for 1988 is allocated under § 1.63-8T to expenditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(i) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity (\$11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity (\$20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing \$9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by \$20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is \$19,000 (A's distributive share of \$2.2 million of gross interest income less A's distributive share of \$300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense (\$990,000) is not

taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is \$8,550 (\$19,000 × \$9 million/\$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under § 1.163-8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all \$4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under § 1.163-8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is \$5,100, computed as set forth in the following table:

<i>Gross income:</i>	
Interest income	\$22,000
<i>Deductions:</i>	
Distributive share of P's expenses from the activity	(12,900)
Interest expense on A's acquisition debt	(4,000)
Net passive income	5,100

(vii) A's net passive income from the activity for 1988 (\$5,100) is less than A's equity-financed income from the activity for 1988 (\$8,550). Accordingly, under this paragraph (f)(4), \$5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) *Net income from certain property rented incidental to development activity*—

(i) *In general.* [Reserved]. See § 1.469-2(f)(5)(i) for rules relating to this paragraph.

(ii) *Commencement.* [Reserved]. See § 1.469-2(f)(5)(ii) for rules relating to this paragraph (f)(5)(ii).

(iii) *Services performed for the purpose of enhancing the value of property.* [Reserved]. See § 1.469-2(f)(5)(iii) for rules relating to this paragraph (f)(5)(iii).

(iv) *Examples.* [Reserved]. See § 1.469-2(f)(5)(iv) for examples relating to this paragraph (f)(5)(iv).

(6) *Property rented to a nonpassive activity.* [Reserved]. See § 1.469-2(f)(6) for rules relating to this paragraph.

(7) *Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property*—(i) *In general.* If a taxpayer acquires an interest

in an entity described in paragraph (c)(3)(iii)(B)(3) of this section (the "development entity") after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) *Royalty income from property.* For purposes of this paragraph (f)(7)—

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of—

(1) The taxpayer's gross royalty income for the taxable year from such item of property; over

(2) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T (f)(4)) that are reasonably allocable to such item of property.

(iii) *Exceptions.* Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if—

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(2)(ii) (a) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and

ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

(iv) *Capital expenditures.* For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) *Example.* The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in example (5) in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for \$13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($\$27,000 \times .10 = \$2,700$) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest (\$13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) *Limitation on recharacterized income.* The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) *Meaning of certain terms.* For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) [Reserved]. See § 1.469-2(f)(9)(iii) for rules relating to this paragraph.

(iv) [Reserved]. See § 1.469-2(f)(9)(iv) for rules relating to this paragraph.

(10) *Coordination with section 163(d).* [Reserved]. See paragraph 1.469-2(f)(10) for rules relating to this paragraph.

(11) *Effective date.* For the effective date of the rules in this paragraph (f), see § 1.469-11T (relating to effective date and transition rules).

[T.D. 8175, 53 FR 5711, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988; as amended by T.D. 8253, 54 FR 20538, May 12, 1989; T.D. 8290, 55 FR 6981, Feb. 28, 1990; T.D. 8318, 55 FR 48108, Nov. 19, 1990; 55 FR 51688, Dec. 17, 1990; T.D. 8417, 57 FR 20758, May 15, 1992; T.D. 8477, 58 FR 11538, Feb. 26, 1993; T.D. 8495, 58 FR 58788, Nov. 4, 1993]

§ 1.469-3 Passive activity credit.

(a)-(d) [Reserved]

(e) *Coordination with section 38(b).* Any credit described in section 38(b) (1) through (5) is taken into account in computing the current year business credit for the first taxable year in which the credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) *Coordination with section 50.* In the case of any cessation described in section 50(a) (1) or (2), the credits allocable to the taxpayer's activities under § 1.469-1(f)(4) shall be adjusted by reason of the cessation.